Dr Ishrat Husain: ‘When there is no neutral umpire, markets are rigged by the elite for their own advantage’

BR RESEARCH   MAY 2ND, 2017

BR Research recently sat down with renowned economist Dr. Ishrat Husain on the side lines of the Punjab Economic Forum. Having retired as Dean of the Institute of Business Administration, Dr. Ishrat Husain is currently Public Policy Fellow at the Woodrow Wilson Center in Washington DC. He has been a career bureaucrat and a former Governor of the State Bank of Pakistan, while also having a long and distinguished career with the World Bank. We discuss the state of the economy and the role of institutions in promoting inclusive and sustainable growth. Below are edited excerpts of the interview.

BR Research: Boom and bust cycles are quite frequent in Pakistan as the country is susceptible to internal and external shocks. What measures does the government need to take to reduce susceptibly to shocks?

Ishrat Husain: We have to look towards proactive economic management. The markets have to be regulated but also given a sense of direction.

The government and the regulators have a role not only of penalising but also have a responsibility to guide and promote. If you are aware that there is going to be no shift in the policy direction in the future, your behaviour will be totally different as compared to a situation where there is continued uncertainty and unpredictability.

A private individual does not have the information that a government official has. This informational asymmetry has to be reduced and not on a selective basis but across the board. By achieving this transparency investor sentiment will be bolstered resulting in sustainable economic growth.

BRR: Sticking to this theme of informational asymmetry, how important is communication in modern state-society relationship?

IH: This country suffers from weak communication between policymakers, general public and investors, which also results in mixed signals for the market. The continuity and the predictability of economic policies have been lacking in this country, and it has suffered considerably because of it.

When I was the governor State Bank, people used to ask me why I went on air and gave interviews to newspapers. I told them that the era of the central bank is over where it used to stay silent. I gave them the example of Alan Greenspan (of the US Fed) who appeared publicly many times, although of course it is obvious that you do not reveal any classified information.

You have to give the citizens and private sector businesses a sense of direction of where they are heading. However, the situation is quite opposite in Pakistan. Here, we are in a confrontational attitude. If the government says anything, it is labelled as a liar, which has become a major issue. The trust deficit has become very wide.

By doing this you are doing a great disservice to the country. If you look at the economic policy manifesto of PPP, PML-N and PTI there is no difference. If they are agreeing on the economic side, then they should support those common economic policies despite their political differences. A Charter of Economy ala the Charter of Democracy will be very encouraging to local and foreign investors.

Narasimha Rao as the Congress PM dismantled the License Raj, opened up the economy and adopted liberalisation policies in India. These policies were continued by his successor Atal Vajpayee of BJP. This continuation in policies acted as a catalyst which helped the Indian economy take off.

The economic vision should be shared by everyone. It is a national vision that should not be exclusive to any political party or individual. If that can be achieved, the investor will breathe a sigh of relief because he knows that any political change will not affect economic policies.

BRR: Pakistan is a predominantly consumption based economy with over 90 percent of the GDP consumption based. Some observers argue that the high import bill is catering to the domestic demand. Do you think this is a threat?

IH: If you take this 90-95 percent consumption, and if you take the import intensity of that consumption, it is not that high. There has to be a sense of proportion. Our entire import bill is around $40-45 billion, which is roughly about 12 percent of the current size of our economy. Now you have to decompose the imports into capital goods, raw material for capital goods, raw material for consumption goods and the consumer goods.

If I decompose this 12 percent, the main items are petroleum and petroleum products, machinery and equipment, raw materials for capital goods. Imports for consumer goods or raw materials for consumption will be around 3-4 percent of GDP. So the import intensity of consumption is much lower and I am not worried about that.

BRR: What are you concerned about then?

IH: I am more concerned about the generating capacity of our foreign exchange. We have neglected our exports. For 6 years during 2001-07, the dollar traded at 60 rupees and even then exports doubled. Economic theory and empirical evidence tells us that there is no unique or correct way to measure equilibrium exchange rate. Trading partners 'weighted exchange rate' is different from competing countries 'weighted exchange rate'.

If you move away from only trade and combine trade and capital financial flows together, then the outcome turned out to be positive and that is how we built up our reserves from a low level of $ 1300 million to more than $12 billion in a six-year period.

It is impossible to artificially peg the exchange rate at a certain predetermined level and build up your reserves at the same time.

So just blaming everything on the exchange rate is also misplaced. If you depreciate the currency by 10 percent, the foreign buyer will say “give 5 percent as a discount.”

Then 40 percent of your exports are using imported raw material which is adding value. So the cost of this 40 percent will go up and your net gain will be limited to 2-3 percent as a result of 10 percent currency devaluation. But at the same time your import inflation will hit your domestic consumers and your fiscal deficit will further increase as the debt servicing burden in rupees would rise by 10 percent. Foreign investors would see their profits in dollar terms decline, discouraging them to bring in new investment.

That is why I always used to look at the holistic picture and not just a partial picture because exchange rate is a very sensitive subject. On one hand you have to maintain the market’s confidence. The moment the market realises you do not have money they will hit hard. So the exchange rate has to be calculated along these parameters.

If you always have cost benefit analysis framework in your mind you are better off. People tend to look at the costs in isolation but the benefit should be seen as well.

BRR: What do you suggest for fixing the export growth problem?

IH: The cost of doing business for exporters has gone up tremendously. There should be no question of any refunds or taxes. If our competitors are given rebates and cash concessions, the government should also provide the same.

The cost of giving rebate and cash compensation is much lower than the cost of doing devaluation. That is the calculation you have to do. The moment you do this calculation you will say the tax collection is going down by $1 billion but incremental exports will increase by $10 billion in the next 4-5 years.

Whenever domestic sales are more profitable than your export sales which are quite tough to sell in the international market, production will be directed to cater to domestic sales. Many of the big textile exporters are opening retail outlets because the economics of retail is much better. The government should focus on improving their return on exports and reduce anti-export bias.

Additionally, to handle exports you need to have a different structure. I brought in the long term financing rate to 3 percent in my tenure. Textile import machinery worth $5 billion was imported during that time because the MFA was ending and we were going to enter a competitive world market for textiles.

Our spindles were obsolete and the government at that time facilitated in modernising them, and it was only for those who were importing machinery for exports. So it was a targeted subsidy which paid off because our exports increased so much the substantial difference was not that much.

Once you lose the market share it is very difficult to get it back and it is not just supplier-specific but country specific as well. When I went to Faisalabad in the previous government's tenure the textile manufacturers were almost in tears. It was Christmas time and they could not complete their orders because there was no gas or electricity.

BRR: Laptop assembly has started taking place in the country by Haier for Punjab and Sindh governments. How can we improve the trade balance through improving local production?

IH: The infant industry argument applies here. For these kinds of industries, you have to give a push in the beginning. You acquire what is called learning by doing, initially sorting out issues like skilled labour and in the beginning you ought to have a guaranteed supply contract with the government and its departments and bodies.

As you expand, economies of scale will kick in and bring down your unit cost of production. Once you penetrate the market and assure customers that the locally made product is comparable in quality, cost and reliability to international vendors then the industry will become sustainable.

There is a big transformation required in the mind-set so what we have to do is start on a modest scale and then gradually build it up. To that end, the government is taking the right step by reducing corporate tax.

BRR: How much room does any government have in Pakistan to focus on economic growth in the face of security concerns and war against terror?

IH: Since 1990, Pakistan has fallen behind its peers and has had a decline in the growth rate from 6.5 percent to 4.5 percent with short-lived periods of good economic growth.

Let us consider the hypothesis that the security situation and terrorism are responsible for this decline. It may be valid to a certain extent but the economic decline started in the 1990s, which was before the country got entangled in the war against terror in the post-2001 period.

The average growth rate in the 1990s when the country was relatively peaceful was already down from 6.5 percent in the 1980s to 4 percent. Investment ratios, export growth, and social indicators all took plunge in the 1990s. Poverty that was showing a downward decline until the 1980s had also worsened by the end of the 1990s.

Contrastingly, the period from 2002-08 saw acceleration in terror activity but still the country recorded a remarkable turnaround. The growth rate reached 6 to 7 percent on average, Investment-to-GDP ratio peaked to 23 percent and foreign direct investment flows reached above $5 billion.

Then if you consider the 2013-16 period macroeconomic stability has been achieved and economic growth rates are moving in a positive direction. The confidence of domestic and international investors has been restored which is reflected in the up-gradation of Pakistan to the MSCI EM Index and improved credit ratings by Moody's and others. Therefore, these recent developments also negate the view that Pakistan's security situation and particularly its deep involvement in war against terrorism is responsible for its poor economic and social performance. Hence, the security deficit argument does not hold up.

BRR: If the security argument doesn't hold up then what does hold the most in your opinion?

IH: It is the governance and the role of institutions. There are several studies that have illustrated the linkage between good governance and positive economic growth. The aim should be to create political and economic institutions that are inclusive and pluralistic which create incentives for everyone to invest in the future.

Presently there are institutions that are extractive which protect the political and economic power of only small elite that takes income from everyone else. Institutions that promote good governance and facilitate broad based and inclusive growth are the pillars of modern development strategy.

In Pakistan a minority elite comprising about 1-2 percent of the population has used state and markets for their political power and self-enrichment to the neglect of the majority of the population. This small minority has been able to enjoy this unfair accumulation of wealth in the midst of widespread poverty and squalor.

When there is no neutral umpire, markets are rigged by the elites for their own advantage which leads to inefficient market outcomes and resource allocation. The state, which should ensure equitable distribution of gains from economic growth, is also controlled by the same elite that evades taxes and appropriates the public expenditures for its own benefits.

The solution lies in getting the institutions back on their feet by promoting merit, integrity, dedicated service and problem solving as had been the case before the 1990s.

There are already many examples of successful institutions working effectively in the middle of this general atmosphere of institutional decay and their success can be attributed to these factors.