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Conference Report*

The Lahore School's Eighth Annual Conference on Management of the Pakistan Economy took place on 16 – 17 May, 2012 at the school's Main Campus. The topic of this year's conference was: "Towards Accelerated Economic Growth in Pakistan: Its Need and Feasibility". It was attended by the country's leading economists, Pakistani and foreign academics, and renowned researchers from India, Sri Lanka, United Kingdom, and United States. Some 25 research papers and oral presentations were made during the two days of the conference.

The richness of the discussions during the two days of the conference cannot be adequately captured in a short report but, as a record of the salient issues raised, it could be useful for the participants as well as others interested in the subject. Since discussions in different sessions tended to overlap, what is offered here is a composite summing-up rather than a chronological account of the actual proceedings.

Key Messages

1. A push towards accelerated growth is both feasible and essential to creating employment and alleviating poverty in Pakistan.

2. Pakistan's current macroeconomic imbalances are unsustainable and must be corrected, but the required adjustments can be gradual and be brought about as economic growth accelerates.

3. The biggest hurdle to accelerated economic growth at present is the acute energy shortage, which calls for a concerted government response at overcoming mismanagement in the power sector, renegotiating contracts with power suppliers, and devising a strategy to rely increasingly on domestic and renewable sources of energy, notably, water and coal.

4. Accelerated growth is contingent on higher private investment, though public investment in infrastructure would remain vital to sustaining future growth. Economic uncertainty, credit squeeze due to the large public sector borrowing, the law and order situation, and

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not least the energy crisis hold back private investment, but economic growth could itself improve the investment climate.

5. Sustainability of economic growth depends critically on Pakistan's ability to compete in world markets. Productivity improvement in existing export industries is obviously important, but Pakistan's export base also must be broadened towards higher value added industries. Access to technology and improved worker skills will be critical.

6. Pakistan's geo-strategic location is an asset but trade opportunities remain under-exploited. The country has failed to reap benefits from the free-trade agreement with China. Trade with India has considerable potential, but it will depend critically on Pakistan's ability to compete.

7. The 18^{th} constitutional amendment and the 7^{th} NFC award devolved key federal functions to the provinces along with greatly increased federal fiscal transfers. Decentralization is to be welcomed but its actual implementation faces certain challenges, notably, preventing fiscal slackening in provinces and ensuring satisfactory delivery of social services (health and education) at local levels.

Issues Discussed

1. Feasibility of Accelerated Growth

The conference opened with a discussion on conditions necessary for bringing about accelerated growth in Pakistan. The conventional wisdom is that the macroeconomic imbalances and high inflation constrain the economy's ability to grow, which implies that without significant improvement in these two areas, accelerated growth would not be sustainable. However, Pakistan's current stagflationary state could not be explained in these terms since its macroeconomic imbalances and inflation were broadly similar to those in other but more rapidly growing economies, viz., Bangladesh, India, Indonesia, and Sri Lanka. The country's macroeconomic imbalances and inflation obviously need to be brought down but not too suddenly if the economy is not to be further depressed. A heterodox alternative to the conventional approach to stabilization was proposed, which showed that Pakistan's growth could be accelerated while the required macroeconomic adjustments were phased over the next few years.

The immediate constraint on Pakistan's economic growth in fact is the acute energy shortage that has seriously hurt industrial productivity.

However, from the longer-term perspective, Pakistan's low investment rate and weak international competitiveness has held back growth. The heterodox approach is contingent on overcoming these constraints on economic growth.

This approach to accelerated growth is rather different to the one proposed in the Pakistan Planning Commission's *Framework for Economic Growth*, launched May 2011. Although the *Framework* called for "rethinking" Pakistan's growth strategy, no new ground seemed to have been broken. A point was made that, by ignoring Pakistan's own past experience and that of other high growth economies, the *Framework* has uncritically placed faith in the market and private enterprise and is generally dismissive of the role governments routinely play in promoting economic growth. This policy orientation appears to be at odds with the recent calls for greater state activism in the advanced countries, not to mention the state's role in other Asian economies. The *Framework* also did not address the core concerns of mobilizing revenue, income distribution and equity or provide a roadmap of how it would be implemented. In fact, the government has not adopted the *Framework* as a guide to policy.

2. Why Accelerated Economic Growth?

The discussion then moved to the basic compulsion behind choosing this path, i.e., alleviating poverty and reducing unemployment. Some 20-30 million people are estimated to be currently living in absolute poverty and about 3.5 million are unemployed. While overall unemployment has risen in the post-2007 period, real wages rose slightly in the agricultural sector but declined in the construction sector. It is somewhat puzzling that the actual situation is not worse considering the combined effect of the natural disasters, high inflation and low economic growth.

The explanation was seen to lie in certain recent developments in the rural economy, viz., a very large increase in worker remittances into rural areas, substantial improvement in wheat procurement price, an increase in non-farm rural activities, and possibly the transfer payments under the Benazir Income Support Programme and other government income-support programmes. Urban areas too have benefited from the growth of the informal sector and the income-support programs.

The poverty picture, however, could be much worse if the absolute poverty measure was raised to the World Bank's definition of $1.25 per day, which would entail more than doubling the current poverty cut-off threshold. In order to ensure that the poor do not get hurt through deficit reduction and benefit from economic growth, government will need to invest in maintaining a "social floor". In other words, without appropriate measures to protect the poor and create employment, growth alone will not be enough.

3. The Energy Crisis

The energy crisis was seen as the most serious constraint on investment and economic growth, an issue that surfaced in different sessions. Power cuts are the single biggest cause of the underutilized capacity and the rise in production costs in different industries. The problem was held to be the outcome of two policy shifts during the 1990s: (i) The increased reliance on the private sector for the generation and distribution of electricity; and (ii) the reorientation of power generation from the domestic hydroelectric sources to imported fuels, greatly raising the generation costs. The contracts with the independent power producers (IPP) and later rental power producers (RPP) have proved to be highly costly for both the government and the nation. Instead of the promised improvement in power supplies and public finances, the opposite has happened. To deal with the crisis, the immediate steps involve a renegotiation of the earlier contracts.

Despite the substantial increases in electricity tariffs over time, the drain on fiscal resources has continued. The increased budgetary costs have not been due to consumer subsidies, but rather a result of the past contracts, which were highly favorable to power producers. The government now faces a situation where it faces the consumers' wrath at the cost and unreliability of electricity while the power producers cite government's wholesale violation of legally binding commitments. The so-called circular debt problem is just the pile-up of non-payment of electricity bills along the electricity supply chain.

4. Private Investment

That the investment rate in Pakistan must rise substantially to support higher growth was self-evident. That private investment would be the principal trigger of growth was also incontrovertible, though it was frequently stressed that public investment remained critical to improving social and physical infrastructure.

The high fiscal deficit and government borrowing from commercial banks has raised interest rates and "crowded out" private

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investment. Nevertheless, after sharply declining in 2009, the private sector off-take of credit has shown signs of weak recovery recently. The fact that private savings have been currently higher than investment is suggestive of capital flight, but in fact it has primarily been a consequence of the fiscal deficit. While Pakistani investors have become more active in overseas investment, there is little evidence of actual capital flight.

Despite the general pessimism, several industries have managed to thrive, and Pakistan's future economic prospects were regarded as fundamentally bright. This is due to a strong consumer base with evident upward social mobility and a rising middle class, falling dependency ratio with the rise in working population, the country's natural resources and, not least, its geo-strategic location. If conditions are to improve and growth picked up, Pakistan's economy – as the other rapidly growing Asian economies – could get into the virtuous circle of high growth-high investment-high savings.

5. *International Competitiveness*

Rapidly growing economies aggressively promote their exports, but Pakistan remains a laggard. The discussion focused on the reasons for poor productivity growth and the failure to broaden the country's industrial base. While there are isolated cases of creativity and technological sophistication, the country has continued to rely heavily on traditional textile exports and low value-added activities. Industrial deepening and a move towards more sophisticated products has been hindered by the barriers to technology transfer. Subcontracting arrangements with foreign firms to locally produce manufacturing components could be one means of accessing foreign technology. This might enable Pakistan to start producing more complex, diversified, and higher value added products.

Apart from the energy shortage, low labor productivity was cited as the pervasive reason for lack of competitiveness. According to one recent survey, a number of firms considered labor productivity to be a major determinant of production costs. The same survey reported serious skill shortages because of poor education and inadequate worker training. Poor infrastructure and market imperfections have also raised production costs but rather surprisingly corruption, injustice, and political interference were not found to be significant factors.

The other side of international competitiveness is the quality of products produced. Quality certification and adherence to health, labor, and environmental standards have become highly important in international trade, but have remained neglected in Pakistan.

Firms' ability to survive in the domestic and foreign markets is a key indicator of competitiveness. A study of the factors affecting firm entry, scale and survival in Punjab found that exporting firms have tended to enter highly concentrated industries, that entry and survival have increased with real exchange rate depreciation, and that new firms have tended to be larger in districts with higher concentration of medium sized firms. New entrants in export industries were attracted to existing industrial clusters, though the existing large firms also have had a chilling effect.

Preoccupation with international competitiveness was criticised on the grounds that the concept was ambiguous and liable to result in incoherent and misguided policies. This criticism, however, was not sustained because measures to enhance productivity could benefit Pakistan without hurting other countries. At a time when industrial policy is back on the policy agenda in industrial countries, Pakistan's own approach to industrialisation deserves reconsideration.

6. Pakistan's Geo-strategic Location

A corollary of the discussion on international competitiveness was the discussion on Pakistan's strategic importance and international trade relations. An overview of Pakistan's trade relations with its neighbours indicated that there is enormous unexploited potential for trade with India, China, UAE, Iran, and the Central Asian Republics. Contrary to a common perception, Pakistan's non-oil trade within the region has grown very rapidly and now accounts for 25 per cent of its exports and 35 per cent of imports. UAE, Afghanistan and China (with roughly equal weight) account for virtually the entire Pakistani exports to the region, while the share of India and Sri Lanka is barely one per cent.

China and India hold the prospect of becoming Pakistan's key trading partners and could underpin economic expansion, provided a few pressing issues are resolved. Although Pakistan's exports to China have grown rapidly since the signing of the FTA in 2006, their composition (concentrated on cotton yarn) has not been conducive to longer-term growth. On the other hand, the rapid rise in Chinese imports has wiped out many small to medium scale light industries, though consumers have benefited from lower import prices. However, the FTA could benefit Pakistan from China's industrial restructuring resulting from rising wages. Chinese investment into Pakistan could also become a major source of financing and technology, thus helping Pakistan's own industrial restructuring.

The heightened interest in Pakistan to normalize trade relations with India was welcomed. Although trade between the two countries has risen rapidly in recent years, the sharp rise in Pakistan's trade deficit with India (now $1.5 billion) was a concern. Two sets of questions were raised during the discussions: One, given the experience of the FTA with China, would Pakistani industry not suffer from Indian imports? And, two, while Pakistan's exports had enjoyed MFN treatment in India for some time, why had they failed to grow? On the other hand, India's exports to Pakistan appear not to have been significantly hurt by the absence of MFN. The explanation for the differential trade performance of the two countries was held to lie in the relatively weak competitiveness of Pakistan's industry, differences in tariff structures as applied to what each country exports, and India's high non-tariff barriers.

7. *Making Devolution Work*

The conference's concluding session was devoted to a discussion on making provincial devolution work. The 7th National Finance Commission (NFC) Award and the 18th amendment to Pakistan's constitution were major steps towards fiscal decentralisation and enhancement of provincial autonomy. The NFC award has brought about a very significant increase in the provinces' share in federally collected taxes and made the sales tax on services a provincial subject. The 18th constitutional amendment, at the same time, devolved a great number of government functions to the provinces and granted them enhanced borrowing powers. Although the amendment had the potential of bringing about a fundamental change in governance, little devolution has actually taken place.

A number of concerns were raised. (i) While devolution would require time to become established, key social areas – health and education – could be further neglected. (ii) The consolidated fiscal deficit is liable to rise because federal expenditures would not fall in line with the devolved functions while the revenue-raising effort at the provincial level could slacken. (iii) There is ambiguity with respect to a number of critical areas, notably, registration and pricing of drugs, inter-provincial distribution of wheat and fixing of its procurement price, operation of the national social security scheme, and, perhaps most important, granting of concessions on gas and oil exploration and decentralisation of the power sector. There is also the risk of increased provincialism at the expense of nation building.

While the above-mentioned concerns are real, the devolutionary measures were seen as irreversible and welcomed as a start towards decentralization. As experience is gained, changes and innovations could be introduced to improve the system. The measures have created greater harmony in federal-provincial relations and, by devolving critical services to local levels, have made government accountability more transparent.