PAKISTAN'S BALANCE OF PAYMENTS PROSPECTS AND POLICY PROPOSALS

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Analysis of current account balance of Pakistan

As we look at the accounts on a long term basis we find that since FY03, the trade balance in goods is in continuous deficit and the deficit is ever increasing. It reached a maximum of US $ 14,970 million in the year FY08 mainly because of increase in oil prices (see next page).

The world economic slowdown and reduction in oil prices brought down the trade deficit but still it remained unreasonably high as compared to the potential of the economy. The decreased deficit of the services account is mainly attributable to the lower payments on account of transportation because of lower imports, and the other major cause being the lower payments for other business services. If we look at the income account, there is an ever increasing debt burden. Although foreign investment both direct and portfolio is attractive investors want return on their investment to stay in business. Under the present circumstances it is a pipe-dream to produce a positive income account. The only component of a surplus is current transfers from workers abroad to their families. As a rule of thumb, when a country is in a crisis, creditors avoid lending any money or alternatively they also charge for the risks involved. Such a situation gives rise to a vicious circle where a country has low productivity, low exportable surplus, low reserves for payment, low investment from abroad, low capacity to borrow on soft terms and so on. In order to get out of this vicious circle a country has to make extraordinary efforts. With ever increasing current account deficit, we are facing difficulties

[redacted]

CURRENT ACCOUNT BALANCE

(Million US $)

ITEM	JUL-JUN							Jul-Jan.	
	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY09*	FY10*
Trade Balance- Goods	**(359)**	**(1,279)**	**(4,514)**	**(8,441)**	**(9,711)**	**(14,970)**	**(12,627)**	**(9,078)**	**(6,617)**
Exports- goods	10,974	12,459	14,482	16,553	17,278	20,427	19,121	11,370	10,945
Imports- goods	11,333	13,738	18,996	24,994	26,989	35,397	31,747	20,447	17,562
Services (Net)	**(2)**	**(1,316)**	**(3,293)**	**(4,430)**	**(4,170)**	**(6,457)**	**(3,381)**	**(2,438)**	**(1,731)**
Exports- services	2,712	2,644	3,319	3,769	4,140	3,589	4,106	2,423	2,120
Imports- services	2,714	3,960	6,612	8,199	8,310	10,046	7,487	4,861	3,851
Income (Net)	**(2,211)**	**(2,207)**	**(2,386)**	**(2,667)**	**(3,582)**	**(3,923)**	**(4,407)**	**(2,654)**	**(1,658)**
Current Transfer (Net)	**6,642**	**6,613**	**8,659**	**10,548**	**10,585**	**11,476**	**11,163**	**6,114**	**7,519**
Of which: Workers Remittances	**4,237**	**3,871**	4,168	4,600	5,494	6,451	7,811	3,089	2,345
Current account balance (CAB)	**4,070**	**1,811**	**(1,534)**	**(4,990)**	**(6,878)**	**(13,874)**	**(9,252)**	**(8,056)**	**(2,487)**

* Provisional

Source: State Bank of Pakistan

in controlling the budgetary deficit for various reasons, and there is a lack of good governance. Though government has taken several steps on its own and also as a part of IMF conditionality more steps are needed to control expenditure and enhance government revenues.

The main cause underlying our balance of payments difficulties is our inability to increase value addition to the raw materials we export. The main underlying reasons are the high cost of energy for the production of tradables, poor infrastructure, and low capital investment in the modernization of the machinery and equipment to generate internationally competitive products. Heavy investment, strategic planning and above all the determination of the government and the nation are required for gaining a competitive edge in the global markets in order to achieve a trade surplus. It is worth mentioning that due to certain factors, like low production, low quality, income inelastic demand for our products and weak image of the Pakistani traders in the global market, Pakistan has not been able to utilize its quota in the United States and the European Union (average quota realization has been around 70 %) in the less liberal scenario of the past[1]. We need to explore the area of services where we can perform better with relatively little investment and easily acquire competitive advantage over our rivals.

[1] WTO Regime and Its Impact on Pakistan, Syndicate No. 1o, Civil Services Academy, Lahore, 31st Common Training Programme

Services are the fastest growing sector in the global economy, constituting more than 60% of GDP of many countries. "Services are the largest and most dynamic component of both developed and developing country economies. Services currently account for over 60 percent of global production and employment. Services, such as telecommunications, banking, insurance and transportation are strategically important for enhancing overall economic efficiency, performance and growth. With services liberalization we may access quality service providers and as a labor-abundant country we can develop capabilities to capitalize our human resource with massive training and development programs and capacity building initiatives. This would generate savings, faster innovations enhance transparency and predictability with technology transfer and optimum utilization of the work force.

The following factors seem to be affecting our exports:

i. Law and order and "war on terror" affecting, among other things, the inflow of foreign direct investment (FDI)
ii. Power shortage also affecting investment flows, both foreign and domestic.
iii. Erosion of competitiveness because of the increase in unit prices of imports used as inputs for exportables.
iv. On the demand side constraints are.

   a. Recession in the world economy although now there are some indications of an upturn.

   b. Dependence on raw material exports with low value added.
   c. A number of other countries have competitive edge in case of a number of commodities and services.

   d. We have not made any visible progress in diversification of our exports mix.

Around 30-35% of our imports are composed of crude/ furnace oil. We have to spend substantial amount on import of edible oil, chemicals and chemical products for manufacturing and agriculture, import of fertilizers, sugar and even wheat.

Workers' remittances are a big part of net transfers and it is this component that is largely supporting the balance of payments along with other private and official transfers. As our economy has the tendency of an increasing current account deficit, we are facing difficulties in financing this deficit. "War on terror" and expenditure on law and order is increasing our budget deficit and building pressures on our external resources because we are not generating enough public revenue. As a result the cost of borrowing is increasing; FDI inflows are drying up and exerting further pressures on cost of external financing. Our reserves have mainly been built on borrowing from the IMF.

Policy Proposals

Balance of payments problems may be resolved by taking the following steps:

i. Efforts should be made to restore law and order and conclude the country's "war on terrorism". Both these factors are expected to pave the way for increase in production and exports. Also, these improvements should have salutary effects on FDI and tourism inflows.
ii. Increase in FDI should lead to inflow of advanced technology, expansion in services and growth in production
iii. Inflow of FDI should also lead to capacity building in human resource sectors with healthy effects on production. Even if skilled people move abroad, that should lead to expansion in home remittances.
iv. In addition to improvement in law and order, visible progress should be made in good governance: particularly transparent and timely decision making, monitoring of efficient implementation and setting up effective accountability mechanisms.

v. Control of law and order situation will give a boost to our stock exchange and consequently lead to an increase in foreign portfolio investment.
vi. The quality of social and physical infrastructure should be improved
vii. Alternative energy resources should be developed, leading to enhanced production including exportable surplus with increase in competitiveness
viii. There should be improvement in macroeconomic stability, particularly the containment of inflation to a modest level and keeping the Pakistan Rupee competitive in the international market (in terms of REER)
ix. Serious efforts are needed to diversify our exports with emphasis on the services sector, dairy products, fruit and vegetables and labor intensive segments of small scale industry.
x. In addition to diversification of exports there is a need to revisit the direction of trade and exploiting untapped markets (including those in Africa and Latin America)

The long term sustainable level of the balance of payments deficit depends on two fundamental variables: (1) the ratio of foreign savings to investment and (2) growth in foreign exchange earnings from exports of goods and services, workers' remittances and other private transfers. Depending on these two variables, sustainable annual current account balance of payments deficit could fall anywhere in the range of 2-3% of GDP. Hence, there is need for developing guidelines and a framework which will keep the current account balance of payments deficit at sustainable levels taking into account the gap between savings and investment and the growth in foreign exchange earnings. Consideration may be given to the following guidelines:

- Establish a ceiling for the share of foreign savings in total investment to ensure that large balance of payments deficits do not finance consumption and that the country doesn't become over-reliant on external financing. Various empirical studies suggest that foreign savings should not exceed 20% of total investment in the medium term and over the long run should stay within the range of 12-15%.

- Place limits on total external debt and foreign investment (debt and equity) servicing obligations in relation to total foreign exchange earnings just as the Fiscal Responsibility and Debt Limitation Act places limits on public debt in relation to GDP. The purpose should be to ensure that the net debtor position of Pakistan in relation to the outside world has a reasonable relationship to the capacity to service foreign debt and investment obligations treating total foreign exchange earnings as a proxy for repaying capacity.

- Relate the future build-up of total investment of income payments to future foreign exchange earnings and transfers. This guideline will make it possible to take into account not only the size of debt and equity obligations but also the interest rate on external loans and the rate of return on foreign investment. At present, total foreign investment income payments are around 9-10% of total foreign exchange earnings and transfers. It appears desirable to maintain this percentage at less than 10 in the medium term.

- The above guidelines still leave open the question of balance between equity and debt to meet a given balance of payments gap. During the last few years Pakistan has made some moves to generate equity financing. However, the last two years have witnessed a reversal of that strategy. Hence, it is vital that in the medium term a reasonable ratio is maintained between gross debt and equity flows, say 1:2. In other words only about one third of the new foreign obligations should be in the form of external debt.

- Pakistan badly needs foreign investment to supplement its own resources to upgrade technologies and to assist in expanding and diversifying exports. The Board of

Investment (BOI) needs to gear up its efforts to attract direct foreign investment in export related industries and in the energy sectors.

- It seems that competitive pressures for Pakistan's textile and clothing exports (64% of exports) arising from the phasing out of the Multifibre Arrangement (MFA) were not anticipated fully and new investments on the scale required to move up the value chain have not been forthcoming. The textile industry, thus, needs to adjust to the realities of the world market and restore its competitiveness through enhancing productivity. The structural problems characterizing Pakistan's textile and clothing sector cannot be solved without major investments in both plant and equipment and human skills, investments in there areas are not taking place at the required scale.

- The government has already met the textile industry at least half way largely through credit subsidies. The textile industry needs to adjust to the realities of the world market and must restore its competitiveness mainly through enhancing productivity. Conceptually, any subsidy in support of textile exports where international prices are falling is not a good option. The fact that Pakistani textile exports are dominated by cloth and yarn while etc in the world clothing imports that are expanding faster is a handicap which cannot be easily addressed by further cash subsidies.

- Pakistan's export sector, in general, is faced with structural constraints e.g. extremely narrow export base, low unit value exportables, lack of competitiveness, lax quality control etc. Hence, any future export growth strategy will have to be premised on structural solutions.

- Any cosmetic measures to boost exports might yield some marginal increases but would in no way address the root causes of the problems afflicting the export sector.

- The government needs to carefully examine the adequacy of the existing incentive regime for Pakistan's exports.

- The government also needs to review the overall production structure of the country to determine whether the existing tariff regime encourages production for domestic consumption or for exports.

- There is also a dire need to re-orientate our exports strategy from the goods sector to services exports. Services are a fast growing sector of the Pakistan economy and their export potential needs to be tapped through seeking enhanced market access.

- The government should also assess the efficacy of subsidies as a tool of export promotion and in this regard an analysis ought to be made of the impact of R&D support being provided to textile garments. The evidence so far leads to the conclusion that financial support has not helped expand value of textile exports.

- For the long run an ambitious program of increasing Pakistan's market share in world trade which at present is a paltry 0.15% is needed, but this cannot be achieved without massive efforts to diversify exports and make export development a central plank of our policy. Despite the fact that Pakistan has liberalized its trade substantially since the late 1980s (trade – GDP ratio changed to 0.5 during liberalized period from 0.1 during the pre-liberalized period) it shows a much lower response to trade liberalization in terms of exports growth compared to its competitors and regional counterparts (India; 0.4%; China 1.3%; Bangladesh 0.6%; Sri Lanka 0.3%; Malaysia 2.7%; Turkey 0.8% and Iran 0.1%).

- Policy attention needs to be focused on non-textile manufactured exports, the new promising areas of IT exports and agricultural and livestock products – areas where Pakistan's world presence is minimum.

- In order to broaden the export base, Government policy must specially target foreign investment in manufacturing, aimed both at improving technology and productivity of promising export sectors.

- A cabinet level committee to be chaired by the Prime Minister could help improve much needed policy coordination and implementation of export and industrial policies as well as close monitoring of exports.

- Import of goods management with competitive alternatives, exports oriented imports, rails, roads facilities and other transport facilities, reducing wear and tear leading to save imports on parts, domestic savings and lower dependency on external resources

- Imports of services management by developing our HR capacity for earning of foreign exchange through various modes of supply of services or otherwise through migration of HR and earning transfers through deploying our resources on more remunerative jobs.

- We need to increase domestic savings and investment and deploy our resources for financing a competitive debt and equity mix so that we move to sustainability in the medium term

- Government policies need to be adjusted to ensure social safety nets for the poor to protect the welfare of those who are likely to be displaced in the transition period by the process of trade liberalization and globalization more generally.

- Skill development and training schemes must be instituted so that any displaced workers can be quickly retained, relocated and reabsorbed in the labor force. It is important to keep inflation in check in order not to lose the gains from trade liberalization and other policy reforms that have been undertaken.

- Reduced tariffs, particularly on imported raw material, imports, components and machinery can help boost exports. However, other complementary policies are also required. Meanwhile, with capacity constraints being reached in the economy and inflation remaining high, overestimating potential growth of the economy in the short term runs the risk of letting demand grow at a rate that cannot be sustained, which would make it difficult to contain inflation.

- Policy coordination on exports needs substantial improvement. The responsibilities for export promotion are very dispersed among many agencies, including the Ministry of Commerce, the Trade Development Authority (a very good idea), the Ministry of Industry, the Textiles Ministry, etc. A cabinet-level committee could help by closely monitoring exports and speedily resolving policy and implementation issues.