

East Asia FTA: Effects on China's Selected Industries*

Wai-Heng Loke

*Division of Economics
The University of Nottingham Ningbo China*

waiheng.loke@nottingham.edu.cn

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Abstract

The main purpose of this paper is to take a closer examination on the likely industry effects on China of a potential East Asia free trade area, i.e. ASEAN+3. The question being asked here is, how would a full East Asia FTA in this region affects its industries, particularly the major and some sensitive industries – agriculture, motor vehicles and electrical and electronics industries . Preliminary findings indicate that there might be some opportunities for some agriculture industries such as ‘fish’ industry to expand. Some industries like ‘textiles’ and ‘clothing’ are likely to expand even further. However, ‘motor vehicles’ may face challenges given that Japan and Korea are much more developed in this industry.

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1. Introduction

The first 12 years of the 21st century has been an exciting time period for Asia. Much attention has been given to this part of the world and one of the notable developments is the increased interests among the Asian nations in free trade agreements (FTAs). This can be seen from the rise of the number of FTAs signed by individual Asian countries from only 53 at the beginning of the century to at least 250 FTAs by the end of 2012 (Asia Regional Integration Center). The latest news on FTA talks in this region is among China, Japan and Korea where the three are planning to begin FTA negotiations in early 2013.

Many studies on the potential effects of various FTAs can be found in the literature. Most results point to a similar conclusion that members of an FTA will experience an overall welfare improvement while non-members will experience negative welfare effects. In general, a member country is expected to experience positive effects of an FTA if the FTA provides opportunities for greater market access as a result of reduced or removal of trade barriers. The gains will be larger in those sectors/industries where the country has a comparative advantage particularly those sectors/industries that are currently experiencing high trade barriers (e.g. high tariffs) in major export destinations. Once trade barriers are removed, such sectors/industries are then expected to expand. In addition, removal of trade barriers on imports can also translate into lower production cost for local industries that rely on imported inputs. This may also increase the competitiveness of these industries in the world and hence a likely industry expansion. On the contrary, less gain is expected if the current tariff rates are already very low in the sector/industry among the members.

The purpose of the present paper is to take a closer look at the likely industry effects on China of a potential East Asia FTA, i.e. ASEAN+3. The analysis is still very preliminary and at exploratory stage. The question being asked here is how would a full free trade area in this region affects its industries, particularly the major and some sensitive industries – agriculture, motor vehicles and electrical and electronics industries . To do so, the present study adopts a simple and pragmatic approach. The study first reviews and compile results in recent empirical studies in the literature. This is then followed by taking a closer look at China's latest trade pattern and tariff rates in recent years in some selected industries.

The remainder of the paper is presented in the following sections. Section 2 provides a brief overview of China's economy, giving more attention to its trade sector and its trade policies. Section 3 reviews related empirical studies on the likely impacts of East Asia FTA. Section 4 examines

China's latest status on its comparative advantages/disadvantages in various industries in the world. Section 5 looks into the trade barriers that China faces in its exports, namely the import duties faced by China in its major export destinations for selected industries. Section 6 concludes with a discussion on the likely effects on selected industries in China.

2. China economy: an overview

2.1 Economic structure

Many studies on China's remarkable economic growth can be found in the literature (for examples, Naughton (2007), Greenaway *et al* (2010), Winters and Yusuf (2007)). This section reviews selectively and briefly on the economic structure, trade size in the economy and trade policies adopted and tariff rates in the recent years.

Table 1 reports the economic structure of China's economy in the past two decades. A clear pattern in the changing structure can be observed. First, the share of agriculture sector in GDP has consistently declined over the years from 27 per cent in 1990 to 15 per cent in 2000 and a further fall to 10 per cent in 2010. On the contrary, the industry and services sectors have both experienced notable rise in their respective shares in the GDP during this period. The industry sector is the largest sector in the economy with a GDP share of 47 per cent in 2010. The manufacturing has been the main component within the industry sector, constituting 32 per cent of GDP during the period, with a slight fall to 30 per cent in 2010. This slight contraction in the manufacturing share is most probably due to the fall in global demand for manufacturing goods particularly from the US and the Europe markets as a result of the current economic recession experienced in the two regions. The services sector records a steady rise over the years and in 2010, the share was 43 per cent.

Table 1 China's Economic Structure (% of GDP)

	1990	2000	2009	2010
Agriculture	27.1	15.1	10.3	10.1
Industry	41.3	45.9	46.2	46.8
Manufacturing	32.7	32.1	32.3	29.6
Services	31.5	39.0	43.4	43.1

Source: World Development Indicators, World Bank

2.2 Trade pattern

China's trade sector has expanded dramatically over the years as reported in Figure 1. The trade to GDP ratio rose steadily prior to 2001. A notable higher rate of increase can be observed from the early 2000s to 2006, where the ratio reached the peak of over 70 per cent in that year. This confirms China's greater integration into the world economy after accession to the WTO in December 2001. The ratio fell during the period 2006 – 2008 and climbed back slightly later in the last two years. The trade sector is currently around 60 per cent of GDP. Although the percentage is modest when compared to small and open economies such as Singapore and Malaysia, but given its large economy size, this share is significant and does indicate the country's increasing connection with the rest of the world. Figure 1 also indicates that the rising trade sector concentrates on goods as the services trade share stays below 10 per cent of GDP throughout the period.



Source: World Development Indicators, World Bank

Figure 2 provides further details on China's trade pattern with the world. Both exports and imports of goods and services rose dramatically over the years and the figure indicates a close correlation between exports and imports trend. While there is a close correlation between the two, exports exceed imports in most years with a record trade surplus during the period 2005/2006. This close correlation between exports and imports pattern is a common feature experienced by many other economies that are actively participating in the global production network with increasing fragmentation of international production.



Source: World Development Indicators, World Bank

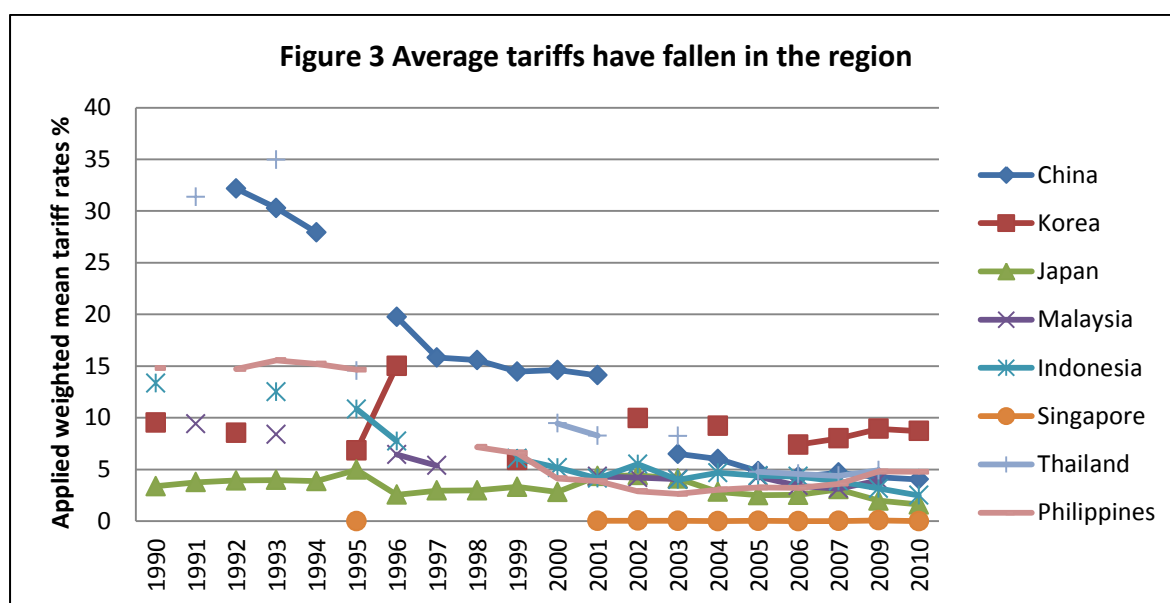
On the direction of trade, China trades mostly with Asia, followed by Europe and North America. In 2011, exports to and imports from Asia was 47 per cent and 58 per cent of total

exports/imports respectively. In terms of individual major trading partners, China's top exports destinations include United States (17 per cent of total exports), Hong Kong (14 per cent), Japan (8 per cent) and Korea (4 per cent). Major suppliers of China's imports include Japan (11 per cent of total imports), Korea (9 per cent), Taiwan (7 per cent) and United States (7 per cent). (China National Bureau of Statistics, 2012)

2.3 China's trade policy

While the trade to GDP ratio above confirms China being increasingly integrated into the world economy, it cannot be immediately seen as an increasing openness in terms of policy direction. This is because trade figures are sensitive to the changes in import intensity of export production. Given the ongoing fragmentation of production of high-tech industries, the rising trade to GDP ratio may be just reflecting such phenomenon.

Trade openness can also be assessed by examining the tariff rates. Figure 3 reports China's overall average applied tariff rates in comparison with some key East Asian countries' rates over the period 1990 – 2010. In the 1990s, China's average tariff rates were the highest among the selected economies. While most countries have reduced their tariffs over the years, China's reduction has been the most impressive of all. By 2010, China's average applied tariff rate is below 5 per cent, lower than Korea's and comparable to countries like Malaysia, Indonesia and Japan's rate.



Source: World Development Indicators, World Bank

Average MFN tariff rates at the WTO level at more detail subsectors are presented in Table 2, with additional information on the US, the EU, Taipei China and Vietnam. Singapore is not included in the table since the country's tariffs are zero in almost all subsectors. Within China, average tariff rates are generally lower for the non-agriculture products (9 per cent) than agriculture products (17 per cent). The lower tariff rate on non-agriculture products than agriculture products is a common feature for all the countries in the table.

Comparing tariffs on agriculture goods, China's average rate of 17 per cent, lies somewhere in the middle range among the countries in the table. The rate is considerably lower than Korea's 44 per cent, Japan's 22 per cent and Thailand's 22 per cent.

On non-agriculture goods, China's average tariff rate is somewhat on the higher range – 9 per cent. Japan has the lowest rate of 3 per cent while Viet Nam has the highest rate of 11 per cent.

Table 2 Simple average MFN applied duties, 2010

	China	Japan	South Korea	Taipei	Thailand	Malaysia*	Indonesia	Philippines	Viet Nam	US	EU
Agriculture products	16.8	21.6	43.7	12.7	21.5	14.5	10.1	9.7	17.0	7.0	15.4
Animal products	14.8	18.9	22.1	16.7	28.7	3.9	4.4	21.0	16.1	2.3	22.2
Dairy products	12.0	93.3	67.5	15.7	24.3	2.3	5.5	3.9	9.4	20.3	48.3
Fruit, vegetables, plants	14.8	10.6	57.4	19.8	30.8	3.0	5.9	9.8	21.1	4.9	11.1
Coffee, tea	14.7	15.3	53.9	8.5	28.3	5.7	8.3	15.7	26.4	3.2	6.5
Cereals & preparations	24.3	42.0	134.5	31.8	18.4	4.5	5.8	10.9	19.0	3.5	14.3
Oilseeds, fats & oils	11.0	9.0	37.0	18.6	9.9	1.8	3.9	5.6	8.5	4.6	5.7
Sugars and confectionery	27.4	27.2	16.8	16.1	22.6	2.5	7.1	16.0	14.4	10.3	21.6
Beverages & tobacco	22.3	14.6	31.7	16.0	42.2	120.9	51.8	8.2	43.6	15.6	20.0
Cotton	15.2	0.0	0.0	0.0	0.0	0.0	4.0	2.6	6.0	4.1	0.0
Other agricultural products	11.4	4.4	16.1	3.3	9.5	0.6	4.2	3.4	5.8	1.1	4.1
Non-agriculture products	9.4	2.9	7.2	5.9	10.5	7.5	9.4	6.4	11.4	3.3	4.5
Fish & fish products	10.9	5.5	16.1	18.9	11.7	1.1	5.8	8.1	16.7	1.0	10.5
Minerals & metals	7.4	1.0	4.6	2.8	6.0	11.2	6.4	4.9	8.2	1.7	2.0
Petroleum	4.8	0.6	4.1	2.6	6.0	0.7	0.3	3.0	13.1	1.4	2.0
Chemicals	6.6	2.2	5.7	2.8	3.1	2.9	5.2	3.8	3.5	2.8	4.6
Wood, paper, etc.	4.4	0.8	2.2	0.4	6.9	10.1	5.0	6.6	11.5	0.5	0.9
Textiles	9.6	5.5	9.1	7.4	8.0	10.3	9.3	9.1	9.7	7.9	6.6
Clothing	16.0	9.2	12.6	11.7	29.8	15.9	14.3	14.8	19.7	11.7	11.5
Leather, footwear, etc.	13.2	9.0	7.9	5.2	12.4	13.9	8.9	6.6	14.1	3.9	4.2
Non-electrical machinery	8.0	0.0	6.0	3.1	4.1	3.6	2.3	2.3	3.4	1.2	1.9
Electrical machinery	8.3	0.2	6.2	4.0	7.5	4.3	5.8	4.0	8.9	1.7	2.8
Transport equipment	11.5	0.0	5.5	8.4	20.3	11.6	10.6	9.1	18.0	3.0	4.3
Manufactures, n.e.s.	11.9	1.2	6.7	3.3	10.2	4.8	6.9	4.9	10.5	2.4	2.7

Source: World Trade Organization, <http://stat.wto.org/TariffProfile/WSDBTariffPFReporter.aspx?Language=E>

Note: * data for year 2009, same source. Singapore and Brunei are not shown as the countries' tariffs are zeros for most goods.

3. Likely impacts of East Asia FTA on China: selected literature review

A number of studies analysing the economic impact of an East Asia FTA on member economies and also non-members can be found in the literature. Many empirical works in recent years

adopt the Global Trade Analysis Project model (GTAP model) developed by Hertel (1997) to assess the impact of free trade agreements among a subset of economies in the world. Some of the recent studies focusing on the East Asia region are briefly reviewed here¹. Most of these studies point to a similar conclusion that members will obtain positive gains when participating in a potential FTA. For example, Urata and Kiyota (2005) examine the impacts of an East Asia FTA and their study indicates that all the FTA member economies will benefit from an East Asia FTA. The ASEAN economies in particular will obtain significantly larger benefits as compared to the Northeast Asia economies namely Japan, Korea, China, Hong Kong and Chinese Taipei. The study also notes that non-members such as the USA, the EU and Australia/New Zealand will experience negative impacts due to trade diversion as a result.

In another study, Park (2008) examines the effects of a number of potential East Asia FTA scenarios. The study concludes that ASEAN FTA (AFTA) brings positive gains to its members and their welfare benefits can be further enhanced if the FTA membership is expanded to other Northeast Asian economies. Kwan and Qiu (2010) arrive at similar conclusions that an ASEAN+3 trade bloc is beneficial to all member countries.

While a full East Asia FTA is welfare improving, some analysis shows that there are clearly some challenges in selected sectors. Ahn *et al* (undated) for example conclude that for China, the automobile industry and the petrochemical industry may suffer in the short term. Japan's agriculture sector and its textile industry are like to be negatively affected. The study also suggests that Korea's agriculture sector may also suffer negative effects.

4. Comparative advantages of China's industries

This section examines China's recent comparative advantages and disadvantages in various industries using the concept of revealed comparative advantage (RCA) index introduced by Balassa (1965). It is assumed that the comparative advantage of a country is reflected or revealed in its trade pattern. The RCA index is given by:

$$RCA_{ij} = (X_{ij}/X_i) / (X_{wj}/X_w)$$

where X_{ij} : value of country i 's export of commodity j ;
 X_i : value of country i 's total exports;
 X_{wj} : value of world exports of commodity j ;
 X_w : value of world exports

An industry with an RCA value greater than 1 means the share of that commodity in the country's exports is greater than the world's average and hence the country is interpreted as possessing comparative advantage in that commodity. Conversely, an RCA value less than 1 means the country does not have a comparative advantage in that commodity.

Table 4 reports the RCA index values for various industries. China is found to clearly possess comparative advantage in the exports of manufactured goods. RCA values are more than 1 in 15 industries. Listed below are those that record RCA values greater than 3 (the first three) and greater than 2 (the next three), meaning that China's export share of that commodity relative to its total exports is more than 3 times (for the first three) and more than 2 times (for the next three) the world's average:

- EDP and office equipment
- Clothing

¹A detailed review of recent studies on East Asia FTA can be found in Plummer (2009, chapter 7). The overall results suggest positive economic outcome when there is closer economic integration among countries.

- Personal and household goods
- Telecommunications equipment
- Textiles
- Office and telecom equipment

These are all manufactures. In fact China is the top exporter of EDP and office equipment, textiles, clothing, telecommunications equipment, office and telecommunications equipment in the world, supplying 40, 32, 37, 33 and 30 per cent of 2011 world exports respectively (WTO, 2012). On the contrary, China is relatively weak in the exports of agricultural products and fuels and mining products, with one exception in the exports of fish in which it has an RCA value of 1.20.

Table 4 China's Revealed Comparative Advantage, 2010

Industry	RCA value
EDP and office equipment	3.57
Clothing	3.48
Personal and household goods	3.42
Telecommunications equipment	2.93
Textiles	2.89
Office and telecom equipment	2.64
Other manufactures	1.92
Miscellaneous manufactures	1.69
Machinery and transport equipment	1.45
Other machinery	1.25
Integrated circuits	1.24
Fish	1.20
Scientific and controlling instruments	1.19
Other semi-manufactures	1.15
Other transport equipment	1.05
Iron and steel	0.88
Other chemicals	0.58
Transport equipment	0.53
Non-ferrous metals	0.50
Chemicals	0.48
Food	0.37
Raw materials	0.29
Other food products	0.29
Automotive products	0.24
Pharmaceuticals	0.18
Fuels	0.11
Ores and other minerals	0.10

Source: Author's calculation based on data from WTO website

5. Tariff barriers faced by China in its exports

This section takes a closer look at the tariff duties faced by China in its exports, as a partial analysis to ascertain the likely effects of a full East Asia FTA on China. In particular the section aims to examine whether China can continue to increase further in those exports that the country is currently already good at, and whether China will have greater opportunity to develop certain industries currently not having a comparative advantage. To narrow the scope, only tariff duties imposed by the top 10 export destinations are analysed. The following six sample industries are selected:

- a) Fish and crustaceans, molluscs and other aquatic invertebrates (HS03)
- b) Cereals (HS10)
- c) Cotton (HS52)
- d) Articles of apparel and clothing accessories, knitted or crocheted (HS61)
- e) Electrical machinery and equipment and parts thereof; (HS85)
- f) Vehicles other than Railway or tramway rolling, etc (HS87)

Table 5 summarises the results. More details are reported in tables in the Appendix.

Table 5 Tariff barriers faced by China's exports, 2010/2011

Commodity	East Asia region		Other parts of the world	
	Exports share (%)	Tariff rate faced	Exports share (%)	Tariff rate faced
Fish and Crustaceans, etc. (HS03)	34.52	7.03	65.48	7.34
Cereals (HS10)	71.62	27.2	28.38	3.86
Cotton (HS52)	69.45	5.58	30.55	11.37
Articles of Apparel, etc. (HS61)	34.02	7.31	65.98	9.73
Electrical Machinery and equipments etc. (HS85)	43.81	1.86	56.19	3.27
Vehicles other than Railway or Tramway Rolling, etc. (HS87)	19.58	5.88	80.42	10.32

Note: The percentage above is calculated based on top 10 exports destinations.

Tariff rate faced is the simple average Ad Val. Duties

Source: Tariff Analysis Online, WTO

For 'fish and crustaceans etc.', 65 per cent of the exports goes outside of East Asia where nearly half of China's exports go to the US and the EU. China exports 35 per cent of this commodity category within the East Asia region, mainly to Japan, Korea and slightly less to Hong Kong. Given the current tariff duties faced by China are 5 and 16 per cent in Japan and Korea respectively, and that China has a comparative advantage in fish from RCA analysis in the previous section, if the East Asia FTA is materialised where tariff is completely removed, China is expected to expand its fish industry and exports are likely to increase, particularly to destinations such as Korea.

In the exports of 'cereals', among the top 10 export destinations, 72 per cent goes to countries within East Asia region, namely Korea, Japan, Taipei China and Hong Kong. One interesting observation is made that while Korea is the top destination for China's exports of 'cereals', the tariff duties faced is also the highest in the list – 106 per cent. This suggests that if the Korean tariff is removed, exports of 'cereals' may increase extensively.

For 'cotton', China exports 69 per cent of 'cotton' to countries within the East Asia region, mainly to Hong Kong, Korea, Indonesia, Thailand and Japan. Hong Kong's tariff rate is already zero while tariffs imposed by the other East Asia countries range between 4 – 9 per cent. Given that China

possesses a comparative advantage in textile from the RCA analysis, with the full implementation of an FTA in this region, some cotton export expansion can be anticipated within this region.

For ‘articles of apparel and clothing accessories etc.’, 66 per cent of China’s exports are directed to outside of East Asia, mainly to the EU and the US. Within East Asia, the main destinations are Japan and Hong Kong and a small amount to Korea. Tariff duties faced in this commodity exports are still significant in the region. Hence a removal of tariff is likely to generate an expansion of this industry and an exports increase.

For ‘electrical machinery and equipment and parts thereof etc.’, China’s major destinations are the EU, Hong Kong and the US. Given that the current tariff duties imposed are already very low, the effects of any further tariff reduction on this industry is likely to be minimal.

In the exports of ‘vehicles other than railway or tramway rolling etc.’, China’s main export destinations are outside of the East Asia region even though the tariff rate faced is higher outside the region. This is not surprising given that Japan’s and Korea’s automobile industries are more developed and competitive than China’s.

6. Concluding remarks: effects on China’s industries

Analysis from the previous sections shows a number of interesting observations. First, due to the recent significant reduction in tariff rates by China in recent years, its average rates in both agriculture and non-agriculture are comparable to many East Asian economies. Although the tariff rates are still higher compared to developed countries/regions such as the US and the EU in some sectors, its rates are already lower than Japan, Korea and Thailand in some industries particularly in the agriculture sector. For example, protection in terms of tariff is found to be quite high in Japan’s and Korea’s agriculture sector (e.g. the cereals industry in Korea).

Second, the high tariff in some of these industries in the region suggests that there is still room for market access when tariffs are removed. There are some indications in the RCA analysis that China has some revealed comparative advantages in the agriculture sector, for example in the exports of ‘Fish etc.’ A full East Asia FTA including agriculture is likely to expand some of this agriculture industries.

Third, some manufactured industries like ‘textiles’ and ‘clothing’ are likely to expand further given a full East Asia FTA since China has comparative advantages in these industries and that existing tariff rates in the region is still quite high. On the other hand, the electrical and electronic industries may not experience dramatic changes mainly because the current tariff rates are already very low.

Fourth, the motor vehicles industry is likely to experience some challenges given that China does not possess a comparative advantage in this industry while other countries like Japan and Korea have a comparative advantage. A full East Asia FTA may mean a contraction in this industry at least in the short term. This could pose a concern for China if the country hopes to develop this industry and this also suggest that an implementation of an East Asia FTA covering all goods sectors can be a challenge.

Finally, given that China is still facing notable tariff barriers outside of East Asia region (Table 5), gains from freer trade with other regions can also be substantial, thus trade liberalisation approach should not be just confined at this regional level.

As a concluding remark, this study is still at its preliminary stage and it has yet to incorporate many other aspects of a potential East Asia FTA. The next step for further analysis includes (i) adding more industries and (ii) adding other trade barriers – NTBs into the analysis.

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Appendix – Additional Tables

Top export destinations , 2011	
United States	17.09
Hong Kong, China	14.12
Japan	7.81
Korea Rep.	4.37
Germany	4.02
Netherlands	3.13
India	2.66
United Kingdom	2.32
Russia	2.05
Singapore	1.87

Source: China National Bureau of Statistics

Top supplier of imports, 2011	
Japan	11.16
Korea Rep.	9.33
Taiwan, China	7.16
United States	7.00
Germany	5.32
Australia	4.74
Malaysia	3.56
Brazil	3.01
Saudi Arabia	2.84
Russia	2.32

Source: China National Bureau of Statistics

03 FISH AND CRUSTACEANS, MOLLUSCS AND OTHER AQUATIC INVERTEBRATES

Exports to	Share (%)	Ad val. Simple average
		MFN duties
United States of America	26	0.48
European Union	23	9.71
Japan	14	5.53
Korea, Republic of	12	15.56
Hong Kong, China	6	0
Canada	4	0.59
Brazil	3	8
Mexico	2	19.5
Australia	1	0
Nigeria	1	13.13
Total exports value (US\$)	7,790,927,524	

Source: Tariff Analysis Online, WTO

10 Cereals

Exports to	Share (%)	Ad val. Simple average MFN duties
Korea, Republic of *	28	105.84
Japan	19	1.2
Taipei, Chinese	5	1.75
Hong Kong, China *	5	0
Nigeria	5	6.88
Benin	4	7.5
Papua New Guinea	4	0
Saudi Arabia, Kingdom of	3	0
Côte d'Ivoire	3	8.75
European Union	3	0
Total exports value (US\$)	555,864,746	

Source: Tariff Analysis Online, WTO

52 COTTON

Exports to	Share (%)	Ad val. Simple average MFN duties
Hong Kong, China	34	0
European Union	9	6.36
Korea, Republic of	8	8.57
Indonesia	7	8.79
Turkey	5	7.42
Brazil	4	24.33
United States of America	4	8.84
Thailand	4	4.66
Japan	3	5.87
India	2	9.91
Total exports value (US\$)	7,278,516,023	

Source: Tariff Analysis Online, WTO

61 ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, KNITTED OR CROCHETED

Exports to	Share (%)	Ad val. Simple average
		MFN duties
European Union	28	11.6
United States of America	24	11.97
Japan	18	9.12
Hong Kong, China	12	0
Canada	3	16.84
Australia	3	8.6
Korea, Republic of	1	12.8
Norway	1	8.12
Chile	1	6
United Arab Emirates	1	5
Total exports value (US\$)	61,829,969,327	

Source: Tariff Analysis Online, WTO

85 ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES

Exports to	Share (%)	Ad val. Simple average
		MFN duties
European Union	20	3.33
Hong Kong, China	20	0
United States of America	19	1.75
Japan	7	0.19
Mexico	4	3.24
Korea, Republic of	4	5.41
Taipei, Chinese	3	3.68
Singapore	3	0
Canada	2	1.3
India	2	6.73
Total exports value	512,620,261,937	

Source: Tariff Analysis Online, WTO