TRADE DEFICIT WITH CHINA: REALISING GAINS FOR PAKISTAN

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Abstract

The trade deficit between Pakistan and China has been expanding for several years for a variety of reasons with serious repercussions for Pakistan's economy. This paper aims to suggest policy options for Pakistan to address this issue. It analyses quantitative and qualitative information regarding Pakistan's economy and trade figures with China. Many of the issues in promoting Pakistan's exports have been highlighted. Given the significance of the China-Pakistan Economic Corridor (CPEC) in determining future economic ties of both countries, its impact on boosting Pakistan's export potential, and challenges have been elaborated. The paper also discusses the promise of the economic transformation in China for Pakistan. A number of recommendations to reduce the trade deficit with China have been offered but the paper also attempts to explain why they may not be enough. That said, there is still plenty to gain for Pakistan from its economic relationship with China and it can certainly be sustainable.

***Keywords**: CPEC, trade, economy, industry, connectivity*

Introduction

International trade is one of the most critical components of a country's economic outlook. Developing strong trade relations and

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sustaining them brings stability to the external accounts of an economy. Trade between two countries has political, cultural, and economic ramifications. When the trading partner shares its border and is the second biggest partner in terms of trade value, the significance of maintaining strong trading relations becomes pivotal. The interests of Islamabad and Beijing seem to match regularly in international affairs and the two countries are often on the same page on multilateral forums.

That said, this warmth is not reflected in the trading relationship between the two countries. Despite harmonious interactions, the representatives from both sides have struggled to come to terms while renegotiating the free trade agreement. The original agreement, signed in 2006, helped in boosting Pakistan's exports to China. In the last few years, however, imports from China have risen much sharply. Pakistani exporters have found it difficult to penetrate Chinese markets, whereas there has been a surge of Chinese products in Pakistan.

Pakistani exporters have complained about the terms of the agreement and the lack of incentives offered to them under the agreement. The swelling up of Pakistan's trade deficit with China in recent years proves the agreement to be harmful to Pakistan. Pakistan's exporters have also suffered from various other issues such as the energy crisis, political instability, and lack of competitiveness. On the other hand, the rise in demand for Chinese goods and changing consumption patterns have also tilted the trade figures in China's favour.

Trade agreements are bound by political influence and bureaucratic hurdles. In today's rapidly transforming and competitive world, countries need to make swift adjustments to ensure a facilitative environment for local businessmen. With Pakistan under persistent macroeconomic pressure, policy measures need to be taken seriously.

This paper explores multiple ways through which Pakistan can reduce its trade deficit with China and make trade between the two countries mutually sustainable. It analyses the causes of the present situation and examines the opportunities lying ahead for Pakistani policymakers and the business community that could be availed to improve the present outlook.

The study draws on expert opinions and national accounts data. It also incorporates the latest developments and views from the business community, including both export-oriented industries and those affected by Chinese imports. The paper also analyses the evolving nature of international trade and proposes gainful strategies for Pakistan in accordance with them.

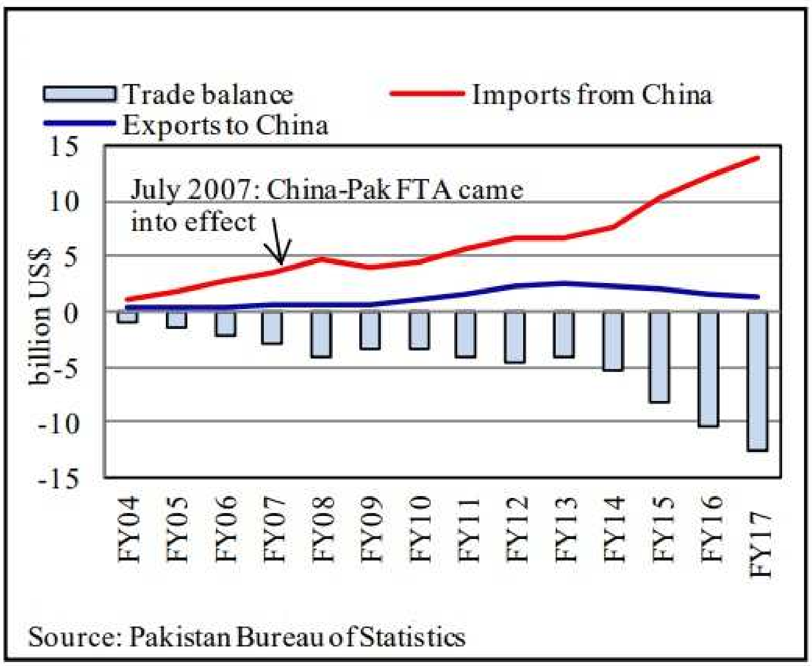
China-Pakistan Trade Outlook

Pakistan and China commenced bilateral trade in the 1950s and have entered into multiple arrangements since then. Efforts have been made to facilitate and promote trade between the two countries through various measures. In 1979, an overland trade route was established after the completion of the Karakoram Highway. Due to harsh weather and the long distance between main Chinese markets and the border crossing, however, a very small portion of trade between the two countries moves through land route. In 2006, the two countries signed a free trade agreement (FTA), which led to a significant rise in Pakistan's economic dependence on China. There was a significant rise in Pakistan's exports to China. In Pakistan's overall exports, China's share doubled by 2010.[1]

Despite promising numbers, according to Naved and Sarah, the structure was not encouraging. The export basket to China compromised mainly of primary manufactures and raw materials. They also observed that from 2000 to 2010, the list of commodities exported was largely unchanged.[2] For the expansion of exports, it is necessary that Pakistan shifts from primary products to higher value-added products. One of the causes of difficulty for Pakistani products in entering the Chinese markets is nontariff barriers imposed by the Chinese government.

On the other hand, the low cost of Chinese products has driven out many local manufacturers and impaired the economy. Pakistani importers and Chinese exporters have also been accused of understating the value of imported Chinese products in Pakistan. Due to this practice, there have been revenue collection losses and the domestic industry has suffered from unfair competition.

Pakistan's trade balance with China in the year in which the FTA was implemented was negative $2.4 billion. 10 years later, in 2016, the deficit rose to $12 billion.[3] Under the FTA, China granted relatively more concessional lines to Pakistan but the latter has availed only 5 per cent of them, whereas China has availed 57 per cent. A key cause of Pakistan's underutilization is the irrelevancy of the concessional line given by China or negotiated by Pakistani officials.[4]



The above graph illustrates the failure of FTA. Before 2007, the trend had already set in and there was a need to counter the widening trade deficit. Rather than improving the external outlook of Pakistan's economy, the FTA with China contributed to the worsening of it. Moreover, the volume of exports also began to fall after a few years. On the other hand, several factors contributed to the sharp increase in imports from China, including the growing demand for machinery to cater for the development activities taking place in Pakistan, the establishment of local assembly plants that have raised the demand for raw materials from China, a large market with a strong demand for cheap goods, and an overall shift from other trading partners.

While capital goods have a significant share in Pakistan's import basket, their contribution in spurring local industry has not been remarkable. Furthermore, Pakistan's industry has been well outpaced by the growth in the Chinese industry, leaving Pakistani goods with little share. The non-innovative approach and lack of diversification have also contributed to the declining share of Pakistani goods in the Chinese market. Indirect factors, such as China's FTA with ASEAN countries and the slowdown of China's economy, have also significantly contributed to the poor export volume.

The impact of geography and infrastructure development in boosting trade with regard to CPEC is examined by Matthew McCartney. He studied cases of transformative infrastructure expansion in the nineteenth century to present conditions under which CPEC could support Pakistan's economic objectives. Analysing CPEC politically, he warned that infrastructure development was not always undertaken to sustain economic benefits. The author also alarms about the negative impact of infrastructure development on Pakistan's trade outlook with China as there is a possibility that Chinese goods will increase in Pakistan at the expense of local ones and China may get access to more markets through Pakistan. This could crowd out Pakistan's exports to other countries as well and weaken the local industry.[5]

The Federation of Pakistan Chambers of Commerce and Industry (FPCCI) published a report titled *FPCCI's Stance on CPEC* in 2017. Among the various concerns highlighted by FPCCI, the two major concerns were feelings of mistrust towards the government and the adverse impact on local businesses. Many experts gauge that the inflow of Chinese investment and business enterprises will prove to be detrimental to the interests of Pakistani business communities. It also pointed out flaws in FTA-I which inflicted severe losses on the local economy.[6]

Realising the detrimental impact on the local economy, the Pakistani government pushed for renegotiating the trade deal with China and the FTA-II came into effect on 1 January 2020. The terms under the new agreement are more favourable for Pakistan. There are greater incentives for exporters while import restrictions would not only reduce import bill but also protect local industries from Chinese competition in the domestic market.[7]

Challenges Faced by Pakistan

Pakistan's persistently poor export performance is the main challenge that has to be addressed to reduce the trade imbalance with China. Afia Malik, Ejaz Ghani, and Musleh ud Din suggested that Pakistan failed to become competitive globally despite the liberalisation of the trade regime. They pointed towards policies that supported domestic industries but reduced their incentives for participation in international trade. According to them, local industries did not prepare themselves to deal with the competitiveness of the global markets. They have called for attention towards strengthening state institutions and improvement in their capacity to support the private sector in boosting exports.[8]

The growing deficit between China and Pakistan witnessed in the last few years reflects various weaknesses in the economic environment of Pakistan. With the rapid advancement in technology and an extensive focus on research and development, countries are at greater risk of losing their share in global markets if they do not adapt. Pakistan's trade deficit with China is not only because Chinese industries are more vibrant and competitive but also since China's other trading partners have progressed and taken their share in the Chinese markets at the expense of Pakistani goods.

Data for trade in commercial service is a pertinent reflection of an economy's advancement. Pakistan exported just $3.9 billion worth of commercial services in the financial year 2017, whereas China reported figures around $205 billion in the same category.[9] Demand for services is on the rise globally and Pakistan's deficit in service trade is likely to widen despite positive developments in the local IT industry.

There has also been little progress in modernising goods produced in the country. Pakistan's main exports are primary and low-technology products, which lack sophistication and demand from high-end consumers. This deficiency has also contributed to growing import costs in recent years as machinery and electronic equipment have been usually imported. Hence, there is no surprise that Pakistan's terms of trade are in an adverse state. According to data from the Pakistan Bureau of Statistics, the average terms of trade were 56 per cent from 2008 to 2017 while in the previous decade (1998-2007) this figure was around 88 per cent.[10]

Lack of innovation has hampered the integration of Pakistan's economy into the global economy. Former Finance Minister and present Advisor to PM on Finance, Abdul Hafeez Sheikh, pointed out that a continuing failure of government and business community has been the inability to integrate the Pakistani economy with the rest of the world. Pakistan has lagged in boosting exports and has also failed to attract capital from abroad.[11]

Integration also opens up avenues for the transfer of capital and technology that are necessary for sustainable economic progress. The United Nations Industrial Development Organization (UNIDO) points out that in developing countries like Pakistan that the development potential of local industries cannot be attained often due to isolation from the global economy. Moreover, local businesses also get stuck in uncompetitive business models.[12] Pakistan has struggled to remain competitive and has lost its share in the global economy to its rivals.

Future of Textile Industry

China is one of the largest importers of Pakistani cotton and cotton occupies the majority share of Pakistan's total exports to China. However, the textile sector fears stiff competition from China in the times ahead. As CPEC is gaining momentum, China has begun to focus primarily on the Xinjiang province, which happens to border Pakistan. Xinjiang contributes 60 per cent to China's seven million tons of cotton production. While it was previously underdeveloped, the province is now being industrialised rapidly to accommodate a major textile hub.

To develop the said textile hub, China has also unveiled a 10-year development plan for the textile industry in Xinjiang. As per this plan, by 2023, Xinjiang is expected to become China's largest cotton textile production base along with the largest garment export processing base.[13]

In Pakistan, many believe that with such developments taking place adjacent to Pakistan, serious setbacks to the local textile industry are expected especially in the absence of safeguarding measures in the bilateral agreements between the two countries. It was articulated by Mian Zafar Iqbal of FPCCI that more than a hundred textile mills had shut down during the tenure of the previous government. He pointed out that machinery worth millions of rupees in the spinning sector was sold as scrap. According to Iqbal, on the contrary, Chinese investors were installing the latest machinery in Xinjiang. He shared that government officials had repeatedly neglected appeals from the people working in the largest contributing sector of the Pakistani economy. He even added that despite being one of the largest producers of cotton in the world, Pakistan could end up as only a raw material supplier if the government did not address the challenges and protected the interests of the local textile industry in CPEC negotiations.[14]

In the last decade, Pakistan has lost its market share in international markets to its competitors. The share of value-added textile goods in Pakistan's export basket has also been declining. Energy shortage, higher costs, and lack of innovation have jolted Pakistan's key industry. Pakistan can no longer rely on it to cover up deficiencies in other sectors.

Pakistan needs to diversify its export mix and also modernise the textile industry to produce competitive value-added products. This will require investment in human capital and machinery. By collaborating with China and incorporating its expertise, the textile sector can be revived more effectively. Due to the limitation of resources, joint ventures with Chinese firms would be more viable.

China's Economic Transformation and Opportunities under CPEC

Over the last few decades, low cost manufactured goods from China have benefited the consumers in developing countries and elevated the living standards of the lower and middle class. Local markets in many of these countries including Pakistan are dominated by Chinese goods. However, access to these goods has had a detrimental impact on local industries as it is quite tough to compete with Chinese manufacturers.

Largely based on its manufacturing prowess, China's staggering growth rates have turned around the global economy. While serving many of the needs and ambitions of the world's most populated country, the era of rapid growth has resulted in economic imbalances in the country. The services sector, human development, and environmental protection have not been exhibiting impressive figures during this period. This has raised concerns domestically and internationally. It looks unlikely that such a model will be sustainable in the coming years.

China consistently achieved double-figure GDP growth for decades but that is no longer the case. The gains from initial policy reforms and imported technologies seem to be exhausted. Moreover, demographic challenges are also likely to halt China's economic expansion.

China 13th Five Year Plan (2016-20) emphasises achieving more "balanced, inclusive and sustainable development."[15] It also aims to open up Chinese markets more deeply for other countries and look to increase imports of items that have limited supply at home.

In the follow-up, China hosted the first-ever import expo in China in November 2018. Millions of Chinese buyers were given the platform to engage with representatives of foreign companies and governments. The expo signified Beijing's commitment towards making China a more open market for the rest of the world. By the end of the six-day event, multiple deals worth billions were secured. In food and agriculture-related industries, the valuation of the agreements was $12.7 billion.[16]

Like Pakistan, Bangladesh has been suffering trade losses against a much larger economy. Indian economy's size and technical advantages have been detrimental to industrial development in Bangladesh. The trade deficit with India is likely to persist while policy measures can only limit the harm. Connectivity is also a major issue for Bangladeshi exporters. Much of India's consumer base is hard to access despite being surrounded by India. Geographical limitations are more severe for Pakistani exporters.

Pakistan must realise the economic reality of having China as a trading partner. Pakistani industries cannot enjoy economies of scale anywhere near their counterparts in China. Moreover, China has stronger trading relationships with the rest of the world, which offers it a range of imported goods.

A study at Stimson Centre in Washington DC highlighted that apart from extending close ties with Pakistan, China is also driven to export its industrial capacity due to economic slowdown in the country and to secure new markets in the region to sustain its economy.[17]

The role of CPEC will be critical in determining the future of China-Pakistan trade. The *Long Term Plan for CPEC* published by the Planning Commission of Pakistan emphasises regional economic integration through enhanced trading activity. Pakistan will have the opportunity to utilise its resources through CPEC and tap its comparative advantage.[18] A study by Deloitte on CPEC's impact on Pakistani exports also made encouraging forecasts. It stated that farmers in northern areas had the potential to double their sales through the corridor. The present mode of sending fruits to China via air is much costlier.[19]

In the near future, Pakistan's domestic economy is largely going to be shaped by Chinese investments under CPEC. The development work requires machinery from China which is raising import costs for Pakistan. Until 2030, when all CPEC projects are expected to be completed, such imports are likely to continue. On the other hand, the returns from CPEC investments and the operationalisation of SEZs is not quite certain.

Expressing his views on CPEC, Raja Amir Iqbal, former president of Rawalpindi Chamber of Commerce, posited that the SEZs held the key to the success of CPEC as they could create new jobs and help in the expansion of the economy. He suggested that local industries needed to be given support in these zones and joint ventures between Chinese and local companies needed to be encouraged. Failure to do so, he argued, would allow Chinese companies to take up a majority share which would eventually scale down the benefits for the Pakistani economy.[20] Pakistan's overall debt burden and restructuring requirements would also offset some of the advantages offered to exporters under CPEC. Policymakers in Pakistan need to come up with a long-term strategy and resist political temptations. The gains from CPEC can only be maximised if time and effort are put in place to address longstanding issues.

Covid-19: Implications for China-Pakistan Trade

The outbreak of coronavirus has halted business activity across the globe. The global economy has slowed with only essential items being traded. Given this scenario, infrastructure development and connectivity have been pushed behind in the policy agenda. The progress of CPEC projects has been disrupted with local labour forced to stay at homes and Chinese manpower facing travel restrictions.

Countries are expected to alter their trade relations and globalisation is likely to be compromised. This will cause CPEC projects that are aimed at strengthening regional connectivity to be less impactful than previously expected. As countries rushed to secure the supply of healthcare equipment, China's supremacy in manufacturing was apparent. Chinese economy's resilience would mean that it would recover sooner than its trade partners and is likely to increase its exports. Moreover, the Chinese authorities would be more cautious about future economic downturns and would like to ensure local production of essential items. This will minimise opportunities for countries like Pakistan to penetrate the Chinese market.

Lastly, Covid-19 has boosted demand for technological goods and services, which is an area where China is much more advance than Pakistan. Pakistan will look towards Chinese companies soon to secure such products. This will further compromise gains made by Pakistan in improving the trade deficit with China. By encouraging Chinese tech companies to invest in Pakistan, this trend can be offset.

Conclusion and Recommendations

It is a daunting challenge to reverse the trade trajectory with China. Nevertheless, there are plenty of direct and indirect opportunities available to offset pressures on the local economy. By concentrating on internal issues and redirecting policies towards better utilisations of resources, Pakistan can strengthen not only the exporters but also meet local demand through domestic products. CPEC projects, especially the planned SEZs can usher in a new era of industrial activity in the country. They can significantly support local producers to become more competitive globally and attract foreign investments in production of high value-added products. Many Chinese companies will be encouraged to set up joint ventures with Pakistani companies, which would help in lowering import costs in the future and also open doors to China's vast market for locally produced goods.

Long term planning and sound implementation are required to generate exportable surplus and attain import substitution targets. An approach dealing exclusively with the trade deficit may not serve Pakistan's interest in the longer run. A comprehensive strategy and continuous collaboration with China will be more practical and fruitful.

Learning from China's impressive growth in the 1980s and 1990s, Pakistan should make concrete efforts to integrate into the global economy. The SEZs and Gwadar port have the potential to transform the country into a regional trading hub. In that case, Pakistan will be able to negotiate more favourable terms with China and other countries as well. China will remain a lucrative market for many years to come. Therefore, products need to be diversified based on the demands of Chinese consumers. Joint ventures can play a critical role in developing products for Chinese markets in Pakistan. Pakistan should offer Chinese businessmen the right incentives and environment to undertake joint ventures with Pakistani counterparts.

Since Pakistan needs to improve its competitiveness, Pakistani businesses must choose their partners carefully. Large and influential Chinese enterprises seem to be a safer option but evidence suggests that they are less motivated by efficiency and profitability and more focused on growth. Strategic and long-term interests between the partners should match so that these joint ventures can sustain their operations in Pakistan.

The services sector is expected to gain a greater share of the Chinese economy in the coming years. Pakistan should focus on such industries and train professionals that can develop in-demand products and services. Understanding future economic trends will be essential to maintain healthy trade ties with China.

Besides these steps, geo-economic leverage can play a significant role in improving Pakistan's trade outlook vis-à-vis China. For better integration in the global economy, Pakistan needs to expand its economic engagement with other countries as well. This will result in new opportunities for Pakistani exporters and also open up the economy for goods from those countries. With China reorienting its economic policies, other countries may take away China's share in Pakistan's import basket. Lastly, the policymakers need to take necessary precautions to safeguard the future of local industries.

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