Exchange rate and trade regime

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The impact of the exchange rate on the economy's overall performance, particularly exports, is currently a hot topic in Pakistan. While a majority of economists believe that when the exchange rate of the Pakistani rupee is kept artificially high, it increases imports as imported goods become cheaper than domestic ones. This also results in lowering exports as they become more expensive. Many quote the example of China, which reportedly manipulated its exchange rate for several years to keep it low to promote its exports.

However, there are those who are not convinced that having a low value of the rupee will result in promoting exports. In support of this view, they quote recent data on Pakistan's trade and exchange rate, which reveals that while the nominal average exchange rate has depreciated by 131 per cent from 2008 (Rs70 per US dollar) to 2021 (Rs162.91 per US dollar), exports have only increased by 64pc in dollar terms over the same period (from $21 billion in 2008 to $34.5bn in 2021).

Additionally, imports have risen by approximately 75pc (from $39.5bn in 2008 to $69bn in 2021). This led to a deterioration of the trade balance by 89pc. This view is also supported by a study conducted by the Pakistan Institute of Development Economics (PIDE) in 2021 that found that a 1pc depreciation of the real exchange rate leads to a 0.45pc increase in export demand but also results in a 0.65pc increase in import demand.

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In addition, they also give several other reasons why the depreciation of the exchange rate may not be able to improve Pakistan's trade balance.

Firstly, a significant portion of Pakistan's exports consists of low-value-added textiles and agricultural goods, which lack branding and are therefore less elastic.

Additionally, the country's imports primarily consist of essential energy products, raw materials, chemicals and capital goods used by the exporting industry as inputs for production. As a result, these imports are less responsive to price increases resulting from a depreciation of the currency. This highlights the limitations of the devaluation policy in improving the trade balance of Pakistan, as the nature of exports and imports are less elastic.

Secondly, Pakistan has historically pursued import substitution policies which created an anti-export bias. Import substitution policies, which have an inward-looking approach, provide protection and

subsidies to local industries by imposing tariffs on imports. This results in local firms being able to sell their products domestically at higher prices without any competition.

This can lead to the local industry focusing only on the domestic market. Furthermore, since local firms have been provided protection through import tariffs, they do not have any competition, which can lead to a lack of investments in innovation and quality enhancement, ultimately resulting in export stagnation.

Another reason for Pakistan's stagnant exports is its inability to attract Foreign Direct Investment (FDI) through Multinational Corporations (MNCs) and Global Value Chains (GVCs). MNCs and GVCs are major contributors to a country's exports, accounting for nearly 80pc of global exports. Pakistan has only been able to attract a small volume of FDI ($2.91 billion in 2021) compared to its competitors like India ($53 billion in 2021).

> A 1pc depreciation of the real exchange rate leads to a 0.45pc increase in export demand and a 0.65pc increase in import demand, according to a study by PIDE

Furthermore, the small volume of FDI has been decreasing over the past five years. Additionally, the FDI that Pakistan has attracted has been in domestic consumption-based sectors, such as independent power producers, consumer goods, and automobiles, rather than in export-oriented sectors.

This lack of FDI, combined with a focus on the domestic market, has failed to generate the technological shift required for export growth in the highly competitive international market. It is worth noting that exports in newly industrialised countries such as Vietnam, Cambodia and China have been primarily FDI-led, but Pakistan has so far failed to use this channel to boost exports and improve its trade balance.

Pakistan's exports have also been hindered by several other factors, including a weak legal framework for copyrights, patents, and geographical indications, lack of research and investment in export sectors (specifically for new varieties of cotton and rice), exports concentrated in limited goods and markets, and domestic factors such as political uncertainty, inconsistent economic policies, uncompetitive investment climate, high tax rates, and low-quality human capital.

In a nutshell, the exchange rate may have a nominal impact, but if Pakistan wants to increase its exports, it will need to radically change its trade policy. For this purpose, it will need to pursue export-led policies.

This would mean integrating Pakistan's economy within the region and with the rest of the world. While this may take time, it could urgently take some steps unilaterally, such as reforming its customs tariff policies. This would enable the local industry to procure cheaper inputs, and Pakistan will be in a better position to become a part of the global value chain.

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