DRIVING PAKISTAN'S INDUSTRIALISATION STRATEGY:

Rethinking Import of Capital Goods

Aadil Nakhoda

Pakistan has one of the lowest gross fixed capital formation (GFCF) rates in the world. The gross fixed capital formation can be a useful indicator for the level of business activity in a country and to gauge the level of confidence in its economic future. According to the World Bank's World Development Indicators, the value for Pakistan was at 14 percent in 2022. It was one-half of the average reported for the South Asian region and almost two-fifths of the average reported for the East Asia and Pacific region. Further, it is more intriguing to note that it has remained consistent for Pakistan since the 1960s when the data was first reported, whilst major regional counterparts have shown significant improvement over the last four decades. For instance, India increased from 16 percent in 1970 to 36 percent in 2007, whilst Vietnam also reported a surge in the early 2000s when it undertook reforms to boost its economic activities. Low levels of business activities are likely to not only reflect poorly on exporting activities but also on the ability to attract FDI. Therefore, the low levels of GFCF as a percentage of GDP must raise concerns for policymakers.

Several developing countries tend to be reliant on the supply of imported capital goods to produce their goods domestically as their capabilities to produce high-tech machines and equipment are likely to be low. According to the trade statistics available at the World Bank's World Integrated Trade Solution (WITS), the imports of capital goods in Pakistan constituted between 18 percent and 20 percent of total imports into Pakistan between 2018 and 2021. India reported between 21 percent and 25 percent. The numbers for the East Asian countries are starkly different as more than 40 percent of imports into Vietnam were capital goods, whilst it exceeded one-third for Thailand. The average share of capital goods in total imports for the East Asia and Pacific region is also approximately 40 percent. It is also crucial to note that the share of fuels in total imports in Pakistan has traditionally been higher than the share in other Asian counterparts.

The average tariff on the imports of capital goods in Pakistan is relatively higher than in its Asian counterparts. Although the average tariff rate on all products imported into Pakistan was 9 percent in 2021, it was 8.9 percent on the imports of capital goods. India imposed an average weighted tariff on capital goods of 5.9 percent, Thailand imposed a rate of 1.7 percent and Vietnam imposed a rate of 0.4 percent. East Asian countries impose negligible tariff restrictions on the imports of capital goods, allowing their manufacturers easier access to the latest machinery, equipment and technology needed to produce their goods.

As the balance-of-payment crisis in 2022 put pressure on the foreign exchange reserves and the currency exchange rate, the government undertook several interventions to reduce the trade deficit vis-a-vis a reduction in import demand. According to data on government interventions borrowed from Global Trade Alert, Pakistan imposed interventions such as trade payment measures which included cash margin requirements, internal taxation on imports and import tariffs to discourage imports. Businesses have also reported difficulty in opening their letters of credit with their banks, which is crucial in importing capital goods into the country. According to the State Bank of Pakistan, the amount of stock provided by the scheduled banks as fixed investment/long term loans under the State Bank's Long Term Financing Facility (LTFF) and Temporary Economic Refinancing Facility (TERF) schemes to private sector businesses increased from approximately PKR 180 billion in January 2020 to PKR 650 billion at the end of September 2022.[1] However, this has declined to PKR 562 billion in January 2024. Although the rise can be attributed to the recovery in business confidence and support to businesses post COVID-19,

fall in the stock is likely an indicator of poorer business and investor confidence.

Unfortunately, the most affected category according to the different stages of production was the import of capital goods. Import of capital goods in 2022 decreased by approximately 40 percent, whilst import of consumer goods decreased by 7 percent. Import of consumer goods such as vegetable oil and tea increased by at least 12 percent in 2022, while import of capital goods such as mobile phones, weaving machines, and electric motors and generators decreased by more than 50 percent in 2022, increasing challenges for manufacturers.

Duty-free import of capital goods into Pakistan will increase imports by $4.8 billion, an increase of almost 48 percent.[2] Import of parts and accessories of vehicles will increase by almost $700 million, import of mobile phones will increase by $500 million, import of gears and gearings will increase by $350 million, import of buses will increase by $280 million and the import of water tube boilers will increase by $180 million. The major beneficiary of reduction in the tariffs on the import of capital goods is likely to be the auto industry. There is a need to rethink the government policies that have led to greater interventions and restrictions on trade as they have harmed the capabilities of the producers in Pakistan. Comparatively, the increase in trade creation as a percentage of total imports into the regional counterparts is much lower. It is 21 percent for India, 6 percent for China and 3 percent for Vietnam. The findings suggest that Pakistan has stronger restrictions on the import of capital goods into the country not only in the form of import tariffs but also in the form of non-tariff related government restrictions.

Technical non-tariff measures can play an important role in ensuring that the products imported into the country meet minimum standards. The presence of technical NTMs can limit the imports of dangerous and substandard products into the country. Several countries have reduced their tariff rates and adopted technical non-tariff measures in order to not only ensure that imported inputs are available at the lowest cost possible, but also comply with certain quality standards. The importers of capital goods complying with technical NTMs are more likely to meet with production process and procedure standards that should limit the production of outdated and redundant goods. The frequency index and the coverage ratio, the proportion of products facing at least one technical NTM and the proportion of imports facing at least one technical NTM respectively, is calculated using data borrowed from UNCTAD's NTM Hub and import data from BACI's CEPII dataset. At approximately 5 percent each, Pakistan has one of the lowest frequency and coverage ratios for technical NTMs on the imports of capital goods. China, Vietnam and the EU have at least one measure on all their imports of capital goods. The South Asian nations lag behind.

Inspection, certification, and pre-shipment inspections are commonly applied by China and Vietnam on their imports. The lack of such measures in Pakistan is not only likely to increase the inflow of substandard and low-quality products but also increase the likelihood of redundant technologies installed in the country that produce outdated products. With the surge in demand for better environmental standards from key export market destinations, this may create a situation where exports from Pakistan are further limited as machinery and equipment may fail to meet the desired standards of our importers.

In essence, Pakistan must rethink its policies on the import of capital goods if it is to encourage local manufacturing and improve the capabilities of local manufacturers. The government restrictions, which include non-tariff barriers and tariffs, have limited the ability of manufacturers to import needed machinery and equipment. The high tariff rates accompanied by the complex web of government interventions have deterred investments by the private sector in Pakistan. In order for Pakistani producers to become competitive, it is imperative to reduce import tariffs on all products imported into Pakistan, particularly capital goods, and consider imposing technical measures that ensure redundant, substandard and dangerous goods are not imported into the country, whilst pursuing newer and deeper trade agreements with trading partners that involve negotiations on developing the capabilities of small and medium enterprises, technology transfer clauses when receiving FDI and deterrence from dumping low quality products. Pakistan needs a rethink on its trade strategies. Policies that encourage access to the best technologies regionally and globally through import of capital goods is key.

The author is a faculty member at the Institute of Business Administration, Karachi. His research interests include topics on international trade, development economics and firm business strategies. He is also a member of the EconomicAdvisoryGroup.

Note on Data sources: Data on gross fixed capital formation was extracted from the World Bank's World Development Indicators. Data on import shares by product category and on import tariffs was borrowed from the World Bank's World Integrated Trade Solution (WITS). Data on import levels for 2021 and 2022 to calculate the growth rate was borrowed from CEPII's BACI dataset. Data on NTMs was extracted from UNCTAD's NTM Hub.

[1]SBP combines the data for LTFF (Long-Term Financing Facility) offered to export oriented businesses for purchases of imported and locally manufactured machinery and equipment and TERF (Temporary Economic Refinance Facility) available to all business, except in the power sector, to purchase new machinery and equipment. Both schemes serve similar purposes.

[2]The methodology to calculate the amount of trade creation is similar to that adopted by United Nations ESCAP's Trade Intelligence and Negotiation Adviser (TINA) (https://tina.trade). The numbers reported are calculated as average for 2019, 2020 and 2021. This reduces the COVID-19 related distortions to trade data.