Country Update Note 2

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

Dr Salamat Ali[1]

1 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 to China, 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) signed in 2007. The study uses a mix methodology. It analyses firm-level export data for the recent period (from 1-1-2017 to 31-12-2018). 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 in the study period[2].

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 in all sectors. The tariff preferences accorded to Pakistan under the Pak-China FTA in 2007 have gradually eroded as China later signed deeper and comprehensive trade agreements with other regional economies, which relegated Pakistan's firms to a comparative disadvantage, and thus widened bilateral trade deficit.

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 as key barriers in accessing Chinese market. The stringent sanitary and phyto-sanitary (SPS) requirements, technical barriers to trade (TBT), high cost of customs compliance and the inadequacy of logistic facilities, act as major constraints to the growth of Pakistan's exports to China. Moreover, Pakistan's firm do not utilize most of the trade preferences as these high value-added products covered in the FTA concession lists are not produced in the country.

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.

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[1] Professional Trade Economist (Salamat.ali@alumni.lse.ac.uk).

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

2 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 2017, of US$ 21.40bn total exports, around 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 which 60% firms are of large size while 40% comprise small- and medium-sized enterprises. In this period, of 14, 489 total exporters only 1,269 firms shipped to China.

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[3]. On this distribution, 123 small, 398 medium-sized and 748 large firm 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[4] (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 potentially high cost of exports to China which only large firms can incur, or the presence of informal barriers to trade. These barriers to exports are further investigated in the next Section.

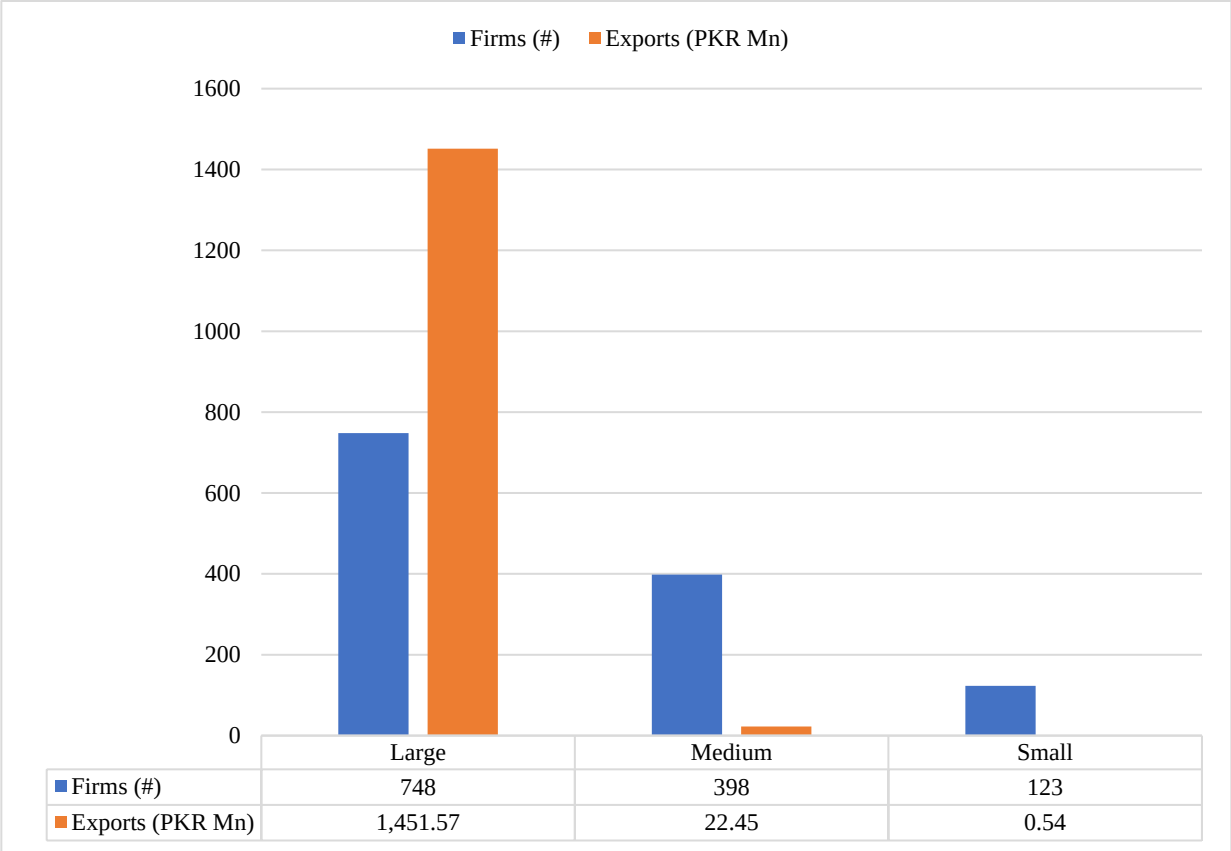
[3] In the absence of information on number of employees by firm, this approach of computing firm size is quite standard in international trade literature.
[4] Of 317 exporters in the textile sector, only 49 are MSME.

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



2.1 Utilisation of Trade Preferences

Pakistan and China entered into an FTA 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[5], were given no tariff concession. After the FTA, the volume of Pakistan's trade with China has increased manifolds but the increase in imports is substantially larger than that for exports.

The second phase of FTA started in July 2013, which aimed at removing 90% tariffs on all products. However, 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.[6] These relatively high tariffs place MSME's at a comparative disadvantage in Chinese market.

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.

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.*"

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.*"

[5] http://www.sbp.org.pk/publications/staff-notes/Pak-China-trade-balance.pdf

[6] "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/.

3 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).

I. 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.

II. 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.

III. Firms have not benefitted much from China's tariff preferences, although the preferential regime is quite 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 exempt 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 quantity control measures (Table 4). Surprisingly, no sector is exempt from the technical barriers to trade.

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

4 Findings and Recommendations

China is Pakistan's third largest export market. It absorbs around 7% of Pakistan's exports, and these exports are concentrated in textiles, minerals and fruit and vegetables. The analysis of export data and interview with stakeholders indicate that Pakistan's export 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. Because of the high compliance costs, exports to China are dominated by large firms and the contribution of small and medium-sized exporters is relatively limited. The gradual erosion of trade preferences in Chinese markets and the emergence of battery of SPS measures and technical barriers to trade have constrained the ability of small firms to benefit from the large export potential to Chinese market.

In terms of policy implications, the national government and multilateral institutions should build capacity of small firms to meet the regulatory requirements imposed by China. 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.