Macroeconomic Environment's Impact on the Pakistan's MS

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A Few Caveats

- I have 33 slides, and the good part is that there are no regressions.
- The bad part is that I have only sixteen and a half minutes for this.
- Statistics are like clay, of which you can make a God or a Devil as you please (Yule & Kendal, 1961.)
- As I get older I have an inclination towards fewer regression equations and rely more on intuition, hindsight and the institutional structure of the economy behind these econometric models.
- That does not mean that LSE's graduate students should not have excellent knowledge of Taylor's Rule, Granger's Causality and Vector Auto Regressive models, etc., to name a few.
- There is a season and reason for everything.

Introduction

- The share of manufacturing sector in Pakistan's GDP in recent years is between 14-16% and ranks third in order after the services sector followed by agriculture (21-22%).
- The basic premise of our paper is that macroeconomic policies and industrial policy in Pakistan has significantly affected the performance of its components including MS.
- A rigorous testing of our hypothesis would require what econometricians call a test of 'Granger-Causality'.
- To put it simply; does aggregate economy's performance influence its components or its components affect the macro aggregate?

- The performance of Pakistan’s MS has been a story of boom bust cycles of growth
- Pakistan’s MS has struggled to grow on a sustained basis and continues to be plagued by a host of structural problems including low productivity and lack of innovation in product and process technologies.

- The irony is that , most economic indicators are still reflecting “below-par performance” (IPR, Feb 2015).
- The MS lacks diversification with textiles and food accounting for a major chunk of the total value added in the MS.

- While much has been written on the performance and problems afflicting the manufacturing sector e.g. Ara (2004), Haque (2014), Rukhsana (2001), Kemal (1998), Pasha and Kalim (2002), little attention has been paid to the question of how the macroeconomic environment has affected its performance.

- This paper is a step in that direction.

- It attempts to explore the role of macroeconomic environment in driving private investment in the MS.
- It is argued that a stable and predictable macroeconomic environment is essential for the competitiveness and growth performance of the sector.

- A stable macroeconomic environment facilitates private investment in the MS by access to affordable financing through well-developed financial markets, predictable tax and public expenditure policies, and ease of long term regulatory business planning in a low inflation environment.

A Historical Perspective on Pakistan's MS

- Starting from virtually scratch at the time of independence, Pakistan has made significant strides in the industrialization process.
- The share of MS in GDP has gradually increased from 10.37 % in the 1950s (large scale 5.04 % and small scale 5.34 %) to 17.47 % in 2000s (large scale 11.85 % and small scale 5.62 %).
- Table 1 below shows that there is a significant development in the MS especially in the large scale industries whereas the share of small scale industries has almost stagnated. (11.85% vs 5.62%)
- A clear policy debate is needed to foster our SMEs given the structure of Pakistan's economy
- Some recent works of Azam (2014, 1013) reflect this emphasis.

- Interestingly, in researching on this topic we came across a few useful studies by Haque (2014) – a paper presented at the last conference here and an excellent book edited by Rashid Amjad and Shahid J Barki (2013): Pakistan; Moving the economy forward.
- A common thread of these works is that our emphasis should lie on the micro rather than only the macro.
- "Small" in the economies under stress (which include Pakistan) needs more attention than the big (macro) picture. However we cannot ignore the basic pillars of growth and development namely – macro stability structural reforms and well functioning institutions.

- While Amjad's R. (2013) book and its outlined agenda provide a ray of hope, Haque's (2014) work based on past performance is more cautious, a bit more scary and proposes a tall order for the major stakeholders of the economy.
- Pakistan's competitiveness disadvantage in the 21st century emanates largely from its low and slow growing economy. Thus, Pakistan has to overcome lack of technology-intensive industries which also holds back progress in the most contributing sector (such as) agriculture and services.
- Haque's prescription being that "Pakistan must, before all else, agree on the general direction of its industrialization. This is as much a political as an economic exercise requiring consensus building among (several) stakeholders. Thus, his recipe calls for a fundamental rethinking of industrial policy.
- If history is any guide for Pakistan's future, I am more sympathetic towards Haque's view and Pakistan's need to focus more towards agriculture sector and small scale manufacturing related to agro-business.
- Our skepticism is based on the frequent policy changes in Pakistan by the government, a lack of policy coherence, absence of long term commitment to particular policies and frameworks, incompetence, corruption and sector-specific expertise.

- Getting back to the historical perspective, on average, the growth performance of the MS looks quite impressive.

- The MS grew at an average annual rate of 7.1 % during the period 1950-2010, whereas the large scale and small scale sectors exhibited growth rates of 8.9 % and 5.6 % respectively.

- Except for the decades of the '70s and '90s, which have been dubbed as the lost decades for the MS, the MS has grown at a healthy rate of 8 % on average.

- The manufacturing industries grew at a rate of 7.7 % during the Fifties while the large-scale industries grew at a phenomenal rate of 15.8 %.
- The industrial policies during this period were marked by direct controls on imports, private investment and prices. (Import substitution)

- Growth of MS accelerated further to 9.9 % during the 1960’s.
- A number of initiatives helped in realizing the high growth rate, which included a liberal import policy for raw materials, and a subsidy to exports through a number of schemes such as export bonus scheme, tax rebates, tax exemption, and export performance licensing.
- Such policies were geared to attract private investment in the MS at a time when private sector was reluctant to undertake investment on large scale.

- A sharp fall was witnessed in the growth of MS in the '70s when the growth rate fell to 5.50 %.
- This came on the back of nationalization policies pursued during the ‘70s which had a long run impact on the industrialization process in the country.

- A number of industries including cement, fertilizer, oil refining, engineering, chemicals were transferred to the domain of the public sector with adverse consequences for private entrepreneurship, growth and productivity.
- Moreover, the industrialists faced a number of restrictions including price fixation by the government under Profiteering and Hoarding Act, 1977.
- These measures led to heightened uncertainty about the business environment resulting in a fall in private investment and flight of capital.

- The 1980s witnessed a reversal of the control policies of the 1970s and a process of deregulating and denationalization was initiated.
- Administrative controls were replaced with market-oriented forces, import policy was liberalized, tariff structure was rationalized, par value of rupee was brought closer to its equilibrium value and was made convertible on capital account.
- The market friendly policies contributed to an acceleration of industrial growth to 8.21 % during this period.
- In the '90s, industrial growth slowed down to 3.9% while the growth in the large scale MS plummeted to an annual average rate of 3.54 %.
- A number of factors have been responsible for this depressed growth, including political instability, worsening of law and order situation, reduction in protection rates, emergence of significant infrastructure bottlenecks, and inadequate power supply along with frequent breakdown of power supplies in the early part of the 90s coupled with a sharp increase in the prices of power in the later years.

- The MS regained momentum during 2000s with an average annual growth of 7.3 %.
- However, the performance of the MS has been marred by the energy crisis which has inflicted heavy losses in terms of productivity and competitiveness of the sector.
- Finally, in the last two years, a major concern is continued slow growth in large scale manufacturing. The industrial growth this fiscal year (2014-15) would be even below the dismal 4 % growth of last year. (Pasha 2015)
- Public and private investment is weak, tax collection is expected to be below target, and exports have declined in the face of overvalued exchange rate.
- To maintain foreign reserves, the government has taken on substantial high cost debt which will put pressure on external account in the future.

%age Share of Manufacturing in GDP and Growth Rate

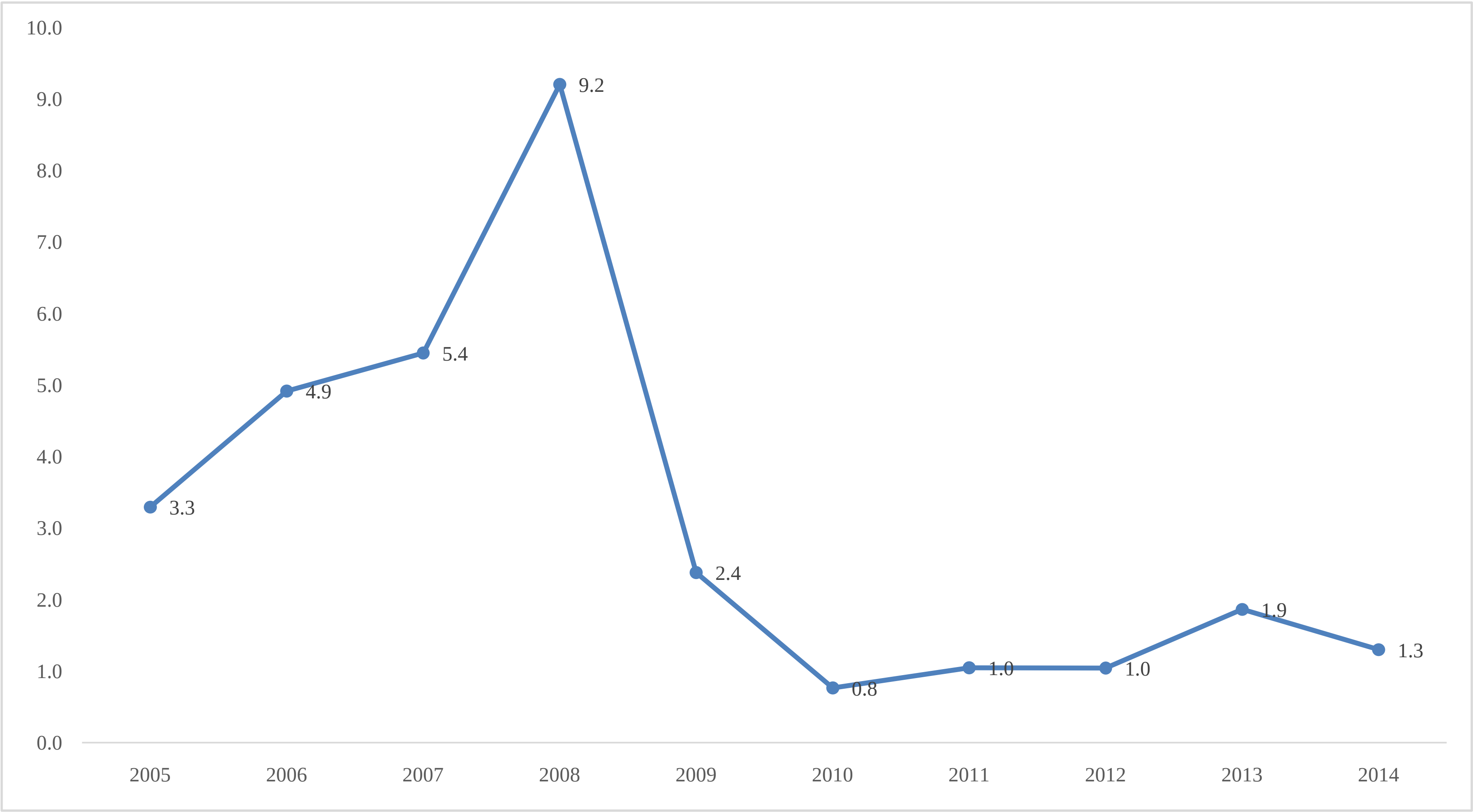
Period	%age Share in GDP			Real Growth Rate		
	Total Mfg.	Large Scale	Small Scale	Total Mfg.	Large Scale	Small Scale
1950s	10.37	5.04	5.34	7.76	15.75	2.30
1960s	14.91	10.65	4.26	9.93	13.39	2.91
1970s	16.52	12.33	4.19	5.50	4.84	7.63
1980s	16.65	12.26	4.38	8.21	8.16	8.40
1990s	17.18	12.15	5.02	3.89	3.54	4.87
2000s	17.47	11.85	5.62	7.34	7.70	7.69
1950-2010	15.43	10.62	4.81	7.11	8.90	5.63

- While the MS has contributed to a respectable economic growth rate that the economy has realized during the last several decades, it significantly lags behind major competitor countries including SE Asian and BRICS economies.
- The sector continues to face constraints including low levels of human capital, poor physical infrastructure, uncertain policy environment, a prolonged power crisis and poor security situation.
- The industrial structure lacks diversification and is highly concentrated in a few industries: e.g more than 37.8 % of industrial value added was contributed by food and textiles alone in recent years.
- Similarly, industries which are exclusively based on indigenous raw materials accounted for almost 60 % of the value added, although their share in output fell over time.

An Overview of Macroeconomic Environment

- Macroeconomic stability is key to achieving robust economic growth on a sustained basis. Historically, the major problem can be traced to persistent Twin Deficits in public finance and external account which leaves little flexibility for prudent macroeconomic management to support the growth momentum. (See Table 2)
- During 2005-2009, Pakistan faced a burgeoning deficit in current account which jumped from 3.3 % of GDP in 2005 to 9.2 % in 2008.
- The mounting current account deficit led to persistent pressure on the exchange rate necessitating a tight monetary policy stance by SBP.
- It is worth emphasizing here that the recent improvement in current account deficit is driven largely by high inflow of remittances coupled with political and financial engineering such as payments from the IMF, friendly money (what classical economists would call Patinkin money), EU bond issue and ‘Islamic Sukuk’.
- It is imperative to think of the possible consequences of a highly leveraged reliance on remittances in the aftermath of falling oil prices and global deflation.

Current Account Deficit (% of GDP)



- Pakistan is also facing the problem of high fiscal deficit and concomitant high inflation. Fiscal deficit during the '80s averaged 7.1 % of GDP falling only slightly to 6.9 % during the '90s.

- Fiscal deficit again surged peaking at 8.2 % of GDP. High fiscal deficits have been inevitably accompanied by high rates of inflation.

- After remaining subdued during the early part of 2000s, the inflation rate climbed again to 7.4 % in 2003-2004. Since then, Pakistan has faced persistent inflationary pressures with inflation remaining in double digits until 2010-2011.

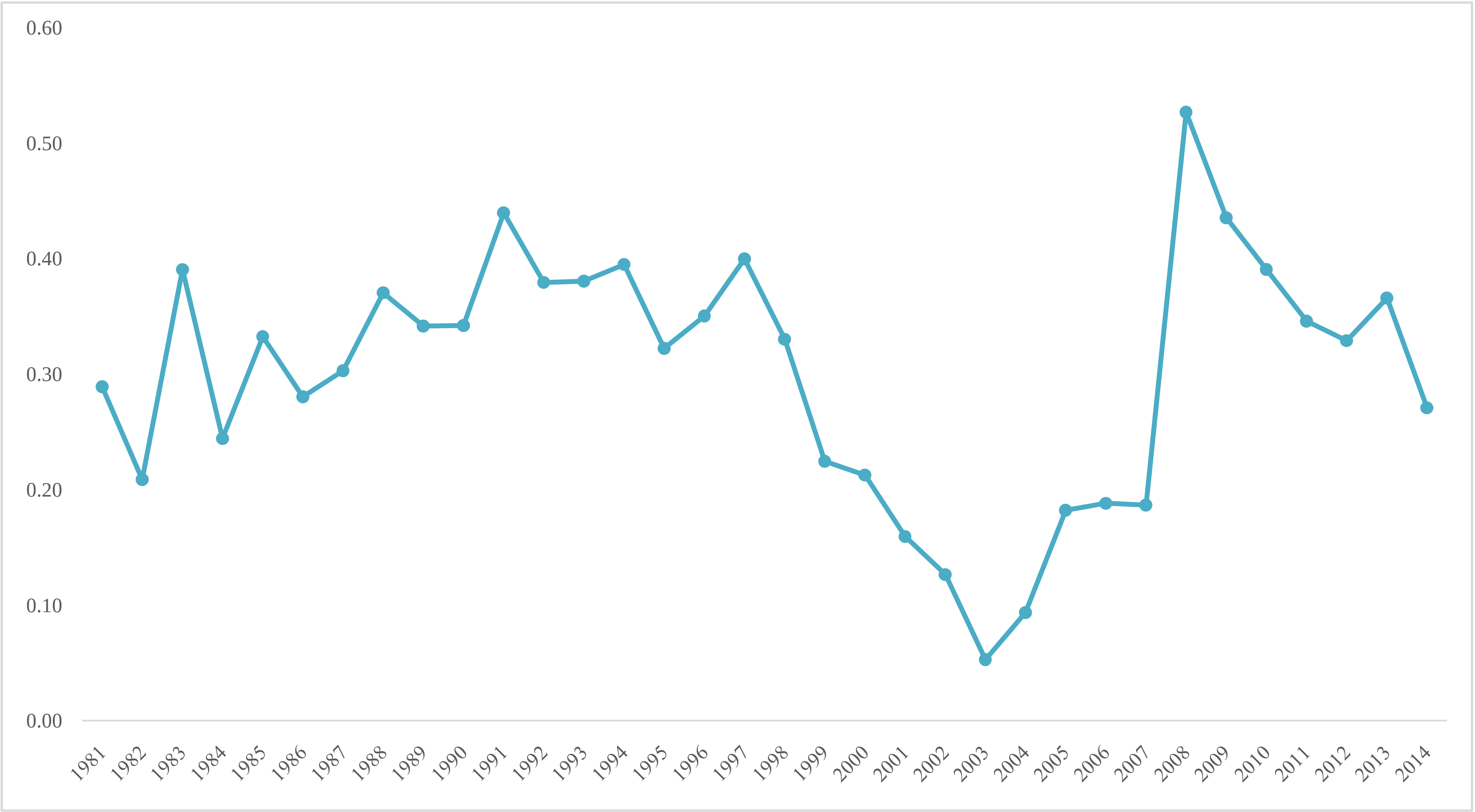
- Recent years have witnessed an easing of inflationary pressures thanks mainly to fall in oil prices.

- To capture the overall macroeconomic situation, we construct a macro instability index (MII) comprising of three core stability indictors including inflation, fiscal deficit and exchange rate variability.
- The index shows that except for a brief period during the mid-2000, the macroeconomic environment has remained largely unstable on the back of high current account and fiscal deficits and high rate of inflation.
- It also witnessed a transition to the managed float system of exchange rate management which led to a 20 % depreciation of the Pak Rupee.
- During this decade, on average the fiscal deficit remained at about 6.8 % of GDP whereas the primary deficit was recorded at 3.5 % of GDP.

Key Macroeconomic Indicators

Year	GDP Growth Rate	Inflation rate	Unemployment rate	As % of GDP			
				Investment	Fiscal Deficit	Trade Deficit	M2
1980s	6.5	7.2	1.4	18.7	7.1	8.9	39.2
1990s	4.6	9.7	5.7	18.3	6.9	4.4	43.0
2000-01	2.0	3.1	6.1	17.2	4.3	1.8	36.2
2001-02	3.2	3.3	7.8	16.8	4.3	0.4	39.6
2002-03	4.8	2.9	7.8	16.9	3.7	0.5	42.6
2003-04	7.4	7.4	8.3	16.6	2.3	1.2	44.1
2004-05	7.7	9.1	7.7	19.1	3.3	4.0	45.5
2005-06	6.2	7.9	7.6	22.1	4.3	6.5	44.7
2006-07	4.8	7.6	6.2	22.5	4.4	6.6	46.9
2007-08	1.7	20.3	5.2	22.1	7.6	9.0	45.8
2008-09	2.8	13.6	5.2	19.0	5.2	7.8	40.3
2009-10	1.6	13.9	5.5	15.8	6.2	6.5	39.4
2010-11	2.7	11.9	6.0	14.1	6.5	4.9	37.0
2011-12	3.5	9.7	6.0	15.1	6.8	7.0	38.0
2012-13	4.4	7.7	6.2	14.6	8.2	6.6	39.0
2013-14	5.4	8.6	6.2	14.0	5.5	5.0	39.0

Macroeconomic Instability Index (MII) for Pakistan



- The macroeconomic environment worsened during the Nineties.
- Various measures including trade liberalization policy and financial reforms along with tariff reforms were implemented in the first half of the '90s
- Yet the economy failed to achieve macroeconomic stability due to political instability, law and order situation and persistent inconsistency in the macroeconomic policies.
- This was further accentuated by freezing of the foreign currency accounts and military takeover in 1999 which created more macroeconomic uncertainty.

- In the early 2000s, the economy witnessed a turnaround with low inflation and contraction in budget deficit thanks to significant foreign capital inflows including remittances and foreign assistance, but this proved short-lived.
- The relatively better performance of Musharraf's regime was not accompanied by any significant direct/foreign investment in MS as the focus of investment remained on the real estate sector.
- The situation was made worse by the global financial crisis and high food and oil prices which contributed to inflationary pressures in the economy.
- The exchange rate has also stabilized with the easing of pressure on external account through financial engineering.
- While some may be tempted to see the stability of Rupee as a sign of economic strength, it must be cautioned that the State Bank of Pakistan is using precious foreign exchange reserves, mostly consisting of borrowed money, to shore up the value of the rupee.

Macroeconomic Policies: Implications for the MS

- During the early part of 2000s, the MS exhibited robust growth on the back of strong domestic demand in an environment of relative macroeconomic stability with low inflation (Amjad, Din and Qayyum 2011).
- This period was characterized by stable macroeconomic fundamentals which contributed to the strong growth momentum in the MS; a largely easy monetary policy stance contributed to buoyant consumption while at the same time lowering the cost of capital thus boosting private investment in the MS.
- Private investment increased from 16.8 % of GDP in 2001-02 to a peak of 22.5 % in 2006-07.
- However, this period of high growth and low inflation was disrupted as the economy was hit hard by the global hike in food and oil prices which quickly added to inflationary pressures in the economy.

- The macroeconomic stability proved elusive as a confluence of factors including food and commodity price shock, unprecedented energy crisis and law and order situation contributed to a sharp slowdown in economic growth. (Mangla and Uppal 2014).
- This situation was worsened by the global financial crisis which led to a sharp fall in foreign exchange earnings with consequent draw down of foreign exchange reserves. On the domestic front, the depressed economic growth contributed to fiscal pressures and consequently fiscal deficit climbed from 4.3% of GDP in 2001-02 to a peak of 7.6% in 2007-08.
- As the twin deficits mounted, Pakistan had to resort to IMF support for the balance of payments which entailed conditionalities such as tight monetary policy and contraction in fiscal deficit.
- These contractionary policies depressed private investment and economic growth plummeted to 1.7 % in 2007-08.

- These macroeconomic developments had an adverse impact on the MS.
- To begin with, a tight monetary policy stance raised the cost of capital thus severely constraining private investment.
- Consequently, growth in the MS fell sharply.
- Rising fiscal deficit also crowded out private investment in a high interest rate environment
- Worse still, in an effort to reign in the fiscal deficit, the government cut public spending on critical development needs including physical infrastructure that further compounded the difficulties of the MS.
- A key area of concern in macroeconomic management has been the lack of coordination between monetary and fiscal policies which contributed to persistence of inflation despite contractionary demand management policies.

- The SBP lowered the discount rate to 12.5% in November 2009.
- Despite this, however, industrial output failed to show a robust pick up due to a combination of factors including hike in domestic power and gas tariffs, fragile domestic security situation and crippling energy shortages.
- On the other hand, in its efforts to revive economic growth, the government resorted to fiscal expansion resulting in almost doubling of the Public Sector Development Program from Rs.219 billion in 2008-09 to Rs.421 billion in 2009-10 in budgetary terms.
- This fiscal expansion at a time of weak economic fundamentals was detrimental to macroeconomic stability with adverse consequences for manufacturing output.

- Demand for credit to the private sector remained sluggish in a high interest rate environment. Credit to the private sector was also constrained by banks’ increasing appetite for risk-free government securities (PIB) which carried a high rate of interest making lending to the private sector an unattractive option
- The increase in the demand for government securities also reflected increasing risk aversion of the banks in the face of mounting non-performing loans in their portfolios.
- These policy developments up to 2012 have led Pakistan to another round of external imbalances and depletion of foreign reserves culminating into foreign reserves shock in 2013 and Pakistan’s vulnerability to default leading to fifth round of IMF longer term loan facility of US$7.5 billion.

- Pakistan's macroeconomic imbalances are driven by deep-seated structural problems including a narrow tax base, cash bleeding state-owned enterprises, and low rate of savings, all of which contribute to a persistent domestic resource gap.
- On the external front, the balance of payments position remains precarious due mainly to lack of export competitiveness that forces a reliance on external sources of financing.
- Addressing these structural issues is critical to achieve macroeconomic stability which is a pre-requisite to attract domestic and foreign investment in the MS.
- There is a need to strengthen public finances through widening the tax base, improving tax collection and prudent public expenditure management.
- It is imperative to restructure or privatize the state-owned enterprises to plug massive leakages of public funds.
- A sustained improvement in macroeconomic fundamentals can be instrumental in boosting economic activity in the MS which is essential for job creation and poverty reduction.
- These measures would create a stable and predictable macroeconomic environment that is essential to put Pakistan's MS on a robust growth trajectory.

Summary Conclusions and Some Tentative Suggestions

- The performance of Pakistan's M.S. has been a story of boom bust cycles of growth.
- The major problem can be traced back to persistent twin deficits in public finance and external account which leaves little flexibility for prudent macroeconomic management to support the growth momentum.
- Apart from fragility of the external account, Pakistan is also facing the problem of high fiscal deficit and concomitant high inflation.
- To capture the overall macroeconomic situation of the country, **we construct a macro instability index comprising of three core stability indictors including inflation, fiscal deficit and exchange rate variability**
- The index shows that except for a brief period during the mid-2000, the macroeconomic environment has remained largely unstable on the back of high current account and fiscal deficits and high rate of inflation.

- Prudent macroeconomic management aimed at consolidating public finances and controlling inflationary pressures is essential to boost industrial investment and economic growth.
- What is needed in this country requires a reassessment of our macroeconomic priorities in the framework of conventional wisdom of fiscal and monetary policies as mentioned.
- In a global competitive world, Pakistan has to find a niche sector perhaps that being the SME.
- The SME sector’s exports have increased steadily, with the bulk of SME units operating in industrial clusters around Karachi, Lahore, and the Sialkot-Gujrat-Gujranwala triangle in central Punjab.

Some Further Suggestions

- With all these desired summary conclusions which can be reffered to as “**Sufficient conditions**”, perhaps equally important are the “**Necessary Conditions**” which are discussed below:
- Pakistan’s macro and manufacturing problems are perhaps more non-economic in nature followed by structural and/or cyclical.
- It is the political economy and not the economy of Pakistan that is stupid.
- Most of the time, policies have worked on “Ad-hoc” basis.

- There is lack of political and economic think tanks.
- Pakistan has isolated itself from global economy in real terms (for well known reasons).
- Political engineering and Financial Engineering strategies will only make a marginal difference but will not solve the fundamental economic problems.
- We have “ego” problems and wrong benchmarks.
- Poor governance and corruption.
- Law and order situation.
- We have weakened our institutions in the country.