Prime Report

RCEP: An Opportunity to Increase Pakistan's Trade & Investment Potential

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KEY MESSAGES

1. With India unlikely to join RCEP in the medium-term, Pakistan's ICT industry, particularly financial technology, business process outsourcing, consultancy and software development has the opportunity to gain a modest share in the regional value chain.
2. With labor costs lower than most RCEP members, Pakistan has the opportunity to develop its regional value chain in the manufacturing and exports of mobile phones.
3. Joining RCEP may inject new momentum to Pakistan's export strategy by geographically diversifying its existing exports.
4. Being part of RCEP would provide the much-needed push to Pakistan's trade and investment policy by bringing transparency, simplicity and predictability in the policy making.
5. Being an outsider, Pakistan is likely to face a larger trade deficit, potential loss of BRI financing and forgo the benefits of deeper regional and global trade integration.

INTRODUCTION

Regional Comprehensive Economic Partnership (RCEP) is a Free Trade Agreement (FTA) signed between 15 Asia-Pacific countries[2] in November 2020. RCEP aims to establish a single, harmonized and predictable set of trade rules that facilitates businesses to locate their supply chains within the region. This mega-regional agreement is largely about liberalizing trade in goods, services, investment and intellectual property rights.[3] The agreement which is expected to come into force by

Figure 1: Stylized Facts about RCEP

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2 These include Australia, Brunei, Cambodia, China, Indonesia, Japan, Laos, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Thailand, and Vietnam. India was one of the members during the initial negotiation phase but opted out due to fears of a widening bilateral trade deficit with China, disagreement over the selection of the base year for tariff reductions, and a lack of progress on services trade. However, it is free to join the bloc if it decides so.

3 Detailed provisions of this FTA are accessible at: https://rcepsec.org/legal-text/

the end of 2021, allows for new members to join within 18 months of its coming into effect. It is imperative to mention that the PTI government claimed in its manifesto that it will "champion and incentivize creation of regional supply chain linkages; focus will be on increasing regional trade." In this backdrop, RCEP might offer a good opportunity for Pakistan to develop and strengthen its regional and global supply chain and enhance its trade potential. This report identifies some opportunities and addresses certain apprehensions pertaining to RCEP and suggests a way forward for the country's possible accession to RCEP.

GLOBAL VALUE CHAIN: RCEP VIS-À-VIS PAKISTAN

In the last two decades international production, trade and investments have increasingly organized within Global Value Chains (GVCs) where different stages of production process are located across different countries. Over the years, the RCEP members have gained prominence in these supply chains. Its 15 members cumulatively contribute 30 percent to global GDP, 27 percent to global trade in goods, 18 percent to global trade in services, 19 percent to global FDI outflows and 30 percent to world's population thus making it the world's largest trading bloc[4] (see Figure 1). The RCEP members' collective share in GVC stands at 24.2 percent as of 2018 (see Figure 2).

Figure 2: Share in Global Value Chain 2018

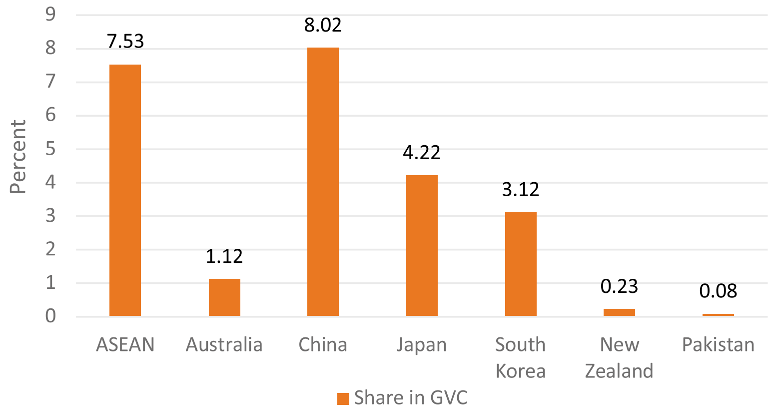
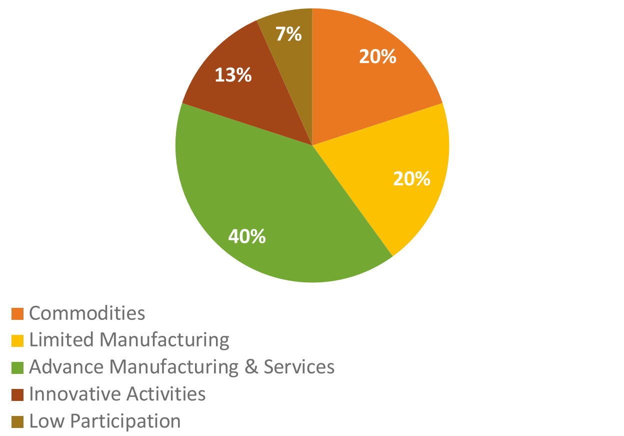


Figure 3: RCEP's GVC Participation Type 2015



Source: Trading for Development In The Age Of Global Value Chains, World Bank Report.

As far as RCEP's participation type in GVCs is concerned, 53 percent are engaged in higher end of GVCs such as advance manufacturing and services[5] and innovative activities[6], 40 percent in limited manufacturing[7] and commodities[8] while 7 percent[9] have limited GVC participation (see Figure 3).

Pakistan on the other hand has a GVC participation of around 30 percent[10] which means 70 percent of its exports are produced using domestic raw materials and intermediate goods thus indicating low participation in regional and global value chains. Its share in world's GVC stands at 0.08 percent[11] (see Figure 2). The country is engaged in lower end of GVC precisely in limited manufacturing[12] often alongside commodities

4 Pakistan's Trade Potential and The Regional Comprehensive Economic Partnership. Webinar organized by Pakistan Institute of Development Economics.
5 Share of manufacturing and business services in total domestic value added in exports is equal to or greater than 80 percent for these countries.
6 This corresponds to the countries that spend a relatively large share of GDP on research and receive a large share of GDP from intellectual property.
7 Countries specializing in limited manufacturing rely on low labor costs.
8 Countries specializing in commodities derive almost a fifth of GDP from natural resources.
9 This includes New Zealand which has low participation in GVC owing to its size and distance to world markets.
10 Asian Economic Integration Report 2019-20. Asian Development Bank. November 2019.
11 Author's calculation based on UNCTAD-Eora Global Value Chain Database.
12 Trading for Development in the Age of Global Value Chains, World Bank Report 2020.

exports and exhibits medium backward GVC integration[13]. Pakistan's share in GVCs is mostly in forward participation implying that some other country adds value in Pakistan's exports to re-export. For example, Pakistan exports yarn and fabric to China, Bangladesh and Turkey, which produce and export value added products to other countries.

During FY19, Pakistan's exports of goods and services to the RCEP members accounted for 16.8 percent[14] of its total exports while 36.4 percent[15] of its total imports were from the RCEP signatories. In 2019 Pakistan exported goods worth $4 billion to RCEP countries. The major export items included textiles and clothing (40 percent) followed by agricultural commodities (28 percent) comprising fruit and vegetables and animal products.[16] In the same year, Pakistan's imports from RCEP stood at $21 billion, with major import items being machinery and electronics (35 percent), followed by chemicals (14 percent), metals (11 percent) and transport equipment (9 percent) respectively[17] (see Figure 4). With the exception of China and ASEAN, Pakistan's trade with other 4 RCEP members remains limited (see Figure 5).

Pakistan's major exports are predominantly confined to rice, textiles and pharmaceutical products. Figure 6 depicts Pakistan's export-oriented sectors or commodities that will most likely face competition from RCEP countries. As evident, the country is likely to face increased competition from Cambodia, Vietnam, Thailand and Myanmar in exports of rice and textiles in particular. The quality improvements and cost-efficiency would be equally important for international competitiveness of these products. In contrast, Pakistan is most likely to maintain its edge in pharmaceuticals or more specifically surgical instruments. Besides low wage labor[18], established capacities for a wide range of products and

Figure 4: Composition of Pakistan's Trade with RCEP

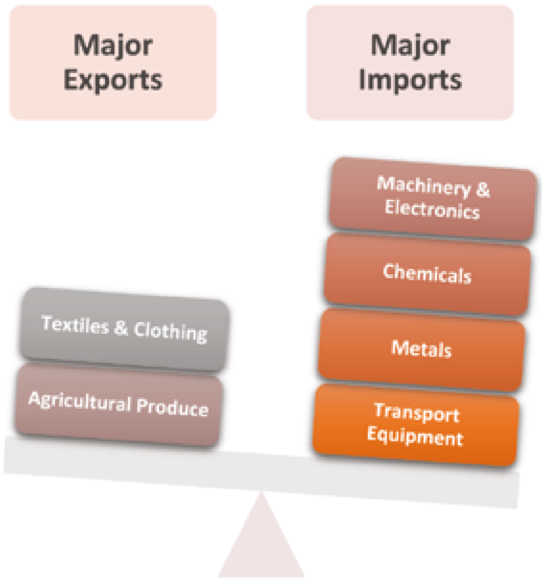
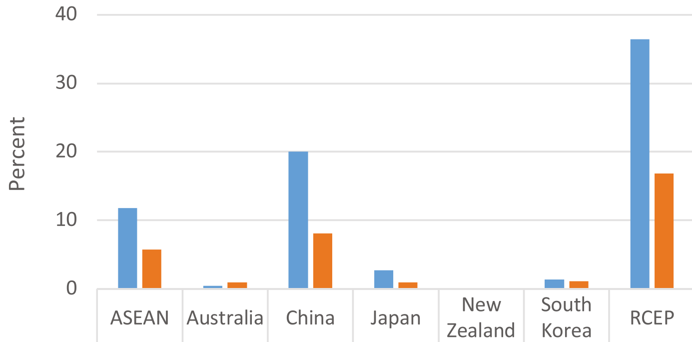


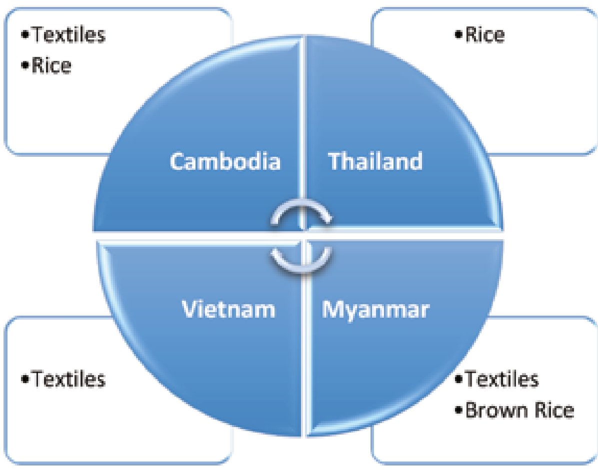
Figure 5: Share of RCEP in Pakistan's Trade FY19



	ASEAN	Australia	China	Japan	New Zealand	South Korea	RCEP
Imports	11.8	0.4	20	2.7	0.1	1.4	36.4
Exports	5.7	0.9	8.1	0.9	0.1	1.1	16.8

Source: Author's calculation based on SBP dataset.

Figure 6: Potential Competition from RCEP



Source: UNESCAP's TINA 3.0

13 The backward participation ratio denotes the foreign value-added contribution to an economy's exports.
14 Author's calculation based on SBP dataset.
15 Author's calculation based on SBP dataset.
16 Trade talks. The News. Retrieved: https://bit.ly/3sEhaFq.
17 Trade talks. The News. Retrieved: https://bit.ly/3sEhaFq.
18 Wage comparison of Pakistan with East Asian Countries can be retrieved from: https://bit.ly/3rE6dT4

a geographically concentrated production hub in a single city – Sialkot - assists the industry to cater to the growing global demand for these products. In this backdrop, it is imperative that the country leverages those sectors where it has a potential edge over RCEP members in order to reap the benefits from this mega-regional bloc and deepen its connection to regional supply chains. Some of these possibilities have been discussed in the subsequent section.

OPPORTUNITIES UNDER RCEP

Given the sheer magnitude of RCEP and its trade significance for Pakistan, the country has the opportunity to join the mega-regional trading bloc that could expand its network of FTAs to support participation in global and regional supply chains. Some of these possibilities have been discussed below:

1. **ICT Services:** Pakistan is the second largest exporter of ICT services in South Asia after India. This sector has a stable base, low cost of operations, a growing domestic market and a reasonably strong network of overseas workers around the world. Although it is unclear what the post-Covid-19 business landscape will look like, ICT and ICT-enabled services will play a more prominent role than they did in the past. The recent recognition of telecom sector as an industry and the proposed tax cuts for the sector in the upcoming federal budget[19] is expected to enhance the productivity and competitiveness of this sector. According to Anabel Gonzalez, a World Bank Consultant on Trade and Investment, India is unlikely to join RCEP in the medium-term which provides Pakistan's ICT industry, particularly financial technology, business process outsourcing, consultancy and software development an opportunity to gain a modest share in the regional value chain.
2. **Mobile Manufacturing:** Another area where Pakistan can develop its regional supply chain via RCEP is manufacturing and exports of mobile phones. With labor costs lower than most RCEP members[20], Pakistan has the opportunity to develop its regional value chain in the manufacturing and exports of mobile phones. In this regard, it can import superior components for cellphone manufacturing from China, South Korea and Vietnam and utilize its own cheap labor for assembling of phones. It is pertinent to note that the introduction of DIRBS (Device Identification, Registration and Blocking System) has significantly reduced the incidences of smuggled phones in the country and has been a catalyst for local assembling of mobile phones.[21] It is interesting to note that in the next three years a China-Pakistan mobile manufacturing firm will be manufacturing 49 percent[22] of its phones in Pakistan and will be focusing on exports as their plant in Pakistan has proved to be the most efficient. In another development, abolishment of withholding tax has resulted in a difference of around Rs. 1,900 per $100[23] device between a locally assembled phone and an imported set making the locally manufactured sets price competitive. With DIRBS and tax incentives introduced, new entrants[24] are expected in the mobile market which is likely to spur a healthy competition and can be leveraged to access RCEP's market.
3. **Health and Pharmaceutical Sector:** This pandemic is most likely going to become endemic and we have to learn to live with it. In this regard, Pakistan's health and pharmaceutical sector has the opportunity to benefit from this mega-regional bloc. Pharmaceutical companies can ramp up production of medicines, surgical equipment, vaccines, etc. Even textile sector can shift production towards manufacturing of Personal Protective Equipment which can be exported

19 Tax cut for telecom sector in upcoming budget. The Express tribune. Retrieved: https://bit.ly/3m32Tjf
20 'Pakistan's labor costs lower than India's and China's,' says Lead Economist, World Bank, South Asia Region. Business Recorder. Retrieved: https://bit.ly/2Pj3dOT
21 China-Pakistan mobile manufacturer eyes to start exporting. Business Recorder. Retrieved: https://bit.ly/3fDBx2b
22 Ibid.
23 Three mobile phone companies to set up manufacturing plants in Pakistan. Profit. Retrieved: https://bit.ly/31sCyBM
24 With tax exemptions introduced, three new mobile phone companies (Vivo, Airlink and Advance Telecom) have shown interest in setting their plants in Pakistan.

to the RCEP market.

4. **Agricultural Commodities:** Since agriculture commodities such as fruits, vegetables and animal products remain major export items to RCEP, there is room for further strengthening this sector's integration into regional value chain. In this regard, Japan, Singapore and Myanmar being a major importer of food products offer a potential market for Pakistan's agricultural products. In addition, being a net importer of agricultural goods and inputs, joining RCEP would allow Pakistan to enhance its export competitiveness through reduced trade costs and access to competitive agricultural inputs. However, in order to successfully assimilate into regional supply chain, it is imperative that the quality of agro-products is improved and that they meet the sanitary and phytosanitary requirements of the RCEP.
5. **Geographical Diversification of Exports:** Joining RCEP may inject new momentum to Pakistan's export strategy by geographically diversifying its existing exports. Most of Pakistan's exports are directed towards United States and European Union. These regions are still struggling to bring Covid-19 under control and are experiencing a deeper recession in the medium-term. On the other hand, the RCEP countries have been more effective in controlling the spread of Covid-19 in general and are likely to experience a sharper economic rebound. If Pakistan joins RCEP, it has the opportunity to geographically diversify its exports to new RCEP markets which may provide a buffer to Pakistani exporters against the existing slowdown in western markets.
6. **Investment Diversification:** RCEP has the potential to help fuel investment in Pakistan. Some of the RCEP members precisely China, Japan and South Korea are large investors in greenfield foreign direct investment projects in Pakistan, creating 28,000 jobs in communication, automotive and renewable energy sectors.[25] This suggests that there might be significant potential to attract untapped investment from other RCEP members in sectors like construction, agriculture, livestock, mining and tourism.
7. **Streamline Trade and Investment Policy:** Being part of RCEP would provide the much-needed push to Pakistan's trade and investment policy by bringing transparency, simplicity and predictability in the policy making. It would reduce red tape and ease the movement of goods, services and investment. Key to this is a unified rule of origin which implies that products manufactured to RCEP-originating criteria can move freely within the bloc with a single certificate of origin, slashing administrative time, complications and costs of sourcing inputs within the region making the member countries more cost-effective and competitive. It is pertinent to note that Pakistan faces significant challenges due to smuggling of products as a result of high tariff rates. Streamlining of trade policy including tariff reduction will likely reduce the illicit trade of goods.
8. **Roadmap to Other Trading Blocs:** In order to integrate into regional and global value chains, it is imperative for a country to be part of trading blocs or have well-established FTAs with multiple countries. In this regard, RCEP offers Pakistan an opportunity to join other mega-regionals and revitalize some of the stalled trade agreements that it has with other RCEP members such as Philippines, Thailand, Singapore and South Korea. Of the 12 countries of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership[26] (CPTPP), seven are already members of the RCEP, with China favorably considering to join. Provided Pakistan joins RCEP, it may be easier for it to be a member of CPTPP with due support from other members of RCEP.

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25 Trade talks. The News. Retrieved: https://bit.ly/3swrbEG.

26 CPTPP has no geographic or regional membership requirement and is open to expansion or addition of new members with due consent of its existing members. Within 30 days of the first meeting of the Accession Working Group, the aspirant economy is required to submit its market access offers/Non-Conforming Measures (NCMs) to the Accession Working Group. An aspirant economy will become a Party to the CPTPP 60 days after either (a) the date on which the aspirant economy deposits an instrument of accession with the Depositary indicating that it accepts the terms and conditions for the accession; or (b) the date on which all Parties have notified the Depositary in writing that they have completed their respective applicable legal procedures.

APPREHENSIONS

Besides the opportunities offered by RCEP, there are certain reservations pertaining to this mega-regional trading bloc. These apprehensions can be divided into two scenarios: i) Risks if Pakistan joins RCEP (An Insider) and ii) Risks if Pakistan choses to stay out of RCEP (An Outsider). These are addressed respectively in the table below:

Table 1: General Apprehensions Regarding RCEP

Scenario 1: Pakistan as an Insider	
Apprehensions	**Remarks**
1. Many view that by joining RCEP, Pakistani firms would face increased competition from member countries which would lead to deindustrialization.	It is pertinent to note that RCEP allows countries up to 20 years[27] of transition period to liberalize most of their tariffs. This provides reasonable time for less developed countries like Pakistan to gradually prepare and open up their industries to international competition. Moreover, the RCEP agreement is flexible enough to accommodate the disparate needs of less developed member countries. It does not commit countries to open services and other vulnerable areas of their economies[28].
2. After participation in RCEP, Pakistan may suffer potential export losses.	The potential export losses might be inevitable in the initial phase. However, at a later stage, Pakistan can make up for this loss by enhancing its export competitiveness through reduced tariff costs and access to competitive inputs under RCEP.
3. After joining RCEP, Pakistan will face increased trade deficit.	Viewing trade agreements from the point of trade deficit alone is not appropriate. Running up more imports than exports may not necessarily be undesirable, especially for countries like Pakistan which is still at a developing stage. After all, it is the people of the country who will benefit through free trade as they will get access to better quality products and inputs at a cheaper price. It is pertinent to mention that Pakistan has existing FTAs with some of the RCEP members such as China and Malaysia and a PTA with Indonesia. Therefore, it is unlikely that FTAs with other countries will have a stronger negative shock. China as a manufacturing powerhouse already sells Pakistan the cheapest products. On the other hand, the opportunities are much more from trade expansion.
4. After joining RCEP, Pakistan may face potential investment diversion.	Not necessarily. Rules of Origin (ROO) determine which goods originate under RCEP and are eligible for preferential tariff treatment. Firms operating in RCEP countries where the cost of labor is high will be incentivized to direct outward Foreign Direct Investment (FDI) to countries with low production costs in labor-intensive industries. In fact, Pakistan with its low-wage economy will be attractive to cost-sensitive investors in the textile industry and other labor-intensive industries. Moreover, even if there is some investment diversion in the initial phase, this could later be made up for by introducing simplicity, transparency and predictability in policymaking through reigniting the reform drive in investment.

27 The Regional Comprehensive Economic Partnership (RCEP): 15 Asia-Pacific nations strike one of world's largest trade deals. Deloitte. Retrieved: https://bit.ly/3wdJu3V

28 RCEP: Emergence of the Largest Trading Block. Institute of Strategic Studies Islamabad. Issue Brief. Nov. 20, 2020.

Scenario 2: Pakistan as an Outsider	
Apprehensions	**Remarks**
1. Pakistan does not have the capacity to negotiate and join RCEP.	Pak-China FTA II offers a good insight into Pakistan's negotiating capacity as this trade agreement is relatively more comprehensive and better negotiated than the Pak-China FTA I. Therefore, not having the capacity should not be the driver in the decision-making process, particularly in this area, as it can be developed over time.
2. If Pakistan stays out of RCEP, it will forgo the benefits of deeper regional trade integration.	This is most likely to happen. China is the largest trading partner of Pakistan. Under RCEP, China will be obliged to give more concessions to RCEP members than Pakistan which will make Pakistan's existing preferential tariff rates redundant. Resultantly, Pakistani exporters would find it more difficult to sell their products to RCEP member countries which would adversely affect Pakistan's regional trade integration. Moreover, by not joining RCEP, Pakistan may actually worsen its trade deficit as these countries are likely to provide more variety of goods and services at lower costs but Pakistan will be unlikely to export to them as easily.
3. If Pakistan stays out of RCEP, it will adversely affect its integration into global value chain.	This is most likely to happen. By not joining RCEP, Pakistan will be unable to attract international supply chains to the country. This is because the RCEP members are more likely to establish different elements of value chains among themselves owing to the Rules of Origin. Pakistan will be stuck with policies that promote import substitution (high tariffs, low imports and high dependency on domestic market) without being able to increase its exports. This will lead the country into a vicious cycle of low quality products and further isolate it from global markets.
4. Not joining RCEP means potential loss of Belt and Road Initiative (BRI) financing.	This is likely to be true. Being a non-signatory of RCEP would imply restricted access to China's BRI funds as RCEP members would be given a priority over non-members for disbursement of those funds[29].

THE WAY FORWARD

Conclusively, it is important to realize that in the current scenario the global trade is evolving and countries are forging multilateral arrangements that will shape the future of the economies. Although FTAs with different regions or countries may not benefit all sectors of the economy in the short-to-medium run, being part of open trade and getting integrated with a trading bloc will be definitely a superior alternative in the long run, allowing for economic rebound from Covid-19. RCEP offers an opportunity to realign Pakistan's trade potential by paving way for its integration into regional and global value chains. This is in line with one of PTI's manifesto promises regarding 'creation of regional supply chain linkages and increasing regional trade' which is targeted to reduce the country's export dependence on few export markets. Analysis of existing trading patterns based on Pakistan's FTAs and PTAs with some RCEP members has not been discussed in this report. However, such an analysis might provide an insight into Pakistan's negotiating capacity and trade gains and therefore requires further research.

29 RCEP: Emergence of the Largest Trading Block. Institute of Strategic Studies Islamabad. Issue Brief. Nov. 20, 2020.

Given the scope of the report, certain policy options are proposed that may facilitate the country's potential accession to RCEP:

1. **Arrange Stakeholder Consultations:** It is imperative that the public stakeholders such as Commerce Division approaches RCEP members to express interest in accession while simultaneously exchange views with them particularly the less developed RCEP members on their experience in negotiating RCEP. This will provide an insight into the negotiating process from the viewpoint of a developing country and may assist in developing a roadmap for Pakistan's possible accession.

2. **Develop a Roadmap for Possible Accession:** It is pertinent to note that time is of the essence as China has already ratified this trade deal and it would, most likely, come into effect from the end of this year or early 2022. Therefore, the Ministry of Commerce should utilize the time to prepare a detailed study on the content and implications of RCEP and establish a specialized unit to develop a strategy for potential accession to RCEP. In the process, it should also actively engage other stakeholders such as the private sector and civil society as their input is imperative for effective negotiation of this mega-regional FTA.

3. **Enhance Public-Private Cooperation to Raise Awareness:** A renewed partnership between Pakistani businesses and government will help prepare for market opening under the RCEP. In this regard, government and Chambers of Commerce and Industries can arrange workshops/ webinars to raise awareness among private stakeholders regarding RCEP and the associated opportunities and risks. This way, the lobbying industries can be made to realize that Pakistan's protectionist and isolationist policies would erode the competitiveness of domestic firms and exporters and would fail to reap gains from international trade.

4. **Leverage Sectors with Export Potential:** In order to compete and integrate into regional value chains, it is imperative that the government facilitates emerging sectors such as ICT, mobile manufacturing and light engineering through R&D, tax incentives and streamlining of business procedures so as to reduce their costs and increase their international competitiveness. These sectors can be leveraged to tap into the RCEP market. Pakistan should also leverage the CPEC for attracting export-oriented FDI.

5. **Overhaul Trade Policy and Trade-related Investment Policy:** In order to reap the potential benefits of RCEP, Pakistan's Trade and Investment policies require an overhaul in letter and spirit. In the long run, the country holds the potential to target even the middle-to higher-end segments of the GVCs given that all border-related procedures are streamlined (automated) and tariff structures are rationalized. Given the critical nexus between trade and investment, investment should be attracted in export-oriented sectors. Some industries such as automobile and steel, have continued to enjoy higher protection, which fueled an anti-export bias. Government should end the protection to redirect the flow of productive capital in export-oriented sectors so as to enable the country to improve its trade along intensive[30] and extensive[31] margins. Improving trade and investment policy would also aid in reducing the existing friction in goods and capital flow.

6. **Establish Digital Trade Portals:** Information to export a product to a given destination is very valuable for firms, particularly for new, small exporters that lack the scale to invest in information searching. Therefore, online trade portals should be established which are easily accessible to everyone and can be a step in making non-tariff measures more transparent and compliance less costly for domestic exporters. This would also assist in improving the quality of the products as exporters would be cognizant of the product standards in the destination markets.

30 The intensive margin of trade refers to the growth of exports in goods that are already being exported.
31 The extensive margin is defined as the growth of exports in new categories.