Country Update Note 2

Trading with China: Challenges and Policy Issues faced by Micro, Small and Medium Enterprises in South and South East Asia

# Introduction

This Country Update Note examines the constraints faced by Pakistan’s micro, small and medium-sized firms in exporting to Chinese market. It informs on the composition of Pakistan’s exports, distribution along firm size and across sectors, tariffs and non-tariff barriers and the use of trade preferences under Pak-China Free Trade Agreement (FTA). The study uses a mix methodology. It analyses firm-level export data for the recent period (from 1-1-2017 to 31-12-2017). In addition, it draws upon the interviews with, China-Pakistan Centre of Excellence\_ a leading research institution\_ and 15 exporting firms that shipped to Chinese market during the study period[[1]](#footnote-1).

The analysis finds that China is Pakistan’s third largest exports market. It sources all sorts of products from Pakistan with a major share of textiles, minerals and fruits and vegetables (see Table 2). These exports are hauled by large firms and the contribution of micro, small and medium-sized (MSME) exporters is relatively limited. However, all key constraints to export growth by small firms\_ such as lack of production of value-added products, inability to meet regulatory requirements and poor logistic network to transport goods from farm and factories to gateway ports\_ pertain to supply side.

Interviews with a leading think tank, China-Pakistan Centre of Excellence, and with private sector firms point to the prevalence of high tariffs as well as a battery of non-tariff measures (NTMs) in accessing Chinese market. Most of the firms are however oblivious of the fact that these NTMs is not specific to China. The use of sanitary and phyto-sanitary (SPS) requirements as well as technical barriers to trade (TBT) has increased overtime, both in developed and developing countries, due to rising consumer concerns about food safety and environmental protection, and China is not an exception.

The tariff preferences accorded to Pakistan under the Pak-China FTA in 2007 have gradually eroded as China later signed many deeper and comprehensive trade agreements with other regional economies, whereas Pakistan did not focus on the growth of preferential trade with other economies. Moreover, Pakistan’s firm could not utilize most of the trade preferences accorded in the FTA as these high value-added products covered in the concession lists are not produced in the country. Despite these challenges, trade with China has increased manifolds since the implementation of FTA. However, in absolute terms, the growth in exports is smaller than that for imports. Although exports have also increased around five folds, from $300 million to around $1.5 billion, Pakistan started from very low baseline.

Pakistan’s small production capacity, inability to upgrade export basket and large domestic demand has drawn attention towards widening bilateral trade deficit with China. This deficit reflects underlying weak macroeconomic fundamentals and structural issues faced by Pakistan’s economy. In addition, the deficit increased mainly because of large imports of machinery and equipment for the CPEC-related projects, but it has started to narrow down in the recent years.

In the context of China-Pakistan Economic Corridor (CPEC), a number of initiatives are under way. With new roads and ports, transportation infrastructure has been improved considerably. Energy shortage has also been overcome to a large extent. Now Special Economic Zones (SEZs) are being set-up in different parts of the country. All these developments would provide ample opportunities for SMEs to become partners in Global Value Chains (GVCs).

This Note is structured as follows. Section 2 explores the firm-level export data and examines the role of tariff concessions under the Pak-China FTA. Section 3 presents the perspective of private sector stakeholders and compiles the list of NTMs faced by Pakistan’s firms in Chinese market. Section 4 concludes.

# Data Analysis

The exploration of firm-level export data for Pakistan for 2017 (from 1-1-2017 to 31-12-2017) indicates that China is Pakistan’s third largest export market, followed by the United States and United Kingdom. In this period, of 14, 489 total exporters around 1,269 firms shipped to China, and of US$ 21.40bn total exports, US$ 1.5bn were destined to China. This constitutes around 7% of Pakistan’s total exports (column 2 of Table 1). The corresponding figure for exporting firms is around 9% (columns 3 & 4 of Table 1), of which 60% firms are of large size while 40% comprise small- and medium-sized enterprises.

#### Table 1: Analysis of Pakistan’s Export to China, 2017

|  |  |  |
| --- | --- | --- |
|   | Exports | Firms |
|   | US$ Bn | %  | # | %  |
|   | (1) | (2) | (3) | (4) |
| All Pakistan | 21.40 | - | 14,489 | - |
| *of which* |   |  |   |  |
| to China | 1.47 | 6.74 | 1,269 | 8.76 |
| *of which* |   |  |   |  |
| by MSME | 0.0230 | 1.56 | 521 | 41.06 |

##### Source: Author’s construction using administrative datasets.

##### Note: MSME stands for micro, small and medium sized enterprises.

Pakistan’s firms export to China in all sectors but a large fraction of them is concentrated in textiles, minerals and fruit and vegetable sectors (column 5 of Table 2). These firms are divided into three groups based on their value of exports to all markets during 2017. Firms with annual export value smaller than 25 percentiles are considered as small-sized, those between 25 to 75 are grouped as medium-sized and above 75 are categorized as large[[2]](#footnote-2). On this distribution, 123 small, 398 medium-sized and 748 large firms exported to China during the study period.

Deconstruction of Pakistan’s exports along firm size (in Figure 1) indicates that large firms dominate the exports landscape. They constitute 60% of all cohort but haul around 98% of exports to China. The concentration of large firms in textile sector is particularly high[[3]](#footnote-3) (column 6 of Table 2). The combined export share of small- and medium-sized firms is less than two percent. This dominance of large firms is not concentrated in any particular sector, but the export share of small and medium-sized enterprises is relatively limited across all product groups (Table 2). This lop-sided distribution along firm size suggests the lack of capacity of small firms to meet regulatory and technical requirements. These barriers to exports are further investigated in the next Section.

#### Table 2: Sectoral Distribution of Pakistan’s Exports to China

|  |  |  |  |
| --- | --- | --- | --- |
|   | Exports (US$ Mn) |   | Firms (#) |
|  | All | Large | Medium | Small |  | All | Large | Medium | Small |
| Sector | 1 | 2 | 3 | 4 |   | 5 | 6 | 7 | 8 |
| 01-05\_Animal | 60.29  | 58.15  | 2.11  | 0.04  |  | 102 | 69 | 25 | 8 |
| 06-15\_Vegetable | 130.62  | 128.11  | 2.49  | 0.02  |  | 122 | 75 | 43 | 4 |
| 16-24\_FoodProd | 36.08  | 35.84  | 0.24  | 0.00  |  | 34 | 27 | 6 | 1 |
| 25-26\_Minerals | 138.44  | 131.06  | 7.23  | 0.15  |  | 212 | 92 | 96 | 24 |
| 27-27\_Fuels | 31.40  | 31.40  | - | - |  | 8 | 7 | - | 1 |
| 28-38\_Chemicals | 1.90  | 1.68  | 0.20  | 0.01  |  | 29 | 13 | 12 | 4 |
| 39-40\_PlastiRub | 17.12  | 15.20  | 1.91  | 0.02  |  | 64 | 26 | 28 | 10 |
| 41-43\_HidesSkin | 39.96  | 38.76  | 1.15  | 0.04  |  | 139 | 107 | 27 | 5 |
| 44-49\_Wood | 2.39  | 2.15  | 0.21  | 0.03  |  | 30 | 15 | 10 | 5 |
| 50-63\_TextCloth | 943.48  | 942.13  | 1.34  | 0.02  |  | 317 | 268 | 45 | 4 |
| 64-67\_Footwear | 0.02  | 0.02  | 0.00  | 0.00  |  | 10 | 6 | 3 | 1 |
| 68-71\_StoneGlas | 1.50  | 0.86  | 0.59  | 0.04  |  | 65 | 18 | 35 | 12 |
| 72-83\_Metals | 45.46  | 43.37  | 2.05  | 0.04  |  | 100 | 45 | 41 | 14 |
| 84-85\_Mach-Elect | 0.53  | 0.16  | 0.35  | 0.02  |  | 44 | 15 | 13 | 16 |
| 86-89\_Transport | 0.02  | 0.01  | 0.00  | 0.01  |  | 14 | 6 | 4 | 4 |
| 90-99\_Misc. | 25.35  | 22.68  | 2.58  | 0.09  |   | 218 | 99 | 96 | 23 |

##### Source: Author’s construction using administrative datasets.

##### Note: These firms are divided into three groups based on their value of exports to all markets. Firms with annual export value smaller than 25 percentiles are considered as small-sized, those between 25 to 75 are grouped as medium-sized and above 75 as large.

#### Figure 1: Decomposition of Exports to China along Firm Size, 2017

## 2.1 Utilisation of Trade Preferences

Pakistan and China entered into a free trade agreement in 2007, whereby China granted tariff concessions on 7,550 product lines for the first five years. Of these, around 35 percent products, such as cotton fabrics, marble, leather articles and medical appliances, were zero-rated within initial three years of implementation of the FTA. However, 15 percent products, which include fish, cotton, paper, plastic and textile items[[4]](#footnote-4), were given no tariff concession. After the FTA, the volume of Pakistan’s trade with China has increased manifolds from around $2 billion in 2007 to around $16 billion in 2017.

#### Table 3: Comparison of Chinese Tariffs for Pakistan and other FTA partners

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Products | Pakistan | ASEAN | New Zealand | Chile |
| Textiles | 2.94 | 0 | 0.1 | 5.8 |
| Apparel | 10.2 | 0 | 2.57 | 0.135 |
| Cereals | 0.2 | 0 | 0 | 1 |
| Fruits & Vegetables | 5.17 | 0 | 10.5 | 2.74 |
| Petroleum Products | 4.51 | 0 | 1.03 | 0 |

##### Source: GTAP 9a Data Set, Base year 2011.

The second phase of FTA started in July 2013, which aimed at removing 90% tariffs on all products. However, not much progress could be made to achieve this objective as Pakistani side could not offer deeper tariff concessions. As a result, overall tariff offered by China to Pakistan remained quite higher as compared to the same offered to other FTA partners of China (Table 3). Consequently, Pakistan lost preference on 79% of exports to China after signing the FTA.[[5]](#footnote-5) These relatively high tariffs place MSME’s at a comparative disadvantage in Chinese market.

A leading think tank, the CPEC Centre of Excellence, noted that “*Overall tariff concessions offered to Pakistan remain quite higher as compared to the tariffs offered to other FTA partners of China for the same commodities. Consequently, Pakistan lost preference on 79% exports to China after signing FTA. Moreover, one of the biggest challenges to the exporters is the non-tariff measures (NTMs). Exporters are required to comply with technical measures, standards as well as custom procedures in the Chinese market that can impede trade and prevent them from exporting*” (Annex-B).

Regarding the utilisation of trade preferences under the Pak-China, FTA, the above think tank further informed that “*Pakistani traders utilise only a tiny fraction of Chinese tariff concessions as they do not export commodities mentioned in the favourable list of items to be exported to China. High value export products on list of items under the FTA favour Chinese exporters because Pakistan lacks capacity to produce and export such goods to China. Examples include machinery, road vehicles, etc.”* (Annex-B).

# Responses of Private Sector Stakeholders

The analysis of interviews with private sector exporters revealed some additional constraints in shipping to Chinese market. The responses of exporting firms are summarized below, and the details are contained in the appendix (Annex-A).

1. Most firms face challenges in meeting procedural and quality requirements imposed by Chinese administration. Stringent SPS requirements, language barrier and inadequate shipping facilities in Pakistan create further obstacles in exporting. Some firms alluded to stiff competition from regional economies, especially Bangladesh and India.
2. Exporting firms are aware of China’s trade policy instruments, both tariffs and non-tariffs. They face challenges in meeting non-tariff measures such as product standards, labelling and certification requirements, as well as customs delays. These NTMs raise compliance cost. In particular, the cost of testing of products is very high.
3. Firms have not benefitted much from China’s tariff preferences, although the preferential regime is quite well-known to them. Most of these preferences apply to high value-added products, whereas these firms mainly export intermediary goods. Rice exporters claim to have benefitted somewhat from the FTA but they face stiff competition from Indonesia, Thailand and Vietnam. Yarn exporters contended that the preferential rate of duty on Pakistan’s yarn is still higher: Pakistan’s exports face 3.5% tariffs, whereas those from ASEAN countries are exempted from the duty taxes.

As non-tariff measures feature repeatedly in discussion with the private sector stakeholders, we investigated their prevalence through Trade Analysis Information System (TRAINS) of UNCTAD. This dataset indicates that most products exported from Pakistan have to meet TBT requirements, followed by SPS and quality control measures (Table 4). Interestingly, these NTMs are not specific for exports to China but are applied by the European Union and markets of East Asia as well. The European markets, although relatively more stringent about these NTMs, attracts large number of MSME and a wider set of export products.

#### Table 4: Non-tariff measures Imposed by China on Pakistan’s Exports

|  |  |
| --- | --- |
|   | NTM Group |
| Products | TBT | SPS | INSP | CTPM | QC | PC | EXP | OTH |
| Textiles | 20 | - | - | - | - | - | - | - |
| Cotton | 29 | 1 | - | - | 4 | - | 3 | 1 |
| Rice | 2 | 6 | - | - | 2 | - | 3 | 1 |
| Fruits  | 2 | 19 | - | - | - | - | 3 | - |
| Vegetables | 2 | 2 | - | - | - | - | 3 | - |
| Petroleum Products | 24 | 3 | - | - | 2 | - | 1 | 4 |
| Ores, slag, Ash | 30 | - | - | - | 6 | - | - | - |
| Fish | 2 | 7 | - | - | 2 | - | 2 | - |
| Total | 111 | 38 | - | - | 16 | - | 15 | 6 |

#####  Source: TRAINS Dataset.

##### Note: Various acronyms used in the table heading are defined as below:

##### TBT Technical Barriers to Trade

##### SPS Sanitary & Phytosanitary measures

##### INSP Pre-shipment Inspection

##### CTPM Contingent Trade Protective Measures

##### QC Quality Control measures

##### PC Price Control measures

##### EXP Export-related measures

##### OTH Other measures

# Findings and Recommendations

China is Pakistan’s third largest export market and volume of trade with China has increased more than 6 folds during the last decade. It absorbs around 7% of Pakistan’s exports, and these exports are concentrated in textiles, minerals, fruit and vegetables. Due to capacity constraints and other supply side issues, Pakistan’s exports have not benefitted much from the preferential regime under Pakistan-China Free Trade Agreement. Although tariff barriers have dropped to great extent, the battery of non-tariff measures, such as testing, labelling and certifications requirements have increased compliance costs. Pakistan’s firm lack capacity to meet these standards. As these NTMs are universal phenomenon, building capacity of firms to navigate these regulatory requirements could increase exports of MSME to Chinese as well as other markets.

CPEC provides a great opportunity for Pakistani firms to integrate with the Global Value Chains. With the improved hardware (infrastructure), Pakistan needs to improve its software (trade facilitation and tariff reforms) to benefit from the emerging opportunities.

In terms of policy implications, there is a need for building capacity of small firms to meet the regulatory requirements. Moreover, in future trade negotiations, Pakistan needs to seek tariff concession similar to those offered by China to ASEAN member states and other regional economies but this would involve offering similar concessions to the Chinese exporters.

**Annex-A: Private Sector Stakeholders’ Responses**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Questions** | **1) Do you export to China? If yes, then what do you export?** | **2) What are the main challenges you have been facing in exporting to China?**  | **3) Are you aware of China trade policy requirements? Do you find it difficult as an SME to meet Chinese requirements/standards?**  | **4) Are you aware of Pakistan’s Free Trade Agreement with China? If yes, have you benefited from its provisions? Also what problems you still face while exporting to China under the provisions of FTA?** |
| **Firm Name** |  |  |  |  |
| **A** | Yes, we export rice. | The quarantine departments in China are difficult to reach out to. The language barrier is another challenge that we face while exporting to China. | Yes, we are aware of China trade policy requirements. No, we do not face any difficulty in meeting the Chinese standards.  | Yes, we are aware of the Pak-China FTA. No, we have not benefitted from its provisions. We still face non-tariff measures such as sanitary and phytosanitary (SPS) measures which we have to comply with.  |
| **B** | Yes, we export yarn. | The competition in the Chinese market brought about by other countries such as Bangladesh and India acts as a great challenge to us. This is mainly because our raw materials are expensive compared to India and Bangladesh. Moreover, poor government policies have led to the shutdown of various spinning units in the industry. | Yes, we are aware of China trade policy requirements. No, we do not face any issue in meeting the Chinese requirements/standards. | Yes, we are aware of FTA with China. No, we have not received any particular benefit from its provisions. The problem we still face is the tough competition from other suppliers/exporters of yarn in China. China should give us preferential treatment if we are to benefit from FTA in real terms. |
| **C** | Yes, we export cotton yarn and fabrics. | We do not face any particular challenges while exporting to China.  | Yes, we are aware of the requirements. No, we do not face any problem in meeting those requirements. | Yes, we are aware of the Pak-China FTA. Since China has not given us preferential treatment therefore our exports still face rigorous competition from other exporters of cotton yarn and fabrics in China. |
| **D** | Yes, we export leather-made products. | We believe the lack of our efficiency and competency acts as a major challenge whilst exporting to the Chinese market.  | Yes, we are aware of China trade policy requirements. Yes, we do face issues in meeting certain non-tariff measures such as product certification, labelling, standards and customs clearance delays.  | Yes, we are aware of FTA with China. No, we have not benefitted from the provisions of FTA. We still face issues related to non-tariff measures/barriers. |
| **E** | Yes, we export woven fabric and grey fabric. | We face high compliance costs and extended delays for business which impact our ability to sell on the Chinese market. | Yes, we are aware of China trade policy requirements. As an SME, we face high compliance cost in meeting those requirements. | Yes, we are aware of FTA with China. But it has done little to boost our exports mainly because the products we export are intermediate goods. Therefore, we are unable to benefit from the provisions of FTA. We still face high compliance costs despite the provisions. |
| **F** | Yes, we export fruits and vegetables. | Yes, we face tough SPS requirements.  | Yes, we are aware of some of the requirements but not all. As an SME, we do face financial/resource constraints in meeting those requirements.  | Yes, we are aware of the Pak-China FTA. No, we have not received any benefit from its provisions. We still face issues related to the fulfilment of technical measures. |
| **G** | Yes, we export rice.  | The only challenge we face is in meeting the SPS standards sometimes.  | Yes, we are aware of some of the China trade policy requirements. As an SME, we do face issues in getting our product tested in laboratories since the cost of the tests is high. | Yes, we are aware of the Pak-China FTA. No, it has done little to benefit us. This is because, despite lower tariffs, other non-tariff measures acts as barriers to our export such as SPS and technical measures. |
| **H** | Yes, we export rice.  | No, we do not face any particular issue while exporting to China.  | Yes, we are aware of some of the requirements if not all. No, we do not face any issue in meeting those requirements/standards.  | Yes, we are aware of the Pak-China FTA. It has benefitted up to some extent as our rice exports have increased. There is no particular problem that we face when exporting to China. |
| **I**  | Yes, we export yarn and spinning. | Yes, we do face issues related to shipment and we also find difficulty in creating personal networks. | Yes, we are aware of some of the requirements. As an SME, we face high compliance costs. | Yes, we are aware of the FTA with China. It has done almost nothing to favour us. We still face issues related to logistics and high compliance costs. |
| **J** | Yes, we export cotton yarn and fabric.  | Yes, we encounter issues such as shipment delays, inadequate availability of containers, lack of dry ports, congestion and high sea-freight which ultimately increases the cost of doing business. | Yes, we are somehow aware of the requirements, if not all. Being an SME, we do not face any specific issue in meeting the Chinese requirements/standards.  | Yes, we are aware of the FTA with China. It must be revised since China has benefitted more from it than Pakistani exporters. Our business has also not seen any boost in exports. We still pay 3.5% duty on our cotton yarn fabric while the exporters from Vietnam and Thailand face zero duty in China. Despite the provisions of FTA, we still face fierce competition from other exporters of cotton yarn in China who are given zero duty whilst we have to pay 3.5%. |
| **K** | Yes, we export rice.  | Due to language barrier, we find it challenging to develop and expand our contacts/business network in China. | Yes, we are aware of some of the requirements. Being an SME, we sometimes feel financially constrained in meeting those standards/requirements such as SPS measures which require us to test our product in lab for meeting the MRL standards etc.  | Yes, we are aware of the Pak-China FTA. It has not benefitted us significantly. We still face issues related to compliance and networking.  |
| **L** | Yes, we export woven and grey fabric.  | Yes, we do face issues such as high transaction cost/high cost of doing business. | Yes, we are aware of some of the requirements. No, we do not face any issue in meeting those requirements. | Yes, we are aware of the FTA with China. It has not really benefitted us in boosting our exports. Despite the provisions, the cost of doing business still remains high which hinders our exports. |
| **M** | Yes, we export rice.  | Yes, we do face challenges in terms of poor logistics and ports’ infrastructure. | Yes, we are aware of some of the China trade policy requirements. Being an SME, we do incur issues related to the fulfilment of certain requirements such as SPS measures. | Yes, we are aware of the FTA with China. It is not really beneficial to us. We still face tough competition from ASEAN countries who export rice to China. If we are to benefit from the FTA, then we should be provided with the same concessions that China provides to ASEAN countries such as Indonesia, Thailand, Vietnam etc. |
| **N** | Yes, we export fruits such as mangoes and oranges. | No, we do not face any major issue while exporting to China except for logistic issues. | Yes, we are aware of some of the requirements. No, we do not face any issue in meeting those requirements. | Yes, we are aware of the Pak-China FTA. But it did not significantly contribute in boosting our exports. Despite the provisions, we still face issues such as shipment delays. |
| **O** | Yes, we export cotton yarn and fabric. | Yes, we do face issues sometimes in terms of shipment delays. | Yes, we are aware of some of the requirements. Being an SME we do face issues in meeting the requirements such as certain technical measures. | Yes, we are aware of the FTA with China. No, it has not quite benefitted us. We still face duties on our exports which makes it hard for us to compete with other suppliers of cotton yarn in China especially those from ASEAN countries as they are given preferential treatment. |

**Annex-B: Research Institution’s Response**

|  |  |  |  |
| --- | --- | --- | --- |
| **Questions** | **1) Provide information about the share of China in your national exports. How many SMEs are exporting their goods/services to China?** | **2) What are the main constraints/challenges posed by China trade policy or trade standards/requirements?** | **3) Have the provisions of the Free Trade Agreements (FTAs) with China been used in your country? Provide specific examples.** |
| **Organization Name** |  |  |  |
| **CPEC Centre of Excellence** | China is ranked as the third largest export destination of Pakistan with a share of 7.7 percent in Pakistan’s total exports, after the United States and United Kingdom. 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. Fruits & vegetables, petroleum products, ores, slag, ash and fish follow. | Overall tariff concessions offered to Pakistan remains higher as compared to the tariffs offered to other FTA partners of China for the same commodities. Consequently, Pakistan lost preference on 79 percent exports to China after signing FTA. Moreover, one of the biggest challenges to the exporters is the non-tariff measures (NTMs). Exporters are required to comply with technical measures, standards as well as custom procedures in the Chinese market that can impede trade and prevent them from exporting their products. | Pakistani traders utilise only a tiny fraction of Chinese tariff concessions as they do not export commodities mentioned in the favourable list of items to be exported to China. High value export products form the list of items under the PTA but this could only favour Chinese exporters because of the export items and nature of industry in Pakistan that has no capacity to export such items to China. Examples include road vehicles, machinery etc. |

1. #####  Ms. Beenish Javed, Research Economist at PRIME, provided valuable research assistance, including interview of exporting firms and collation of their responses.

 [↑](#footnote-ref-1)
2. In the absence of information on number of employees by firm, this approach of computing firm size is quite standard in international trade literature. [↑](#footnote-ref-2)
3. #####  Of 317 exporters in the textile sector, only 49 are MSME.

 [↑](#footnote-ref-3)
4. #####  http://www.sbp.org.pk/publications/staff-notes/Pak-China-trade-balance.pdf

 [↑](#footnote-ref-4)
5. #####  “China to consider Favourable Market Access for Pakistan”, The Express Tribune, September 16, 2017 https://tribune.com.pk/story/1507734/china-consider-favourable-market-access-pakistan/.

 [↑](#footnote-ref-5)