

# **Pakistan's Macro economy – Current Situation and Way Forward**<sup>1</sup>

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I would like to place the current economic situation in the historical context. For the first decades 1950-1990 Pakistan was among the fastest growing economies in the developing world. This achievement was remarkable because Pakistan had inherited an economy without any industrial base; had to rehabilitate and absorb 8 million refugees – almost one fourth of the total population; had to fight a war with a much bigger and stronger neighbour in 1965; lost the Eastern Wing and suffered a trauma in 1971. In the 1970s all major industries, banks, educational institutions were nationalized. In 1980s the country participated in afghan war against the Soviet Union which created some harsh social and geo political consequences. India in this same period was growing at 3 percent per annum – almost half of Pakistan's growth rate. Per Capita income in Pakistan was much higher than that of India and incidence for poverty was much lower than that in India.

Since 1990, the tables have turned. India has surpassed Pakistan not only in per capita income, GDP growth, Human Development indicators but has become one of the fastest growing economy in the world. Bangladesh which was way behind us in all economic and social indicators in 1990 has forged ahead of us and is recording 6 to 7 percent growth rate

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<sup>2</sup> The views expressed in this paper are the personal views of the author and not of those of the Government of Pakistan

with impressive gains in social and human development. Pakistan has become a laggard in South Asia.

Why this reversal of fortune? My research which I carried out at Woodrow Wilson Center in Washington DC. and published by Oxford University Press last year under the title 'Governing the Ungovernable' provides the evidence, insights and analyses. The main thesis of the book is that Pakistan's Institutions of governance which brought about spectacular results in the first forty years have decayed and become dysfunctional. Patronage – based politics has weakened the civil services which formed the backbone of these institutions. I would only give a few examples and leave it to your judgment where these institutions stand today.

PIDC along with PICIC and IDBP brought about an industrial revolution from almost a scratch that led to Pakistan's manufactured exports exceeding that of Malaysia, Indonesia, Philippines.

Agriculture Development Corporation(ADC) pioneered the Green Revolution in the 1960s and a country which could not feed 30 million of its population is now self-sufficient meeting the requirements of 210 million people but also has exportable surplus. It is another story that our cotton production has declined from 14 million bales to 9 million bales in this decade.

WAPDA constructed the largest and highly complex Indus Basin Works including Tarbela, Mangla Dam in the 1960s and 1970s which increased the availability of irrigation water during the Rabi season.

Planning Commission was able to attract the best talent trained at the top universities abroad and its five year plans were the benchmark and reference points for other developing countries.

PIA had established itself a leader in aviation industry and many successful airlines today such as Singapore Airline and Emirates were set up by PIA staff.

I can go on multiplying these examples but this would suffice for the time being.

Coming to the current economic situation where the economy has to be routed to the ICU at such frequent intervals the question that needs to be answered is: whether there has been an appetite for deep-rooted difficult reforms and political ownership of these reforms. The answer is that there is an in built asymmetry in the timing of gains and losses from these reforms. Those who are affected adversely by reforms whether by bringing them into tax net or documenting the economy or removing distortions in the valuation of real estate are all entrenched and want to defend their vested interests. As the losses take place immediately they organize themselves and protest going on strikes and disrupting economic activity. They are supported in these activities by the political parties in opposition to the government and by the media who have also assumed the perpetual role of opposition. The party in power either gets pressurized by its own rank and file or by the fear of a law and order situation and abandons the reforms and thus reverts to maintaining status quo which was responsible for the ill-health of the economy in the first place. The gainers from the reforms are not yet identifiable as it would take time for the gains to actualize. Most of the gains are diffused and dispersed widely throughout the economy. The likely gainers would never be able to group or organize themselves in defence of the reforms because they do not yet exist. This has been the main reason as to why we shun away from reforms which are generally unpopular and adopt adhoc short term palliative measures in order to provide some relief. But as the

underlying structures remain unchanged the external and fiscal imbalances continue to worsen. The country has no other option but to knock on the doors of the IMF or other external donors to bail them out of the crises situation. This lack of political courage and inability to stick to reforms in face of adverse sections is the main explanatory factor for the booms and busts of Pakistani economy in the last twenty five years. Pakistan economy had taken a turn for better in the 2000-2007 period – tax revenues had tripled, exports in dollar terms had doubled, FDI had reached \$ 7-8 billion dollars, current account and fiscal balances were under control, banks were privatized, telecom sector was opened up for competition, local governments were empowered to meet the last services at grassroots level, but these reforms did not survive beyond 2007 because either they were reversed or abandoned for sake of political expediency. I recall attending a high powered meeting in February 2008, when all the proposals to increase the prices of petroleum products, food, fertilizers, utilities in light of international price hike were turned down by the interim Government. It was argued that the party in power would lose the elections and let the new government take these tough and unpleasant decisions. Consequently, the indecision of that time breached all the barriers and flooded the economic landscape costing huge subsidies that led to large fiscal imbalance and depletion of foreign exchange reserves. The new government had to approach the IMF, devalue the currency and take other harsh measures.

The other question I am frequently asked is: until September 2016 the Pakistani economy was doing well but why in the next 18-24 months did it suffer such serious setbacks in form of unmanageable current account and fiscal imbalances. In my view, discontinuity in economic management and consequential uncertainty created thereby

was the main reason for such sharp down fall. After the resignation of the Prime Minister, Nawaz Sharif and the cases filed against Finance Minister there was no body minding the store till Mr. Miftah Ismail was appointed just before the formation of the Caretaker Government. The Caretaker Government adopted a hands-off approach because they interpreted their mandate of non-interference too literally. Then came the elections and formation of new government which also took some time to assess the situation and make up its mind.

The lesson I draw from this episode is that it is in our larger national economic interests that we do away with the Caretaker Government as the costs of disruption to the economy far outweigh any benefit. For example, the last caretaker government stopped funding development projects in April 2018 and it took more than six months before work was resumed after the elections. There must have been cost overruns for this delay.

To my mind, a strong fully empowered Election Commission with the Chief Election Commissioner experienced in administration should be allowed to conduct election and the sitting government should continue to manage the economy thus assuring continuity. After all, all political parties insist that neutral external observers should be allowed to watch the conduct of the elections. The role of Caretaker Government in actual holding of election is minimal and this task can be transferred to the Election Commission.

The second reason we fell off the road was that we exceeded the maximum speed at which the economy could cruise. Given the huge gap between the domestic production capacity and aggregate demand any increase in purchasing power of the people spills over towards imported goods. The Country does not have sufficient capacity to produce petroleum or petroleum products, machinery and equipment, chemicals, raw

material for industry not even vegetable ghee, pulses, milk powder-- all of which had to be imported to meet the demand of a consumption led economy moving rapidly above its speed limit . So this is what happened in the last few years. As economic growth rate sped off its maximum limit the import bill became unsustainable and the balance of payment situation got worse. Excessive borrowing was resorted to meet the deficit raising the debt burden. Tax net was so restricted that the Government did not secure any gains from higher economic growth. Undocumented sectors such as real estate and flight of Capital abroad were the conduit used by the beneficiaries of growth. Decisions to increase prices of electricity and gas were also postponed because of the 2018 elections and fiscal deficit got out of hand. Exports recorded negative growth and were able to finance less than half of imports. Exchange rate was maintained at an untenable level that precipitated depletion of foreign exchange reserves. Once reserves are on a dwindling path the rupee dollar parity comes under attack and investor confidence is eroded. Thus, political inaction and hiatus along with an unsustainable growth path triggered the financial crises which ultimately led to going back for an IMF program. The first review of the program has been successfully completed but it is true economic growth has slowed down and inflation has risen to 12-13 percent. Level of economic activity and aggregate demand had to be curtailed to bring the current account and fiscal balances under control. The popular perception of discontent with the current economic situation has arisen due to this concerted effort of tightening monetary policy and raising interest rate, adjusting exchange rate, documenting the economy and widening the tax net all at the same time aimed at saving the country from becoming insolvent.

Under the stabilization program it was explicitly recognized that the poor would suffer the most through inflation and price hike . Efforts have been

made to protect the poor by reinvigorating, consolidating and expanding the Social Protection Program called EHSAS which provides cash transfers to 5.2 million poor households. While overall austerity was observed in government expenditures the budgetary allocation for Ehsas was doubled to Rs.200 billion. In addition to unconditional cash transfer and cash transfer girls education new targeted programs have been started. Insaaf Sehat Cards entitles free health services upto Rs 700,000 at public and private hospitals for the poor families. Premium for this insurance coverage is paid by the government. Undergraduate scholarship program of 200,000 scholarships to finance higher education of talented boys and girls from poor families has taken off this year. Interventions for nutritious food and supplements are also at design stage. Subsidies have protected 75 percent of domestic electricity consumers from tariff increases. Similarly, the lowest category of gas consumers has not been adversely affected by price adjustments. However, it is a fact that the middle class could not be protected from the onslaught of these price increases because of resource constraints. It must also be recognized that the poor do not have any voice but the middle class is quite vocal.

## **The Way Forward: Structural Reforms:**

I now turn to the second part of my presentation.

Once Macro Economic Stability is achieved and maintained the next step is to resume the path for socially inclusive economic growth, job creation and poverty reduction. This would require some deep rooted structural reforms whose benefits would become apparent after some time but whose foundations have to be laid now. The pre-requisite for sustained growth is that we as households, Government and Corporate Sector increase our domestic savings ratio. Unless that happens our investment ratios would remain inadequate to generate the desired growth rates of 6 to 7 percent to absorb the youth entering the labour force. . If we want these higher growth rates but do not mobilize domestic savings and non debt creating external flows such as Exports, Remittances and Foreign Direct Investment , we would have no option but to keep relying on large external borrowing. The effect of that strategy has been observed by all of us in the last thirty years. To achieve a sustainable and socially inclusive but fast growing economy we have to adopt a new model of democratic governance in which the state, markets, civil society and communities play a synergetic and mutually linked roles.

State through its Executive, judiciary and legislative organs has to ensure that the benefits of economic growth reach a wider set of population, contracts are enforced and justice is expeditious and inexpensive and laws and statutes are designed not for the benefit of small groups but for the majority. Social Protection for the poor and vulnerable

and Investment in human development should form the essential ingredients of the state's responsibilities.

Markets forces would be used for allocating resources efficiently but incomplete or imperfect or noncompetitive market structures would be regulated to remove distortions and opportunities for collusion, connivance, cartelization and rent seeking.

Legislature would simplify, streamline and strengthen the laws and statutes to ensure that these are not misused by a particular segment of the population for their personal or parochial interests.

Judiciary has to ensure that the sanctity of contracts is observed, contracts are enforced, access to justice to the poor is enabled thorough expeditious alternate and dispute resolution mechanisms.

Civil society and communities have to play a proactive role as watchdogs on the state and markets and also participate in the delivery of basic services such as Education, Health, Sanitation etc.

Let me elaborate by focusing on some specific structural reforms that have either been initiated or are needed to bring the country back to reach its potential.

- (a). The 18th amendment to the Constitution and the 7th National Finance Commission have very rightly devolved administrative, legal, and financial powers and authority from the federal to the provincial governments. However, this devolution has remained incomplete so far. The provinces had not transferred powers and resources further down to local governments,

where most of the interaction between an ordinary citizen and the government takes place. The new local government laws approved by the provincial assemblies of KP and Punjab are designed to substantially devolve these powers to the grass root level empowering the communities to make decisions about their development and welfare of their citizens. As Pakistan is rapidly urbanizing the administration and management of metropolitan areas, cities and towns would be entrusted to autonomous, directly elected Metropolitan, Municipal Corporations and Town councils which have been assigned responsibilities along with financial resources and ability to mobilize taxes, fees, user charges, cases for provision of services and development in their respective jurisdictions.

- (b). The administrative machinery of the civil services as a whole has almost reached at the verge of a break down. Therefore, reforms in the police, civil services, organizational structure of the Federal and Provincial Governments and public utilities are being undertaken to reset the direction. The capacity of civil servants to remain neutral and objective, which used to be their hallmark, has to be rebuilt and their morale and motivation revitalized so that they are able to once again regain their lost space in the country's governance structure and processes. Equality of opportunity, transparent and merit based selection, promotion and career progression , performance measured on the basis of key performance indicators, continuous learning and training, as well as compensation based on performance and weeding out of those who are falling behind the curve are necessary but difficult

reforms that could eventually upgrade the quality of civil services at all tiers of the government.

- (c). Management and Regulatory practices in the government need to be modernized and overhauled. Over centralization and the concentration of power , Overly long hierarchical chains, multiple consultations for the sake of form and procedure rather than substance, turf building and turf protection, and the tendency to pass the buck have created a big gap between promises and performance. Public Financial Management Law approved by the Parliament has made a beginning by delegating financial powers from the Ministry of Finance to line Ministries. The rules of business have to be rewritten to assign clear responsibilities to ministries, giving them the requisite authority to fulfill their obligations and holding them accountable for results. Inter-ministerial coordination and conflict resolution is beginning to take place at the level of the secretaries' committees. Regulatory guillotine is being applied to axe outdated laws, rules, regulations and processes. E-government tools under implementation would help ensure transparency and the expeditious pursuit of business and coordination efforts.
  
- (d). Poor educational standards, low literacy levels, large numbers of out of school children, rote learning and memorization, outdated and irrelevant curriculum offerings have made our educational system non responsive to the economic and social needs of the country. Limited access to schooling particularly post primary in the backward districts while the well to do

families send their children to the best private schools have widened inequalities. The Government under Ehsas Scholarship Program has taken the initiative to facilitate talented students from poor families to get undergraduate education at public sector Universities and Colleges throughout the country. There is huge demand both within the country and outside for technical manpower but we are producing only school and college graduates who are not employable. A major program to promote technical & vocational training, make higher education more relevant, reorient scientific research towards national problems has been initiated. Start-ups and entrepreneurship programs have been set up in five major cities. Human capital is the basic factor that would determine whether a country is able to participate in Knowledge economy and technological revolution of the 21<sup>st</sup> century. STEM education right from the primary schools all the way to the Universities has to be promoted for inculcating inquisitiveness, creativity and innovational thinking.

- (e). In the financial sector, access to capital remains restricted to a very small minority while the majority of the farmers, firms, self-employed, employees and households who make large contribution to the country's income are unable to obtain financing from formal institutions as they do not have the collateral and security to offer. As the lower income groups do not have any tangible assets—skills or capital—they have no other option but to be dependent on their landlords, arthhis or money lenders –all of them part of the elite class. Micro finance

has opened up the vista for the poor and the coverage has reached almost one quarter of the eligible borrowers. National Financial Inclusion Strategy through Digital financial services is an attempt to broaden the base and provide access to the underserved sectors. Data analytics would be used, to predict the behavior of potential borrowers, and construct credit scoring models that would enable financial institutions to make credit decisions at low acquisition cost and also mitigate the risk of default. Algorithms are now available to guide the credit decisions and the banks in Pakistan should adopt this methodology to expand their outreach to underserved sectors and underprivileged individuals and firms. Capital Debt market should be developed so that large credit worthy companies can meet their demand for expansion and new investment not through banks but capital market.

- (f). Government enterprises are incurring huge losses as they have been captured by their workers, managers and political and bureaucratic supervisors. Whenever any Government wishes to take some tough measures it is immediately confronted by strikes, shut downs and suspension of transport causing immense hardships to the daily life of common citizens. The government backs down and the status quo ante is restored. By restructuring or privatizing these enterprises not only losses would be curbed helping improve the fiscal situation and increasing spending on Human Capital formation but improved efficiency gains would contribute towards higher growth. It is not realized that the privatization of nationalized commercial banks and the Pakistan Telecom has resulted in

huge gains for the budget in form of corporate profits, dividends etc. The residual value of Government equity showed a remarkable upswing instead of continuous injection for recapitalization of banks. Pakistani banks today enjoy high capital adequacy ratios and low non-performing loans. Telecom liberalization has significantly reduced user charges and provided mobile phone services to 170 million people and access to internet to 70 million people by auctioning spectrum for 3G and 4G. The Government has embarked upon a program whereby these enterprises would either be restructured, sold to strategic investors, merged or liquidated as the case may be.

- (g). The present efforts to widen the tax base and document the economy are facing stiff resistance. In the past these efforts could not bear fruits because of protests, strikes and political pressures. The present Government is committed to enforce a whole set of taxation reforms. Restructuring of the federal Board of Revenue (FBR) and provincial revenue collecting authorities, simplification of tax codes, increased use of electronic data bases talking to each other, minimal contact between tax payers and tax collectors, risk based audit, bringing new tax payers in the tax base , gradually reducing withholding taxes and more transparent valuation methods for assessing import duties and sales tax, reduction of import tariffs, mobilization of urban property tax and agriculture income tax are some of the measures that would correct some of the distortions , minimize leakages and corruption and maximize revenue collection. These measures would help the

country in lowering the Public Debt ratio to 70 percent by FY 2024 and then on a downward slope.

- (h). There are some “rent thick” Sectors such as real estate, construction, railways, ports, airports, highways, media and telecommunications, mining, oil and gas , food procurement in which the Government enjoys disproportionate powers in determining the financial health of a company through administered prices , award of contracts, concession agreements, spectrum allocations and grant of licenses, tariff determination, permits. These sectors have to be made more transparent and exposed to competition. For example, in power sector the new Renewable Energy Policy has introduced open competitive bidding for tariff determination instead of upfront cost plus, guaranteed rates of return, capacity payments. These policies prevalent since 1994 have made our exports noncompetitive and prohibitive for our households. Circular Debt amounting to Rs. 1.6 trillion in addition to trillions of rupees paid out of budget as subsidies is a direct outcome of these flawed policies. Government has brought down the flows of circular debt from Rs 38 billion every month to Rs 10-12 billion and has a plan to bring it to zero, Multiple buyers and multiple sellers with the Transmission company only recovering wheeling charges would enter into contracts without any interference by the Government. Guaranteed rates of return on equity, would be dispensed with. Gas companies would be split into generation, transmission, distribution companies and market competition would be introduced. The present model of price setting relies upon a cost plus

methodology with a guaranteed rate of return allowing uncounted for gas losses.

- (i). Pakistan's exports have performed dismally compared to its neighbors. Export-GDP ratio has declined to 7.5 percent –one of the lowest in the developing world. The composition of export goods basket has remained almost unchanged since 1990s and low tech, resource based items dominate this basket. In addition to product concentration the destination is limited to a few select markets such as EU and the US while penetration in other dynamic markets is negligible. The Government is according highest priority to export expansion by promoting competitiveness in mid tech and sun rise industrial products and services. Artificial crutches to support the sun set industries would be gradually taken away as market determined exchange rate, realistic interest rate and low tariffs on raw materials and components would guide allocation of resources. Incentives that would be performance based and time bound ought to be given for new exportable products and for new export markets. Logistic costs to reach Ports including Gwadar Port should be comparable to those prevailing in other competitor countries. The government would support research and development and commercialization of new products and through Export-Import Bank facilitate exporters to penetrate new markets. Joint ventures with foreign companies that link Pakistani exports to global supply chain, bring in technology and marketing along with FDI should also be given incentives for limited period of time.

- (j). Although the Government should not choose the winners but indicate the priority sectors in which the private businesses should invest under a policy consistent, predicable and enabling environment. The criteria that would guide the selection of priority sectors would be (i) Export-Manufacturing industries and information technology oriented services, (ii) Maximum employment generation – Direct and indirect, (iii) Transfer of technology. Using these criteria, the sectors and sub sectors that have been chose are productivity enhancement in cotton, wheat, oil seeds; efficient utilization of irrigation water through lining of water courses; modernization of agricultural marketing; Small and Medium enterprises; Low Cost Housing, Tourism and Information Technology. Nine Special Economic Zones would be established under CPEC attracting Chinese and other foreign investors to locate their industries.

The Commission on Science and Technology and Commission on Information Technology should bring in all S & T Organizations under one Umbrella and encourage collaboration and integration in the value chain including multi-disciplinary research.

Finally, I touch upon briefly on judicial reforms. The dispensation of justice in Pakistan has become time consuming, expensive, convoluted, and unnecessarily layered. State revenues and bank loans, amounting to hundreds of billions of rupees, are held up due to litigation. Property titles and exchanges of deed have lost their sanctity because of prolonged disputes and complex processes prescribed by

courts. Markets are based on sanctity of Private property and contracts. A judicial system that is unable to ensure protection and security of property rights of an individual and firm would inadvertently generate an ethos where the mighty and powerful are able to enforce these contracts on their own terms through extra legal means. After favourable verdict is announced it still takes years to get decrees granted by the courts executed.

To conclude, the current economic situation is improving as macroeconomic stability is achieved but the benefits to the common citizens would be gradually discernable with resumption of socially inclusive economic growth and job creation. For that to happen, the State, markets and civil society have to work together in harmony and unison showing perseverance and tolerating tough structural reforms. We have to move up the development trajectories that open up opportunities and build up capabilities for the majority of the population –away from the present trajectory that benefits a minority i.,e the elites of this society.

