TRADE AS A SOURCE OF GROWTH AND ECONOMIC DEVELOPMENT[1]

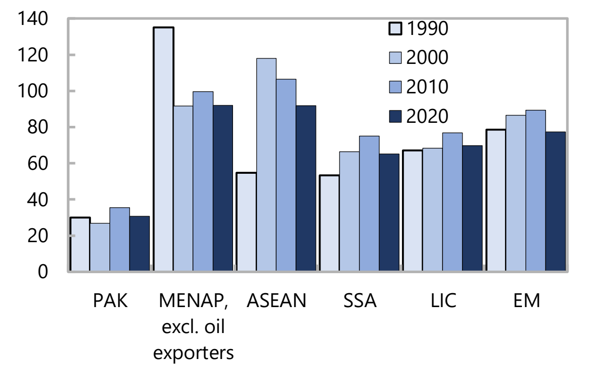
Pakistan is a very closed economy compared to other emerging and developing economies, with net exports often acting as a drag on growth. Complicating the outlook is that only a small number of firms export, primarily of low value-added textile products, while the country has also relied heavily on import tariffs to boost tax revenue, undermining trade integration and further weakening export competitiveness. Comprehensive reforms will be needed to boost competitiveness and support exports.

A. Stocktaking

1. **Pakistan is a very closed economy**. Openness—as measured by the sum of exports and imports—is very low compared to other regions as well as other emerging and developing economies (EMDEs). Moreover, compared to 1990, Pakistan's openness has barely changed, standing in stark contrast to EMDEs which have experienced large gains in the degree of openness.[2]

Figure 1. Openness

(Share of imports and exports in percent of GDP)



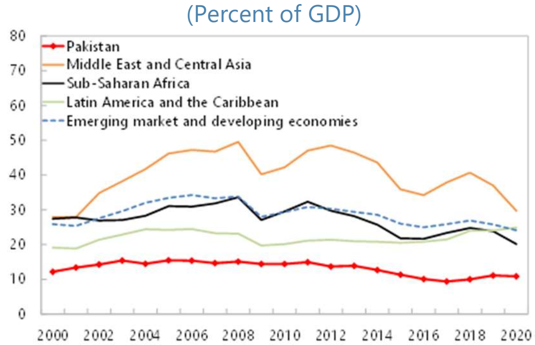
Source: IMF WEO and staff calculations.

2. **This is mirrored in Pakistan's level of exports and share of world exports** (Figure 2). Pakistan's exports, which peaked at about 15 percent of GDP in 2003, have been on a declining trend since 2011 and currently stand at about 11 percent of GDP, which is much lower than peer countries. At the same time, export volume growth has stagnated since FY 2007 amid de-industrialization, resulting in a widening export volume growth gap compared to EMDEs. This has contributed to Pakistan's share of global exports declining by almost 40 percent since the early-1990s to only 0.13 percent of world exports in 2020.

Figure 2. Exports

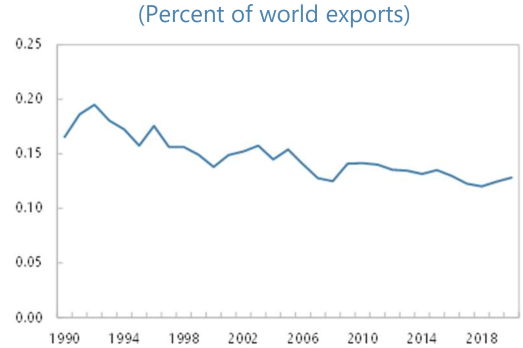
Pakistan and Peers: Exports of Goods and Services

(Percent of GDP)



Pakistan: Share in World Trade

(Percent of world exports)



Sources: IMF WEO, Direction of Trade Database, and IMF staff calculations.

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[1] Prepared by Christine Richmond (MCD).

[2] The World Economic Forum's 2019 Competitiveness Index ranked Pakistan as 138 (out of 141 countries) in terms of trade openness, with weaknesses in trade tariff rates, border clearance efficiency, and prevalence of non-tariff barriers.

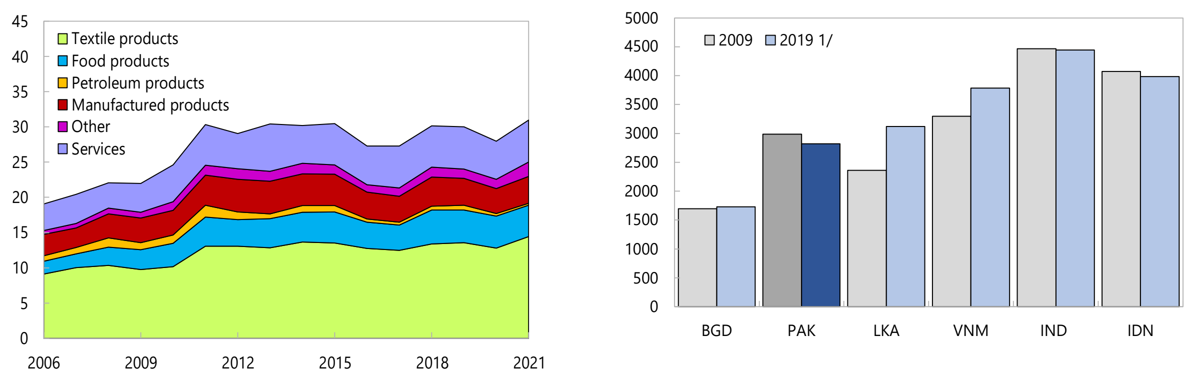
3. At the same time, Pakistan's export product mix has stagnated (Figure 3). In terms of broad export product categories, Pakistan's main exports are textiles and clothing, agriculture (vegetables, food products, animal hides), and services, which have all seen limited growth in value during the last decade. The current export basket lacks technological sophistication—products are concentrated in primary products or low-tech undifferentiated products that entail a low level of technology to produce and are on the lowest rungs of the value chains.[3] Simultaneously, the number of unique products exported has declined. Measured at a HS 6-digit level, Pakistan exported 2,824 unique products in 2019 compared to 2,987 unique products in 2009. This contrasts with many other countries (e.g., Sri Lanka, Vietnam) that have expanded the number of products they are exporting while also moving up the quality and sophistication ladders. While Pakistan is showing some nascent signs of growing its non-traditional exports since 2020-21, they remain a small share of overall exports.

4. Consequently, net exports have frequently been a drag on growth. This has contributed to Pakistan's weak medium-term growth prospects, due to the current unsustainable model's over-reliance on consumption and debt-financed investment. Pakistan's low level of economic complexity suggests that low growth rates will continue unless the country is able to create an environment where a greater diversity of productive activities and more complex activities can prosper, including through exports.

Figure 3. Export Products

Products Exported
(US$ billions)

Products Exported (2019)
(Total number of traded products at the Harmonized System (HS) 6-digit level) 1/



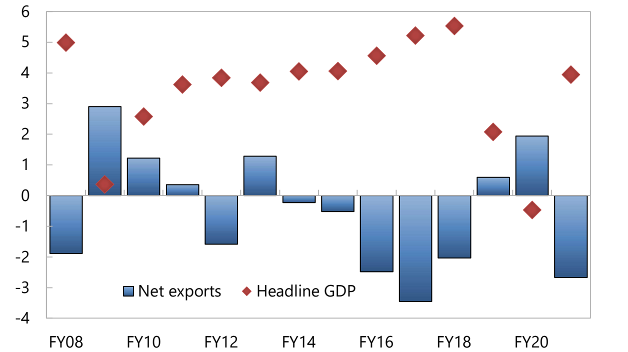
Sources: SBP, WITS, and IMF staff calculations.
1/ LKA value is from 2017, and BGD value from 2015.

[3] Note that cascading taxes will deter firms from producing more complex products that require more stages of production due to a high tax burden. The high taxes translate into higher export prices and hinders their price competitiveness.

5. **Although the exchange rate is now broadly in line with fundamentals, due to a challenging external environment it is unlikely to have a very large impact on exports in the short run**. Historical experience in advanced and EMDEs suggests that exchange rate movements typically have sizable effects on export (and import) volumes. IMF (2015) found that a 10 percent real effective depreciation in an economy's currency is associated with a rise in real net exports of 1.5 percent of GDP, on average, with much of the effect materializing in the first year. However, the benefits accrue mainly when there is slack in the economy and the financial sector is operating normally. Yet, the benefits accruing to Pakistan are likely to be less, largely due to weak global demand and structural bottlenecks: (i) global trade remains weak, raising price competition, particularly for primary products and low-tech undifferentiated products; (ii) presently only a limited number of firms have export experience, with small and/or potential exporters unsure of how to access new markets; (iii) some input prices have risen as part of the government's stabilization plan (e.g., energy prices); and (iv) many firms are also financially constrained and credit is scarce (limited trade credit), which makes it costly for firms to expand production or to begin exporting.

Figure 4. Net Export Contribution to GDP Growth

(Percent)

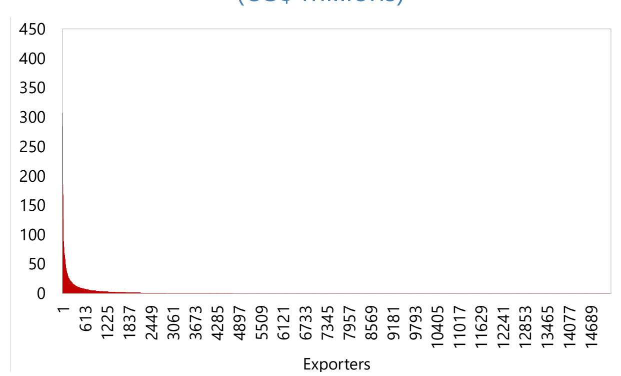


Sources: PBS and IMF staff calculations.

6. **Exported values tend to be small, but concentrated**. In FY 2021, the number one exporting firm exported goods valued at less than US$450 million, or 1.6 percent of total exports. At the same time, exports were concentrated with 198 firms contributing 50 percent of total exports. Less than 3000 firms exported more than US$1 million of goods and services, while the median value of exports by a firm were only about US$105,000.

Figure 5. Value of Exports by Firm

(US$ millions)



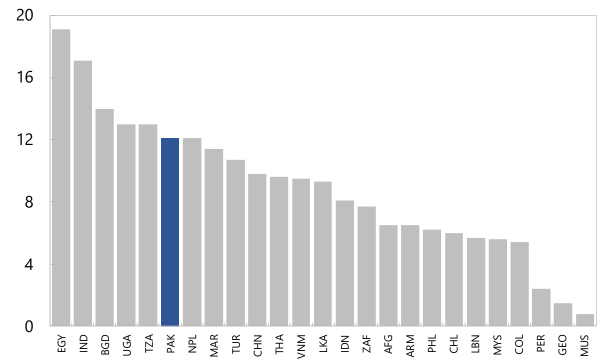
Sources: Pakistani authorities and IMF staff calculations.

7. **Export financing has long been available**. The State Bank of Pakistan has operated an export finance scheme (EFS) with the objective to boost exports since 1973. The EFS provides short-term financing to exporters via banks (commercial and Islamic) for exports of manufacturing goods under two separate facilities: (i) transaction-based facility; and (ii) revolving facility based on the previous year's exports. The financing is offered at highly concessionary fixed interest rates, for up to 180 days. However, the lending is a commercial decision made by the banks, which are assuming the credit risk. In FY 2021, PRs 700 billion was allocated to EFS—with an additional PRs 90 billion also allocated toward export-

oriented investment under the Long-Term Financing Facility—with PRs 565 billion outstanding as of end-June 2021.

8. Pakistan has relied heavily on import tariffs to boost tax revenue, undermining trade integration and further weakening export competitiveness. With limited revenue mobilization and weak tax administration capacity, the government has relied on import duties and related taxes to raise revenue. As a result, tax revenue collected at import stages stands at about ½ of total tax revenue. Although Pakistan has reduced tariffs during the last decade, its tariffs remain relatively high compared to most EMDEs. The high effective protection has resulted in long-protected "infant" industries preventing their development, reducing the incentive to compete with imports and need to export given their protected, privileged domestic market position.

Figure 6. Import Tariff
(Percent, simple average of most favored nation)



Sources: Fenochietto et al. (2019).

9. Pakistan has only signed a limited number of free trade agreements (FTAs). While Pakistan has signed FTAs with China, Sri Lanka, and Malaysia, has preferential trade agreements with Iran, Indonesia, and Mauritius, and is part of the South Asian Association for Regional Cooperation (SAARC), a number of FTAs remain under negotiation or consultation. However, most of Pakistan's exports are to countries with whom Pakistan does not currently have a FTA. For example, in FY 2021 trade with the United States[4], United Kingdom, Afghanistan, and Germany[5] (Pakistan's first, second, fourth, and fifth most important export destinations, respectively) comprised about 37 percent of total merchandise exports, while exports to Pakistan's 3 FTA markets were about 10 percent.[6] The absence of permanent FTAs with the major export market destinations hurts Pakistani exporters' competitiveness as they face higher tariffs than other exporters.[7]

B. Policy Recommendations and Conclusions

10. External trade has not been a significant driver of growth in Pakistan due to limited trade integration, weak export competitiveness, and a low-tech product mix. Pakistan's exports as a share of GDP have declined over the past decade as exports volume growth has stagnated amid considerable de-industrialization. Consequently, Pakistan's share in global trade has steadily

[4] Pakistan is a beneficiary of the United States' GSP scheme for developing countries. However, most textiles and apparel are excluded from these benefits.

[5] Under GSP Plus, a 10-year preferential trade arrangement with the European Union (EU) in effect since 2013, certain products can be imported by the EU at zero duty.

[6] IMF staff calculations based on SBP export receipts by all countries.

[7] New FTAs are being negotiated with Turkey, Thailand, Uzbekistan, and Afghanistan.

declined. The export basket lacks technological sophistication, concentrated on primary goods at the lowest rungs of the value chain. Pakistani exports are moreover susceptible to high volatility from terms of trade shocks and face growing competition from lower-cost economies. Exports are hampered by multiple factors, including the legacy of an overvalued exchange rate, an unsupportive tax and business environment, and a restrictive and non-transparent trade regime. High levels of protection have contributed to an anti-export bias, undermining trade integration and stifling the development of export-oriented and viable import competing industries.

11. Some actions that should be considered in the short- and medium-term are:

- ***Continue to work to further rationalize the tariff structure as part of implementing the approved national tariff policy, based on time-bound strategic protection***. As domestic tax revenue mobilization strengthens, there will be space to rationalize tariffs in line with international practices, which should aim for low tariffs at uniform rates.
- ***Support new and small exporters***. A key supporting mechanism would be for the government to facilitate market discovery and entry because a major cost for exporters is learning about markets and demand. This is where a well-developed country strategy supported by embassies and a strengthened Trade Development Authority can help. Financing for new and small exporters is also important and consideration should be given to develop new export financing instruments, while also reevaluating existing financing instruments. The authorities should also advance their efforts to establish the Ex-Im Bank.
- ***Facilitate integration into the global supply chains***. Including through improving product quality, reliability of the firm, and registering the firm with all necessary entities for tax and business purposes.
- ***Negotiate new Free Trade Agreements (FTAs)***. Pakistan's exporters are facing higher tariffs in Pakistan's major export markets compared with competing economies, which restricts Pakistani exporters' competitiveness. While some FTAs are already in effect (including China, Malaysia, and Sri Lanka), Pakistan would benefit from pursuing high-standard, permanent FTAs with large, important trading partners to secure market access.
- ***Invest in education and human capital***. Raising the average skill level of employees will be crucial to support the production of more complex products.
- ***Reduce red tape and improve the overall business environment***. This is needed to reduce uncertainty, simplify the complicated tax and business environment, and support private sector investment. In particular, a disproportionate GST burden falls on exporting manufacturing industries compared to those in peer countries.
- ***Remove exchange restrictions to facilitate trade***. The authorities should remain committed to phasing out existing exchange measures-when conditions permit-and eliminate them by the end of the current EFF (September 2022).
- ***Develop an export strategy***. This would allow the authorities to articulate and expand on many of the recommendations listed here in greater detail.

References

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