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Choosing the Right Path

As the trade balance of Pakistan deteriorates owing to the poor export performance in the midst of strong economic growth, most economists, policy makers and international financial and development institutions suggest export led growth as the optimal strategy for sustainable growth. The experience of East Asian nations is often presented as a supporting example where strong performance of exports between 1970s and mid 1990s resulted in a burst of economic growth and rising prosperity.

This report will examine the basic principles of an export led growth strategy and the economic benefits associated with it, before critically analyzing the feasibility of this strategy. Moving forward, the report will then explore the essentials of domestic demand driven growth paradigm, presented in modern economic literature as an alternative growth strategy for developing economies. Finally we will evaluate the optimal growth strategy for Pakistan.

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Pakistan: The next Goose?

In the recent years Pakistan's economy has gained considerable strength, underpinned by comprehensive structural reforms, prudent macroeconomic policies and financial discipline. As a result of these proactive and consistent policies, Pakistan has been successfully transformed into a stable and resurgent economy. With the platform now set for economic growth to accelerate further, it is most important to re examine the growth policies of the economy and determine the long term sustainability of the current economic growth while identifying the trail that will take the economy on a higher growth trajectory.

Given the apparent importance of exports in the economic transformation of nations, many economists, policy makers and international financial institutions have suggested an export led growth strategy for Pakistan from time to time; highlighting the need of a dramatic turnaround in the poor export performance of the country. The experience of East Asian nations is often presented as a supporting example where strong performance of exports between 1970s and mid 1990s resulted in a burst of economic growth and rising prosperity unprecedented since the original industrial revolutions in North America and Europe more than a century ago. As a result of this economic prosperity the East Asian economies moved from poverty to affluence, from technological backwardness to sophisticated users of cutting edge technologies, and from rural societies still tied to traditional agricultural and seasonal rhythms to urban societies fully participating in all the cultural storms and upheavals of the late twentieth century. The tales of prodigious growth levels witnessed in the region during the early 1990s are often termed as the East Asian Miracle: Certainly a Miracle, as East Asia had seemed to learn the secrets of King Midas who turned everything he touched to gold!

These nations were often analogized to a flock of geese sweeping across the sky in a V formation: Japan in the lead, with Taiwan, South Korea, Hong Kong and Singapore close behind. Following these, but flying very fast, was Malaysia, Indonesia, Thailand, China and the Philippines. With this, the economists came to believe that other emerging economies would need to follow the trail blazed by Japan and other early developers, to record sustainable economic growth. As a result the governments of developing economies, international financial and development institutions and western governments looked sought to duplicate East Asia's success elsewhere. The policy guidance from all these sources counseled developing countries to introduce reforms that would put them on the path toward export oriented growth and allow ever greater numbers of geese to follow Japan. However since the eruption of the Asian crisis, some sectors have expressed increasing doubts regarding the feasibility of export led growth for many developing economies.

In the next few pages we will outline the underlying principles of an export led growth strategy and the overall economic benefits associated with it, before moving to analyze



the feasibility of this strategy. Moving forward, this paper will then examine the essentials of domestic demand driven growth paradigm and finally evaluate the growth strategy best suited to Pakistan.


The secrets of *Midas Touch*

Export oriented growth strategy (also termed as export led growth policy) is used to refer to a trade and economic policy aimed at enhancing the growth process of the economy by exporting goods for which the economy has a comparative advantage. Reduced tariff barriers, exchange rate policy (devaluation of national currency is often employed to facilitate exports), and government support for exporting sectors are all an example of policies adopted to promote production of exportable goods, and ultimately economic growth.

Firstly the motivation for export promotion emanates from the belief of classical economists that trade is the engine of growth as it contributes to a more efficient allocation of resources within countries, while stimulating growth across respective countries and regions. They justified this with the traditional argument of comparative advantage. Accordingly, opening up a country's markets to the international markets allows a more efficient production and allocation of resources as the country can concentrate on the production of goods in which it has a comparative advantage based on its factor endowments. As a result world trade markets allow producers and consumers of the participating countries to benefit from lower prices, better quality products and more diverse supply of goods.

Secondly participating in trade, particularly export production and promotion, exposes the economy to the latest and most advanced production and marketing techniques, and *learning by doing* process that brings about dynamic innovation and technological diffusion into the economy. This is primarily because trade opens domestic markets to foreign competition and the resulting exposure forces domestic entrepreneurs to pay close attention to the possibilities of innovation while speeding up learning processes. The exporting firms usually face price and quality competition in international markets and subsequently the survival and success of each exporter depends largely on active absorption of the most recent production techniques.

Moreover entrepreneurs in an export oriented developing country learn at an early stage to cater to the discriminating tastes of the affluent consumers of developed countries, which encourages the entrepreneurs to seek front line production technology and sharpens managerial acumen. As a result, the ability of these entrepreneurs to respond to new challenges and to transform themselves to meet the changing business environment is continuously cultivated and strengthened. The innovative entrepreneurial class produced under an internationally competing export oriented regime is more conducive to



generating sustained high economic growth in the long run. Additionally, the export promotion strategy drives a country to higher production and naturally enables the economy to take full advantage of economies of scale and record increasing returns.

Besides this, the growth of exports plays a major part in the growth process by stimulating demand and encouraging savings and capital accumulation. Additionally it is often argued that export earnings are a more efficient means to finance the development needs (capital goods, industrial raw materials, oil, and food) of the emerging economies than foreign debt since the latter is vulnerable to adverse exogenous shocks and currency risks that may result in debt defaults.

Another argument claims that large balance of payment deficits, spurred by large import propensities, may present a hindrance to growth for many developing countries. Thus, moderate trade deficits, or trade surpluses, are more desired. This essentially means that export growth should be ahead of or at least be in pace with import growth.

Lastly it has been argued by some economists that export led strategies allow an expansion of aggregate demand without necessarily building inflationary pressures and without the danger of a wage price spiral, compared with strong domestic demand injections. This partly stems from the real appreciation of the currency that result from large export earnings, which tame inflation and allow real wages to rise.

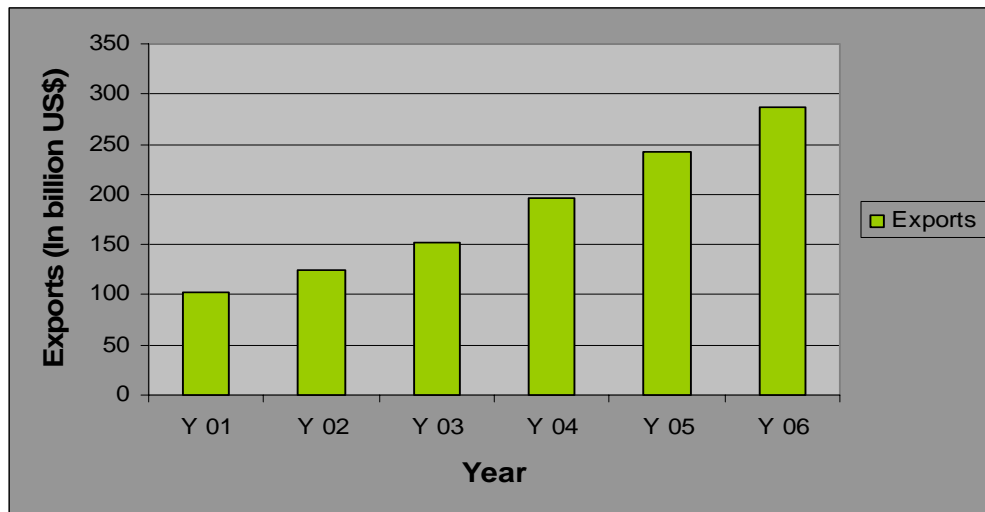
The end of the *Midas Magic*?

The export led growth strategy has been at the center of growth policies of many developing countries due to the benefits of growth associated with it as witnessed in the experience of East Asian economies. However, quite recently a number of economists have hypothesized that the export led growth that the Asian countries followed as the optimal growth strategy, has harmed the growth prospects of the developing countries.

The core theoretical criticism of the simplistic export led growth model emanates from the most basic principle of the model that presumes that an economy grows by increasing its level of exports. This essentially means that the growth of the exporting economy relies on demand growth in other economies. Case in point: China. Clearly the fastest growing economy of the world today, China has emerged as an export powerhouse and currently enjoys rapid, export led growth that represents a miracle made in America. It is interesting to note, that the open market in the US had similarly facilitated the export oriented growth of the other Asian economies in the early 1990s by accommodating to mercantilist, export oriented Asian economic models. Subsequently these economies recorded huge trade surpluses while the overall trade balance for the US deteriorated. Most of this was traced to Asia particularly China, Japan and Korea.


Figure 1 shows the ever increasing volume of Chinese exports to the US economy. Currently the US deficit with China alone stands at US\$ 232 billion for the year 2006. More than 70% growth of China is accounted for by its exports to the US. In this fashion the domestic growth of China is largely dependent on growth of export demand in the US and is therefore extremely vulnerable to any slowdowns originating in its US export markets. Looking into the future this contradiction of export led growth stands to become sharper. With US housing market already cooling, there are signs of a slowdown approaching the biggest economy of the world. Undoubtedly China will be the victim of the worst blow.

Figure 1: China's Exports to the US



The case of China clearly indicates that an export led growth strategy by developing economies will make the respective economies extremely sensitive to the movements in their export markets. This may make the global economy more volatile. The logic follows from portfolio theory. When there are many autonomous centers of growth, the likelihood of a global growth slowdown is reduced as such an outcome depends on a slow down hitting all centers of growth simultaneously. However, if growth of a large segment of the global economy (example the developing economies) is dependent on growth in another segment (example the US), all that is needed for a global slow down is for the leading bloc (the US) to slow as recessions in this bloc will translate into slow growth in the developing world.

Nevertheless if one pretends to be oblivious to future considerations, then the current success picture of China may tempt the developing economies to follow the trail. The economy has been growing at approximately 8% and its technological capacity is



upgraded at prodigious rates and its businesses threaten an ever greater swathe of industry in Europe and the US. However one must pay heed that such growth miracles can only work for first comers, but falls apart once all try to mount on board the export led bandwagon. Export led growth operates via a hierarchical process, with less developed newcomers replacing maturing export economies in which surplus labor supplies have been exhausted and wages are rising. With China's advent, this system may be unworkable. China has huge supplies of labor at rock bottom wages, and population growth ensures that this will hold into the future. It is not clear that any developing country can now enter the system with production costs below those of China, making it impossible for newcomers to enter the hierarchy of export led growth.

Additionally it must be noted that if an export led growth strategy is pursued globally, there is a danger of a *beggar thy neighbor* outcome in which all try to grow on the back of demand expansion in other countries, and the result is global excess supply and deflation. This is because export oriented manufacturing in developing countries cannot expand at rates greater than overall growth in demand for such products. When only a handful of economies, were pursuing export oriented growth strategies, the size of foreign markets was not a constraint. That is no longer true. For example during the 1990s, too many developing countries entered the more advanced product categories, thus creating excess capacity and fostering falling prices. Therefore as more and more economies move to expand their exports following China they face a shrinking market. Thus there is a high possibility that the export led growth paradigm will find itself checkmated. There will be insufficient demand, while new supplier countries will be unable to compete with China.

Another significant criticism regarding the export led growth is that it suffers from a fallacy of composition: The developing countries compete with each other to sell in developed country markets, a phenomenon often known as *export displacement*. Developing countries are rivals with each other, and when one country manages to increase its exports it often does so by crowding out the exports of another developing country. This represents a fallacy of composition as it applies to the developing world. Export led development may work successfully when adopted by one or even a few countries, but it takes on a zero sum dimension when adopted by all. Moreover this increased competition and the drive to capture bigger share of the export market shifts the output on to global goods and commodity markets thereby tilting the focus away from development rooted in domestic market growth.

Lastly to gain competitive advantage in international markets, countries compete across every dimension, including work conditions and the environment. Companies have an incentive to minimize requirements as long as work conditions and a clean environment are seen as adding to costs. The result is a dynamic that has companies lowering requirements or shifting production to countries in which requirements are lower. This is best explained by an examination of the Pakistani soccer ball industry that agreed to do



away with child labor, only to find that production then moved to India which had no child labor restrictions.

The New Midas Touch

Given the shallow and exploitative characteristics of the export led growth model, it is critical for emerging economies to execute a new strategy of development. Modern economists have proposed a new development paradigm based on domestic demand led growth. The Chinese government for example has vowed to maintain a fast economic growth while shifting to domestic driving forces, especially consumption, in order to reduce the heavy reliance on exports.

The new growth paradigm requires the economy to develop its domestic market by necessarily improving the labor standards as this will provide the foundation for a virtuous circle of growth in which rising labor standards will encourage market development and market development promotes better labor standards. Additionally increased government expenditure is a strong stimulator of productive investment and savings.

Despite the shortcomings of the export led growth model and stronger growth benefits of domestic demand led growth, it must be noted that exports will always be essential for development to enable countries to pay for imports of capital goods and other needed resources and the loans incurred to finance growth. However, the challenge is to avoid becoming too dependant on exports and over reliant on foreign economies.

Shooting in the Right Direction

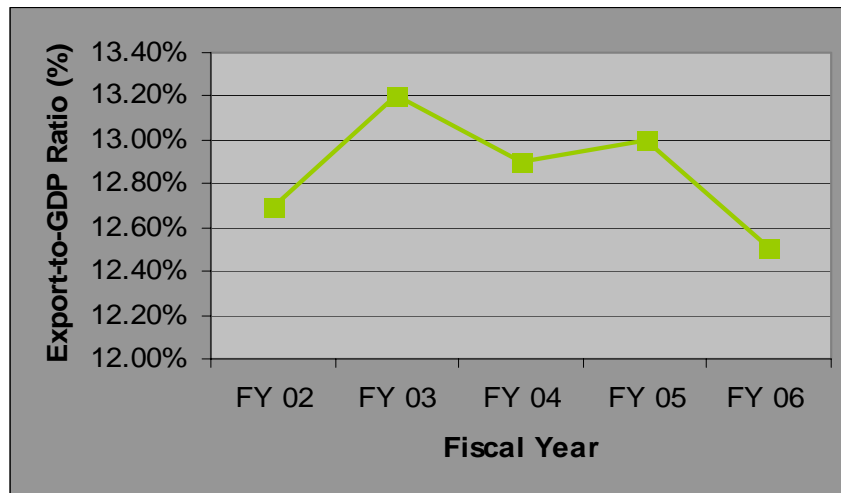
After exploring the essentials of the two most significant growth paradigms, the question arises that which growth strategy must the Pakistani economy execute to uphold the current momentum of high economic growth.

It is interesting to note that despite the economic importance of exports, the performance of Pakistan's export sector is poor especially when viewed in contrast to the East Asian economies. Though the absolute growth in exports that occurred over the past few years deserves applaud when compared to the growth witnessed in the past two decades, it is the fairly low exports to GDP ratio that highlights the poor export performance of the country.

The exports witnessed a growth of approximately US\$ 8 billion in the past six years as against an increase of only US\$ 1.5 billion in 1990s and US\$ 2 billion in 1980s. Despite the prodigious growth, the exports to GDP ratio has hovered around 12% level for the

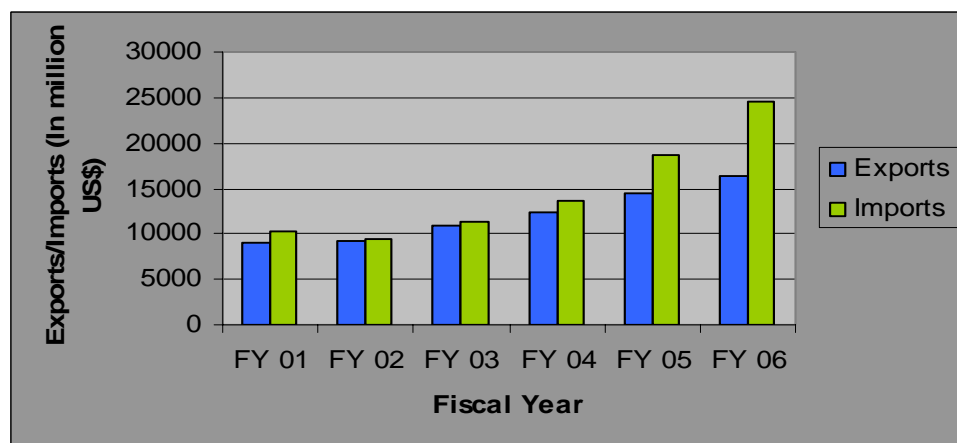
past few years (see Figure 2). This essentially means that exports have contributed poorly towards the high GDP growth.


Figure 2: Exports to GDP Ratio



For this reason it must be emphasized that export promotion and production is especially critical for the economy of Pakistan. Additionally the inability of the exports to keep pace with the ever increasing imports has resulted in a rising current account deficit. This all the more makes export promotion and production a necessity in Pakistan in order to generate significant foreign exchange earnings and overcome the foreign resource constraints for higher level of imports

Figure 3: Pakistan Exports Performance relative to Imports





Hence the end we would like to emphasize that Pakistan might not have the luxury to choose one of the either growth paradigms as its optimal growth strategy by itself. The rising current account deficit presents a significant risk facing the economy that needs to be addressed immediately to sustain economic growth. Therefore it is critical for Pakistan to increase its volume of exports through value addition while reaching out to new markets with sophisticated products. But that said we also emphasize that the focus on global trading system and thereby the international competitive advantage must not over exceed the investment in domestic development.



Economic Snapshot

Fiscal year 06														
	Units	Feb	March	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb
<u>Inflation</u>														
Headline Inflation	%	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39
Core inflation	%	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72
Food inflation	%	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99
Non-food inflation	%	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59
<u>T-bill (Wgt Avg)</u>														
3 month	%	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.64	8.64	8.64	8.64
6 month	%	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81
12 month	%	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01
<u>External Sector</u>														
Export	Mln US\$	1,292	1,536	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	n.a
Import	Mln US\$	1,854	2,269	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	n.a
Trade balance	Mln US\$	(562)	(733)	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	n.a
<u>Remittances</u>	Mln US\$	339	444	401	507	464	376	435	422	410	448	475	391	457
<u>Forex Reserves</u>	Mln US\$	11,516	12,487	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378
n.a = Not Available														



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