Importance of Foreign Trade

<u>Theory of Gains from Foreign Trade:</u>
The gains from foreign trade can be broadly classified into:

<u>(a)</u> **<u>Static Gains:</u>** Static gains arise from optimum use of the country's factor endowments or resources in men, money and material, so that the national output is maximised resulting in increase in social welfare. Static gains result from the operation of the theory of comparative cost in the field of foreign trade. Acting on this principle, the participating countries are able to make optimum use of their resources or factor endowments so that the national output is greater than it otherwise would be. This raises the level of social welfare in the country. Utility or welfare can be measured by indifference curves. Utility or welfare can be measured by indifference curve. As a result of introduction or extension of foreign trade, the people can move to a higher indifference curve. This has been shown in the following figure. Take two countries A and B both producing wheat and cotton. Production possibility curve and indifference curves are shown as below:

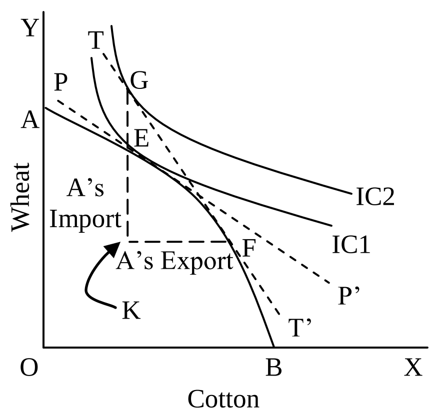


Figure 1 – Country A's Gain from Trade

In the above figure, it can be seen that, before the commencement of foreign trade, country A would be in equilibrium at the point E where the price line PP' is tangent to both production possibility curve AB and indifference curve IC1. The slope of the price line shows the price ratio or cost ratio of the two commodities in the country A; TT' is the terms of trade line showing the price ratio at which goods can be exchanged between these two countries, TT' line is tangent to A's production possibility curve AB. At point F, country A will produce more of cotton in which it has comparative advantage and less of wheat at F than at E. Taking the pattern of demand in the country A, we have the indifference curves IC1 and IC2 representing the demand for the two commodities. Now TT' is tangent to IC2 at G which shows the quantities of wheat and cotton consumed by the country A. It can be seen that as a result of introduction of foreign trade, the country A has moved from E on the indifference curve IC1 to G on the difference IC2, which represents a higher level of social welfare in terms of larger consumption of the two trade goods. This is called *'static gain'* resulting from specialisation brought about by the introduction of foreign trade. It can also be seen that the quantities of the two goods consumed and different from the quantities produced. The quantities produced are shown at F and quantities consumed at G. The difference is accounted for by exports and imports. The country A will be exporting KF quantity of cotton importing KG quantity of wheat.

The gain to country B can be similarly explained. Production possibility curve of B between wheat and cotton is shown by the curve CD in the following diagram. It is clear that given the factor endowments, it is more profitable for B to produce wheat. The country B fixes her production and consumption at point E before the introduction of foreign trade. At this point, price ratio line PP’ and indifference curve IC1 are tangent to production possibility curve CD. The country B would gain from trade if it can sell at a price ratio different from PP’. Given the terms of trade line TT’, the country B will produce at F on the production possibility curve CD:

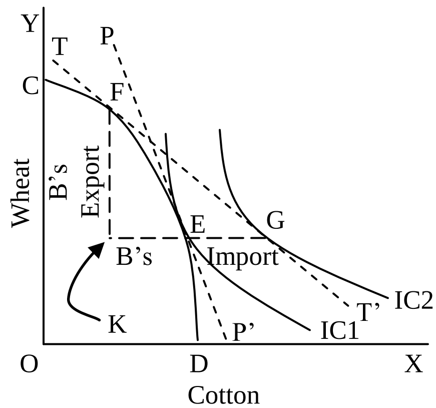


Figure 2 – Country B’s Gain from Trade

From the above diagram, it would be evident that the country B will produce more of wheat in which it has comparative advantage and less of cotton in which it has comparative disadvantage. But given the price ratio as represented by terms of trade line TT’, B will consume the quantities of two goods as shown by the point G where the terms of trade line TT’ is tangent to the indifference curve IC2. It is clear that specialisation resulting from the introduction of foreign trade has enabled the country B to move to the higher indifference curve IC2 and thus consume more of the two goods. This is her gain from international trade. The country will now export KF amount of wheat and import KG amount of cotton. It may be borne in mind that in the case of constant opportunity cost, each country resorts to complete specialisation i.e. producing only one of the two goods. On the other hand, in case of increasing opportunity cost, specialisation is not complete so that a country produces relatively larger quantity of the commodity in which it has comparative advantage.

(b) **Dynamic Gains:** Dynamic gains, on the other hand, refer to those benefits which promote economic growth of the participating countries. International trade also brings to the participating countries that are known as dynamic gains. They relate to economic growth and development which results from the introduction of international trade.

According to the theory of comparative cost, specialisation by different countries in producing commodities for which they are best fitted, results in a larger volume of production and improves productivity. This obviously promotes economic development. There is no doubt that extension of international trade has accelerated economic growth in the participating countries, like China, Malaysia, Indonesia, Turkey, India, Pakistan, Sri Lanka, etc.

<u>Role of Foreign Trade in Economic Development:</u>

International trade increases national income and facilitates saving and opens out new channels of investment. Increase in saving and investment is bound to promote economic growth. Exports earn foreign exchange which can be utilised in buying capital and equipment and know-how from abroad which can serve as instruments of economic growth. The larger the national income and output, the higher will be rate of growth. The higher level of output enables a country to avoid the vicious circle of poverty and put the country in the 'take-off' or self-sustaining growth. Production possibilities and cost of production in different countries differ so widely that foreign trade brings to the participating countries tremendous gains in terms of national output and income.

Foreign trade promotes economic development in the following different ways:

- **(a) Acquisition of Capital Goods from Developed Countries:** The under-developed countries (UDCs) are enabled by foreign trade to obtain in exchange for their goods capital equipment and heavy engineering machines to foster their countries' economic development. For example, Pakistan exports rice, cotton and cotton textiles, leather and leather goods, and sports goods and in exchange she imports heavy engineering machines and tools, trucks, and other capital equipment from the developed countries.

- **(b) Import of Technical Know-how or Skills:** An under-developed country (UDC) is short of all kinds of professionals like engineers, architects, doctors, managers, accountants, economists, and other technical personnel. To cover this shortage and to learn more, a UDC can allow the inflow of technical brains from developed countries.

- **(c) International Market:** The foreign trade can extend the scope of the business to the international market. The domestic market is limited, the foreign trade sector opens new vistas, new marketing channels and new markets. When the markets are extended, the economies of scale are reaped, the efficiency and productivity will increase. Accordingly, the forces of development will set themselves in motion.

- **(d) Foreign Investment:** The foreign trade is also helpful in attracting foreign investment. The foreign investors are attracted towards active trading countries and invest in the form of capital goods and technical expertise. In this way, the assembling plants, the manufacturing plants and the latest technology will come into the country. As our recent investment agreements with China, USA, UK, South Korea, Sweden, Hong Kong, Saudi Arabia and UAE will be helpful in promoting trade and industries in the country.

(e) **Source of Public Revenue:** When there is imports and exports of goods and services, the government can earn the revenue in form of tariffs, custom duty, import licence fees, etc.

(f) **Foreign Exchange Earnings:** Moreover, the external sector also opens the employment opportunities for the country-men in the foreign countries. Hundreds of thousands of Pakistanis are working abroad. Pakistan is earning billions of dollars through foreign exchange remittances. Pakistan has earned $ 2.4 billion on account of workers' remittances working abroad during the year 2001-02, which increased to $ 4.2 billion during 2002-03. Therefore, such remittances are proved to be a major source of foreign exchange earnings.

Import Substitution vs. Export Promotion:

There are two types of economic strategies – import substitution and export promotion, which are helpful in removing the deficit in BOP and accelerating the process of industrialisation and economic development:

(a) Import Substitution: The import substitution strategy or *'import-led'* or *'inward-looking strategy'* aims at producing the import substitutes in the country. The import substitution (IS) strategy will reduce the dependence of a country on foreign goods. It will enable a country to produce the plants, machinery, electronic goods, consumer durables and a variety of goods. In this way, not only the domestic production will increase, but the domestic employment will also be boosted up. This strategy provides self-sufficiency in the economy. But at the same time the country has to rely on heavy foreign loans and assistance in order to complete expensive projects.

The import substitution strategy fosters the process of industrialisation and economic development. It helps in protecting and developing small and medium sized industries. It protects the local manufacturers and labour by protecting them from foreign competitors.

During 1950s and 1960s, the major stress was laid upon initiating the IS strategy in Pakistan. As a result of such strategy the manufacturing sector has had its foundations. The growth rate of manufacturing sector, during this period is estimated at 16% p.a. Some economists accorded that Pakistan, on the basis of such IS strategy, has entered in the stage of *'take-off'*. The import substitution strategy pursued in Pakistan was given the name of *'Easy-Import Substitution Strategy'*, which was mostly confined to the establishment of consumer goods like textile and sugar industry. But inspite of import-substitution in the country, we remained depending upon imports of capital goods, machinery, automobiles, chemicals, petro-chemicals and medicines, thus increasing BOP deficits. Moreover, the industrial sector, which was came into being as a result of IS strategy, was extremely inefficient. There was a misallocation of resources. The goods were produced at the prices higher than the international prices. The investors engaged in import-substitution not only reaped abnormal profits, but they were also exempted from direct taxes. They did not have to face competitors, trade-unions and even the anti-monopoly authority. Moreover, during this period, *'multiple exchange rate system'* was prevailed in the country. Due to this system, the price of rupee had fallen to a greater degree, which led to income disparity and unemployment. Moreover, during this era, Government's major focus was on industrial policies and she ignored altogether the development of agriculture sector.

<u>(b) Export Promotion:</u> Export promotion strategy is also known as *'export-led'* or *'forward-looking strategy'*. Export promotion strategy is aimed at boosting the exports of semi-manufactured and manufactured goods in place of traditional commodities and improving the standard of exports. Export growth is equivalent to the economic growth. Because of comparative advantage when a country specialises in a product, the export-led strategy enables her to make the product available to the world community at cheaper prices. Thus, the international markets are extended for an exporting country. The income and employment levels are expanded. Consequently, the process of economic development is facilitated.

The export promotion strategy will also attract the foreign capital. The countries which are well endowed with natural resources like oil, gas, iron, rubber, tin and other mineral deposits and which are having potential and prospective comparative advantage in these products would be able to attract the foreign investors. The foreign capital, foreign technology and foreign skill will open new vistas. The output and employment will increase, and finally the export will go up.

In export promotion strategy, the subsidies and incentives are given to all the sectors of the economy, rather to a particular sector of the economy (as in the case of import substitution strategy). When exports are boosted enough foreign exchange could be earned which would be utilised in respect of importation. With the help of industrial imports, purchased with the foreign exchange earned through exports, a country may also launch the process of industrial development.

The emphasis of Pakistan's industrial policy has been more on import substitution than on export promotion. The position of domestic industries results in higher prices for the consumer. Industries are become inefficient because of absence of foreign competition, there is no incentive to reduce their production costs. The export industries of Pakistan have to be very efficient in order to compete in the global market.

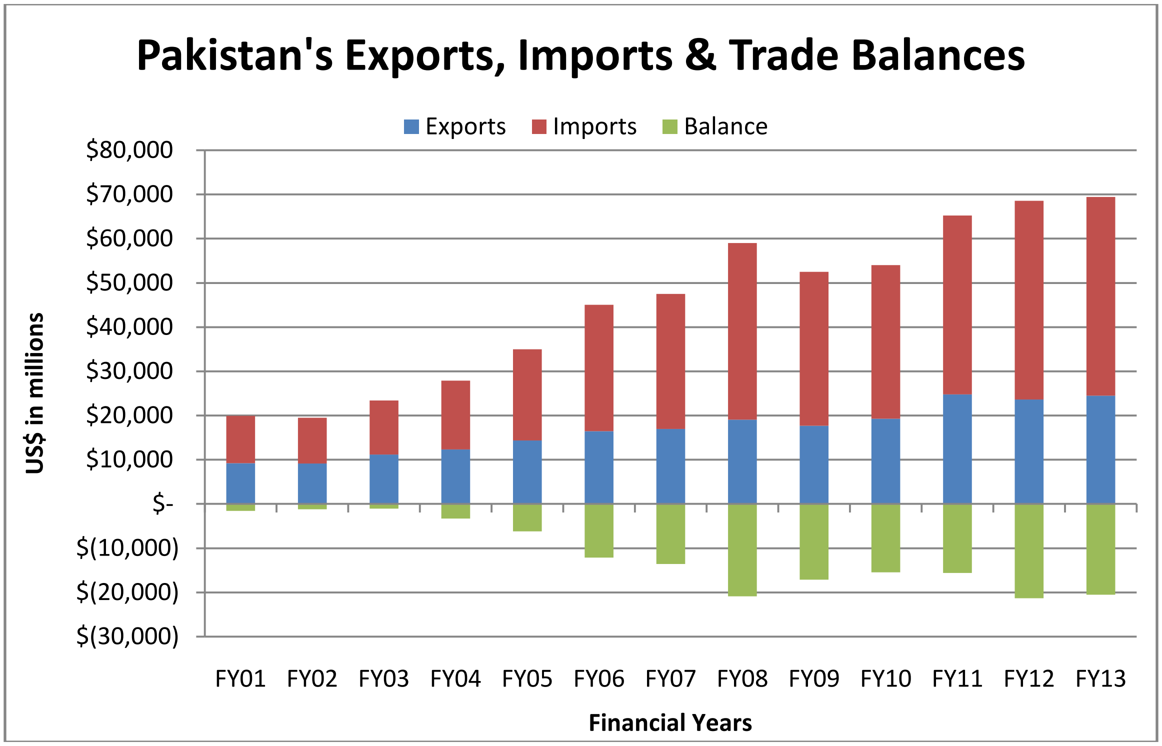
<u>Pakistan's Foreign Trade Sector:</u>

Pakistan's foreign trade balance has always been negative throughout its economic history except for the years 1947-48, 1950-51 and 1972-73. In the first year after independence the country faced huge economic problems and as a result no attention could be paid to industrial sector development. Import bill was less than one hundred million dollars and the trade balance, even will small magnitude of exports, was positive. In the second year of independence, i.e. 1949-50, the trade balance was negative. In 1950-51, because of Korean War boom, our exports increased by 140% as compared to the preceding year. This huge increase in exports resulted in second ever positive trade balance. In 1972-73, Pakistan, once again, had a surplus balance of trade after 21 successive yearly deficits. The success achieved in 1972-73was the result of deliberate policy actions including devaluation and export promotion measures. This surplus partly as a result of a sharp increase in the volume and value of exports and partly due to slower increase in imports. Besides the said financial years of surplus, Pakistan has never achieved positive trade balance.

Pakistan's Exports, Imports and Trade Balance

(All figures in US$ million)

Years	Exports	Imports	Balance
1947-48	138	96	42
1950-51	406	353	53
1960-61	114	457	-343
1972-73	817	797	20
1980-81	2958	5409	-2451
1990-91	6131	7619	-1488
2000-01	9202	10729	-1527
2001-02	9135	10340	-1205
2002-03	11160	12220	-1060
2003-04	12313	15592	-3279
2004-05	14391	20592	-6201
2005-06	16451	28581	-12130
2006-07	16976	30540	-13564
2007-08	19052	39966	-20914
2008-09	17688	34822	-17134
2009-10	19290	34710	-15420
2010-11	24810	40414	-15604
2011-12	23624	44912	-21288
2012-13	24460	44950	-20490

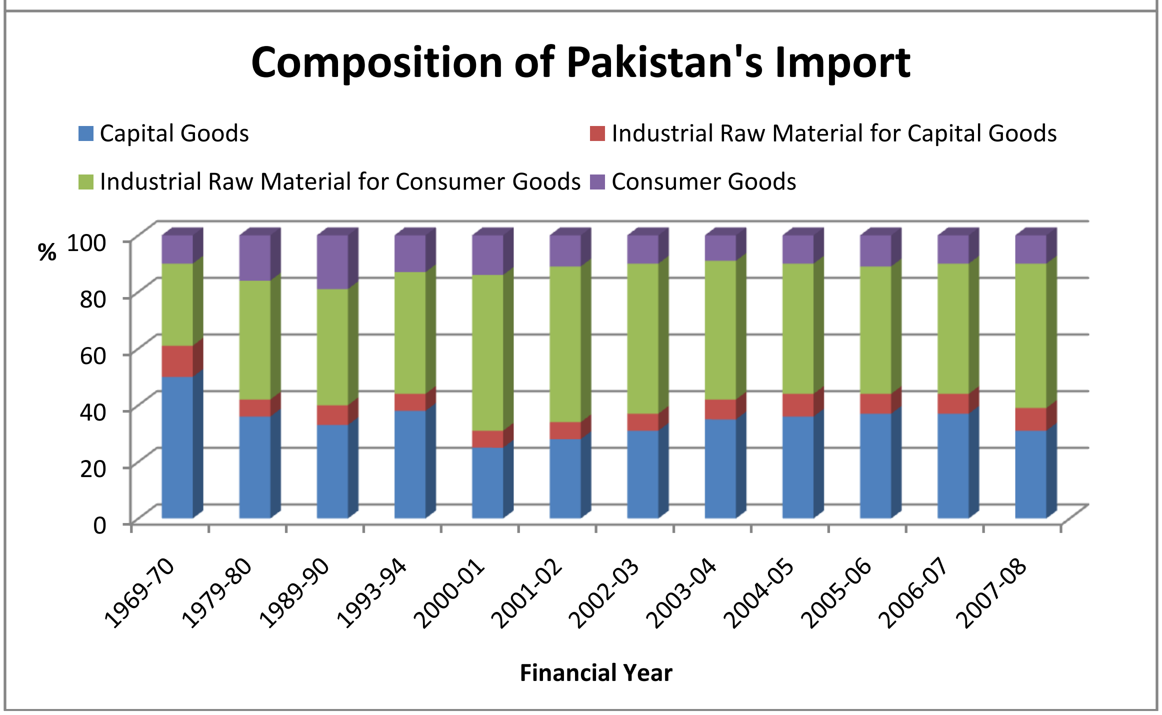


(a) Composition of Exports and Imports: Structure and composition of Pakistan exports and imports have changed over time:

Composition of Pakistan's Exports and Imports

(In Percentage)

Year	Exports			Imports			
					Industrial Raw Material		
	Primary Goods	Semi-Manufactures	Manufactured Goods	Capital Goods	Capital Goods	Consumer Goods	Consumer Goods
1969-70	33	23	44	50	11	29	10
1979-80	42	15	43	36	6	42	16
1989-90	20	24	56	33	7	41	19
1993-94	10	24	66	38	6	43	13
2000-01	13	15	72	25	6	55	14
2001-02	11	14	75	28	6	55	11
2002-03	11	11	78	31	6	53	10
2003-04	10	12	78	35	7	49	9
2004-05	11	10	79	36	8	46	10
2005-06	11	11	78	37	7	45	11
2006-07	11	11	78	37	7	46	10
2007-08	11	11	78	31	8	51	10



In 1969-70 the primary commodities comprised a huge share of 33% of total exports, while of the shares of semi-manufactured and manufactured goods were limited to 23% and 44% respectively. During the fiscal year 2004-05, the shares of primary, semi-manufactured and manufactured commodities are 11%, 10% and 79%. The significant rise in manufactured commodities, i.e. from 33% in 1969-70 to 79% in 2004-05, is a positive sign, but still Pakistan is lack of semi-manufactured goods. Pakistan has to reduce the export of her primary commodities and increase that of semi-manufactured goods. This is due to the fact that our primary commodities are short of international standards. Moreover, the prices of primary commodities are prone to severe price shocks. Whereas, the market for manufactured goods is huge and stable.

The change in composition of imports has not been very conducive to long-term growth requirements. In the above table and graph, it is indicated that the percentage share of 'industrial raw materials for consumer goods industries' has a significant rise from 29% in 1969-70 to 46% in 2004-05. Whereas the percentage share of industrial raw material imports for capital good industries has declined from 11% to 8%. The percentage share of imports of manufactured capital goods has decreased from 50% to 36%. This situation indicates that our consumer good imports (including industrial raw materials) have increased at a rapid pace as compared with capital good imports which are prerequisite for long-term self-sustained economic growth. It is very import to note that we are talking in terms of percentage share and not in terms of absolute values.

(b) Terms of Trade: The TOT of the country has been deteriorating since long, which states that the prices of our exports are decreasing while those of our imports are increasing. This is also one of the major shocks to our exports. Pakistan's annual terms of trade, and unit value indices of exports and imports are tabulated below:

Pakistan's Annual Terms of Trade
and
Unit Value Indices of Exports & Imports
(Base Year: 1990-91)

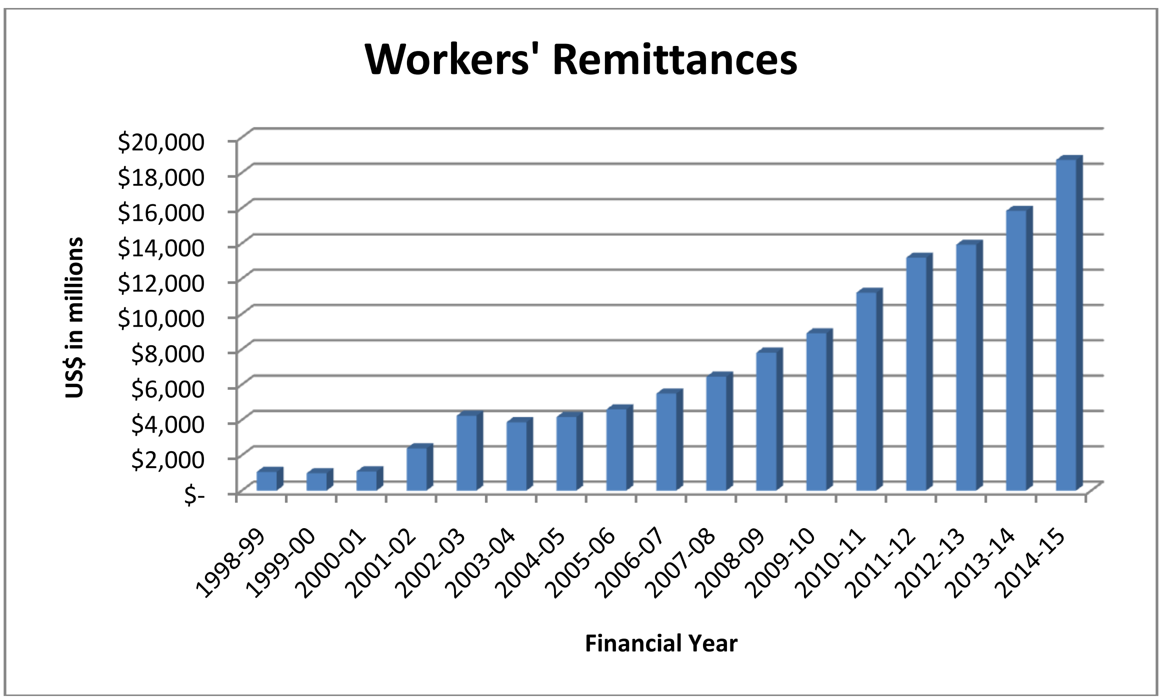
Year	Terms of Trade	Unit Value Indices of Exports	Unit Value Indices of Imports
2000-01	90.96	271.47	298.44
2001-02	90.83	271.18	298.56
2002-03	82.07	254.02	309.52
2003-04	78.68	279.65	355.43
2004-05	73.60	288.84	392.45
2005-06	65.0	299.3	460.4
2006-07	64.1	308.62	481.47
2007-08	58.35	334.83	573.82

(c) Workers' Remittances: Workers' Remittances are a major source of foreign exchange earnings and occupy a significant place in financing the import bill of the country. Pakistan has shown a remarkable progress in workers' remittances from abroad. In 1972-73 the workers' remittances stood at $136 million. In the year 1999-00, the workers remittances stood at $983.73 million. It increases four-fold to $4236.85 million in 2002-03 within the period of two years. Such amount of workers' remittances from abroad has never been achieved before in the economic history of Pakistan. This sharp increase shows the confidence of expatriate Pakistanis in the transparency of economic and foreign policies:

Workers Remittances from Abroad

(All figures in $US Million)

Year	Remittances
1998-99	1060.19
1999-00	983.73
2000-01	1086.57
2001-02	2389.05
2002-03	4236.85
2003-04	3871.58
2004-05	4168
2005-06	4600.12
2006-07	5493.65
2007-08	6451.24
2008-09	7811.43
2009-10	8905.90
2010-11	11201
2011-12	13186
2012-13	13922
2013-14	15837
2014-15	18720

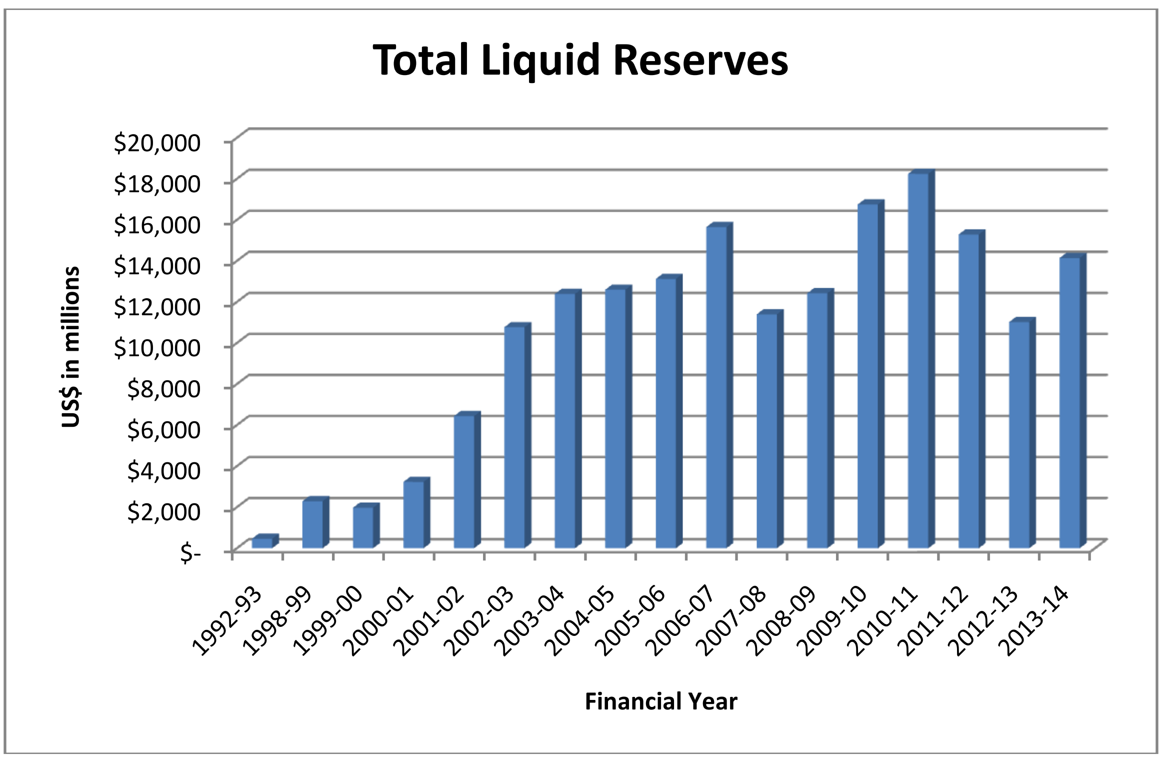


(d) Foreign Exchange Reserves: On November 12, 1998, the foreign exchange reserves of Pakistan were at a ridiculous level of $415 million, hardly sufficient to finance two weeks of imports. The main reasons for such a low foreign exchange reserves were huge budgetary deficit, uncontrollable debt servicing, low foreign investment, heavy government expenditures, poor governance, and worst political conditions. Musharraf's Government's recent economic policies have survived the shortage of foreign exchange reserves. With vigorous and transparent policies of the Government, Pakistan's FOREX reserves stood at $12.6 billion on June 30, 2005:

Pakistan's FOREX Reserves

(All figures in US$ Million)

Year End (June 30)	Total Liquid Reserves
1992-93	464
1998-99	2289.2
1999-00	1,973.6
2000-01	3,231.5
2001-02	6,435.6
2002-03	10,769.7
2003-04	12,389.3
2004-05	12,597.6
2005-06	13,122.4
2006-07	15,647.2
2007-08	11,398.7
2008-09	12,425.2
2009-10	16,750.4
2010-11	18,243.8
2011-12	15,288.6
2012-13	11,019.6
2013-14	14,141.1



(e) Exchange Rate: During the decade of 1990s, Pakistan has suffered a lot from huge fluctuations in foreign exchange rates. During the year 1990-91, the rupee-dollar exchange rates averaged at Rs. 22.42 per dollar. With further devaluation of rupee, the exchange rate climbed up to the level of Rs. 30 during the FY 1993-94 and Rs. 43 during the FY 1997-98. After the nuclear test in May 1998 all the transactions through foreign currency accounts operating in Pakistani banks were frozen. Different exchange rates prevail in the economy. The official exchange rate was around Rs. 46, whereas the commercial banks announced their own exchange rates. During September 1998, the exchange rate in the open market was averaged at Rs. 65. In June 2000, State Bank of Pakistan finally made adjustment in the exchange rate and as a result it managed to pull down to Rs. 55.30 in the open market.

During the past four years, with the massive inflow of remittances, the foreign exchange reserves have been built up which, in turn, has provided stability in the exchange rate.

Strategy to Promote Exports:

Pakistan is in emergent need to promote and foster her exports. During the past 50 years, Pakistan has shown a poor performance in her export growth when compared to other Asian countries, like South Korea, India, Malaysia, etc. During 1980s, it took 10 years to add an amount of just $ 2 billion in our exports, and during 1990s, it took 9 years to add an amount of just $ 1.5 billion. However, Pakistan has shown a considerable achievement during the past 5 years adding $5 billion in total exports. But still we need more than 100% increase in our exports. Pakistan's exports to GDP ratio stands at a very low percentage of just 13% when comparing to Sri Lanka with 27%, Indonesia 32%, Philippines 44%, Thailand 56%, Korea 39% and Malaysia 96%. This simply suggests that Pakistan has to catch up with others. Following are few suggestions to promote our exports in international market:

(a) Role of Private Sector: The following things needed to be done in enhancing the role of private sector:

- The first thing that the private sector must do is to improve their competitiveness by employing state of the art machinery; through better management; through cost effectiveness; and by improving their working environment. They have a comparative advantage in terms of relatively cheap labour, relatively low cost of capital, a strong macroeconomic environment represented by a stable exchange rate, relatively low inflation and strong growth.

- The second most important task that private sector must undertake is to look for new markets and new products. Today our exports are highly concentrated in few items and into few markets. More than 75% of our exports originate from four items, namely cotton, rice, leather and sports goods. Similarly more than one-half of our exports go to 7 countries. This state of affairs will not take us at higher export path. Diversification of exports, both in terms of commodity and regions will be needed. For new markets we need to look at China, Japan, Latin America and ASEAN Region.

(b) Role of the Government:

- The first and foremost duty of the government is to provide a strong macroeconomic environment – an environment where exchange rate is stable; a comfortable foreign exchange reserves; low cost of capital; low inflation, low budget deficit and no debt crisis and consistent and transparent macroeconomic policies.

- The second most important duty of the government is to provide strong infrastructure – transport and communication, roads and highways, power, well-functioning ports etc.

- The third most important duty of the government is to enter into active Trade Diplomacy. We have to explore the possibilities in joining various *Preferential Trading Arrangements (PTAs)*, and have to enter into bilateral negotiation at all levels for *Free Trade Arrangements (FTA).*

(c) Value Addition: Pursue enhancement of manufacturing and marketing capabilities and efficiencies with a view to achieve value addition and increased competitive strength for our core product categories.

(d) Women Entrepreneurship: To energize the women entrepreneurship in support of developing and realizing Pakistan's export capabilities and potential, and enhance overall economic value addition.

(e) Marketing Support: Majority of our exporters are presently weak in the marketing management abilities and the financial /human resources required for aggressive market share enhancement and product and geographical diversification. Due need of upfront investment of funds, SME exporters are shy to invest. It is essential that professional and financial help be provided by the government in partnership with the exporters, for aggressive international promotions, distributors and gaining access to new customers and markets.

(f) Pakistan's Business Image: It is recognized that all countries have their strengths and weaknesses. Success depends upon efficient capitalization of Strengths and management of Weaknesses to provide an honest and positive business image. It is also recognized that image management has to be professionally achieved for best results.

(g) Human Resources and Skill/Technology Support: In alignment with the strategic product, geographic needs and international trading regulations, the skills, training /technical facilities be enhanced amongst all stakeholders especially the exporters, Pakistan's Missions and the Export Promotion Bureau, financial institutions and SMEDA.

(h) Quality, Social and Environment Management: Culture of *'TQM' (Total Quality Management)* and *'CI' (Continuous Improvement)* needs to be inculcated and embedded in support of Quality, Social progressively and meet international standards and specifications as a minimum. Appropriate regulatory framework, quality and social management processes such as ISO/SA certifications and a transparent efficient judicial process needs to be in support.

(i) Foreign Direct Investment and Finance: Foreign Direct Investment needs to be strongly encouraged to strengthen our exporters management expertise, technological and infrastructural support, competitive edge and market access.

Transparent access to finance will be vital for the desired significant increase in exports. Sufficient access at internationally competitive mark ups would need to be ensured, especially for the value adding and Developmental Product Categories.

(j) Small & Medium Enterprise Development: On a medium term basis, the success of Pakistan's exports must heavily rely on the strength of our Small and Medium size exporters. EPB in alignment with the supply chain management efforts of SMEDA, must help enhance the exporting and marketing capacity of the SME's inclusive of adequate finance through the relevant financial institution i.e. State Bank, SBFC, RDFC and other DFI's.