



Institute of Social Studies

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**PAKISTAN-CHINA FREE TRADE AGREEMENT:
AN INITIAL ASSESSMENT OF EXPECTED
IMPLICATIONS ON MAJOR EXPORT ITEMS OF
PAKISTAN**

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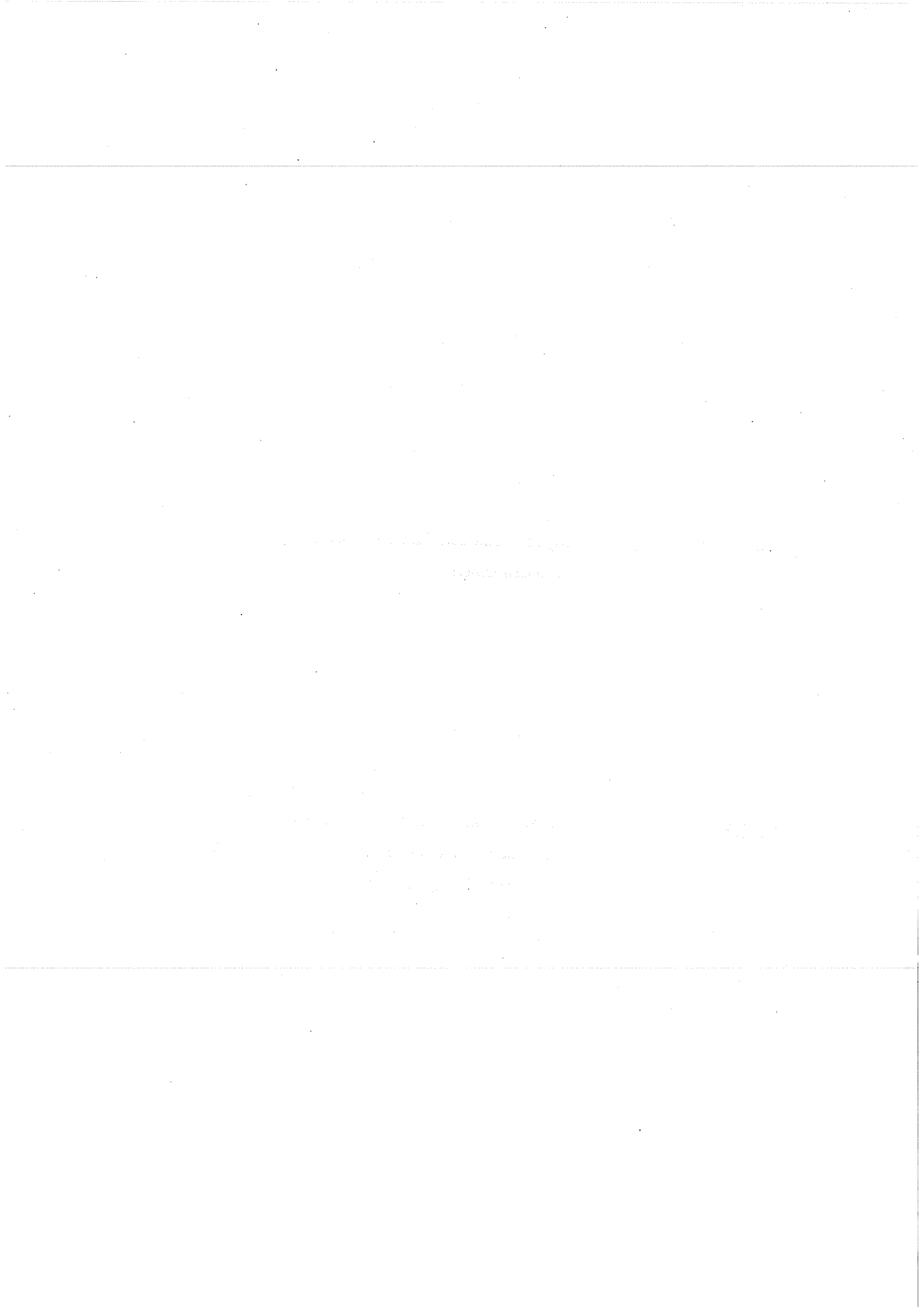
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List of Acronyms

APTMA	All Pakistan Textile Mills Association
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textiles and Clothing
BIPA	Bilateral Investment Promotion and Protection
BMR	Balancing, Modernization and Replacement
CBR	Central Board of Revenue (Pakistan)
CD	Customs Duties
DWL	Deadweight Loss
EHP	Early Harvest Program
EPB	Export Promotion Bureau (Pakistan)
EU	European Union
FBS	Federal Bureau of Statistics (Pakistan)
FTA	Free Trade Agreement
HPAE	High Performance Asian Economies
ICAC	International Cotton Advisory Committee
MFA	Multi Fibre Agreement
NAFTA	North American Free Trade Agreement
NIEs	Newly Industrialized Economies
PC-FTA	Pakistan-China Free Trade Agreement
PTA	Preferential Trade Agreement
RTA	Regional Trade Agreement



Chapter-1

INTRODUCTION

1.1 In the recent past it has been observed that the economic ties in shape of trade agreements have been strengthened among various countries and regions in the world. According to Khor (2005)¹ the “bilateral free trade agreements (FTAs) are made between two countries” and “throughout the world, many governments have signed, are negotiating, or contemplating new bilateral free trade and investment agreements”. In the FTA the trading partners compromise for the rates even lower than the World Trade Organization (WTO) (ibid). In other words the FTAs are aimed to lower tariffs to zero level, sometime with few exceptions for certain products or sectors. Usually it is believed that the free trade agreements bring prosperity and welfare, but it may not be true in all cases and there may be some negative impacts of FTAs against the claimed benefits.

Faced with the changing world economic scenario Pakistan is also striving to promote its free trade relations with other nations for economic growth, development and welfare of its people. A number of developing and developed countries are keen to sign FTA with China. Pakistan and China, who have been enjoying good political and economic relations for last five decades, agreed on a Free Trade Agreement (FTA) in April 2005. According to the available details under the FTA both sides will cut down excise duty and eliminate the tariffs on various commodities². In addition to this an Early Harvest Program (EHP)³, as an initial step to harmonize and facilitate the trade before the implementation of said FTA from 1st January 2008, has also been signed (ibid). The two countries would initiate trade under Early Harvest Program EHP from 1st January 2006, and it has been agreed that China will extend zero-rated tariffs on 767 items while Pakistan would reciprocate by extending the facility on 464 items⁴. Both countries also have an existing Preferential Trade Agreement (PTA), under which they have already reduced tariffs on a list of 1671 items on Chinese side and 575 items from Pakistan side and this list will be made part of EHP(CBR).

¹ http://www.bilaterals.org/rubrique.php3?id_rubrique=30 [Accessed 30 Aug 2005]

² www.bilaterals.org. [Accessed 17 July 2005]

³ The EHP is only a preliminary arrangement to facilitate the trade between two countries before reaching to the full FTA, after the implementation of FTA from 1st January 2008 the EHP will automatically be merged into the said FTA.

⁴ http://www.bilaterals.org/article.php3?id_article=2481. [Accessed 17 July 2005]

The Economic Survey 2004-05 reveals that the textile sector contributes 67% of Pakistan's total exports and within textile sector the cotton yarn and the cotton fabrics contribute a major share. After the elimination of Multi Fibre Agreement (MFA) from 1st January 2005 the impact on textile exports up to great extent is depending on the quality and efficiency. Therefore, it is important to see all the aspects and future implications of FTA on the textile industry, which is the backbone of Pakistan's economy, in order to adopt a viable strategy enabling the textile industry to flourish further. The presence of already existing and expected trade agreements in the region can be a big challenge to the Pakistani producers. If Pakistan does not sign a free trade agreement with China and also with other regional countries it may undermine its export oriented industries. The said FTA will serve the purpose of at least a defence tool for Pakistani exports against foreign competition.

Apart from using the FTA as a defensive strategy by Pakistan there are other reasons as well for the enhancement of trade with China. According to Hussain (2001)⁵ "the strategic direction through which the economic ties between Pakistan and China can be strengthened in the coming decade lies in intensified trade, investment and transfer of technology. This route is feasible as it creates win-win situation for both countries". Xu Changwen⁶ is of the view that the Pakistan-China FTA (PC-FTA) would facilitate trade and would further consolidate bilateral trade relations. Giving reasons Xu, asserts that the said

"FTA will be beneficial because Chinese goods have competitive prices and better quality, fulfilling the demand of Pakistani consumers. Pakistani producers will have easier access to Chinese markets. More investment in Pakistan is expected to come from China; moreover, the establishment of factories in Pakistan would enable the Chinese firms to enhance exports to the Middle East and Africa".

1.2 Research Objectives, Questions and Methodology:

The FTA will be implemented from 1st January 2008 and this study would be the first ever to analyse the implications of the said FTA. The objective of this study would be to see the

⁵ Dr. Ishrat Hussain is a leading economist, he has been working on important positions in various organizations including World Bank, and currently he is the Governor of State Bank of Pakistan.

⁶ A trade researcher at the Chinese Academy of International Trade and Economic Co-operation, a think-tank under the Chinese Ministry of Commerce, (China Daily, April 2005)

possible preliminary economic and political impacts of FTA. As mentioned earlier the textile items account for a significant share (67%) in Pakistan's total exports. The share of cotton yarn and cotton fabrics in total textile exports and in total national export is more than 40% and around 25% respectively (see FBS and APTMA reports)⁷. Therefore, the paper will explore the effects of the FTA on Pakistan's these two major export items. The study will try to unveil the possible impacts on the exports of these two items, competence level of Pakistani producers, overall impact on tax revenue to the government and political implications of FTA.

Trade statistics reveal that current trade volume between China and Pakistan is not very substantial. Then it would be important to look into the other expected gains or to find out the ways to maximize the trade benefits through this FTA. This study will also try to suggest appropriate steps for making the FTA more suitable for Pakistan. Therefore, the study will analyse the expected economic as well as political gains from this agreement.

Following are my research questions;

- * What will be the possible impact on Pakistan's major export items like cotton fabrics and cotton yarn?
- * What will be the possible political gains from the FTA between two countries and in the region as well?
- * How competitive are the Pakistani producers as compared to the other cotton producers in the world?
- * What will be the tax revenue impact?

Methodology: To analyse the above mentioned issues and questions I shall rely on the descriptive method by using standard trade theory. The concept of free trade, tariffs and quotas, consumer surplus & producer surplus and trade creation and trade diversion, Preferential Trade Agreements, Multilateral Trade Agreements will also be discussed briefly. The study will include the description of FTA, empirical evidence showing the comparative analysis of cost of production, global textile scenario and Pakistan's position, tariff structure between two countries and China's demand of cotton yarn and cotton fabrics and its import sources. For the

⁷ http://www.statpak.gov.pk/depts/fbs/statistics/external_trade/trade_14_2.html
http://www.aptma.org.pk/Pak_Textile_Statistics/pxport.asp [Accessed on 12th Nov 2005]

comparative analysis the prices of the said commodities could be very important, but due to the unavailability of prices the comparative analysis will be mainly based on the cost of production in the competing countries. To answer our main question more focus will be on the evaluation of Post MFA performance of the textile exports of Pakistan. This performance evaluation will also be helpful to examine the competence level of textile sector.

The FTA will affect the government tax revenues as well. This issue will be discussed in detail by analysing the current volume of trade and the duties collected from the imported items from China. For the analysis of imports from China and the taxes collected the study will depend on the data from Federal Bureau of Statistics, Export Promotion Bureau and Central Board of Revenue Pakistan. The analysis regarding the cost of production of cotton will be mainly based on the data of comparative production costs by the International Cotton Advisory Council (ICAC).

1.3 Scope and Limitations

The FTA will affect various sectors of Pakistan economy in the long run, which need a comprehensive study to analyze the effects. However, this study will be limited in scope and will cover few basic issues due to various constraints. The major problem is that the FTA details are yet to be finalized and the negotiations are under way to decide the details, therefore, it would be difficult to analyze all the issues and effects of said FTA at this stage. It will be possible when all the details of the agreement are sorted out in black and white. Yet it has not been finalized that what will be new trade patterns with China after implementation of FTA. Would exports and imports increase, and what would be the new trade patterns with China? Therefore, the study would be an initial assessment of the impact on export of cotton yarn and cotton fabrics, the political economy of the said FTA, the analysis of the comparative cost of production of cotton and the tax revenue impact. Due to the time limitation and unavailability of some of the required data the paper will not discuss the employment and welfare effects of the said FTA in detail. However, some empirical evidence from existing FTAs will be presented to analyse the expected employment and welfare effects.

1.4 Scheme of the Paper

The research paper will comprise of five chapters, chapter 2 gives static theoretical framework by discussing the arguments in favour and against free trade, impact of tariffs and quotas elimination, a brief discussion about the consumer & producer surplus and trade creation and trade diversion. It will also include discussion on the topic from the current literature and also findings of some studies to show the advantages and disadvantages of the existing FTAs. After giving the conceptual framework, chapter 3 will discuss the political economy of said FTA, current status of Pakistan-China Free Trade Agreement (PC-FTA), description about the China's textile sector, FTA between China and other countries and the chapter will also include the discussion on import tariffs and estimated tax revenue loss to the government. The chapter 4 includes the empirical evidence with the analysis of comparative cost of production and a brief discussion about the quality of cotton and global production of cotton cloth and cotton yarn and the trade patterns of Pakistan. It also includes the China's demand for yarn and fabrics to analyse the potential of further imports for these two items. Chapter five includes concluding remarks and recommendations.

The chapter two is about the theoretical framework, it includes some background information about the international trade, the concepts of free trade, quotas, consumer and producer surplus. The chapter also includes the detailed discussion regarding the concept of protectionism. The discussion from the current literature will also be included on topics like trade creation and trade diversion, a brief discussion about the preferential trade agreements and multilateral trade agreements along with empirical evidence from the existing free trade agreements will also be presented to highlight the expected gains from the free trade.

2.1 Background

The trade between nations is as old practice as the nations' history. The importance of international trade has increased gradually. Similarly, the volume of international trade has also increased significantly; particularly in the free trade zones (see Box-2.1). Why do nations trade? Why trade is essential? How does it benefit the trading nations? The different production capacity of the factors of production creates the need for international trade. According to Todaro (2000, p.468), "diverse preferences as well as varied physical and financial endowments open up the possibility of profitable trade". Resultantly countries try to specialize in the production of goods in which they find comparative advantage. With the passage of time not only trade volumes have enormously increased but also the patterns have changed. In the modern times the trade has become a complicated and also a political phenomenon. The competition for economic gains among nations is becoming tough day by day, resultantly developing and advanced countries are opting for more free trade agreements in the shapes of FTAs and RTAs. These trade agreements can play a vital role in the facilitation and promotion of trade among the nations.

Box 2.1

- The Importance of intra-East Asian trade in world trade increased significantly from 8% in 1990 to 12% in 2001. The share of intra-East Asian exports in East Asia's overall exports increased from 40% in 1990 to 48% in 2001, while the share of intra-East Asian imports in East Asia's overall imports increased from 48% to 57% during the same period.
- The share of intra-NAFTA trade in world trade also increased over the same period, at 10% in 2001. The share of intra-regional exports in its overall exports increased from 41% in 1990 to 55% in 2001.
- The share for the European Union was significantly higher in world trade i.e. 22% in 2001.

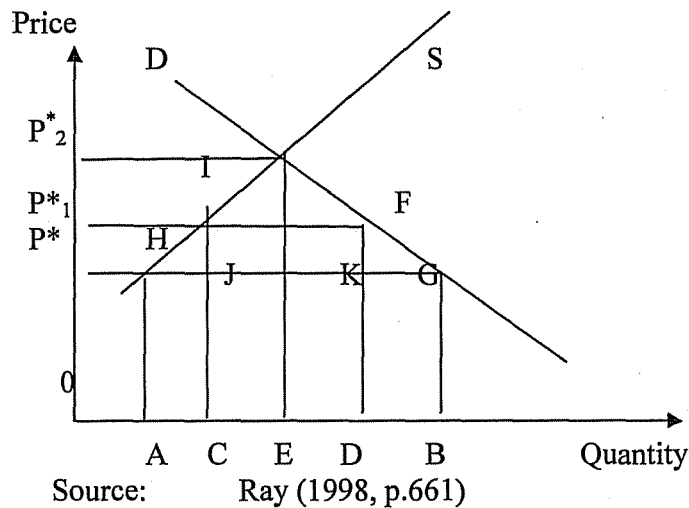
Source: Urata (2003), "Regionalisation in East Asia and Japan's FTA Strategies", May 25, 2003, Phuket, Thailand, Pacific Economic Cooperation Council, www.pecc.org

In the contemporary world not only the isolation of nation states from rest of the world has become difficult but, also the dependence of countries on each other has increased. The globalists believe that the free trade is beneficial for the world, while on the other hand some leading economists are skeptical about the benefits of free trade. Dollar and Kraay (2000) favour the free trade and say that "the openness to foreign trade benefits the poor to the same extent that it benefits the whole economy". According to Ravallion (2004), the increased openness can lead to a rise in the demand for relatively skilled labor, which can harm a vast majority of poor population. Sachs and Warner (1995), asserts that the countries that were more open grew faster compared to the countries which were less open.

2.2 FREE TRADE

Free trade is trade without restrictions, meaning that countries having free trade agreements can sell their products without the restrictions like tariffs and quotas. The tariffs and quotas have been used to protect the domestic industry. Figure-1 explains how tariffs work,

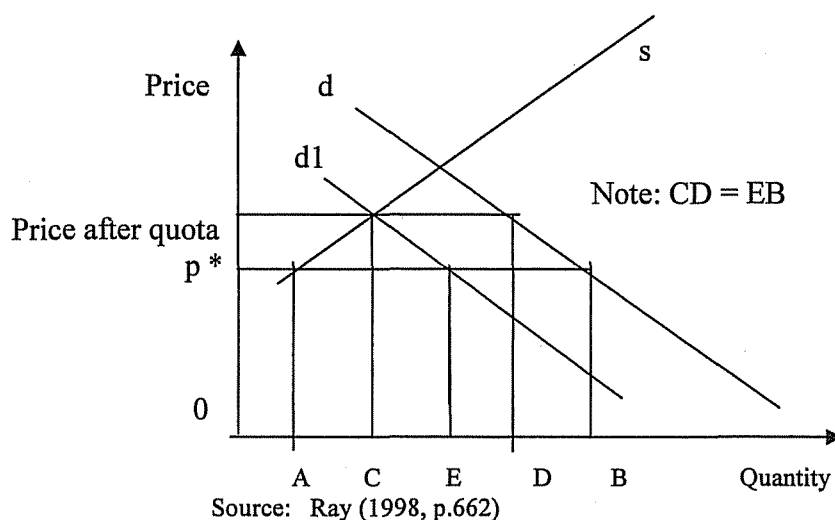
Graph-2.1: Effects of tariffs.



With the assumption that the traded good is an intermediate good, used for further production, the demand curve would be the derived demand for that input. P^* shows the international prices, OA depicts domestic supply, OB total demand and AB is quantity imported. Now suppose a tariff is imposed on the imported commodity, the effect will be that the price will increase to p^*1 and the demand of imported good will decrease to OD , but at the same time the domestic producers are encouraged and supply of the good increased to OC and the imports fall to CD . With high enough tariffs the imports will disappear altogether (point E , p^*2), it can happen for any tariff which takes prices beyond the domestic market clearing price for that good and such tariffs are referred as prohibitive for obvious reasons (Ray: 1998, p.661).

Three immediate effects of tariffs that come into view are: the local buyers lose due to higher prices, sellers gain by supplying at higher prices and government earns tariffs revenue (customs duties).

Figure-2.2: Effect of Quotas.



Quantity OA is bought from domestic sources and AB is imported. Now by imposing quota the buyers are allowed to import duty free up to CD units and the rest will be purchased from the domestic market. This figure marks off a length EB equal to amount CD, the residual demand curve will slide inward by the amount EB at every price, the equilibrium domestic price is just same the as in the case of tariffs i.e. P^*_1 . This observation is a simplified demonstration of the equivalence of quotas and tariffs, so a tariff can be mimicked by a quota and a quota can be mimicked by a tariff (Ray: 1998, p.662).

Is free trade good for economic growth and development? In the literature we find different views on the riddle of free trade. In the early fifties and sixties it was believed that the policy of ISI is best for developing countries, however this view changed to reliance on more exports for growth (Krugman and Obstfeld: 2000, p.266). To support their argument they quote the exemplary growth of High Performance Asian Economies (HPAE), which achieved a high economic growth with policy of open international trade and via rapid growth of exports rather than substitution of domestic production for imports. Ray (1998, p.621), while giving argument in favor of free trade, quotes the example of export led growth by the Newly Industrialized Economies (NIEs) Hong Kong, Korea, Singapore and Taiwan. Other Asian countries like Malaysia, Indonesia, Philippines, Thailand and China also adopted the export oriented policies of NIEs and attained an impressive growth level. According to Giersch (1986, p.204) the removal

of barriers to foreign trade expands the feasible set of consumption possibilities of an economy by providing in effect an indirect technology for transforming local resources into goods and services benefiting the consumers. Free trade would cause world resources to be utilized most efficiently and would maximize world welfare (Salvatore, 1995).

Nonetheless the concept of comparative advantage has great importance in trade theory, but it has been criticized by Ray (1998, p.650) in a sense that it is a static concept, which determines the trade benefits of a country at any one point of time. He adds that according to the Heckscher-Ohlin theory a country should export those goods, which are in relative abundance and cheaply produced. Problem with this approach is that notion of relative abundance pertains to here and now. A country, which is currently facing shortage of capital, may become capital abundance in future.

Although free trade has more positive aspects, at the same time there may be some negative impacts on employment and production after the removal of trade barriers. According to Bhagwati (1996, p/10), "in case of freer trade between poor and rich countries, if the poor countries have more unskilled labour, lower standards of labour and environment then the free trade can be harmful to them". Although there will be trade gains but income distribution will be adversely affected (ibid). This is an indication for developing countries like Pakistan before joining the free trade blocs the pre-conditions like literacy rates, poor labour and infrastructure conditions must be properly addressed. Pomfret (1991, p.140), says that

"the most common argument in favour of trade barriers is the pauper labour argument. In its crudest form, the argument is that if country A's wages are lower than country B's in all activities then the latter's products will be undersold and trade will bring unemployment".

How do tariffs affect consumer and producer surplus in the trading countries? The consumer and producer surplus are gained through the price changes. According to Krugman and Obstfeld (2000) the imposition of tariff has different effects in importing and exporting countries, the price is increased in importing country and decreased in exporting country, which implies that the consumers in the importing country lose while gain in the exporting country. On the other hand the producers gain in the importing country and lose in the exporting country.

The deadweight loss is a concept mainly used in economics, meaning a loss or costs to economy occurred due to inefficiencies of the markets. It is also defined as “a permanent loss of well being to society that can occur when equilibrium for a good or service is not Pareto optimal, (that at least one individual could be made better off without others being made worse off)”⁸. According to another definition, “the term deadweight loss can be applied to any deficiency due to an inefficient allocation of resources. Lost production due to inaccurate forecasting for labour is an example of a deadweight loss”⁹. If the said FTA brings efficiency and competition, there will be best allocation of resources eventually making industries competitive and minimizing deadweight loss.

For further explanation see Figure-1 above and also Ray (1998, p.666). Suppose P^* depicts the free trade price and P^*_1 represents the domestic price including tariff in figure-1. At price P^*_1 the domestic consumption declines from OB to OD, whereas the domestic production increases from OA to OC. The imposition of tariffs cause a loss to the domestic consumer i.e. area $P^*P^*_1FG$ and the producer’s gain will be area $P^*P^*_1HI$. By valuing the producers and consumers equally, the gains of producers can be subtracted from the losses of consumers and we will find the net loss i.e. area IHFG. The imposition of tariff also raises the government revenue, which in this case is the area IJFK. The comparison of areas IHFG (net consumer & producer loss) and IJFK (government revenue) illustrates that the area IHFG is larger than area IJFK. The difference is two triangles, i.e. HIJ and FKG, which make the losses higher than the gains and these are called deadweight efficiency losses incurred due to import tariffs. This discussion has proved that the imposition of tariffs is beneficial to the domestic producers and the government but causes losses to the domestic consumers. The losses to the consumers are greater than the gains of government and producers, so import tariffs decrease the overall welfare of the people. On the basis of these arguments it can be assumed that the said FTA would have positive impacts on trade and will enhance the welfare of the people in both countries.

⁸ <http://www.free-definition.com/Deadweight-loss.html>, [Accessed 19 Aug 2005]

⁹ <http://www.investopedia.com/terms/d/deadweightloss.asp>, [Accessed 19 Aug 2005]

2.3 Import-Substituting Industrialization (ISI) / Protectionism

The policy of protectionism / ISI has some merits and demerits, both positive and negative consequences are historically proved and established facts. The benefits of import tariffs are the collection of government revenues from international trade in the shape of customs duties (CD) and the protection of home industry from foreign competition. The developing and poor countries have been collecting ample taxes (import duties) by imposing high import tariffs. As compared to other taxes the trade taxes are not only easy to collect, but also ensure revenues. The raising of revenue for the governments from import tariffs became the popular and easy method (Pomfret: 1991, p.138). Krugman and Obstfeld (2000, pp.255-258) favor the policy of protectionism for infant industry in the developing countries.

The main arguments against the trade barriers and protection are that they generate the problems of income distribution and keep the home industry inefficient in most cases. Many countries including Pakistan, which have been following the policies of protectionism, could not catch up with the advanced countries (ibid). Pakistan had protected its industries by high tariff rates, but it could not catch up with the advanced countries. Its 32% population is still living under the poverty line and 54% population is illiterate (The World Factbook: 2005). The tax-GDP ratio is low and also there is a huge burden of public debt around 70% of GDP (ibid). Anwar (2003), states that a big number of people are living at subsistence level in Pakistan.

2.4 Trade Creation and Trade Diversion

The trade creation mean a free trade area creates trade that would not have existed otherwise. Resultantly, the supply occurs from a more efficient producer of the product and in all cases trade creation will raise a country's national welfare (Suranovic: 1997-2004)¹⁰. While on the other hand the trade diversion means that a free trade area diverts trade, away from a more efficient supplier outside the FTA, towards a less efficient supplier within the FTA. In some cases, trade diversion will reduce a country's national welfare but in some cases national welfare could improve despite the trade diversion (ibid).

¹⁰ for further explanations and details please see <http://internationalecon.com/v1.0/ch110/110c030.html>, [Accessed on 22 Oct 2005]

The FTAs create the possibilities of trade creation and trade diversion but the overall benefits depend on the size of trade creation and trade diversion. It is common for economists to make the following statement, "If the positive effects from trade creation are larger than the negative effects from trade diversion, then the FTA will improve national welfare"(ibid). In other words if FTA creates more trade diversion than the trade creation then it may reduce the country's welfare. Trefler (2001) quotes (Arvind Panagarya, 2000; Krishna, 2003) who had stated that the increase in the likelihood of welfare gains from free trade depends on the conditions; "that the trade creation "dominates" trade diversion and that import prices do not rise". The trading countries lowering tariffs would produce gains not only on the demand side but also on the supply side by reallocation of resources in the economy¹¹. Therefore, for maximization of welfare, the trading country like Pakistan should try to explore all the possibilities of the trade creation through the FTA.

The argument that by merely exporting raw material to the advanced countries could not help to grow and develop is very important. Pakistan has to make strategies carefully for trade liberalization. The export of raw material like cotton yarn will be beneficial but not as beneficial as the export of finished goods. As we know up to now the progress of WTO is not according to the expectations, therefore, despite waiting for the WTO outcome we should find out other ways for the promotion of trade and ultimately the welfare of people. In this regard the initiated negotiations by Pakistan with several countries for the FTAs need more attention for the early finalization of the agreements to foster the trade.

2.5 Preferential Trade Agreements and Multilateral Trade Agreements

Srinivasan, quotes (WTO, 2001a, p.37) that the PTAs are the agreements among a set of countries involving preferential treatment of bilateral trade. The regional PTAs are called the Regional Trade agreements (RTAs) and the most common form of RTAs are the FTAs (ibid). PTAs foster competition, affect market size and level of trade and create more trade and thus contribute to welfare and growth (ADB)¹². The ADB report further says that the PTAs also affect

¹¹ http://en.wikipedia.org/wiki/free_trade#Economic_arguments_for_free_trade , [Accessed on 14th Nov 2005]

¹² <http://www.adb.org/documents/books/ADO/2002/pta0401.asp>, [Accessed on 13th Nov 2005]

the world economy through trade diversion as member countries start to import more from each other. The countries who do not join the PTAs or FTAs may suffer economic set back. The report has quoted the findings of (Chang and Winters 1999) confirming that the countries remain outside of a PTA suffer clear losses in the shape of reduced exports.

On the other hand the World Trade Organization (WTO) is a voluntary group of nations (more than 140 nations) that negotiates, monitors, and enforces global rules for international trade¹³. The main objective of WTO is to ensure the smooth trade flows among the nations, but up to now it has not progressed effectively. Although some progress has been made but still there is no obvious picture about the implementation of WTO rules (see Heine: 2004)¹⁴. The main problem with WTO is that it is too big forum to reach on a consensus on various issues among nations and this is also a fact that on the WTO forum it has become difficult for superpowers to dictate the developing nations. Urata (2003) states that despite the desire of many policy makers for promoting trade liberalization, it has become apparent that trade liberalization under GATT/WTO have become increasingly difficult. Therefore, nations found FTAs and RTA more beneficial for their economic gains. The USA has been more active in bilateral free trade agreements because it finds difficult to obtain desired results at the forum of the WTO (Bokhari: 2005). Contrary to this PTAs/FTAs are easy to manage and the success of FTAs in the recent past has led the nations to enter into more free trade agreements despite waiting for WTO. Therefore, the FTAs may have some demerits but still nations find them beneficial for economic growth and development and also to avoid economic aloofness.

2.6 Empirical Evidence from Existing FTAs

For the empirical evidence there are many studies showing the impact of FTAs on employment and welfare. Trefler (2001) found mix results of the Canada – U.S FTA. The FTA was associated with substantial employment losses i.e.12 % for import-competing industries and 5% for manufacturing as a whole. On the other hand it found larger labor productivity gains which rose by 14% in export-oriented group of industries at plant level and rose by 15% in import competing group of industries. Trefler (2001) found labor productivity gains and also

¹³ http://www.farmfoundation.org/2002_farm_bill/vsmith.pdf , [Accessed 14th Nov 2005]

¹⁴ http://www.bilaterls.org/article.php3?id_article=546 [Accessed on 30-8-2005]

found more trade creation than trade diversion, in the Canada-US free trade agreement. Gaston and Trefler (1997) found that “shortly after the implementation of FTA employment began falling until 1992 and 390,600 jobs were lost and in contrast to this employment in services sector rose modestly by 123, 000 jobs in Canada”. According to Linda (2004), the Canada’s trade with Mexico was doubled and investment from US to Canada increased substantially. More than one million jobs were created in Canada (for details see box-4.2). The trade between four Mercosur countries increased more than 400% from 1990 and 1997 (ibid). The empirical studies show that the overall impact of the FTAs has been positive on employment and welfare.

This chapter contains five sections including a detailed discussion about the political economy of the said FTA to analyze the political aspects of FTA. Chapter includes current status of FTA, China's FTAs with other countries, China's textile sector and its import pattern of cotton yarn and cotton fabrics. The chapter also includes information on import tariffs in Pakistan and in China and expected revenue loss.

3.1 Political Economy of Pakistan-China FTA (PC-FTA)

The trade among nations not only brings economic benefits and welfare, but in most cases it also ensures bilateral and regional political stability and peace. Economically weak nations remain vulnerable to military threats from stronger nations. This threat compels the small and feeble nations towards integration with other nations. According to Spero (1990, p.23) the start of cold war at the end of 1940s led to more economic cooperation for the rebuilding of western economies and also to provide political and military security. The integration among European states had not only brought economic welfare in the region but also established political stability and peace among the hostile nations. The European Union (EU) with the passage of time is becoming stronger and stronger and now it has taken the shape of monetary union (MU) by adopting euro as common currency and it is expected that one day it will be developed into a political union (PU) as well. Qualitative analysis depicts that free trade enhances economic interdependence among the nations and leads them to peace¹⁵. This has been proved in the case of EU and we found that due to the extended and trustable relations the chances of war among the member states has been minimized. Similarly, there are other trade blocs, who, played an important role not only for the promotion of trade but they also strengthened political stability in the region. The ASEAN which started its journey in 1967 for regional security, termed to preferential trade arrangement and in 1993 with a ten year timetable to shape ASEAN free trade area (AFTA) (Low: 2004). The process of evolution how small trade agreements and PTAs develop to economic union (EU), monetary union (MU) and political

¹⁵ http://en.wikipedia.org/wiki/free_trade#Economic_arguments_for_free_trade, [Accessed on 14th Nov 2005]

union (PU), is explained by Low (2004). Following table explains the stages and process of evaluation.

Table-3.1: Stages of Economic Integration Leading to Political Union

	PTA	FTA	CU	CM	EU	PU
Item-by-item preferential tariff reduction	X	X	X	X	X	X
Removal of all tariffs among members		X	X	X	X	X
Common external tariff			X	X	X	X
Free factor movement (labour & capital)				X	X	X
Harmonise econ policies (fiscal/ monetary)					X	X
Political unification						X

Source: Low, Linda (2004, p.5) "The Political Economy of Trade Liberalization"

PTA = preferential trading area, FTA = free trade area, CU = customs union, CM = common market, EU = economic union, PU = political union

Pakistan like other developing nations has inclined to bilateral trade agreements with other countries. In this regard Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka met in mid 2004 to give a fresh impetus to South Asian FTA slated for 2006 (Low: 2004). The FTA with Sri Lanka has gone into operation and negotiations are under way with China, Malaysia, Singapore, Indonesia, Tunisia, Mauritius, Morocco, Laos, Saudi Arabia, Oman, Kuwait, UAE, Bahrain and Qatar (Bokhari: 2005). Although all countries named above are important for trade relations but keeping in view the historical background of Sino-Pakistani all weather strategic partnership and the regional and global political situation, the importance of FTA between these two countries has more significance. The promotion of overall cooperative partnership between them will exert significant influence on maintaining the stability and regional safety and boosting the traditional friendly relations between other Muslim countries and China¹⁶.

The strong Sino-Pakistani ties amid unpleasant relations between India and Pakistan always remained important for both nations. In the post 9/11 scenario Pakistan needs more pragmatic and all directional strategic cooperation with China. It is a reality that Pakistan and India find it difficult to develop close friendly relations due to territorial disputes. The resolution

¹⁶ Further details on the pros and cons and the interests of China behind this FTA can be seen form http://english.people.com.cn/200504/05/eng20050405_179598.html. [Accessed 23 Sep 2005]

of their conflicts including the core issue of Kashmir can pave the way for sustainable peace and better economic relations among two nations. It is expected that the current leadership on both sides, which is quite capable and also seems willing and determined, can solve the half century old dispute amicably.

The regional and global political situation has forced nations to come closer to each other for better economic future and security. In the current situation Pakistan and China both need each others cooperation in all fields and the extended ties between two nations will benefit each other in several ways. Pakistan is one of the largest Muslim countries, a nuclear power and, moreover, its key geographical location amplifies its importance on the world map. China is showing keen interest to promote its economic relations with Arab and African countries. The reasons for this keen interest are that the Gulf Co-operation Council (GCC) has 45% of total oil reserves, it is the place of 20 million consumers and attracts a large foreign investment totaling US\$ 1.5 trillion in 2003 (Asia Pulse: 2005)¹⁷. Therefore, the increased economic ties with Gulf countries will open the new venues for the Chinese economy. The promotion of expected Sino-GCC trade relations will largely depend on Pakistan due to its ideal geographical location, which will facilitate China to en-route its shipments through sea of Pakistan to GCC/Arab countries and other parts of the world as well. Similarly, Pakistan needs China's technical, economic and political support. As an emerging economic power China can assert its authority in the international financial institutions to ensure that Pakistan gets a fair deal and also to ensure that there is no discrimination against Pakistan (Hussain: 2001). In addition to this China's unprecedented economic growth which, is a role model for developing countries, can lead Pakistan to economic development and welfare through trade, investment and transfer of technology through closer economic ties between two nations.

Many developing and advanced countries are keen to sign FTA with China, which depicts that China is playing the role of growth engine both for the region and world economy as well. Currently China is pursuing the establishment of FTA with 23 three countries across the

¹⁷ Asia Pulse , www.asiapulse.com [Accessed on 8 March 2005]

world¹⁸. The talks are also under way between China and India for the establishment of FTA. In these circumstances Pakistan will need to play a dynamic role not only to promote its trade relations with China and other neighboring countries but also to protect its economic and political interests in the region.

The current volume of trade between China and Pakistan is not significant, although it is expected that it will enhance in future. Nonetheless, along with fortified economic ties it is also very important to strengthen the political relations between two countries. The Sino-Pakistan close political relations will also promote regional security and peace, which is quite essential for the economic development in the region. We know there is a positive relationship between economic development and peace and it would not be wrong to say that peace is a necessary condition for development. The armed conflicts and wars often suspend or reverse development and less developed countries are more likely to experience internal conflicts than richer and developed states¹⁹. The regions and countries engrossed in political crisis and conflict find it difficult to exploit their resources for growth and development and most of their budget is allocated for defense purpose. The countries like Pakistan, Indonesia, Bangladesh, India and many African countries have a lot of natural resources, but the political crisis and conflict never allowed them to grow faster. Pakistan and India are spending huge share of their national budget on defense for last five decades and the conflict between two countries have left millions of people to live under poverty line. On the other hand the countries with stable and strong political culture are able to grow faster than others. The establishment of the European Union is a most appropriate example to realize the importance of political stability and peace for economic development. If we compare the economic situation and level of development before 1958, with the current level of development in Europe the difference is very clear. The desired economic growth and development was possible only when these nations had sorted out their conflicts and established political stability in the region.

¹⁸ http://www.bilaterals.org/article.php3?id_article=1418. [Accessed 11 Sep 2005]

¹⁹ Nils Petter Gleditsch, Are Knudsen, Astri Suhrke & Henrik Urdal (March 2003), Conflict and Development: Framework for a proposed research area, PRIO International Peace Research Institute, Oslo

Can we expect the Sino-Pakistani trade relations be extended into a bigger regional bloc by including India, Bangladesh, Iran and Afghanistan etc. in future? The answer to this question up to large extent lies in the resolution of Kashmir dispute. In the case of EU it has been proved that the warring and hostile nations became economic partners and friendly nations. Then why the Sino-Pakistani bilateral relations can not be an initial step towards the journey for world's one of the largest common market and economic union? Although relations between two nations are at 2nd stage (see table-3.1) but the possibility of such a bloc would always be there. It depends on the strong political will of the regional leaders who provide workable solution to the burning issues. Once these issues are resolved the world can see a biggest economic union benefiting directly more than 2 billion people. A liberal international economic system along with economic prosperity would also enhance the possibilities of peace (Spero: 1990, p.22).

3.2 The Status of FTA and Pakistan's Preparations

On 6th August 2005 Pakistan and China have finalized two separate lists of 52 items on which import tariff would be brought to zero level under Early Harvest Program (EHP) as part of Free Trade Agreement²⁰. The duty free commodities have been decided on reciprocal basis in order to facilitate each other. The list of duty free items include Pakistan's exports; bed-linen, table linen, terry towels, blended fabrics, synthetic yarn, synthetic fabrics, surgical goods, mangoes, oranges, dates, tarpaulin, marble articles, sports goods, cutlery, certain dyes, guar gum and medicines, the duty free imports from china include industrial machinery and chemical raw materials (ibid). The duty reduction plan would be implemented in different phases and both countries have agreed that the first reduction in tariffs will take place on January 1, 2006, and by January 1, 2008, tariff will be brought to zero on all items²¹.

Keeping in view the increasing competition in future especially after the elimination of Multi Fibre Agreement (MFA), Pakistan government had already taken numerous steps in order to enable the textile sector to compete the world market. These measures include various tax exemptions, like elimination of taxes on supply and import of ginned cotton, import of man-

²⁰ <http://www.jang.com.pk/thenews/aug2005-daily/06-08-2005/business/b4.htm>. [Accessed 8 Aug 2005]

²¹ www.bilaterals.org. [Accessed 17 July 2005]

made staple fibre and its raw materials²². In the national budget²³ for the FY 2005-2006 government has announced a reduction in the customs duties rates on synthetic, woolen and cotton raw materials/products. In this regard most important step was the textile vision 2005. According to (Economic Survey: 2003-04) the textile vision 2005 was established to make textile sector an open market driven, innovative and vibrant, which is internationally integrated, globally competitive and fully equipped to take the benefit of opportunities created by the quota free textile regime. Under this program 4.0 billion \$ has been invested during 1999 and 2003 for Balancing, Modernization and Replacement (BMR). The heavy inflow of investment in BMR and other mentioned measures will hopefully enable the textile sector of Pakistan to meet the challenges of post quota regime and the said FTA successfully.

It has been observed that the trade between China and Pakistan has grown during last fiscal year. According Mahmood²⁴, the trade between China and Pakistan was more than two billion dollars in the year 2004-05 for the first time. The trade volume has jumped from 1.4 billion dollars during 2003-04 between two countries. It is believed that, it has been possible due to the measures taken by the government for the promotion of free trade and also due to the existing preferential trade agreement between two countries.

3.3 FTA Between China and Other Countries / Blocs and its Current Trade Partners

In the last decade China's unprecedented economic growth and development has played the role of growth engine for the region and the world as well. Along with huge size of the economy the impressive growth pattern has attracted not only the developing countries but also the advanced countries. Many countries are interested to sign FTA with China and negotiations are under way. In this situation Pakistan's need for a free trade agreement with China was augmented and by realizing this need it had signed the FTA. The said FTA at least will serve the purpose of a defence strategy to protect Pakistan's home industry against the competitors in future. The details of the FTAs between China and other countries are given below:

²² <http://www.dawn.com/2005/05/11ebr9.htm>. [Accessed 9 Aug 2005]

²³ <http://www.cbr.gov.pk/budget2006/home.asp?p=salientfeatures2006.htm>. [Accessed 8 Aug 2005]

²⁴ www.nation.com.pk/daily/nov-2005/8/bnews1.php , [Accessed 8th Nov 2005]

China – Thailand: The FTA for agriculture produce between two countries came into effect from October 2003 and the tariff for 188 kinds of fruits and vegetables have been cut to zero²⁵. The report asserts that the FTA between two countries has been helpful to enhance the trade volume. The trade has shot up to \$60 million over the first 20 months and also a boost in logistics cooperation has been recorded after the implementation of FTA.

China – ASEAN: China has signed an exclusive FTA with ASEAN (a ten country bloc), expected to come into force in 2010, it will be world’s third largest trading bloc after NAFTA and EU²⁶. According to this agreement China and ASEAN nations will lower tariffs on more than 7,000 industrial goods. It seems that the said FTA will have far reaching economic effects on the neighbouring as well as other nations in the world.

China – Australia: A framework agreement between China and Australia for potential FTA has been signed in October 2003²⁷. According to the details China would not be allowed to have special access to Australia’s textile market (ibid). Apart from this the FTA’s are under negotiation between China – Chile, China-Brunei, China-Malaysia, China - New Zealand, China – India, and China-Vietnam²⁸.

After the signing of FTA by China with Australia, India and USA, Pakistan will be facing increasing competition for textile related exports because these three countries are also cotton producing and textile items exporting countries.

Table-3.2 China's Principal Export and Import Sources, 2004

Export Destinations		Import Sources	
1	United States 21.1%	1	Japan 16.8%
2	Hong Kong 17.0%	2	Taiwan 11.5%
3	Japan 12.4%	3	Republic of Korea 11.1%
4	Republic of Korea 4.7%	4	United States 8.0%
5	Germany 4.0%	5	Germany 5.4%

Source: <http://www.dfat.gov.au/geo/fs/chin.pdf> [Accessed on 12th Nov 2005]

²⁵ http://www.bilaterals.org/rubrique.php?id_rubrique=26. [Accessed 16 July 2005]

²⁶ http://www.bilaterals.org/rubrique.php?id_rubrique=95. [Accessed 16 July 2005]

²⁷ http://www.bilaterals.org/rubrique.php?id_rubrique=97. [Accessed 16 July 2005]

²⁸ http://www.apec.org/webapps/fta_rta_information.html. [Accessed 30 Aug 2005]

The table 3.2 reveals that the close competitors of Pakistan are not among the top five trading partners of China. However, as mentioned above the negotiations are underway for FTAs with other countries including India and Australia which are potential competitors of Pakistan in the textile sector. After signing the FTA with aforementioned countries the trade volume with China will increase, in that scenario Pakistan needs to plan its future export strategies.

3.4 China's Textile Sector- and Import Sources of Cotton Yarn and Cotton Fabrics:

China is the largest producer of raw cotton, cotton yarn and cotton cloth in the world. The planted area is 5690000 hectares land and the production of cotton is 6314070 mt (Gain Report: 2005). The lucrative prices offered to the cotton growers for their raw cotton always encourage them to grow more. In this regard China has adopted an appropriate price policy which has strengthened the industry and enabled it to sustain cotton production during last four years (Becerra: 2004). Moreover, the adoption of Genetic Engineering (GE) cotton enabled the crop to resist against pest attack and eventually to increase the crop yield. The adoption of GE cotton has also led to the drop of production cost. On the other hand the capacity of mill consumption has also increased massively; the industry was processing 6.5 million tons of raw cotton in 2002-03 as compared to 2.2 million tons in 1998-99.

China's position is very strong in the textile export market, it has been the driving force of the world textile industry and it is not only the largest producer but also the largest consumer of cotton (Becerra: 2004). It is expected that imports of raw cotton will average one million tons a year, sharing 15 percent of world trade. Becerra states that the low labour costs and appropriate policies have been helpful to improve its competitiveness and its share of world textile and apparel exports during last four years. According to Jane Li²⁹ China has dominated the textile and apparel market and China's apparel sector is beyond comparison in respect of the variety and scope of its operation. Textile and apparel exports also generate a large portion of China's manufacturing output. In addition to this there are 21,144 enterprises and employing around 15 million workers in the textile sector.

²⁹ <http://www.amrc.org.hk/5203.htm>

China imports a huge quantity of cotton yarn and cotton fabrics from rest of the world, details are given in the following tables:

Table-3.3 China's country-wise Imports of Cotton Yarn and Thread

Unit: Metric tons

countries	2001	Share%	2002	Share%	2003	Share%	2004	Share%
China	123,759	23.8	207,871	34.8	283,768	41.3	282,926	41.2
Pakistan	189,825	36.6	180,757	30.3	189,868	27.6	186,634	27.2
India	76,995	14.8	65,568	11.0	54,555	7.9	76,204	11.1
hong kong	46,646	9.0	54,708	9.2	51,292	7.5	27,967	4.1
Indonesia	28,885	5.6	31,914	5.3	33,756	4.9	33,904	4.9
Taiwan	18,771	3.6	16,718	2.8	32,548	4.7	31,106	4.5
Korea, South	13,156	2.5	14,554	2.4	16,250	2.4	14,548	2.1
Thailand	7,418	1.4	9,189	1.5	10,896	1.6	13,625	2.0
Other	13,801	2.7	15,917	2.7	676,961	98.4	20,034	2.9
Total	519,256		597,196		687,857		686,948	

Source: <http://www.fas.usda.gov/qainfiles/200504/146119477.pdf>

Table-3.4 China's country-wise Imports of Cotton Fabric

Unit: 1000 Square Meters

countries	2001	Share%	2002	Share%	2003	Share%	2004	Share%
China	309396	24.7	368188	27.9	466950	35.3	487898	35.6
Hong kong	368302	29.4	403631	30.6	362696	27.4	390848	28.5
Japan	140431	11.2	137835	10.5	139627	10.6	139934	10.2
Pakistan	158132	12.6	175532	13.3	131258	9.9	116084	8.5
Taiwan	129730	10.4	133476	10.1	112163	8.5	108569	7.9
Korea, South	36274	2.9	30610	2.3	41655	3.1	44150	3.2
Indonesia			16428		16853		13580	
Macao	16213	1.3		0.0	14575	1.1	0	0.0
India	58234	4.7	15826	1.2		0.0	17537	1.3
Other	35235	2.8	36922	2.8	37212	2.8	51844	3.8
total	1251947		1318448		1322989		1370444	

Source: <http://www.fas.usda.gov/qainfiles/200504/146119477.pdf>

China's total annual demand of cotton yarn in year 2004 was 686, 948 metric tons where as its own production was 41.2% of total demand, that means around 60% reliance on imported cotton yarn. In respect of cotton fabrics China's own production is 35.6% out of its total demand, again it has to import a significant share from rest of the world. It is evident from above tables that the share of Pakistan's export of cotton yarn and cotton fabric has declined over time. The share of cotton yarn which was 36.6% during 2001 in China's total import of cotton yarn plummeted to 27.2% in 2004. Similarly, during the same period the share of cotton fabric declined from 12.6% to 8.5%. This declining trend in the exports of these two items to China is continued during the current fiscal year i.e. 2004-05, which has also been confirmed by the EPB report of Jul-Mar 2004-05. The EPB report also depicts that during the same period i.e. Jul-Mar 2004-05 the exports of Cotton Yarn had enormously increased to U.S.A., Indonesia, Philippines

and Thailand, while a significant increase in the export of cotton fabrics have also been recorded to U.A.E, Saudi Arabia, Sri Lanka, Italy and South Africa. Apparently this could be the possible explanation of declining exports of the said items to China, but also it could be the case that China is giving more preference to import from other countries as compared to Pakistan.

The situation in 2005 in respect of exports of the said items to China is not very encouraging, but the potential for trade diversion is still there because China has to import a significant share of these two items from rest of the world (see tables 2 & 3), but it depends on the terms and conditions of the FTA. However, the proposed FTA is to be implemented from 1st January, 2008, so still there is sufficient time to chalk out the new trade patterns with China. As it was discussed in chapter-2 that the trade creation always enhances the welfare of the country, therefore, to maximize FTA benefits Pakistan has to create more trade. Although the possibilities of trade diversion will be there but we know that it may or may not enhance the welfare of the country. Therefore, the stress and planning should be for more trade creation in future. However, the FTA will protect the Pakistani producers against other competitors until the signing of FTA between China and other competing countries takes place.

3.5 Import Tariffs and Expected Revenue Loss

Under existing preferential trade agreement (PTA) between two countries, China had reduced the rates of customs duties on 893 items imported from Pakistan and these rates range from zero to 50% and out of this long list around 20 items are zero rated³⁰. Similarly, under PTA Pakistan had also reduced the rates of customs duties on 188 items imported from China, ranging from zero to 25% and it is worth mentioning that out of 94 items 77 items are zero rated and most of these items are food items.

Pakistan imports a number of items from China, including food items, fresh vegetables, beans, grams, milking machines, dairy machinery, vehicles, poultry incubators and brooders, machinery for sugar manufactures, washing machines, textile machinery and chemicals etc (CBR). The rates of customs duties vary from 5% to 25%. The textile related items which are

³⁰ <http://www.epb.gov.pk/epb/jsp/epbdocs2004/PTA.pdf>

imported from china are listed in table-3.5, with current duty rates and schedule of gradual reduction of duty rates:

Table-3.5 Gradual Reduction of Customs Duty Rates on Textile Items Under PC-FTA

Rs. Million						
	Textile Related Items Imported from China	Customs Duty Rates (%)			Dutiable Import Value	
		04-05	After (1.1.06)	After (1.1.07)		After (1.1.08)
1	Machines for extruding, drawing, texturing or cutting man made textile materials.	5	5	0	0	189.1
2	—Carding machines	5	5	0	0	485.6
3	—Combing machines	5	5	0	0	15.9
4	—Drawing or roving machines	5	5	0	0	192.4
6	—Textile spinning machines	10	5	0	0	1821.0
7	—Textile doubling or twisting machines	5	5	0	0	77.5
8	—Weft winding machines	5	5	0	0	0.7
9	—For weaving fabrics of a width not exceeding 30cm	20	10	5	0	14.1
10	—Power looms	25	10	5	0	5.1
11	—For weaving fabrics of a width exceeding 30 cm, shuttleless type	10	5	0	0	9.0
12	—With cylinder diameter not exceeding 165mm	5	5	0	0	9.1
13	—With cylinder diameter exceeding 165mm	5	5	0	0	2.2
14	—Flat knitting machines; stitch-bonding machines	5	5	0	0	0.1
15	—Dobbies and Jacquards; card reducing, copying, punching or assembling machines for use therewith	5	5	0	0	2.3
16	—Parts and accessories of machines of heading 84.44 or of their auxiliary machinery	10	5	0	0	18.4
17	—Tops and flats	20	10	5	0	3.2
18	—Of machines for preparing textile fibres, other than card clothing	10	5	0	0	1.1
19	—Spindle flyers and ring travellers	5	5	0	0	7.5
20	—Spindles	10	10	5	0	140.4
21	—Spinning rings	20	10	5	0	59.5
22	—Shuttles	10	5	0	0	1.4
23	—Reeds	25	10	5	0	16.3
24	—Sinkers, needles and other articles used in forming stitches	5	5	0	0	20.2
25	Machinery for the manufacture or finishing of felt or nonwoven	5	5	0	0	5.1
Total (1 to 25)					3097.2	
Textile Related Items as percent of total dutiable imports					27.2%	
Total Dutiable Imports from China					11370.6	

Source: CBR Pakistan

It has been agreed between the two countries that the rates of customs duties initially under EHP will be gradually reduced as evident from the above table, and then will be brought to zero from 1st January 2008 on all traded items. The share of textile related dutiable imported machinery from China is around 27% of total dutiable imports. This is a substantial share that

means the elimination of tariffs will have a notable impact and it will be helpful to trim down the cost of production of textile items in Pakistan.

The estimated tax collection was Rs.29,000 million from customs duties, sales tax, income tax and central excise duties against all the traded items during 2004-05 (Table-3.6). While estimated tax collection on the items considered for FTA was Rs. 1174.1 million. Similarly, the revenue loss for next two financial years against FTA items has been estimated around Rs.2.0 billion. When all traded items will be brought under the FTA i.e. from 1st January 2008, then the revenue loss will reach around Rs.30 billion annually.

Table-3.6 Projected Collection of Taxes on Imports from China 2004-05
Rs. In million

	Customs			Central	Total
	Duties	Sales Tax	Income Tax	Excise Duties	
All items	12512.6	12409.9	4261.0	20.6	29204.1
FTA Item	691.4	179.0	303.7	0.0	1174.1
Expected Loss in Federal Taxes due to FTA					
Period	Customs			Central	Total
	Duties	Sales Tax	Income Tax	Excise Duties	
1.1.6 to 31.1.7	163.8	24.6	9.8	0.0	198.2
1.1.7 to 31.1.7	670.2	100.5	40.2	0.0	810.9
1.1.8 to 31.1.8	691.4	103.7	41.5	0.0	836.6
Total Loss	1525.4	228.8	91.5	0.0	1845.8

Source: CBR (Pakistan)

The FTA will cause around Rs.30 billion in terms of overall tax revenue loss to the government. It has been shown that the gains of existing free trade countries have been more than losses. If the said FTA creates more trade then the expectations from FTA can be realized. These gains can be realized through many ways. Pakistan imports a significant amount of textile related machinery from China i.e. more than Rs.3 billion annually, which is 27% of total dutiable import value from China and this amount may increase in future after the implementation of FTA. Pakistan also imports a huge quantity of textile related machinery from rest of the world other than China. This has ranged between Rs. 25 billion to Rs. 34 billion during 2001-02 to

2002-03 (APTMA)³¹. By taking the advantage of FTA Pakistani manufacturers can benefit by importing more duty free machinery from China. The import of duty free input items will help enable Pakistani industries to reduce the production costs and gain a better competitive position in the world market.

The Duty Structure on Pakistani Exports in China Under Existing PTA since 2003

Hundreds of textile related items are exported to China and the duty rates vary from 5% to more than 20% on different goods. Some of the textile related items are given table 3.7 below with their duty rates charged in China.

Table-3.7 China's Tariff Concession to Pakistan under PTA (2003)

S.No	Textile Related Items	Tariff rate conceded (%)
1	Other woven fabrics of tussah silk	12
2	Unbleached or bleached woven fabrics of spun	12
3	Other woven fabrics of spun silk	12
4	Uncombed cabled cotton yarn	4.5
5	Combed cabled cotton yarn	4.5
6	Cotton Yarn (excl. sewing)	5
7	Dyed woven cotton fabrics	9
8	Coloured woven cotton fabrics	9
9	Dyed plain cotton weave	11
10	Printed plain cotton weave	11
11	Unbleached plain cotton weave	13
12	Coloured ramie yarn	6
13	Paper Yarn	6
14	Other woven fabrics of flax	11.5
15	Single Yarn of nylon	7
16	Dyed woven fabrics of synthetic filament yarn	18
17	Dyed woven fabrics	18
18	Unbleached plain weave fabric	20.5
19	Men's or boy's coats of man made fibers	15
20	Women's or girls coats of wool	18
21	Men's or boy's jackets of synthetic fibers	15
22	Men's or boy's jackets of other textiles	15
23	Men's or boy's trousers of cotton	15
24	Women's or girls suits of other textiles	15
25	Women's or girls suits of cotton	15

Source: CBR Pakistan

The above table depicts that the tariff rates are ranging from 5% minimum to 20.5% maximum, however, after 1st January 2008 these rates will be brought to zero level on all items.

³¹ http://www.apmta.org.pk/pak_Textile_Statistics/itm_print.asp , [Accessed on 8th Sep 2005]

The overall share of textile related export items from Pakistan to China is more than 70% and the share of cotton yarn and cotton fabrics is 42% and 29% respectively (FBS)³². These figures indicate that the elimination of duties can bring a major export boost to these two items.

³² These figures have been taken from the report of FBS Pakistan reports

Chapter-4 Empirical Evidence

This chapter is comprised of six sections. For highlighting the Pakistan's position in world ranking it includes a section about the global textile scenario and country-wise production of cotton cloth and cotton yarn. The current trade patterns of Pakistan to evaluate the future changes in the trade patterns after the implementation of the said FTA have also been discussed. The chapter includes the important analysis about the textile exports of Pakistan during the post MFA period to estimate the impact on its major export items. Moreover, it include the discussion about the comparative analysis of cost of production which will enable us to know the competitiveness of the Pakistani producers in the world market. After the implementation of FTA should Pakistan expect changes in its trade patterns with China and rest of the buyers of the said commodities? The discussion will try to find out the answer to this important question.

4.1 Global Textile Scenario and Pakistan

Like food items the textile items are also vital for human beings. The modernization and the increasing population have resulted into the enhanced demand of cotton and textile manufactures. The world cotton market has witnessed dramatic changes during last five decades and the consumption of cotton, which was only 7.6 million tons in 1950-51 mounted to 18.5 million tons in 1998-99 (Becerra: 2004). The main cotton producing countries in the world are Argentina, Australia, Azerbaijan, Brazil, China, Egypt, Greece, India, Kazakhstan, Pakistan, Spain, Sudan, Turkey, Turkmenistan, USA and Uzbekistan, and Pakistan is the 4th largest producer of raw cotton³³. During last three decades four leading cotton producing countries China, USA, India and Pakistan accounted for 48% of total production in 1970-71, 52% in 1980-81, 61% in 1990-91 and 66% in 2002-03 (Becerra: 2004). The demand for textiles in the world is about \$18 trillion, which is likely to increase by 6.5% in 2005, the share of China in total textiles exports of US \$400 billion is major i.e. \$ 55 billion, followed by Hong Kong \$38 billion, Korea \$ 35 billion, Taiwan \$16 billion, Indonesia \$9 billion and Pakistan \$7.4 billion³⁴.

³³ www.cotlook.com. [Accessed 3 Aug 2005]

³⁴ www.ptj.com.pk/web%202004/03-2004/global.html. [Accessed 6 Aug 2005]

Pakistan is one of the major suppliers of yarn sharing around 30% and cotton cloth 8% in the world market (Economic Survey: 2003-04). Within the country the textile sector of Pakistan is playing a pivotal role in the national economy. There are 1221 ginning factories with capacity around 20 million bales per year, 400 mills with installed capacity (000 Nos) spindles 9286.8, rotors 145.6 and looms 10.2 (ibid). The textile production includes cotton ginning, cotton yarn, cotton fabric, fabric processing (grey-dyed-printed), home textiles, towels, hosiery & knitwear and ready made garments. The share of textile sector in the economy in respect of GDP, exports, employment, investment, foreign exchange earnings and contribution to the value added industry makes it the largest determinant of growth in manufacturing sector (ibid). Moreover, the share of textile in total manufacturing is 46%, value addition is 9% of GDP and also provides jobs to 35% out of 45.76 million of labour force in the country (see Economic Survey 2003-04 & 2004-05). However, being a developing country Pakistan's textile sector is facing many constraints like poor infrastructure, skill gap, poor marketing, costly supply of electricity and weak private sector etc.

4.2 Global Production of Cloth and Cotton Yarn and Pakistan's Ranking

More than 80 countries around the globe produce cloth and the share of the six major producers is more than 70% of total production. The major producers are China with around 28% share, followed by Pakistan (14.7%) and India (14.4%). Pakistan being the 2nd largest producer of the cloth has immense importance in the world cloth market and its closest competitors are China and India. Share of six major cloth producing countries is shown in the following table.

	2003	Share (%)
Brazil	641.0	5.6
USA	581	5.1
China (Mainland)	3180.5	27.7
India	1652.6	14.4
Pakistan	1686.9	14.7
Turkey	531.1	4.6
Sub-total	8273.1	72.0
Others	3222	28.0
World Total	11495.1	100.0

Source: http://www.aptna.org/pak_Textile_Statistics/gpc_print.asp

A large number of countries produce cotton yarn in the world and the major producers are China at top with 45% share, followed by Pakistan (13.5%) and India (9.5%), for further details see table-4.2. As a cotton yarn producer Pakistan's position is strong in the world. Again Pakistan's close competitors are China and India, but Pakistan can reap advantage of free trade agreement with China and can augment export of cotton yarn to China without duties and the lesser transportation cost will be an added benefit. The more export of cotton yarn to China with lower costs will create a producer surplus for Pakistani producers and consumer surplus for the consumers of textiles items in China, Pakistan and also for other consumers in the world.

Table-4.2 Major Producers of Cotton Yarn (Fig in '000' Metric tons)

	2003	Share(%)
Brazil	635.8	2.9
USA	1240.9	5.7
China (Mainland)	9836.0	45.0
India	2074.8	9.5
Pakistan	2956.0	13.5
Turkey	1127.6	5.2
Sub-total	17871.1	81.7
Others	4000.8	18.3
World Total	21871.9	100.0

Source: http://www.aptna.org.pk/pak_Textile_Statistics/gpyarn_print.asp

4.3 Trade Patterns of Pakistan

It is important to see the current trade patterns of Pakistan for the futuristic analysis. The major export items are raw cotton, cotton fabrics, cotton yarn & thread, knitwear, bed-wear, woolen carpets, leather, rice, fish & fish preparations, fruits and vegetables³⁵. Pakistan's major exports destinations are USA with around 28% share, followed by UK(7.4%), Germany(5.1%), Italy(3.9%) and China stands at number 13 with 2.06% (EPB). Moreover, out of top 20 export items of Pakistan, China imports only 5 items namely; cotton yarn (13.2% share), cotton fabrics (3.1%), chemical and its products (6.7%), leather (7%) and fish and fish preparations (12.9%) (ibid). While other export items are leather tanned, towels, bed ware, sports goods, raw cotton and rice, the share of cotton yarn and cotton fabrics is more than 75% in total exports to china. In

³⁵ http://www.statpak.gov.pk/depts/fbs/statistics/external_trade/monthly_review/review.pdf. [Accessed 6 Sep 2005]

respect of cotton fabrics the USA is the major importer with around 20% share and China is also among top ten importers but sharing only 3.1%. Following table depicts the country-wise details;

Table-4.3 Pakistan's Country-wise Exports of Cotton Fabrics (Value in '000' \$)

S.No.	Top 10 Buyers	2003-04	% Share	2002-03	% Share	2001-02	% Share
1	U. S. A.	333328	19.5	290859	21.6	249884	22.1
2	TURKEY	117559	6.9	60566	4.5	36428	3.2
3	HONGKONG	108920	6.4	118669	8.8	97756	8.6
4	ITALY	83121	4.9	54994	4.1	42714	3.8
5	UNITED KINGDOM	82815	4.8	57389	4.3	58314	5.2
6	BANGLADESH	68067	4.0	31716	2.4	34865	3.1
7	SPAIN	61848	3.6	31760	2.4	25726	2.3
8	DUBAI	60873	3.6	70446	5.2	54153	4.8
9	GERMANY	53928	3.2	33974	2.5	24478	2.2
10	CHINA	52531	3.1	48481	3.6	55029	4.9
	SUB TOTAL	1,022,990	59.8	798,854	59.4	679,347	60.1
	Next Top 10 Buyers						
11	SRI LANKA	42013	2.5	25108	1.9	20305	1.8
12	SOUTH AFRICA	39664	2.3	34793	2.6	23062	2.0
13	BELGIUM	39531	2.3	34353	2.6	27505	2.4
14	GREECE	30696	1.8	22246	1.7	21186	1.9
15	MEXICO	27451	1.6	21580	1.6	14832	1.3
16	SAUDI ARABIA	26410	1.5	24040	1.8	16592	1.5
17	PORTUGAL	25898	1.5	9888	0.7	8321	0.7
18	AUSTRALIA	21889	1.3	26272	2.0	22667	2.0
19	CANADA	20912	1.2	22915	1.7	18541	1.6
20	EGYPT	19655	1.1	18505	1.4	11881	1.1
	SUB TOTAL	294119	17.2	239700	17.8	184892	16.4
	SUB TOTAL OF 20 CNTs.	1317109	77.0	1038554	77.2	864239	76.4
	OTHERS	394383	23.0	307096	22.8	266589	23.6
	TOTAL	1711492	100	1,345,650	100	1130828	100

Source: EPB Pakistan

The other major importers of cotton fabrics are Turkey (6.9%), Hong Kong (6.4%), Italy (4.9%), UK (4.8%) and Bangladesh (4%). The above table reveals that the share of China, USA, Hong Kong, UK and Dubai has declined over the period of three years i.e. 2001-02 to 2003-04. The major importers of cotton yarn are Hong Kong and China sharing 31% and 13% respectively. Other significant importers are South Korea, USA, Bangladesh, Japan and Turkey. The details are given in the following table:

Table-4.4 Pakistan's Country-wise Exports of Cotton Yarn (Value in '000' \$)

S.No.	Top 10 Buyers	2003-04	% Share	2002-03	% Share	2001-02	% Share
1	HONGKONG	353354	31.4	291646	31.4	264443	28.4
2	CHINA	148735	13.2	107607	11.6	108258	11.6
3	SOUTH KOREA	123807	11.0	131113	14.1	153326	16.5
4	U. S. A.	111347	9.9	64912	7.0	65333	7.0
5	BANGLADESH	55517	4.9	21277	2.3	18244	2.0
6	JAPAN	54282	4.8	52607	5.7	72713	7.8
7	TURKEY	47018	4.2	28008	3.0	18437	2.0
8	PORTUGAL	41664	3.7	25923	2.8	22218	2.4
9	ITALY	20243	1.8	19650	2.1	13547	1.5
10	DUBAI	18253	1.6	18978	2.0	15172	1.6
	SUB TOTAL	974220	86.5	761721	82.1	751691	80.9
	Next Top 10 Buyers						
11	INDONESIA	12190	1.1	13880	1.5	10445	1.1
12	SRI LANKA	9913	0.9	5343	0.6	4646	0.5
13	EGYPT	9188	0.8	5275	0.6	5922	0.6
14	MAURITIUS	8347	0.7	7086	0.8	8271	0.9
15	CANADA	8057	0.7	9091	1.0	10897	1.2
16	SPAIN	7446	0.7	6568	0.7	4,332	0.5
17	HONDORUS	6549	0.6	3035	0.3	3541	0.4
18	AUSTRIA	5926	0.5	5173	0.6	3987	0.4
19	PHILIPPINES	5734	0.5	4482	0.5	3335	0.4
20	BAHREIN	5420	0.5	6074	0.7	7694	0.8
	SUB TOTAL	78770	7.0	66007	7.1	63070	6.8
	Sub Total of 20 CNTs.	1052990	93.4	827728	89.2	814761	87.6
	OTHERS	73886	6.6	100630	10.8	114930	12.4
	TOTAL	1126876	100	928,358	100	929691	100

Source: EPB Pakistan

The table 4.3 and 4.4 show the major buyers of cotton yarn and cotton cloth from Pakistan. In respect of fabrics and cotton yarn China is at number ten with 3.1% share and at number two with 13.2% share respectively. The share of China, particularly regarding fabrics, is very low.

Import Patterns of Pakistan: Pakistan's main imports are machinery including textile machinery, transport equipments, chemicals, food & live animals, minerals, fuels, lubricants, vegetable oils and fats etc. from Saudi Arabia (12.03%), UAE (8.3%), Japan (7.04%), USA (7.6%), China (8.9%), Kuwait (4.6%), Germany (4.4%) and India (2.3%)³⁶. In addition to this Pakistan also imports various commodities from UK, Australia, Malaysia, Thailand, Indonesia, Iran, Italy and Singapore.

Pakistan's imports from China are primary goods like food and live animals, meat and meat preparations, dairy products, vegetables, coffee, tea, beverages, tobacco, oil seeds, crude

³⁶ http://www.statpak.gov.pk/depts/fbs/statistics/external_trade/cumulative_imports.html, [Accessed 16th Nov]

rubber, crude fertilizer etc³⁷. Moreover, the manufactured goods include; organic and inorganic chemicals, dyeing coloring and tanning materials, medicinal and pharmaceutical products, fertilizers, paper and paper board, textile yarn and fabrics, iron and steel, machinery and transport equipments, road vehicles etc. The imports from China contribute around 9% of Pakistan's total imports and China is among three top countries including Saudi Arabia (12.03%) and UAE (8.3%) (EPB). Although China is not an important destination for Pakistani exports but it is one of three most important countries in respect of Pakistan's imports, which indicates that the said FTA have the potential to be beneficial for Pakistan economy.

4.4 ANALYSIS OF PAKISTAN'S TEXTILE EXPORTS DURING POST MFA PERIOD

The Multi Fibre Agreement (MFA) after remaining in force for more than 30 years was replaced by the Agreement on Textiles and Clothing (ATC) in 1994 (Jane Li)³⁸. It is believed that the MFA was serving the interests of advanced countries, so quota free regime was expected to be beneficial for the developing countries because they will not face any more quota restrictions, which can lead them to the expansion of exports (ibid). The following box describes the real motives and the constraints faced by the developing countries because of MFA.

Box 4.1

"The MultiFibre Agreement (MFA) set the rules for international trade in textiles and garments made from cotton, wool and synthetic fibre. It sets quotas limiting the amount of imports of textiles and clothing from "developing" to "developed" countries, essentially safeguarding industries in the industrialized countries, controlling the level of market access for developing country imports. Meanwhile the growth of textile and garments industries in many countries has been heavily dependent on the quota allocations under the MFA".

"The phase out of the MultiFibre Agreement and its quota system, which is supposed to bring textiles and garment trade under the WTO, was sold to the exporting countries in the South as being a great sacrifice by the powerful economies, which dominate the GATT/WTO talks. But it was used as a lever to force developing countries to make commitments to other WTO agreements on trade-related investment measures, intellectual property and services, and to agree to lower tariffs".

"The MFA's quota restrictions helped to facilitate the domination of the global garment trade by garment TNCs (transnational corporations). They did this by securing quotas, through their subsidiaries, allotted to developed countries. So many small and medium garment firms either became part of the TNCs' subcontracting chains or closed shop".

Source: <http://www.tieasia.org/factsheettwo.htm>, [Accessed on 12th Nov 2005]

³⁷ <http://www.china-customs.com>, [Accessed 10 Aug 2005]

³⁸ <http://www.amrc.org.hk/5203.htm>, [Accessed on 6th Aug 2005]

According to Nordas (2004), “the elimination of MFA and its replacement with the ATC has different dimensions, including political gains related to the credibility of the multilateral trading system, efficiency gains by eliminating highly distorting quotas and also gains for the consumers”. The main constraint to the efficient producers of the textile items was that its supply was restricted by the quotas. Therefore, the elimination of the quota restriction has created an opportunity for the countries like Pakistan to take the advantage of open competition.

As mentioned earlier, Pakistan’s preparation in textile sector will enable it to compete in the world market. This has also been confirmed by the Textile Industry sources in Pakistan. Saeed³⁹ (2005) asserts that “Pakistan’s competitive advantage has come from its ability to adopt latest technologies faster than its competitors”. This can be tested on the bases of post MFA performance i.e. from 1st January, 2005, of the textile sector of Pakistan.

Several reports confirm the satisfactory performance of Pakistan’s textile sector during the post MFA period. In this regard see the following exports figures released by the Federal Bureau of Statistics Pakistan giving a comparative picture between two periods.

Table- 4.5
Post MFA Analysis of Textile Exports (in terms of quantity)

Major Items	Jul-Feb 2004 05	Jul-Feb 2003 04	Difference
Raw Cotton Qty.M.T	73021	25117	191%
Cotton Yarn Qty.M.T	301173	338873	-11%
Cotton Cloth Qty.M.T	1551690	1481541	5%
Readymade Garments Qty.M.T	19278	18049	7%
Knitware (Hosiery) Qty.M.T	46536	40522	15%
Towels Qty.M.T	79117	62169	27%

Source: <http://www.epb.gov.pk/epb/jsp/June2004/impactovaup0405.htm>, the figures are taken from this source and the table has been regenerated

³⁹ Arif Saeed, APTMA, <http://news.bbc.co.uk/2/hi/business/4634787.stm> [Accessed on 6th Aug 2005]

According to this report of FBS for the period July-Feb 2004-05, the exports of most of the major textile items have increased. Raw cotton has shown a remarkable increase of 191%, towels 27%, hosiery 15%, ready made garments 7% and the exports of cotton cloth grew by 5% as compared to the corresponding period of last year.

Similarly, EPB's following report for the period July-September, 2005 giving the comparison with last year, in terms of value, shows a healthy picture of textile exports. The export of ready made garments have been around 106% higher as compared to the last year, bed ware recorded around 72% growth and similarly, cotton cloth and cotton yarn have witnessed 50% and 44.3% growth respectively.

Table-4.6 PAKISTAN'S INCREASING EXPORT TRENDS OF SELECTED COMMODITIES					
DURING JULY-SEPTEMBER 2005					
VALUE IN 000 \$					
S.NO.	COMMODITIES	JUL-SEPT. 2005	JUL-SEPT. 2004	ACTUAL INC.	
		VALUE	VALUE	VALUE	%
TEXTILE & GARMENTS					
A	CATEGORY	1,898,090	1,191,849	706,241	59.26
1	COTTON CLOTH	617,912	412,213	205,699	49.90
2	BED WARE	465,684	270,831	194,853	71.95
3	READYMADE GARMENTS	351,471	170,727	180,744	105.87
4	COTTON YARN	303,750	210,491	93,259	44.31
5	TOWELS	149,229	120,258	28,971	24.09
6	RAW COTTON	10,044	7,329	2,715	37.04

Source: http://www.epb.gov.pk/epb/jsp/June2004/increasing_decrease_trend.htm [Accessed on 12th Nov 2005]

The above mentioned performance is also confirmed by various news reports. According to a Daily⁴⁰, Pakistan has maintained around 26% of world yarn exports and 10% of world cotton exports during last five years. The emerging textiles report confirms its commendable performance in these words; "taking advantage of its quota free access to the US market, Pakistan became the largest supplier of carded cotton yarn after its share surged to 32% over the five-month period while ranking second supplier of combed cotton yarn after Mexico"⁴¹

According to a BBC report⁴² on Pakistan's textile exports:

⁴⁰ <http://www.jang.com.pk/thenews/jun2005-daily/28-06-2005/business/b9.htm>, accessed on 6th Aug, 2005

⁴¹ <http://www.emergingtextiles.com/?q=art&s=040726amark&r=free>, [Accessed on 20th August, 2005]

⁴² <http://news.bbc.co.uk/2/hi/business/4634787.stm>, [Accessed on 6th August, 2005]

“the industry is doing its best to respond to the changing global context brought about by the ending of the MFA, which was intended to help boost trade from developing countries. Business people are investing in new technologies, in regular contact with buyers, and in touch with latest trends in fashion and fabrics”.

In addition to this the exports of textiles and clothing have grown by 10% during last six months and highest growth was recorded in bed linen 29% and cotton cloth 20% (ibid). The achievement by the textile sector of Pakistan has also been confirmed by an Indian report⁴³, depicting that during the post quota regime Pakistani textile exports grew by 12%. This increase in exports of textile related items is mainly attributed to the end of textile quota restrictions (MFA) and to the preparation of Pakistan for the competition.

Our main issue was the impact on the exports of cotton yarn and cotton fabrics after the implementation of FTA between China and Pakistan. In this regard based on the EPB and other reports we can conclude that the exports of these two items are quite satisfactory in the post MFA period. Although the FTA and the MFA conditions may not be comparable, however, it proves at least one thing that Pakistan's textile sector has the potential and can compete in the world market on the basis of the quality of its products. It also shows that the heavy investment in BMR has started paying dividends in shape of high quality products. Therefore, the impact on the exports of cotton yarn and cotton fabrics will be positive and these major export items and other textile exports of Pakistan will not be vulnerable in the post FTA regime.

4.5 Cost of Production of Raw Cotton- Global Comparative Analysis:

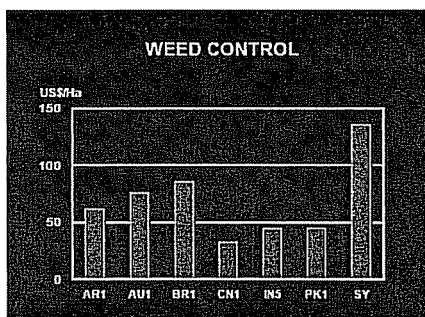
The idea of comparative cost of production and prices, as discussed in chapter-2 in theoretical framework, has great importance in international trade. Varied preferences and varied physical and financial endowments create the possibility of gainful trade (Todaro: 2000). The basic principle that enables the producers to capture a sizeable share in the domestic or world market is the production of best quality goods with possible minimum cost. Perfect and open competition ousts the feeble and less efficient firms out of business. In the WTO context due to increasing free trade the aspect of cost minimization has amplified manifold. In the world cotton

⁴³ <http://www.bharattextile.com/newsitems/1996430>, [Accessed on 3rd Sep 2005]

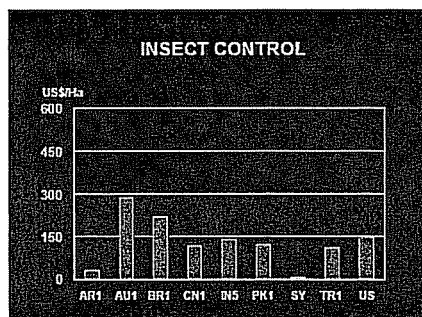
market, where around one hundred countries are producing cotton, the cost of production will count a lot. The foremost competitors in the cotton market are Argentina, India, Pakistan, Australia, Brazil, China, Turkey, Mali, USA and Syria (ICAC: 2001). The analysis of cost of production of raw cotton is based on the data gathered by the International Cotton Advisory Committee (ICAC)⁴⁴. The analysis would be mainly based on the two latest reports of ICAC i.e. 2001 and 2004 and the comparison will be restricted to ten countries producing more than 75% of the total cotton. The cost includes the inputs and operations like pre sowing, sowing, growing, harvesting, ginning, economic and fixed costs. There are few caveats of the ICAC reports while doing comparisons among different countries. Some inputs are free or subsidized in various countries, whereas in some countries economic, fixed costs and opportunity costs are not determined.

According to ICAC report of 2001(for more details see graphs at annex-1), the land rent is lowest in Brazil, followed by India, USA and Pakistan.

Graph-4.1



Graph-4.2

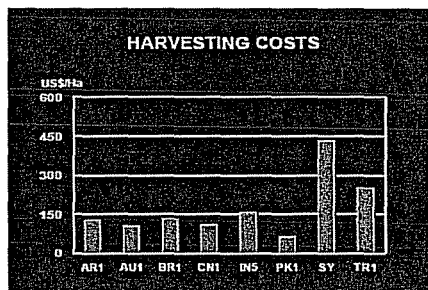


Source: http://www.icac.org/cotton_info/speeches/Chaudhry/2001/brazil2001.pdf

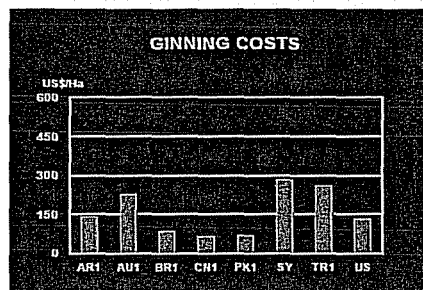
In respect of weed control China is most efficient followed by Pakistan and India, for insect control Pakistan is on third position after Syria and Argentina. In the use of fertilizers Pakistan, Turkey and USA have the lowest costs particularly when compared to Brazil and China where the cost is too high. Pakistan's ranking is among top three cost efficient countries regarding harvesting, economic, ownership, ginning and seed cotton costs.

⁴⁴ The ICAC is undertaking surveys on cost of production of raw cotton in the world since 1983 and in this respect it is the only source of authentic information. (www.icac.com).

Graph- 4.3



Graph- 4.4



Source: http://www.icac.org/cotton_info/speeches/Chaudhry/2001/brazil2001.pdf

Due to the shortage of water in Pakistan the irrigation costs are high as compared to other competitors except Syria, where the irrigation cost is the highest. According to the ICAC report of 2004 (see Annex-1), there is substantial variation in the net costs of producing a kilogram of lint, it is lowest in India and highest in USA. The net cost is comparable among Brazil, China and Pakistan.

On the basis of ICAC reports we can conclude that Pakistan is an efficient producer of cotton and it is among top four countries whose cotton production cost is least in the world. However, the irrigation costs, and as compared to net costs in exporting countries and lint producing costs, are high in Pakistan, requiring more efforts and planning to trim down the costs to make it more efficient. As discussed in theoretical framework, with the imposition of tariffs and quotas the price of imported goods increases and demand declines. Since the cotton yarn and cotton fabrics are the intermediate goods being exported to China, will have the benefit of elimination of tariffs in the shape of increased demand. The possible effects of elimination of tariffs will result in buyers gain in shape of lower prices and sellers will gain by more sales and eventually more profits.

Due to similar economic, weather and labour conditions Pakistan will face close competition from India. There are chances of a FTA between China and India meaning that a possible tough competition from India in future. However, in present circumstances Pakistan will have the advantage of a FTA over India and the free trade as theory suggests (Chapter-2) will

further enable Pakistan textile industry to become more efficient. Although Pakistan will have the advantage of FTA over its close competitors but apart from this it is also an efficient producer of raw cotton. Pakistan has the comparative advantage over India in respect of fertilizers costs, insect control, seed control, ownership and net costs excluding land rent and seed value (Chuadhary: 2001). On the other hand India is also facing problems like poor roads and ports, high cost of power, obsolete technology and moreover, around 90,000 power looms are unorganized⁴⁵.

Pakistan is the fourth largest cotton producer country in the world and its ideal strategic location and a good quality of cotton makes its position better. Its cotton is inherently of good quality, with high fibre strength and staple length ranging from 15/16 to 1-1/4⁴⁶. Moreover, the bulk of cotton produced has a fibre length of above 1-1/32 and 30-40 counts of yarn from this material can be manufactured. According to Memon (2004),

“the textile industry enjoys several advantages over many other countries as far as the production of quality fabrics concerned, which include availability of high-grade locally produced raw cotton and trained manpower. The induction of shuttleless weaving machines in the recent years has resulted in high growth in fabric production”.

Moreover, the cost of textile labour wages in Pakistan is \$0.34/hour, as against India (\$0.57/hour), Bangladesh (\$0.25/hour) Sri Lanka (\$ 0.40/hour) and China (\$ 0.69/hour) (ibid). The labour cost is the second lowest in Pakistan after Bangladesh.

However, some other sources have pointed out the declining quality of its cotton in recent years. The problem of clean cotton picking⁴⁷ exists in Pakistan which causes damage to the quality of cotton. In Pakistan picking is done by the illiterate rural women who usually do not know the importance of clean cotton and they show least care in clean picking. Sofia and Hussain (2005), say that the quality of a lot of cotton is damaged in the fields during the picking of produce and also the obsolete ginning machines deteriorate the micronnair length of fibre. It has been observed that over the period of few years the quality of cotton has deteriorated. In this

⁴⁵ <http://bharattextile.com/newsitems/1996430>. [Accessed 3 Sep2005]

⁴⁶ <http://www.pakistan.gov.pk/divisions/contentinfo.jsp?DivID=18&cPath=165&ContentID=1513>. [Accessed 25 Aug 2005]

⁴⁷ to collect or pick raw cotton from its trees

regard the apprehensions shown by Planning and Development Division Pakistan⁴⁸ are noticeable. It states that Pakistan cotton contains foreign matters, trash and water which, is considered poor by international standards. As a result these impurities decrease the beneficial effects and incur 10-15 percent loss to the value of raw cotton and its manufactured goods. In addition to this the quality of ginned cotton has been deteriorated during the last few years and moreover, the country did not have any recognized and scientifically devised standardization and grading system, which resulted into sale of its raw cotton on discounted rates (ibid).

Keeping in view these apprehensions and the forthcoming free competition after the elimination of MFA, the government of Pakistan promulgated the Cotton Standardization Ordinance in 2002⁴⁹. The main purpose of this ordinance was to ensure the quality of cotton, “but unfortunately the proverbial bureaucratic red-tape seems to have come in the way of its enforcement” (ibid). To overcome these problems and hurdles the immediate attention is required from the concerned authorities, because Pakistan cannot afford the declining quality of its cotton amid open global competition.

The problems like scarcity of irrigation water, expensive fertilizers and deplorable conditions of poor farmers and cotton growers can lower its better comparative position against the competitors. The ICAC report (2004) has indicated two reasons for high production cost of cotton in Pakistan, namely the high costs of irrigation water and comparatively expensive fertilizers. These two problems have created lot of nuisance for Pakistani cotton growers. It has been observed that due to costly and less effective fertilizers and the shortage of water the cotton growers are in trouble, even sometimes they are unable to cover costs. Pakistani farmers make diligent efforts but sometimes they are not benefited according to their efforts (Monnoo: 2004). In addition to this Pakistan has the lowest stock-to-use ratio, which can be a great risk in the times of crop failure.

Along with the latest technology and investment, the human resources and education play a key role for the development and growth. Pakistan textile industry needs concerted efforts for

⁴⁸ http://www.pakistan.gov.pk/divisions/ContentInfo.jsp?DivID=18&cPath=165_171&ContentID=1513 [Accessed 13th Sep]

⁴⁹ <http://www.dawn.com/2004/02/23/ed.htm#1>, [Accessed on 12th Nov 2005]

filling the skill gap by establishing textile related training and research institutions in the country. Similarly the agriculture sector is the largest sector in Pakistan, employing around 42% of total employed labor force (Economic Survey 2003-04). The performance of our textile sector largely depends on the health of agriculture sector, therefore, like textile sector there is a need to give more attention and to make a comprehensive plan to invest in the agriculture sector. These issues are of extraordinary importance and need to be addressed properly, otherwise it may jeopardize the cotton production in the country and resultantly it may hurt Pakistani textile exports in future.

4.6 IMPLICATIONS OF FTA

We have discussed the concept of free trade and its merits and demerits, the policy of Import Substitution Industrialization and Protectionism, import tariffs and quotas and the concept of trade creation and trade diversion. The main findings were that, in general free trade among nations is good, but it may have some disadvantages for countries which are small and less competitive as compared to other partner. The two pre-conditions as discussed in chapter-2, that trade creation “dominates” trade diversion and that import prices do not rise, must be fulfilled for the welfare gains. Let us see what will be the possible impact on Pakistan’s major textile export items after the implementation of said FTA.

As discussed in the theoretical framework (Ch-2), free trade brings efficiency and eliminates the monopoly. During last few years the performance of textile sector has been satisfactory and particularly during last six months it showed noteworthy growth in exports. This performance depicts that the impact of ending of quota regime has been positive.

The textile sector largely depends on agriculture sector of Pakistan, it employees 42% of the labour force, while the textile sector employees 35% of the total labour force. If there is more emphasis on trade creation then there will be positive welfare effects in the country. Therefore, it is expected that the FTA will enable Pakistan to enhance its exports and the increasing exports will need more production and to fulfill the demand for more production there will be positive effect on employment. To meet the increasing demand, the cotton growers will be given more incentives by the cotton purchasers, increasing the welfare of millions of people linked with

agriculture sector. Similarly, a large number of people i.e. 35% of total labour will be benefiting in the textile sector either by supplying more cotton yarn and cotton fabrics to China or by manufacturing more final goods.

Since the actual data to quantify the employment and welfare effects during post quota period is not available, but still it can be assumed on the basis of increasing trends in exports of the textile items during post MFA period a positive welfare effect. The textile and agriculture sector both employ 77% of Pakistan's total labour force that means 35.2 million out of 45.8 million people will be benefited. However, this is an estimate but in order to support this argument further, we can quote the empirical evidence from existing free trade agreements in the world, see the following box:

Box 4.2

The Impact of FTAs on people and business can be significant in terms of more trade, investment and employment creation. The Canadian Department for Foreign Affairs and International Trade has reported important gains in trade, direct foreign investment and job creation for Canada under NAFTA.

* Canada's merchandise trade with Mexico doubled over the same period, reaching US\$9 billion in 1998. Its exports to US and Mexico increased 80% and 65% respectively in the first five years of NAFTA, reaching US\$271.5 billion and US\$1.4 billion in 1998.

* Investment to Canada from the US reached US\$147.3 billion in 1998, up 63% from 1993 and

* Investment to Canada from Mexico tripled in 1998 as compared to 1993.

* More than one million new jobs created in Canada since 1 January 1994. NAFTA's temporary entry procedures facilitated travel to NAFTA markets by countless business visitors, including well over 100,000 Canadian professionals, traders and investors since 1996.

* A similar story could be told of Mercosur, the third largest trading pact after NAFTA and EU. Formed in 1991, trade between the four Mercosur countries increased more than 400% from 1990 and 1997 when it reached a total of more than US\$20 billion.

Source: for further details visit http://www.tcf.or.jp/data/20041108-09_Linda_Low.pdf, [Accessed on 6th Nov 2005]

The overall outcome of the existing free trade agreements is encouraging in the above mentioned cases including NAFTA, EU and Mercosur. It has been noticed that there were positive effects on volume of trade, share in world trade and the creation of jobs.

How Pakistan can take maximum benefits from the FTA? It needs to do a number of things to gain from the FTA. Pakistan imports a lot of machinery from China and rest of the world, the import of cheap machinery will enable its industries to become more cost efficient from China. In the agriculture sector along with the import of cheap pesticides and fertilizers from China, Pakistan can also imbibe the modern techniques for the replacement of ancient methods for better quality and higher yield. The agricultural produce particularly fruits, seafood, vegetables, which are difficult to store for long time can reach to China with lesser time and lesser cost. One major advantage of exports to China is the lower transportation cost due to road link between two countries, especially when compared to other destinations like USA or EU.

The FTA can enhance the possibilities of trade creation in agriculture sector of Pakistan as well. Its agriculture sector has the potential to introduce new venues particularly in the dairy farming sector it can accelerate with the help of China by adopting the latest technologies in the respective field. On the other hand the available agricultural produce particularly fruits, sea food, vegetables which are difficult to store for long time can reach to destination within short span of time and with lower transportation cost. Therefore, it will not be wrong to say that the FTA on the one hand will be helpful to boost up the textile sector by making it more cost efficient and on the other hand will also be supportive to Pakistan's agriculture sector.

5.1 Conclusion

This study has explored the benefits and the unintended losses in the context of the free trade and interdependence which is a global phenomenon. During the discussion about the political economy it was argued that the greater cooperation was not only required for better economic future but also for the regional political stability.

The detailed analysis of global comparison of cost of production of raw cotton showed that Pakistan is one of the four most efficient producers in the world in the subject area, which can be a point of satisfaction for Pakistani producers.

The main concern was to find out the impact of FTA on Pakistan's major exports. After the discussion about economic and political gains it has been observed that the expected economic gains are lesser than the others. With small trade volume particularly the exports, the economic gains from the FTA can not be very high. Contrary to this analysis the study has shown that the FTA has a potential for substantive political gains. From the economic point of view the FTA can serve as the defence strategy against foreign competition, and if seen from the political point of view, the FTA will play more effective role to strengthen the ties between two countries and also to establish stability in the region which is directly linked with economic stability.

5.2 Answer to the Research Questions

To find the impact on the export of cotton yarn and cotton fabrics a detailed discussion was carried out. The trade patterns of Pakistan show that there is lot of potential for further exports of these two items to China. Pakistan has to decide between two choices either it can go for trade diversion or trade creation. As discussed earlier trade diversion may or may not benefit the country, while in case of trade creation the welfare of the country is certain as theory suggested. As we know trade creation is caused by extra output which resultantly creates new jobs and ultimately leads to welfare of the people. Therefore, the second choice seems more

beneficial and despite exporting the raw materials, by value addition Pakistan can maximize the economic gains. The added benefit of the value added goods like knitwear, hosiery, garments and other made-ups is that they add more job creation along with production and export earnings.

China is also a competitor of Pakistan in textile exports; therefore, the supply of cheap cotton yarn and cloth to China can create difficulties for Pakistani textile exporters in the world market. Despite supplying intermediary goods to a competitor it is better to promote the value added sector and create more trade. In this regard Bangladesh has set a good example, which by importing yarn and fabrics from Pakistan and other countries has increased the export volume of textile made ups significantly (see Baig:2004).

Nonetheless, based on certain assumptions and facts we can anticipate the positive impacts of FTA on the exports of cotton yarn and cotton fabrics. In fact we could not quantify the effects on the exports of these tow items clearly, due to various constraints. Therefore, it leaves an opportunity for further research to investigate this issue in detail.

Our second question was about the competence level of Pakistani textile sector. The discussion on this issue showed that Pakistan is one of the efficient producers of raw cotton and other textile items and it has the potential and ability to compete its close competitors including advanced countries. Therefore, as mentioned earlier if FTA between China and India in future takes place, even then Pakistan will have the advantage over India, as it is more efficient in the production of cotton and have adopted latest technologies in its textile sector. The post MFA performance has also shown its satisfactory competence level.

One of the important questions was about the political gains from the said FTA. The said FTA beside some economic benefits seems more beneficial from the strategic point of view and it will bring political stability and harmony not only between two countries but in the region as well. In respect of question about the tax revenue loss we found out that this loss would amount to approximately Rs.30 billion annually to Pakistan after the implementation of FTA with China.

The trade liberalization is only a necessary condition but not a sufficient condition for growth and development (see Low: 2004). So it is imperative to mention here that the benefits from said FTA will only be possible if Pakistani manufacturers continue the efforts to maintain the quality of their products and to bring about improvement wherever it is essential. If the quality remains poor and inefficiency issue remains unresolved than, there is danger of huge unemployment particularly in the inefficient agriculture sector.

5.3 Policy Recommendations

On the basis of our detailed discussion on the topic following measures are proposed to maximize the FTA gains and to avoid future crisis;

- The quality, efficiency and cost minimization are always vital amid open competition. Although Pakistan has come in better competitive position due to heavy investment in BMR, but still it lacks the supporting infrastructure, skills and cheap power for textile sector etc. It is therefore, recommended that safe and modern road network, quality rail link, institutions to fill the skill gap and provision of cheap electricity must be ensured to enhance the efficiency.
- It has been noticed that the current trade volume specifically export to China are not very substantial; therefore, to maximize the benefits of FTA it would be necessary to increase the overall trade volume with China. In this regard along with textile sector there is a room to explore our agriculture sector for creating more opportunities.
- Pakistan imports a lot of machinery from rest of the world that can be imported from China, it will help to reduce the production costs in all industries including textile sector.
- Our discussion has showed that a number of FTAs and RTAs are taking place in the world and many countries are trying to finalize the trade agreements for more trade gains. As Pakistan has also started negotiations with 14 countries for FTAs but, there is a need to finalize them at the earliest, this will pave the way to new trading zones for our exporters.

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- During the discussion it was also observed that for growing cotton the genetic engineering is becoming more popular for various reasons. This technique is currently adopted in nine countries including India and China, therefore, Pakistan should see the possibility of adopting the genetic engineering cotton, it will help enable to lower the production cost, reduce insect's damage and to increase the growers' income⁵⁰.

⁵⁰ For details on the benefits of genetic engineering see http://www.icac.org/cotton_info/speeches/Valderrama/2004/benin_2004.pdf. [Accessed 21 Sep 2005]

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Annex-1 (following graphs have been taken form Source:

http://www.icac.org/cotton_info/speeches/Chaudhry/2001/brazil2001.pdf)

