Pakistan’s Structural Economic Woes

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Amid recent stagflation, the Pakistani economy is trapped in a scenario where the country is faced with low growth prospects, persistent macroeconomic imbalances, and enlarged vulnerabilities of a sizeable fraction of the populace. The donors, in general, and the IMF, in particular stress short-run demand management policies like budgetary reforms, prudent monetary policy, the policy of market-determined exchange rate, expansion of social safety nets, and across-board privatization amongst others. Nevertheless, our economic issues are structural we have insufficient investment; we have a lower share in global trade; we have allocative inefficiencies, and we are faced with low productivity dilemmas; all restraining firms’ capabilities. Unless we reduce these structural bottlenecks, we cannot have a sustainable level of growth which can reinstate our economic sovereignty.

Pakistan has a history of truncated growth trajectory, with periods of high growth, followed by lacklustre growth performances. The irony is that the higher growth periods are largely driven by growth in private consumption, owing mainly to population growth and remittances, with a partial role played by growth in government expenditure. In other words, investment and export-led growth, which is the only way to a sustainable growth performance, has been lacking in Pakistan. Pakistan has been an investment-deficient country, with the investment-to-GDP ratio remaining below 20 per cent over the last four decades. In particular, private investment has remained around 10 per cent of GDP which is roughly half of regional peers and only one-third of more dynamic emerging markets in Asia. Likewise, Foreign Direct Investment (FDI) has averaged around 0.8 per cent of GDP since 2010. Overall, lower investment has kept capital deepening to decline instead of rising over time which, in turn, has severely impacted growth in labour productivity.

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Similar is the case with Pakistan’s share in international trade. Pakistan’s share in global trade is around 0.12 per cent, compared to 0.19 per cent of Bangladesh, 1.65 per cent of India, and 1.17 per cent of Vietnam. Currently, Pakistan is among the top ten countries with the lowest export orientation in the World, with an export-to-GDP ratio averaging 12.3% for the period 2000-2020. In addition, Pakistan’s exports lack diversification, including both product diversification as well as market diversification. For instance, Pakistan’s exports are mainly comprising resource-based items such as cotton, rice, hides and skins over the past many decades, dominated largely by textiles products and rice. Similarly, Pakistan’s export market is highly concentrated as its main trading partners are only three, the United States, Europe, and the PRC, though it also sells much of its rice to the Middle East. The only economy for which it is a major market in Afghanistan. Further, Pakistan has never been efficient concerning value addition. Unlike Pakistan, most of its regional neighbours and competitors were able to transform their export base from primary commodities to high-value-added items. For example, over the past two decades, compared to an increase of 16 percentage points in the share of manufactured exports in Pakistan’s total exports, the share of regional competitors has

on average increased by 43 percentage points. All these statistics exhibit a lack of capabilities of our firms to compete in or get access to global markets.

In general, firms' capabilities are interlinked with investment and exports in both directions. On one hand, investment and exports are essential for growth in firms' capabilities, but, on the other hand, more capable or more productive firms are likely to invest and export more. Given this inter-linkage, lower investment combined with lower integration in global trade has barred the country to benefit from the technology, knowledge and business networks that accompany FDI and trade, causing stagnancy in aggregate productivity. In a recent report titled "From Swimming in Sand to High and Sustainable Growth", the World Bank shows that, in Pakistan, aggregate productivity has been shrinking due to a decline in within-firm productivity. In other words, firms' capabilities to become productive have dwindled over time, irrespective of the age, size, type, and location of firms. Though allocative efficiencies, defined as the reallocation of market shares towards more productive firms, have offset to some extent the decline in within-firm productivity it has not been enough to counterbalance the decline in overall total factor productivity. Overall, in Pakistan, a 40-year-old firm is as productive as a young firm of fewer than 10 years in age, compared to regional peers where older firms are between 30 and 40 per cent more productive than younger ones. Likewise, with respect to size, Pakistani firms have not been able to boost gains in productivity from economies of scale as they struggle to grow larger over time. Though the relationship between size and productivity is a bit steep in the case of State Owned Enterprises (SOEs), in the case of publically listed firms, the relationship becomes almost flat for very large firms. This differential can partly be explained by high capital-intensive production in the mining and power sectors in which many SOEs operate.

Furthermore, the ownership structure also matters for productivity. Though family-owned firms in Pakistan show similar levels of productivity as the nonfamily-owned their productivity has declined faster. Family-owned firms have experienced an average decline in productivity of 7.5 per cent compared with just 4.5 per cent for non-family-owned firms. Likewise, the contraction in productivity is independent of firms' locations. In Pakistan, about 46 per cent of publically listed firms are located in Sindh, followed by 43 per cent in Punjab, and the remaining 11 per cent are distributed across other provinces. On average, firms in Punjab experienced an 8 per cent decline in productivity compared with 4 per cent for firms in Sindh. Also, in Pakistan, we have a dearth of innovations which is partly explained by weak university-industry linkages, unavailability of specialized skills, and weak enforcement of trademarks. This is seriously hampering productivity as is shown by the distribution of innovative firms. The share of innovative firms in the least productive quintile of firms is only 12.7 per cent compared with that of 51.3 per cent in the most productive quintile. COVID-19 has also put some voids on productivity as within-firm productivity has fallen by 23 per cent in 2020 compared with 2019 levels, exhibiting a reduction in economic activities due to travel restrictions across the globe.

What needs to be done? I would like to posit that more trade and more investment are powerful channels both for increasing within-firm productivity and improving allocative efficiency. First, we need to re-orient our subsidized credit from those schemes which are focusing on financing working capital and channel it to long-term financing for investment expansions and innovations. Likewise, support in logistics or infrastructure and regulatory facilitations should be the theme of focus instead of providing direct subsidies or tax rebates to export financing schemes. Second, inefficient SOEs are not only a drain on aggregate productivity but are also a burden on government fiscal space. So, reforms in SOEs like full compliance with corporate governance, induction of CEOs from the market, joint-ownership structure etc. are earnestly needed. Even, we should not be hesitant in privatizing those SOEs where the presence of the public sector is not

justified. Third, we need to open our market to global firms by providing level playing fields to them. Competition not only improves the welfare of consumers but also augments the productivity of domestic firms by providing opportunities for technology adoption, imitation, and joint ventures. Only these measures can ensure a rise in investments and exports which are the only ways to persistent and sustainable growth.

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