

Fixing the Trade Imbalance: Policy Recommendations

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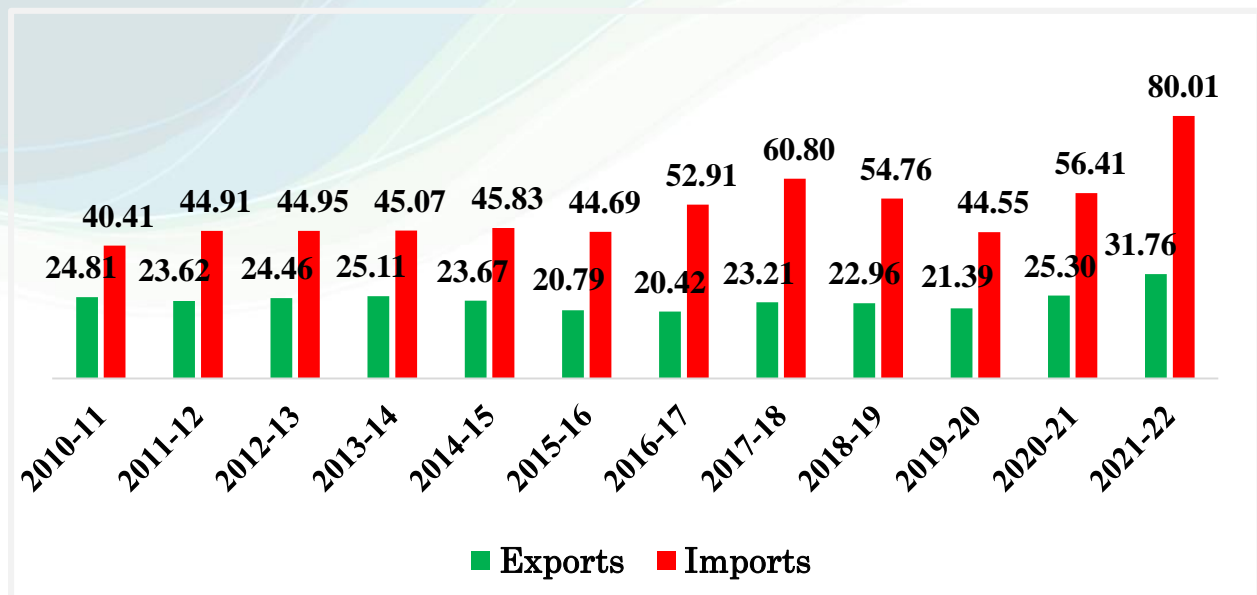
Abstract

This policy brief is an analysis of trade imbalance in Pakistan with a special focus on exports. Trade performance of the country is historically analysed, followed by the identification of structural impediments in trade development, and flaws in our trade policies. A diagnostic approach is applied to highlight factors responsible for ever-ballooning trade deficit, and to recommend suitable policy interventions for its redressal.

Introduction

Balance of trade refers to the difference between net exports and imports of a country. When a country's imports exceed its exports, it is faced with trade deficit. Unfortunately, Pakistan has been experiencing perennial trade deficits since 1950s, with an average deficit of \$29.098 billion on yearly basis (Figure 1) in the last decade. Due to rising international fuel prices and falling exports, the country's trade deficit is widening. Swelling import bills have strained the government's budget, as well as investors' confidence in the economy. It has put a strain on the economy, resulting in a higher current account deficit. The foreign exchange reserves are no longer sufficient to meet debt service obligations. They have reduced our capital account as well. Resultantly, our domestic currency has devalued. Pakistan's trade policies have failed to turn around the trade balance because of their anti-growth bias. Structural economic impediments have been impeding our exports growth even more. To reduce the growing trade deficit, trade policies ought to be reformed with the major focus on enhancing exports' competitiveness, sophistication, and improving the business and investment environment.

Figure 1: Pakistan's Trade Deficit (2011-2022)



Source: Pakistan Bureau of Statistics¹

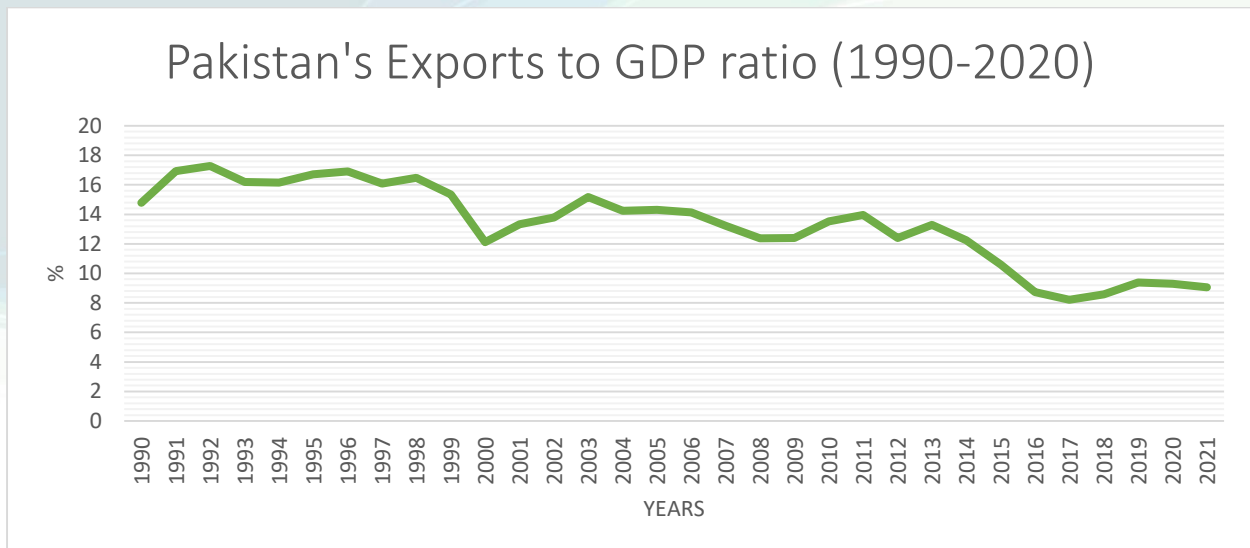
¹ <https://www.pbs.gov.pk/sites/default/files/tables/trade/14.08.pdf>

Considering the negative consequences of trade balance on the economy, it is pertinent to highlight the causes behind the ever-ballooning trade deficit, and some of the policy interventions to address them. Doing so warrants a diagnosis of economic structure and trade policies of the country.

Trade Performance: A Historical Analysis

Over the years, Pakistan's exports have shrunk from 16% to 10% of GDP (Figure 2). In the manufacturing sector, we are producing and exporting 150 products less than what we were exporting in 1990s. Consequently, our share in global trade has fallen from 2% to 1%. The fact that Pakistan ranks much below the smaller economies in terms of its exports, speaks volumes about the challenges it faces. A comparison of exports performance with the regional countries suggests that South Asia's total exports of goods and services increased by 165% in the years 2005-2017². Thailand's and Vietnam's exports rose by 519% and 50% respectively Pakistan's exports increased by only 50%, from USD 19.1 billion to USD 28.7 billion³ (Figure 3). Pakistan's share in the global export market has reduced and imports have kept increasing resulting in huge trade deficit. The declining exports coupled with increasing reliance on imports exacerbates the balance of trade.

Figure 2- Pakistan's Exports to GDP Ratio



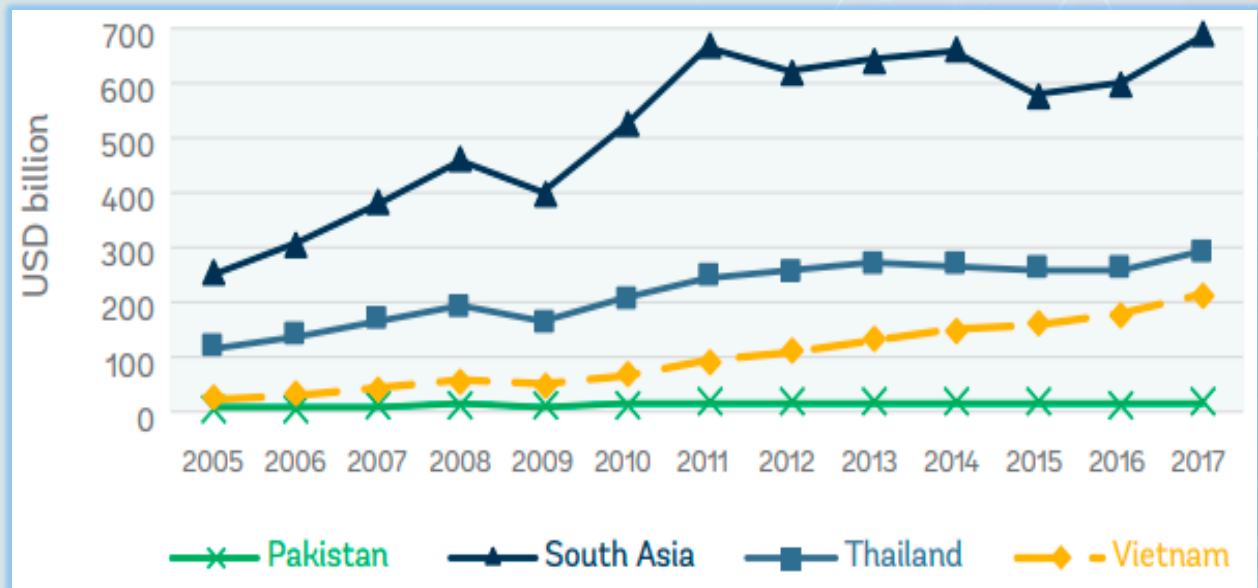
Source: *The World Bank Data*⁴

² <https://documents1.worldbank.org/curated/en/855261578376618421/pdf/Modernizing-Trade-in-Pakistan-A-Policy-Roadmap.pdf>

³ <https://documents1.worldbank.org/curated/en/855261578376618421/pdf/Modernizing-Trade-in-Pakistan-A-Policy-Roadmap.pdf>

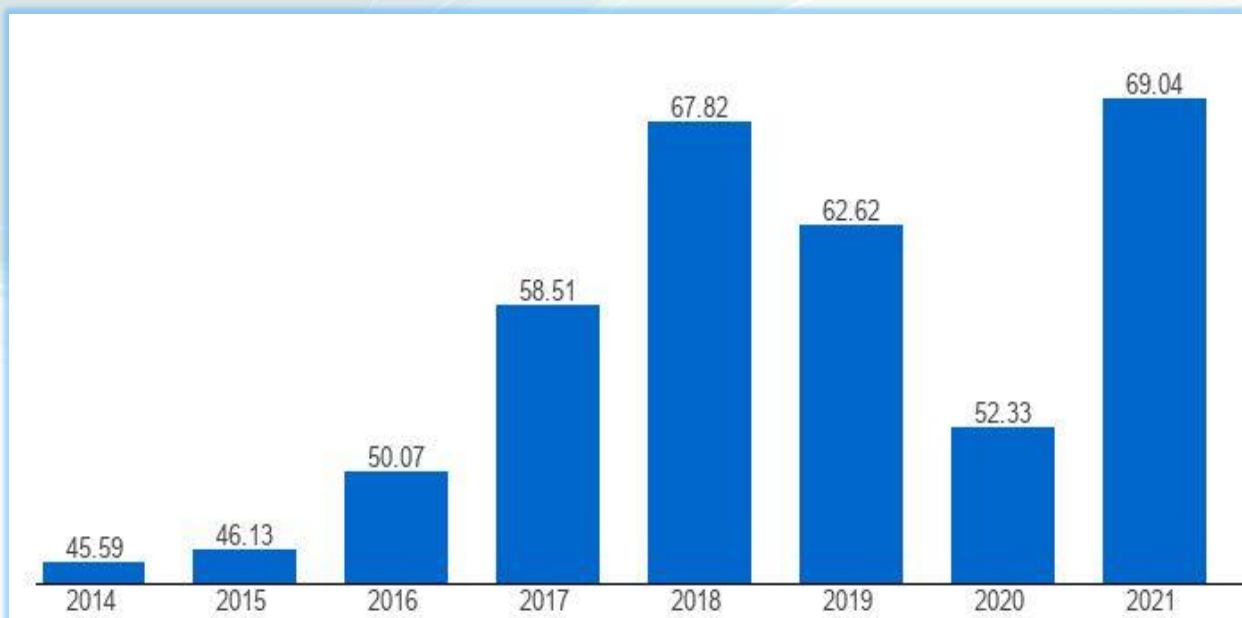
⁴ <https://data.worldbank.org/indicator/NE.EXP.GNFS.ZS?locations=PK>

Figure 3: Pakistan’s Exports Compared to Peers, 2005-2017



Source: United Nations Conference on Trade and Development⁵

Figure 4: Pakistan’s Imports (billion dollars)



Source: The Global Economy.com⁶

⁵ <https://unctad.org>

⁶ https://www.theglobaleconomy.com/Pakistan/imports_dollars/

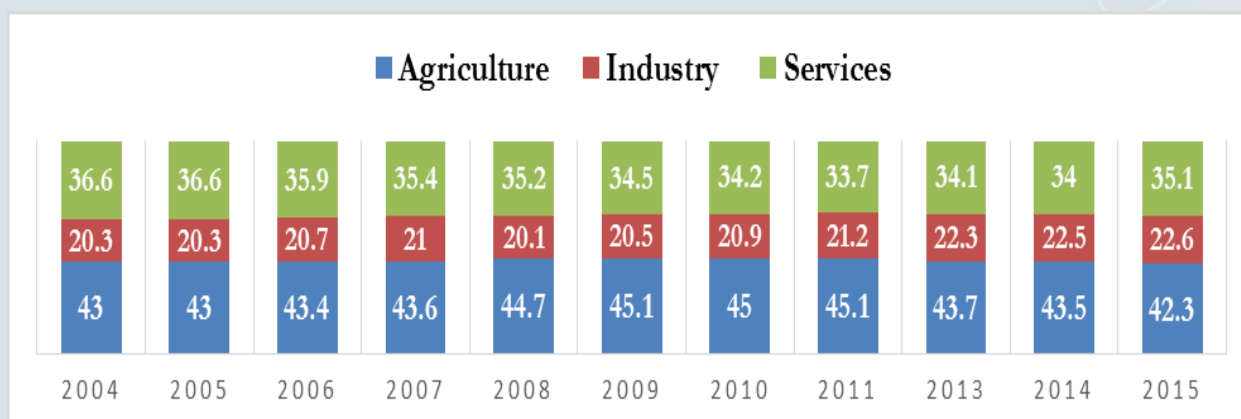
Structural Impediments to Trade Development

A closer look into country's economic structure underlines the structural impediments which act as binding constraints to sustained exports' growth, which are stipulated below:

1. Irregular Structural Transition

Pakistan as an economy leaped directly from being an agriculture economy to working in the tertiary sector (services sector) while bypassing the manufacturing sector. The transition from agriculture to services sector was not accompanied by the development of human resource and required level of industrialization. This skipping of the phase where agri-economies evolve into industrial / manufacturing, created disparity in the skillset and income of the workforce. The table below highlights the share of employment by each major economic sector. It has remained static throughout. Moreover, the skill requirement in the agriculture and manufacturing sector is also very low. As agriculture and industry employs the highest number of workforce, our majority of labor force is unskilled, less productive, and mostly underpaid (Figure 5). Resultantly, it affects the quality of the products they produce.

Figure 5: Sectoral Share in the Work Force



Source: Ministry of Finance⁷

2. Consumption-led Growth Model

Quality of our economic growth is poor. 96.2% of Pakistan's growth is consumption-led. Since we have no industry, more than 90 percent of our consumption is import-based. Being a consumption-led economy, our demand for consumer goods increases whenever there is economic growth. As a result, our imports increase while our exports remain stagnant. This widens the trade deficit.

3. Low Productivity Trap

Labour productivity is the hallmark of economic development. Unfortunately, Pakistan's labour productivity is one of the lowest in the region (Table 1). It has not been able to produce more goods or services with the same amount of resource or produce the same level of goods

⁷ https://www.finance.gov.pk/survey/chapters_19/12-Population.pdf

and services, with less resources. One explanation is the higher employment of labour force in agriculture and manufacturing sector of economy, where the skillset of workforce is low.

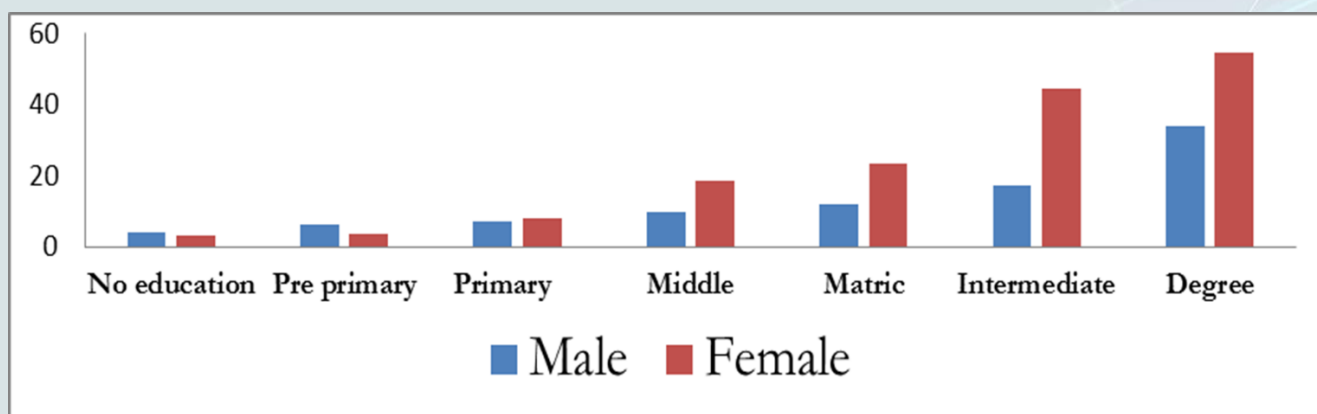
Table 1: Comparison of Labour Productivity among Pakistan, India and China

Country	Labour Productivity (2018)
Pakistan	\$15,430
India	\$18,565
China	\$29,499

Source: Data from International Labour Organisation⁸

That is the reason that the youth with the highest academic qualification is the most unemployed. Because they are not provided with the opportunities to employ their skills in the economic development. Refer to the figure below to understand the participation of labour force in terms of their education level.

Figure 6: Unemployment Rate by Education Level



Source: Pakistan Bureau of Statistics⁹

Critical Analysis of Trade Policies

Historically, the trade policies of Pakistan have proved ineffective in altering the balance of trade towards exports. They have failed to ensure exports' competitiveness, diversification, and products' sophistication. Realising its ineffective annual trade policies, Ministry of Commerce started formulating Strategic Trade Policy Framework, holistic three-year policy framework, in 2008, to enhance the scope of trade policies, and engender policy continuity.¹⁰ Up till now, four Strategic Policy Frameworks have been implemented and the fifth one is continued, but

⁸ <https://profit.pakistantoday.com.pk/2019/02/25/why-did-pakistans-labour-productivity-fall-behind-india-and-china-this-past-decade/>

⁹ https://www.pbs.gov.pk/sites/default/files/labour_force/publications/lfs2020_21/LFS_2020-21_Report.pdf

¹⁰ <https://tdap.gov.pk/wp-content/uploads/2022/01/STPF-2020-25-1.pdf>

the trade goals have not been met. Following factors have hindered the progress on these Strategic Policy Frameworks:

- Ineffective ministerial coordination
- Absence of Monitoring and Evaluation Mechanism
- Continuity of unrealistic exchange rate
- High tariffs on intermediate inputs
- Policy disconnection with global production and value chains
- A clear disconnect between export-oriented strategies and investment policy

Factors Responsible for Trade Deficit

- ***Increasing Reliance on Imports:***

Pakistan has an import-led growth model. Therefore, dependence on imports is increasing day by day and adding to trade deficit.

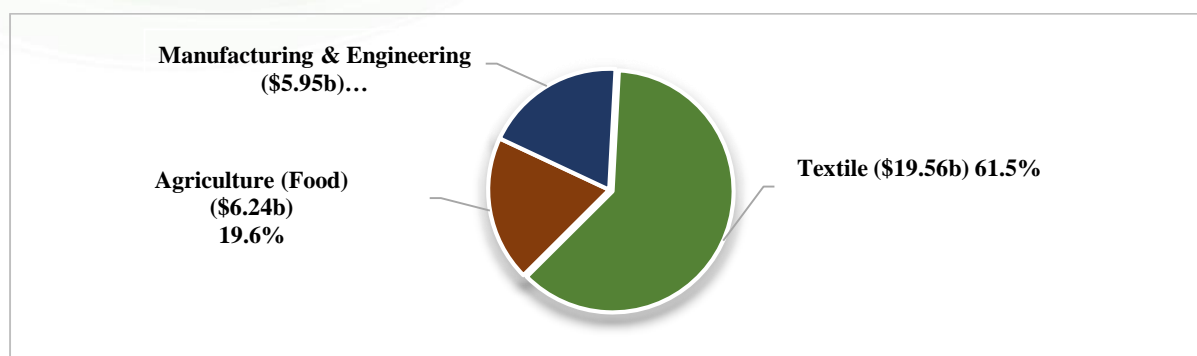
- ***Exports with High Price Elasticity and Low-Income Elasticity***

Pakistan's export mix is such that the export goods have low-income elasticity and high price elasticity. Because of low-income elasticity, the demand for exports does not increase even when the global economy is growing. And high price elasticity implies that with the increase in the prices of exports, its demand falls in the global market.

- ***Limited Export Basket***

Unfortunately, Pakistan has a limited number of goods in the export basket to sell, which is the main cause of the trade deficit. Textile sector has not focused on ready-made garments and winter clothes, which are the most demanding textile products in the international market. On the engineering and manufacturing side, exports figures are \$4 billion only. Exports are too narrow on specific products. For example, we earned \$19 billion in the textile industry, where we are compatible with only seven products, which is our scope of exports in the main textile industry.

Figure 7: Pakistan's Sectoral Breakdown of Exports



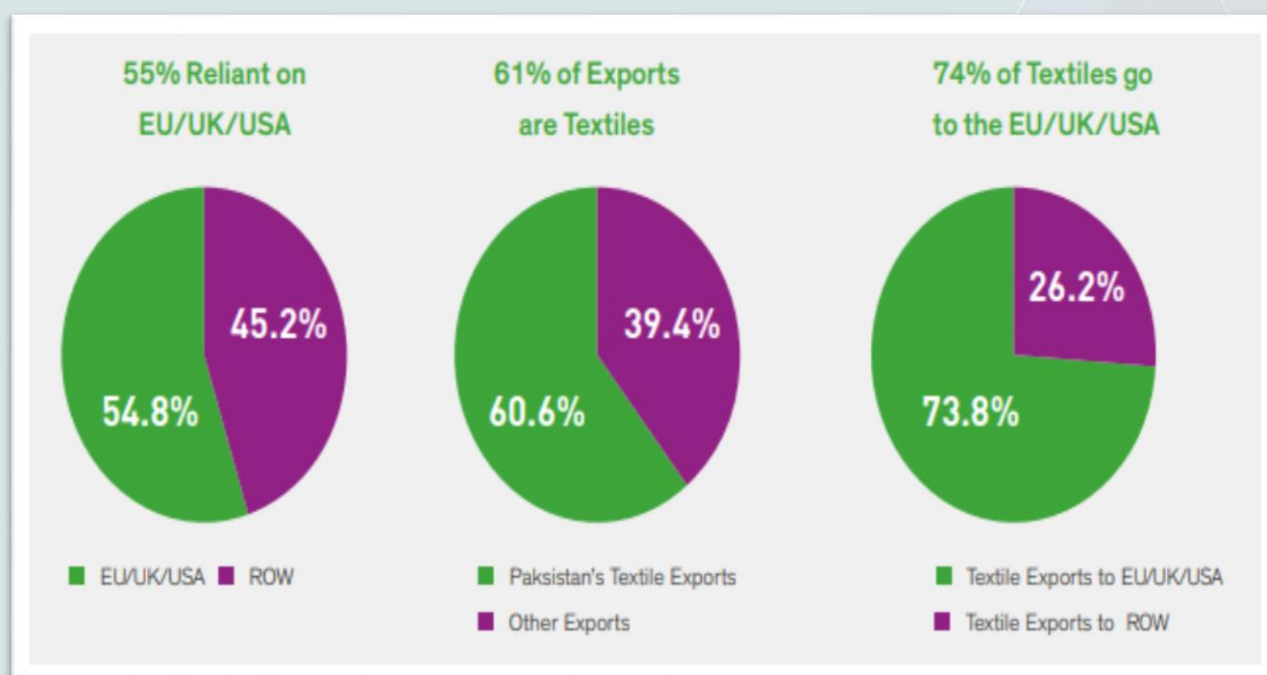
Source: Pakistan Bureau of Statistics¹¹

¹¹ <https://www.pbs.gov.pk/sites/default/files/tables/trade/14.02.pdf>

- **Static Export Market**

Pakistan has failed to penetrate into new markets for its exports. Over the years, it has been exporting only to a select few world markets. Major export destinations of Pakistan include US (21%), China (11%), UK (7.3%), Germany (5.4%), and very negligible exports with the remaining countries¹². The figure below highlights that majority of Pakistan's exports remain heavily skewed towards the US and UK markets.

Figure 8: Lack of Product and Market Differentiation



Source: International Trade Centre, Trade Map¹³

- **No regional Trade**

There is not much regional trade going on in the South Asian region. It is just 5% of the country's total trade. One of the solutions to Pakistan's economic problems is trade with India.

- **Low Productivity:**

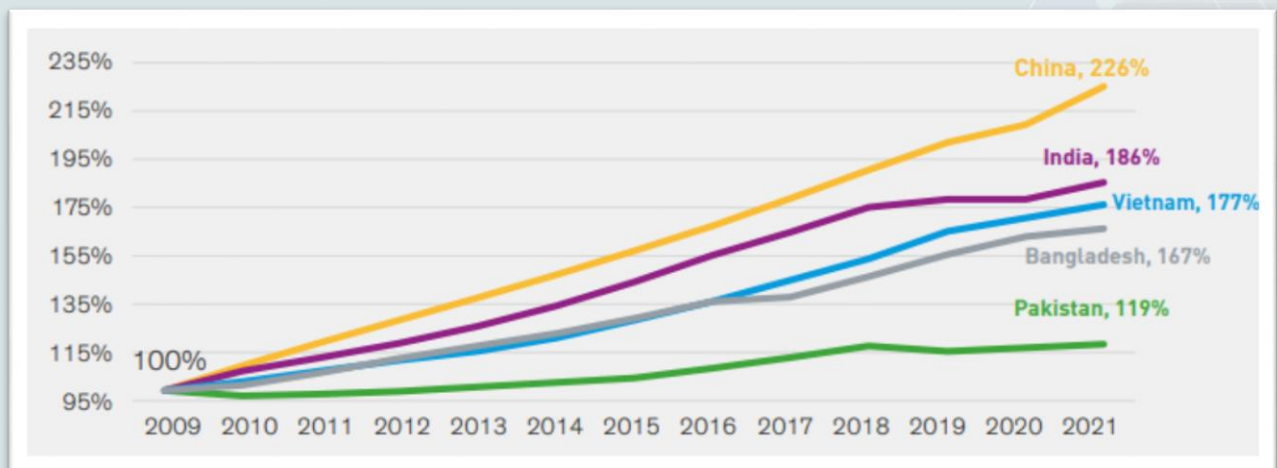
One of the biggest challenges that Pakistan faces is lack of productivity and the inability to add value to production. Our goods lack competitiveness both regionally and globally. The lack of economic growth in Pakistan compared to its counterparts in the region has hurt its ability to compete globally. In 2006, Pakistan had higher GDP per capita than Bangladesh, India and Vietnam. Pakistan had a GDP per capita of \$836, while Bangladesh had a GDP per capita of \$509. Lack of productivity has a domino effect on the worker's output in the manufacturing sector, hence reducing the ability of the firms to export finished goods. In essence, workers'

¹² <https://trendeconomy.com/data/h2/Pakistan/TOTAL>

¹³ <https://intracen.org/our-work/regions-and-countries/asia-and-the-pacific/pakistan>

lack of productivity is leading to several disadvantages for the exporting firms. In 1996, Pakistan had higher exports as a percentage of GDP than both Bangladesh and India. Today it is on the downslide. Bangladesh, Vietnam, and India have reported a significant growth in their exports as a percentage of GDP over the last two decades, while that of Pakistan remains stagnant. The graph below highlights stark difference between Pakistan's labour productivity compared with the neighbouring countries. While other economies in the region are benefiting from greater integration with other regional and global economies, Pakistan suffers from its absence.

Figure 9: Labour Productivity



Source: International Labour Organisation¹⁴

- **Non-Integration in Global Supply Chain:**

While Asian economies are increasing their participation in the global value chains, Pakistan remains a laggard. According to a recent publication by the Economic Advisory Group, participation of Pakistan in global value chains is minimal. India, Vietnam and Thailand have all reported values of more than \$90 billion in 2017, in terms of participation in global value chains, while Pakistan was at meager \$6 billion. Vietnam's participation in GVCs increased from \$12 billion in 2007 to more than \$90 billion in 2017.

- **High Cost of Doing Business:**

High energy tariffs and import tariffs, particularly tariffs on imported raw materials, raise the cost of manufacturing and farming in Pakistan making our products less competitive in the export market. Average effective tariff is the highest in the region.¹⁵

Policy Recommendations

- Government should make trade a centerpiece of the national development strategy.
- Further rationalisation of tariff slabs for raw materials and intermediary goods ought to be undertaken.

¹⁴ https://www.ilo.org/wcmsp5/groups/public/---ed_emp/documents/publication/wcms_123614.pdf

¹⁵ Business Recorder (brecorder.com)

- Pakistan needs to invest in research and development in agriculture sectors where we cannot meet our yearly wheat requirement. For example, we have to import wheat for domestic consumption. As per the report of United States Department of Agriculture, Pakistan's national average yield is 15 percent lower than India despite same climate situations, and with the same land conditions.¹⁶
- Dollarisation is the biggest challenge to Pakistan's economy at the macro level. Entering into currency swap agreements followed by their effective implementation is one way to do it. Because trade agreements with the countries are of no help to Pakistan if transactions take place in dollars.
- Pakistan needs to understand and utilise the rules of origin intelligently. Bangladesh is the best example to follow as it successfully the rules of origin to access tariff-free market access for its apparel products under the EU's GSP.
- In view of the absence of banking channels in few countries, 'Business-to-Business Barter Mechanism' for selected products should be implemented in order to facilitate trade with these countries.
- The current policies to support exporters through favours and handouts should be terminated as it tilts the balance in favour of larger exporters that are not only concentrated within a select few industries but have failed to innovate. This exacerbates the challenges and reduces the competitiveness of firms in the global and regional markets.
- Instead of targeting specific firms to boost exports, the government must ensure that smaller exporters receive the right information to export their products. This can be done by setting up trade information portals. Several African and Central Asian countries have developed trade information portals. They provide accurate information to exporters and importers on trade procedures and processes along with the time taken, and officers responsible for each step is also shared. This is likely to reduce the trade obstacles that prevent smaller exporters from participating in international trading activities as well as hinders the addition of new products in the export market.
- Pakistan is mostly involved in forward linkages as it sells raw materials and intermediate goods, which are converted into exports to its trading partners. East Asian economies focus more on adding value to production within their borders by increasing the foreign value-added content in their exports through backward linkages. Pakistan should follow this practice.
- To penetrate into new export markets, government of Pakistan needs to employ tools of economic diplomacy.
- A ministry of human resource development should be set up and tasked to develop the human resource.
- Strategic Trade Policy framework must focus on encouraging greater productivity levels by fostering competition and innovation. Small and medium enterprises must be encouraged to be more competitive while ensuring that the quality of goods produced by them meets international standards. For instance, firms that adopt international certifications, which set standards in production and provide blueprints for different processes, are likely to see a significant jump in their productivity levels. This will also help boost exports.
- Ministries of commerce, industries and board of investment should be merged to enact harmonious trade and industry policies and to effectively implement them. Trade

¹⁶ <https://www.brecorder.com/news/40153416>

professionals should be hired instead of government official for effective design and execution of policies.

ACTION MATRIX

Problem	Pathways to Solutions	How to Implement Each Solution	Actors Responsible	Implementation Timeline
Trade Deficit: In FY 2021-22, Exports were \$31.76 billion In FY 2021-22, Imports were \$80.01 billion Trade Deficit at \$48.259 billion	Increasing Productivity Boosting Competition among firms Lowering the cost of business	Invest in Research & Development. Establishment of Ministry of Human Development. Issuance and regulation of international standards compliance certificates. Removal of protectionist tariffs on intermediate inputs. Removal of untargeted subsidies to big exporters. Reforms and capacity building of Competitive Commission of Pakistan. Removing the information asymmetry by setting up trade information portals, especially for smaller exporters. Rationalisation of tariff slabs for raw materials and intermediary goods ought to be undertaken.	Ministry of Planning Development and Special Initiative. Ministry of Finance. Ministry of Commerce. Ministry of Industries. Board of Investment. Ministry of Energy	All these policy measures can be incorporated and regulated under the Strategic Trade Policy Framework, which spans over a time period of 3 years.

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Hasnain Akram is working as Research Assistant at Chair Economic Security, Islamabad Policy Research Institute. Before joining IPRI, he was working as Policy Consultant at Strategic Policy Planning Cell, Prime Minister Office. His research interests include Economic Security, Political Economy, Trade, Energy and Power Sector, and Energy and Climate Policy.

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