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Foreign savings and investment in Pakistan

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Foreign savings' and the 'net external resources inflows' are the two popular acronyms used for the current account deficit in the balance of payments. Considering the critical linkages between the current account deficit and the macroeconomic dynamics of a country, it would be interesting to explore whether these acronyms have a raisen d'etre or these create a false sense of economic illusion.

A country suffers from the current account deficit when the sum of its trade balance and invisible balance are in the negative indicating that the country in question is spending more on the purchase of foreign goods and services than it is earning through the sale of its domestically produced goods and services in the world markets. Ostensibly the term 'foreign savings' suggests that the country has saved a specific amount in its external accounts while in reality the deficit reflects a gap or excess demand in its foreign exchange transactions for a given period of time. This is an apparent contradiction which requires further analysis. The key question is: Does a higher current account deficit indicate that the country is saving more through its external transactions and that a current account surplus implies that the country is "dissaving" externally?

The clue to this paradox is provided by the fundamental identity derived from the national income accounts, which is formally written as S-I = X-M where symbols S,I,X and M indicate respectively the national savings, total investment, exports of goods and services and imports of goods and services. If the left hand side of this identity which indicates the saving-investment gap is in the negative, it invariably follows that the right hand side, the foreign exchange gap would be in the negative as well and vice versa.

The macroeconomic dynamics of any country is critically embodied in the above identity and its four constituents. The identity highlights one of the most important behavioural relationship of an economy namely the current account deficit added to the national savings equals the level of total investment. This implies that given the saving rate of a country, higher its current account deficit as a ratio of GDP, higher would be its investment-GDP ratio. Inversely, if the current account registers a surplus, the investment level would be lower than the national saving rate by that very margin.

To illustrate, the current account deficit as a ratio of GDP for Pakistan, on an average annual basis was 5.8 percent in 1970s, 3.9 percent in 1980s and 4.5 percent in 1990s.

The national saving rate for the three decades was 11.3 percent, 14.8 percent and 13.8 percent and the investment ratio was 17.1 percent, 18.7 percent and 18.3 percent respectively.

In the three decades, current account deficit successively financed 34 percent, 21 percent and 25 percent of the gross investment of the country. On an average basis, the current account deficit has financed about one fourth of total investment of Pakistan in the three decades.

The above data show that Pakistan has heavily depended upon current account deficit to finance its investment level in the past. However, this dependence has been substantially reduced in the last five years i.e. 1997-98 to 2001-02, as the current account deficit fell from 3.0 percent of GDP in 1997-98 to 1.9 percent in 1999-00 and 0.9 percent in 2000-01 before it turned surplus in 2001-02.

The close linkages between the current account deficit and the macroeconomic dynamics for Pakistan can be seen from the level of investment and its components for the years 1992-93 and 2001-02. The gross investment in 1992-93 touched the highest level of 20.7 percent of GDP but it included a component of current account deficit equivalent to 7.1 percent GDP. The year 2001-02 was exceptional for Pakistan as the country registered a current account surplus of 0.1 percent of GDP (State Bank of Pakistan Annual Report 2001-02), but the gross investment fell to 13.8 percent of GDP as the national saving rate for the year was 13.9 percent of GDP. The significant improvement in the current account balance has been followed by a steep decline in the investment ratio.

Since the components of the national savings such as public and private savings as well as the net factor income from abroad have hardly undergone any significant change in the nine year period, it is the behaviour of the current account which makes a fundamental difference in determining the volume of investment in the country.

By critically examining the national savings, investment and the current accounts for the years 1992-93 and 2001-02, it can easily be deduced that labelling of current account deficit as 'foreign savings' is not a helpful practice in defining the macroeconomic relations of the basic variables. The concept of 'foreign savings' a nomenclature for the current account deficit could give an erroneous signal that running a deficit in the current account is a desirable outcome as it supplements the national saving rates and raises the level of investment. In fact, the large levels of the current account deficit historically maintained may be camouflaging the phenomenon of persistently low saving rates of the country.

The labelling of current account deficit as 'foreign savings' or 'net external resources inflow' could be misleading for the simple reason that the current account deficit depicts the net addition to external liabilities and therefore it should be labelled as 'net external borrowing' rather than 'net external resource inflows' or 'foreign savings'.

The current account deficit as a component of total investment needs a micro level analysis to fully assess its impact on economy of any country.

Let us suppose that there are four countries A,B,C, and D, each suffering from current account deficit equivalent to 5.0 percent of GDP. Let us further assume that country A has a large component of interest payments in its invisible account which is the major factor of its current account deficit. Country B suffers from a deficit because it is spending huge amounts of foreign exchange on technical and professional training of its manpower abroad. Country C spends huge amounts of foreign exchange on imports of luxury goods which is the main factor of its current account deficit, while country D incurs the deficit due to large imports of capital goods and raw material for capital goods. It is obvious that even though the current account deficit as a ratio of GDP is the same for the four countries, the macroeconomic dynamics of the current account deficit for each country is different because of the wide differences in the components of the current accounts of these countries.

It is not difficult to see that current accounts of the countries B and D have a higher investment component while the current accounts of countries A and C have a higher component of consumption. Therefore, interpreting current account deficit as a source of investment for each country may not be the best practice in understanding the macroeconomic dynamics of these countries. Only micro level analysis could provide a real insight into the actual stimulus provided by the current account deficit to the investment and growth of a county.

The key issue in investment financing in Pakistan stems from the fact that it has a national saving rate which is abysmally low and hovers around 13.0 percent of GDP for the last three decades. This compares most unfavourably when compared to the average saving rate of developing countries, which is around 18.0 percent and that of India which is 24.0 percent of GDP almost double the rate of saving of Pakistan. With such a low rate of national saving, Pakistan had an investment rate of 18 percent on average annual basis for the last 30 to 35 years but it has continuously added to external liabilities and debt by running a current account deficit of about 4 to 5 percent per annum on an average basis for the years 1970-71 to 1999-2000.

The economy of Pakistan presents a unique paradox which arises from its high dependence on 'net-external borrowing' or the current account deficit to finance its gross investment. The reduction in the net-external borrowing' in the recent years has led to a steep fall in the level of investment affecting the growth performance of the economy. The only way that Pakistan can get out of this paradox is to raise its national saving rates from the present level of 13 percent to a level of 20 percent in the near future. This raises the two fundamental but related questions: What determines savings in a country and why is saving rate so low in Pakistan?

The views expressed here are personal to him and do not represent Planning Commission.

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