Working Paper # 031

CPEC WORKING PAPER SERIES

Current Account Deficit of Pakistan and CPEC

Dr. Noureen Adnan
Policy Head
Financing and Financial Sector Integration, CoE CPEC

Younas Kakar
Senior Research Fellow
Financing and Financial Sector Integration, CoE CPEC

Ministry of Planning, Development & Reform

Pakistan Institute of Development Economics

A PUBLICATION OF
CENTRE OF EXCELLENCE
CHINA-PAKISTAN ECONOMIC CORRIDOR

GET MORE
www.cpec-centre.pk

Contents

Introduction:

Current account is one of the two components of balance of payments, the other being capital account. It comprises of net trade in goods and services, net primary income and net secondary income. Trade in goods and services represents major portion of current account that's why a deficit in trade balance normally results in deficit in current account. Primary income comprises of compensation of employees, investment income and other primary income. Investment income includes income from direct investment, portfolio investment and other investments. Secondary income largely contains all current transfers between residents and nonresidents. These transfers are broadly categorized into personal transfers, worker's remittances and other current transfers.

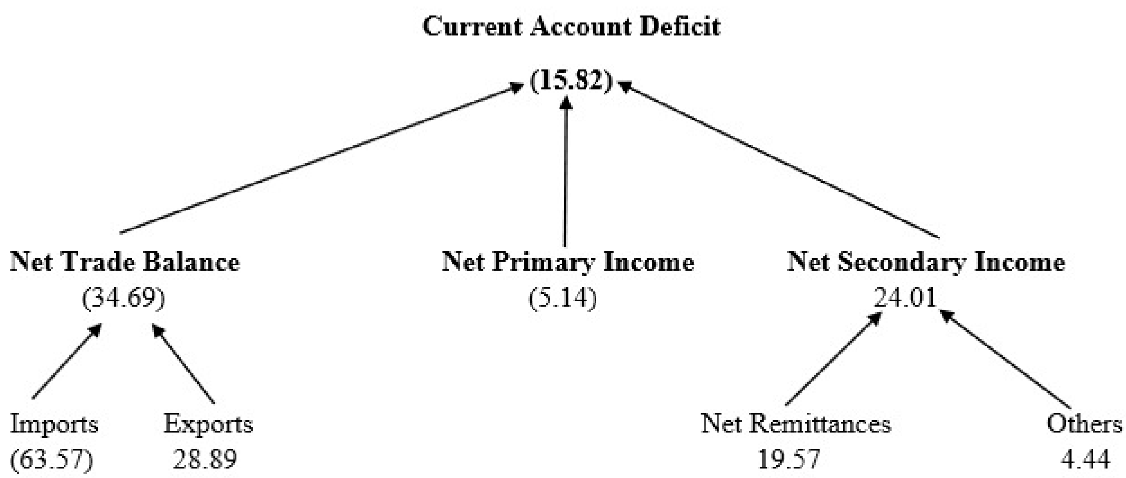
A deficit in the current account occurs when the cumulative outflows from all components of current account exceeds the inflows from the corresponding components. A current account deficit for extended period may results in more debt and exchange rate crises, therefore attainment of sustainable current account balance becomes crucial for overall economic stability and growth. Considering the primary elements of current account, trade balance and remittances plays an important role in sustaining current account balance. Trade balance is of pivotal importance in managing current account deficit because of its proportionate size in current account and government's ability to influence it. Similarly, a drastic decline in remittances is unlikely to happen in short run, so the prevailing pattern of remittances is expected to continue in long run contributing to sustainability of the current account.

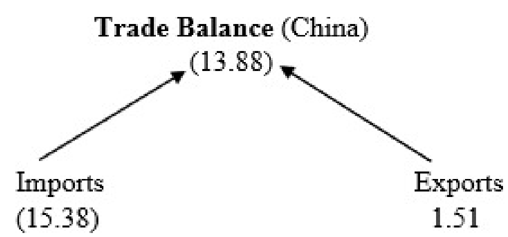
Current Account Deficit of Pakistan

Pakistan's current account balance shows a deficit of $15.82 billion during FY17 as compared the corresponding figure of $7.09 billion for FY16, depicting an increase of $8.72 billion. This increase in current account deficit is largely due to an increase of $9.59 billion in trade deficit as a result of $11.66 billion incremental imports of goods and services during the FY17.

The current account deficit can be bifurcated as follows

a) Trade Deficit ($34.69 billion)
    a. Goods Deficit ($29.94 billion)
    b. Services Deficit ($4.74 billion)
b) Net Primary Income ($5.14 billion)
    a. Primary Income Receipts $0.67 billion
    b. Primary Income Payments ($5.81 billion)
c) Net Secondary Income $24.01 billion
    a. Secondary Income Receipts $24.19 billion
    b. Secondary Income Payments ($0.16 billion)



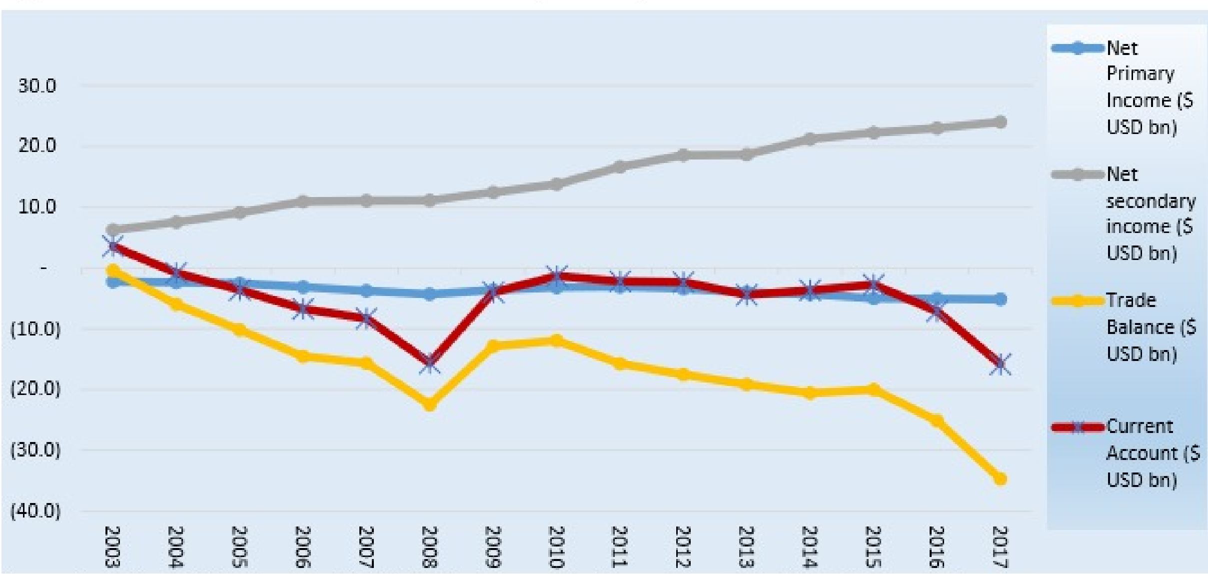


Source: World Bank Development Indicators (WDI) & International Trade Centre (ITC) / UN COMTRADE statistics
Values are in US $ Billions for 2017

Figure 1 illustrates that country's current account balance has deteriorated over time from current account surplus of $3.57 billion during FY03 to all time maximum deficit of $15.82 billion in FY17. The major contributing factor in this deficit is disproportionate variations in imports and exports over the time as the imports has risen by $48.36 billion (318%) from $15.21 billion in FY03 to $63.57 billion in FY17 while there is only $14.11 billion (95%) increase in exports ranging from $14.8 billion to $28.9 billion during the corresponding period. Furthermore, it can be seen from the chart that current account balance moves in tandem with trade balance showing the importance of trade balance in over all current account balance.

Similarly, out of total increase in current account deficit over the time, an increase of $2.9 billion comes from increase in net primary income deficit ranging from $2.2 billion in FY03 to $5.1 billion in FY17. However, the increasing trend of inflows over the time in secondary income in general and remittances in particular, has played pivotal role in easing the pressure on current account balance. There has been a considerable increase of $17.78 billion (285%) in net secondary income surplus fluctuating from $6.2 billion during FY03 to $24.01 billion in FY17 where in $15.6 billion comes from increase in remittances from expatriates.

Figure: 1: Current Account of Pakistan (2003-17)



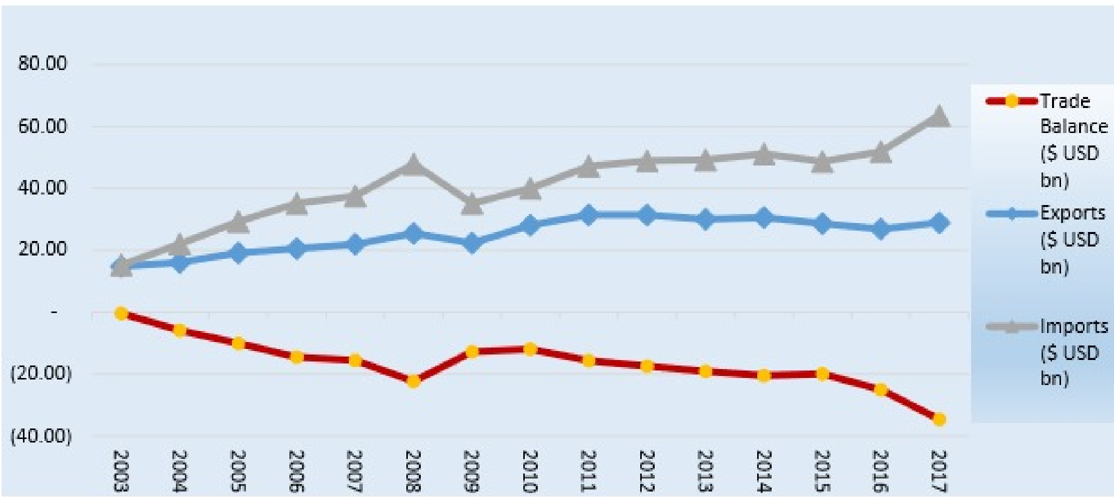
Source: Author's calculation based on World Bank Development Indicators & International Trade Centre (ITC) / UN COMTRADE statistics. Amounts in US $ Billion.

Trade Deficit of Pakistan

Trade deficit during FY17 is $34.69 billion (Goods deficit $29.94 billion, Services deficit $4.74 billion) which shows an increase of 38% as compared to corresponding figure of $25.10 billion during FY16. The increase in trade deficit is mainly due to:

a) An increase in imports of goods by $10.42 billion representing a rise of 24%.
b) An increase in imports of services by $1.24 billion demonstrating a surge of 14%.

Figure: 2: Trade Deficit of Pakistan (2003-17)



Source: Author's calculation based on International Trade Centre (ITC) / UN COMTRADE statistics.
Amounts in US $ Billion.

It is evident from table 1 below that trade deficit has increased over the time except during FY09 where there is a sharp reduction in deficit mainly due to reduction in imports by $12.78 billion. However, the trade deficit has increased by $34.2 billion from $0.44 billion in FY03 to $34.69 billion in FY17. This increase in deficit is due to inconsistent increase in exports and imports over the time. There is an increase of $48.35 billion in imports as compared to an increase of $14.11 billion in exports during the corresponding period.

Table 1: Trade Deficit of Pakistan (2003-2017)

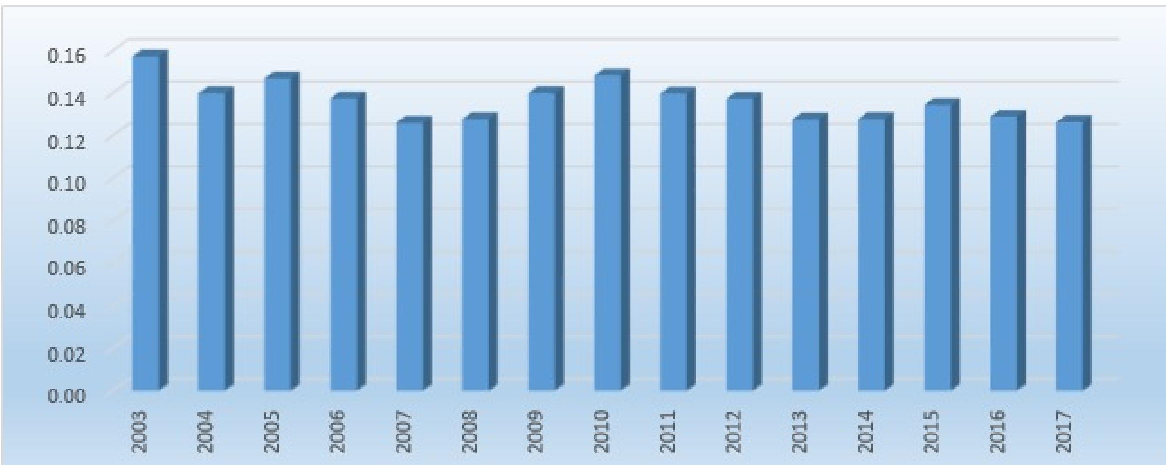
Years	Exports	% age change in Exports	Imports	% age change in Imports	Trade Deficit
2003	14.78		15.21		(0.44)
2004	16.03	8%	22.01	45%	(5.98)
2005	19.11	19%	29.28	33%	(10.17)
2006	20.54	8%	35.10	20%	(14.56)
2007	21.95	7%	37.59	7%	(15.64)
2008	25.47	16%	47.93	28%	(22.46)
2009	22.31	-12%	35.15	-27%	(12.84)
2010	28.06	26%	40.02	14%	(11.96)
2011	31.43	12%	47.15	18%	(15.72)
2012	31.37	0%	48.90	4%	(17.53)
2013	30.04	-4%	49.17	1%	(19.12)
2014	30.60	2%	51.14	4%	(20.54)
2015	28.60	-7%	48.62	-5%	(20.02)
2016	26.81	-6%	51.91	7%	(25.10)
2017	28.89	8%	63.57	22%	(34.69)

Source: Author's calculation based on International Trade Centre (ITC) / UN COMTRADE statistics.
Amounts in US $ Billion.

Trade Competitiveness of Pakistan

Pakistan's performance in trade has deteriorated over the time in terms of its share in worlds and regional trade. Figure 3 demonstrates that Pakistan's share in the world exports has declined from 0.16% in FY03 to 0.13% in FY17 losing 0.03% share in world's exports which amounts to a reduction of $7.06 billion in exports during FY17.

Figure: 3: Pakistan's Exports as % of World's Total Exports (2003-17)



Source: Based on World Bank Development Indicators (WDI)

However, table 2 shows that there has been a substantial increase in the corresponding shares of its regional competitors particularly that of Bangladesh and India. Bangladesh and India have successfully grabbed additional share of 0.09% and 1.23% of world's exports that amounts to $19.86 billion and $281.74 billion respectively in FY17. Furthermore, it is pertinent to mention that among the main South Asian competitors i.e. Bangladesh, India, Sri Lanka, Maldives and Nepal, Pakistan is the only country that has lost its share in the worlds exports over the corresponding period.

Table 2: Exports as % of Worlds Total Exports

Years	World's Exports	Bang's Share	Bang's Share in %	India's share	India's share in %	Maldives's share	Maldives's share in %	Nepal's share	Nepal's share in %	Pak's share	Pak's share in %	Sri Lanka's share	Sri Lanka's share in %
2003	9,388	7.93	0.08%	84.80	0.90%	0.58	0.01%	1.08	0.01%	14.78	0.16%	6.54	0.07%
2004	11,443	9.12	0.08%	116.02	1.01%	0.69	0.01%	1.23	0.01%	16.03	0.14%	7.28	0.06%
2005	12,987	11.19	0.09%	154.58	1.19%	0.48	0.00%	1.28	0.01%	19.11	0.15%	7.89	0.06%
2006	14,929	12.89	0.09%	193.32	1.29%	0.78	0.01%	1.23	0.01%	20.54	0.14%	8.51	0.06%
2007	17,394	14.09	0.08%	240.08	1.38%	1.80	0.01%	1.44	0.01%	21.95	0.13%	9.41	0.05%
2008	19,931	17.50	0.09%	305.12	1.53%	1.97	0.01%	1.71	0.01%	25.47	0.13%	10.11	0.05%
2009	15,926	17.05	0.11%	260.85	1.64%	1.71	0.01%	1.54	0.01%	22.31	0.14%	8.98	0.06%
2010	18,900	21.65	0.11%	348.04	1.84%	2.01	0.01%	1.57	0.01%	28.06	0.15%	11.10	0.06%
2011	22,462	26.99	0.12%	446.38	1.99%	2.44	0.01%	1.86	0.01%	31.43	0.14%	13.64	0.06%
2012	22,832	27.59	0.12%	443.85	1.94%	2.49	0.01%	1.93	0.01%	31.37	0.14%	13.57	0.06%
2013	23,534	31.64	0.13%	468.27	1.99%	2.91	0.01%	2.19	0.01%	30.04	0.13%	15.08	0.06%
2014	23,935	33.06	0.14%	485.58	2.03%	3.30	0.01%	2.41	0.01%	30.60	0.13%	16.74	0.07%
2015	21,258	34.97	0.16%	428.63	2.02%	3.15	0.01%	2.24	0.01%	28.60	0.13%	16.94	0.08%
2016	20,790	37.58	0.18%	430.43	2.07%	3.15	0.02%	2.12	0.01%	26.81	0.13%	17.45	0.08%
2017	22,845	39.16	0.17%	488.09	2.14%	3.47	0.02%	2.43	0.01%	28.89	0.13%	19.12	0.08%

Source: Author's calculation based on World Bank Development Indicators (WDI)

Trade Deficit with China

Pakistan and China have signed frequent agreements[1] and MoUs to strengthen the trade partnership. The first agreement was signed in 1963 and since then multiple agreements have been signed between the two countries including;

- Six MoUs on trade facilitation in 2001
- Agreement on support for Gwadar Seaport in 2002
- Seven MoUs for communication energy and trade in 2004
- Twenty-one MoUs and agreements on infrastructure, energy defense and social sector in 2005
- China Pakistan Free trade agreement (CPFTA) in 2006
- Agreement on bilateral cooperation on trade, agriculture, technology, and economy in 2008
- Thirteen MoUs and agreements on cooperation in economy, energy, banking, security, and technology in 2010
- Sixty-two agreements on China Pakistan Economic Corridor (CPEC) in 2013
- Nineteen agreements on CPEC in 2014

The objective of all these agreements was to strengthen the bilateral ties and cooperation in trade, energy, infrastructure, defense and other mutual interests. Therefore, the trade between the two countries has expanded manifolds since then, however, out of $34.69 billion of overall trade deficit of Pakistan in FY17, a deficit of $13.88 billion comes from trade with China, which illustrates an increase of 33% from preceding year (see table 3).

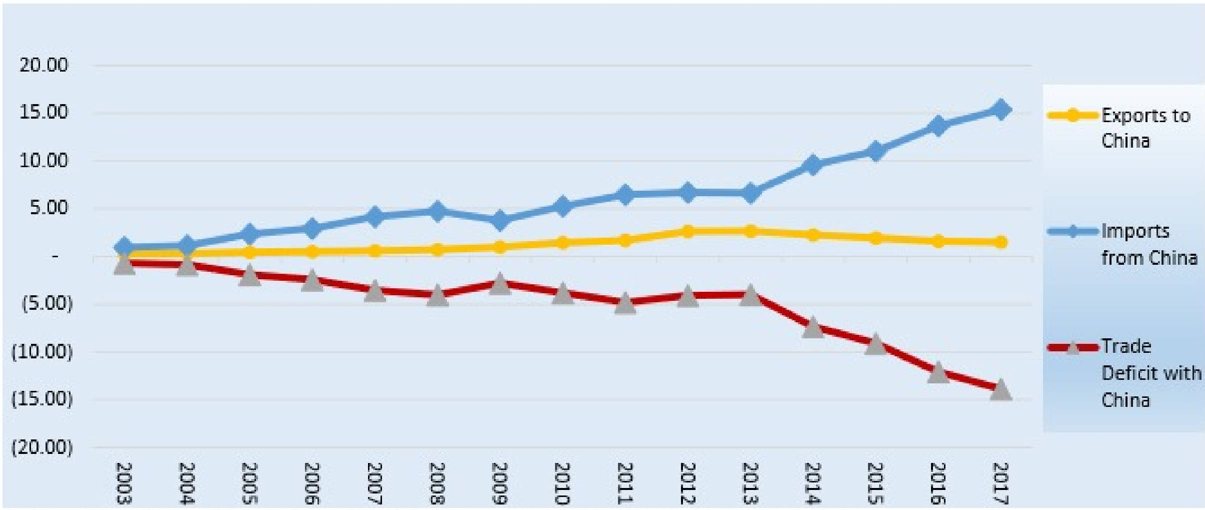
Table:3 Trade Deficit with China

Years	Exports to China	% age change in Exports	Imports from China	% age change in Imports	Trade Deficit
2006	0.51		2.91		(2.41)
2007	0.61	21%	4.16	43%	(3.55)
2008	0.73	18%	4.74	14%	(4.01)
2009	1.00	37%	3.78	-20%	(2.78)
2010	1.44	44%	5.25	39%	(3.81)
2011	1.68	17%	6.47	23%	(4.79)
2012	2.62	56%	6.69	3%	(4.07)
2013	2.65	1%	6.63	-1%	(3.97)
2014	2.25	-15%	9.59	45%	(7.34)
2015	1.93	-14%	11.02	15%	(9.08)
2016	1.59	-18%	13.68	24%	(12.09)
2017	1.51	-5%	15.38	12%	(13.88)

Source: Author's calculation based on International Trade Centre (ITC) / UN COMTRADE statistics.
Amounts in US $ Billion.

The rise in trade deficit is mainly due to the soaring trends of imports from China that raised by $14.43 billion from $0.96 billion in FY03 to $15.38 billion in FY17 and meanwhile there is slight increase of $1.25 billion in exports to China from $0.26 billion to $1.51 billion during the aforementioned period. Therefore, the bilateral trade deficit has also climbed by $13.18 billion from $0.70 billion to $13.88 billion during this period. Figure 4 portrays the trends of trade deficit, imports and exports of Pakistan with China during the same time span.

Figure: 4 Trade Deficit with China (2003-17)



Source: Author's calculation based on International Trade Centre (ITC) / UN COMTRADE statistics.
Amounts in US $ Billion.

So far, the trade balance between the two economies is in favor of China, however, Pakistan can exploit the opportunities of bilateral trade by effectively negotiating CPFTA, export promotion and import substitution through development of special economic zones under CPEC. The import bill of around $5.95 billion with China during FY17 in sectors of electrical machinery and equipment, organic chemicals, fertilizers, plastic and rubber articles, glass and glassware and knitted or crocheted fabrics can be substituted through local production with technical and technological assistance from China (see table 4).

Table: 4 Proposed Substitutable Imports from China

Products	Amount
Electrical machinery and equipment.	3.65
Organic chemicals	0.79
Fertilizers	0.49
Plastics and articles thereof	0.42
Rubber and articles thereof	0.27
Knitted or crocheted fabrics	0.21
Glass and glassware	0.13
Total	**5.95**

Source: Author's calculation based on International Trade Centre (ITC) / COMTRADE statistics.
Amounts in US $ Billions for 2017

Trade Deficit with China and CPFTA

China Pakistan Free Trade Agreement (CPFTA) was a landmark strategic contract between the two nations that aimed at trade facilitation, economic cooperation, reduction in trade barriers and easy access to markets on reciprocal basis. Both countries agreed to remove around 36%[2] of the total tariff line in the first phase of implementation (2006-2012). Contrary to Pakistan, China has efficiently utilized the concessions offered under CPFTA with considerable increase of $3.77 billion in its exports, while Pakistan could only achieve an increase of $2.11 billion during the first phase of implementation (see table 3).

With an objective of further reduction in tariffs and simplification of trade procedures, the negotiations on the second phase of implementation started in 2013, but the consensus is still awaited. Pakistan needs to consider the following areas to boost its exports and gain maximum benefit from the second phase of CPFTA;

- The exports of Pakistan are less competitive because of the generous concessional tax rates offered to South East Asian Nations (ASEAN) by China, therefore, Pakistan must try to attain the same benefits that China is offering to ASEAN or any other nation having the FTA contract with China.

- While negotiating the second phase of CPFTA, the top-performing and future potential exports of Pakistan to China must be included in the tariff elimination/concession list.
- In order to halt the increasing trends of imports and protect the local manufacturers and industries, a stringent protection list needs to be an integral part of CPFTA.

Trade Deficit with China and CPEC

The MoU for the flagship project of China Pakistan Economic Corridor (CPEC) of Belt and Road Initiative was signed in 2013[3] with a portfolio of energy and infrastructure projects worth around $50 billion. China has the competitive advantage in infrastructure development, manufacturing and financing options, whereas, Pakistan is enriched with natural resources, human capital and favorable geostrategic location for trade. Therefore, CPEC offers opportunity to both the economies to efficiently benefit from the potential economic factors for enhancement of the trade volume with the world.

With infrastructure development and energy projects, CPEC will offer some magnificent opportunities to the economy of Pakistan such as; export promotion, expansion in the industrial sector, tourism enhancement, improvement in the urbanization process, efficient regional connectivity, employment generation and better financial integration. Besides this, CPEC is also expected to deal with the socio-economic issues of the country through better connectivity resulting in improved economic growth. Table 3 reports the bilateral trends of trade after CPEC, depicting a sharp rise in imports by $8.76 billion from FY13 to FY17 whereas the export volume has declined by $1.14 billion during the same period. However, it is pertinent to mention that out of $8.76 billion increase in imports, $5.15 billion increase comes from imports of machinery, mechanical appliances, nuclear reactors, electrical machinery and equipment, and Iron and steel[4]. Furthermore, for developing countries like Pakistan, import of such machinery and equipment is inevitable to catalyze and sustain industrial and economic development.

Establishment of the Special Economic Zones (SEZs) under CPEC has become crucial component for fast-track industrial development of Pakistan. The Special Economic Zones under CPEC have a huge potential to offer export led growth to Pakistan with product diversification. Pakistan needs to address the issue of product diversification as it lags behind from its regional competitors in diversified product exports[5]. Once the SEZs are developed, the efficiency would rely on well-organized services like one-stop shop, better infrastructure, good business environment, reforms for strengthening the business environment and a balance between urban / social development and industrialization in Pakistan[6].

Policy Recommendations:

- **SEZs under CPEC and Current Account Deficit**
  The total current account deficit of Pakistan mainly emerged from the trade deficit, whereas the major chunk of the trade deficit developed from trade with China, therefore, Special Economic Zones (SEZs) under CPEC needs to be developed keeping in view the objective of fast-track industrial growth, export promotion through diversified products. Furthermore, while developing SEZs, due consideration may also be given to the fact that the exports could be boosted by ensuring value addition in existing exports through manufacturing processes.
- **Import Substitution through SEZs under CPEC**
  With technical and technological assistance from China in SEZs development under CPEC, the import bill of billions of dollars with China in sectors of electrical machinery and equipment, organic chemicals, fertilizers, plastic and rubber articles, glass and glassware and knitted or crocheted fabrics (FY17-$5.95 billion) can be substituted through local production.
- **Export Promotion through CPFTA and CPEC**
  The exports of Pakistan are less competitive because of the generous concessional tax rates offered to South East Asian Nations (ASEAN) by China, therefore, Pakistan must try to attain the same benefits that China is offering to ASEAN or any other nation having the FTA with China. Thus by ensuring level playing field, the increase in production of exports quality products through SEZs under CPEC may result in an overall increase in exports.
- **Increase in Primary Income through International Financial Integration**
  The current account deficit of Pakistan can also be reduced through more inflows in the primary income which could be accomplished by providing more opportunities of investments in foreign financial markets. The objective of access to foreign financial markets may be achieved if measures are taken for attainment of an efficient international financial integration.
- **Increase in Secondary Income through Remittances**

Secondary income in general and remittances, in particular, has a substantial positive impact on the current account of Pakistan. Therefore, the inflows in the form of remittances can be increased by regulating and ensuring transfers through formal banking channels.

- **Export promotion through Financial Inclusion**

  For export-led growth of Pakistan, government needs to devise a sound financial framework for easy access to financial services to local manufacturers and industries. By providing concessional loans to small domestic enterprises like cottage industries, primarily in the node cities of CPEC, may contribute not only to the export promotion but also to the government's objective of an inclusive financial system.

- **Diaspora investments and balance of payment**

  The pressure on overall balance of payment can also be temporarily reduced if the government offers more favorable investment opportunities to expatriates with the condition of payment of income to be made at maturity along with principal. Similarly, investment from expatriates may also be attracted in social housing schemes, pension plans and diaspora banking for ensuring long term inflows for sustainable balance of payment.

References

[1] Asian Development Bank (Available from https://aric.adb.org/trade-investment)

[2] http://fta.mofcom.gov.cn/pakistan/xieyi/fta_xieyi_annex_en1.pdf

[3] Board of Investment (Available from www.boi.gov.pk/userfiles1/file/list%20of%20mous.docx)

[4] http://www.intracen.org/itc/market-info-tools/statistics-import-country-product/

[5] Export performance of Pakistan: SBP Staff Notes

[6] Mahmood, Zafar. "Opportunities and Challenges of Special Economic Zones under CPEC for Pakistan." The International Academic Seminar on Industrial *Cooperation and Construction of Industrial Zones, CPEC", Beijing China, 5-7 January 2018.*