



# A Plea to Pakistan: Fix Your Economy

by *Jesus Felipe and Juan Miranda*

**P**AKISTAN'S POLITICAL AND economic environment is complex. However, the new government must realize that they have only a narrow window of opportunity to shift the country's path to a growth model leading to modernization of the economic base.

While there are short-term problems in need of attention, in the medium- to long-term the key objective should be to upgrade and diversify the country's backward economic base away from low-productivity agriculture and low-end textiles. To achieve this, Islamabad needs to implement a coherent and credible program of modernization in the form of an industrial policy plan, at the center of which must be the strategic collaboration of public and private sectors. This should be developed by a joint team from relevant departments, e.g., Planning Commission, Finance and Industry.

Pakistan is going through a difficult period in its history. Extreme political uncertainty, macroeconomic imbalances and commodity inflation during the second half of 2007 and the first half of 2008 have com-

bined to pose a serious threat to the country. After months of struggle, in November 2008 Pakistan had to knock on the door of the International Monetary Fund to avert a default on its international debt obligations. This does not mean, however, that all is lost. The situation requires skillful policy making. However, the question is: Are Pakistan's policy makers up to the task?

Developing countries have to know when and how to break with the past. Although Pakistan is blessed with fertile cropland—it inherited the world's largest irrigation system from the British—its growth model for decades has prevented the country from achieving the success that East Asian countries have experienced since the mid-1960s. Pakistan's model can be referred to as “elitist growth.” In this model, economic and political power is effectively controlled by a small group of elites, with the market, state and institutions rigged in their favor. These elites,

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which include rich landowners, do not support investment in human capital for the masses and as a consequence, Pakistan's human-resource base is very weak. Since this model creates a fragile economic structure and institutions, it leaves the country vulnerable to the impacts of globalization, including increasingly tough international competition. This is most clearly reflected in Pakistan's very poor export performance and loss of market share.

Pakistan's policy makers must alter the country's growth model and implement a version of the kind that transformed East Asia over the span of three decades from a group of backward economies into modern industrial and service centers. This must be Pakistan's objective for the next two decades. Today, governments are evaluated by their capacity to deliver, not by their political views or predicaments, and Pakistan's policy makers must now start delivering to the 160 million citizens to whom they are accountable. They will have to face vested interests, even within the government itself, that oppose change. Indeed, why should the wealthy and influential landowners tax themselves to provide schooling when they see no obvious benefit to agricultural production? The answer is that if they do not do it, sooner or later their privileged position will be challenged.

Policy makers in Pakistan face four interrelated problems that need their immediate attention. The first is the deterioration in macroeconomic conditions. During fiscal year 2007-08, the fiscal- and current-account deficits reached worrying levels of 7% of GDP and 8.4% of GDP, respectively. The second problem is structural in nature. Although services are the largest sector of the economy, Pakistan is mainly an agrarian economy. However, agricultural output growth is low and the reallocation of labor from agriculture into industry and services contributes little to overall labor productiv-

ity growth. More than 40% of the labor force is employed by the agricultural sector and on very low wages. Prosperity and development will occur only when this sector grows and when industry and services can absorb the huge surplus of agricultural labor by offering decent jobs. Moreover, Pakistan's manufacturing sector, concentrated in textiles, shows little sign of upgrading its technology or diversifying.

Thirdly, unemployment and underemployment are permanent fixtures of the Pakistani landscape. During the past few years, the percentage in total employment of "unpaid family workers" (i.e., members of a family effectively working but not getting a salary) has increased, and today this group represents more than a quarter of all those employed. The lack of access to productive and decent employment for large segments of the population is the main cause of poverty in the country. Pakistan's low level of structural transformation is adding to the problem. Industry does not create employment and, therefore, workers shift from agriculture into low-productivity services jobs. However, the services sector is not creating enough employment to absorb both those moving from other sectors and new entrants into the labor force.

The fourth problem is social. Pakistani society suffers from social backwardness, scoring poorly in health, education and fertility indicators based on its per capita income. The country is afflicted by great divides at many levels, e.g., income, gender, regions, religion and language.

It is difficult for a country with these characteristics to sustain a high growth rate and thus avoid the boom-bust cycles that have characterized Pakistan's economic performance for decades. What can Pakistan policy makers do? The IMF support program was signed in November 2008 and time will tell if it helps or just complicates the present situation. It must be noted that,

in the past, Pakistan did not complete all IMF programs. Tough measures must be implemented, but fiscal and monetary austerity will only aggravate existing problems. In Pakistan's current context, stabilization policy cannot be separated from growth policy. A failure to reduce imbalances may hurt growth, but stabilization, in the sense of price stability and fiscal adjustment, will not necessarily lead to economic growth. While fiscal discipline helps maintain low inflation, it also acts as a deflationary force as it leads to excess capacity and unemployment. In the short term, it will be very difficult to slash the budget deficit, as this may create social unrest. The lessons of the pain inflicted to some countries during the international crises of the 1990s and early 2000s should not be forgotten.

Pakistan is in need of a carefully thought out medium-term program of industrialization, upgrading and structural change. ADB is working on an innovative program with Pakistan's government that, if properly instituted, should help put the country on the right path. The new economic team must seize this momentum for change and implement a growth strategy that leads to the transformation of the economy in the direction taken by successful Asian countries. Much needed reforms in areas such as taxation (withdrawal of concessions and exemptions given to the rich), energy policy, and elimination of subsidies to some rent-seeking industries, with a view to fostering competition, should be undertaken with this objective in mind. This requires good policy, as the market will not do it alone. A well-developed plan in the form of an industrial policy program, understood as a plan for strategic collaboration between

public and private sectors, will be an important tool for change. Industrial policy is not about "picking the winners" (some favored sectors believed to be key) but about public and private sectors jointly identifying new activities where Pakistan can excel. It is also a process of identifying the market failures that impede the structural transformation of the economy and removing constraints. This requires strategic collaboration between public and private sectors, as well as the development of the appropriate institutions for change.



*Pakistani Prime Minister Yousuf Raza Gilani must urgently address serious economic woes.*

Exports must be at the center of this development strategy. While textiles and clothing will remain a vital export sector in Pakistan, they cannot be the engine of growth. ADB's research on the level of sophistication of Pakistan's exports (i.e., the degree to which the export structure resembles that of developed countries) indicates that until 1995 the share of exports of "fabrics, woven of continu-

ous fibers," a product with medium-level sophistication, was increasing (and had reached about 11% of total exports). However, afterwards, this share declined dramatically and today its contribution to total exports is very small. On the other hand, the share of, for example, "linen and other furnishing articles," with a much lower level of sophistication, has increased steadily and today it represents almost a quarter of Pakistan's total exports.

Pakistan's problem is not only that it continues to remain narrowly focused on textiles, but that its export structure has shifted to substantially less sophisticated textiles. Diversification needs to be given the highest priority. This is the only way to achieve sustained high growth rates and create productive and decent employ-

ment. The plan has to be realistic—Pakistan will not be able to get into the electronics sector like Malaysia or Singapore in the next few years because it does not have the capabilities required—and based on the identification of a feasible set of activities that Pakistan can develop, given its current capabilities. For example, some of the products that Pakistan should consider exporting in larger quantities are medicaments, pneumatics, plastic packaging containers and frozen meat. These are products that require capabilities similar to those Pakistan already has but whose exports are negligible. These products have a significant level of sophistication. Private and public sectors should jointly analyze why the country does not already export these products (and many others). It is crucial to increase the quality of dialogue between exporters who know the real problems in their sectors and the policy makers who can directly help.

What are the essentials of the industrialization program that Pakistan needs? First, there must be a strong national commitment and for this to happen, the country's political leadership must explicitly acknowledge it. Second, the country must establish high-level coordination and deliberation councils, and the authority for carrying out industrial policies must be vested in agencies with demonstrated competence. Third, mechanisms of transparency and accountability must be put in place. Fourth, public support must target activities, not sectors; incentives should be provided only for "new" activities; activities that are subsidized must have the clear potential for providing spillovers and demonstration effects, and should be activities that have the capacity to renew themselves, so that the cycle of discovery becomes an ongoing one. Fifth, there should be clear benchmarks for success and failure. And finally, there must be a built-in sunset clause to prevent incentives re-

maining in place forever.

It is fundamental that the main stakeholders in this process be simultaneously involved. These are entrepreneurs and government policy makers in the relevant Ministries. Each plays a key role in the design and implementation of a successful industrial policy program. While the government must show political commitment to structural change, policy makers will have to design and coordinate the program, and entrepreneurs will have to carry it out. In the final analysis, the plan will only succeed if existing firms upgrade into higher technology activities and new firms develop in new areas. For this reason, the agencies promoting the program must maintain channels of communication with the private sector. The key to a successful transformation of Pakistan's economy lies in embedding private initiative in a framework of public action that encourages restructuring, diversification, and technological dynamism beyond what market forces on their own are capable of generating. This program will also contribute to the gradual elimination of unemployment and underemployment.

Finally, there is the much-needed social transformation of the country. The elite must realize that it will not be possible to progress when social indicators such as infant mortality and female primary and secondary enrollment levels remain among the lowest in the world. Female literacy is also at the bottom of the international league, and the country suffers from the problem of "missing women" (relatively low female population), a consequence of various forms of gender discrimination. These are all issues that must be attended to.

Pakistan's policy makers have a tough job ahead of them. If opportunities for change and modernization are not seized, the economic situation will continue to deteriorate. Should this happen, the consequences could be disastrous. ■