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Export Competitiveness and Growth

Tenth Five Year People's Plan 2010-15

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Introduction

At the dawn of a new decade, Pakistan is faced with difficult economic conditions. Externally, a deepening global recession and the resultant fall in demand is expected to have a significant adverse impact on the country's exports. Refer to Box 1 for different estimates on global economic growth in 2009). In spite of the country's low level of integration with the global economy, impact of the worldwide recession started manifesting during the second part of 2008¹ as the export growth rate slowed down. Pakistan has been caught in a cycle of stop-go growth since the 1990s. In FY 08, the economy grew at a rate of 2%, as compared to 4.1% in the preceding year and contrary to an impressive average annual rate of 7% between FY 03 to FY 06. In line with historical experience, the country once again lost the growth momentum generated during the earlier part of this decade.

Box 1: Various Estimates on Global Economic Growth and World Trade in 2009.

- The World Bank estimated a contraction in global economic growth during 2009.
- The United Nations estimated the world economy to contract by 2.6% in 2009.
- The IMF estimated global economic growth to slow down to 1.3% during 2009.
- World Trade Organization predicted world merchandise trade to decline by 9% in 2009 – the largest decline since World War II, exports of developed countries to fall by 10% while developing countries' exports to contract by 2-3% in 2009.

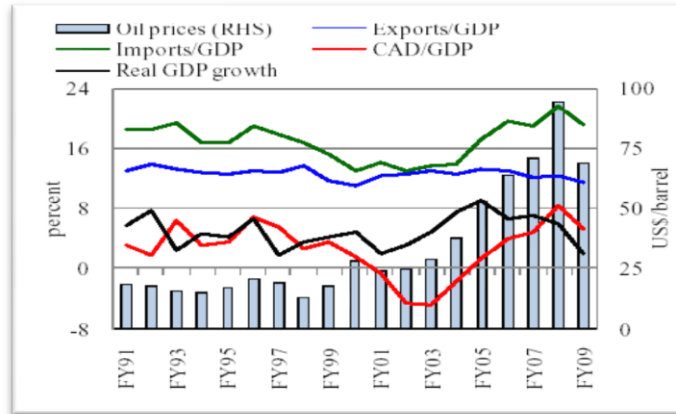
During FY08, a surge in oil prices led to a rise in import bill and a rapid deterioration of Pakistan's external position (See figure 1) with the current account deficit reaching at an all time high level of US\$ 13.9 billion. While FY09 has seen a reduction in the current account deficit to US\$ 8.9 billion, weak demand for country's exports in the aftermath of the global financial crises is likely to continue to put significant pressure on Pakistan's external position. A key contributor to the macroeconomic instability was the rising fiscal deficit which reached 7.6% of GDP in FY 08 – the highest in 10 years. While the government has been successful in bringing the budgetary deficit down to 5.2% in FY09, the country's low level of resource mobilization² implies that fiscal policy options can only be used selectively for reviving the economy. For the country to move to a higher sustainable growth trajectory there is a need to relax the country's balance of payments constraint and develop new drivers for growth.

In light of these challenges it is necessary to identify the 'critical ingredient' which has the potential of directing the economy to a high growth trajectory. The experience of East Asian economies illustrates that the export sector has the potential to serve as an economy's engine of growth. Therefore, a medium term strategy, which creates a conducive environment for promoting the country's export sector, may serve as a way forward to breaking the syndrome of stop-go growth. To that end, improving competitiveness of this sector is the key.

¹ Almost 60% of Pakistan's total exports are destined to advanced economies and any slack in demand from these countries will significantly reduce the country's export earnings (planning commission's panel of economists, october, 2008: p 18).

² In 2008-09, Pakistan's tax-to-GDP ratio stood at 9% of GDP (with indirect-tax-to-gdp ratio at 5% and direct-tax-to-gdp ratio at 4%). (Pakistan Economic Survey 2008-09). This number is very low compared to a developing country average of 18%.

Figure 1: Pakistan's External Position



Source: State Bank Annual Report 2008-09

The competitiveness challenge is daunting, as difficult economic conditions underscore the weak positioning of Pakistan's industry in terms of low technology intensity and low productivity. Few firms are involved, directly or indirectly, in international trade. These firms which are trading internationally are producing products which are not aligned with global trends. For example, textile and medium/high technology exports account for 6 and 54 percent of world trade, respectively, while as a share of Pakistan's export basket, these products account for 53 and less than 10 percent, respectively.

Global competitiveness indicators also rank Pakistan in the bottom quartile of the world. The World Economic Forum's Global competitiveness ranking of Pakistan fell from 92 out of 131 countries in 2007-08 to 101 out of 134 countries in 2008-09 and remained stagnant at 101 in 2009-10. Pakistan's business competitiveness ranking also fell from 67 to 79 over the same period.

Central to achieving the objective of export competitiveness is the role of the private sector. Private sector planning requires a medium to long term horizon in order to ensure sustainable long term returns. However, policy unpredictability and the government's short-term view to policy-making has significantly increased the risk of investment, reduced planning horizon of entrepreneurs and led to non-optimal allocation of resources. To encourage the private sector to be export oriented, the government needs to build a supportive policy framework – two main pillars of which should be consistency and continuity. Finally, the government needs to adopt a participatory approach by devising an appropriate incentive structure to ensure active private sector involvement.

Internally, two major challenges faced by the country today are shortage of energy and security-related issues. For the former, it will take some time to eliminate the deficit in energy generation capacity. Therefore, in the immediate future, export oriented industries must be given priority in energy allocation in order for the government to pursue export led growth. In the case of the latter, Pakistani businesses suffer from cost of terrorism prevalent in the country. According to the Enabling Trade Index -2009, Pakistan is ranked 118/121 countries in business cost of terrorism. There is a need to compensate businesses for these costs, particularly export industries to ensure they stay competitive internationally.

Against this backdrop, this report will attempt to propose a medium term strategy for Pakistan's Tenth Five Year Plan for boosting the country's future export competitiveness and growth. While there is tremendous potential for export of services, particularly health, education and Information Technology services, this is outside the scope of the working-group report. Section 1 of the report develops the baseline projections for

Pakistan's exports over the next five years. Section 2 examines the degree of product and market concentration in order to identify priority areas for policy support to raise export performance above the base case scenario. The opportunities provided by the WTO regime, and regional co-operations are discussed in Section 3. Measures to enhance Pakistan's higher technology exports are the focus of Section 4. Section 5 discusses the issues and recommendations for the agro-based export sector. Section 6 provides a review of macroeconomic policies along with revisions necessary for export oriented growth. Finally, section 7 sets out the conclusions and recommendations with a summary matrix of recommendations laid out in Section 8.

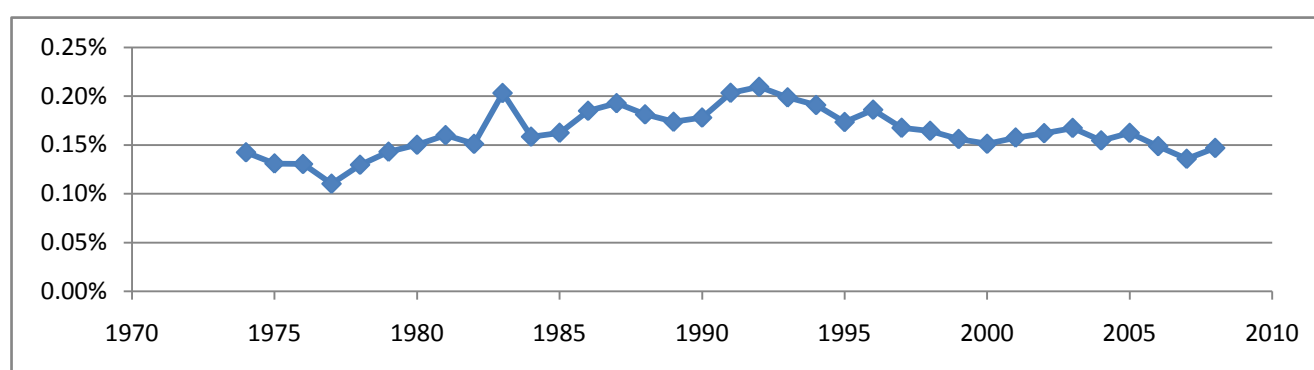
1. Baseline Export Projection – 2014

This section looks at the performance of Pakistan’s export sector historically. The objective is to establish the trends that have been displayed and the factors that determine this trend. This will allow forecasts to be made about future performance of the sector.

1.1 Historical Trends

In past two decades exports earnings have shown tremendous growth, increasing from US\$6.3 billion to US\$19.2 billion, however it is a mistake to look at this growth in isolation. In order to assess the performance of Pakistan’s export sector it is necessary to study how the sector has performed relative to world exports. Pakistan’s export share has declined since the early 90s indicating worsening performance of the sector relative to the world (see figure: 2).

Figure: 2 Pakistan’s exports as a share of world exports 1974 - 2008



In this section the performance of Thailand, Malaysia and our neighbor India is used as a point of comparison in order to evaluate Pakistan’s performance. All three have experienced tremendous export led growth, therefore providing a benchmark to emulate. Furthermore India is a natural point of comparison given the geographical proximity. These countries have shares of over 1% in world exports today while Pakistan’s share fluctuates around a mere 0.15% pointing to the dismal performance of the export sector. Export shares of the comparator countries have increased over the years meaning they have been outperforming the growth in world exports (table 1). Although Pakistan has achieved positive growth rates in this decade, these rates have been just sufficient to maintain the export shares. The goal for the next five years should be to outperform the world export growth rate and achieve rising share in the world trade.

Table 1: Country’s Exports as a share of World Exports

	1974	1980	1990	2000	2008
Pakistan	0.14%	0.15%	0.18%	0.15%	0.15%
India	0.56%	0.43%	0.57%	0.70%	1.32%
Malaysia	0.55%	0.74%	0.94%	1.61%	1.43%
Thailand	0.32%	0.37%	0.74%	1.13%	1.25%

1.2 Projections

To forecast exports earnings, as a first step Pakistan's export growth rate is studied historically. It is visible from figure 3a & 3b that the growth rate has shown considerable variation over the years. No pattern in trade earnings can be established from one year to the next and the decade wise trend line shows how inconsistently Pakistan's exports have grown.

Figure: 3a Pakistan's Export Growth (1974-2008)

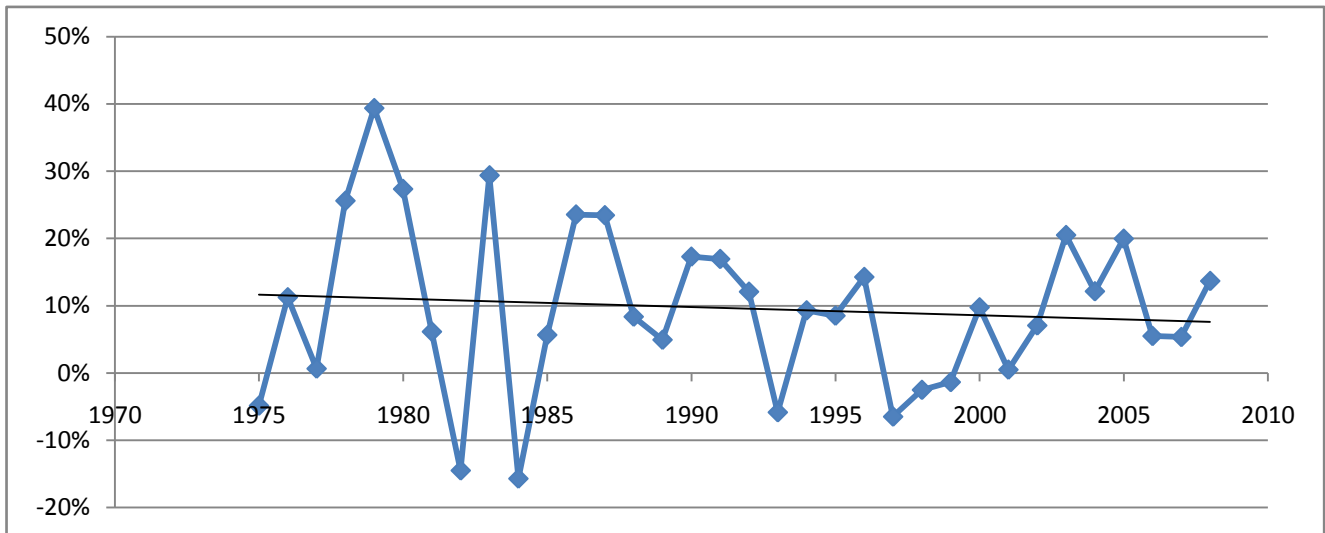
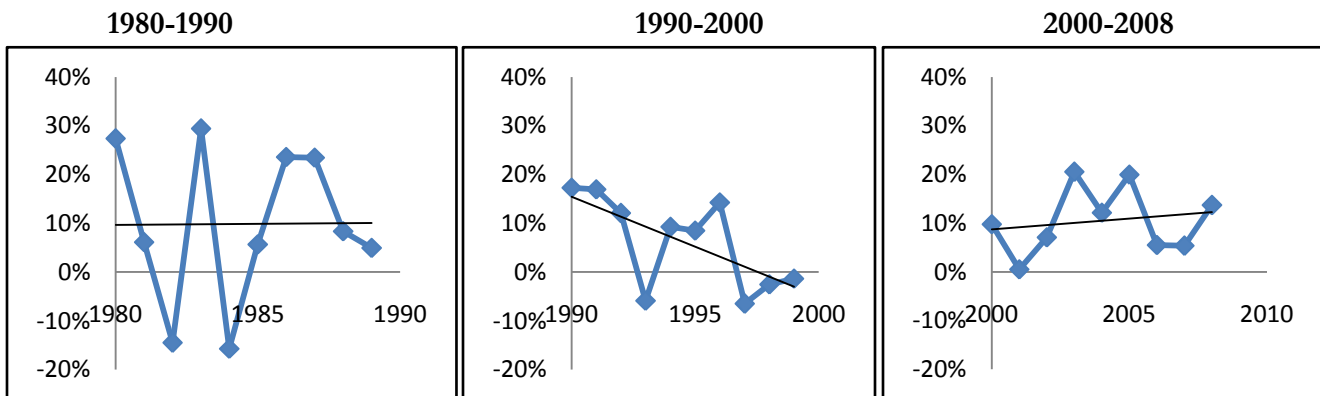


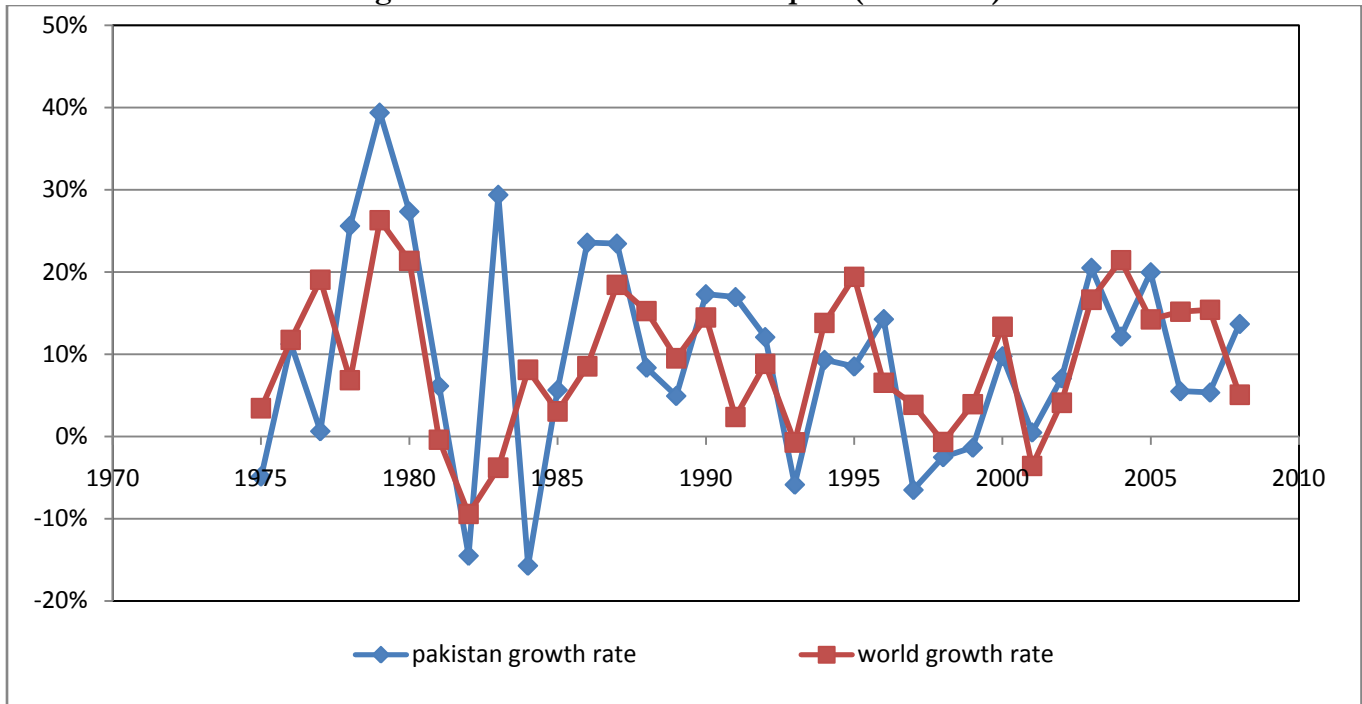
Figure: 3b Pakistan's Export Growth (Decade Wise)



Unlike imports, which are closely related to domestic business activity, exports are more dependent on developments outside the domestic economy. Demand originating in foreign countries is the predominant factor in explaining the export earnings of a country. Therefore it is worthwhile to look at the trend of Pakistan's exports relative to world export. While Pakistan's growth rate appears to be in tandem with world export growth rate³, it has never been able to outperform it. (see figure 4).

³ Regression of Pakistan's export on world exports gives a statistically significant relationship

Figure: 4 Pakistan and World Export (1974-2008)



Given the failure to establish any pattern from study of the historical trend alone, establishment of a link between world GDP and Pakistan's exports would allow forecasts to be made. The elasticity of world exports to world GDP has been established in a World Bank study (2009)⁴ and results in table: 2 confirm this link. Thus as a next step the elasticity of Pakistan's exports to World GDP has been calculated over the 1974 – 2008 period as well decade wise (results in table 2). For the overall period the elasticity is less than 1, however in the 2000's Pakistan's exports have been elastic to world GDP. Using projections for world GDP by the World Economic Outlook for the 2010-2014 period and the 00's elasticity of Pakistan's exports to world GDP, Pakistan's exports in 2014 is estimated to lie in the range of US\$23.3-25.0 billion (depending on whether 2008 or 2009 is taken as the base year). In short, with the sluggish trend of world GDP, Pakistan may at best achieve \$25 billion exports at the end of the next five years. The Strategic Trade Policy Framework (STPF) 2009-2012 targets \$22 billion by 2012, which implies exports of 28 billion in 2014. This target, therefore, implies that exports in the next five years will significantly outperform recent experience which seems rather optimistic.

Table 2: Decade wise elasticity of Pakistan's exports to World GDP & World Trade

With respect to	80's	90's	00's	Overall
World GDP	1.24	1.32	1.33	1.39
World Export	0.54	0.74	0.73	0.66

Data source: World Development Indicators (2008)

⁴The Trade Response to Global Downturns - Historical Evidence, Caroline Freund. World Bank 2009

2. Export competitiveness – Product and Market Diversification

Pakistan's exports have grown at an average annual rate of 8.8 percent between 1980 and 2008. Pakistan performed well during the eighties with an average per annum growth rate of 9.9 percent. The decade of nineties saw a sharp dip in export performance with the growth rate falling to 6.2%. The current decade started with resurgence in Pakistan's export performance with the average annual rate reaching a historical peak of 10.5%. While this was an improvement over the past, it was low relative to other South Asian countries. From 2000 to 2008, Pakistan's export performance was below India (annual average of 20.3%), and Bangladesh (13.8%). It is generally believed that the lack of product and market diversification is the reason behind Pakistan's poor export performance.

Therefore, the purpose of this section is to first analyze Pakistan's product and market concentration. Such an exercise should be helpful in guiding a future policy for diversifying the country's export base. Secondly, the section will aim to identify products and markets which are growing rapidly in world trade and hence provide Pakistan with the opportunity to improve its export performance in the medium term.

Product and market concentration indices are calculated by taking the under root of the sum of the squares of the share of each product or market in total exports for that year. The index can take a value between 0 and 1, the smaller the value, the lesser the concentration. The indices are estimated for the period 1974-2008 using products (at the two-digit level) or markets that account for greater than 90% of Pakistan's exports. For identification of rapidly growing products and markets in world trade, Pakistan's current export performance is benchmarked relative to world trade to assess the degree of dynamism⁵ of the country's existing export structure.

The framework for analysis is illustrated in Table 3 and is based on a five year window i.e. from 2003 to 2008. The exercise entailed the following steps:

- Products and markets which accounted for ninety percent of Pakistan's total trade over 2003 to 2008 were identified.
- For the products and markets identified, average annual growth rates of Pakistan's commodity (market) share in world trade as well as the commodity's (or market's) aggregate share in world trade over the period under study were calculated.
- Finally the two measures obtained– the former illustrating Pakistan's performance in a particular commodity while the latter exhibiting the respective commodity's performance in world trade – were plotted against each other to classify Pakistan's performance in existing products as being either champions, under achieving, declining or achieving in adversity while classifying existing markets as rising or declining.

⁵ The concept of dynamism is based on performance in world trade such that a product (or market) is classified as dynamic if Pakistan's share of that commodity (or market) in world trade as well as that commodity's (or market's) share in world trade has increased over a given time period.

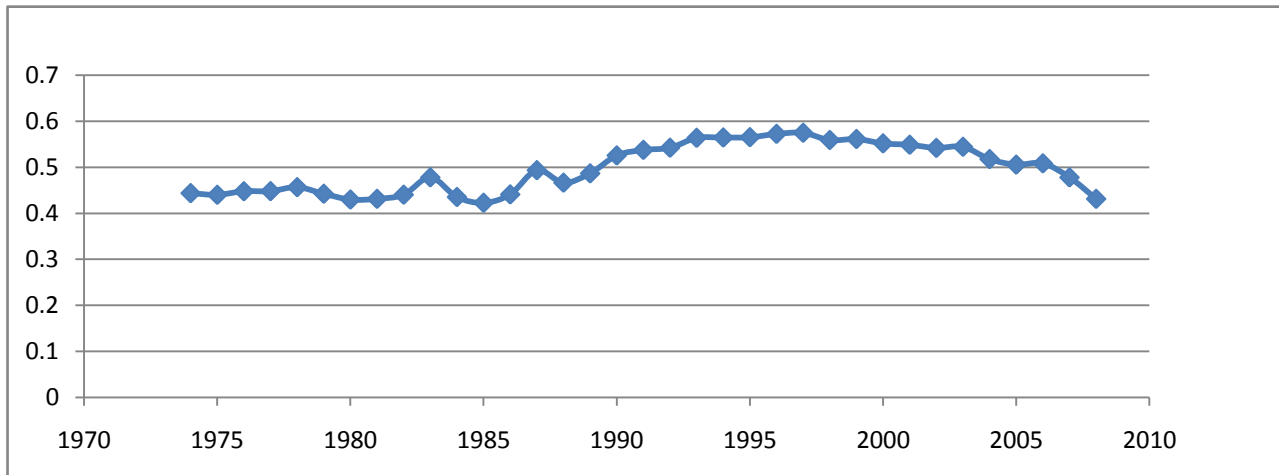
Table⁶ 3 Framework for Analysis

	Commodity's (market's) Aggregate Share in World Trade	
Pakistan's Commodity(market) Share in World Trade	<i>Rising</i>	<i>Falling</i>
<i>Rising</i>	Champions	Achievers in Adversity
<i>Falling</i>	Under Achievers	Declining Sectors

2.1 Products

The product concentration index has historically remained above 0.40 (figure 5). The index has shown a declining trend since the mid-90s and now stands at an all time low of 0.43. Pakistan has been quite successful in broadening its product export base recently. However, the index remains substantially higher than Malaysia (0.3), Thailand (0.28) and India (0.25). Thus, Pakistan suffers from a fairly concentrated product mix – 15 products account for 90% of our exports. This highlights the need to focus on product diversification. A future strategy to enhancing export competitiveness should aim to bring this index down by increasing the number of products in the export base and decrease dependence on 2 sectors: textiles and rice which still account for close to 70% of all of Pakistan's exports.

Figure: 5 Product Diversification Index 1974 - 2008



Data Source: UN Comtrade SITC Rev.1

Results (table 4) reveal that major exports like rice and bedding essentials, traditional exports like surgical instruments and emerging exports of jewellery and processed food are champions. Similarly, products identified as underachievers can be grouped into three main categories – 1) Major Exports i.e. textile and clothing exports which include textile made-ups, cotton fabrics, men's garments and knitwear, and textile

6 Lall and Weiss (2004), Industrial Competitiveness: The Challenge for Pakistan, Asian Development Bank (ADB)

accessories, 2) traditional sectors – which include Fish, Leather and footwear, Sports goods and Carpets, and 3) Emerging sector such as fruit exports.

Table: 4 Classification of Pakistan’s Commodity Exports

<p>Champions Rice (12%) Surgical Instruments (1.3%) Jewellery (1.2%) Molasses (1.0%) Polyesters(0.9%) Raw Cotton (0.8%) Animal or vegetable fats/oils (0.8%) Ores and base metals (0.8%) Furniture (& parts- mattresses) (0.3%) Transport equipment (0.05%) Woven fabrics(other than cotton) (0.02%)</p>	<p>Achievers in Adversity Petroleum and its products (5.7%) Cement & construction material (2.9%) Women's garments (1.9%) Chemical and its products (1.9%) Telecom equipment & parts (0.4%) Knitted or crocheted fabrics (0.3%) Vegetables (0.2%)</p>
<p>Under Achievers Textile Made-ups (15.4%) Woven Cotton fabrics (11%) Men's garments (4.4%) Men's Knitwear (4.3%) Textile Clothing accessories (2%) Leather, and leather products - except foot wear (1.9%) Sports goods (1.6%) Carpets and Rugs (0.9%) Fish and Fish Preparations (0.7%) Fruits (0.7%) Wheat and meslin (0.2%)</p>	<p>Declining Sectors Cotton Yarn (6%) Synthetic Textile garments (3.2%) Textile Garments (2.4%) Woven synthetic fabrics (1.4%) Women's Knitwear (1.3%) Footwear (0.7%) Miscellaneous manufactured articles (0.3%) Cutlery (0.3%) Yarn other than Cotton (0.2%) Synthetic textiles (0.2%)</p>

Export shares of the Commodities for 2008 are shown in brackets.

It seems that Pakistan enjoys a fairly healthy export structure – about 60% of the country’s commodity exports are in dynamic trade categories (see table 5). The key to promoting export led growth will require significant diversification of the country’s product base and the strategy should be to focus on this 60 percent, i.e. the champions and underachievers plus other emerging sectors (for example meat exports) which currently constitute a very small percentage of overall exports but have exhibited tremendous growth potential over the past few years.

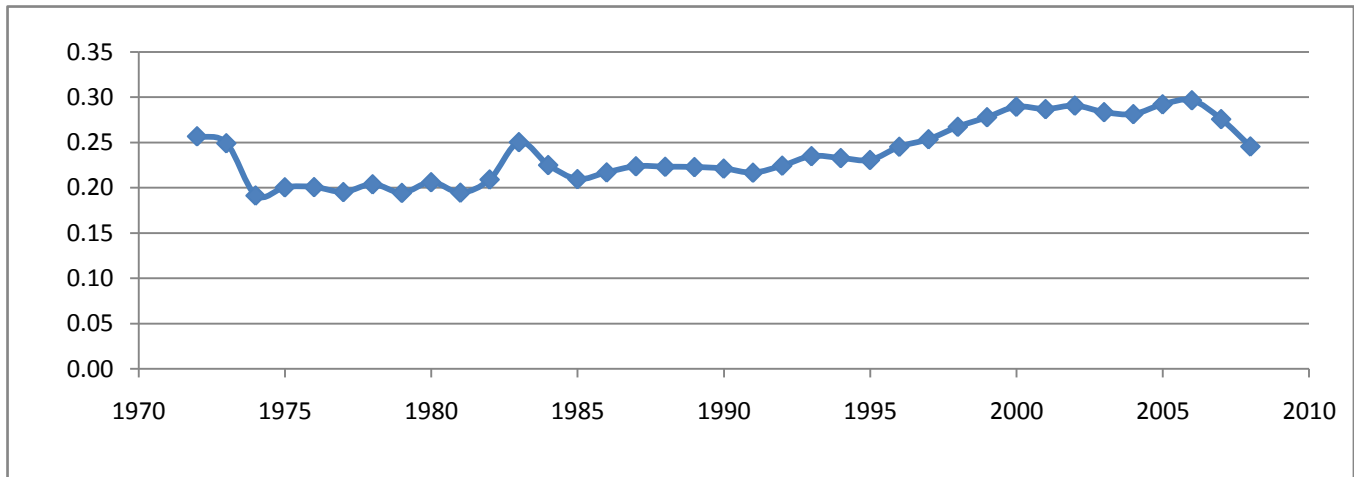
Table: 5 Percentage Shares of Pakistan’s Exports in Each Category (Along Products)

Year	Champions	Under Achievers	Achievers in Adversity	Declining Sectors
Average (2003-08)	13.32	49.19	10.03	20.04

2.2 Markets

Historically Pakistan’s market base has been quite well diversified and till mid nineties the concentration index remained below 0.25 (Figure: 6). After a period of increased concentration, with decrease in share of USA from 25% of Pakistan’s total exports in 2000 to 18% in 2008, the market diversification measure has improved to 0.25. It is encouraging to look at the figure for market diversification of other countries which stand at 0.23 for Thailand, 0.27 for Malaysia and 0.20 for India. Pakistan seems to be doing quite well in terms of reaching out to a well diversified market for its exports; In 2008, 90% of our exports were going to 45 countries.

Figure: 6 Market Diversification Index 1972 - 2008



Data Source: UN Comtrade SITC Rev.1

This indicates a broad market base and with greater access in existing markets, the volume of exports can be increased. Therefore, instead of wasting resources trying to break into new markets, efforts should be on increasing the volume of exports within the existing large markets. One concern is that the share of Pakistan’s exports going to declining markets in the world is very large (table 6a), as this category includes the country’s largest export destination USA (18%), and countries in EU (16.6%) such as UK, Belgium, France, Spain and Italy. While these are declining markets, they cannot be ignored because of their important presence in the global market – US (9%), and UK (3.5%). There is a need to work towards gaining greater market access through negotiations and special arrangements in these markets.

Table: 6a Pakistan's trade structure

	Rising Markets	Declining Markets
Pakistan's Share	33.9%	58.5%
Markets' Share in World Trade	41.4%	52.8%

Further, in the medium term focus should be on dynamic world markets (see table 6b). Of these, markets such as China, India and UAE, in which Pakistan is doing well, should be the key targets for market development initiatives for expanding and strengthening the country's existing export share to these markets. Moreover, from a long term perspective, efforts to break into new markets should be focused towards dynamic world markets in which Pakistan is currently underachieving (such as Russia and Brazil) so that the country can realize the full potential offered by high growth markets in world trade. Finally a future strategy must also aim to target regional hubs (for instance UAE serves as a natural hub for Middle East). Such trade destinations should be identified specifically for EU, Africa, and East Asia, and these should be the focus of market development initiatives (see sections 3 and 7.5) to enhance Pakistan's presence in these regions.

Table: 6b Dynamic Markets of the world

Country	Share in world exports	
	(1998)	(2008)
China	3%	5.6%
Rep. of Korea	1%	2.1%
Russian Federation	1%	1.9%
India	1%	1.5%
United Arab Emirates	1%	1.1%
Australia	1%	1.1%
Brazil	1%	1.1%

3. WTO and Trade agreements

Under the WTO the use of traditional instruments of industrial policy such as subsidies, high protection for selected industries through local content requirements, etc are no longer permissible. The elimination of the quotas under the Multi-fiber Agreement (MFA) from January 2005 brought the textile and clothing trade under GATT rules. While the Doha Round is currently stalled, the direction is clear, i.e. world trade will continue to be increasingly based on competitiveness. Thus for Pakistan to accelerate export growth, it will have to focus on increasing export competitiveness, supplemented by negotiating better access to key markets, and expanding trade with neighbours where it can exploit the transport cost advantage. In addition, it will have to exploit niche markets (such as organic foods) and adopt unconventional market development initiatives (refer to section 7.5)

3.1 Free Trade Agreements (FTAs) and negotiating improved access

The slow progress of the Doha Round since its 2001 launch and its suspension in July 2006 has strengthened the interest in entering Regional or Free Preferential Trade Agreements. Within FTAs, Pakistani businesses will find it easier to trade with FTA partners and to invest in their markets. FTAs also present business opportunities for Small and Medium Enterprises (SMEs) to enhance their market access. Therefore, Pakistan is strengthening trade relations with countries in South and East Asia, Asia Pacific and South America. This does not, however, mean ignoring the conventional trading partners like America and the European Union. In this respect, the high level of political relations and the partnership in war against terror needs to be translated into deeper, more permanent and beneficial economic and commercial relations. This can be achieved through negotiating FTAs and special access arrangements such as Generalized System of Preference (GSP) of the EU and the Pak-US Trade and Investment Framework Agreement (Bilateral Investment Treaty (BIT)). Pakistan's objectives in negotiating bilateral and regional preferential/free trade agreements are:

- To seek better market access by addressing tariff and non-tariff measures;
- To further facilitate and promote trade, investment, and economic development; to enhance the comparative value of Pakistan's exporters;
- Build capacities in specific targeted areas through technical cooperation and collaboration. The need is for future FTAs to target the high growth markets that have been identified in section 2.

3.2 Regional Cooperation

Pakistan is a member of the two regional groupings: South Asian Association for Regional Cooperation (SAARC) and Economic Cooperation Organization (ECO) but has not been successful in promoting the intra-regional trade in a significant way. Political differences: failure to develop infrastructure and protocols for large scale overland trade and similarities in the trade structure, together with absence of comparative advantage in the capital intensive and high value added products (that are normally imported in the region) are some of the reason for this lack of success.

Recommendations:

Vertical specialization: Trade complementarities can be developed within the region, if the countries in the region are able to achieve vertical specialisation through production sharing arrangements. Vertical specialisation would not only allow the regional trading partners to strengthen their trade ties, but also enable them to reap economies of scale by concentrating on a specific production process in the value-addition chain.

Joint marketing initiatives: Most of the South Asian countries are direct competitors in the world market for their exports. Therefore, it would be in the interest of the South Asian countries to forge an alliance for the marketing of their competing export products. This would promote mutual economic cooperation in the region and will allow them to reap the benefits of improved export opportunities.

Pakistan has very low regional integration with exports to the four neighbours standing at just 17% of the total exports (Average intra-regional trade over 2007-2008 stood at 74.0% for Europe, 58.2% for EU15⁷, 50.4% for NAFTA and 44.6% for East Asia). From amongst the neighbours who form Pakistan's natural trading partners, China and India provide tremendous potential for export growth since they are large, rapidly growing markets. The efforts that have been made so far and the opportunities and challenges that lie ahead are discussed next for trade with these two countries.

3.3 Trade with India

Estimates on trade potential suggest that Pakistan- India trade could be in a range of \$ 3 to \$ 10 billion compared with the annual official trade flows over the last six years of less than \$400 million; in other words only 4% to 13% of the potential bilateral trade is being exploited. Since Pakistan and India account for almost 90 % of South Asia's GDP, low bilateral trade is an important constraint for growth of South Asian exports to the rest of the world, as well as for an expansion of intraregional trade. Viewed in the larger regional context, South Asia is the least integrated region compared to other regions such as East Asia, Latin America, Europe and Central Asia, Middle East and North Africa as well as sub-Saharan Africa. The reasons for the relatively low trade have been political tensions, difficulties with land based investment of goods the use of import-substitution policies to promote industrialization and weak commitment to regional integration.⁸

It is important that trade with India does not remain hostage to foreign policy since there are several advantages of normalizing trade between the two countries. To begin with, the advantage of geographical proximity – cheaper transportation costs and trade complementarity in goods in which either country has a comparative advantage are overwhelming. The shorter distances will render it unnecessary for industry to carry high levels of inventories of raw material, intermediate goods and parts, thereby reducing cost of operations and the country's overall trade deficit while also improving allocation of scarce resources

Cooperation in the agriculture sector could turn out to be beneficial to Pakistani farmers. The success achieved by India in raising yields per acre through improvements in extension services and research and seed, irrigation and mechanical technologies offers opportunities that Pakistani agriculturists can exploit gainfully. The Pakistan textile sector (cotton based fabrics and short-staple fiber yarn/fabric) should be expected to benefit (through increased production and higher productivity owing to a more modern technological base and equipment) from an improved access to the huge Indian market, with the latter having a distinct advantage in polyester fibers and related fabrics. Similarly, Pakistan's leather products (manufactured from the more durable cow skin) will be well-received in the Indian market where leather products are essentially made from goat skin.

⁷ EU15: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Luxembourg, Netherlands, Italy, Portugal, Spain, Sweden and United Kingdom

⁸ Naqvi, Zareen and Schuler, Philip. (2007) "The Challenges and Potential of Pakistan-India Trade." The World Bank.

The sequencing of policy implementation should be that as a first step trade relations between the two countries should be normalized by trading on the most favoured nation (MFN) basis. As a second step, policymakers should address problems related to land based trade, information exchange, trade facilitation, banking, non-tariff barriers, visas and communication. As a third step, an enabling environment for investment has to be created so that India and Pakistan can enter into joint ventures.

3.4 Trade with China

The FTA with China (2007) envisages a phased and gradual program of on substantially eliminating tariffs on all bilateral trade. It is important to note that most of the products in Pakistan's Category I (0% tariff) and II (5% tariff) include machinery, raw materials and intermediate goods. The FTA therefore provides significant opportunities to Pakistani investors to import raw materials and machinery and equipment at lower duties from China and export the finished goods in the expanding market of China under preferential tariff.

However, according to one estimate Pakistan has comparative advantage in only a narrow range of products (11 products at HS-2 digit level) including raw materials such as cotton and raw hides and some food products. On the other hand, China has comparative advantage in a broad range of commodities (84 product categories). Therefore it is important that Pakistan concentrate its efforts getting China to reduce/eliminate non-tariff barriers on the products in which Pakistan has a comparative advantage. In this regard food products offer the greatest potential and the government should give these priority both in terms of removing barriers and providing incentives.

It is important to emphasize that whereas the difference in the pattern of comparative advantage indicates the existence of significant trade complementarity between the two countries and hence a large potential for expansion of bilateral trade, it also indicates that trade between Pakistan and China is likely to be tilted in favor of China at least in the short term. The situation may change in a longer term perspective however in the short term Pakistan and China can achieve greater economic integration by helping to evolve a vertically integrated production structure in sectors that are of economic significance in the bilateral context. Some of the potential areas where regional production sharing systems can be developed are leather products, textiles and clothing, and light engineering. Such arrangements would allow the two countries to specialize in different production processes within a particular industry and thus achieve benefits of specialization and scale economies.

4. Higher Technology Exports

4.1 Introduction

Competitiveness requires a strong human and technical base which is able to support enterprises in handling, adapting and improving new technologies and selling the output to sophisticated and demanding world markets. According to the new dynamics of world trade, the ability of a country to master and use new technologies matters more than factor endowments for a country's comparative advantage. In essence, to improve export competitiveness a country must upgrade technologies in all activities, build new capabilities and find new markets and niches⁹.

High Technology products use advanced and fast-changing technologies, with high R&D investments and prime emphasis on product design. These in turn require sophisticated technology infrastructure, high levels of specialized technical skills and close interactions between firms and research institutions. However, some products like electronics have labor-intensive final assembly, and their high value-to-weight ratios make it economical to place this stage in low wage countries. High technology products lead in new international integrated production systems where different processes are separated and located by MNCs according to fine differences in production costs – i.e. the basis of rapid growth in intra-industry trade.

The fact that technology plays a significant role in the trade patterns of advanced industrial countries is widely accepted. However, for a developing country, climbing the technology ladder is just as important. Developing countries are assumed to be technology followers, importing innovations from developed countries and using them passively. Once they import a technology, they can use it efficiently, without extra effort. In East Asia the interaction between the relocation of simpler high technology processes and fast growing markets resulted in growth of high technology exports. Technology intensive products provide enormous technological benefits to a developing country because of spillover effects including creation of new skills and generic knowledge that can also be generally used in other activities.

Since high technology products have fast changing technologies, and some require large R & D investment, they tend to have the highest entry barriers. However, many high technology activities require much simpler technologies for final assembly, where low wages are an important competitive factor. Developing countries, like Malaysia, Thailand, and Philippines, have now become major high technology exporters by starting at the relatively simple assembly processes. Earlier on these countries lacked strong local capabilities, but with the passage of time, they upgraded their role by moving into greater local content, design and development and marketing.

4.2 Comparison of World and Pakistan Export Structures According to Technological Level

Looking at the structure of world exports, the share of medium and high technology exports in the total in 2008 was 57.6% and their growth (10.1% and 9.3% respectively) from 1998 to 2008 has more or less kept pace with world export growth (10.1%). On the other hand the share of primary, resource based and low technology manufacturers in world exports was 11%, 15% and 16% respectively in 2008. The growth of exports of textile, garments and footwear industries has been the slowest (7%), (Table 8). In contrast, Pakistan's exports are dominated by low technology manufactures which accounted for two-thirds of the total exports in 2006-2008. Their share has fallen from three-fourth of total exports in 1998-2000 due to the slow growth in the world market in textiles, garments and footwear which accounted for over 7% of Pakistan's exports in 1998-2000. The continued slow growth in world trade in this category, due to their

⁹ Lall and Weis (2004), Industrial Competitiveness: The Challenge for Pakistan, Asian Development Bank.

large weight in Pakistan's total exports, will remain a drag on Pakistan's overall export growth for some time to come. The combined share of medium and high technology exports has remained more or less unchanged over this period. However, high technology exports have grown at an impressive 17.5% per annum, though this growth is from a very small base.

The performance of medium technology exports was disappointing with their growth rate being below both the world growth rate for this category and Pakistan's growth rate of total exports. Within medium and high technology exports, the automotive and electronic & electrical exports have grown faster than world growth (Table 8). But again, the original shares of these exports are too small to have a significant impact on their respective sectors. Normally, one would expect a progression up the technology ladder, i.e. from low to medium and from medium to high technology exports. Unfortunately, this does not seem to be happening in Pakistan, and there is an urgent need to address this problem. It is proposed that the strategy for the next five years should be to focus on the medium technology exports. There are some "Champions" in this category, such as Woven Synthetic Fabrics, Surgical Instruments and Polyesters (Table 9), which should be given priority and other potentially high growth products, like Medicaments and Pharmaceutical goods and light engineering industry products have to be identified for special attention in the medium term.

Table 8: Distribution of Pakistan and World Exports According to Technological Level

Sector	World Exports*		Pakistan Exports		
	2008 Share (%)	1998-2008 Growth (%)	1998-2000 Average Share (%)	2006-2008 (%)	1998-2008 Growth (%)
Total		10.1			9.6
Primary	11.4	11.2	12.3	12.7	10.1
Resource Based Manufactures	14.8	10.5	3.5	10.9	23.9
- Agro Based	7.1	8.6	2.8	2.7	10.0
- Other Resource Based	7.6	12.6	0.7	8.2	40.9
Low Technology Manufactures	16.2	9.2	74.7	66.7	8.2
- Textile, Garments and Footwear	5.8	7.0	70.5	62.8	8.1
- Other Low Tech	10.5	10.7	4.2	3.9	8.9
Medium Technology	35.5	10.1	8.6	8.1	8.7
- Automotive	9.1	9.1	0.1	0.4	24.0
- Process	9.0	11.4	6.3	4.5	5.4
- Engineering	17.4	10.1	2.2	3.2	14.1
High Technology	22.1	9.3	0.8	1.4	17.5
- Electronic & Electrical	15.2	8.6	0.1	0.6	30.8
- Other High Tech	6.9	11.1	0.7	0.8	12.2

Source: UN Comtrade SITC Rev. 2 (3-digit level). The classification of commodities according to their technology levels is according to Lall, 2000

* Does not include Oil Exports.

Table 9: Pakistan's Top Exports in Each Technological Category

Commodity	Share in 2008 (%)
Primary	16.6
- Rice	12.0
Resource Based	13.2
- Refined Petroleum products	5.7
- Cement and Building & Monumental Stone	2.9
Low Technology	60.5
- Textile Made-up articles	15.4
- Woven Cotton Fabrics	11.0
- Textile Yarn	6.2
- Knitted Undergarments	4.6
- Men's Outerwear of Textile Fabrics	4.3
- Clothing Accessories of Leather	3.7
- Knitted Outerwear and Clothing Accessories	3.2
- Other	12.3
Medium technology	8.2
- Woven Synthetic Fabrics	1.4
- Surgical Instruments	1.3
- Ethanol	1.1
- Polyesters	0.9
- Machine Tools for Working Wood; Carving	
Materials	0.6
- Other	2.9
High technology	1.3
- Medicaments and Pharmaceutical Goods	0.6
- Telecommunication equipment & parts	0.4
- Aircraft and associated equipment & parts	0.1
- Rotating Electric Plant and Parts	0.1
- Batteries, Electric Accumulators, and Parts	0.1
- Other	0.1

The phenomenal growth achieved by the East Asian countries was largely because of their export oriented growth strategy which was driven by the rapid growth of their medium and high technology sectors. In particular, Taiwan's SME based approach is one that Pakistan has the potential to emulate (Box 2). SMEs have traditionally played an important role in Pakistan's medium and high technology exports and it is this sector which has the greatest potential for providing the base for a strategy for promoting medium and high technology exports in the future. There are some important features of SMEs which allow them to be more effective for generating export opportunities and enhancing both domestic and global competitiveness of the economy. These include having a high level of flexibility in terms of adapting to evolving markets and technologies, as well as higher efficiency at reaping the benefits of new developments and innovations. They also face a number of barriers in their development – their small size means that they have few resources and limited access to credit; they lack economies of scale and have high relative costs in accessing and utilizing information technology, and managerial and marketing services.

Box 2: Taiwan's SME Based Export Growth Strategy

SMEs played a vital role in Taiwan's rapid export oriented growth. To begin with, most of the Taiwanese firms pursued the Reverse Value Chain strategy in labor-intensive manufacturing activities. Reverse Value Chain strategy is a generic approach in which a new firm starts by mastering the simple assembly operations to develop process capabilities, typically on subcontract basis, followed by later extension into product design capabilities, and finally new product creation/branding activities. Because of the limited resources of the SMEs, they were unable to invest much R&D efforts. Hence, the state played an important role in diffusing process technologies to the SMEs in the early stage, and helped diffuse various design know-how to SMEs to enable them to enter the phase of new product creation/branding activities in the later stage.

In short, the Taiwanese model can be described as a SME-Public Research Institute Innovation Network model (Wong, 1995). The model can be best characterized as one involving the promotion of indigenous SMEs coupled with the large scale development of public research institutes to facilitate technology assimilation/transfer and cooperative R&D promotion in support of the indigenous SMEs.

Pakistan's industry has repeatedly demonstrated its ability to adapt and reverse engineer imported machinery and equipment. Examples include the experience with the equipment for processing kinnow's for exports. A processing plant (which has equipment for sorting, washing, waxing, grading, and packaging) was initially imported and subsequently, through the process of reverse engineering, such plants were made locally. Today there are about 200 kinnow processing plants in Pakistan and all except one have been made locally. Agricultural machinery provides similar examples where harvesters, threshers and tube wells are now all locally produced with the designs based on imported machinery. Similarly, there is a flourishing consumer durables industry manufacturing washing machines, electric and gas cookers, sewing machines, etc. based on reverse engineering. It is important to take this domestic production capability to a level such that more of these goods can be exported. The lessons learnt from Taiwanese experience point to what the government needs to do in order to upgrade the SME sector to achieve this goal. Given that public resources are limited, it is important that government's policies and investments are targeted towards industrial clusters found across the country. There are many industrial and export clusters in Pakistan, like the textile cluster around Faisalabad, the engineering, pharmaceutical and textile clusters around Karachi, the high technology defense cluster around Wah and Kamra, and the light engineering/sports goods cluster in the Sialkot, Gujrat, and Gujranwala triangle (Box 3). By targeting infrastructure, skill development, development of common facilities, and technology investments according to these clusters' needs, the government could unleash a dynamic process of technology based export growth in the next five years.

Box 3: Engineering Hub in North Punjab – Gujrat, Gujranwala and Sialkot Districts



The triangle formed by Sialkot, Gujranwala and Gujrat, with a population of 8.3 million and an area of 12,196 square kilometers, is one of the most active regions of industrial activity in Pakistan. This triangle contains a significant portion of Pakistan's light engineering industry. In addition to Sialkot, the industrial hub of surgical instruments in Pakistan, the triangle is home to the Gujrat-Gujranwala domestic appliances industry with the electric fans cluster around Gujrat and other appliances cluster around Gujranwala. Moreover, Wazirabad is home to the cutlery industry and an agricultural machinery cluster is around Daska.

1. Surgical Instruments - Sialkot

Surgical instruments export is a US \$70 billion world market of which Pakistan's share in 2008 was US\$270 million, i.e. less than 0.5%. The industry in Pakistan operates at two levels: first, a number of preliminary operations are done at the small or cottage level, and second, the heat treatment, finishing and quality control is done at a the medium or large scale. The industry employs approximately 150,000 people. The largest markets for Pakistan are USA (24%), Germany (15%) and UK (10%).

2. Electric Fans – Gujrat

Pakistan captures a mere US \$27.5 million from the worldwide fans export market of US\$4.5 billion, i.e. about 0.6%. There are about 500 fan manufacturing units operating around Gujrat and, with the exception of a few large firms, nearly all the units fall into the category of cottage industry. The small units are the real backbone of this industry and provide employment to a significant portion of the local population. The largest markets for Pakistan are UAE (23%), Yemen (18%) and Saudia Arabia (17%).

3. Domestic Electric Equipment other than Fans – Gujranwala

Domestic electric equipment exports, other than electric fans, have a US \$85 billion market of which Pakistan's export (US\$9.4 million in 2008) is less than 0.02%. Much of this industry is integrated with the electric fans cluster around Gujrat especially at the level of small and medium sized firms. Domestic appliances exported include refrigerators, freezers, washing machines, sewing machines, gas cookers, etc.

The scope and diversity of engineering activities in this triangle is large and the technological sophistication of many of the operations is quite high. There is considerable division of production processes resulting in high level of intra-firm trade and economies of scale. In brief, the industrial base exists and the missing ingredients can provide a quantum leap. Also the world market for these products is huge (over US\$ 160 billion), and a small increase in Pakistan's share would translate into a very large increase in export volumes.

4.3 Recommendations

There is need to systematically develop these clusters with a view to pushing medium and high technology exports. To achieve this, the country needs to develop local capabilities by setting a strong industrial policy, developing specialized worker skills, promoting local R&D, and providing good quality infrastructure to these clusters.

Development of Specialized Skills: The ready availability of skilled workers for firms facilitates the adoption and use of new technologies, thereby enhancing the firm's prospects of jumping into the higher technology value chains. At the managerial levels capable managers and engineers are needed to adapt and use sophisticated technology, manage complex production processes and to develop and market products demanded internationally. Hence, significant commitment is required in terms of public investment in relevant technical and general education. A proposal to establish an Engineering University, a Management School, a Technology Park and a Technical Training Institute Complex in Sialkot in collaboration with Sweden is just the kind of project needed to provide a quantum jump in SME based medium and high technology exports. Unfortunately, this project is currently suspended and it is recommended it should be revived and implemented in a public-private partnership mode on a priority basis. Similar initiatives need to be developed for other industrial/export clusters in the country.

Promotion of Local R&D: The importance of developing local capabilities of Research and Development for the promotion of production and exports of High Technology products cannot be overstated. It is not only essential for fulfilling the requirements of continuously upgrading the products, but also for reaping the benefits of many technological spillovers that the country receives by participating in high technology value chains. This would allow the country to move into greater local content by designing and developing new products itself. To accomplish the task of developing such capabilities, the government needs to encourage and support partnerships between firms and research institutions, and establish stronger property rights. Government support can take a range of forms, including the standard tax incentives for R&D expenditure, cost sharing for various consultancy services, and provision of finance for technology support, particularly in the form of venture capital for relatively high risk or innovative initiatives. Also the engineering university and technology park project referred to above can play a key role in this regard.

Secure Energy Needs: The availability of a reliable supply of gas and electricity at internationally competitive costs is a significant competitive factor in the production of Higher Technology exports. Currently the country is facing a severe shortage of electricity and gas. One approach maybe to ensure uninterrupted power and gas supply to medium and high technology industry clusters. The consumption share of these clusters in the total is very small and therefore this policy will not have a significant negative impact on other consumers, but the positive impact on exports and growth of targeted clusters could be huge.

Provision of Common Cluster Facilities: Since critical competitiveness problems need to be addressed at the firm level and most firms in the medium and high technology sector are relatively small, it is necessary to develop common facilities for firms producing technology intensive products. (See Box 4 for examples of such facilities). The government can outsource the whole process to a third party that specializes in providing such common facilities. With some initial support from the government, such projects could give a significant boost to the production of technology intensive products in the country.

5. Agro-based Exports

5.1 Introduction

The decade of 70s and 80s saw a shift in emphasis from the agricultural sector to manufacturing sector in the developing world, which was viewed as the basis of export oriented growth. It was believed that agriculture exports cannot be the driver of growth as increases in production would exceed expansion in demand leading to a secular decline in prices of agricultural commodities. This view was reinforced because of production subsidies and trade barriers on agriculture imports in developed countries.

Today the export potential of the agricultural sector is beginning to be realized, because of the recent upsurge in agricultural prices, and the possibility of reduction in trade barriers under the Doha round. One contributor to the rise of agro-based commodity prices was the oil price hike which created demand for bio-fuels like ethanol. Another is that, as income levels have risen in developing countries, their food preferences have shifted towards consumption of more expensive edible items like meat, which has resulted in increased demand for grains for animal feed. Because of limited land resources, additional demand generated by bio fuel and animal feed have resulted in an upward pressure on most agricultural prices.

These changing trends are especially pertinent to Pakistan which is primarily an agricultural based economy, with the agricultural sector being the largest income and employment generating sector of the country¹⁰. Pakistan has a natural comparative advantage in agriculture, with agro-zones ranging from tropical to temperate, abundant land resources, knowledgeable farming communities and an excellent irrigation system. Also, the labour intensive nature of this sector makes it ideally suited for harnessing the potential demographic dividend. Pursuing agro-based export strategy has the potential of generating much needed employment opportunities, and, given our limited capital resources, the investment required for moving into higher value products in this sector is much less than that for technology intensive commodities.

With the emergence of China as the low cost manufacturer to the world, especially for low and medium technology manufactures, potential for Pakistan to pursue an export oriented strategy based on manufactures alone is limited. Matching China's low prices achieved through economies of scale is a difficult target for Pakistan in the medium term, and the agricultural sector provides an excellent alternative for acceleration of Pakistan's export growth in the medium term.

The following analysis will look at the current performance and identify key areas of focus for the development of the agro-export sector.

5.2 Non-Perishables

Rice exports have shown tremendous growth and it has emerged as Pakistan's second largest export commodity, accounting for 12% of total exports in 2008. Pakistan is producing 8.5 million MT of rice and domestic consumption is 2.7 million MT leaving a large surplus for exports. The exports are primarily comprised of basmati (\$1.1 billion) and other varieties such as Irri (\$0.9 billion). While the quantity of basmati rice exported is lower, due to their higher prices they contribute more significantly to export earnings. Pakistan is one of the few countries in the world where Basmati rice is grown, which gives Pakistan an edge in capturing the increasing global demand for this variety. India is the biggest exporter of Basmati rice in the world, but for the past two years a ban has been imposed by Indian Government on rice exports, which has increased the demand of Pakistani Basmati rice in the world. Once this ban is lifted,

¹⁰ Technology bases industrial vision and strategy for Pakistan's Socio-Economic Development, PIDE

Pakistan's Basmati rice exports will be adversely affected unless the country has been able to establish the quality of its rice in the global market. The pressing issue for the sector is the low level of modernization (lack of milling facilities).

Wheat

In wheat, Pakistan remains at the margin between being a net exporter or importer depending on the state of harvest that year. Therefore wheat does not seem to have the potential to be one of the drivers of agriculture sector led export growth.

In terms of infrastructure, the rice and wheat sectors face serious deficiencies in the post harvesting facilities, like storage and milling. Currently, most of the crop is stored in the open and milled using primitive techniques, which result in significant wastages of crop. In the medium term, the government should focus on providing the policy framework (with continuity) which encourages private sector investment in modern storage, milling, testing etc.

Cotton

Raw cotton accounted for only 0.8% of the total exports in 2008. Over the last few years, there have been serious production related problems including a low yield due to pest infestation of the crop. The amount of pesticides used has increased significantly, but this lowers the quality of the crop and also increases its cost. Countries like India tackled this problem by introducing of BT (genetically modified) cotton seeds, which increase yields and have built in pest resistance. There is a need for introduction of BT cotton in Pakistan¹¹, along with the development of integrated pest management and testing facilities¹². This could give a rise to a substantial export surplus in cotton, as well as enhance the competitiveness of the textile industry in Pakistan.

5.3 Perishables

Pakistan's performance in the agriculture sector, in commodities other than rice, has not been very impressive – contributing a mere 2.5% of total exports. Perishable commodities include fish (1.2%), vegetables and fruits (1%), and meat (0.3%). The following analysis aims to identify the possible causes of the poor performance and to identify areas where Pakistan needs to concentrate in order to enhance agro-exports.

Fruits and vegetables

The 1% share of fruits and vegetables in Pakistan's total exports has been stagnant over the years and this sector falls in the "Under Achievers" category. The lackluster performance of the horticulture industry in Pakistan is due to the use of poor production practices (e.g., flood irrigation of fruit tress), poor pest management, inadequate harvesting and post-harvest procedures, as well as to a lack of infrastructure, especially for post-harvest treatment and cold chain.¹³ The world exports of this sector are large and increasing, an opportunity Pakistan has been unable to tap.

¹¹ BT cotton is being sown on substantial area in Pakistan, but there are seeds smuggled from across the border and not custom-made for Pakistani conditions

¹² Hamid (2008)

¹³ Horticulture Action Plan: Background Paper July 2007, Competitiveness Support Fund

The main fruits exported are ‘Kinnow’ and Mangoes, commanding shares of 35% and 20% respectively of fruit and nut export in 2008. Within the vegetable category half of the exports are potatoes, while onions contribute about 20%. The Progress Report on the Agribusiness Development Project (2007) calculated the Domestic Resource Cost (DRC)¹⁴ for these major agricultural commodities of Pakistan and it found that all these commodities have DRCs substantially less than 1 (See Table 13). This indicates that Pakistan has a significant comparative advantage in the production of these commodities. It highlights that despite having an edge in production of these fruits and vegetables; Pakistan has failed to expand exports.

Table 13: DRC of selected crops

	Kinnow	Mango	Onion	Potato	Dates
DRC	0.34	0.22	0.37	0.43	0.13

Pakistan’s primary export markets are UAE and other neighbouring countries, India, Iran and Afghanistan. The inability to tap the potential offered by western markets is due to the poor quality standards of the fruit and vegetable produced. Little has changed in production technology, harvesting practices, post harvest care and packaging within the horticulture industry over the last decade. Also, exports to western markets have to meet stringent health and quality standards for which testing and certification facilities in Pakistan are weak. As a result the industry has been unable to establish itself in export markets or indeed to significantly improve the volume of output. The aim should be to improve the product’s standard relating to size, shape, chemical residues and also the process standards relating to packaging.

Fish and fish preparations

Fish and fish preparations today constitute less than 1% of our total exports, a share that has been showing a declining trend over the years. Exports have suffered due to poor marine fish harvesting technology as well as post harvest handling and processing methods. Existing practices are not in compliance with international standards. Further freshwater treatment facilities are scarcely available. The sector requires improvement in institutional and infrastructural facilities and training of manpower with the aim to meet the international quality standards.

Meat and meat preparations

In 1998 Pakistan did not export meat and meat preparations. Since then, the sector has shown tremendous growth attaining 0.3% share in total exports in 2008. This is an emerging commodity with considerable export potential and requires actions on the supply side. As is the case of all other food exports, meeting health and quality standards is of immense importance for the growth of this sector.

5.4 Agro-based manufacturers

Processed food

The processed food exports stood at US\$47.8 billion worldwide in 2008 with Pakistan’s share being a mere \$25.6 million. The contribution is negligible in Pakistan’s exports (less than 0.1%) coming primarily from export of fruit juices. The sector provides considerable value addition opportunity for Pakistan; however, at present the country has a very small fruit and vegetable processing industry concentrated around major

¹⁴ The DRC is measure of efficiency and is the ratio of factor costs in social prices to value added in border prices.

cities. Much of their production is consumed locally. The sector is dependent on availability of packaging, sugar and other inputs at internationally competitive prices.

Leather and leather manufacturers

Leather and leather manufactures are traditional exports of Pakistan, however the sector's share in total exports has been declining lately. It is one of the few sectors in the economy that exports most of its production. In the leather tanning industry there are issues relating to the use of a high proportion of damaged local hides and skins due to diseases and improper preservation. Furthermore it suffers from poor compliance to environmental standards. The predominant made-up industry in the leather sector is the footwear industry, which is highly under developed. It suffers from lack of trained human resources, and availability of good quality shoe components. The emphasis should be on providing the financial and technical support required by the sector to upgrade its technology and quality as well as compliance with environmental standards, in order to improve its share in the global market.

5.5 Recommendations

There are two sets of main constraints which need to be addressed if Pakistan is to achieve growth in agro-based exports. First, is the inability to meet quality standards. The Sanitary and Phytosanitary Agreement of the WTO is a list of standards that pertain to food safety and animal and plant health. There is need for a more pro-active public sector involvement to ensure that these standards are understood, and facilities are available to meet them. This involves building of physical infrastructure and local facilities for testing quality standards. Second, is the development of marketing infrastructure. The key to getting full value from fresh produce is to preserve the quality and enhance shelf life from the moment it is harvested to when it is arrived at the supermarket. This requires post-harvest treatment and a cold-chain from the farm to the international carrier (ship or aircraft). Establishment of the treatment facilities and cold – chain requires considerable investment. The government has an important role to play in realizing this investment. It includes establishing a supportive policy framework, investing in necessary facilities at the port (air or sea), investment in incentives in the private sector in the form of duty free imports, R&D grants, seed money, and access to credit at competitive rates, etc.

The specific recommendations with regards to agro-based exports are:

- Direct Government intervention in marketing and trade of agricultural commodities to stabilize prices and avert market failures, must be practiced prudently and be kept to a minimum.
- Strengthen agricultural marketing, through public-private partnerships in the development of agricultural markets, and revisions in the provincial laws and regulatory framework for agriculture marketing/market committees.
- Promote links with international supermarket chains, like Metro, to expand the market access available to agricultural commodities.
- For perishables, invest in the establishment of post-harvest treatment and a cold-chain from the farm to the international carrier. Furthermore, invest in incentives for the private sector in the form of duty free imports, R&D grants, seed money, and access to credit at competitive rates.
- Set up quality assurance/certification infrastructure to make sure that the commodities meet international standard (EurepGAP & HACCP¹⁵). For this, the government should encourage international laboratories, like Bureau Veritas, to set up their offices in the country and provide quality assurance and certification services to the exporters.

¹⁵ It is solely a food safety program, which consists of seven principles (activities) that specifically address three basic objectives on hazard assessment, risk management, and documentation control.

- Revitalize seed industry with focus on hybrid and GMO technology such as Bt Cotton, Bt Maize and Hybrid Rice, vegetables and fruits – pass breeders’ rights and other supporting laws.
- Promote demand driven agricultural research through competitive grants system.

6. Supportive Policy Framework

6.1 Trade Policy

Experience has shown that supportive economic policies played a key role in rapid, export oriented growth in Asia. In this regard, an outward oriented trade policy, competitive exchange rate policy and policies for ensuring macroeconomic stability were the most important. This section examines Pakistan's experience with policies in these areas and discusses reforms and adjustments needed to promote competitiveness and growth.

6.1.1 Introduction

Trade policy reforms in Pakistan have sought to reverse the strongly protectionist, inward-oriented import substitution policies of the previous decades. In particular, the Government of Pakistan embarked on a substantial trade liberalization program in 1998, with a view to enhance domestic competition; improve trade integration with an increasing emphasis on export diversification and outward-orientation; and gradual alignment of domestic relative prices of traded goods with international prices. Improvements in the trade policy regime have been realized through tariff cuts and rationalization, as well as through the removal of import quotas, import surcharges, and regulatory duties. The control of State enterprises on imports and exports of certain products was also eliminated.

While, there has been substantial trade liberalization in Pakistan since 1998 (the un-weighted i.e. simple average statutory tariff has fallen from 47.1 percent in 1997/98 to 14.4 percent in 2005/06¹⁶), it is nevertheless important to emphasize that there has been an increase in tariff dispersion¹⁷. Tariff dispersion increased from about 45 percent of the simple average tariff in 1997/98 to over 76 percent in 2005/06¹⁸. The main reason for this increase is that lower tariffs have been cut by a greater proportion than higher tariffs. Items like cars and motorbikes are still subject to tariff rates two-to-three times higher than normal maximum customs duty rate. In implementing the reforms, the government has been following the principle of tariff escalation by stages of production which has aggravated the problem of tariff dispersion. Consequently final consumer goods continue to be protected at relatively higher nominal protection rates and that effective protection rates (EPRs) are probably even more skewed in favor of domestic production of final consumer goods.

As a result, the trade regime continues to have significant anti-export bias. The ratio of (average) effective exchange rate for imports (EERm)¹⁹ to that of exports (EERx) is one measure of this - the higher the ratio

¹⁶ Growth and Export Competitiveness, World Bank Study (2006)

¹⁷ As measured by the coefficient of variation, which expresses tariff dispersion as a percent of the average tariff (i.e. standard deviation as a percent of the mean).

¹⁸ Growth and Export Competitiveness, World Bank Study (2006)

¹⁹ In the current context, EERs for imports refer to nominal exchange rates adjusted for (protective) import levies and any scarcity premium that exchange controls may generate. As such, the EERm indicates the domestic currency cost of one unit of foreign currency (US\$, in this case) worth of imports. For exports, EERx represents the exchange rate after adjustment for the existing export promotion schemes, such as subsidized export credits and freight subsidy. Thus, EERx represents domestic currency equivalent of proceeds from exports worth one unit of foreign currency.

above one, the higher the bias against exports²⁰. According to this measure, Pakistan's average anti-export bias has reduced from 37-44 percentage points during the 1990s to about 18-19 percent between 2003 to 2005. (Table 9) It can be concluded that with the average bias remaining just below 20 percent, the structure of incentives created by the trade policy still favors the production of import substitutes. It also constitutes a significant barrier to the emergence of new areas of exports and to the expansion of exports that are being compensated effectively for the duties/taxes paid on imported and domestically acquired inputs.

Table: 9 Estimates of Anti-Export Bias Based on the ratio of effective exchange rates for imports and exports

Fiscal Year	Average Total Nominal Protection Rate (%)	Average Total Nominal Export Subsidy Rate (%)	Nominal Exchange Rate (Rs.US\$)	EERm	EERx	Anti-Export Bias (EERm/EE Rx)
03-04	18.9	0.09	57.50	68.37	57.55	1.19
04-05	18.5	0.08	59.29	70.26	59.34	1.18

Prolonged tariff escalation is harmful to efficient resource allocation and to the development of competitive and dynamic production patterns with an expanding export base. An escalating tariff structure, with the resulting high EPRs for finished/ final products, encourages low value-added pattern of production in the economy, while discouraging the development of efficient backward linkage production. This limits the potential increase in value-added through economically efficient deepening in the economy. In addition, the extremely high protection provided to specific manufacturing sectors, such as motor vehicles, may slow down the development of efficient and competitive industries. An escalating tariff structure also aggravates anti-export bias of the trade regime. Further, tariff escalating regime is quite susceptible to rent seeking activities.

Imports are subject to Pakistan's VAT like generalized sales tax and the income withholding tax. Also a limited number of imports are subject to the Central Excise tax. Since tax evasion maybe easier on domestic production than imports, actual EPRs are enhanced further. Also, despite the efforts in recent years to reduce the large number of tariff exemptions and concessionary rates, which are managed through the issuance of Statutory Regulatory Orders (SROs), Pakistan's tariff system still has considerable tariff exemptions and concessions. Some of the concessionary rates have been linked to the deletion programs in the auto industry and others are end-user exemption or concessions on imports of raw materials, machinery and equipment, and in some cases on imports of final goods. There are even examples of tariff exemptions granted to specific companies. Such a glut of tariff exemptions and concessions complicates the tariff system significantly, making it very difficult to trace the likely changes in effective protection rates and also creating an element of uncertainty as to the principal direction of the ongoing tariff reforms. Furthermore, the existence of such an option keeps the trade policy regime vulnerable to the interest group pressures and rent seeking.

²⁰ If the ratio EERm/EERx is unity, this would imply that the trade regime is, on average, neutral towards imports substituting production and export production and exporting.

6.1.2 Trade Policy Framework 2009-12

Trade Policy Framework (2009-12) is the most recent initiative undertaken by the government to overcome weaknesses of the past as well as to provide a way forward for the future.

The main thrust of the Trade Policy Framework 2009-12 is on the following areas:

- Preparation of a rational tariff policy and structure with short and long term tariff measures aimed at making the industry competitive.
- Re-design of export refinancing scheme and sectoral credit allocation parameters, while focusing more on high value sectors, more sophisticated export products and non-traditional items.
- Adoption of an exchange rate policy to promote exports and manage imports.
- Measures to promote procedural efficiencies and trade facilitation, including effective implementation of National Transport and Trade Facilitation Strategy and other reform efforts aimed at trade facilitation to improve the ranking of Pakistan in the global competitiveness index.
- Revamping the business processes in line with international best practices in order to enhance productivity and improve competitiveness.
- Upgrading local industry's capacity to integrate into the global supply chain and increasing the capacity of Pakistani firms for technology absorption, technology development and innovation creation.

In line with previous policies, trade policy 2009-12 reiterates the need for developing coherent, comprehensive initiatives to realize the objectives of product and market diversification. Some specific sectors which will receive policy and development support during the next three years include: textiles and clothing, leather, chemicals, pharmaceuticals, meat and meat products, agro-processing and dairy, minerals, light engineering goods and machinery, gemstone and jewelry, and services. The policy also proposes continuation of cluster development programs to increase the share of non-traditional products in Pakistan's exports.

To improve the policy and regulatory environment for doing business, the policy focuses on improving the quality of governance and management structures for enhancing export competitiveness. The initiatives planned under this head include: enhancing institutional efficiencies and coordination arrangements; financing export competitiveness development; reorienting relationship between government and industry; and setting up of an export target for the future. Other supply side constraints that the policy also intends to overcome include rising cost of capital, electricity shortages, and increasing cost of doing business due to deteriorating law and order situation.

Finally for increased market access, Trade Policy Framework 2009-12 emphasizes the opportunities offered by the Regional Trade Agreements such as SAFTA and ECOTA. Moreover, it aims to negotiate with US and ASEAN, European and GCC countries to fully tap the huge potential offered by these markets.

6.1.3 Recommendations

It is recommended that, the trade regime's anti-export bias be reduced with the objective of promoting export diversification and boosting export competitiveness. To that end, steps such as continually reducing the general maximum customs duty (CD) rate, eliminating existing tariff exemptions and concessions on highly protected sectors as well as changing the nature of tariffs – from specific to ad valorem on certain products such as edible oils is recommended.

6.2 Exchange Rate Policy

Pakistan's export performance has been poor relative to East Asian Economies such as Korea (see table 10-A). Starting forty years ago from a per capita income that was about two-thirds of the Korean level and exports that were more than four times Korea's, by 2007, Pakistan's per capita income and exports were only about 4 percent of Korea. From 1960-2007 while real GDP growth in Korea was 8.3 percent, in Pakistan it was only 5.5 percent per annum. One of the most important and consistent export policy tool used by East Asian economies to achieve such tremendous export performance is the exchange rate. The main objective of exchange rate policy in these export-driven economies has been to maintain the real value of the currency near the level needed for achieving a balance on the current account. This meant sharp devaluations from time to time, coupled with fine-tuning adjustments. The result was an overall incentive regime that did not penalize exports and provided substantial incentive to exporters²¹.

Table: 10-A Pakistan's Patchy Economic Performance relative to the East Asian Success

	Per capita Income(US\$)		Exports(US\$)	
	1960	2007	1960	2007
Pakistan	85	790	220m	16bn
Korea	130	18,500	50m	372bn
China	105	1,597	-	1217bn
Malaysia	784	4,535	1.1b*	176bn
Thailand	317	2,600	458m**	131bn

*1962 **1964

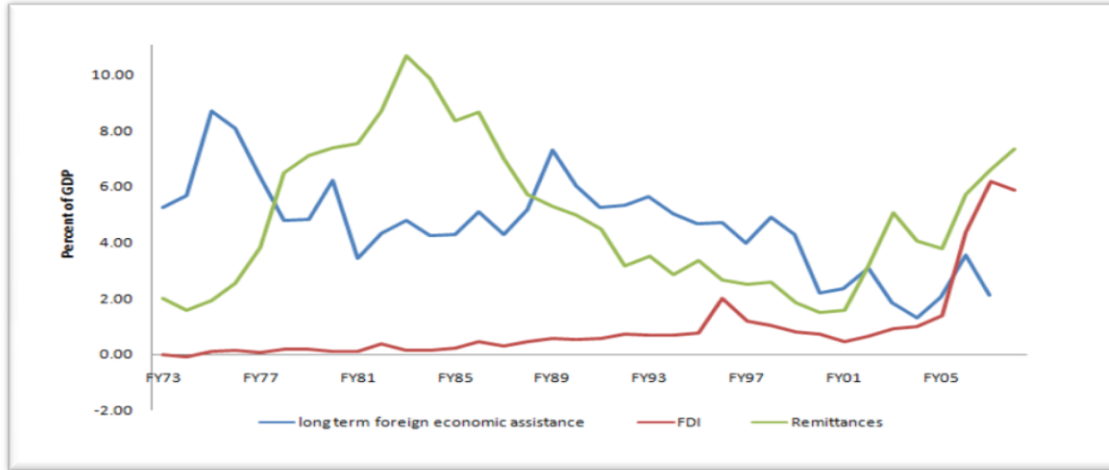
Historically, Pakistan's experience with exchange rate policy has not been encouraging from the perspective of ensuring export competitiveness. For long periods, the country maintained an overvalued exchange rate; which encouraged imports rather than exports²². In addition to affecting a country's macroeconomic stability, an overvalued exchange rate impacts the size of a country's tradable sector. Dutch Disease predicts that a large influx of capital flows is likely to cause a real exchange rate appreciation (spending effect) as well as bias production against the tradable sector (resource movement effect). Both effects adversely impact competitiveness of a country's tradable sector.

Persistent overvaluation of the currency can be attributed to large external inflows. In particular, in Pakistan large inflows of remittances and foreign assistance have been responsible for overvaluation of the exchange rate. Remittances have ranged from an average of 7.1% of GDP in the 1980s to 4.5% in the 1990s and around 6.5% over 2000 to 2008 (Figure 6). Likewise a generous amount of foreign assistance has poured in owing to fortuous events such as the Cold war in 1960s, the Afghan war in the 1980s and the war against terror since 2001.

²¹ Ikram (2009)

²² Ahmad 2009

Figure: 6 External Flows Over Time (1973-2008)



Source: Ahmad (2009)

Since overvaluation damages competitiveness by artificially altering the price ratio between tradable and non-tradable commodities, a medium term strategy for enhancing export performance must include an exchange rate policy that targets competitiveness of the country's tradable sector. The East Asian experience provides important lessons for formulating a competitive exchange rate policy [Table 10-B]. These countries have consistently maintained a positive balance on goods and services (except Thailand which had a small deficit) and have received only a small amount of net current transfers over the past three decades. The effect on exchange rate has been sterilized by channeling the surpluses towards building foreign exchange reserves. The case of Pakistan presents a contrasting picture with a large negative balance coupled with an approximately equivalent amount of net current transfers (i.e. largely remittances).

Table 10-B: Trade Balance, Transfers and Reserves – Pakistan and Lessons from East Asia: 1975-2005 (average)

(percent of GDP)

Country	Balance on Goods & Services	Net Current Transfers	Net Foreign Direct Investment	Official Development Assistance	Increase in Reserves
Singapore	7.3	-1.1	6.7	0.1	7.9
Malaysia	7.5	-0.8	3.6	0.4	3.6
Indonesia*	2.9	0.6	0.4	1.1	0.5
China**	1.6	0.4	2.4	0.3	3.1
South Korea	0.5	0.5	0.04	0.1	1.8
Thailand	-1.3	0.5	1.8	0.7	1.5
Pakistan	-8.2	7.8	0.6	2.6	0.5

Source: World Development Indicators 2008

*Data available from 1981

**Data available from 1982

If Pakistan is to achieve international competitiveness the following is recommended:

- Follow an exchange rate policy with the specific goal of achieving a zero balance on goods and services. This will require first correcting the overvaluation in the exchange rate. On average real exchange rate overvaluation has been equal to approximately 21 percent over FY07-09. In addition, to avoid the anti-export bias, real exchange rate must be sterilized against the appreciating effects of remittances, which were approximately 5% of GDP in FY09. Given that the elasticity of the exchange rate with respect to remittances is 2.4%, this implies a correction of approximately 12%²³. Therefore, from an export oriented point of view real exchange rate is currently overvalued by approximately 33%. Therefore, it is recommended that a medium term competitive exchange rate policy should aim for an average depreciation of the real exchange rate by 6% per annum over the next 5 years.
- Owing to Pakistan's position as a front-line state in the war against terror, a generous amount of foreign economic assistance is likely to continue in the future (long term foreign economic assistance increased from \$ 2.2 billion to \$3.8 billion from FY 08 to FY 09). Moreover the ongoing global recession has substantially increased the amount of earnings remitted home by expatriates²⁴. Avoiding appreciating affects of external inflows will be crucial for maintaining future export competitiveness. Therefore it is recommended that the exchange rate is sterilized against external flows by directing them towards building reserves in order to provide a cushion for easing out future fiscal or balance of payment strains.

6.3 Macroeconomic Stability

Macroeconomic instability makes the domestic economic environment less predictable, increases risk and uncertainty, thereby hampering resource allocation decisions, investment and growth. It is widely argued in the literature that macroeconomic instability adversely affects the rates of productivity growth and investment mainly by creating uncertainty about current and future macroeconomic environment²⁵.

Historically, Pakistan has suffered from two main sources of competitive disadvantage. The first is the country's repeated episodes of macroeconomic instability while the second is a low rate of national savings. Macroeconomic instability is defined as a rise in one or more policy-affected indicators, such as the inflation-rate, overall deficit to GDP ratio and external debt to GDP ratios²⁶. Over the past two decades Pakistan has suffered from all these symptoms of macroeconomic instability. According to the Global Competitiveness Report (2009-10), Pakistan ranks at 114 in terms of macroeconomic stability compared to India (96), Bangladesh (84), Malaysia (42), Korea (11) and China (8).

The second factor undermining growth and competitiveness in Pakistan is the country's low national savings rate which is the underlying cause of low investment rates and bop current deficits. Pakistan's national savings rate is significantly lower than other developing countries [Table 11]. The primary reason

²³ Ahmad (2009) argues that real exchange rate has remained overvalued for the most part over the sample period which ranges from 1972 to 2009. Estimation results suggest that there has been an increasing trend in real exchange rate overvaluation averaging at approximately 21 percent between FY07-FY09.

²⁴ Remittance inflows have been consistently increasing from \$ 4.6 billion (FY06) to \$ 5.5 billion (FY07) to \$6.5 billion (FY08) to \$ 7.8 billion in FY09. As percentage of GDP, these numbers stand at 3.6% (FY06), 3.8% (FY07), 3.9% (FY08) and 4.7% in (FY 09)

²⁵ Fischer (1993) and Bleaney (1996)

²⁶ Fischer (1993)

for low national savings is a low rate of government savings on account of the country's small tax to GDP ratio – which is barely 10% compared with close to 18% in the case of India, China 18.3%, Indonesia 12.4%, Malaysia 14.8% and Thailand 15.3% (Table 12) and in excess of 32% in the case of OECD countries. Three main reasons can be identified for this low ratio; a) the inelasticity of the tax structure; b) the horizontal inequity of the tax system – implying that it either does not extend to certain sectors like wholesale and retail for GST and agriculture for income tax or gives preferential treatment to some sectors and activities (for instance taxing the rich and partnerships lightly); and c) poor collection efficiency of the administrative system.

Table: 11 Pakistan and Comparator Countries – Investment and Savings Rate as % of GDP (2007)

	Pakistan	India	China	Indonesia	Malaysia	Thailand
Investment	23.0	38.2	32.4	24.9	23.1	29.9
Domestic Savings	16.0	35.1	50.0	28.9	37.1	33.4
National Savings	17.8	37.2	54.5	26.1	36.2	32.0

Table 12: Tax Revenue (as % of GDP) 2007

Pakistan	China	Indonesia	Malaysia	Thailand
10.2	18.3	12.4	14.8	16.9 ¹

¹For 2006.

While in the short term, foreign borrowings may be used to supplement the low rate of national savings in order to finance investment, in the long run, there is a limit to it and persistent borrowing will result in a buildup of debt. The result would be a deterioration of the country's external position leading to macroeconomic instability. Therefore a strategy for ensuring sustainable levels of competitiveness in the future must entail an increase in national savings rate.

As stated above, an important reason for the low national savings rate is the negligible contribution of public sector saving, which in turn is the result of Pakistan's low tax-to-GDP ratio. Thus the key to achieving macroeconomic stability may be in improving government's tax mobilization efforts

7. Enhancing Export Competitiveness: Issues and Recommendations

7.1 Skills Development

7.1.1 Introduction

Until the 1990s, the private sector had neglected the skill gap, because production technology tended to be rather simple and competition limited as industry was heavily protected. However, with the opening up of the economy and the induction of modern technology the nature and level of the skills required is rapidly changing. With the production structures slowly moving out of the intermediate to the higher range of value added products, there is greater demand for both standardized and higher level skills. Unfortunately Pakistan's experience with skill development and improvements in total factor productivity have not been encouraging..

In terms of skill development Pakistan's performance has been low relative to other developing countries. A comparison of productivity measures with few regional economies indicates that Pakistan's estimated manufacturing value-added (MVA) per capita is lower than Thailand, Philippines, Sri Lanka, India and China. During the period 1990-2006 (period of trade liberalization), overall labor productivity in Pakistan grew by a modest 1.29 percent (Table 14). This is quite low as compared with labor productivity growth of other developing countries like India, Sri Lanka, Bangladesh, Malaysia, Indonesia, Singapore, Thailand, China and Korea. The labor productivity growth of the manufacturing sector of Pakistan during the same period was 2.08 per cent, which is higher than that of Sri Lanka and India, but lower than that of other countries in the selected sample. During the nineties, TFP growth in the manufacturing sector was only 1.64 percent, due to low and falling levels of investment.²⁷

Strong growth in productivity is essential for sustaining the competitiveness for the industries in which the country has comparative advantage and for attaining the comparative advantage where the productivity levels are low relative to competitor countries. Given that Pakistan's young labor force is expected to grow at 3% per annum in the foreseeable future, an effective policy towards skill development will also enable the country to reap the potential of the demographic dividend.

Table 14: Annual Average Labour Productivity growth (1990-2006)

	Bangladesh	India	Indonesia	Korea	Malaysia	Pakistan	Singapore	Sri Lanka	Thailand	China
Overall	2.92	3.38	2.99	3.93	2.69	1.29	3.34	2.84	3.61	9.07
Manufacturing	4.05	-1.1	3.09	8.76	5.11	2.08	5.29	1.74	2.6	11.97

Source: Asian Productivity Organization (2009)

7.1.2 Recommendations

It is proposed that Pakistan develop a vision and strategy for skill development which aims to significantly reduce the country's skill deficit in the next 5 years (**see box 2**). To implement the strategy, it is recommended that skill development initiatives should be undertaken through public-private partnerships. In working out a modality for such initiatives, the government should consider both supply-side interventions such as technical training grants to institutions (managed by either the public or the private

²⁷ Total factor Productivity Growth in Pakistan: An Analysis of the Agricultural and Manufacturing Sector - Azam (2009)

sectors) that meet eligibility criteria for such support - of particular importance in such an intervention would be a transparent and competitive bidding process for access to funding - and demand side interventions in the form of training vouchers to those seeking technical training in disciplines of their choice.

Box: 2

Skill Development Program – A vision for the Tenth Five Year People’s Plan

If Pakistan is successful in getting the skill development program right, the country will be able to harness the demographic dividend. The aim of such a program should be to provide within the next five years a pool of trained and skilled workforce. Some specific recommendations for achieving this are as follows:

- Create an adequate pool of skilled personnel in line with the requirements of export sector industries with particular emphasis on the sectors identified in section 2.
- Assess the skill deficits sector wise and develop programs to meet the gaps through a concerted effort.
- Skill training should be such that supply side responses are in line with the demand side impulses emanating from the market.
- Pro-active private sector involvement facilitated through public sector incentives for management and running of skill development initiatives.
- Finally, there should be emphasis on skill development of new entrants in the labor force.

Furthermore the type of skills imparted through such initiatives should be customized according to education levels. For instance, unskilled workers or those with elementary education should be trained in basic, practical skills like, while workers with secondary level schooling or more should be provided with a wider variety of well-structured and effective technical and vocational training. Such training should be driven by market-demand.

Imparting skills is crucial indeed but it is equally important that the Government ensures the quality of these skills. To that end, it is recommended that a system of international certification be adopted. In a globalized world only those skills will have market value, and are likely to be sought by the private sector, that have been certified by an internationally recognized organization. Only a credible certification system will have acceptance and ensure quality and relevance of training. Such an approach will ensure employability to graduates of skill training programmes in line with emerging market needs, and strengthen their capability to earn a higher and steady stream of earnings in markets in Pakistan or abroad.

7.2 Reducing the Cost of Doing Business

7.2.1 Introduction

In Pakistan, the high cost of doing business is largely the consequence of two specific factors namely – an unfavorable policy environment for doing business and a weak physical infrastructure. The former entails policy-specific issues, as well as cumbersome requirements for complying with a wide range of government rules and regulations within the control of either the Federal or the provincial government. To compensate export industries for the high costs of doing business a number of measures were undertaken during the period 2002-03 to 2007-08 (see box 3)

Box: 3***Existing Government Initiatives for promoting exports***

The Government announced and implemented the following important initiatives aimed at reducing the cost of doing business for export industries

- Provide concessionary long-term project finance to export oriented enterprises for import of machinery for various projects.
- Share 50% of the cost for relocation of export oriented industry to Pakistan. This includes Freight expenditure, Machinery/equipment transfer cost, wharfage and handling costs, inland transport, offloading, insurance, and agency charges.
- Provides 25% freight subsidy for designated products and countries to share some of the burden with exporters.
- Subsidy @ 25% of inland freight was allowed, provided the factories were located beyond 250 km from exporting sea ports, to encourage export of finished products of furniture, granite and marble from far flung areas of Pakistan.
- The Sales tax regime has been eliminated for the entire Textile Chain, and for Leather products, Surgical Goods, Carpets, and Sports Goods.
- The priority export sectors were facilitated by zero-rating duty on their machinery and raw materials.
- Introduced a special Textile/garments package in the shape of Research and Development (R&D) Support at 6%. Leather footwear was also provided R&D support at 6%.

7.2.2 Business Environment**7.2.2.1 Issues**

Some specific factors related to an unfavorable environment which increase the cost of doing business in Pakistan are as follows:

Government's Short Sightedness, Uncertainty and Policy Unpredictability: Private sector investment projects usually require a long term focus. Unfortunately, the government's short sightedness in policy-making and the subsequent unpredictability of future outcomes has made the country's investment climate highly uncertain. This discourages innovation and entrepreneurial risk-taking by the private sector and leads to non-optimal allocation of resources.

A Nuisance Tax Structure for Businesses: The inefficient provincial and local tax structures also raise the cost of production. The same tax base is subjected to multiple taxes by different tiers of the government. For example GST is levied by the federal government, professional tax by the provincial government, and a professional fee by local governments on a wide array of businesses.

Labour Levies: In addition to the problem of a nuisance tax structure, private businesses are also required to contribute towards monetary and non-monetary benefits of workers according to different legislations, enacted both federally and provincially. Some examples of such payments include compulsory salary

bonuses, Group Insurance, Workers welfare Fund, Social Security, Provident Fund, etc. According to some estimates, such contributions towards monetary and non-monetary benefits add an additional 25% to the wage bill. These payments act as taxes – some on profits and others on the payroll – hence increasing the cost of doing business by a substantial amount, while the benefit actually received by the workers are relatively small. Furthermore, they deter formalized employment and de-motivate small employers from expanding their scale of production.

Weak contract enforcement: The legal and judicial system provides weak contract enforcement with lengthy delays and high litigation costs. Also there is prevalence of a trust deficit in the industry. Consequently businesses – especially small and medium enterprises prefer to deal with only a handful of trusted buyers and suppliers which in turn leads to inefficiencies such as market segmentation, raising the cost of organizing large scale production and discouraging business development. In Pakistan, in case of default, it takes on average 3 years and costs 24% of claim, which is better than other South Asian countries (India – 4 years) but much worse than East Asian countries like Thailand where it just takes over a year to resolve claims at only 12.3% of the cost of the claim.

7.2.2.2 Recommendations

It is recommended that administrative regulations should be rationalized. To this end, the degree of regulation should be reduced, a multiple tax structure should be corrected and the accountability of public functionaries should be strengthened. This will not only reduce the cost of doing business but will also help in curbing opportunities for rent seeking by political and bureaucratic functionaries and the potential for arbitrary exercise of discretionary powers.

Equally important is an improvement in legal systems. Businesses need a timely, efficient and effective system for the administration of justice, which requires judges who are better qualified, suitably educated and skilled in commercial matters-corporate, banking and tax laws and appropriately trained to implement clearly drafted procedures and rules on imposition of costs for wasting the time of courts and for effective case management. Businesses should take recourse to courts only as a last resort but this requires feasible options like Alternative Dispute Resolution. Presently, however, the law pertaining to arbitration is basically defective as decisions by arbitrators are not binding and can be reversed in courts. Hence, there is need for improving the availability of and access to, such options.

Delays in tax-related refunds and customs duty drawbacks are major issues undermining the competitiveness of Pakistan's export sector. It is proposed that a transparent, rule-based tax refund system should be implemented. One possible strategy is to make interest payments at market rates mandatory on delayed refunds. Such a system would ensure that compliant exporters have access to a fast track system whereby non-compliant exporters face the risk of stringent assessments which would eventually create incentives for compliance.

7.2.3 Infrastructure

Poor physical infrastructure has been a major factor hampering the competitiveness of Pakistan's export sector. Whereas the lack of repair and maintenance has resulted in the deterioration of physical infrastructure, and inefficiencies in the public sector utilities have contributed to high cost of production, thus eroding the competitiveness of domestic manufacturers.

7.2.3.1 Sector Specific Issues

Power Supply: Despite efforts to encourage efficient utilization of energy resources, the technical, financial, and operational efficiency of the power sector has continued to deteriorate resulting in costly yet unreliable power supply According to a survey conducted by the World Bank "Improving the Investment Climate in

Pakistan", a majority of the respondents identified the problems of power supply as a major obstacle to business expansion. It is estimated that a typical business in Pakistan on average loses 5.6% percent of annual output due to power outages as compared with less than 2% for the average plant in China. Given the high frequency of outages since the last two years these losses have increased considerably. According to one estimate the cost of outages owing to the acute shortage of power was approximately 9% of value added in the industrial sector, representing a 7% loss in industrial output²⁸. It is difficult for a country to develop at a rapid pace with the estimated power shortage of 6,000 megawatts by 2010²⁹.

Telecommunication Services: Though the government has strived to upgrade the quality of telecommunication services, access to these services is still far from satisfactory. According to a study conducted by the World Bank, the average waiting period for a business to get a fixed-line connection is 6 to 7 weeks in Pakistan, which is more than 3 times than the waiting period experienced by businesses in China. In addition, the cost of fixed-line connection is six times that in Malaysia and four times that in India. Consequently, the utilization of information and communication technology is very low in Pakistani industry especially the small-scale industry: similarly, only one in three businesses normally interact with their customers or suppliers via the internet. It appears, therefore, that most Pakistani businesses have thus far been unable to take advantage of productivity gains through the use of information and communications technology. Furthermore, the availability is limited -the Enabling Index (2009) ranks Pakistan at number 88 or worse in comparison to 121 other countries in various dimensions of the availability and use of ICTs such as number of telephone lines, mobile and internet users.

Transport: The poor quality of transportation network continues to be a major problem faced by the Pakistani industry. Lack of repair and maintenance of the existing roads have resulted in the rapid deterioration of the road network. It is also estimated that 70% of the national road network is in "fair to poor" condition, whereas 90% of the provincial network in Punjab is rated as "fair to poor". Poor road conditions not only lead to delays but also result in excessive wear and tear of transport vehicles contributing to high transportation costs. The rail network is also riddled with inefficiencies. The unsatisfactory state of the transportation network has imposed enormous costs on the economy. The World Bank estimates that transport sector inefficiencies cost the economy 4% to 5% of GDP annually. (Also see section on trade facilitation).

7.2.3.2 Recommendations

Investments in economic infrastructure and better management and maintenance of existing assets are critical. However, given the severe resource constraints, it is recommended that the export sector be given priority in allocation of existing capacity (power and gas) and with regards to infrastructure investment decisions. For example, infrastructure investments, in the first instance, should be targeted at industrial estates and export concentrations /clusters such as Sialkot.

7.3 Trade Facilitation

The Global Enabling Trade Index (2009) measures the factors, policies and services facilitating the free flow of goods over borders and to destinations. The index is comprised of four broad areas: (1) market access, (2) border administration, (3) transport and communications infrastructure and (4) the business environment. Pakistan has been ranked at 100 among the 121 countries studied for the report, highlighting

²⁸ State of the Economy: Emerging from the Crisis, Second Annual Report, 2009, Institute of Public Policy, Beaconhouse National University, Lahore.

²⁹ Pakistan Infrastructure Capacity Assessment, World Bank, Report no.41630-Pak, November, 2007.

the dismal performance of the government at creating conducive environment for exports. The following sections aims to as a first step identify the problems faced in areas (2) and (3) and then suggest targeted steps for improving the situation in the medium term.

7.3.1 Border Administration

Compared to more efficient countries, such as India, Malaysia and Thailand, Pakistan, on average, requires up to 100% more documents and 70% more days to export anything (see table 15). The inefficiency of export procedures in terms of the time taken and documents required is an indicator of the government attitude towards exports in general. There is a need to adopt modern, simplified and transparent export procedures. Cumbersome procedures for exporting goods have developed over the years primarily in order to check under invoicing during the days of the overvalued Rupee. Today with the foreign exchange constraint having eased and there being a negligible premium on the official exchange rate, there is no need for the existing complicated and time consuming procedures. Unlike other measures suggested for trade facilitation, this proposed deregulation of export procedures puts no strain on the limited resources of the government and will also not result in any loss of revenue for it. A computerized system needs to be developed to make the export clearance procedures efficient, lowering the number of days it takes to export and the number of documents that are required.

Table: 15 Variables indicating the efficiency of export procedures

Country	Documents to export (number)	Time to export (days)
Pakistan	9	24
India	8	17
China	7	21
Malaysia	7	18
Thailand	4	14

Source: The Global Enabling Trade Report 2009, World Economic Forum.

7.3.2 Logistics

The Logistics Performance Index (LPI) ranks Pakistan 68 out of 150 countries. The 90th rank of Pakistan in domestic logistic costs and 88th rank in timeliness highlight the areas of weakness in the system.

- Challenges facing the local logistics industry include developing an efficient less-than-truck- load and less-than-container-load supply chains to serve the Small and Medium Enterprises and to offer an integrated supply-chain management service with real-time cargo monitoring and internet based transactions. This will require changes in customs procedures
- Movement of goods from production centers to ports by road and rail should be made quicker and hassle-free.

- In Pakistan rail freight is more expensive and less efficient than road and therefore caters to less than 10% of the cargo movement in the country. Creating an efficient rail-freight service requires granting a concession to a private operator through competitive bidding. Such a concessionaire could carry the responsibility of managing goods terminals so that future shippers can count on an efficient door-to-door service which is presently unavailable.
- Speedy development of road infrastructure as part of the National Trade Corridor Improvement Program. This program (part of vision 2030) aims to link Pakistan to potential trade and transport corridors in the region.
- Air freight is particularly important for non-traditional exports such as fish, horticulture and floriculture. Investment in handling and cold storage facilities would benefit exports of such products. Incentives from government to facilitate and stimulate private sector investment in cold storages at the airports and the sea ports will facilitate exports of these agro products.
- Suitable and reciprocal land transit trade rules must be developed in close coordination with regional economies.

7.4 Business Support Initiatives

Encouraging the growth of export oriented clusters and facilitating the establishment of business support centres and common facilities to exploit the export potential of medium and small exporters.

Export Oriented Clusters: According to the Global Competitiveness Report 2009-10, there has been significant cluster development across many sectors of the economy. The most prominent is the surgical instruments cluster in Sialkot. Other examples include marble and granite, gems and jewellery, leather, horticulture, dairy, furniture and textiles clusters. Cluster development has improved access to technology and has facilitated business activity. There is a need to make this one of the corner stones of the strategy. This would require supporting the development of business support centres and common facility centres and providing seed money for selected export oriented activities.

Business Support Centres: which provide consultancy, design, human resource development and information services to the export sector.

Common Facility Clusters: It is proposed that as a first step the government should identify deficiencies that are faced by specific export sectors. For example rice manufacturers don't have access to a DNA testing facility. Similarly basic facilities pertaining to heat treatment, precision and material testing are not available to small and medium enterprises and to the engineering sector. Once the deficit has been identified, public provision of these facilities should be matched with industry specific clusters to facilitate access which would in turn enhance the competitive advantage of Pakistani exports. **Box 4** provides information on some existing and proposed common facility centres and business support initiatives in specific sectors as an illustration of the broad range of support centres that are possible.

Box: 4 Existing and Proposed Business Support Initiatives

1	Cutlery Institute of Pakistan Wazirabad CFC for cutlery skill development, design and business advisory services	The Cutlery Institute of Pakistan has been in operation since the last 10 years and with the support of TDAP and SMEDA it is providing facilities in areas like skill development, mechanical engineering, product designing and prototyping, and business advisory to the cutlery sector.
2	OCTANe Solutions - Training & Service Center of Simulation Design	Two CNC machines will be installed to cater to the major cluster of foundries. This facility would reduce the time of machining hence produce a new improved quality product.
3	Automotive Simulation Design Training & Service Centre	Automotive Simulation Design Training & Service Centre introduces state-of-the-art CNC machines for quality and productive gains in foundry parts machining for automotive industry.
4	Solar Kilns for Leading Clusters of Furniture Sector	The proposal is to implement 5 solar kilns in key geographic areas for the furniture industry. This project adds an indispensable component to allow the Pakistani furniture industry to increase its export volumes by utilizing properly seasoned wood.
5	Common Facility for Marble Processing & Training Centre	The proposal is to establish a marble-processing unit with modern machinery located in Mohmand Agency, FATA, for cutting the rough marble into commercial slabs. The main objective of this project is to enable the cluster industries to move up the value chain.
6	Common laboratory for Drug Formulation	The laboratory would be serving pharmaceutical units for drug testing and quality control compliance to current good manufacturing practices.
7	Gems Processing Centre	The project will introduce scientific lapidary skills and mining technologies in the target area by training over 1000 existing and potential miners.
8	Computer Pattern Designing in Sialkot	This CFC has facilitated 300 SMEs to get their patterns developed, 122 participants trained and 28 are under training.
9	Light Engineering Sector in Gujranwala	The center has provided testing services to 206 SMEs and 130 students have completed Auto Cad training.

10	Gujranwala Tools, Dies and Moulds Center	This new center, opened with government support in January 2010, will aim to provide facilities like metal dies, moulds, heat treatment and surface finishing to the local industry. Moreover, the center will also provide services like mould design, technical assistance and training of new technologies.
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Seed Money Under the WTO regime R&D support is the only permissible subsidy. Given the fiscal constraints, it is proposed that instead of giving R&D support to all exporters, the government intervention be targeted to industries that have the highest export growth potential (identified in section 2). The government may explore different alternatives such as allocating more R&D funds to specific industries and/or help them by providing funds for marketing initiatives (discussed below).

7.5 Market Development Initiatives

Image Building and export facilitation through Off-shore Expo - Centers: Since 2001, because of terrorism and the ongoing war in Afghanistan, Pakistan’s international image has suffered. In addition, because of travel advisories by various countries and terrorist incidents in major cities, international buyers are reluctant to come to Pakistan. These factors have adversely impacted Pakistan’s exports. To address these problems and facilitate Pakistan exporters its is recommended that off-shore regional expo - centers be set up in the Middle East, Europe, North America and East Asia. Such natural regional hubs are UAE in Middle East, Hong Kong in Far East and UK or Germany in Europe. These expo-centers should be designed to provide a “cost effective” way for Pakistani exporters and industry associations to open off-shore sales/liason offices, display their products and from time to time organize industry - specific exhibitions. The expo centers would also house government’s trade offices and would be a point of contact for importers in the region for information on Pakistani products, as well as for buyers’ complaints and other issues. These expo centers should be set up as a public-private partnership and physical setting up of the expo - centers and their management should be outsourced through a transparent, competitive process.

Large Diaspora: So far, no organized effort has been made to benefit from Pakistani Diaspora in market development. The Pakistani diaspora can be an important asset for export promotion, both as a market as well as in the marketing of Pakistani products. In many countries, Pakistani - origin entrepreneurs own/manage small shops to large national retail chains. These entrepreneurs need to be identified and targeted to help in the export promotion efforts in the country of residence. It is recommended that the government outsource preparation of such market development strategies for countries with large Pakistani diaspora.

8. Recommendations - Summary Matrix

ISSUES	POLICIES	INVESTMENTS
<p>1. Product and Market Diversification</p> <ul style="list-style-type: none"> • 15 products make up 90% of Pakistan's total exports • Market concentration no more than other countries • 58.5% of Pakistan's exports go to declining markets 	<p>Concentrate promotion efforts on</p> <ul style="list-style-type: none"> • The dynamic products (champions and underachievers, for details see pg. 14) • Other emerging sectors such as meat exports which are currently small but have exhibited tremendous growth lately <p>Do not waste resources on expanding to new markets, but concentrate on negotiating special arrangement with or market development initiatives in :</p> <ul style="list-style-type: none"> • Large declining markets: US and EU • Potentially large dynamic markets: India and China (for more details refer to pg.16) 	<p>Details of investments required to enhance exports along the products and markets identified here are given in points 2-8.</p> <ul style="list-style-type: none"> • Regional Expo Centers • Tapping the potential of Pakistani Diaspora (see point 8)
<p>2. Agro based exports</p> <ul style="list-style-type: none"> • In spite of a natural comparative advantage, the potential of agro-based exports to serve as an engine of growth has not been harnessed • Inability to comply with the Sanitary and Phytosanitary agreement of the WTO • Weak Marketing Infrastructure • Inconsistent government intervention • Not part of any global supply chain 	<ul style="list-style-type: none"> • Prudent and less Government intervention in marketing and in stabilizing prices and averting market failures • New Agricultural Marketing laws and regulations 	<ul style="list-style-type: none"> • Strengthen infrastructure (such as cold chains) through partnerships with the private sector • In partnership with private sector, set up quality testing/certification infrastructure to ensure compliance • Revitalize seed industry with focus on hybrid and GMO technology • Promote links with international supermarket chains like Metro
<p>3. Higher Technology Exports</p> <ul style="list-style-type: none"> • Low proportion of high/medium technology exports in total exports (9.5%) 	<ul style="list-style-type: none"> • Encourage and support partnership between firms and research institutions • Improve safeguards for 	<ul style="list-style-type: none"> • Development of specialized training centers • Increase R&D

<p>and stagnation in medium technology sector</p> <ul style="list-style-type: none"> • Specialized skills deficit and lack of customized infrastructure for production of high technology exports • Energy related issues (see point 2) • Lack of R&D initiatives: <ul style="list-style-type: none"> • Inadequate funding • Weak property rights 	<p>intellectual property rights to encourage private sector investment in R&D</p>	<p>support through cost sharing and provision of cheap credit</p> <ul style="list-style-type: none"> • Provision of common facilities tailored for high technology export clusters (see point 4)
<p>4. Skills Development</p> <ul style="list-style-type: none"> • Nature and level of skills required is rapidly changing – greater demand for both standardized and higher level skills. • Pakistan’s performance has been low relative to other countries. • Need to reduce skills deficit in next five years. 	<p>Adapt a Skill Development Strategy with the following salient features:</p> <ul style="list-style-type: none"> • Emphasize skill development of new entrants in the labor force. • Create adequate pool of skilled personnel in line with requirements of export oriented industries. • Supply side initiatives for skill development should be responsive to market demand. • Type of skills imparted should be customized according to education levels • Ensure quality of skills imparted by adopting internationally recognized certification systems. 	<ul style="list-style-type: none"> • Skill Development Initiatives should be taken up through public private partnerships – a major driver of which should be a skill development fund which would support: • Largely, supply side interventions – technical training grants to (public and private) institutions that meet eligibility criteria. • Demand Side interventions – Primarily training vouchers for those seeking technical training. • Quality Assurance Grants/subsidies for independent skill testing/certification institutions.
<p>5. Cost of doing business</p> <ul style="list-style-type: none"> • Unfavorable business environment <ol style="list-style-type: none"> i) Government’s Short Sightedness, Uncertainty and Policy Unpredictability ii) Nuisance Tax Structure 	<p>Business Environment</p> <ul style="list-style-type: none"> • Enhance policy predictability by providing legal cover, where possible, so as to make frequent changes in policy difficult. 	<ul style="list-style-type: none"> • Start a system of paying compensation for losses suffered by businesses because of changes in “policies with legal cover”.

<ul style="list-style-type: none"> iii) Numerous Labor Levies iv) Weak contract enforcement • Poor physical infrastructure <ul style="list-style-type: none"> i) Power supply ii) Telecommunication services iii) Transport 	<ul style="list-style-type: none"> • Administrative regulations dealing with business should be simplified and rationalized. • Improve judicial system dealing with commercial issues and increase availability of alternate dispute resolution (ADR) services • System for expeditious tax refunds and custom duty drawbacks <p>Infrastructure</p> <ul style="list-style-type: none"> • Priority in allocation of existing capacities of power and gas to the export oriented industries/clusters • Better management and maintenance of existing assets 	<ul style="list-style-type: none"> • Expansion in number of commercial courts and judges dealing with commercial cases • Establish ADR facilities with necessary staff in all large cities. • New infrastructure investments targeted at industrial estates and export clusters • Investments to improving marketing infrastructure such as cold chains for agro-based exports.
<p>6. Trade Facilitation</p> <ul style="list-style-type: none"> • Cumbersome export procedures – one of the worst performers in the world. • Inadequacies in the transport network – resulting in one of the highest domestic costs in the world. 	<ul style="list-style-type: none"> • Adopt modern, simplified, transparent and reliable export clearance procedures • Encourage private sector involvement in movement of cargo by rail more efficiently • Develop rules for transit trade (by land) in close coordination with regional economies/neighbors 	<ul style="list-style-type: none"> • Establish a computerized system to make export clearance system quick and painless • Set up a logistics improvement fund to support the development of efficient less than truck load and less than container load supply chains to serve small and medium enterprises. • Support development of integrated supply chain management services with real time cargo monitoring and internet based transactions • Support investment in cold storage and associated handling facilities for agro-based exports at air and sea ports and in temperature controlled wagons for railways.

<p>7. Business support initiatives</p> <ul style="list-style-type: none"> • Lack of business support services for small and medium exporters 		<ul style="list-style-type: none"> • Targeted subsidies/seed money for R&D for industries which have the greatest export potential. <p>Invest in development of:</p> <ul style="list-style-type: none"> • Export oriented clusters to facilitate business activity and ensure improved access to technology. • Business support centers to provide consultancy, design, human resource development, and information services. • Common facility centres for public provision of common facilities targeting industry specific clusters
<p>8. Market Development Initiatives</p> <ul style="list-style-type: none"> • Inadequate market access • Poor image • Weak linkages with international market networks 	<ul style="list-style-type: none"> • Use Pakistani diaspora as an asset for marketing country's exports 	<ul style="list-style-type: none"> • Develop off shore expo centers at regional hubs for market development, export facilitation and image building
<p>9. FTAs and Regional Trade</p> <ul style="list-style-type: none"> • Trade with neighbors accounts for only 17% of Pakistan's total exports • Potential of FTAs not fully exploited • Pakistan's access to developed markets, such as USA and EU, is much worse than most other developing countries. 	<p>Enhance trade with India through:</p> <ul style="list-style-type: none"> • Normalize trade relations by eliminating negative list and moving to trading on most favored nation(MFN) basis • Address problems related to information exchange, trade facilitation, banking, non-tariff barriers and visas. <p>Enhance trade with China by:</p> <ul style="list-style-type: none"> • Negotiating reductions in non-tariff barrier in sectors in which Pakistan has a comparative advantage (such as Food products) 	<ul style="list-style-type: none"> • Under FTAs build capacities in targeted areas (specifically high growth markets - see pp. 15-16) through technical cooperation and collaboration

	<ul style="list-style-type: none"> Promoting vertical specialisation which will allow benefits of economies of scale to be reaped by concentrating on a specific production process in the value-addition chain <p>Negotiate FTAs and special access arrangements (such as GSP [EU] or BITs [USA]) with selected countries only – criteria being (i) large market; (ii) dynamic market; or (iii) neighbor to:</p> <ul style="list-style-type: none"> Maximize market access by reducing tariff and non-tariff barriers. Further facilitate and promote trade and investment to enhance the comparative value of Pakistan’s exporters 	
<p>10.Supportive Policy Framework</p> <ul style="list-style-type: none"> Trade regime continues to have significant anti-export bias Persistent overvaluation of the exchange rate has undermined export competitiveness Pakistan’s repeated episodes of macroeconomic instability undermine export competitiveness 	<p>Trade Policy</p> <ul style="list-style-type: none"> Reduce tariff dispersion (which is among the largest in the world) by lowering the general maximum customs duty rate Eliminate existing tariff exemptions and concessions on highly protected sectors Change the nature of tariffs from specific to ad valorem, where applicable <p>Exchange Rate Policy</p> <ul style="list-style-type: none"> Follow an exchange rate policy in which the target exchange rate is one which would achieve “Zero Trade Balance” Aggressively accumulate foreign exchange reserves to serve as a cushion for 	

	<p>future balance of payment shocks</p> <p>Macroeconomic Stability</p> <ul style="list-style-type: none">• Number one goal should be to increase Pakistan's tax-to-GDP ratio to expand fiscal space and public sector savings to finance the needed infrastructure in support of export led growth	
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