IPR

ANALYSIS

9 reading time minutes + Charts & Table

STRENGTHEN THE ECONOMY WITH INDUSTRIAL POLICY

October 2020

For an economy that is forever close to external default, it is odd that Pakistan has not changed its economic strategy. In fact, one may ask if there is any strategy at all. Clearly, what we have been doing for three decades has not worked. Yet, our policy stays the same.

That is why we are locked in an endless loop of 'near default' followed by lifelines from IMF and others. When the discipline of the IMF goes, we are back in the familiar zone of 'near default'. Because each crisis requires us to take more debt, what we owe others and what we must pay to service the debt keep growing each year. Its glaring confirmation is seen in the high and ever increasing share of markup payments in GoP's budget. In FY 20, actual payment of markup grew by 25% over FY 19. It was 38% of total federal spending, 80% of net federal revenue[1], and 6.3% of GDP. All other spending fell by the wayside. A more flawed example of public fiscal management will be hard to find.

Our macro indicators will be weak until we do not design a strategy to bolster them. That depends on growth, not just on cutting expenses. In turn, growth should come from boosting production, especially of goods for export. It is time to shift to a new game plan and move ahead to expand and build manufacturing.

The way to push production of goods is to have the right business climate for firms to prosper in. Government must meet private sector needs for public goods and soft and physical infrastructure. Credit, even subsidized loans, and tax and tariff incentives must accompany. In short, we must build the competitiveness of our firms. It is hard for any economy to provide all of the above across the board. Thus, government must make these available to a select group of industries, those with the most chance to increase export. In essence, Pakistan must have an industrial policy, a strategy that has been tried and tested successfully in East Asia.

[1] Federal revenue minus transfer to provinces

It is time to shift to a new game plan to expand and build manufacturing. Pakistan must have an industrial policy, a strategy that has been tried and tested successfully in East Asia.

Once manufacturing and exports pick up, our external account would rest on a sounder base. Growth in GDP would not be limited to short cycles of boom and bust. If done well, Pakistan could see a period of sustained GDP growth. It is time to reverse decades of thinking that gives us an economic strategy of survival by seeking help from others. We must rely on growth based on the skills and initiative of our firms. Not all selected sectors will be successful. Some would be, others less so. But we will be on track to learn lessons and move forward.

So far, we have followed an opposite path. In the last three decades, Pakistan's manufacturing as % of GDP has fallen. Concomitantly, exports too declined. This must change.

An industrial policy makes a huge claim on government capacity. Not only must government make a well thought policy. It must have the means to implement it and the funds to finance it. With limits on funds available, Pakistan must choose wisely where to spend. It must cut waste, such as on PSE subsidy.

Incentives must go to firms that meet preset criteria of performance not to those with the most ability to lobby. There should be a fixed sunset for incentives. We can no longer have 'infant industries' that are sixty years old and whose exports depend entirely on the eternal good graces of the taxpayer. Most of all, we must have civil servants that can implement the policy with minimum influence from anyone within or outside government.

For those who believe that the above is not possible, it is well to remind that we have no option. It has to be done.

Let us see what our economic policies have wrought:

- GDP growth has been volatile. In 68 years between 1952 and 2020, there have been just two occasions when our GDP growth rate was over 7% in two successive years, Fig 1. We have never had any meaningful growth momentum. We were close to one in the 1960s, but that was frittered away by going to war.

- Apart from the 1960s, our GDP has grown only in times when the country received foreign aid. This happened in the 1980s and in the 2000s, and for a couple of CPEC years. Growth did not come from what we produced, but from what we borrowed and spent, Fig 2. Gradually, the economy's growth potential and competitiveness are on a decline.

- In proof of above, compare the trend lines between Figs 3, 4 and 5. Manufacturing has fallen at a rate more than investment and rate of fall in exports exceeds that of manufacturing. That is, even the declining amount invested does not boost exports.

- In 1992, Pakistan 'liberalized' its economy. (Since then, there has been some scaling back). One test of whether liberalization worked or not is how it affected productive capacity of the country. All indicators show that since then the real economy has faltered. Manufacturing and exports as a % of GDP have been in long term decline. Investment as % of GDP has been up and down, but in decline, Figs 3 to 5. Whether there is causality needs more study.

- Liberalization of capital flows has not helped. Throughout these years, our external account has been fragile and kept in balance by foreign loans, Fig 6.

- So, if growth has been low and volatile and macro indicators weak, what is happening with the Pakistan economy? A couple of things:

  - We do not have a strategy. The economy has drifted from one act of firefighting to the next.

  - Without a restraining guiding strategy, economic policies favour those with influence. While the economy serves elite interests, there is no incentive to make it more efficient or productive.

  - What flows from the above is that our policies must be inclusive. An economy grows when the majority of citizens feel empowered and bring forth their enterprise and ideas to it. It cannot grow merely with a select group playing an active role.

    Yet one crisis has followed another. Business as usual is no longer possible. What should be done? Based on a study of growth economies and development literature, below are some lessons:

  - Growth comes from having efficient industries that produce goods for export. Research shows high correlation between manufacturing and GDP growth rates, Fig 7. And the produced goods must become more complex and value added over time. We must:

    - Promote manufacturing, agriculture productivity, IT, and access to technology
    - Build and improve targeted infrastructure
    - Reduce cost of doing business
    - Improve human capital and develop their skills

    GDP growth will bring more tax revenue. Exports will earn more forex. They will reduce the stress on fiscal and current account balances.

- We have East Asia as guide. Leaders there were consumed by the idea of modernization, economic transformation, and pride in their countries. The real East Asian miracle is the rigour and effectiveness with which governments developed and implemented a plan of growth.

- These are things that only a credible political leader can do. There is overemphasis in Pakistan on sourcing the 'best economic minds'. Economic policies operate in a political context. East Asia's transformation was led by the likes of Deng Xiaoping, Lee Kuan Yew, Mahathir Muhammad, and Presidents Rhee and Park of South Korea. They chose economic well-being over all else in order to exit from the fragility created by the world wars.

- Based on the East Asian model and findings of leading thinkers on development, we summarize some essentials for sustained GDP growth. Each bullet below needs detailed policies in support. That would make a long paper, such that IPR has issued before. The purpose here is to capture the headline things to do. In the past, IPR has researched and published details for each of the bullets below:

  - Create a sound business climate

  - Institute a sound growth strategy with market-based policies that nudges the economy towards desired ends. Support it with industrial policy

  - Increase output and production built on higher investment backed by higher savings. Always low, domestic savings have been in decline for over a decade. There must be policies to increase savings.

  - Channel savings to desired industries and public goods, including via DFIs and off-budget infrastructure projects. The closure of DFIs since the 1980s, has left no valid vehicle for private project finance. Businesses need certainty about financing costs. DFIs offered fixed cost funding for private projects, that scheduled banks do not provide. Decline in our industry almost coincides with DFIs closure.

  - Offer tax and tariff incentives and access to credit to industries prioritized by industrial policy.

  - Promote capital accumulation: The economy must have more plant and machinery, more public goods, including human capital and infrastructure.

  - Repeated research confirms that human resource quality is key for technology adoption, innovation, and growth.

  - Federal and provincial governments must build well-functioning industrial parks and SEZs

  - Re-orient PSDP to support industries through public goods that firms need.

  - Promote structural transformation: increase share of manufacturing in GDP and exports and move up the value added chain Fig 8 A and B.

  - Gradually improve governance and build institutions

  - GoP must set up a Science and Technology Commission. Its mission must be to disperse technology through the economy. It should carry out the dual role of creating a more science literate workforce and of helping firms acquire and use tech in their production processes. This is a critical need. One reason Pakistan's export has not responded to the fall in Rupee is that our goods can no longer compete globally. We must have new export products with more knowledge. This will also enable us to attract industries that are exiting China and other countries.

Our top priority should be economic growth. For decades, it has not been a priority. It needs a national consensus because there are choices to make. Currently, the economy is trapped in low income, low savings, low investment, and low technology. We must also bring down regional trade barriers for trade and investment to effect production sharing arrangements. New industries may need protection from imports until they can compete. Where needed, and for limited periods, government may offer these comforts.

It would help to recall that development is a process that interacts between factors. These factors are labour, capital, government policies and working, better techniques, better skills, and institutions. It is a constant process of optimizing among them.

Fig 1: GDP Growth Rate 1953-2019 %

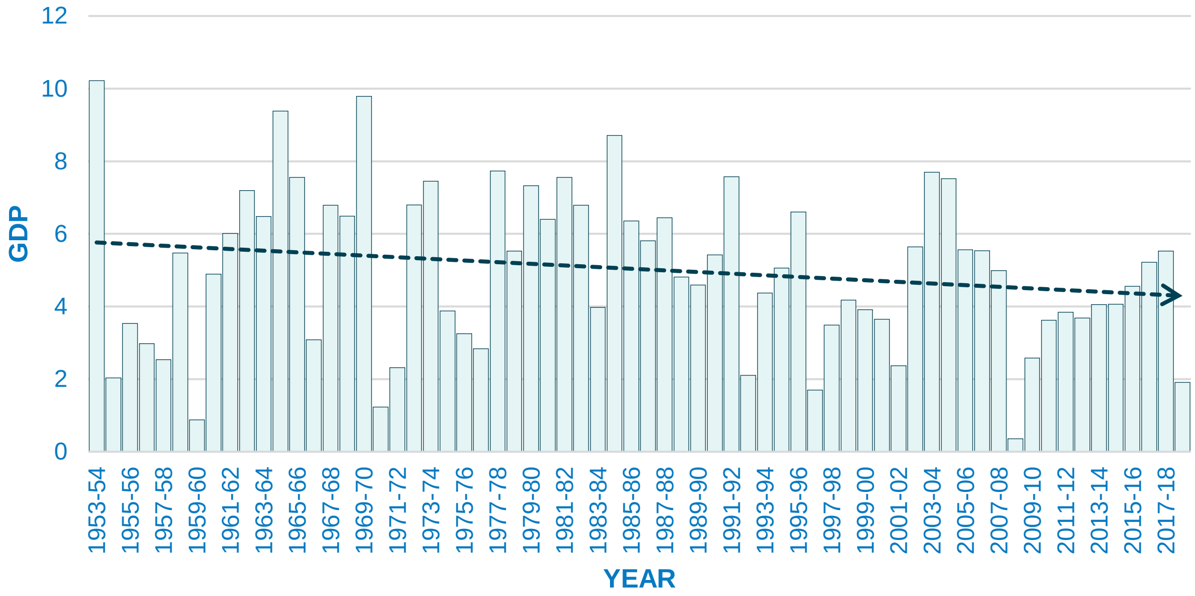


Fig 2: Falling growth potential %

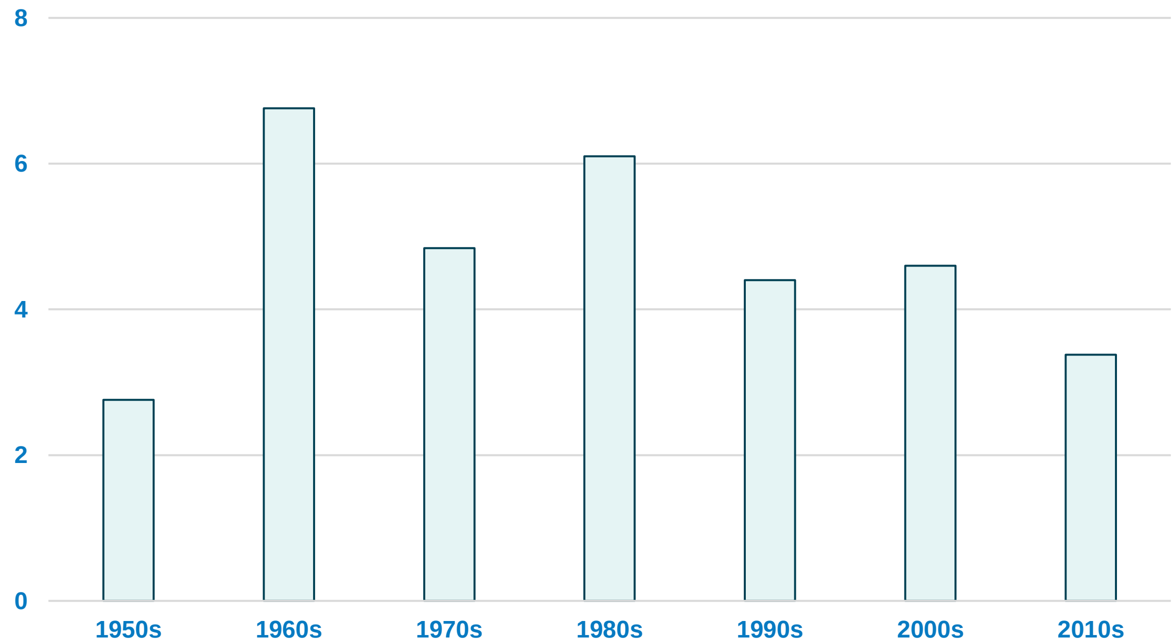


Fig 3: Pakistan: Manufacturing as percent of GDP 1990-2020

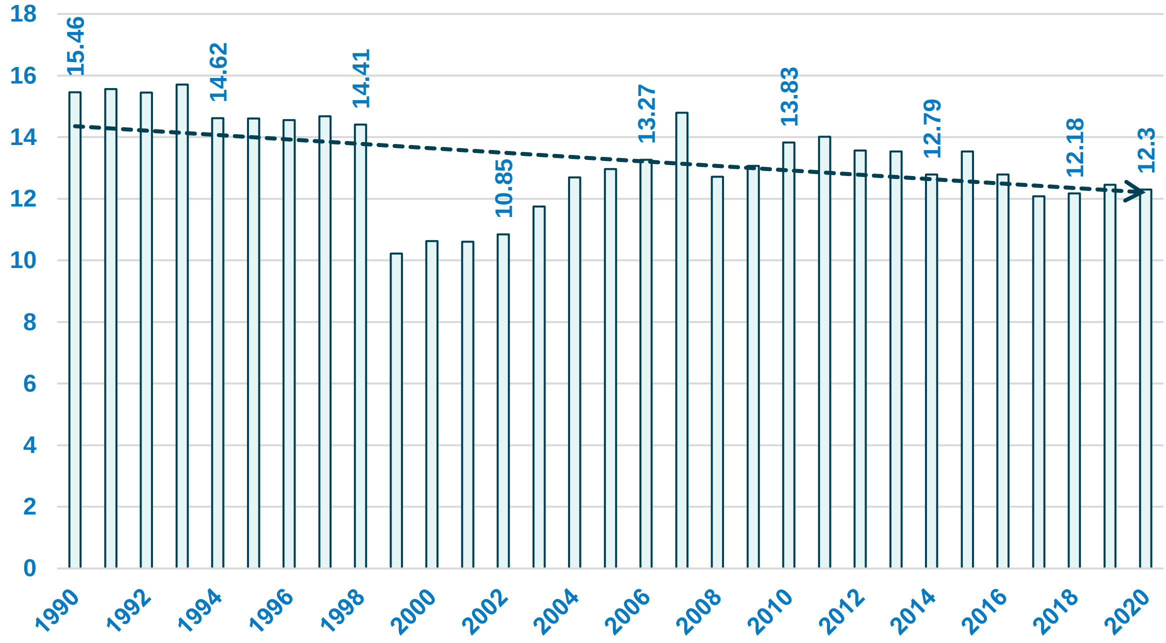


Fig 4: Loss in competitiveness Pakistan's declining export to GDP 1992-2020

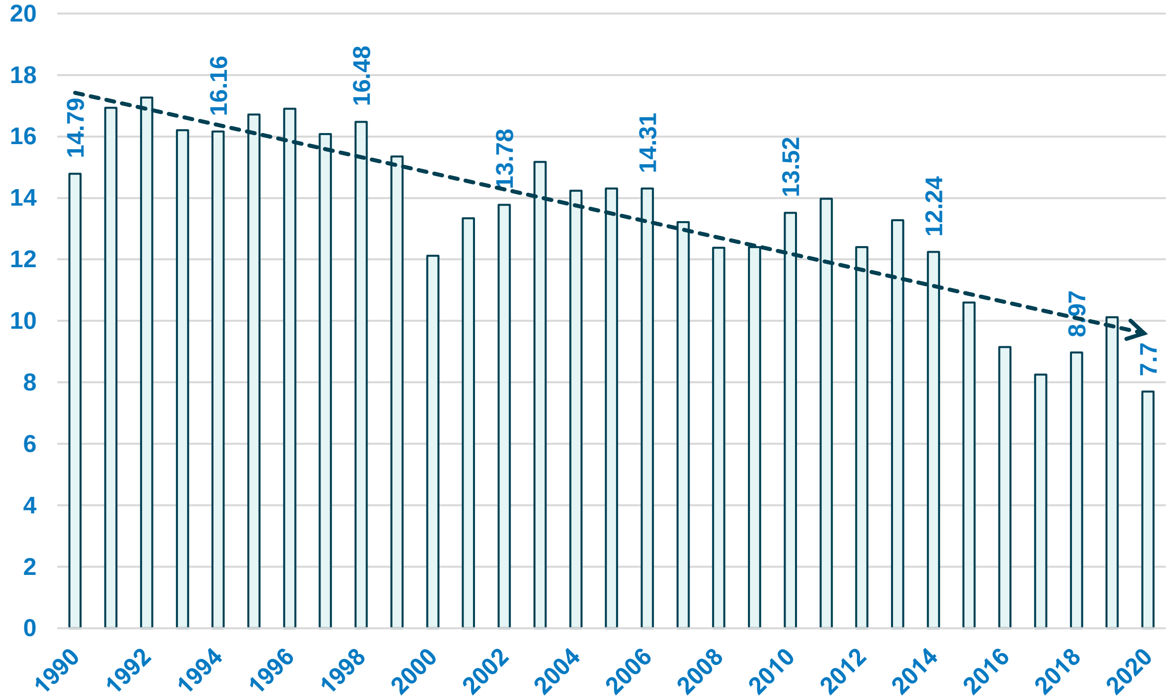


Fig 5: Pakistan's falling investment/GDP 1990-2019

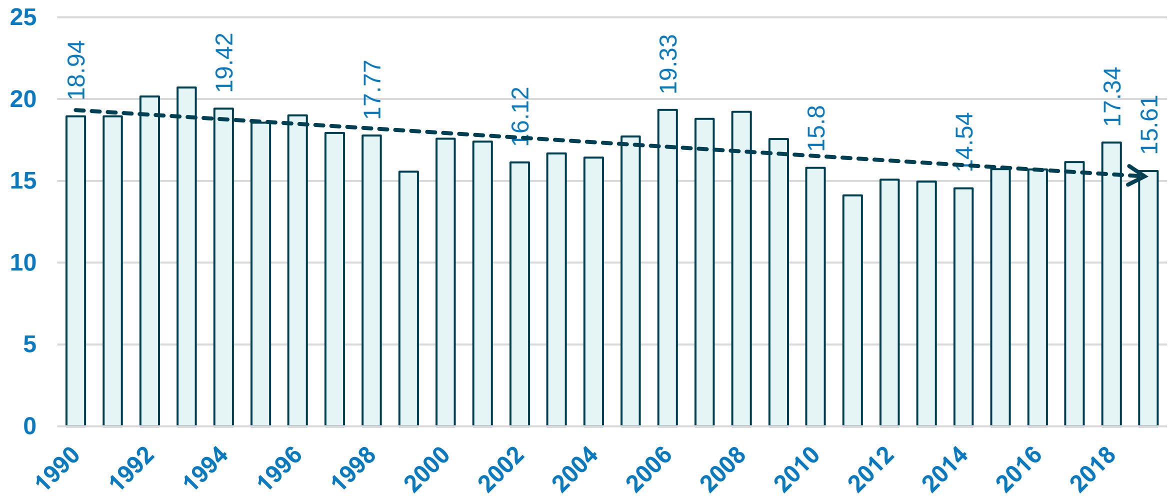


Fig 6: Macroeconomic Instability: High twin deficits

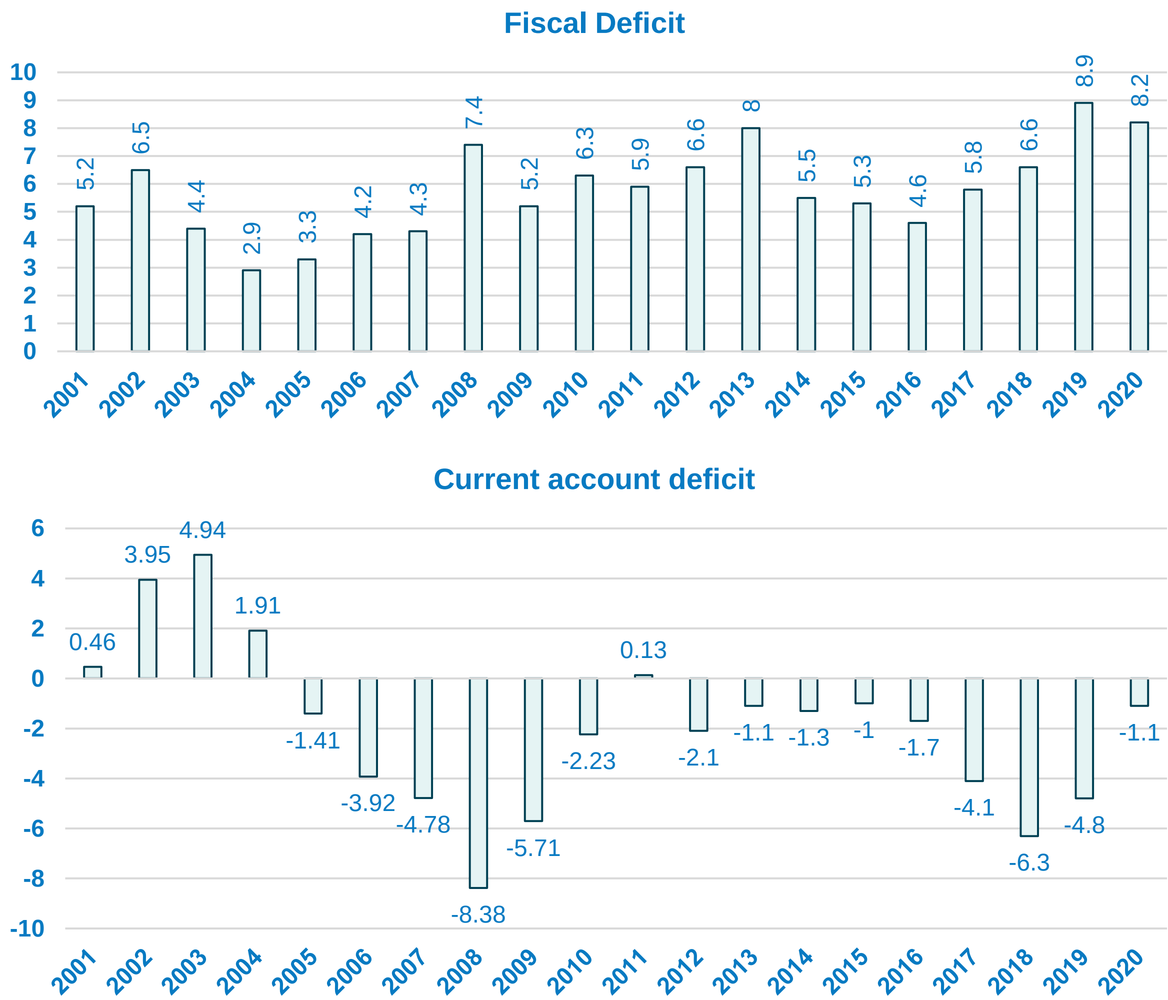
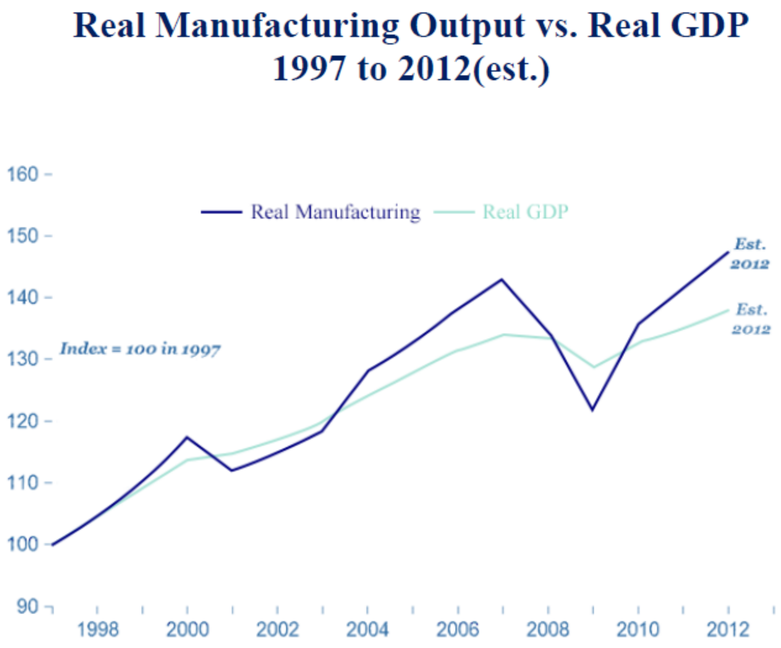


Fig 7: Correlation between growth in manufacturing and GDP growth rates[2]



[2] Source: US Bureau of Economic Analysis, the graph is based on American manufacturing data

Fig 8A: Structural transformation: Share of Manufacturing %				
Economy	**1960**	**1980**	**2000**	**2017**
japan		23.5(1994)	22.6	20.7
Republic of Korea	11.2	21.6	26.0	27.6
Singapore	10.6	26.5	25.9	17.9
Malaysia	10.3	21.9	30.9	22.3
Indonesia	--	13.4	22.7	20.2
Thailand	12.5	21.5	28.6	27.1
Vietnam	--	20.5	18.5	16.5
China			31.9	29.3
India	14.8	16.8	15.9	14.9
Pakistan	11.4	14.3	13.7	13.5

Source: The Global economy database

Fig 8B: Structural transformation: How China's exports shifted from low to high tech								
		1985	**1990**	**1995**	**2000**	**2005**	**2010**	**2016**
Low-tech	China	17.0	40.2	46.4	41.2	15.9	29.3	30.9
	World	14.1	16.6	16.7	14.7	9.7	13.0	15.5
Medium-tech	China	4.9	20.8	18.9	19.6	23.0	24.0	24.5
	World	32.4	33.5	32.6	29.6	26.8	27.6	29.4
High-tech	China	2.1	5.3	13.0	22.4	41.0	34.9	32.6
	World	13.3	15.6	19.6	23.0	18.6	19.6	21.3
Others	China	76.1	31.6	21.1	16.1	19.9	11.4	11.3
	World	37.5	31.1	27.3	27.6	44.6	33.9	27.7

Source: Calculated from UN Comrade database

Fig 9:
In 12 years, debt indicators greatly worsened 2007-2019, where is the money going?

Indicator	Multiples in 2019 since 2007
Total debt and liabilities	8X
As % of GDP	1.8X From 58% to 104%
Domestic debt	8.5X
External debt	6.7X
GDP Current Rs.	4.2X From 9.2 T to 38.5 T
Exports current USD B	1.36X, From 16.9 B to 23.2 B
Total Forex Earning	1.65X,From 32 B to 53 B Includes export of good and services, remittances, FDI

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