Making exports a policy priority: nothing mercantilist about it

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Exports are crucial for Pakistan's development, yet, they have been stagnant for too long. Increasing them should be a policy priority. This column presents three arguments in praise of exports and suggests avenues for boosting them. Exports bring foreign exchange into the economy, essential to finance well-needed imports, and to reduce macroeconomic risks. They also create good quality jobs, pulling labor out of low-productivity informal activities. And, importantly, exports are associated with productivity gains through increased scale and increased exposure to sophisticated global clients. To boost exports, the Government of Pakistan needs to make exporting more profitable than selling domestically by adjusting its tariff policy and modernizing its export and investment promotion initiatives.

A little background…

Pakistan's exports have stagnated since the turn of the century. Despite the rapid recovery from the COVID19 shock – exports of October and November 2020 are roughly on par with those of 2019 – a long-term examination of export performance reveals stagnation. In 1990, the export market share of Pakistani firms stood at 0.19%. By 2019, it had fallen by almost 40% to 0.12%. The combination of three elements seem to be behind this trend. First, little capacity to attract FDI, crucial to take advantage of the powerful export platforms that GVCs have become during the last two decades. Second, an overvalued exchange rate during much of the 2010s that made exporting more difficult. Third, a tariff policy that rewards domestic sales rather than exporting seem to be behind this trend. Indeed, the country is today more inward looking than it was at the turn of the century.

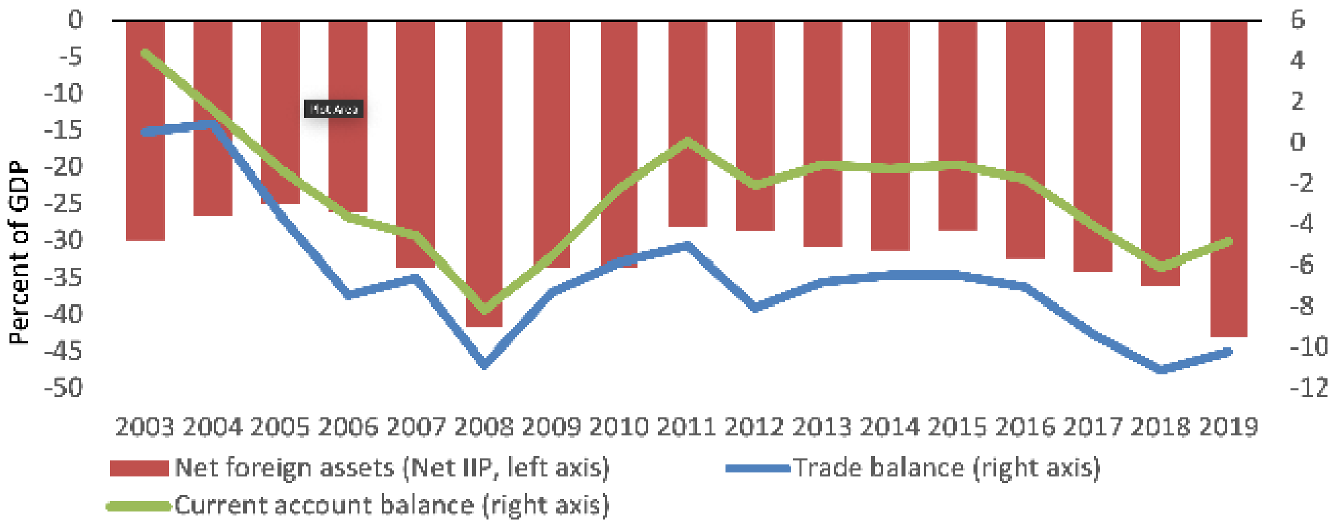
Concerns about inward orientation are not mercantilist in nature. Mercantilism, a common economic theory in Europe during the 16th to the 18th century, associates an economy's wealth with the accumulation of precious metals (or hard currency, in modern times). Within this framework, then, trade surpluses are inherently good, because they allow countries to accumulate wealth. As a result, a nation can only grow wealthier at the expense of another one (someone must run a trade deficit for you to run a trade surplus). What follows is protectionist policies that curb imports, and a collapse of trade (because countries retaliate!). But this column is not promoting mercantilism in the least. Instead, this column argues that it is increased productivity, leading to more and better jobs, and then to greater welfare of people that is at the base of a country's wealth, not a positive trade balance. Indeed, exports are not good per se. That is, there is in principle nothing 'honorable' about exports. They are just a means to an end. As put by Krugman "what a country gains from trade is the ability to import things it wants. Exports are not an objective in and of themselves: the need to export is a burden that a country must bear because its import suppliers are crass enough to demand payment". It so happens that they are a pretty useful 'burden' to bear, for three reasons: macro stability, job creation, and productivity. That's why, from a purely instrumental point of view, exports should be a policy priority.

Boosting exports for macro stability…

Stagnating exports in Pakistan led to systematic current account deficits (CADs) over the past two decades, increased macro instability, and therefore heightened perceived risk of future

lower growth. High effective rates of protection for domestic industries, coupled with an overvalued exchange rate during much of the 2010s contributed to underwhelming export performance. With relatively fast import growth, the trade deficit led to persistent CADs, despite high remittances. Accumulated CADs added to the stock of net foreign liabilities (NFL), that now stand at about 40% of GDP. These generate a stream of debt servicing and amortization payments that falls on future generations. Accumulated NFLs, in turn, lead directly to future current account deficits through larger income outflows. They increase the perception of country risk, driving interest payments up and compromising macro stability.

Figure 1: Pakistan's trade and current account imbalances and net foreign assets since the turn of the century

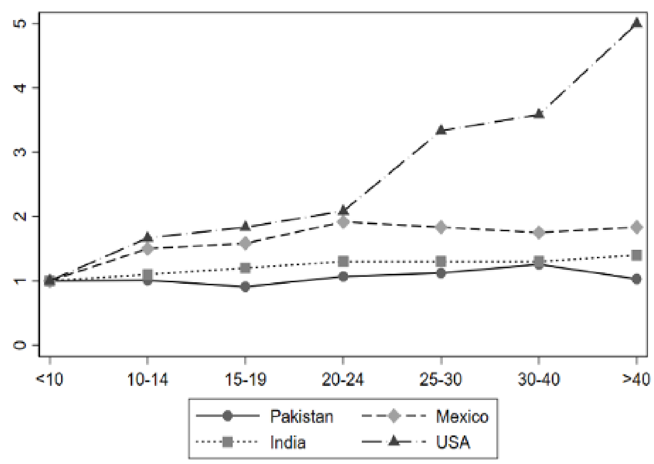


Source: IMF-IFS, Ministry of Finance, Pakistan Bureau of Statistics and World Bank

Boosting exports for job creation…

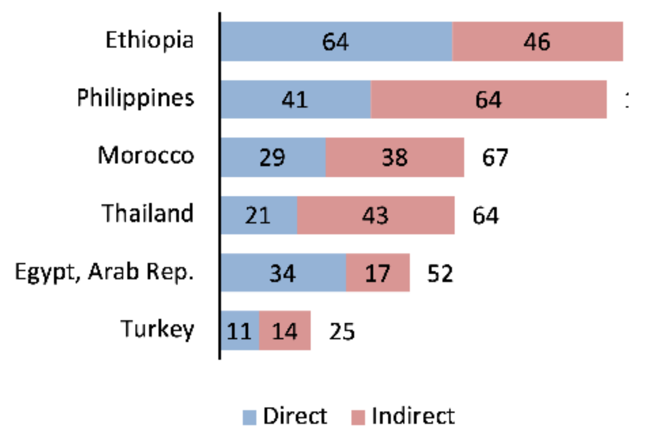
Exports can be a powerful engine for the creation of good quality jobs. Increased export competitiveness has substantial potential to create quality jobs. This is crucial for Pakistan, a country in which almost three out of four jobs outside agriculture are in the informal sector, which operates at low productivity levels, and therefore offers relatively low wages to its workers. Increasing export activity helps pull workers away from the low-productivity/low-wages informal sector, into the higher productivity/high-wages formal sector. Indeed, formal job creation in Pakistan has been a challenge in Pakistan recently, as formal firms struggle to grow large as they grow old. In fact, a young, formal firm in Pakistan, with less than 10 years in operations is about the same size as a firm with 20-25 years in operations (Figure 2). Data for comparable labor abundant countries specialized in labor intensive industries, such as Ethiopia or the Philippines shows that every additional one million US dollar exports, between 64 to 41 jobs are created directly and an additional 40 are created indirectly (Figure 3). This means that if Pakistan's exports had grown at the same rate as Vietnam's during the last fifteen years, Pakistani exporters would have created an additional 6 million direct jobs in the sector – about one-fourth of the 23.6 million additional workers that entered the labor force during that period.

Figure 2: Plant Size by Age in the Cross Section



Source: Mexico, India and USA data come from Hsieh and Klenow (2014), data for Pakistan comes from Lovo and Varela (2020)

Figure 3: Direct and indirect jobs per $1 million exports



Source: Autor's calculations based on the Jobs Content of Exports Toolkit (World Bank).

Boosting exports for productivity growth…

Underwhelming export performance has resulted in sluggish productivity growth, crucial for sustainable economic growth in the long term. To be sure, low export performance is both cause and consequence of productivity stagnation. Successful integration into the global marketplace through exporting requires a minimum threshold of productivity of firms. At the same time, as firms export systematically, their productivity increases through more exposure to competition, and knowledge transfers (there is 'learning by exporting'). An example of this bidirectional relationship between productivity and exporting is the fact that Pakistani exporters are on average more productive than non-exporting, comparable firms, and their productivity grows as they export more systematically (Figure 4). Yet, Pakistani firms have not taken advantage of this productivity-enhancing platform that exporting activity offers. They have not done so, in part, because high effective rates of protection for domestic industries make the domestic market much cozier than distant and highly competitive export markets. Essentially, high effective rates of protection have made exporting relatively unprofitable when compared to selling domestically, virtually shutting down a great escalator for productivity growth: exporting.

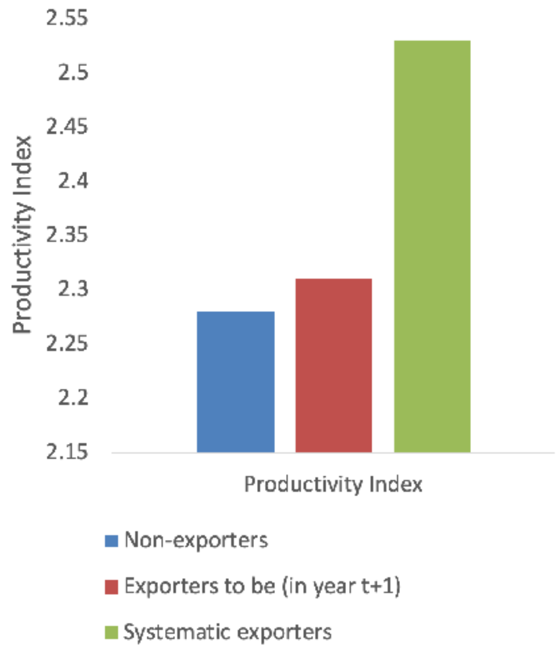
the additional job creation is estimated at 6 million. During that period, data from Pakistan's Labor Force Surveys suggest 23.6 million new workers were added to the labor force.

Atkin et al (2017) provide the most direct evidence on productivity gains through exporting. They randomly provide opportunities to export to Egyptian rug manufacturers. By focusing on a narrow industry, they can measure productivity more convincingly than previous researchers. They find that several years after the initial export opportunity, firms that received the opportunity (treated firms) have higher quality-adjusted productivity. Treated firms produce higher quality rugs but do not take any longer to manufacture them. The authors document productivity improvements that come in part from knowledge flows between foreign buyers, local intermediaries, and the producers (exporters).

Boosting exports, but how?

Increasing exports will require making exporting more profitable than selling domestically. A reasonable question to ask is: if exports are great, then why don't Pakistani profit maximizing firms export more? The answer is because economic policies have made exporting a less profitable activity than focusing on the domestic market. How to change that? There are three areas in which reforms could greatly impact export performance in Pakistan by increasing its relative profitability: import tariff reforms, export promotion, and investment promotion reforms. First, the combination of high tariffs on final goods and relatively lower tariffs on intermediates and raw materials, make effective protection of domestic industries high. This means these firms will choose the market in which they are protected (the domestic one) relative to the one in which they are not (the global one). They will sell domestically rather than exporting. The high import duties act implicitly as an export duty – they make domestic markets much more attractive than export markets. Second, export promotion in the form of direct support to exporting firms should place more importance on new exporters than old, be linked to performance targets, and be subject to rigorous impact evaluation. This way, support can focus on what interventions that are proven, rather than assumed, to be impactful in reducing exporting costs for firms. Third, investment promotion with focus on attracting efficiency-seeking foreign direct investment will be instrumental in helping Pakistani firms leverage the powerful platform that GVCs are for export growth.

Figure 4: Productivity and exporting in Pakistan



Source: Lovo and Varela (2020).

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