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Pakistan's Economy
Pangs of Political Instability

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The State Bank of Pakistan recently published its report for the third quarter. Syed Naveed Qamar, the Finance Minister of the new democratic government, led by the PPP, presented his first budget in the Parliament. In between, the government also unveiled the Economic Survey for the fiscal year 2007-08.

What are the major issues in Pakistan's economy? How stable is it today? Have the previous governments, since the military takeover, managed the economy better? What are the challenges facing the PPP government?

The above mentioned reports provide basic data on Pakistan's current economic situation and highlight the status of Pakistan's economy. Even though the assessment of the Economic Survey may not be critical of the government, since it is produced by them, the facts therein need to be accepted. Despite concerning itself mainly with the macroeconomic aspects of Pakistan's economy, the State Bank's report is much more critical than the Economic Survey.

Since it will be difficult to review Pakistan economy in all its aspects, this brief will look into certain key issues and attempt to make an assessment

I
ECONOMIC GROWTH 2007-08
LED BY THE SERVICES

During the previous fiscal year 2006-07, Pakistan's economic growth rate was 6.8 per cent and it was expected that during 2007-08, it would touch 7.2 per cent. Unfortunately, the growth rate declined to 5.8 per cent during this period. This was not surprising, since the previous year had been politically tumultuous for Pakistan, affecting its economic growth. Ever since the sacking of Chief Justice Iftikhar Choudhary, Pakistan has faced crisis after crisis, including the lawyers' movement, violence in Karachi, the Lal Masjid debacle, militancy in FATA and NWFP and its impact on other parts of the country, the return of Benazir Bhutto and her subsequent assassination, and the decision to postpone the elections – all the above events indubitably made a huge impact on the economy.

What sectors have contributed to the economic growth? And what sectors affected it? Pakistan's economic growth in the current fiscal year was primarily driven by the services sector, whose contribution has increased since last year.

Compared to last year's 7.6 percent, the services sector grew at 8.2 percent this year. While the Transport and Communication sectors alone contributed to 10 per cent of the GDP, the Telecom sector contributed more than a hundred billion rupees, especially with the mobile market of Pakistan growing at a fast pace. In every 100, 39.4 in Pakistan are mobile cellular subscribers, when compared to 34.8 in China, 25.9 in Sri Lanka, 13.3 in Bangladesh, and 14.8 in India. This growth is both the reason and expression of an expanding middle class in Pakistan.

While the failure of crops during the last fiscal year has affected the contribution of agriculture to Pakistan's economic growth, a combination of factors (discussed subsequently) reduced the contribution of the manufacturing sector as well.

According to the overview outlined in the Economic Survey, "three-fourth contribution to this year's growth came from the services sector alone with only one fourth coming from the commodity producing sector. It is, therefore, safe to conclude that this year's growth is services sector-led-growth."

For the year 2008-09, one could expect the services sector to continue its positive performance. The overall economic growth, however will depend on how much the agricultural and manufacturing sectors contribute.

II
AGRICULTURAL AND MANUFACTURING SECTORS WHERE DOES THE PROBLEM LIE?

Clearly, as the data suggest, agricultural and manufacturing sectors failed in 2007-08. Since, the contribution of manufacturing and agricultural sectors will be crucial in determining Pakistan's economic growth in the forthcoming year, there is a need to look into what has gone wrong during this fiscal period.

The agricultural sector has always been the main contributor to Pakistan economy. Though its contribution to the GDP has halved today compared to the 1950s (from more than 50 per cent of the GDP to 21 per cent), agriculture remains the most important sector. With more than two-thirds of the total population living in rural areas even today, this sector provides employment to 44 per cent of the work population.

> Besides the inherent flaws in fiscal development in Pakistan, the previous government, completely failed in its policies and its approach. The fiscal deficit is expected to increase to 6.5 per cent of the GDP from 4 per cent. This also has affected the inflation rate, which is expected to spiral further.

Crop failure in 2007-08, the main reason for the poor performance of agricultural sector, was due to the following: natural factors; negative intervention, in terms of adulterated pesticides; and continuing failure to make bold reforms.

Of the five major crops, wheat and cotton harvests were a disaster, while the rice harvest was satisfactory, with sugarcane and maize doing better. Cotton in particular is important for Pakistan, due to its contribution towards the manufacturing industry and also the country's exports. Its significance for Pakistan's economy can be seen from the fact that cotton textiles account for 46 per cent of total manufacturing and 60 per cent of total exports. Had it not been for the relatively better performance of minor crops, livestock and fishing, the agricultural sector's contribution to the GDP would have been a total disaster.

The manufacturing sector's performance has been equally bad, in terms of its contribution to the economic growth during this fiscal year. The reasons as also stated by the Economic Survey report, are obvious: "Heightened political tension, deteriorating law and order situation, growing power shortages, cumulative impact of monetary tightening and rising cost of doing business." The manufacturing sector primarily comprises textile, fertilizer, cement, mining, engineering and steel industries.

Is the manufacturing industry, especially the large scale manufacturing sector likely to bounce back? According to the State Bank of Pakistan's report, "the crisis-like situation in domestic energy sector as well as in the international commodity market does not appear to be settling down in the near future. Thus the LSM sector is likely to remain under pressure in the short term." Much will depend on the international market prices along with Pakistan's ability to produce the required energy and distribute it without disruption. It is a serious challenge, but not an impossibility.

III
FISCAL DEFICIT & INFLATION LEGACY OF PML-Q?

Fiscal deficit of any country is always linked to global and national developments and the government's policies to address them. Besides the inherent flaws in fiscal development in Pakistan, the previous government, led by the PML-Q, completely failed in its policies and its approach. The fiscal deficit is expected to increase to 6.5 per cent of the GDP from 4 per cent (from 398 billion rupees to 683.4 billion rupees). This also has affected the inflation rate, which is expected to spiral further.

Currently, inflation stands at 10.3 per cent. According to the State Bank of Pakistan's report, "since longer term structural price changes are the major contributor to global inflation, the impact of inflationary expectations is likely to be more lasting. There are evidences that the erosion in purchasing power and squeeze in profit margins are contributing to second round of inflationary pressures."

The inherent flaws include the narrow tax base in Pakistan, tax evasion, tax omission, and over dependence on indirect taxes. How many in Pakistan actually pay tax? Increasing the tax rate is unlikely to increase the collection. On the contrary, the greater the increase in tax rates, the more will be the tax evasion. Rather, what is essential is expanding the tax base - which subsequent governments have failed to achieve.

Tax exemptions, given by subsequent governments, mostly for political reasons and at times, due to pressure from lobby groups, have also affected the entire tax collection process. An unfortunate truth in Pakistan has been that the richer and more politically powerful one is, the more exemption he/she gets.

While this has generally been a problem in Pakistan, the political unrest during the last year severely hampered revenue collection. In 2007-08, defence expenditure increased by 10 per cent, from 250 billion rupees in 2006-07 to 275 billion rupees in 2007-08.

On the positive side, the per capita income increased by 18.4 per cent. Does this reflect an increase in per capita income across all sections, or an increase only within the economically rich? If the latter is true, then this would only affirm that economic growth in recent years has benefited only the rich, not the poor. However, it appears that besides the upper class, even the middle class is growing rapidly.

Undoubtedly, the performance of the PML-Q led government since 2006 has played a major role in Pakistan's increased fiscal deficit and inflation, the new government has to take appropriate measures to arrest them, than complaining.

IV
TRADE & FDI FLOW
WILL THEY PICK UP THIS YEAR?

Pakistan's exports from 2002-06, grew at 16 per cent annually, but dropped to 4 per cent during 2006-07. Failure of crops, problems in the manufacturing industry and inadequate energy supply – have added to Pakistan's export woes.

Besides, Pakistan's major export basket is composed of only a few items; cotton, leather, rice, synthetic textiles, and sports goods – these five items alone contribute to more than 72 per cent of the total exports. Hence, a problem in the production of any of these five items can cause the country's exports to suffer.

> Despite the fact the FDI has declined during the fiscal year 2007-08 by 32.2 per cent, Pakistan was still able to attract a substantial amount of 3.6 billion dollars during this year, compared to 5.3 billion dollars during 2006-07.

The textile industry, which forms a primary component of the economy and accounts for 57 per cent of Pakistan's exports, needs overall reforms in all respects – from installing productive machines to improving the skills of workers. Unfortunately, during this fiscal year, the export of textile materials recorded a decline of 2.5 per cent. But fortunately, the food group, especially rice, contributed positively to Pakistan's exports. Despite contributing to only about 13 per cent of the country's exports, the food group grew by 22.4 per cent.

In terms of destination of exports, though it is not a major problem, the fact that Pakistan's goods are sent mainly to the USA, Germany, Japan, UK, Hong Kong, Dubai and Saudi Arabia, is an issue that the government has to look into.

While the exports declined, on the other hand, imports increased by 28.3 per cent. According to the Economic Survey report, "the surge in international community and oil prices is reflected in Pakistan's import bill. Pakistan's import was inflated by $ 4099 million, in the first ten (July0April) months of the current fiscal year, mainly on account of higher international prices of commodities, including oil."

On the positive side, despite the political instability, foreign direct investment (FDI) continues, and according to the Economic Survey report, FDI "has emerged as a major source of private external flows for Pakistan as well amidst widening savingsinvestment gap."

Despite the fact the FDI has declined during the fiscal year 2007-08 by 32.2 per cent, Pakistan was still able to attract a substantial amount of 3.6 billion dollars during this year, compared to 5.3 billion dollars during 2006-07. If the new government is able to provide political stability, one could expect the FDI in Pakistan to increase, in the forthcoming year.

V
CONCLUSIONS

An obvious conclusion is that the previous government failed to sustain the economic growth that it achieved during 2004-07. The PML-Q government, it seems, got carried away by the country's encouraging economic growth, and in its self-congratulatory babble, the echoes of building a consensus on major issues got sidelined. Particularly, efforts to build consensus on water and energy security got diluted by undemocratic decisions, taken without any consultation.

For example – there was no consensus on the scrapping of the Kalabagh dam construction - a decision taken solely by Musharraf, without any proper debate in the Parliament. The new PPP-led government should work towards building consensus on crucial issues - from addressing the country's fiscal security and inflation, to achieving water and energy security.

Since the agricultural sector continues to be the major provider of employment to nearly two-thirds of Pakistan's population living in rural areas, the importance of agriculture needs to be underlined. Since water is a major issue, both droughts and floods are likely to become major causes for concern. Construction or the lack of major dams across the Indus, and the quantity of water flow on the main river and its tributaries is likely to become a matter of life and death for the majority in Pakistan.

Factors responsible for the poor performance of the manufacturing sector are likely to improve, if Pakistan were to become politically stable and improve its law and order situation. Much will depend on how the new government resolves vital issues at the national and provincial levels.

At the national level, reaching an understanding on the continuation of Musharraf and restoring the judiciary are likely to be two crucial issues, towards reaching an understanding amongst the leading political parties – PPP and PML-N. If Sharif and Zardari fail to reconcile their differences on these issues, Pakistan is likely to remain politically unstable.

In the energy sector, it has become imperative for Pakistan to move ahead at a faster pace than before, to bring in gas from Iran and Central Asia. The gas pipelines from Iran and Turkmenistan via Afghanistan, assume importance in this context.

From India's perspective, water and energy are important concerns for Pakistan (for the above-mentioned reasons), to increase the productivity in its agricultural and manufacturing sectors. Hence, it is also imperative for Pakistan to reach an understanding with India on the Iran-Pakistan-India (IPI) and Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipelines, along with a better understanding on sharing of the Indus waters.

Besides, the new government needs to formulate a coherent policy towards dealing with Balochistan, violence in NWFP and FATA, and taking concrete measures in terms of cross-border terrorism across the Durand line. Failure to address the latter is only likely to heighten the incidence of cross-border strikes by the US-led allies, based in Afghanistan, as happened during the second week of June. This was not the first cross-border strike and is unlikely to be the last.

Thus, politically, Pakistan's economy is inter-twined with not only political stability at the national level, but also with regional security. Much will depend on how the PPP led government reformulate Pakistan's economic priorities and policies and link it with external relations.

An economically weak Pakistan is not in the interest of the region as well.

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