

THE CHINA-PAKISTAN ECONOMIC CORRIDOR AND THE GROWTH OF TRADE

Table of Contents

1. Introduction	2
2. Pakistan's Trade Performance	2
3. China-Pakistan Trade	7
4. Effects of Import Competition on Pakistan's Exports.....	12
5. Anecdotal Feedback from Private Sector and Government Stakeholders.....	16
5.1 What products is Pakistan likely to export to China?	17
5.2 Chinese Perspectives on Doing Business in Pakistan	18
5.3 Pakistani Perspectives on Doing Business with China	22
6. Conclusions and policy recommendations	25

List of figures

Figure 1. Pakistan's Trade is Well Below Potential.....	3
Figure 2. Corruption and the tax regime are viewed as significant constraints to private firms	5
Figure 3. Pakistan rates poorly on global competitiveness (out of 137 countries).....	5
Figure 4. The RCA of Pakistan's exports changed only marginally from 2005 to 2016	6
Figure 5. Bilateral merchandise trade – China Pakistan (2003-2018).....	7
Figure 6. China's exports complement Pakistan's imports much more than Pakistan's exports complement China's imports	8
Figure 7. Pakistan exports textiles to China and purchases machinery, 2017	8
Figure 8. Pakistan's imports of services from China have expanded sharply	9
Figure 9. China's concessions to Pakistan in the CPFTA-1 were limited in sectors of key importance to Pakistan.....	10
Figure 10. 72 percent of Pakistan's exports were accorded only partial or no liberalization under the CPFTA-1	11
Figure 11. Pakistan's export performance declined in sectors hit by competition from China's imports, 2005-16.....	14
Figure 12. Several Pakistani sectors benefited from increased inputs from China	16

List of tables

Table 1. Ease of Doing Business 2019	4
Table 2. Tariff preferences in CPFTA-1 for major Pakistani exports to China.....	12

List of boxes

Box 1. Gwadar Port Faces Real Limitations.....	21
Box 2. Can Internet Connectivity Be Leveraged?	23

1. Introduction

This note explores Pakistan’s opportunities to benefit from increased trade with China in the context of the China Pakistan Economic Corridor (CPEC). The analysis takes into account the effect of the China Pakistan Free Trade Agreement (CPFTA-1), first signed in 2007, and the amended version of the agreement (CPFTA-2) that was negotiated and concluded in April 2019. While China-Pakistan bilateral trade flows have increased dramatically over the last 15 years, there is potential for further benefits to Pakistan in terms of increased demand for Pakistani exports and increased supplies of inputs that can improve efficiency and reduce the costs to Pakistani firms. This study provides recommendations for maximizing trade benefits under CPEC, particularly through policy improvements that increase the feasibility/profitability of private and public investments.

CPEC has made progress in improving connectivity between the two countries. The development of roads and ports has played a major role in CPEC’s making more rapid progress than any of the other six corridors envisioned under China’s Belt and Roads (BRI) initiative.¹ Investment in trade infrastructure, including improvements in customs linkages, is vital to promote regional trade.² But improved physical infrastructure may not result in substantial gains unless there are corresponding improvements in Pakistan’s business climate, customs and regulatory regimes, and market access framework with China.³ If Pakistan is to garner the full benefits of increased connectivity, it must ensure that the complementary policies—in particular, improvements in the overall business climate, trade policy, and trade facilitation—are in place.

This note is structured as follows. Chapter 2 provides an overview of Pakistan’s external trade performance, Chapter 3 discusses trade flows between Pakistan and China, and Chapter 4 analyzes the impact of growing China-Pakistan trade relations on Pakistan’s global trade competitiveness. Chapter 5 presents the results of interviews with business representatives and government officials from Pakistan and China on investment and trade. A final chapter provides policy recommendations.

2. Pakistan’s Trade Performance

Pakistan’s exports of goods and services fell as a percentage of GDP from 13.5 percent in 2010 to 8.5 percent in 2018. Pakistan has considerable scope to increase its exports.⁴ A gravity model analysis, taking into account the country’s size, income level, geographic location, and historical ties, estimates that Pakistan’s potential exports exceed the actual level of exports by a

¹ See “The Economic Benefits of the Modern Silk Road: The China Pakistan Economic Corridor.” Pakistan-China Institute and the Association of Chartered Certified Accountants, 2017.

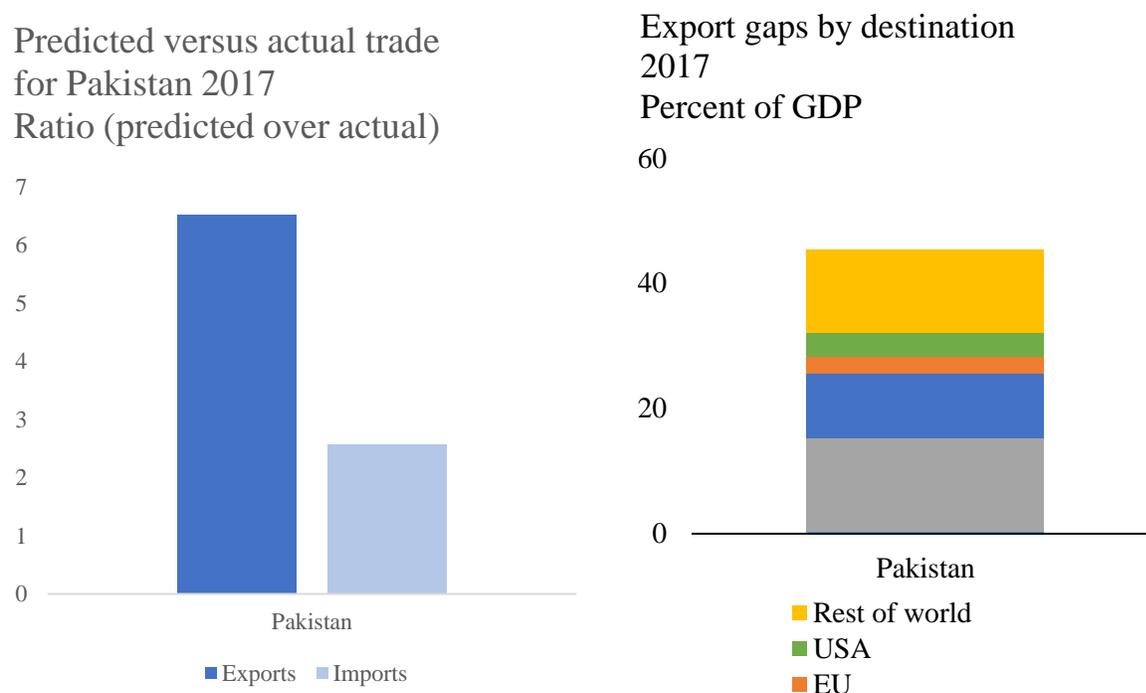
² See Samad, G., and Ahmed, V. (2014) “Trade Facilitation through Economic Corridors in South Asia: The Pakistan Perspective.” ADM, Developing Economic Corridors in South Asia, Chapter 7. Ahmed and Shabbir also highlight the need to improve transit and commercial trade between Afghanistan and Pakistan: Ahmed, V., and Shabbir, S. (2016) “Trade & Transit Cooperation with Afghanistan: Results from a Firm-Level Survey from Pakistan” Sustainable Development Policy Institute, Working Paper No. 153.

³ See Rafiq, A (2015). “The China-Pakistan Economic Corridor: Barriers and Impact.” United States Institute of Peace.

⁴ This analysis is based on a gravity model of trade that takes into account distance to trading partners, common borders, common language, colonial ties, regional trade agreements, and GDP. See *South Asia Economic Focus*, Spring 2019.

factor of 6 to 1, and its potential imports exceed actual imports by a factor of 2 to 1 (Figure 1). As Figure 1 shows, the estimated difference between Pakistan’s potential and actual level of exports is largest for trade with India (15 percent of GDP) and China (10 percent).⁵

Figure 1. Pakistan's Trade is Well Below Potential



Source: South Asia Economic Focus, Spring 2019.

Note: Results based on a cross-country gravity equation that uses distance, common border, common language, colonial ties, regional trade agreements, and GDP to predict the potential level of exports.

Low exports reflect the anti-export bias of Pakistan’s overall protectionist trade policy framework and its poor business climate. The fact that potential exports significantly exceed actual exports across several export destinations suggests that the main driver of low exports is supply constraints, rather than barriers imposed by trading partners. And the fact that Pakistan’s imports are also below potential may reflect Pakistan’s overall protectionist policy stance, which limits participation in global value chains and thus opportunities for growth and specialization. In addition, high import duties incentivize firms to sell domestically, rather than in export markets, hence the anti-export bias they introduce.

Critical problems include inadequate infrastructure, inefficient transportation and logistics services, high tariff and non-tariff barriers, and the significant costs that government administrative requirements impose on production and trade. In the 2019 Ease of Doing

⁵ See also Ahmed V., Batool S. (2017) India–Pakistan Trade: Perspectives from the Automobile Sector in Pakistan. In: Taneja N., Dayal I. (eds) India-Pakistan Trade Normalisation. Springer, Singapore. Ahmed V., Batool S. (2017) India–Pakistan Trade: A Case Study of the Pharmaceutical Sector. In: Taneja N., Dayal I. (eds) India-Pakistan Trade Normalisation. Springer, Singapore. Manzoor et al. (2017) Health Services Trade between India and Pakistan. The Pakistan Journal of Social Issues Volume VIII (2017).

Business Report, despite some improvement from 2018, Pakistan is ranked 136th out of 190 countries (Table 1). Securing an electrical connection can take up to a year (even after making informal payments).⁶ Registering individual or business property requires dealing with a dozen offices involved in validating the status of land. Tax administration—an area in which Pakistan ranks 173rd—is viewed as particularly burdensome. Inadequate trade facilitation and high trade costs have discouraged exporters, while also raising the prices and reducing the availability of imports (trade facilitation and other connectivity issues are discussed in Chapter 4).⁷

Table 1. Ease of Doing Business 2019

Selected indicators	Rank out of 190 countries
Ease of doing business	136
Starting a business	130
Dealing with construction permits	166
Getting electricity	167
Registering property	161
Getting credit	112
Paying taxes	173
Trading across borders	142
Enforcing contracts	156
Resolving insolvency	53

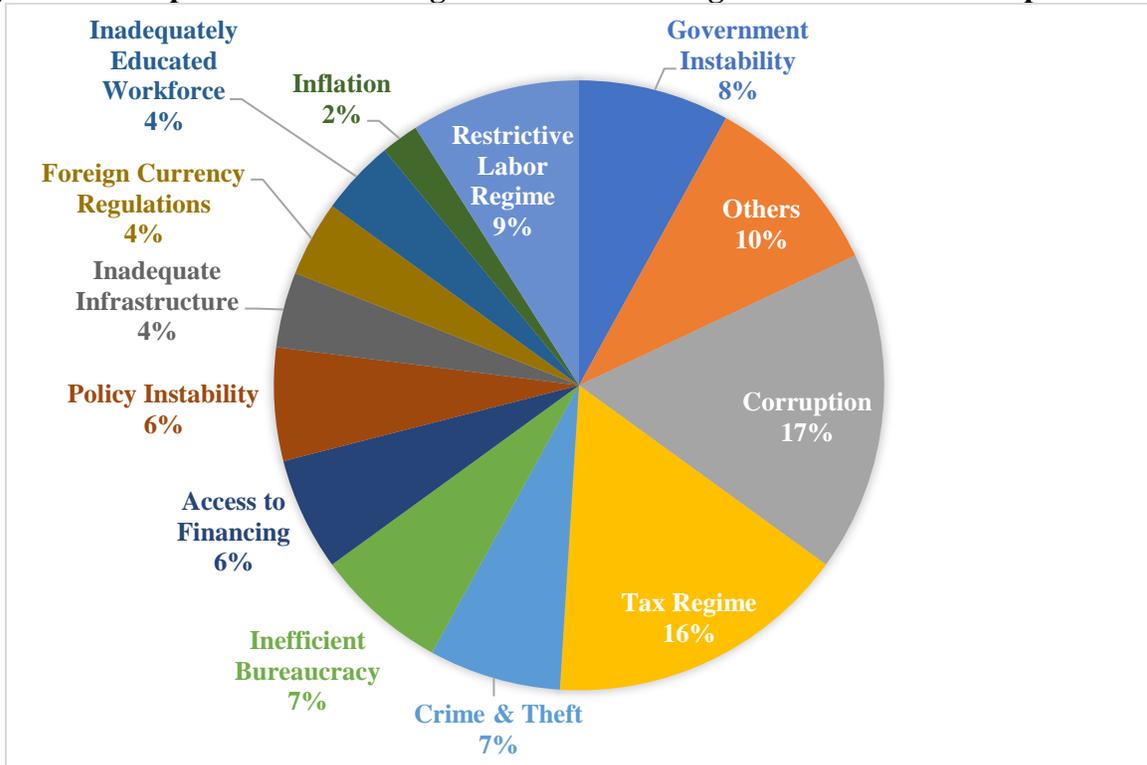
Source: <http://www.doingbusiness.org>

The World Competitiveness Report 2017-18 ranked Pakistan 115th out of 137 countries because of structural impediments such as corruption, taxation, political instability, a restrictive labor regime, and lack of skilled labor. Difficulties in accessing finance, inadequate infrastructure, inefficient bureaucracy, and complex foreign currency regulations also were highlighted as hindering business (Figure 2). The global competitiveness ranking points out that major issues of weak administration are directly under the control of the government—for example, the numerous approvals required to start a business, the prevalence of corruption, and high tariff and non-tariff barriers to trade—as are areas that will require significant investment, such as infrastructure and the education/training system (Figure 3). Many of the constraints to trade particularly affect small- and medium-sized businesses, which lack the resources to devote additional staff to complying with government requirements, and often lack the connections to resolve these kinds of problems quickly.

⁶ Vaqar, Dr & Adnan, Muhammad & Mohsin Ali, Syed. (2014). Energy and Tax Reforms, Firm-level Analysis from Pakistan. 10.13140/2.1.4411.6803.

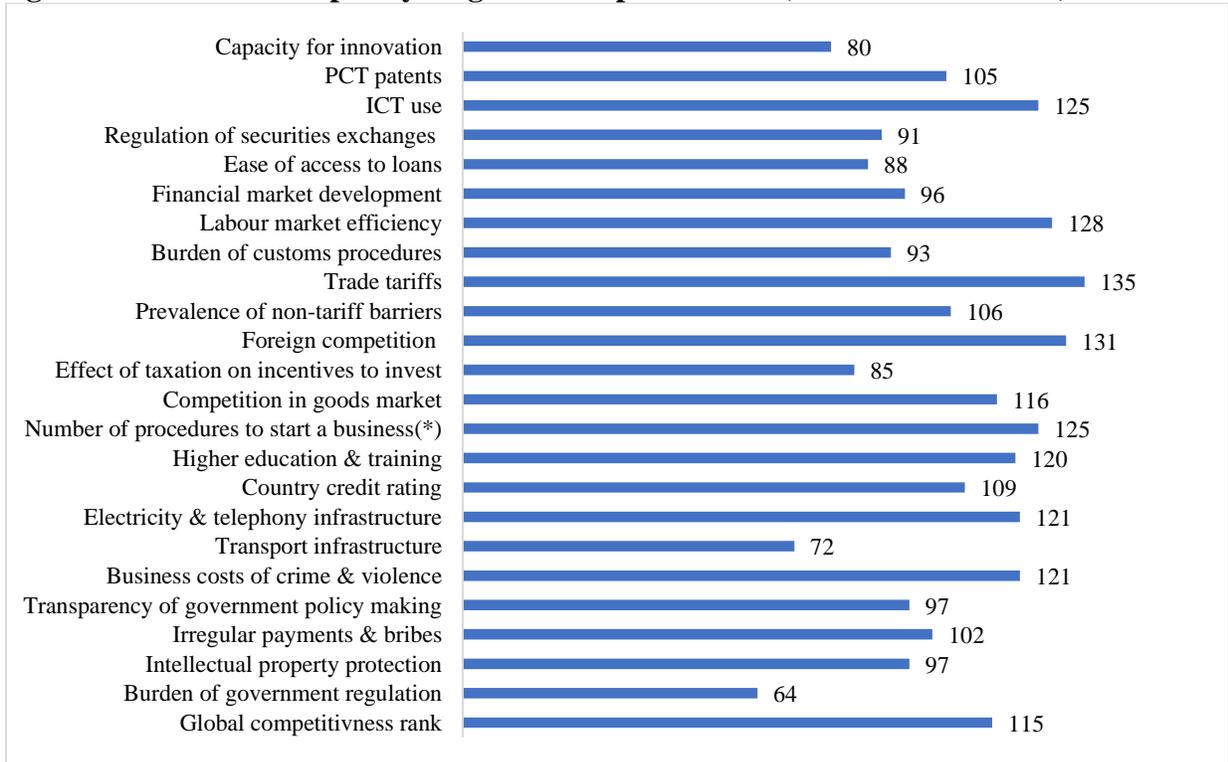
⁷ These issues have been found to impact small firms and exporters more acutely. See Ahmed, V., Suleri, A. Q., & Javed, A. (2015). Strengthening South Asia Value Chain: Prospects and Challenges. South Asia Economic Journal, 16(2_suppl), 55S-74S. <https://doi.org/10.1177/1391561415594900>.

Figure 2. Corruption and the tax regime are viewed as significant constraints to private firms



Source: World Competitiveness Report 2017-18.

Figure 3. Pakistan rates poorly on global competitiveness (out of 137 countries)



Source: World Competitiveness Report 2017-18.

Pakistan’s high tariffs impair potential exporters’ ability to compete with firms from countries with lower tariff regimes. While the Government has attempted to compensate exporters for the cost of tariffs by providing tax exemptions on inputs to export production, procedures to access these exemptions are opaque and complex. Trade costs and delays at the border make it extremely difficult for firms to participate in global value chains, which are an important potential source of demand and technological improvements. Moreover, the high tariffs on final goods incentivize firms to orient their sales in domestic markets, where profit margins are higher due to the duties. This tariff structure creates a perverse incentive whereby Pakistani firms that are successful in the local market in selling goods with high import content are not capable of competing internationally.

The sectoral composition of Pakistan’s exports changed little from 2005 to 2016. The ranking of industries in terms of their revealed comparative advantage (RCA)—showing patterns of specialization—has been stable over this period, with a 91.7 percent correlation between the ranking of industries by their RCA in 2005 and in 2016. Sectors with RCAs in 2005—for example, textiles and apparel activities and agribusiness—had roughly a similar level of RCA in 2016. Sectors with substantial changes were more likely to show a decline than an increase (dots below the 45-degree line in Figure 4 indicate a fall in the RCA over the period).

Figure 4. The RCA of Pakistan’s exports changed only marginally from 2005 to 2016



Source: World Bank analysis based on UN-COMTRADE data

3. China-Pakistan Trade

While the United States continues to be Pakistan’s largest export destination, China has been the country’s most dynamic growth market over the last decade. Trade between China and Pakistan expanded by 41 percent per year from 2003 to 2007, and by 11 percent per year from 2007 to 2018, rising from US\$1.2 billion in 2003 to US\$16.2 billion in 2018. after the enactment of the China-Pakistan FTA. The increase in trade between the two countries is both the result of increased trade preferences between the two countries, as well as of improved connectivity – both planned and realized, in the context of CPEC.

But China’s exports to Pakistan have increased more rapidly than Pakistan’s exports to China. China’s exports to Pakistan increased by 19.8 percent per year. Pakistan’s exports to China also rose rapidly, but at the more modest pace of 13.6 percent per year. By 2018 Pakistan’s exports to China equaled about US\$1.75 billion, while China’s exports to Pakistan reached US\$14 billion (see Figure 5).

Figure 5. Bilateral merchandise trade – China Pakistan (2003-2018)



Source: World Bank, based on UN Comtrade.

These differences in bilateral export growth mostly reflect characteristics that are intrinsic to the two countries, rather than anything specific to their relationship. Most importantly, China’s exports to the world increased dramatically from 2003 to 2018, while Pakistan’s exports grew only modestly. In addition, in terms of complementarities, some evidence suggests that the structure of China’s export supply is a better match for Pakistani import demand than the other way around, as demonstrated by the trade complementarity index (Figure 6).⁸ Thus, the reduction in trade barriers between the two countries may have had a larger impact on demand for China’s

⁸ The trade complementarity index shows how well the structure of a country’s imports matches another country’s exports. The index can provide useful information on the prospects for trade between countries entering into an agreement to lower trade barriers. Trade complementarity between countries k and j is defined as $TC_{ij} = 100(1 - \sum(|m_{ik} - x_{ij}| / 2))$ where x_{ij} is the share of good i in global exports of country j and m_{ik} is the share of good i in all imports of country k . The index is zero when no goods are exported by one country or imported by the other and 100 when the export and import shares exactly match.

exports than for Pakistan’s exports.⁹ Pakistan’s exports to China are concentrated in textiles, vegetables, and food production, while Pakistan’s imports from China are mainly of machinery, chemicals, and metals (Figure 7).

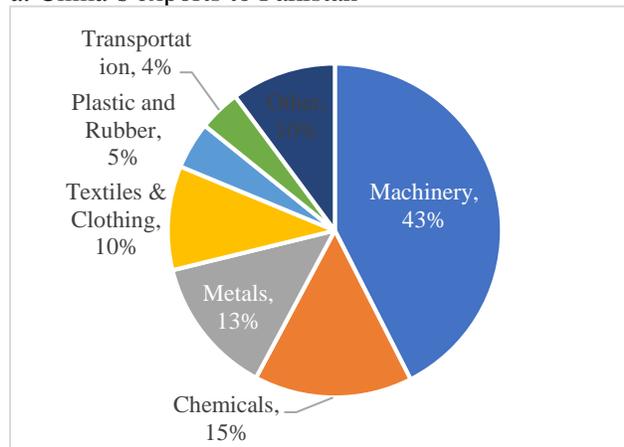
Figure 6. China’s exports complement Pakistan’s imports much more than Pakistan’s exports complement China’s imports



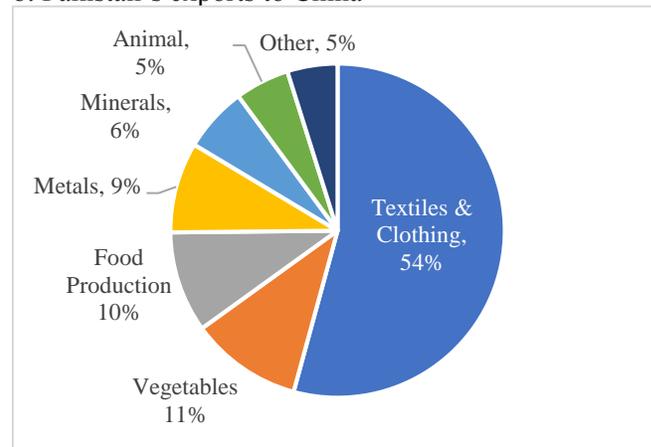
Source: WITS – UNSD Comtrade, World Development Indicators.

Figure 7. Pakistan exports textiles to China and purchases machinery, 2017

a. China’s exports to Pakistan



b. Pakistan’s exports to China



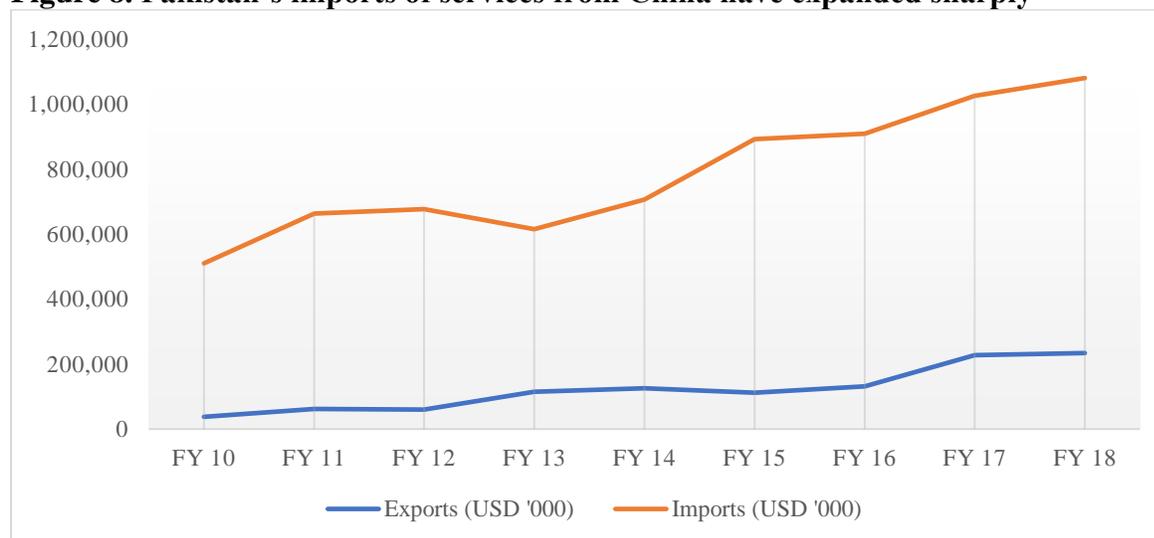
Source: World Bank, based on UN Comtrade.

The rise in Pakistan’s services exports to China in recent years is less than the increase in its imports of services from China. Pakistan’s services exports to China rose from US\$62 million in 2010 to US\$234 million in 2018, or by significantly less than the US\$570 million rise in Pakistan’s imports of services from China (Figure 8). Pakistan’s export of services to China

⁹ This indicator assumes that trade is inter-industry. In a world of global value chains, with intra-industry trade, lack of trade complementarity does not mean lack of trade opportunities.

remained largely confined to general “business services” and “government services,” although Information and communication technology (ICT), financial, and transport services had a small share. While China is also exporting these services to Pakistan, its construction services exports have increased sharply. The relatively slow growth of Pakistan’s services exports reflects in part the lack of Government assistance in identifying export opportunities for Pakistani firms, and the lack of an agreement between the two countries to eliminate double taxation.

Figure 8. Pakistan’s imports of services from China have expanded sharply



Source: State Bank of Pakistan.

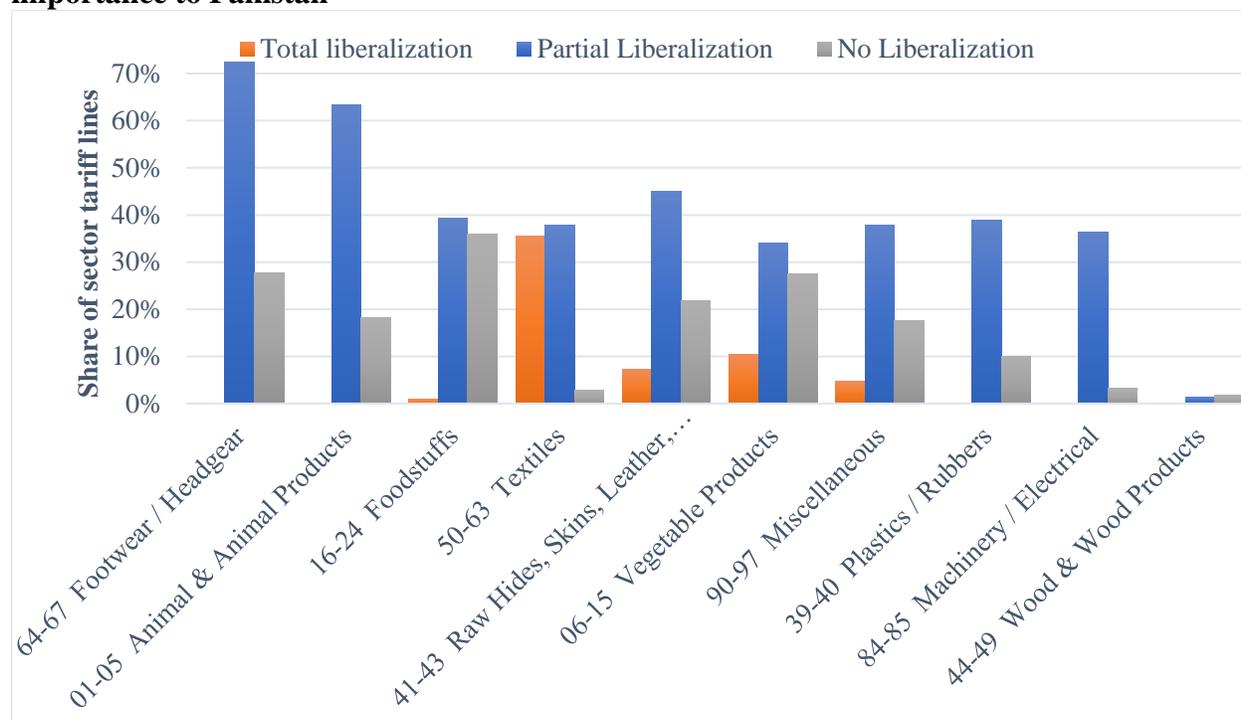
Note: FY18 imports are for the months July-May.

CPFTA-1, which came into effect in 2007, did not fundamentally alter the growth pattern of China-Pakistan trade flows. China’s exports to Pakistan before CPFTA-1 – from 2003 to 2007 – grew by 44.9 percent, while after CPFTA-1 – 2008 to 2018 - they grew by 11.9 percent. Similarly, Pakistan’s exports to China grew by 25.1 percent before CPFTA-1 and by 10.2 percent after its implementation. The size of these growth rates is likely due to the low levels of trade between the two countries before CPFTA-1.

The limited impact of CPFTA-1 on Pakistan’s exports to China is due, at least in part, to the fact that China made only limited tariff concessions in sectors in which Pakistan has most potential, including agriculture, textiles, and footwear (Figure 9). Tariff concessions accounted for less than 5 percent of the increase in exports from Pakistan to China following 2007. In cotton yarn, for example, the preferential tariff levied on exports from Pakistan to China is 4.2 percent, or only 0.8 percentage points lower than the Most Favored Nation (MFN) rate of 5 percent. In rice, which is another large export product for Pakistan, the tariff rate is 65 percent, equal to the MFN rate. Thus, more than half of Pakistan’s exports to China face a preferential tariff rate that is less than one percentage point lower than the MFN rate (Table 2). Looking across sectors, only 30 per cent of tariffs under the CPFTA-1 were fully liberalized (Figure 10). Moreover, the 2010 free trade agreement between China and ASEAN countries lowered 93 percent of tariff lines to zero. This further reduced the relative preferences Pakistani exporters enjoyed in Chinese markets, leading to a decline in the growth of Pakistan’s exports in key sectors, particularly textiles and clothing. Reductions in preferential tariffs for high-potential

products in sectors such as textiles, rice, vegetables, and raw hides and skins could increase Pakistan’s exports to China in the short run.

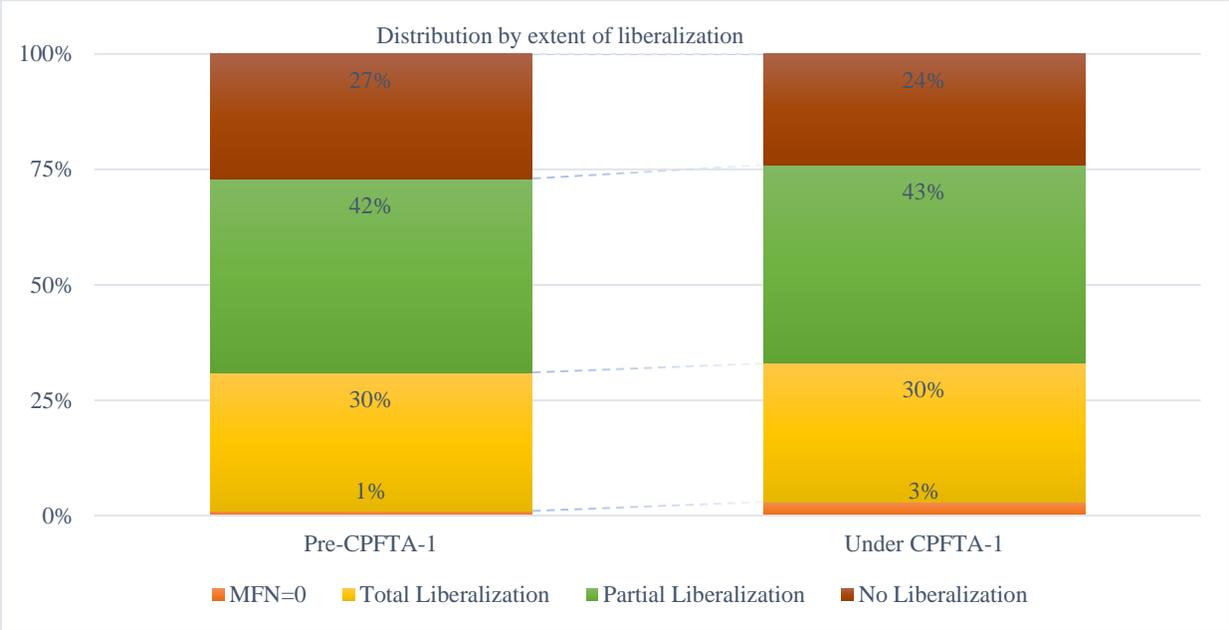
Figure 9. China’s concessions to Pakistan in the CPFTA-1 were limited in sectors of key importance to Pakistan



Source: ITC-World Bank dataset on preferential margins and preferential trade.¹⁰

¹⁰ Espitia, A., A. Mattoo, M. Mimouni, X. Pichot, and N. Rocha (2018) How Preferential is Preferential Trade, May 2018, World Bank Policy Research Working Paper No. 8446.

Figure 10. 72 percent of Pakistan’s exports were accorded only partial or no liberalization under the CPFTA-1



Source: ITC-World Bank dataset on preferential margins and preferential trade

Table 2. Tariff preferences in CPFTA-1 for major Pakistani exports to China

Key Pakistani exports (cotton yarn, rice, leather, and fresh and dried nuts) receive zero or partial concessions under CPFTA-1

Preferential and MFN tariffs for top export products to China - 2018

HS4	Description	Exports 2018 (thousands)	Share (%)	MFN Rate Simple Average	Preferential Tariff
5205	Cotton yarn, with >=85% cotton, not put up for retail sale	753,650	42.9%	5.0%	4.2%
1006	Semi-milled/wholly milled rice	161,302	9.2%	65.0%	65.0%
5209	Woven fabrics of cotton, with >=85% cotton, >=200g/m2	58,724	3.3%	10.4%	0.0%
7402	Unrefined copper/copper anodes for electrolysis refining	2,899	0.2%	2.0%	0.0%
2610	Chromium ores and concentrates	59,801	3.4%	0.0%	0.0%
4107	Leather of other animals, without hair on	17,579	1.0%	5.8%	3.3%
2515	Marble, travertine, and other calcareous monumental or building stone	21,256	1.2%	3.7%	0.0%
5208	Woven fabrics of cotton, containing 85% or more by weight of cotton, weighing not more than 200g/m2	44,800	2.6%	10.1%	0.0%
0802	Other nuts, fresh or dried	34,553		18.6%	16.9%
0306	Crustaceans, fresh, chilled, or frozen	25,842	1.5%	9.6%	6.2%
Total Trade		1,180,406			

Source: ITC-World Bank dataset on preferential margins and preferential trade (Espitio et al, 2018, *Data for 'Other nuts, fresh or dried' (0802) are reported for 2016, last available

The agreement of CPFTA-2 in April 2019 is expected to lead to some increase in Pakistan's exports. The amended agreement is expected to have significant implications for trade between the two countries.¹¹ China is expected to extend duty-free access to an additional 313 tariff lines, which will enable many of Pakistan's major export products—including textiles, leather, sports and surgical equipment, rice, and sugar—to compete on the same terms as ASEAN products. This is expected to boost exports to China. China also will allow an additional US\$1 billion of potatoes, onions, wheat, and cherries to enter the country under the quota, in addition to the US\$1 billion allowed under the initial CPFTA-1 agreement. This is not expected to have any immediate impact for Pakistan, since Pakistan does not fill the existing quota (Pakistan's total exports of these products to the world equal only US\$216 million). In turn, Pakistan is reducing tariffs on China's exports of yarn, which currently face the MFN rate of 5 percent in Pakistan. This provision is expected to reduce production costs for Pakistani apparel producers, but also to reduce profit margins for Pakistani yarn producers. However, CPFTA-2 continues to not cover services trade, a major weakness of the initial agreement which could benefit Pakistan.

4. Effects of Import Competition on Pakistan's Exports

¹¹ This paragraph is based on a press release on the agreement and World Bank analysis. All information on the extent of tariff concessions should be viewed with caution, since there has been no official statement on the provisions

Given the current emphasis on China-Pakistan integration and its potential for the future, a key question is how China-Pakistan trade ties are affecting Pakistan's export competitiveness. For other BRI investments, a World Bank study found a strong correlation between an increase in China's investments and an improvement in export performance. BRI investments increased trade flows between China and the recipient country by up to 4.1 percent, and states that complemented investments with trade reforms benefitted nearly three times as much as those that did not implement reforms.¹²

Increased regional integration (with China) can affect competitiveness through three channels. First, integration increases competition at home, which induces firms to increase efficiency and induces a better reallocation of resources: sectors that cannot match the efficiency of the competitor shrink, releasing resources (labor and capital) to other sectors that can successfully compete. Second, integration with China may boost Pakistan's export competitiveness with the world in some sectors if firms use Chinese markets as a platform for learning, leading to an increase in productivity in other markets as well. Third, integration with China may increase the availability of inputs that are more varied, cheaper, or of better quality than previously available, increasing the competitiveness of Pakistani firms that use those inputs. We examined these three channels in turn.

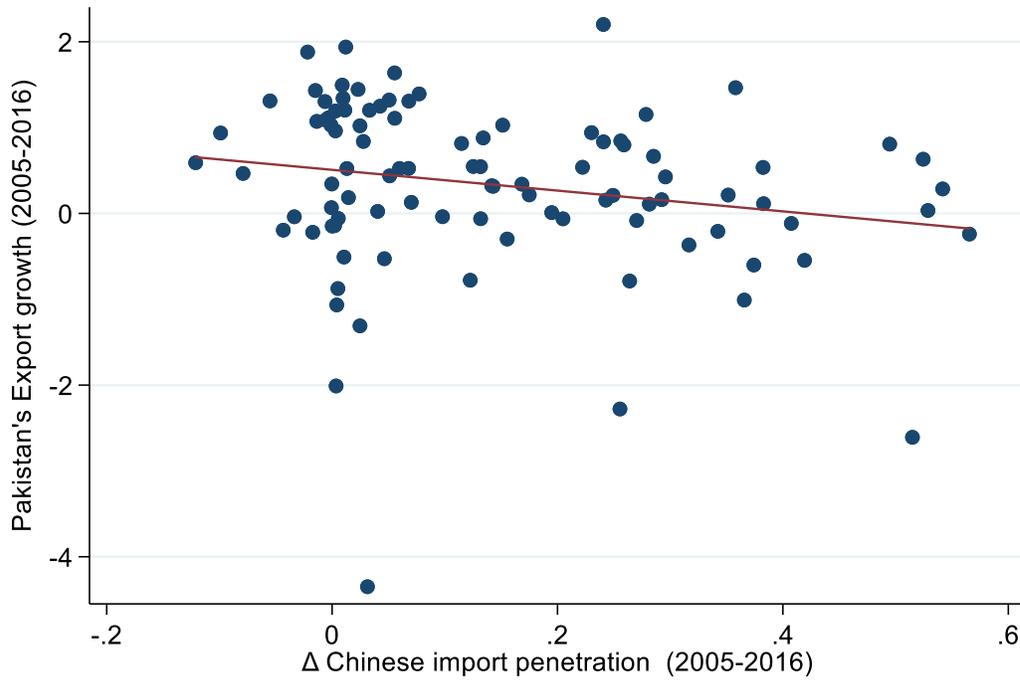
Channel 1: Increased competition. Some Pakistani sectors that faced strong import competition from China decreased their export competitiveness. The export growth, global market share, and RCA of Pakistani sectors that faced increased import competition from China tended to decline from 2005 to 2016 (see Figure 11).¹³ Regression analysis confirms that increased import penetration from China in a given Pakistani sector over 2005-16 is significantly associated with reductions in that sector's RCA, export growth, and growth of market shares in global markets. While this may seem to be bad news for the shrinking sector, it may be a sign that resources are being reallocated into more efficient activities.

¹² Baniya, S., N. Rocha, and M. Ruta. 2018. "Trade Effects of the New Silk Road: A Gravity Analysis." Policy Research Working Paper 8694, World Bank, Washington, DC.

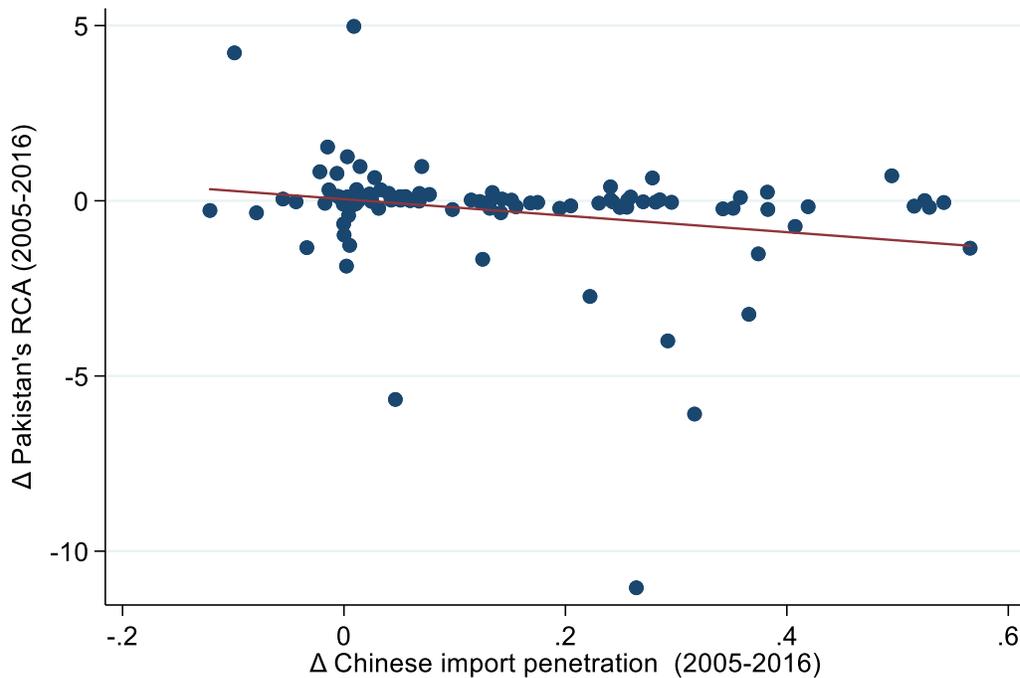
¹³ This analysis is focused on exports because of the lack of adequate data on production.

Figure 11. Pakistan's export performance declined in sectors hit by competition from China's imports, 2005-16

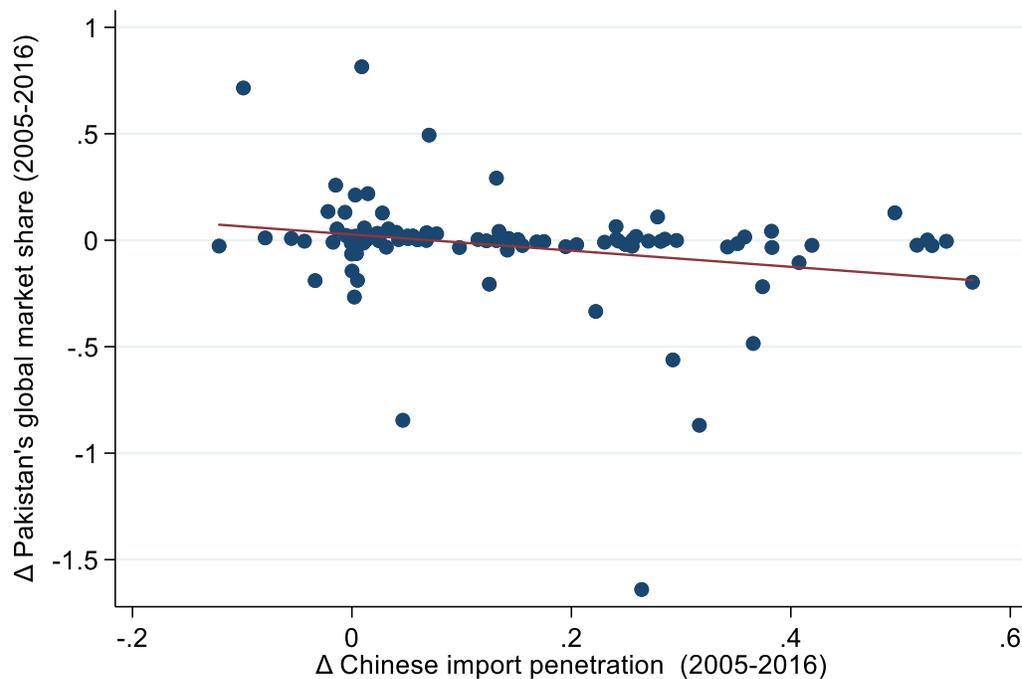
a. Export growth



b. Revealed comparative advantage



c. Global market share



Source: BACI from CEPII.
 Note: HS classification at the 2 digit level.

Source: BACI from CEPII.

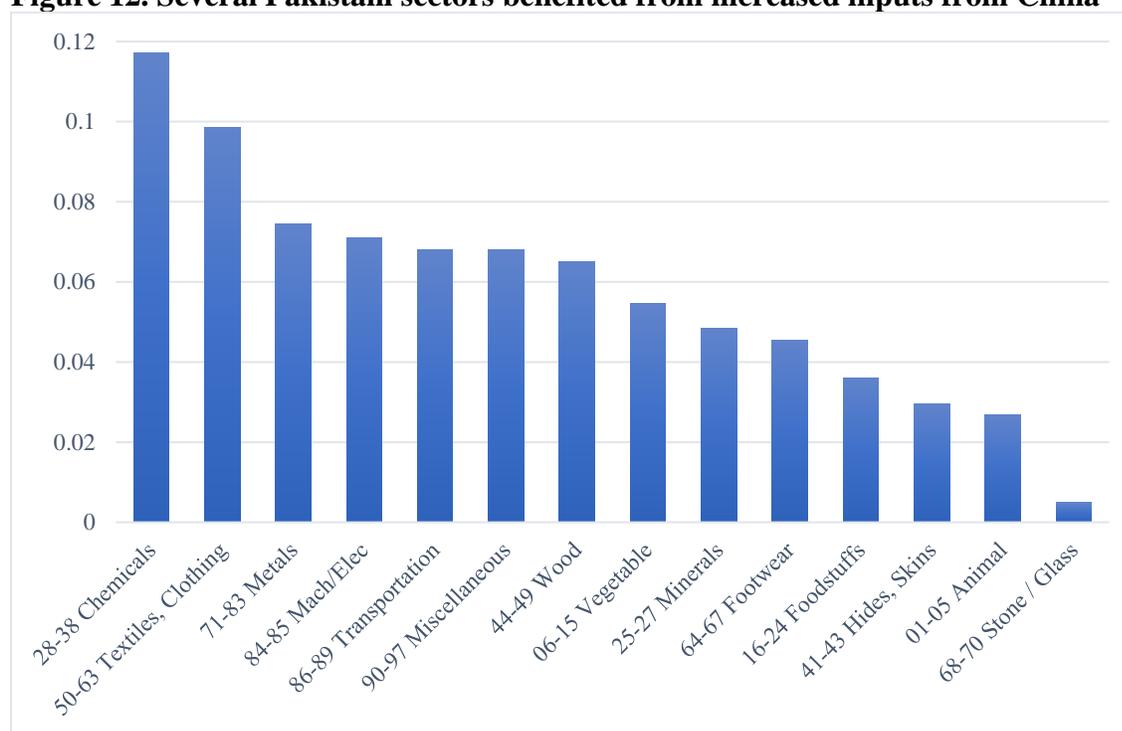
Note: Each dot represents a sector, according to the harmonized system of classification at the 2-digit level.

Channel 2: China as a learning platform for exporters. There is little evidence to suggest that exporting to China helped Pakistan increase exports to other markets. In principle, selling to one export market can help firms learn how to meet standards for quality, consistency, and timeliness that may be higher in foreign than in domestic markets. Thus, learning during the process of exporting can help firms improve the competitiveness of their products. Also, it can be difficult to obtain information on foreign markets, and exposure to foreign buyers can help firms gain contacts that are useful in other markets. However, the evidence on this is mixed. For example, membership in regional trading blocs often does not lead to increases in exports to the global market. It is possible that Pakistan’s exports to China did not lead to export success elsewhere because the types of products Pakistan exports to China are those in which Pakistan already has an established comparative advantage (more than half are textiles and clothing).

Channel 3: Cheaper, more varied, and better intermediates. Pakistani firms that had access to increased inputs from China to produce their exports gained competitiveness with the rest of the world. Anecdotal evidence already points to links between integration and competitiveness. For example, by increasing imports of polyethers from China, Pakistan’s exporters of electric accumulators (batteries) improved their position to export to Afghanistan. This finding is in line with the evidence from other countries that trade can improve firm performance through access to a wider variety of intermediates at better prices, or of better quality. But how generalized were these gains? Regression analysis shows that sectors that experienced an increase in the availability of inputs from China over 2005 to 2016 enjoyed increases in RCA, export growth,

and global market share. A 1 percentage point increase in the share of inputs from China in total purchases of inputs from 2005 to 2016 boosted export growth in that sector by 4.7 percent and the global market share by 1 percentage point. The sectors that experienced the largest increase in inputs due to imports from China included plastic and rubber, chemicals, and textiles and clothing (Figure 12). This channel is particularly important in light of the composition of Pakistan’s imports from China, 85 percent of which were of industrial supplies and machinery, which in principle should have helped domestic firms produce at lower costs; in addition, Pakistan’s agriculture sector has benefited from increased imports of nitrogen, phosphorus, and potassium fertilizers from China.

Figure 12. Several Pakistani sectors benefited from increased inputs from China



Source: Authors’ calculations based on BACI and GTAP I-O Tables for Pakistan.

5. Anecdotal Feedback from Private Sector and Government Stakeholders

This section reports on interviews with representatives of the Pakistani and Chinese business communities. A semi-structured questionnaire was sent in three rounds to a private and public panel of experts, surveying 27 Pakistani business groups and 12 Chinese enterprises that have investment relations with Pakistani private investors. The questionnaires and list of those interviewed in the Pakistani business community are provided in the annex. In addition, the team held in-depth discussions with various government officials in China and Pakistan to understand how the commercial advantages of Gwadar port could be enhanced.¹⁴

¹⁴ The following stakeholders participated in our consultations: CPEC program authorities: Ministry of Planning, Development & Reform; Centre of Excellence on CPEC, provincial focal persons at Planning & Development Departments; China Government departments and agencies: National Development and Reform Commission (the leading ministry), Ministry of Commerce, Ministry of Transport, Ministry of Industry and Information, National Railway Administration; Pakistan Government departments and agencies: Ministry of Communication, Ministry of

5.1 What products is Pakistan likely to export to China?

According to respondents, the product composition of Pakistan’s exports to China is unlikely to change significantly in the short term. This is consistent with the analysis above showing that the kinds of products Pakistan exports have not changed much over time. There was some concern that a slowdown in the Chinese economy would result in a decline in Pakistan’s primary sector exports to that country.

Several sectors were cited as having substantial potential for exports to China:

- (a) Pakistani businesses in textile, leather, surgical and medical equipment, and rice remain upbeat on trade with China, as they expect large demand for these goods in the coming years, particularly in the west China region.
- (b) Chinese investors cited textiles, oil and gas, chemicals, instrument processing, building materials, automobiles and auto parts, and seafood as the main areas of demand from China for Pakistani goods.
- (c) It was suggested that sectors where Pakistani exporters might find market opportunities could be identified by examining the export profiles of peer economies. For example, Bangladesh and India are exporting seafood, vegetable oil, and skins to China. Support in these areas could help Pakistani firms compete with other exporters—for example, in meeting China’s growing demand for seafood.
- (d) The Sialkot business community has plans to manufacture musical instruments for export to China, although they indicated a lack of support for scaling up current initiatives, which are operating at a micro to small scale.
- (e) Finally, the representatives from the Lahore and Sarhad Chambers of Commerce and Industry have seen some expression of demand for Halal food and meat from Chinese importers. However, Pakistani producers in this sector are likely to face difficulties in supplying China because they lack understanding of border-specific food trade regulations and compliance certifications, and of provincial or local-level food regulations. At present, red meat and chicken from Pakistan find their way to China largely through Vietnam, which has better capacity to handle food safety regulations.

Respondents described cooperation in the agriculture sector that could enhance Pakistan’s agro-based exports to China. China is already working in Pakistan toward introducing new hybrid varieties of rice. In May 2018, Pakistan exported to the Philippines 100 tons of heat-tolerant hybrid rice seed, produced with technical support from China and its scientists. This export initiative was a result of a partnership between the private sector companies Yuan Long Ping High-Tech Agriculture Co., Ltd., of China and Pakistan Guard Agricultural Research and Services Company. The priority now should be to replicate this experience in other major crop sectors, including wheat, maize, and cotton. Furthermore, central bank researchers have suggested that it may be feasible to obtain China’s support in developing the fruit processing industry in Gilgit-Baltistan, setting up the “Sino-Pakistan Hybrid Rice Research Center” at

Ports and Shipping, Planning Commission, Ministry of Water and Power; financial institutions: Ministry of Finance, central banks in China and Pakistan, Export and Import Bank, and China Development Bank.

Karachi University, constructing meat production and processing facilities in Khyber Pakhtunkhwa, and developing the KP-China Sustainable Donkey Development Program.¹⁵

5.2 Chinese Perspectives on Doing Business in Pakistan

Chinese respondents who had moved to Pakistan before CPEC cited an attractive internal rate of return as a key reason for investing in Pakistan. Some of these industries are now facing higher costs in China, including rising wages and expenditures required to comply with stringent production and environment laws. Other businesses from China wanted to make use of technology or machinery that was outdated for China, or did not fulfill the now-stringent environmental requirements but could still pay off if relocated to countries such as Pakistan with less stringent environmental laws.

Chinese investors felt that unfair competition impeded their investment in Pakistan. The terms agreed on investment with competing countries often do not appear to reflect a level playing field. There is a lack of clarity surrounding projects recently offered to the Saudi Arabia and the United Arab Emirates (UAE) governments that did not follow the usual competitive bidding. The informal trade in goods also poses unfair competition in some sectors. Increasing market transparency, improving the framework for investor and consumer protection, and strengthening the Competition Commission of Pakistan were viewed as important steps to ensure a stable, fair, transparent, and predictable business environment.

Chinese investors viewed Pakistan's policies as unclear and arbitrary in several areas. They cited a lack of clarity in reforms governing land, energy, taxation, customs, and the regulatory regime Chinese investors face in Pakistan. Uncertainty over Pakistani policies in these areas is why a buying mission from China, which had been expected to arrive in January 2019, has not yet materialized. The frequent changes in government have increased uncertainty, while tensions concerning social, ethnic, religious, and other issues have adversely affected investor sentiments. The investors also expressed concern over insistence by provincial governments in Pakistan that they use local labor, who they feel lack adequate skills, and they complained about Pakistan's uncertain and often arbitrary regulatory duties and anti-dumping duties.

Support by Pakistan's Government for Chinese investment was viewed as weak. Visits of business delegations from China have had limited success because of a lack of follow-up by Pakistani authorities, and the Government appears to have little appetite for inquiring into the reasons that past business visitors have invested little in Pakistan. Chinese investors also felt that Pakistan's public sector needs to make greater efforts to understand international trade laws.

Pakistan needs to reconsider the role of federal and provincial Boards of Investment (BOIs) in promoting linkages with the Chinese private sector. Interviewees indicated that BOIs in Pakistan have played a limited role in raising awareness of investment opportunities on both sides of the border. The Chinese private sector representatives interviewed for this policy note had limited understanding of opportunities in Pakistan's agriculture and industrial manufacturing sectors. They felt that BOI staff should have greater sector-specific expertise and

¹⁵ Kamal, J. and M. H. Malik (2017) "Dynamics of Pakistan's Trade Balance with China" SBP Staff Notes 04/17. State Bank of Pakistan, Karachi.

knowledge about the laws and regulations governing manufacturing industries in Pakistan, which can differ by sector. BOIs could also play a larger role in helping investors gain access to critical services, including electricity and gas connections, roads in new special economic zones (SEZs), and telecommunications infrastructure, and could facilitate compliance with environmental, labor, and municipal laws. Potential investors also feel that there is a need to change the statutory terms of reference for BOIs, to include increasing the promotion of outward foreign direct investment through their contacts in counterpart investment promotion agencies in China and other countries.

Chinese investors expressed interest in the retail sector in Pakistan. The success of the Korean lifestyle brand Miniso in several Pakistani cities has led Chinese brands to undertake market surveys in various cities. So far only one Chinese lifestyle brand (Ximi Vogue) has opened a store. However, the BOI in Islamabad reports having met with several other brands that may be opening branches in the near future. Chinese specialized low-cost furniture brands have shown some interest in opening branches in shopping malls in Karachi, Lahore, and Islamabad. And Shandong Senlin Wood Industry Co., Ltd., Weijin International Co., Ltd., Sitong Packaging Co., Ltd., and Jiangxia Garments Co., Ltd., are attracted to Pakistan's fast-moving consumer goods market.

Some start-up enterprises in Pakistan's services sector (e.g., fintech and e-commerce) have attracted equity from Chinese partners. Examples include Alipay buying Careem's stake in Pakistan and Diwaai (a digital health platform) being trained by Alibaba's entrepreneurship program. This increased business-to-business engagement is expected to result in a better understanding of business opportunities and potential joint ventures.

Chinese state-owned and private firms that are interested in investing in Pakistan appear to have different sectoral preferences. Investments by China's central and state-owned enterprises in Pakistan are largely undertaken by communications firms, including China Mobile, Huawei, ZTE; by building materials firms, such as China Machine-Building International Corporation and China Road & Bridge Corporation; by firms involved in oil and gas exploration, such as China Petroleum Engineering & Construction Corporation; and by mechanical firms, such as Zoomlion. Investment in Pakistan would be more attractive with support from the major financial cooperation departments, such as China Development Bank and Export-Import Bank of China. The prospects for joint ventures between Chinese and Pakistani private firms appear promising in textile, agricultural products, steel, household appliances, cement, chemical industry, electric power, packaging, and the retail industry. Some Chinese private sector firms are interested in investing in public goods in Pakistan, including infrastructure. However, interviewees felt that an all-round guarantee system, including mechanisms for sound investment risk prevention, effective prognosis, comprehensive coordination, and emergency response, would have to be established to ensure the implementation of major strategic projects.

The interviews cited several sectors in which joint ventures with Chinese firms would be beneficial. Pakistani enterprises that are willing to enter into joint ventures and are in the process of finding a Chinese partner highlighted the need to develop more light manufacturing clusters across Pakistan. China's light manufacturing was viewed as a sunset sector that will eventually

relocate to other countries.¹⁶ The private sector representatives from China highlighted other sunset sectors, including wood furniture, plastic ware, and building accessories (e.g., handle locks and chains).

The Chinese business interviews indicated that increased investment would depend on the on-time completion of the next phases of CPEC, particularly cross-border financial integration, activation of a fiber-optic link, and development of SEZs. A significant number of potential Chinese investors wanted to understand the new government’s priorities under CPEC, particularly a greater orientation of CPEC toward agriculture, livestock, and social sector development. They seemed concerned about the delay in executing plans related to SEZs, particularly in Rashakai and Dhabejee.

Chinese respondents also paid particular attention to the development of Gwadar port as an investment destination. Gwadar port’s management has been transferred to the China Port Holdings Company, which has installed new loading and unloading equipment and upgraded oil supply, seawater desalination, and sewage treatment systems. As a result of these investments, respondents claimed that containers are cleared in less than 48 hours at Gwadar, more rapidly than at other ports in Pakistan. Chinese firms said that their decisions on using the port would depend, in part, on how Pakistan’s own domestic businesses make use of the port and how efficiently it is connected to the main road and rail arteries inside Pakistan. The China Ocean Shipping Company expressed interest in operating a cargo ship with a capacity of 5,000 containers on a weekly basis, and it is now shipping seafood consignments to the UAE from Gwadar Port.

¹⁶ There has been some debate as to whether Pakistan should focus on receiving “green sunrise” or “brown sunset” industries. However, given a lack of clarity on future industrial policy in the country this debate remains confined to academic circles.

Box 1. Gwadar Port Faces Real Limitations

The development of Gwadar port holds considerable promise but faces challenges.

Gwadar port could make a significant contribution to transit and commercial trade with Afghanistan and Central Asia, and shorten the distance for China to import oil and other petroleum resources.¹⁷ If realized, the planned development of Gwadar International Airport (which would make the area more attractive to investors) and Saudi Arabia's proposed finance of an oil refinery at Gwadar also could result in substantial increases in traffic through the port.

To achieve its potential, Gwadar will require adequate road and rail connections with the hinterland, as well as expanded capacity to handle large cargos efficiently. Security concerns have to be addressed to complete the ongoing projects in Gwadar.¹⁸ Successful development also will require the participation of local businesses and workers. Including business and labor associations in decision-making would diffuse tensions by helping them to visualize the future gains and to have a sense of ownership in the development process.

The lack of connectivity, coupled with high logistics costs and security concerns, impairs the usefulness of the port of Gwadar. Only the land connection from Karachi through the coastal highway is in operation. The proposed high-speed road connection between Sukkur and Gwadar through M8 is still not operational; a large patch of M8 is missing between Khuzdar and Hoshab. As a result, exports originating from the northeast of the country are routed via Karachi port. Trade originating from Quetta may be shipped through the Quetta-Basima-Hoshab-Gwadar section, but for security reasons the route is not fully operational for large-scale logistics activities.

Interviews with Chinese firms emphasized the need for improvements in the policy framework for SEZs, industrial estates, and export zones, to make them attractive for investment. The governance model of SEZs is still not very clear to potential investors. Interviewers felt that giving all new industrial estates and export zones the same incentives as SEZs would avoid fragmenting industrial and export incentives. Essential to the success of SEZs are more timely approvals by government, use of a single window to help firms navigate the bureaucracy, and greater attention to trade facilitation, intellectual property protection, environmental assessment processes, and e-commerce. Further investments should be made in captive power and easier access to utility connections. The availability of land in these zones could be increased by permitting larger land lots, simplifying the land acquisition process, and removing limitations on foreign ownership of land. Finally, removing requirements that foreign investors enter into joint ventures with Pakistani firms or use local workers could boost foreign investments in SEZs.

Officials of the State Council of China outlined a path toward identifying sectors of latent comparative advantage. The starting point would be to identify high-growth sectors for the future depending on the availability of resources, including skilled labor. Local private sector

¹⁷ Deloitte (2016) "How will CPEC boost Pakistan Economy?" Deloitte.

¹⁸ Abid, M. and Ashfaq, A. (2015). "CPEC: Challenges and Opportunities for Pakistan." Pakistan Vision, 16 (2)

firms already working in these industries could be supported by removing constraints. Second, foreign firms could be invited in sectors that are critical to future economic growth but lack a vibrant local private sector presence. Third, the Government could encourage the process of self-discovery by local entrepreneurs and support them in scaling up innovations in emerging industries. Fourth, expediting the construction of SEZs would promote clusters and overcome barriers arising from weak infrastructure—for example, difficulties in accessing electricity and gas. Finally, firms that are pioneering in certain new or emerging sectors would require time-limited tax breaks, as well as improved access to credit and foreign exchange.

5.3 Pakistani Perspectives on Doing Business with China

Pakistani interviewees emphasized that structural reforms to reduce the cost of doing business were necessary to maximize the gains from CPEC. The devaluation of the rupee, which interviewees felt exceeded expectations, further increased input costs. Accessing bank credit remains a lengthy and cumbersome procedure, even for the zero-rated export-oriented sectors. There are clear examples of double taxation, reflecting a race among provincial governments to expand their revenues, even if it results in distortionary costs to other provinces and cuts into the margins of the business community. For example, Punjab has an infrastructure development cess.¹⁹ However, if a consignment originating from Punjab is cleared in Sindh, the latter also charges a similar cess. And bottlenecks in the investment regime, particularly those related to transportation, communication, and power supply, have become a major constraint on foreign direct investment.

Interviewees argued that low tariffs on Chinese goods have been largely offset by the heavy reliance on trade taxes in Pakistan. Imports from China face customs duties, regulatory duties for several tariff lines, sales tax, additional sales tax, and the withholding tax on imports. Firms in Duska, Gujrat, Chiniot, Gujranwala, Karachi, and Lahore cited the imposition of duty on imports of wire rod used in furniture, doors, windows, and drawer railings. The Engineering Development Board and National Tariff Commission in Pakistan had initially exempted wire rod imports from tariffs because local production was small. However, tariffs were imposed on wire rod in 2017, in part as an anti-dumping action. It was suggested that the Federal Board of Revenue should have a mechanism to consult producers when determining the input-output ratios for imported raw materials and finished goods. The business community in Sindh province reported that the high regulatory duties and sales taxes on energy, imported raw materials, and intermediate goods made it impossible to scale up exports to China. Nevertheless, the business community generally agreed that Pakistani firms have saved money by importing goods from China.²⁰

Interviewees also cited several industries that face stiff competition from China. Industries whose output has declined since the signing of the CPFTA-1 and that continue to face competition from low-cost Chinese producers include pig iron, coke, chipboard, metal drums, bicycles, sewing machines, television sets, electric bulbs, plywood, electric transformers, electric

¹⁹ A cess is a tax that is added to an existing tax.

²⁰ For example, Chawla aluminium was importing plant equipment from Germany but is now importing from China.

meters, deep freezers, switch gears, electric motors, cycle tubes, and storage batteries.²¹ One step that could help these firms recover is to invite Chinese interest, in the form of joint ventures through debt or equity arrangements, to achieve economies of scale.

Several respondents suggested that the Government of Pakistan support shops in China dedicated to the sale of Pakistani handicrafts, particularly the products of women-led enterprises. The Chinese Embassy in Islamabad pointed out that Pakistani cultural and gift shops are not found in the main Chinese cities. The Export Development Fund is a possible source of funds. The experience of the Punjab Small Industries Corporation in establishing a network of shops providing marketing and a promotional platform for artisans, which are attracting local and foreign visitors in large numbers, could be replicated in major Chinese retail spaces and shopping malls.

Interviewees indicated that the Government should support technology transfers from China to improve agricultural productivity. Pakistan continues to struggle with high levels of salinity and high water tables, issues in which private farms in China have developed expertise. The Pakistani agriculture authorities could discuss with their counterparts how Pakistani farmers can acquire this expertise and relevant technology. Government support to build the capacity of farm labor could over time help to boost Pakistan's agriculture exports to China.

Box 2. Can Internet Connectivity Be Leveraged?

The China-Pakistan fiber-optic cable line will help to diversify Pakistan's connections to the world, both by improving connectivity through China to third countries and through the eventual installation of a new undersea fiber-optic interchange at Gwadar port.

Better Internet connectivity would strengthen supply chain coordination, improve the integration of ICT services, and facilitate paperless trade and e-commerce.

Improved Internet access also would increase the efficiency of the construction and management of the industrial parks, roads, rails, and ports envisioned under CPEC. The online WEBOC (web-based one system) at Sost dry port, which was made feasible by the new fiber-optic cable, could be integrated with the Chinese customs system to reduce leakages in goods and delays encountered at the China-Pakistan border. Fiber cable connectivity also can help boost tourism revenues by facilitating international advertising and online hotel bookings, and by enabling visitors to use GPS navigation systems.

Additionally, fast and secure Internet connectivity can increase the use of electronic payments. One of the major hurdles e-commerce faces in Pakistan is that around 95 percent of transactions are paid for on a cash-on-delivery basis. Facilitating payments through digital banking would greatly expand the potential for e-commerce, both from domestic and international sources. Technical training institutions and exchange programs could be initiated, with the help of Chinese universities and companies, to introduce Pakistani entrepreneurs to efficient digital banking systems while limiting the risks from cybercrime activities.

²¹ A more detailed list may be found in Kamal, J. and M. H. Malik (2017) "Dynamics of Pakistan's Trade Balance with China" SBP Staff Notes 04/17. State Bank of Pakistan, Karachi.

The majority of the respondents argued for revising CPFTA-1 to broaden preferential access to China’s market for Pakistani exports. Businessmen in Punjab and Sindh felt that the structure of tariffs negotiated 12 years ago may no longer be relevant, given the structural changes driven by the energy crises between 2009 and 2013 and the distortions created by the tariff regime. In addition, respondents questioned why the CPFTA-1 did not result in strong growth in services trade, as had been anticipated. While anecdotal evidence points to difficulties in obtaining visas, language differences, and cultural barriers as likely explanations, a more rigorous evaluation is necessary. Finally, weak customs enforcement (on both sides) has impaired the effectiveness of administrative measures, including border controls, to limit the misuse of concessions.²²

Interviewees expressed concern that several issues, including sanitary and phytosanitary standards and other Chinese regulations, were impairing Pakistani export opportunities. They argued that China’s relatively low tariffs on imports from ASEAN countries and other countries reduced Pakistan’s ability to compete (most respondents emphasized the need to negotiate tariffs that are equal to or lower than those provided to ASEAN and Bangladesh). It was recognized, however, that a decline in the complementarity with Chinese imports contributed to the limited growth of Pakistan’s exports to that country. In any event, the CPEC Joint Coordination Committee and Joint Working Group meetings should be used as a forum to discuss Chinese policies that limit Pakistani exports. An assessment of why exporters from other countries, particularly Bangladesh, India, and Vietnam, find it easier than Pakistani firms to export specific products to China would serve as a useful input into these discussions. For example, China now imports soybean meal, which traditionally came from Pakistan, from Bangladesh. This is of particular importance, since rising tariffs on China’s soybean imports from the United States may provide an opportunity for Pakistani exporters.

Many also noted that it is becoming politically difficult to justify the incentives provided to Chinese companies that invested in the power sector during the early harvest program of CPEC. The Government’s view remains that Chinese firms, like other private sector power providers, were eligible for incentives under the 1994 independent power producer policy. However, since then there have been no major investments in wind, solar, or coal, for which under the CPEC arrangement the Government had guaranteed a higher rate to the Chinese companies. There are now voices in Parliament that are asking for a review of the 1994 independent power producer policy. Such debates in Parliament will prompt a more cautious approach from potential Chinese investors.

The business community urged greater cooperation between the Government and the private sector in promoting Pakistani exports. China is putting on exhibitions to promote “made for China” instead of just focusing on “made in China,” to calm fears in several developing countries regarding their growing trade deficits with China. The China International Import Expo held in Shanghai in November 2018 was one example.²³ The Prime Minister led Pakistan’s delegation to the Expo, and made a strong case that China could import textiles, sports

²² Ahmed, V. (2017) *Pakistan’s Agenda for Economic Reform*. Oxford University Press.

²³ Organized by the Chinese Ministry of Commerce, this initiative was welcomed and supported by the World Trade Organization, the United Nations Conference on Trade and Development, and the United Nations Industrial Development Organization.

goods, engineering goods, IT services, and medical technologies (including surgical instruments) from Pakistan. Given the importance of the Expo (over 400,000 purchasers from China and overseas attended), the business community felt that private sector involvement in preparations would have projected the “brand Pakistan” more strongly. In future events, the Ministry of Commerce in Islamabad could secure a larger pavilion for Pakistan and also support participation by small and medium enterprises.

Provincial and municipal business groups called for greater attention to facilitating interactions between Chinese business delegations and Pakistani small and medium sized enterprises and business clusters in second-tier cities. The Sialkot Chamber of Commerce and Industries also expressed concern that business delegations visiting from China under the government auspices were only taken to provincial capitals and not to second-tier cities like Sialkot. Chinese business delegations tend to visit Islamabad, or perhaps the provincial capitals.

6. Conclusions and policy recommendations

This note explores Pakistan’s opportunities to benefit from increased trade with China in the context of CPEC. While this report shows that CPEC has resulted in greater connectivity between the two countries, it also highlights that improved physical infrastructure may not result in substantial gains unless there are corresponding improvements in Pakistan’s business climate, customs and regulatory regimes, and market access framework with China and the world.

The necessity of improving Pakistan’s business climate is at the core of this report’s conclusions. Pakistan’s actual exports globally, and with China, fall significantly below potential. This highlights the degree to which Pakistan’s current economic governance framework reflects a protectionist, anti-export bias. This policy framework limits Pakistan’s participation in global value chains and reduces access to growth opportunities for Pakistani firms. Critical deficiencies include inadequate infrastructure, inefficient transportation and logistics services, high tariff and non-tariff barriers, and significant government-induced administrative requirements, as well as the costs of corruption, a burdensome tax administration system, and a restrictive labor regime. While CPEC-related investments in infrastructure, especially energy and transportation-related infrastructure, can help improve the environment, focused action on the business climate is required to maximize the potential benefits of CPEC.

The terms of Pakistan’s current trading relationship with China also highlight the degree to which Pakistan’s business climate constrains its trade potential. Consistent with their respective global economic performance between 2003 and 2018, China’s exports to Pakistan have increased more rapidly than Pakistan’s exports to China. Because of the relative intrinsic strength of China's exporters, China was better able to increase exports to Pakistan than Pakistan was to China after the reduction in trade barriers that occurred through CPFTA-1. The ratification of an amended trade agreement, CPFTA-2, in April 2019 is a welcome first step to expand Pakistan’s access to the Chinese market, but without a more focused effort to improve Pakistan’s business climate the competitiveness of Pakistani industry will continue to lag. Tariff relief for Pakistani exports under CPFTA-1 was not optimally matched to areas where Pakistani industry stands to benefit. But we found that Pakistan’s poor export performance, to China and the world, is due largely to defects in the policy environment as well as in the investment

climate, not primarily because of market access concerns. A priority for future negotiations between China and Pakistan should be services trade. The amended CPFTA-2 does not cover services, a key area of growth in Pakistan.

Chinese imports had overall positive effects on Pakistan's productivity and resource allocation. First, integration with China increased competition at home, which induced firms to increase efficiency allocate resources better. This meant that some Pakistani sectors that competed directly with new imports from China suffered, and lost market shares and RCAs. Second, integration with China increased the availability of inputs that are now more varied, cheaper, or of better quality than previously available. Analysis revealed that Pakistani sectors that used imported intermediates from China more intensely, increased their competitiveness in international markets. Finally, we found no effect of Pakistani sectors that increased their exports to China also improved their export performance in other markets.

Interviews with Pakistani and Chinese business and government stakeholders also highlighted that there is considerable room to strengthen trade facilitation, including by providing bonded warehouses, shed facilities, passenger and cargo scanners, cold chain management systems, quarantine facilities, and forensic laboratories for customs officials.

The introduction of a risk management system would help direct customs inspections to shipments with likely violations. Harmonizing document requirements between Pakistan and China, eliminating redundant inspections at Pakistani border crossings, making the single window operational in ports, and better training the Anti-Narcotics Force to limit damage from their inspections would reduce trade costs. Investments under CPEC may be aimed toward further improvements in logistics performance, trade facilitation, and greater automation of customs processes. The CPFTA-1 could be improved by including a stronger dispute resolution mechanism, procedures for identifying and removing non-tariff barriers, and provisions to facilitate cross-border investment, coupled with greater involvement by the private sector, consumer groups, and civil society in negotiations.

The limited boost in Pakistan's trade performance from increased trade and investment with China could be magnified by expanded liberalization with third countries, particularly in South and Central Asia. Interviewees urged the Government to sign the Agreement on the Afghanistan-Pakistan Transit Trade Agreement (and its extension to Tajikistan and other Central Asian republics) and the South Asian Association for Regional Cooperation (SAARC) Transport Agreement and make the Quadrilateral Traffic in Transit Agreement (between China, Kyrgyz Republic, Kazakhstan and Pakistan) operational. The Government should urge China to reduce barriers to the entry of Pakistani workers, allow long-term work permits to encourage increased trade in educational, medical, and ICT services, make it easier for Chinese citizens to acquire e-visas to facilitate tourism in Pakistan, and reduce impediments to opening businesses in cities that do not host economic zones.

Finally, we found that both Chinese and Pakistani authorities need to give greater attention to investment and trade promotion activities. Greater business-to-business engagement between firms on both sides can overcome the high information costs and overtime promote value chains. In particular, greater attention should be paid to facilitating business-to-business interactions in second-tier cities. Chinese investors felt that the Pakistani Government could

improve its follow-up of Chinese business delegation visits, improve staff expertise in federal and provincial BOIs, and increase support to investors in gaining access to critical services and complying with regulatory requirements. Pakistani interviewees emphasized an increased role of the Government in promoting Pakistani exports—for example, through trade exhibitions—and greater assistance from the commerce ministries in both countries to support trade in services (one point concerned securing China’s help in resolving concerns over piracy, privacy, and data protection issues in the Chinese ICT sector).

In the short-run, we recommend that Pakistani authorities focus on steps to improve the business climate, consistent with the *Ease of Doing Business* measures. Some measures would require increased investment—for example, improving access to electricity (delays in obtaining electricity connections is a common complaint), strengthening transportation services, or ensuring that the education and training system provides the skills required for a modern economy. Administrative improvements—for example, simplifying the processes for starting a business, registering property, or compensating exporters for taxes on inputs—require intensive coordination across Government departments, but could be achieved through strong management. Addressing other necessary administrative improvements, such as making tax administration more efficient, may require overhauling institutions. Finally, improving transparency and reducing corruption, which are frequently cited by businesses as a major problem, involve a long-term struggle.

As a result, the near-term focus of reform efforts should be on removing the anti-export bias of Pakistan’s current domestic tariff and taxation regime. The structure of trade taxes is riddled with various forms of tariffs, regulatory directives, and special regulatory orders, which promote anti-export bias and prevent Pakistani firms’ integration in global value chains. A simpler and more transparent structure aimed at reversing anti-export bias, and a clear commitment to phase out regulatory and additional duties that impede trade, are required. Easier access to duty exemption schemes would help enhance the liquidity and working capital of exporting enterprises. Reducing impediments to imports from China to global averages while improving the supply capacity of domestic firms could significantly increase Pakistan’s exports.

In the near- to medium-term, we recommend that Chinese and Pakistani authorities develop and implement an action plan for industrial cooperation to help ensure that growing Chinese imports contribute to Pakistan’s global export competitiveness. A clear action plan and well-defined roles and responsibilities are necessary to implement the memorandum of understanding on industrial cooperation. Chinese firms emphasized the importance of improving cross-border financial integration, activating a fiber-optic link, and speeding up development of SEZs to encourage investment in Pakistan. Chinese investors urged the elimination of provincial-level requirements that foreign investors hire local workers. Chinese assistance in the agriculture sector would be important—for example, technical support for the introduction of new crop varieties, coping with high levels of salinity and a high water table, and designing processing facilities.

In the medium- to long-term, investments and policy changes to increase connectivity are essential to support the rise in trade envisioned under CPEC. A more efficient process for planning transport investments is critical to improve connectivity and limit the waste of

resources. One particularly costly problem is the lack of coherence between investments in ports, economic zones, and hinterland connections. The failure to provide adequate road and rail transport to the rest of the country greatly limits the use of Gwadar port. Similarly, the lack of adequate transport (and energy) infrastructure impairs the competitiveness of firms located in SEZs. Improved coordination across Government ministries, and between central and provincial governments, along with a clearer division of responsibilities, is essential to support efficient development of SEZs, industrial estates, and export processing zones. Further investments are necessary to fully capitalize on the recent installation of the China-Pakistan fiber-optics cable—for example, integrating customs procedures between the two countries to reduce delays and leakages in goods. Filling in the gaps in Pakistan’s infrastructure network, including around Gwadar Port and between Pakistan and its immediate neighbors, can help foster new opportunities for Pakistan to be a competitive participant in regional and global value chains.