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Pakistan's Deteriorating Economic Situation: How Much of it is Caused by Politics?

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Abstract

Pakistan's economy is in a state of deep crisis, the worst in its troubled history. While some natural disasters – an earthquake in 2005 and floods in 2010 – contributed to the poor performance of the economy, much of it was the result of weak management by the civilian government that took office in the spring of 2008. The cumulative loss to the economy during the five-year tenure of the current administration may be as high as 16 per cent of the gross domestic product (GDP). On a number of previous occasions the military intervened when the government in place was deemed to be performing poorly in the economic field. Such an outcome seems unlikely this time around as the military has become conscious of the latent power of the street. This has been demonstrated by the Arab Spring. The country's youth and the civil society do not want to see the army intervene in politics once again. That said, the current government, as it prepares for the general elections that must be held before the spring of 2013, has adopted a populist approach towards economic management. This includes the recent decision by the central bank to ease the supply of money. This may win votes but may further aggravate the already weak economic situation.

Introduction

If the Pakistani economy were growing at a rate of 6 to 7 per cent a year, it would be performing as well as Bangladesh of today while still lower by a couple of points from

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India’s current rate of GDP increase. Instead the rate of GDP growth in 2010-11 was only 2 per cent and, even for those who are optimists, the rate in 2011-12 will not be higher than 3 per cent. This means that the economy is performing well below its potential by as much as 4 to 5 per cent a year. I pointed this out to President Asif Ali Zardari in a meeting in his office a few months ago. He said that that was an unfair comparison – comparing apples with oranges. ‘The Indians have had democracy ever since they became independent; Bangladesh also has had years of democratic rule. Pakistan was governed by military dictators for a good part of its history. Democracy returned to the country less than three years ago. Without democracy you cannot have sustained economic growth,’ he explained.

The democratic government of Pakistan People’s Party (PPP) took office in March 2008, with its leader Yusuf Reza Gilani as prime minister. The PPP had won the most seats but not a majority in the elections held in February. It initially formed a coalition with the Pakistan Muslim League under Mian Mohammad Nawaz Sharif which collapsed in May. General Pervez Musharraf held on to power as president until August 2008 when he was forced out of office and replaced by PPP’s co-chairman Asif Ali Zardari[2]. Since then the elected representatives of the people have had total control over economic policymaking. How well have they performed? One answer to this question is to estimate the loss of potential national income because of indifferent policy performance. Extending the above arithmetic to the period during which the elected civilians would have held power suggests a cumulative loss of close to US$30 billion in national income, equivalent to US$166 per head of the population.

Failures of Public Economic Policy in Six Areas

Has the return to democracy been good for economic development? As indicated above, the economy is performing considerably below the rates of growth being achieved by other countries of mainland South Asia. Some of this poor performance can be blamed on factors beyond the control of policymakers in Islamabad. The great flood of 2010 shaved off at least one percentage point from the rate of growth, at least for a year, possibly even two. Terrorist activities, which have taken such a heavy human toll and are exacting a heavy economic price, cannot be blamed on government policies. It is the consequence of geo-politics with Pakistan a largely passive player. The Lahore-based Institute of Public Policy estimated in its 2009 annual report that persistent terrorism was costing the economy in a number of different ways. ‘These costs (direct and indirect) aggregated to Rs678 billion (approximately US$8.4 billion) in 2008-09, equivalent to 5 per cent of the projected GDP.’[3] Some of this could have been contained and, therefore, reduced by the adoption of the right sets of policies. It would

[2] Asif Ali Zardari and his son Balal Bhutto Zardari were elected co-chairmen of the Pakistan People’s Party following the assassination of Benazir Bhutto on 27 December 2007.

[3] Institute of Public Policy, *State of the Economy: Emerging from the Crises*, Lahore, 2009, p. 13.

not be an exaggeration to suggest that poor policies are costing the economy at least 2 to 3 per cent in lost growth every year. If this trend continues poor policy performance would have cost the economy 16 per cent of the gross domestic output in the five-year period between 2008 and 2013.

The failure of the policymakers stretches over a number of fronts. At least six of these matter a great deal: absence of a clear leadership in economic matters; absence of strategic thinking concerning the revival of the economy and bringing growth back; absence of clear division of authority between the central government and the provinces; absence of fiscal discipline; reliance on central bank finance to meet the government's fiscal deficits; and lack of attention to increasing Pakistan's share in the global markets. Most of these failures can be lumped together under the heading of poor economic governance.

Perhaps the most important of these failures is not to entrust economic management to one individual who should then have appointed a team reporting to him on different matters. There was hope that the appointment as finance minister of Dr Hafeez Sheikh, who had gained some invaluable experience working at the World Bank and also as a minister in one of the administrations under President Pervez Musharraf, would result in the economy being placed in the hands of an individual with demonstrated ability and reasonably good relations with the political establishment. Sheikh quickly brought a talented team together – Shahid Kardar as governor of the State Bank of Pakistan, the country's central bank, and Nadeem ul Haque as deputy chairman of the Planning Commission – but it soon became apparent that he was not given the political space that was needed to design and implement an effective economic policy. Important personnel changes were forced upon him. He had worked with two central bank governors and two secretaries of finance since taking office. Shahid Kardar, the governor, resigned in July 2011 followed by Jaffer Qamar, the chief economist at the Planning Commission and the government's auditor general Tanvir Ali Agha.

Sent on the defensive, the finance minister was not able to develop a strategy for the economy's revival. The failure covered both the short term as well as the long term. In spite of strenuous efforts, he was not able to develop a tax policy that would have satisfied the International Monetary Fund (IMF) that blocked the release of US$4 billion from the US$11 billion committed as an emergency loan in late 2008. Central to the fund's programme was the reform of the general sales tax that would have helped to increase by a bit the abysmally low tax-to-GDP ratio. It is now about 9 per cent, one of the lowest in the world. The political leadership based in Islamabad was not able to persuade the provinces to adopt the new measure. The result is not just the loss of support of the IMF. It has also seriously constrained government spending in a number of sectors important for the health of the economy. Pakistan today is investing about a third of what is required for the development of its vast human resource and about half of what is needed for improving its underdeveloped physical infrastructure.

While the Planning Commission got busy developing a long-term strategy for growth and produced several versions of a five-year plan, it does not have the total commitment of the political machinery to start implementing it.[4] The Commission's draft papers present a change in what it terms the development paradigm. It is right for the planning officials to focus on improving economic efficiency rather than increasing investment to move growth to a higher plane. An investment-focused approach would need the resources the country does not have. But the focus on obtaining growth from efficiency means improving the quality of governance. This in turn means rebuilding institutions, improving the quality of human resource, reforming the structure of the civil service, putting in place effective legal structures to ensure, among other things, that contracts are observed. While all these initiatives are worthwhile and will contribute to economic betterment, it would take a long time before they become effective. They will not speed up economic recovery and place the country on the same growth trajectory as the rest of South Asia. As the World Bank's *World Development Report* for 2011 emphasises, it takes a generation to develop institutions that would support and sustain economic and social development. 'Even the fastest-transforming countries have taken between 15 and 30 years to raise their institutional performance from that of a fragile state today, says the report.'[5] The World Bank considers Pakistan to be one of the several fragile states in the world today.

There was hope that the adoption of the 18th amendment to the constitution would pass on to the provinces the responsibilities that really belong to them but the process of transfer has not proceeded smoothly. The timing of the amendment in the summer of 2010 and the issuance of the National Finance Commission (NFC) award in the fall of 2009 were done in the reverse order. The latter should have preceded the former. However, the provinces, having been given additional resources as a consequence of the NFC award, are not prepared to accept additional responsibilities unless they come with new resources. The resource-strapped federal government does not have much funding to pass on to the provinces. Decentralisation of authority, therefore, is not happening according to the envisaged timetable.[6]

Adopting a responsible fiscal stance has proved to be extraordinarily difficult for the democratic government in Pakistan. It understands that the deficits that the government is currently running are unsustainable. And yet it has shown carelessness in terms of controlling current expenditures or disciplining large loss-incurring enterprises. Senior government officials continue to spend public money on themselves or on those activities that do not have

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4 Government of Pakistan, The Planning Commission, *Pakistan: New Growth Framework*, Islamabad, April 2011.

5 The World Bank, *World Development Report, 2011: Conflict, Security, and Development*, Washington D.C., 2011, p.10.

6 For a detailed discussion of the 18th amendment, see Shahid Javed Burki, 'The 18th Amendment: Pakistan's Constitution Redesigned', ISAS Working Paper No. 112, 3 September 2010; and Institute of Public Policy, *State of the Economy: Devolution in Pakistan*, *Fourth Annual Report*, Lahore, 2011.

a positive impact on the economy. Public corporations such as Pakistan International Airlines, the railways and Water and Power Development Authority continue to run heavy losses.

The government has leaned on the central bank to adopt an accommodating monetary policy that will adversely affect the long-term health of the economy. On 30 July 2011, Acting State Bank Governor Yaseen Enver announced that the discount rate was being brought down from 14 per cent to 13.5 per cent. The acting head took a position different from the one adopted publicly by Kardar. The former governor had openly expressed a deep concern over Islamabad resorting to the printing press for financing large fiscal deficits. His successor adopted a different policy stance. 'The key parameter in this assessment is the outlook for inflation which in FY 2012 is expected to remain in line with the announced target. SBP's forecast for inflation ranges between 11 and 12 per cent,' he told the press in a meeting following the announced cut.[7]

According to Bloomberg, 'Shahid Kardar's departure as central bank chief on July 12, the second person to quit the post in a year, had threatened to expose a breakdown in policymaking, undermining efforts to revive growth amid rising costs and terrorism. The risks fanned Pakistan 10-year government bond yields to the highest levels after Greece among debt markets tracked by Bloomberg.'[8]

The final economic management problem is the disregard of the country's export potential. While other South Asian nations are racing ahead developing niches in the global marketplace – India in the sectors of information technology, pharmaceuticals and health services; Bangladesh in garments – Pakistan remains wedded to old products (textiles) and old markets (North America and Europe). It has lost market share both in total manufactured goods exports and textile and clothing exports in 2005-08 to exporters from other major developing countries.[9]

How Politics Influences Economics

While politics and political science have mostly been ignored by economists, it is difficult to understand many developments in economic history without bringing them in as explanatory factors. Without an appreciation of the environment in which policymaking is carried out it is hard to fully understand why those in power do what they do. Why did Governor Shahid

[7] Shahid Iqbal, 'SBP cuts interest rate to 13.5 pc', *Dawn* (31 July 2011), p.1.
[8] Bloomberg, 'Pakistan cuts rates after bank chief resigns', *Gulfnews.com* (31 July 2011).
[9] Institute of Public Policy, *State of the Economy: Devolution in Pakistan*, Fourth Annual Report, *Op. Cit*, p. 18.

Kardar of the State Bank of Pakistan resign after being in office for only a few months? Why, after the governor's departure, did the central bank decide to lower the rate of interest when Pakistan has the second highest rate of inflation in Asia? Economic theory and practice would have suggested a tightening of money supply, not its easing. This was not expected by a dozen or so senior economists who, when they were questioned before the bank's credit committee met, predicted that either the policy would not change or there might be a slight rise in the rate. India, for instance, faced with a lower rate of inflation than in Pakistan has raised the discount rate eleven times last year. The Pakistani central bank's action confounded economists and further eroded the confidence of those watching economic developments about the seriousness of the policymakers in addressing the grim economic situation the country currently faces.

The answers to these questions are not to be found in economics but in politics. As democracy continues to take hold in the country, policymakers are working to ensure their survival not only by keeping the men in uniform satisfied with their performance. This is what happened in the past when a series of prime ministers were sent home by the powerful military for having failed to provide good economic management. Their removal was in fact demanded by senior politicians who occupied the opposition benches in the legislature. And when the military intervened even the press welcomed its arrival. There are no calls this time around for history to repeat itself. The reason is that political forces are looking at some of the developments outside the country's borders and drawing important lessons for shaping their own actions. Three of these developments are particularly important. Two of these occurred – or, more accurately, are still occurring – in the Arab world while the third took place in Turkey which, like Pakistan, is a large Muslim country engaged in an effort to strengthen the democratic structure still in the process of being built.

The first of these is the effective use by the youth in the Arab world of the new media to get organised and challenge the established political order. They used such new instruments of communication frameworks as Facebook and Twitter and such devices as the IPad and mobile telephones to gather and demonstrate on the streets. This expression of discontent did not need political organisations for mobilisation. The strength of this uprising was drawn from the depth of despair that had built up over years and decades. The authoritarian regimes in Tunisia and Egypt were not able to use their well-developed security forces to keep themselves in power. Once the military establishment in these two countries indicated that it would not intervene to keep in place the discredited leaders, regime change became inevitable and happened quickly. Yemen, Libya and Syria have not gone the way of Tunisia and Egypt for the reason that those in power have managed to stay there by exploiting the social, cultural and religious divisions in their societies. They may have bought some time for themselves but not longevity.

As Reza Aslan wrote in *Time* magazine's special issue on Islam, 'a new kind of global identity is forming across North Africa and the Middle East as young people – who make up the overwhelming majority of the region's population – are beginning to rise up and demand a voice in their political and economic destinies. While this so-called Arab Spring has progressed in fits and starts and though it has been more successful in transforming certain societies (Tunisia and Egypt) than others (Libya, Syria), what is taking place across the lands that Ibn Battuta [the 14th century Arab explorer] travelled centuries ago is not, as it has often been portrayed in the West, merely a nationalist phenomenon. On the contrary, this generation – which is intimately interconnected by new communication technologies like satellite television, social media and the Internet – has formed a new kind of transnational identity, one that cannot be identified by any ethnic, national or sectarian borders. It is an identity founded on young people's shared ambition to free themselves from the grip of their corrupt and inept political, religious and economic institutions…'[10]

The second lesson being drawn from the Arab Spring by Pakistan's old as well as new political establishment is that the 'street' has been inserted as another balancing factor in the evolving democratic systems. If there is general dissatisfaction with the way the executive branch is acting and its actions cannot be constrained or controlled by the legislature and the judiciary, the street will be prepared to act. The 'street' is not just in the Arab world but is in all parts of the Muslim world. It is able to throb with activity because of youth of the population. The median age of the populations in Muslim countries is much lower than in other parts of the world. It is only 21 years in Pakistan, which means that some 80 million people in a population of 180 million are below that age. Most of them are not active participants in the established political order. They are, however, deeply concerned about their present economic situation and future prospects. They will become politically active if the state of the economy continues to follow its present trend and does not promise them a better future.

The third important development of note is the sudden departure of all senior military commanders in Turkey. As Anthony Shadid, the Pulitzer prize winning journalist, wrote in *The New York Times*, 'fifty years ago, when a populist prime minister tangled with the Turkish military, he ended up on the gallows, the mandate of three election victories little consolation. This time around, the rivalry climaxed with most of Turkey's military high command resigning simultaneously, its leader complaining of powerlessness and bad press.'[11] There is a consensus among analysts that this action by the commanders has strengthened the position of Recep Tyyip Erdogan, the thrice elected prime minister, rather than weakened it. The once powerful militaries in the Muslim world have had to recognise that the people of their countries want representative political orders in place rather than rule

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[10] Reza Aslan, 'World Wanderer: Ibn Battuta chronicled the medieval era's great globalization force: Islam', *Time* (1 August 2011), p.33.

[11] Anthony Shadid, 'Turkish prime minister climbs a higher perch in wake of resignations', *The New York Times* (30 July 2011), p.1.

by strong men. The Pakistani military establishment recognises this. It has also been weakened by the circumstances surrounding the death of Osama bin Laden, killed in an operation launched by American troops deep inside Pakistani territory. The military is still attempting to explain to the people how a foreign force could penetrate so deep into the country's territory without its knowledge. And if there was knowledge of this operation why was it allowed to take place?

Conclusion

An important lesson Pakistan's political establishment has drawn from these developments is that it cannot simply rely on the support of its traditional constituencies. It has to keep an eye on the way people are reacting to its policies. The street also matters. It also seems to have gained some confidence that the military, while still influential in several aspects of policymaking, is not likely to directly intervene. These are reasonable responses to the important developments outside the country's orders but they have not resulted in good economic policymaking. One important illustration is the way Islamabad is dealing with the State Bank and the way it is using monetary policy to keep the street on its side. Most political mistakes are made by sacrificing the future to the present. It is quite clear that the current rulers are getting ready for the next general elections. They have to be held in the next 20 months. If held under the current political dispensation this would be the first time in the country's history that an elected government would have completed its full term.

To get to that point the PPP-led government seems to have concluded that it is important to bring growth back by easing money supply and that tightening of money would reduce investment by the private sector and thus slow down the rate of increase in employment. These are short-term responses to a difficult economic situation but their consequences will, in the long run, be politically and economically grim.

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