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Pakistan: a tumultuous economy and divided politics

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Pakistan's economy remained sluggish in 2011 due to domestic political instability, energy shortages, deteriorating Pakistan-US relations, global climate change and internal security concerns.

For the fourth year in a row, GDP growth in 2011-12 will fall below its long-term growth rate. Per capita income will increase by around 2 per cent, in sharp contrast to the 5 per cent annual growth experienced during the 2002-07 period. The investment rate dropped to 13.4 per cent — its lowest level in the last four decades. Fiscal imbalances arising out of subsidies to loss-making public enterprises, low tax-mobilisation efforts, inefficiency and waste in public expenditure resulted in excessive borrowing from the banking system. And when the government decided to terminate its ongoing arrangements with the IMF, the flow of external resources for budgetary support was interrupted. The shortfalls in financing were made up by additional borrowing from the domestic banking system.

Pakistan's fiscal deficit rose to around 7 per cent of GDP, and the tax-to-GDP ratio declined further to below 9 per cent. New inter-governmental fiscal arrangements that favour provincial governments in the allocation of the country's divisible tax pool further exacerbated Pakistan's fiscal situation. Although growing expenditure on defence, debt servicing, internal security and energy fall within the domain of the federal government, its share of taxes has gradually receded and now represents only 42.5 per cent of the total tax pool. This disconnect between the burden of expenditure and the accrual of revenue has intensified fiscal imbalances, as the provincial governments have little incentive to raise additional revenues from their own sources, while they can spend quite liberally in the absence of constraints and controls. Inefficiency and waste in public expenditure have therefore become commonplace, as the absorptive capacity of the provincial governments has not kept pace with the growth in revenue allocated to them.

Inflation in 2011-12 is projected to remain at around 12 per cent, which is beyond the acceptable threshold for the Pakistani population, and much higher than the long-term rate. The government's heavy reliance on borrowing from commercial banks crowded out private-sector credit and complicated the transmission of monetary-policy signals in the allocation of credit. Private-sector credit grew by only 4 per cent, while credit to the federal government by commercial banks expanded by 74.5 per cent. In an economy where the private sector is the main driver of economic activity and generator of employment, such a situation has naturally become a source of serious concern.

The spill-over of fiscal imbalances into the energy sector was another impediment to the economy's revival. The circular debt between buyers, suppliers, refiners, producers and consumers of electricity has disrupted the normal business cycle. While the peak-load demand has increased substantially, constrained generation and distribution due to fuel shortages, gas shortfalls and liquidity crises have placed a heavy cost on industry and exporters. The capacity utilisation rate of public-sector generation companies fell to 25 per cent, while the small- and medium-enterprise (SME) sector is suffering the most as they lack any recourse to captive power supply, unlike large enterprises. The banking sector's non-performing loans to the SME sector have also risen because of the low capacity of these enterprises to service their debt.

Pakistan-US relations suffered a serious setback [1] after 2 May when Osama bin Laden was captured and killed by US Navy SEALs in an operation undisclosed to Pakistani authorities. The NATO attack on Pakistani border [2] posts in Mohmand Agency in November triggered strong reactions in Pakistan against US and NATO forces. The retaliatory action taken by Pakistan to have the Shamsi airbase vacated, and the stoppage of NATO supply trucks headed to Afghanistan, did not fit well with US public opinion. The freezing of US$700 million in assistance to Pakistan by US Congress and stalled reimbursements from the Coalition Support Fund added fuel to the fire. The results of public opinion surveys carried out in the two countries show the majority of Americans have a negative view of Pakistan, while over 85 per cent of Pakistanis consider the US in a similarly negative way.

Pakistan also experienced floods for the second year in a row. The 2011 floods were limited to the southern province of Sindh, unlike the 2010 floods which devastated the whole country. But the combined damage to livelihoods and property by the two sets of floods is estimated at US$10 billion — almost 5 per cent of GDP.

Internal security concerns in 2011 were not confined to the Taliban and jihadi attacks or suicide bombers. The year also witnessed an eruption of urban violence in Karachi, Pakistan's business capital and largest metropolitan area. The targeted killings of workers from two rival political parties disrupted normal life in the city for several months. Eventually, the Civil Armed Forces were called in to assist local police. The situation was brought under control and the city has since remained calm.

The year 2011 was particularly tumultuous for Pakistan's economy [3], society and politics, but 2012 does not seem to be shaping up much better — election campaigning to begin this year will make the management of Pakistan's economy even more difficult.

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This is part of a special feature: 2011 in review and the year ahead [5].

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