

# Issues about the economy

Pak-Eco

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DURING my just concluded visit to Pakistan I met a number of journalists writing on economic issues. They asked me many questions about the state of the Pakistani economy and its future prospects. While I tried to answer these questions as best as I could, I was puzzled by the degree of scepticism that was implied in many of them about the government's claim that Pakistan had finally turned the economic corner and was set to proceed on a trajectory of fairly rapid growth.

It is important to reflect on the doubts that persist and also about the way the media perceives the current economic situation. In recent years, economists have begun to focus on what they call "behavioural economics". This deals with the way people react to various economic stimuli and the way they relate to the economic environment in which they function. Since confidence about the future is an important determinant of the way people will save and spend money and the way entrepreneurs will invest, lingering doubts about government pronouncements need to be seriously addressed.

The most frequently asked question was about Islamabad's claim that the gross national product in the current fiscal year was likely to be in the neighbourhood of seven per cent. "Do you believe in this estimate?" I was asked. Some journalists posing this question said that their doubt was based on the fact that they had been lied to before. I gave two answers to this question. One, it is exceedingly difficult and also very risky for governments to lie or even exaggerate about such broad estimates as GDP growth.

The performance of a country such as Pakistan that has had active programmes with the International Monetary Fund in the recent past and in which development institutions such as the World Bank and the Asian Development Bank are deeply engaged is under careful scrutiny. Since national income accounts are carefully looked at by these agencies, there is not

can be supplied with capital to work with and if it can also acquire skills that would make it more productive, the rate of growth should be much larger than the rate of increase in population. This is where investments of different types enter the picture.

The best way to move this discussion forward is to think in terms of the returns on investment — what the economists call the incremental capital output ratio, or ICOR. The ICOR measures the proportion of GDP that needs to be invested in order to produce one per cent increase in national output. At the moment, Pakistan is investing about one-fifth of its GDP; if the ICOR is four that would produce a rate of growth of five per cent a year. An ICOR of three would mean a rate of growth of nearly seven per cent a year. A lower ICOR means a more efficient economy.

There is considerable debate in the country on economic issues. Some of it is founded on misplaced suspicions about the government's intentions, some of it is based on the absence of good information about the structure and characteristics of the economy, and some of it is related to the fears that history would repeat itself and produce unpleasant consequences. The government should not be dismissive about these concerns. It should earnestly join the discourse.

Let us look at two economies in our neighbourhood, China and India. China has been investing some 40 per cent of its GDP with which it has achieved a rate of growth averaging 10 per cent a year. The Chinese ICOR, therefore, is of the order of four. The Indian growth rate has averaged at just over six per cent a year for the last couple of decades with investment of about 25 per cent of GDP a year. This means an incremental capital output ratio of slightly more than four. Pakistan's ICOR cannot be lower than those of India and China for the reason that its economy is not more efficient than those of these two countries. Therefore, in order to achieve rates of growth of seven to eight per cent a year, Pakistan will need to increase its rate of investment by about 50

I base this confidence on the deep structural changes in the financial structure of the last several years that have brought new instruments of savings into the market while removing some of the major distortions. But much more needs to be done in this area. While Pakistan has one of the better banking systems in South Asia and now has an exceptionally vibrant capital market, it needs to develop new instruments that would attract more personal and business savings to be channelled into the productive sectors of the economy.

One other line of questioning about the performance of the economy concerned the impact of growth on the incidence of poverty and income inequality. There is a widespread impression in the country that economic revival is not benefiting the poor; that the rewards of growth are being captured by the rich; that, given the relatively

unequal distribution of income in the country, a trickle-down growth of development would succeed only with much higher rates of GDP increase.

I saw several articles in the newspapers that recalled the experience of the "decade of development" under President Ayub Khan when, as conventional wisdom has it, much of the benefits of GDP increase were reaped by the infamous "22" families. I have always had misgivings about that interpretation of the Ayub Khan period but this is not the place for getting into that subject. The important point is to underscore that there are many who believe that

history is about to repeat itself.

The Musharraf government has taken a different stance. It maintains that the growth in the economy is much more broad-based than the mainstream press maintains; that the small and medium sized industries are playing an important role in both economic recovery and laying the foundation for high rates of growth that would be maintained over a long period of time; and the government is now using the fiscal space it created through better macroeconomic management into investing resources that would directly benefit the poor. Islamabad does not agree with the analyses of some of the think tanks that in spite of the revival of growth the number of people living in poverty has continued to increase.

Injecting my thoughts on this sub-

looked at by these agencies, there is not much point in the government exaggerating the rate of growth of the economy. If the prime minister has said, as he did in Jeddah during a recent visit, that he expected the economy to expand by seven per cent in 2004-2005, that is what is likely to happen.

Sometimes it also helps to go beyond the numbers the government provides and to look around what should be easily visible and discernible. For a visitor such as this writer, the fact that the Pakistani economy was booming was quite apparent. The Karachi stock market was climbing relentlessly and new records were being set almost every day while I was in Pakistan. Driving around Lahore, Islamabad and Rawalpindi, one cannot help but notice all manner of construction activity involving not just houses and new residential estates but also offices, roads and infrastructure. All this is indicative of an economy on the rebound. This was my second answer to the question about the reliability of growth rate estimates.

"Even if Pakistan achieves a rate of growth of seven per cent this year, will this level of growth be sustained in the future as the government claims?" This is a much more legitimate question to ask. My answer usually took me into some simple development economics. Economic growth rates are the product of a number of changes, among them the rate of increase in population; the amounts of investment by the government, businesses and households; and improvements in worker productivity.

Pakistan's population is growing at just above two per cent a year. Unless there is a decline in the productivity of the work force, this increase should result in at least two per cent increase in gross domestic product. If the existing and new workforce

increase its rate of investment by about 30 per cent, from the current 20 per cent to somewhere near 30 per cent. Is this feasible?

Such an increase is possible if the country increases the rates of savings by households and businesses, contains government expenditures on non-productive parts of the economy, and is able to receive considerably larger doses of external capital flows. The last mentioned item has played a critical role in economic revival. Remittances by the Pakistanis living abroad are responsible for adding somewhere between one to one and a half percentage points of growth over the last few years. There is considerable scope for increasing this flow, doubling it perhaps over the next five years.

The reason for this is that the extremely well-off members of the Pakistani diasporas in North America that saves between \$15 and \$20 billion a year are developing confidence in the economic future of their homeland and are prepared to invest not only in real estate and the stock market but also in start-up businesses. This palpable change in attitude is largely the result of the policies adopted by the Musharraf government. Their continuation would add to the confidence of the members of the diasporas.

It would, however, be imprudent to rely on external capital flows for producing high rates of economic growth. There is a clear lesson to be drawn from the two economic booms of the sixties and the eighties which were the products of spikes in external capital flows. Once those flows ceased, the rate of economic growth slowed down. There is hope this time round that external flows — in particular those originating with overseas Pakistanis — will continue and that business and household savings rates will begin to increase.

In presenting my thoughts on this subject to those I talked with, I emphasized that the development community now knows much more than it did a few decades ago about devising a pro-growth strategy. Such a strategy has essentially three components. One, the economy must grow at rates of about three times the increase in population. For Pakistan, this would imply a rate of growth averaging at 6.5 per cent a year to be sustained over several years, if not decades.

Two, the public sector must invest heavily in improving the quality of the human resource. This includes not only reaching the goals of universal primary education for boys as well as girls but also providing secondary and tertiary education to a significant proportion of the population. And the state must help to develop a skilled workforce needed by a growing economy.

Three, given Pakistan's resource endowment, there has to be a significant amount of public sector attention given to improving agricultural productivity. This would mean simultaneous movement along a number of fronts by both the public and private sectors. The most important part of this strategy has to be the rehabilitation of the large irrigation network the country possesses and which it has neglected to adequately maintain.

There is, therefore, considerable debate in the country on economic issues. Some of it is founded on misplaced suspicions about the government's intentions, some of it is based on the absence of good information about the structure and characteristics of the economy, and some of it is related to the fears that history would repeat itself and produce unpleasant consequences. The government should not be dismissive about these concerns. It should earnestly join the discourse.