Commentary

Pakistan's Economy and Regional Challenges

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Abstract

Pakistan was one of the top 10 fastest growing developing countries between 1960 and 1990 recording an annual average growth rate of 6 per cent. The structure of the economy was also transformed during this period with the share of agriculture coming down from 50 per cent to 20 per cent. The subsequent 25 years have, however, brought about a significant decline in growth rates and in more recent seven years, it has lagged behind other South Asian countries. A combination of political instability and disruption of evolving democratic process, lack of continuity in policies and poor governance have contributed to this outcome. Pakistan has also not utilized its geographic location to take advantage of intra-regional trade and investment. Many promising opportunities were lost due to lingering tension with India. The future potential can only be realized if Pakistan is able to position itself for meeting the future challenges of integration into the regional and global economy, reaping demographic dividends because of youthful population and moving up the ladder of technology. The realization of these goals will depend upon sound macroeconomic policies, strong institutional and governance framework, investment in infrastructure and human development and political stability.

Keywords

Governance, political stability, economic assistance, terrorism, growth, fiscal policies, foreign exchange

An Overview

In 1947, Pakistan had 30 million people with a per-capita income of US$100. Agriculture accounted for almost 50 per cent of the economic output with hardly any manufacturing, as all industries were located in India. Despite that, Pakistan

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was unable to feed 30 million people and was dependent on PL-480 imports from the United States of America (USA). From thereon, Pakistan has come a long way. Today with more than 200 million people, the per-capita income has risen 13 times and stood at US$1,468 in 2016. Pakistan is the third largest exporter of rice in the world, exporting 2 to 3 million tons annually and producing enough food grains to feed its people. Pakistan is also one of the five major textile-producing countries in the world. The structure of the economy has also transformed during this period.

The share of agriculture has come down from 50 per cent to 20 per cent and agricultural productivity has risen. While the population has risen seven times, the actual production has outpaced population growth. Agriculture is no longer dominated by cereals, grains and crops. Within the agricultural sector, there has been a significant shift. Livestock, dairy, mutton, beef, poultry and similar other products account for 55 per cent of the agricultural output. Pakistan has become the third largest producer of milk in the world. Thus, there has been a movement in a direction where the same land resources are being used more efficiently in order to produce more. Manufacturing and industry now account for 25 per cent of the national income; there was not even a single industry worth its name at the time of partition. The services sector now dominates the national economy in terms of output (55% of GDP) and employment.

Pakistan's Growth Record

Pakistan's overall growth record has been quite impressive; on an average, the economy grew at an annual rate of slightly above 5 per cent during the last six decades. In per-capita terms, the growth rate was 2.5 per cent annually. The trends in sectoral GDP growth rates show that industry, including the manufacturing sector, has been the most dynamic sector of the economy.

In the regional context, Pakistan grew faster than South Asia by an average 2 per cent through most of the 1960s and 1970s and at similar rates during the 1980s. However, since 1993, Pakistan's growth has been below the regional average. In the first 20 years after independence in 1947, Pakistan had the highest growth rate in South Asia. According to the World Bank (2002) Pakistan exported more manufactures than Indonesia, Malaysia, Philippines, Thailand and Turkey combined in 1965. By the 1990s, Pakistan had become the slowest growing country in South Asia, an exact reversal of its previous role. However, the incidence of poverty has declined from 46 per cent in the mid-1960s to 18 per cent. Nevertheless, inter-personal, regional and gender disparities appear to have intensified. Human development indicators have not kept pace with the growth in per-capita incomes. What are the factors responsible for this reversal?

The main explanatory factor for this reversal is the paradigm shift in the basic model of development brought about by Zulfiqar Ali Bhutto soon after assuming power in 1971. The Bhutto regime nationalized all the major manufacturing industries, banking, insurance, education, etc. and caused a major disruption to the economy and an erosion of private investor confidence that persisted for the next 20 years. This experiment with socialism had a negative impact on industrial development, export expansion, the quality of education and gave an overarching role to the bureaucracy in economic decision-making. The substitution of a culture of entrepreneurship, risk taking and innovation by rent seeking and patronage suppressed the dynamism of the private sector. The emergence of bureaucrats as business leaders reinforced the new culture. Bureaucratic harassment, problems of law and order, unreliable and expensive power and inadequate infrastructure also discouraged investment. This partly explains why the private sector was reluctant to make long-term commitments. The disintegration of the unified economy of East and West Pakistan and the resultant formation of Bangladesh as an independent country severed from Pakistan also caused tremors in this period.

The opportunity to undo most of the damage done by nationalization was missed by the Zia-ul-Haq regime (1977–1988). Instead of taking proactive measures to reverse the state-owned dominated economy, the Zia regime maintained the status quo. Although the path pursued by Bhutto was not followed and the process of nationalization was abandoned, the preferential orientation towards public sector did not diminish in any perceptible way. The economic performance was impressive in this period not due to any fundamental policy or institutional reforms. The regime benefited from the output that came on stream from large public sector investments made in the 1970s, the most significant among them being the Tarbela Dam that added considerably to irrigation water availability and hydel power capacity as well as to the fertilizer, steel and cement factories. Macroeconomic imbalances in the form of large fiscal and current account deficits of the 1980s had repercussions on the economy in the subsequent period in the form of increased debt burden. Real defence spending increased on an average by 9 per cent per annum during this period while development spending rose to 3 per cent per annum. Defence spending averaged 6.5 per cent of the GDP in this decade and contributed to large fiscal deficits and a rapid build-up of public debt. The neglect of development spending was one of the contributory factors to slow growth in the 1990s.

Although the Nawaz Sharif regime introduced major economic liberalization reforms in 1991, both private investment and exports tended to stagnate or decline through the 1990s. Macroeconomic sustainability was a serious problem. The financial sector was dominated by inefficient state-owned banks and access to capital was limited. The policy environment in relation to rules, taxes and import tariffs was unstable. The arbitrary use of statutory regulatory orders (SROs) negatively affected the level playing field. This was needed for investors to compete based upon business fundamentals rather than their ability to secure special deals.

The frequent changes in government throughout the 1990s and consequential political instability played havoc with the economy. Uncertainty and discontinuity of economic policies, patronage-based economic governance benefitting a small elite to the exclusion of the majority of the population and exogenous shocks derailed the economy from its tracks. Investment ratio dived south and persistent fiscal and current account deficits led to accumulation of large unsustainable domestic and external debt throughout the decade. The ratio of debt servicing payment to foreign exchange earnings reached almost 40 per cent. The freezing of foreign currency accounts of residents and non-residents in the aftermath of the 1998 nuclear tests eroded investor and business confidence in the economy. Sanctions by leading bilateral donors dried up the flows of official aid to the country. International capital was hesitant as the risk profile had heightened significantly. Incidence of poverty doubled from 18 to 34 per cent during this decade. The withdrawal of US aid after the end of the Afghan war and the imposition of sanctions by the Western governments following the nuclear tests in 1998 further accentuated economic difficulties.

The military government that came to power in October 1999 had economic recovery as one of its professed objectives. Despite sanctions of all kinds, the new government assembled a team of technocrats as part of its Cabinet and embarked upon a series of structural reforms during 2000 and 2007. Nevertheless, 11 September 2001 also changed the geostrategic importance of Pakistan in a significant manner. The alliance of Pakistan with the USA and North Atlantic Treaty Organization (NATO) forces in the war against terrorism not only restored international financial aid but also increased the volume of flows. It was during this period that Pakistan successfully implemented a nine-month stand-by and three-year Poverty Reduction and Growth Program with the International Monetary Fund (IMF) in 2000–2004. The Paris Club re-profiled the stock of official development assistance (ODA) and non-ODA bilateral debt. The USA cancelled its bilateral debt by US$1 billion. Investment picked up to 24 per cent of GDP and foreign direct investment (FDI) touched US$5 billion in 2007. As a result of economic reforms, investment boost, external assistance and debt relief, the economy bounced back and recorded high GDP average growth rate of 6.3 per cent a year. Devolution to local governments and empowerment of elected officials at district level improved the delivery of basic public services. Poverty was reduced by 10 percentage points. Unemployment rate fell from 8.4 to 6.5 per cent and about 11.8 million new jobs were created in the 1999–2008 period. Gross and net enrolment at primary level also recorded some improvement along with children immunization, incidence of diarrhoea and infant mortality.

The reforms and governance improvement of these seven years were not sustained and some of them were reversed, halted or modified in the post-2008 period. Constitutional amendments devolving authority from the federal and provincial governments and increased allocation from divisible taxable pool to the provinces were welcome steps. However, the local governments were abolished and access to basic services and the quality of governance suffered. Internal security resulting from intensified attacks by terrorists upon key installations and personalities and a poor law and order situation created a wait-and-see situation among the prospective investors. The 2009 IMF program aimed at macroeconomic stabilization was aborted and later resumed in 2013.

The analysis as discussed shows that initially the shift in the economic paradigm under Bhutto initiated the drift, but subsequent inconsistency, discontinuity and lack of coherence in economic policies, political instability, weak domestic security and law and order, poor governance, unwillingness to take tough but unpopular decisions to set the course of the economy right, and impaired implementation capacity of the government agencies led to the secular decline in Pakistan's growth rates. Pakistan underperformed—as compared to other countries with similar per-capita incomes—in just about all of the social indicators, a phenomenon called the 'social gap'. The discrepancies are especially large for women, that is, a 'gender gap' reinforced the social gap. These twin gaps stunted the growth rate since no country can hope to make much progress in a globalized world economy without an educated and healthy work force.

Growth, Poverty and Inequality

How has growth affected incidence of poverty in Pakistan? The earliest published data on poverty incidence available pertains to 1963–1964 and therefore it is difficult to estimate as to what proportion of population was living below the poverty line at the time of independence. The provinces constituting Pakistan were relatively backward compared to the provinces inherited by India. Also, a large migration of refugees facing dire economic conditions took place in the early years of Pakistan's formation. Thus, it may be safe to guesstimate that 50 to 60 per cent of the population was living below poverty in 1950. The most recent survey carried out in 2004–2005 indicates that this proportion has halved to 24 per cent and came further down to 18 per cent by 2011–2012.

Although poverty declined from 40 per cent in 1963–1964 to 17 per cent in 1987–1988, it rose both in the decades of the 1960s and 1990s. In the decade of the 2000s, there was once again a movement towards reduction in the incidence. While poverty levels may have declined, the social indicators have not kept pace with income growth. Pakistan ranked 147th in Human Development Index (HDI) in 2017 among a group of 188 countries and the value of Pakistan's HDI is 0.55, slightly above the low HDI cut-off point. Almost half of the population is illiterate and only one-third of the female population is literate. More than half of the population does not have access to decent health facilities. Infant mortality rate of 80 per thousand is still very high. The health status of women and children is particularly low. Female labour force participation rates are the lowest among South Asian countries. The progress has clearly faltered in comparison to countries with similar per-capita incomes and growth rates. An above average growth in GDP and per-capita incomes was achieved with below average improvement in human development indicators.

The picture of the long-term trends of economic growth, poverty and inequality for Pakistan is highly ambiguous as income inequality has declined and increased during periods of high growth. There is, however, a consistent pattern that shows that income inequality does increase when the growth rates are low. Rural–urban income disparities have also risen in the 2000s, which was a period of high growth. In the early 1990s, the difference in poverty level between urban and rural areas was 8 percentage points which had widened to 13 percentage points by 2004–2005. Despite remarkable reduction in poverty—almost 10 percentage points in a relatively short period of time—there has been an increase in income inequality as well as urban–rural disparities.

Structural Reforms

The main thrust of the reforms undertaken since 1991, albeit in a hesitant and faltering manner, was to allow greater freedom to the private sector to own, produce, distribute and trade goods and services while gradually withdrawing the public sector from this arena. The role of the state in Pakistan was redefined as a facilitator, enabler, protector and regulator rather than directly managing and presiding over the commanding heights of the economy. Government intervention was justified for social protection of the poor, provision of public goods, infrastructure, human development, and science and technology (S&T). Although the state has not always adhered to the new role assigned to it and has shown dominance in actual practice, there seems to be an implicit and unwritten political consensus in the country on the boundaries between the public and private sectors. It is another issue that the political party in opposition always makes it difficult for the ruling party to implement reforms.

Significant efforts were made in unilaterally liberalizing the trade regime. The maximum tariff rate was reduced to 25 per cent with the average tariff rate down to just 9 per cent. The number of duty slabs was reduced to four. Quantitative import restrictions were eliminated except those relating to security, health, public morals, and religious and cultural concerns. The statutory orders that exempted certain industries from import duties or provided selective concessions to privileged individual firms were phased out. Import duties on 4,000 items were reduced. A number of laws were promulgated to bring the trade regime in conformity with World Trade Organization (WTO) regulations. These include anti-dumping and countervailing measures and protection of intellectual property rights. A stable exchange rate policy helped maintain predictability and competitiveness of Pakistani exports.

Fiscal policy reforms and consolidation were initiated by raising tax revenues, reducing expenditures, cutting down subsidies of all kinds and containing the losses of public enterprises. Tax reforms were aimed at widening the tax base, removing direct contact between tax payers and tax collectors, introducing value-added tax (VAT) as the major source of revenue, simplifying tax administration and strengthening the capacity of the Central Board of Revenue. Although these reforms made some progress, other elements such as random audit of selected tax returns under universal self-assessment scheme automation and reorganization of the tax machinery did not make much headway. The reversal of the tax reforms in 2008 and poor enforcement and compliance have kept tax–GDP ratio stagnant at 9 per cent since 2009.

As one of the sources of fiscal problems was triggered by the losses and inefficiencies of public enterprises, the government actively pursued an aggressive privatization plan whose thrust was sale of assets to strategic investors. The sectors in which most progress has been made are oil and gas, banking, telecommunications and energy. Foreign investors were encouraged to participate in the privatization process and a large number of them were successful. The transactions completed in the five-year period up to 2007 yielded $ 3 billion. The privatized banks lacked efficiency in delivering services, yet contributed substantial sums to the national exchequer. They have all become profitable compared to the pre-privatization situation when they were incurring losses with a large volume of non-performing loans. The speed on privatization has once again picked up since 2014 as the previous Pakistan People's Party (PPP) government was most reluctant to let go of its control of public enterprises.

Deregulation of oil and gas, telecommunication, media and civil aviation sectors also brought about significant positive results. Oil and gas exploration activity was stepped up and constant discovery and production from new gas fields operated by private sector companies added new capacity to meet the growing energy needs of the country. Power generation capacity, however, did not keep pace with the rapid demand and expansion and reforms in the transmission, and distribution of public utility companies did not make much headway. Diversion of natural gas to CNG at subsidized rates and new connections to households on political grounds did create misallocation of scarce natural gas resources, creating a potential gap between supply and demand. The reforms in the energy sector were stalled and Pakistan has consequently been faced with serious energy shortages that have crippled production and exports since 2009. Circular debt accumulation has created fiscal problems and also supply chain disruptions. The Nawaz Sharif government had won the elections on the promise of energy reforms but the progress so far has not been that impressive.

The telecommunications sector witnessed a boom since the private sector companies were allowed licenses to operate cellular phones. The number of mobile phones has reached more than 120 million, or a penetration rate of almost 70 per cent, by 2014. Long-distance international and local-loop monopoly of Pakistan Telecommunications Corporation was broken and new licenses including those for wireless local loop were issued. The customers are reaping rich dividends as the prices of phone calls, whether local, long distance or international are currently only a fraction of the previous rates. Lower telecommunication costs and increased penetration have a favourable impact on the productivity in the economy. Internet penetration and broadband wireless connections are growing rapidly since the 3G and 4G licenses were issued a few years ago.

Economic Governance

The cornerstone of the governance agenda in the 2000s was the devolution plan which transferred powers and responsibilities, including those related to social services, from the federal and provincial governments to local levels. Development effort is driven at the local level by priorities set by elected local representatives, as opposed to bureaucrats sitting in provincial and federal capitals. Decentralization, de-concentration, accountability and people's participation in their local affairs could have improved the delivery of basic services to the citizens at the grassroots level. However, the transition created its own set of dislocations and disruptions particularly in the exercise of the responsibilities towards law and order and security that shifted the authority from deputy commissioners to elected District Nazims. This problem could have been fixed but the abolition of the whole system designed in 2001 has created a huge vacuum in the delivery of basic services at the grassroots.

Another move was to separate policy and regulatory functions which were earlier combined within a ministry. Regulatory agencies were up for economic activities such as banking, finance, aviation, telecommunications, power, oil, gas, etc. These regulatory structures are now independent of the ministry and enjoy quasi-judicial powers. The chairman and board members enjoy security of tenure and cannot be arbitrarily removed. They are not answerable to any executive authority and hold public hearings and consultations with stakeholders. These regulatory authorities have not been fully effective due to non-observance of the principle of placing the right person at the right job.

The National Accountability Bureau (NAB) was established under a new legal framework as the main anti-corruption agency. A large number of high government officials, politicians and businessmen were sentenced to prison, subjected to heavy fines and disqualified from holding public office on charges of corruption after conviction in the courts of law. Major loan and tax defaulters were also investigated, prosecuted and forced to repay their overdue loans and taxes. However, subsequent actions taken in response to political expediency have tarnished the image of the NAB and compromised its integrity.

The root cause of fiscal indiscipline had to be surgically removed so that it did not recur in the future. A fiscal responsibility law, which keeps a lid on the government's propensity to borrow it way out of difficult situations, was approved by the parliament. Debt–GDP ratio has to be reduced by 2.5 percentage points each year and it cannot exceed 60 per cent. Any deviation has to be explained to the Parliament and needs its approval. However, this law has been breached for the last few years as it does not have any remedial measures built in.

Restructuring and strengthening of the Central Bank and the banking sector also played a pivotal role in the economic revival. The State Bank of Pakistan (SBP) kept price stability, financial stability and growth in mind while formulating its monetary policy, macroprudential regulations and developmental initiatives, which involved a fine balancing act and at times difficult trade-offs. As inflationary pressures had not surfaced in the early 2000s and fiscal policy lever could not be exercised due to a heavy debt burden, the Central Bank used monetary policy to provide the stimulus to kick start the economy. Policy rates were cut down successively which, with a strong transmission mechanism, translated into low lending rates by banks. Private sector credit picked up, existing capacity was fully utilized and new investment was undertaken to expand productive capacity. The period of expansionary monetary policy gave a big boost to output expansion and employment. Only in early 2005, when inflationary expectations started surfacing, was the monetary policy stance changed. Indirect market-based policy instruments were used in place of directed credit to priority sectors. Caps on lending and deposit rates and preferential treatment to government enterprises were removed and interest rates and exchange rates were allowed to be determined by the market interplay. Credit allocation decisions were made by the individual bank guided by prudential regulations without any directive from the Central Bank.

The banking system started to meet the financing requirements of sectors such as agriculture, small- and medium-sized enterprises (SMEs), salaried classes and the poor who had no access to credit in the past. The borrower base of the banking system multiplied from over 1 million to 4.5 million households in five years. The middle and lower middle class consumers are now enjoying car loans, mortgages, credit cards, consumer durables. Small farmers are using bank credit for buying chemical fertilizers, certified seeds, insecticides, small implements and hiring tractor services. Small and medium entrepreneurs are using bank credit to expand their fabrication and manufacturing capacities and upgrading technology. Landless labour and poor women in the rural areas are receiving microloans for poultry, small livestock, sewing machines, etc. The number of households who have borrowed microfinance loans has gone up from almost zero to about three million. Despite these developments in the early 2000s, the recent experience of banking lending is not very satisfactory. The temptation to channel funds to the government for financing fiscal deficit has diverted credit from the productive sectors particularly agriculture, SMEs, etc. The outreach for SMEs, agriculture and microfinance therefore remains limited and is not expanding at a desirable pace particularly in the rural areas and backward districts. Financial inclusion has therefore become a key area of concern.

Role of Foreign Assistance in the Post-2001 Period

A large number of observers and casual empiricists both within and outside Pakistan have been making bold but untested assertions that it is the massive aid flows and debt relief resulting from Pakistan's participation in the war against terror after 11 September 2001 (hereafter, 9/11) that has been responsible for the large reserve accumulation and economic turnaround. It is true that following this event, workers' remittances started shifting from open market to interbank market, debt relief was provided and new loans and grants were granted and official sanctions were removed. In addition, the Coalition Support Fund of US$1 billion annually started pouring in from the USA. The US military and civilian foreign aid was restored. There were also huge costs incurred by Pakistan. It has been conveniently forgotten that thousands of innocent lives of Pakistani soldiers and civilians have been lost, a deep sense of insecurity prevails in the country, foreign travel advisories have discouraged visits of businessmen, tourists and buyers, higher war risk premiums are charged, shipping freights have gone up, insurance premiums on Pakistani goods have escalated and export orders have been diverted. The frequency and ferocity with which suicide bombers have attacked political leaders, installations and targets has added to the gravity of the law and order problem in the country. Export orders of billions of dollars have been cancelled as buyers cannot visit Pakistan and new markets cannot be accessed for the same reason. As against continued growth in exports in other countries of the region, there has been a significant slowdown in Pakistani exports, particularly textiles, due to the uncertainty created in the minds of buyers aboard and their limited exposure to the actual conditions. The information technology (IT) industry, which was just taking off in 2001, has been badly hurt as all contracts for outsourcing were cancelled. Pakistan is no longer on the radar screen of the global IT industry which is expanding rapidly.

A careful calculation of costs and benefits of Pakistan's participation in the war against terror would reveal that the benefits received via foreign assistance pale into insignificance compared to costs incurred since 2001. This does not include the huge social and psychic costs borne by the entire population, particularly the internal displacement and involuntary migration of millions of inhabitants of the Federally Administered Tribal Areas (FATA) and Khyber Pakhtunkhwa province. Those who attribute the economic turnaround to foreign assistance should look at both the costs and benefits of the calculation.

The data shows that even if we assume the extreme case that all official transfers, debt relief and all foreign loans/credits represent the 'gift' of 9/11 to Pakistan, this combined amount represents at its peak only 10 per cent of total foreign exchange earnings of the country in FY 2006. Pakistan's own foreign exchange earning capacity expanded from US$15 billion annually to US$46 billion in these six years or from 20 to 33 per cent of GDP. It was Pakistani exporters and workers overseas who provided the bulk of foreign exchange supplemented by private foreign investment. But this entire amount cannot be attributed to a direct fallout of 9/11 because Pakistan has been receiving foreign loans and grants every year since the 1950s. For example, in FY 2000 and 2001, the two years prior to 9/11, 16 per cent and 19.9 per cent of foreign exchange earnings were received in the form of foreign loans and grants. The country had a positive overall balance and positive current and capital account balances in FY 2000–2001 much before 9/11 occurred. Even in FY 1999–2000, the deficit on the overall balance was quite small: less than 1 per cent of the GDP. Pakistan's reserves had started accumulating in FY 2000–2001 and SBP's own reserves had almost doubled after paying off the foreign currency deposits of almost US$1.7 billion to the non-resident and institutional holders and US$2.8 billion in debt servicing to external creditors. Thus, this perception that everything good that has happened to Pakistan is a direct consequence of 9/11 is not only incorrect but highly exaggerated.

The reasons for build-up of foreign exchange reserves were not only the debt relief and external capital flows but also macroeconomic policies. The Central Bank pursued a stable exchange rate at a realistic level for several years that helped maintain predictability and competitiveness of Pakistani exports. There was a major and perceptible liberalization of the foreign exchange regime. Foreign investors were allowed to bring in capital without any restrictions in any sector of the economy and repatriate their capital, remit profits, dividends, royalties and fees without any prior approvals. Foreign companies were allowed to raise funds from domestic banks and capital markets.

Financial sector reforms were accelerated in this period. The Central Bank was granted autonomy and the control of the Ministry of Finance over banking institutions was diluted. Net non-performing loans of the banking system were brought down to less than 3 per cent of total advances and loans; minimum capital requirements were raised to US$1 billion, and the quality of new loans improved. Capital adequacy ratios were raised and made variable according to the strength of the bank. Mergers and consolidation of financial institutions have eliminated a number of weaker players and the range of products and services offered by the banks widened. The privatization of Habib Bank, United Bank and Allied Bank, three large nationalized commercial banks of Pakistan, has transformed the banking sector into an efficient, privately owned and managed sector but regulated by a strong and vigilant Central Bank. The share of the private sector ownership of the banking assets has risen to 80 per cent and the banking sector is facing a healthy but strong competitive environment. The banks are highly profitable and automation, on-line banking, automated teller machines, real time gross settlement and multiple channels of delivery have improved the efficiency of services in response to market competition. The widening of the banking spreads, however, remains an area of concern and shows that there are still inefficiencies in the system.

Faltering of Economic Growth since 2008

The question naturally arises: If these structural reforms were implemented then why has economic growth faltered and stagnated since 2008 and what can be done to get back on the trajectory of high growth rates? Five explanations can be advanced in this regards.

First, there was high political uncertainty caused due to the conflict between President Musharraf and the Judiciary in 2007 leading to widespread agitations throughout the country. The situation was exacerbated by the declaration of emergency and the issuance of the National Reconciliation Ordinance that gave reprieve to all outstanding criminal cases against politicians. The assassination of the most popular leader of the country, Benazir Bhutto, and the elections of the 2008 further added to political instability.

Second, the caretaker government did not take timely and appropriate decisions in 2007 to respond to the global price hike including those for food-products, oil, electricity and gas. These price adjustments were avoided because of the impending elections. However, they caused serious damage to the economic balances. Fiscal deficit widened to 7.4 per cent of GDP breaching the limit prescribed in the Fiscal Responsibility Act. Excessive government borrowing to meet the deficit together with increased prices of imported commodities which were outside the administered prices regime of the government led to higher inflation.

Third, electricity and gas load shedding due to shortfall in generation and poor distribution had adverse impact on manufacturing and export sectors. Large scale manufacturing growth slowed down to 4.8 per cent, almost half of the rate recorded in 2007–2008. Since then, the performance of the sector has been unimpressive.

Fourth, a worsening trade imbalance fuelled external current account deficit to exceed 8.4 per cent of GDP. Foreign capital inflows that were required to finance this deficit dried up due to political uncertainty leading to depletion of foreign exchange reserves. The drawdown of reserves created panic in the foreign exchange market, leading to a depreciation of the rupee by about 25 per cent vis-à-vis the US$ in 2009, further intensifying inflationary pressures.

Finally, but most importantly, when the economy was in such turbulent waters, it needed firm hands on the steering wheel. This was not the case as Pakistan saw five finance ministers and five governors of the Central Bank during the 2008–2014 period. Economic management played second fiddle to political management and coalition politics. The neglect of the economy by the incoming government and backtracking from the reform path were the main factors for low investment and therefore stagnant growth rates.

Tax reforms were either reversed or not pursued in right earnestness. Maximum import duty rates were raised to 35 per cent, more slabs were introduced and the effective rate of protection went up. In income tax, the universal self-assessment was not fully implemented as the random audit of selected tax returns was deeply resisted by powerful lobbies. Automation and reorganization of tax machinery were disrupted, and incentives were given only to those who had met the performance standards. The targets were extended across the board to every official irrespective of their meeting the eligibility criteria. Tax–GDP ratio has therefore remained stuck at a dismally low level of 10 per cent. New concessions and exemptions were granted to selected few through the SROs.

The privatization process of public sector enterprises was brought to a halt and those laid off from service in 1997 and 1998 were rehired with full benefits for the past 15 years, thus causing further financial stress. Excess employment over and above the already high manpower ratios created financial gaps that had to be met by the government. Chief executives were appointed on the basis of loyalty and affiliation rather than competence and suitability for the job. A number of these appointees faced cases in accountability and higher courts for indulging in corruption and abuse of power. The drain on the exchequer because of these losses of these public enterprises amounted to US$5 billion annually or one-fifth of the recurrent budget.

Civil services and the institutions forming the main pillars of the delivery of basic services to the citizens—law and order and security infrastructure, education and health, drinking, water and sanitation, adjudication of disputes and land records—have become totally dysfunctional. A comprehensive report on the reform of administration and civil services was prepared through a broad consultative process but the findings of the report have remained shelved so far.

Devolution of powers from the federal to the provincial government and the large financial resources transferred to the provinces under the 18th amendment and the 7th National Finance Commission (NFC) award are most welcome. But this devolution remains incomplete unless the powers and resources are further decentralized and devolved to the local governments. Since 2009, this tier at which most of the interaction between the citizens and the government functionaries takes place has remained non-existent. The hardships and difficulties faced by teachers, health workers, low-ranking police and other officials have worsened the governance at the grass root level.

Challenges for the Future

Structural reforms in the areas of finance, tariff and tax administration, privatization of state-owned enterprises, creation of an enabling environment for the private sector, liberalization of foreign exchange and FDI, market orientation and openness to the global economy have brought about at least 2-percentage point increase in the total factor productivity. If this hypothesis is found to be empirically valid, then the output potential of Pakistan's economy should have risen from 5 to 7 per cent annual growth. The cyclical fluctuations around this mean would either result in lower or higher actual outcomes depending on the agriculture production variability, external economic environment such as prices of oil and commodities or demand for Pakistani products, macroeconomic stability, etc. It would therefore be fair to surmise that the growth rates should range between 6 to 8 per cent annually in the next decade if Pakistan gets back to its growth trajectory sooner than later and all other things remained constant. Let us analyse the pre-conditions for future growth in Pakistan.

First, how far will the global economic conditions remain favourable for Pakistan? The global economy, despite the recent financial turbulence in the US mortgage market, remains buoyant at present and has never had such sustained high growth. Of course, the USA is the key driver of the world economy but the relative share of emerging countries particularly China and India is on an incline. The decoupling of the emerging economies from the USA has not yet been fully tested and proven and therefore the risks to the global economy cannot be ignored. Most analysts, however, believe in soft landing and continuation of a benign environment from which emerging countries can derive benefits.

Second, the speed at which Pakistan successfully integrates into the global goods, services, financial and labour markets will determine the extent of benefits to the external sector. Since 2012, exports have been stagnating, showing a declining share in the buoyant world market. Diversification of exports in composition as well as markets is badly needed to capture the lost market share. Attention to labour productivity, efficiency within the firm and plant, aggressive marketing, and research and development (R&D) should replace the traditional mode of the private firms looking to the government for concessions and subsidies. The business-as-usual mode would be highly detrimental to inculcating private sector dynamism and innovation.

Third, the policymakers in Pakistan should steadfastly persevere in pursuing sound, credible and consistent economic policies. Fragmented, parochial and turf protecting decision making should give way to a more collegial and collaborative process. Fiscal Responsibility Law would certainly act as a safeguard against excessive borrowing but there are many other policy lapses or delayed responses which can do harm. For example, extra-budgetary and contingent liabilities of public sector corporations can create fiscal stress and should be carefully managed.

Fourth, the intermediation between good policies and their impact on the lives of the majority of citizens takes place through strong institutions and a well-functioning governance structure. Strengthening local government institutions would make significant difference to access by the common citizens but the lingering reluctance to part with powers by the provincial governments, the absence of supporting infrastructure, lack of capacity building at lower levels, clogging of systems and outdated procedures are continuing constraints that need to be tackled. Civil services have to be reorganized and made more responsive to meet the needs of the common man and carry out the basic functions of the State impartially, transparently and efficiently. Accountability for results has to be built in the system rather than extraneously enforced. Most of Pakistan's key institutions have lost their way and have to be brought back to their original track.

Fifth, supply of critical infrastructural facilities such as power, natural gas, pipelines and storages, roads and railways, urban mass transit, water supply and sewerage, ports and civil aviation have not kept pace with the growing demands of the industry, commerce and general public. Government, despite increased development expenditure outlays, would not be able to meet this demand in any meaningful way. Public–private partnerships in both capital investment as well as operations and maintenance would have to be put in place. The manner in which skills, technology and innovation are changing the competitive advantages of nations, Pakistan would have to redouble its efforts in the fields of education, skill upgradation and S&T. Raising the average years of schooling received by Pakistan's population of 15 years and older—from 3.5 years to 5.5 years, that is, to the levels of countries such as Thailand or Venezuela—would result in real per-capita growth rate by 2 percentage points per year. Investing in human capital through better education and healthcare also directly benefits the poor by improving their current living conditions. Although a beginning has been made in higher education, the state of scientific research organizations in Pakistan is dismal. The whole governance and incentive structure of these organizations needs to be revamped to bring them at par with at least China and India.

Sixth, the continuation of political stability and a predictable, orderly and constitutional transition of power from one regime to the other would add a lot of strength to Pakistan's economic prospects. The risks associated with an uncertain political transition process would be mitigated if different political parties take over the reins of the government at pre-determined regular intervals of time through a fair and transparent electoral process. Fortunately, the thrust of economic policies of all leading political parties in the country is much the same but this positive aspect has been lost in the loud noise of political bickering, venomous rivalries and unwarranted accusations against each other. The links between political stability, economic growth and social cohesion are mutually reinforcing and need to be further nurtured and developed in Pakistan. The lessons of the 1990s are that the gains achieved so far can be reversed if Pakistan does not manage political governance with tolerance, a healthy respect for dissent and differences of opinion, and reliance on institutions rather than personalities.

Pakistan is facing serious problems of internal and external security. A reversion to normalcy in the security conditions of the country would reassure the investor community and help in the mobility of factors of production. Foreign buyers and technical personnel would resume their visits to Pakistan as improved security would allow their free movement in and out of the country.

Raising investment in physical capital, particularly water and power management, better education and healthcare and improvements in institutional quality will have the largest pay off in terms of increased growth and reduced poverty. An increase in Pakistan's investment ratio by 5–6 percentage points could result in an increase in the country's annual real per-capita GDP growth of about 1 percentage point. The pace of economic growth can be raised by improving the score of institutional quality by 1 point. Pakistan not only has to raise its investment rate but the quality of its institutions as well as health and education indicators to levels achieved by Malaysia, Thailand and Singapore. To achieve the higher investment rate, tax revenue yield has to be raised to provide the fiscal space needed for social and infrastructure spending while reducing the debt to GDP ratio. Base broadening and better taxation of agriculture, urban property and service income could yield more than 2 to 3 per cent of GDP increase in revenues.

Intra-Regional Trade: Failure and Future Prospects

Pakistan is located strategically as a bridge between South Asia and Central Asia, China and South Asia and West Asia. Before 1947, the Indian subcontinent historically had high intra-regional trade. As much as one-fifth of the trade took place within the region. However, with six per cent intra-regional trade in recent years, it is the least integrated region in the world. Cross-border investment is negligible and while there is an overall liberal environment for foreign investment flows, there are a host of formal and informal restrictions on flows originating from within the region. Common historical and cultural heritage would—in other parts of the world—have eased the movement of the people, educational exchanges, access to each other's media and cultural resources, the sharing of scientific and technological knowledge and other forms of cooperation, but none of this has happened in South Asia. Trade facilitation across borders within the region is hampered by all kind of hurdles. Issues of phytosanitary, health and environmental standards, quality testing and adherence to specifications are raised, causing considerable delays, lengthened travel times and higher transaction costs. Truck crossings, where allowed, take several days and allegations of harassment by the border officials are rampant. Non-tariff barriers on India–Pakistan trade have therefore diverted normal trade flows to informal networks or border trade, or are routed through third parties such as Dubai and Singapore which raise costs for end-users.

Demography: Negative and Positive

Looking to the future, particularly the long term, South Asia's challenges are many but at least four of them will make a material difference to the social and economic outcomes in the next 50 years. The first challenge is the demographic: South Asia will be the only region of a sizeable population with more than 50 per cent of its population in the productive employable age bracket. The flip side is that this region can ease its unemployment problems by supplying young workers to the rest of the world in an environment of ageing populations and the rise in dependence ratios. Whether this challenge can be transformed into a dividend will depend upon the priorities, policies and programmes that the governments of these countries are able to conceptualize and implement.

South Asia can be well positioned to reap the benefits of favourable demographics. To the extent that these countries invest in education, particularly technical and vocational education, expand access to higher and professional education and upgrade the quality and relevance of instruction, there is a strong likelihood of this demographic transition in paying dividend. However, this dividend may elude South Asia if it fails to meet the goal of educating a growing younger population, equipping them with marketable skills and facilitating their mobility across the borders. The challenge is quite daunting as two-thirds of the world's illiterate population resides in South Asia and the addition of new entrants to the labour force every year equals the entire population of a mid-size country.

Climate Change: Tough Choices

The second challenge is coping with climate change and its consequences for agriculture, food production and energy supplies. Over 500 million people in South Asia have no access to electricity while growth is typically associated with carbon emissions. How South Asia can balance its energy needs and growth while addressing global warming is a serious dilemma for policymakers. A recent World Bank study (2015) on the impact of climate change on South Asian countries provides an authoritative account of what we can expect in the coming decades. The study postulates that the imperatives of climate change and policies adapted to contain carbon emissions may slow progress towards many development goals, such as eradicating poverty, combating communicable diseases and ensuring environmental sustainability. Geography, coupled with high levels of poverty and population density, has rendered South Asia especially vulnerable to the impacts of climate change. High population levels translate into increased resource demands on an already stressed and largely degraded natural resource base. With an estimated 600 million people subsisting on less than US$1.25 per person a day, even small climate variations can cause irreversible losses and tip a large number of people into destitution.

The region shares common geological formations and river basins, leading natural hazards to frequently transcend national boundaries. With climate change, the frequency and incidence of such natural disasters is projected to increase. If climate projections are indicative of future trends, the risks associated with water-related climate variability are likely to worsen. The Himalayas is a vital life-sustaining resource for South Asia, supporting the approximately 1.5 billion people who live directly in the floodplains of its many rivers: the Indus, Ganges, Brahmaputra and Meghna. With rising temperatures, the ice mass of the Himalayas and Hindu Kush is retreating more rapidly than the global average, posing an unprecedented threat to water supplies, lives and economies in the region.

With melting glaciers, flood risks would increase in the near future. The floods in Pakistan in August 2010 that caused a major devastation to human lives and property are a preview of the damage that extreme climatic events can bring about. In the long term, and in the absence of replacement for the water provided by glaciers, water shortages could result at an unparalleled scale. Reduction of yields for major crops by as much as 20 per cent and an even sharper decline in agricultural incomes are part of the worst-case climate scenarios for the region as well as a growing scarcity of water. Avoiding this future will necessitate balancing more variable water supplies with the accelerating demand for water and would require significant adjustment to the region's agriculture.

Reaping Benefits of Technology: The Sooner the Better

The third challenge facing the region in the future is the speed with which South Asia is able to reap the benefits of technology and to use this as an engine of growth and human development. The capacity of South Asian countries to assimilate, adapt and widely diffuse emerging technologies is constrained by the shortages of skilled, technical and vocational manpower, outdated educational systems and neglect of R&D. A highly competitive world has raised the demand for skilled workers and professionals, yet the record of many South Asian countries in terms of meeting this demand is not very encouraging and the deficit in skills remains one of the major obstacles to successful technological diffusion. While the global average for Technical and Vocational Education and Training (TVET) enrolment is 10 per cent, in South Asia, this rate is only 1 per cent. In addition to poor enrolment, the TVET system in South Asia also suffers from other constraints, such as the gender gap.

The gross tertiary enrolment in South Asia is 10.5 per cent, which is one of the lowest in the world, second only to sub-Saharan Africa. The region is also characterized by disparities in access to higher education by females, and the choice of disciplines by the enrolled students is also a matter of concern: only one-fifth of the tertiary level students in South Asia go for S&T subjects. Not only is access limited, but quality and relevance are also not up to the mark. A low availability of well qualified and competent teachers is among serious constraints hindering the expansion of quality higher education in the region. Additionally, the curriculum is outdated and has poor linkages with industry. As a result, the majority of graduates face difficulties in finding decent productive jobs.

On the Western front, the pace at which Gwadar Port can be made fully operational and linked with the transport network of Central Asian Republics and Western China will determine the accrual of additional economic gains to Pakistan in the coming decade. Once this network becomes effective and the Chinese Pakistan Economic Corridor is completed, the economy should be able to extract benefits of at least another 0.5 to 1 percentage point of the GDP. With the removal of sanctions, work on completing the Iran–Pakistan gas pipeline should be accelerated. The Central Asia–South Asia (CASA) electricity grid would link Kyrgyzstan, Afghanistan, Pakistan and India. Turkmenistan–Afghanistan–Pakistan Pipeline will also help relieve the energy shortages in Pakistan. Similarly, power import from India to Punjab will also ease the pressure in the Lahore area.

Conclusion

The future economic prospects of Pakistan look promising but their actual realization would depend upon a number of critical factors such as benign global economy, successful integration of Pakistan into the global economy, sound macroeconomic policies, a strong institutional and governance framework, investment in infrastructure and human development and political stability. Under a constellation of these favourable conditions, it should be possible to add 2 to 2.5 percentage points to the current trend growth rate whereby per-capita income would double to US$2,600 by 2030.

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