Policy Note

Should Pakistan liberalize trade with India against the backdrop of an FTA with China?

A Comparative Advantage Analysis for the Manufacturing Sector

It is well documented, especially in the case of Asia, that international trade expansion is an important driver of economic growth. Countries like Japan, China, South Korea, Malaysia, Thailand and few others experienced exceptional GDP growth rates by following trade-led growth policy. However, nations in South Asia have learnt little. On the one hand, Southeast Asian bloc of countries has made tremendous progress by virtue of trading with their regional partners (61% of their manufacturing exports are within the region), whereas, trade between the SAARC member countries is minimal. Further, the expansion in regional trade especially intra-industry trade helps the economies to expand their global trade; Southeast Asian counties holds 8.2% of world's total exports, while South Asian countries (Pakistan and India) share is only 0.5% (Asian Development Bank & Asian Development Bank Institute, 2013).

Manzil Pakistan is a Karachi based think tank dedicated to developing and advocating public policy that contributes to the growth and development of Pakistan.

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KEY FINDINGS

The study finds eighteen products which require prompt government attention in order to attain competiveness in the global market in the long run. These products are termed as vulnerable in our report and feature as main products of interest for review by policy makers.

In addition to this, comparison of RCA values amongst India, Pakistan and China, shows that there are twelve items for which India has a comparative advantage over China but we end up importing them from the latter. The comparison also identifies four products which could have a large potential market in India but are being predominantly sold to China. This can be attributed to the artificial advantage given to China and the ease of access to Chinese market as a result of Pak-China Free Trade Agreement (FTA), and barriers enforced on the Indian side.

Remarkably low trade in South Asian region is mainly attributed to trade restrictions between Pakistan and India, as Pakistan enjoys a strategic geographical location essential for connectivity within the region. It's a reprehensible reality that despite multiple episodes of talks in the last decade, the two neighbors fail to normalize trade relations.

Owing to the exigent nature of the problem and the concerns of the local business community, Manzil has investigated the competiveness of Pakistan's manufacturing sector which operates in an open trading regime with China. This sector now faces imminent but an unknown impact if Pakistan is to liberalize trade with India and grant it an MFN/NDMA status. This implies that the negative list, which comprises of 1209 items, will be abolished. This policy note is provided as an indicative paper for trading associations and the government, for review, in order to formulate an informed trade policy.

Definitions and Methodology

The study identifies two categories of industries which are explained below:

A. Vulnerable Industries which are defined according to the following conditions:

a) Those which are losing their comparative advantage position (moving from **advantage to disadvantage** position)

b) Those which are facing difficulties to achieve or maintain a comparative advantage position (moving from **disadvantage to advantage** position)

B. Inefficient Industries which fall into one of the following groups:

a) Inefficiently imported industries in which India is more competitive than China but Pakistan is importing from China i.e. $RCA^I > RCA^C > RCA^P$

b) Inefficiently exported industries in which Pakistan is more competitive than China and India i.e. India is least competitive, i.e. $RCA^P > RCA^C > RCA^I$, but Pakistan is exporting to China than India

China has been used as reference for inefficient industries because Pakistan has recently completed an FTA with China which has given the latter a cost advantage over India even though transportation costs are higher for China as compared to India.

The study constructs a Revealed Comparative Advantage (RCA) index at HS 2 digit level code for Pakistan, India and China from 2003 to 2012. Change in RCA trends is studied to identify products which are showing a decline or an improvement in competitiveness over the years. The RCA trends are also compared across the countries to find evidence of inefficient trade, i.e. trade violating the theory of comparative advantage.

RECOMMENDATIONS

The findings of this paper serve to inform popular opinion at home and abroad. Policy makers suggest that liberalizing trade between Pakistan and India will enhance trade within the region, as there is strong probability of trade diversion to regional members. Normalizing trade with India will provide India land route access to Afghanistan and Central Asian states. Pakistan will benefit from the transit trade because it will then access economies of Nepal and Thailand. It has been suggested that significant improvement in growth rates and per capita income can be attained in the long run by increasing trade with India on the basis of comparative advantage. However we recommend caution and further investigation before any position on liberalization with India is taken by the Government of Pakistan.

The 18 product lines identified as vulnerable industries translate into 1100 items at HS 6 level. It is recommended that protection should be given to these sectors in presence of a more open trading regime in the short run. Out of these 1100 items we can confirm that 284 items are already on the negative list. There are 816 items which are not on the negative list. We propose an industry/firm level investigation to assess their preparedness for these 284 products because they face a possible removal from the negative list if India is awarded the MFN status. We also suggest the government should review possible protection for the 816 items that are not on the negative list.

RESULTS

A. VULNERABLE INDUSTRIES

Table 1 lists the products falling into the two categories classified as vulnerable industries and explained above. These products have been taken at the HS2 level.

TABLE 1: VULNERABLE INDUSTRIES

From Disadvantage to Advantage		From Advantage to Disadvantage	
Code	**Name**	**Code**	**Name**
19	Cereal, flour, starch, milk preparations and products	54	Man-made filaments
20	Vegetable, fruit, nut, etc food preparations	56	Wadding, felt, nonwovens, yarns, twine, cordage, etc
24	Tobacco and manufactured tobacco substitutes	60	Knitted or crocheted fabric
28	Inorganic chemicals, precious metal compound, isotope	64	Footwear, gaiters and the like, parts thereof
30	Pharmaceutical products	96	Miscellaneous manufactured articles
32	Tanning, dyeing extracts, tannins, derivs, pigments etc		
37	Photographic or cinematographic goods		
39	Plastics and articles thereof		
48	Paper & paperboard, articles of pulp, paper and board		
71	Pearls, precious stones, metals, coins, etc		
73	Articles of iron or steel		
74	Copper and articles thereof		
82	Tools, implements, cutlery, etc of base metal		

The *disadvantage to advantage* category includes products that have shown improvement over the years but have not yet achieved global competitiveness. RCA for these sectors have shown an upward movement since 2003 (Figure 1). The list has products such as Precious Stones and Fruits which are amongst Pakistan’s major exports to China and India respectively. Product lines such as Pharmaceutical, Plastics, Paper, Tools and Cutlery, Tobacco etc. which are listed above have also been highlighted by some other studies as sectors having potential to strengthen Pakistan’s deteriorating Balance of Payments.

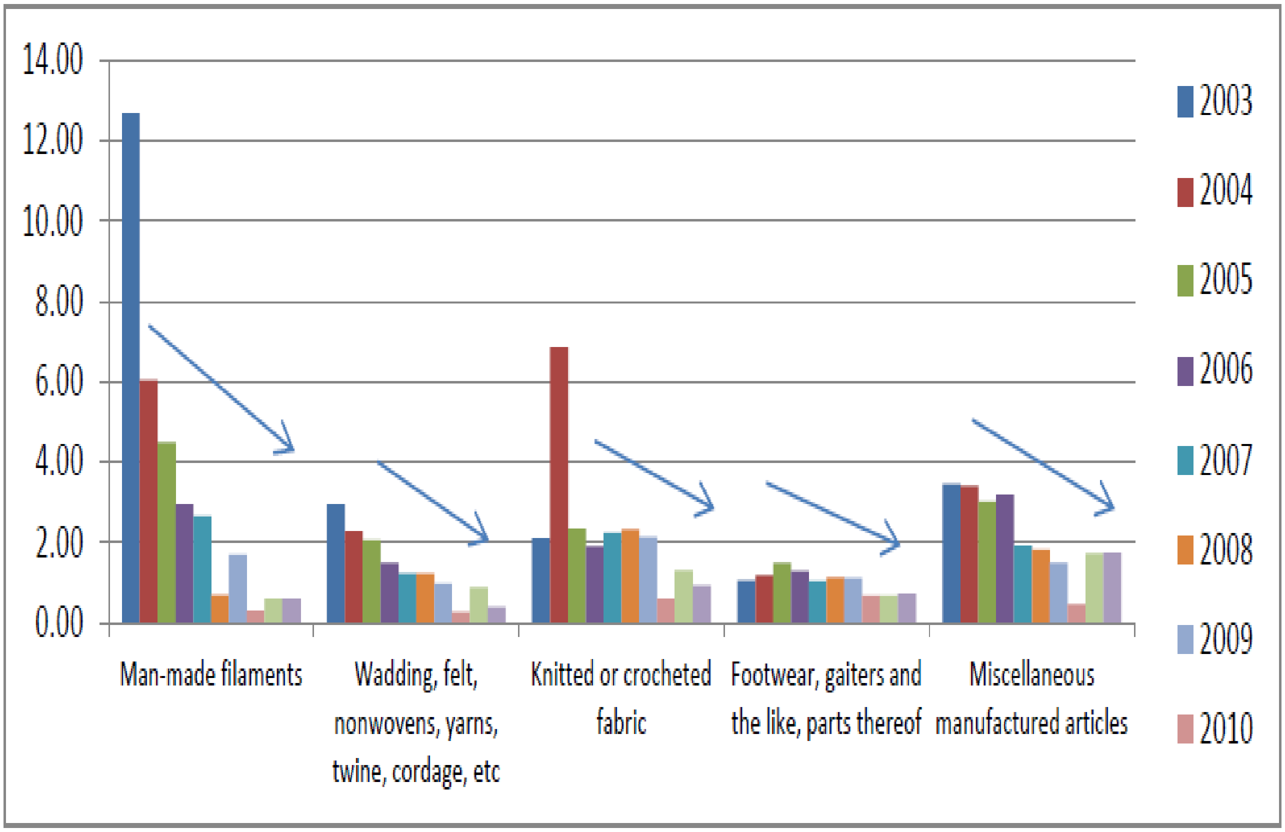

FIGURE 1: RCA FOR *ADVANTAGE TO DISADVANTAGE* INDUSTRIES

The product lines in the *advantage to disadvantage* category are the most vulnerable as these products had the comparative advantage in the global market but lost it over the course of time (Figure 2). For example, the RCA value for man-made filaments dropped from 12.6 in 2003 to 0.59 in 2012. Similar deterioration is observed in the competitiveness of other products in this group. The causes of the decline in RCAs can be numerous. A micro level study of each industry is required to identify factors for fall in output and exports.

Paper and paperboard

The prospects for paper and paperboard businesses in Pakistan are sound in theory, however due to comparatively higher local costs of production, this industry is unable to retain global competiveness despite some growth in exports. Local producers are operating at a capacity of 48% on an average in very high capital intensive set ups, whilst fuel costs which are 40% of variable costs continue to escalate .Currently Pakistan is ranked 84th in the export of paper and paperboard products while India and China are ranked 35th and 3rd respectively. Domestic supply of paper and paperboard caters to around 59% of the total domestic demand. Legal import is limited and expensive, given import tariffs of 25% and a contestable anti-dumping duty of 20% on imports from Korea, Indonesia, China and Taiwan. Huge quantity of paper and paperboard is illegally imported from Afghanistan and other border countries to meet domestic demand. Given strong demand conditions and excess spare capacity, should policy makers intervene to correct low domestic production?

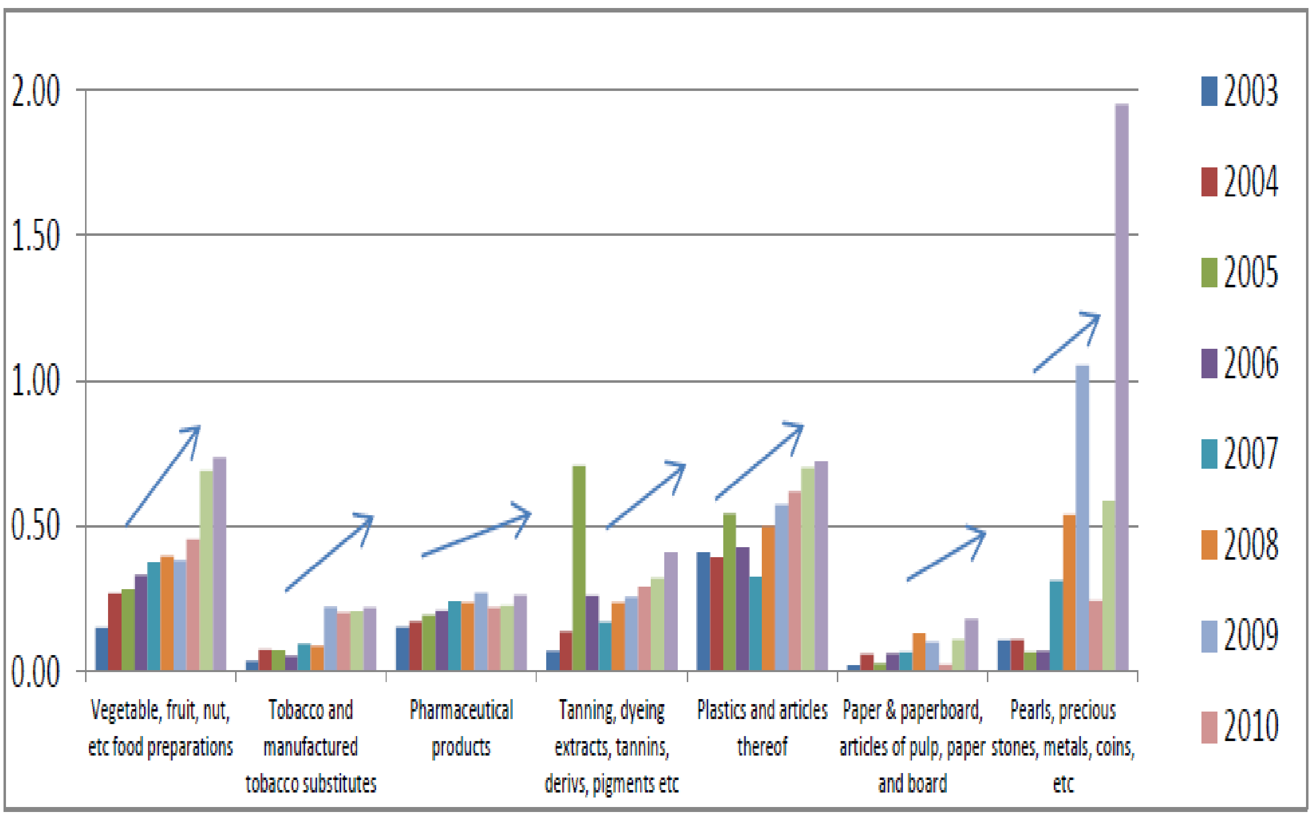

FIGURE 2: RCA FOR SELECTED *DISADVANTAGE TO ADVANTAGE* INDUSTRIES

However, in order to understand the RCA trend, it is important to delve into a more sophisticated analysis to identify multiple factors such as trade policies, natural calamities, and resource constraints etc. which impact the export share of a particular product in the global trade market.

Waiting For the Other Shoe to Drop?

Footwear manufacturers already face tough competition from China, which occupies an astounding 29% of the world export basket. If India is granted an MFN status, the footwear industry in Pakistan may struggle to compete against low cost and large scale manufacturers in India who drive their advantage from low cost but highly skilled labor. Pakistan ranks 50th in exports of footwear whilst India ranks 12th in the world. Pakistani footwear may not be able to compete against Indian products if it is removed from the negative list due to higher production costs, higher energy costs, lack of skilled labor and outdated production methods. Footwear industry in Pakistan has become less competitive in the last ten years despite a resource advantage. Should we formulate policy to nurture footwear manufacturers so that their natural advantage is regained?

B. Inefficient Trade

The study finds that there are 12 products for which India has greater comparative advantage than China, and therefore, according to the theory of comparative advantage importing these products from India rather than China is more beneficial for Pakistan. The list is given in Table 2. Trade data shows that Pakistan imports a major proportion of these products from China. Moreover, the share of Chinese exports for these products, like many others, has increased significantly over the last few years. In 2012, the share of these twelve products was one fourth of the total imports from China. The large share of these imports from China signifies the need to address the inefficiency.

TABLE 2: INDUSTRIES WHICH SHOW PRESENCE OF INEFFICIENT TRADE IN IMPORTS

S.No.	Name
1.	Miscellaneous edible preparations
2.	Organic chemicals
3.	Tanning, dyeing extracts, tannins, derivs ,pigments et
4.	Essential oils, perfumes, cosmetics, toileteries
5.	Soaps, lubricants, waxes, candles, modelling pastes
6.	Miscellaneous chemical products
7.	Silk
8.	Vegetable textile fibres nes, paper yarn, woven fabric
9.	Man-made filaments
10.	Stone, plaster, cement, asbestos, mica, etc articles
11.	Iron and steel
12.	Vehicles other than railway, tramway

Four products have been identified which Pakistan can export to both India and China. Given that, for these products India is at a greater comparative disadvantage than China, Pakistan should export these products to India. However, a comparison of Chinese and Indian shares in Pakistan's exports shows that exports to China for these are more than exports to India. It is suggested that exporting these products to India rather than China is more lucrative for Pakistan as the potential to grow is greater in Indian market. The list of these items is given in Table 3.

TABLE 3: INDUSTRIES WHICH SHOW PRESENCE OF INEFFICIENT TRADE IN EXPORTS

S.No	Code	Name
1.	42	Articles of leather, animal gut, harness, travel goods
2.	61	Articles of apparel, accessories, knit or crochet
3.	62	Articles of apparel, accessories, not knit or crochet
4.	63	Other made textile articles, sets, worn clothing etc

CONCLUSION

Our analysis provides a list of products which require immediate facilitation to attain or sustain global competiveness. This list comprises of Pakistani industries which have shown some improvement but are struggling to achieve global competitiveness along with those which have lost their competitiveness in recent years. The study suggests that these industries have the potential to grow and hence strengthen the deteriorating trade balance of the country. It is proposed that these items should be protected from additional competition when trade with India is liberalized. Further research to investigate the reasons for vulnerability of these industries and the extent to which they should be protected is recommended. If such investigation concludes that Pakistan’s trade agreements with its partners have been significant in reducing competitiveness of the industries identified in this study, protectionism for these industries albeit limited becomes admissible for review. This prescription would also be subject to assessing the impact of increased production in these industries, on markets and welfare.