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Key Global Developments Impinging on Pakistan's Growth Prospects

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About the project

Funded by: International Growth Center (IGC)

Key Counterpart: Pakistan Business Council

Impact: The findings of this study fed directly into the deliberations by the sub-committee on competitiveness, led by Dr. Naved Hamid (IGC Resident Country Director), under Prime Minister's Economic Advisory Council (EAC). This work has also significantly deepened engagement with the private sector. The findings were presented to the Pakistan Business Council and incorporated into a set of PBC sponsored sector studies to inform their advocacy efforts.

This policy brief is based on an ongoing study "Sectoral Productivity and Competitiveness" by Shahid Yusuf (Growth Dialogue, George Washington University) and Ijaz Nabi (IGC and CDPR). It is compiled by Zara Salman (CDPR).

In brief

- China remains the largest producer and exporter of textiles and garments by a wide margin followed by the European Union (EU), Bangladesh and Vietnam.
- China's declining exports of garments creates opportunities for other leading producers of garments especially the ones already tightly integrated into global value chains (GVCs).
- Pakistan and Bangladesh in particular, will need to diversify into garments using manmade fabrics that has higher unit value and can generate larger export earnings.

International Growth Centre

How low and middle-income countries become high-income economies?

Most countries classified as high income grew their per capita GDP slowly but steadily over many decades. They experienced periods of negative growth, but these were few and of short duration.

Since 1965, Pakistan's GDP per capita has also risen in all but eight years (Figure 1). Yet, to become an upper middle- income country, it needs to push GDP growth into the 7-8 percent range and to sustain these rates for an extended period.

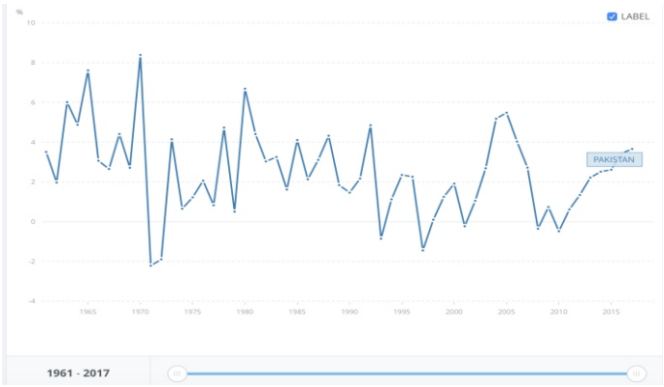
This calls for a long-term strategy that is attuned to global developments; a strategy that builds manufacturing capabilities and fully exploits the growth potential inherent in the export of manufactures – following the lead of East Asian economies.

However, unlike the East Asians, Pakistan's strategy will need to be multi-sectoral, relying also on other drivers of growth, in particular tradable services, agriculture and agri-processing activities.

Can Pakistan adopt the Korean Model?

Korea became a high-income nation in three short decades because it mastered the technology and logistics of light manufacturing and efficiently managed and progressively upgraded its factory labor. It also incentivized investment by large diversified conglomerates, promoted exports and steadily moved up the value chain.

Figure 1: Pakistan's per capita GDP growth 1965-2017



Source: WDI

A key factor that contributed to Korea's rapid climb up the income ladder was the speed with which it was able to diversifinto the production of steel, machinery, chemicals, transport, complex capital goods and electronics and to render these industries globally competitive. Supporting investment in transport and energy infrastructures paralleled this diversification.

In case of Pakistan, manufacturing has an important role. However, only a multi-sectoral strategy that builds and exploits the full potential across all sectors can deliver the sought-after economic results. A fresh approach is needed primarily because global environment and technology have evolved in ways that are reducing both the relevance and efficacy of polices that worked in the past for countries like Korea.

In addition, voluminous empirical research has enhanced our understanding of the factors that underpin productivity of manufacturing activities increasingly complemented by value adding services.

Globalization may go into reverse

A natural resource-poor, lower middle-income economy that runs a chronic trade deficit must export in order to grow and to cover the cost of imports. However, the following developments demonstrate that increasing exports will be a challenge in the current global environment.

1. Slowing of trade

Between 1980 and 2011, world merchandise trade rose annually at 7.3%, creating ample opportunities for late starting economies such as Korea and Singapore. Moreover, the emergence of China with its expanding economy, deman for imports and participation in global value chains also helped sustain global growth and fueled demand for exports from other developing nations.

But the engine of trade now appears to be slowing. Global GDP is expected to increase by between 3.3 and 3.6 percent during 2019-2020 with trade rising almost in step or only marginally faster.

Two sets of reasons are advanced for the slowdown in trade. The first has to do with compositional changes manifested in the reduction of the share of advanced economies in global GDP, from an average of 59% to 43% between 1980 and 2007. With higher trade elasticities, these advanced economies are more responsive to changes in prices. This is compounded by a shift in the composition of demand towards products and services that are less trade intensive.

The second set of reasons are structural. This includes (i) an increasing share of services in consumption; (ii) a consolidation of global

value chains as the process of fragmentation comes to an end and now seems to be reversing with more of the value added component being concentrated in fewer countries especially China; (iii) anupsurge of protectionism as signaled by tensions between the United States and a number of its major trading partners; and (iv)a diminishing pull on aggregate demand exerted by post 2008-09 Financial Crisis credit expansion. Furthermore, China's weakening growth momentum since 2012, a trend that looks likely to continue, and the sluggish performance of advanced economies have dampened trade.

With the upsurge of populism, advanced countries - with the United States in the lead - are beginning to question the advantages of free trade and are now engaging in protectionist practices, trying to rebuild their domestic manufacturing capabilities to reduce their reliance on imports.

A slackening of South-North trade will make it more difficult for Pakistan and other economies to pursue a growth trategy based on industrial deepening and the export of manufactures. South-South trade that has risen strongly, might be more promising but many developing countries are attempting to build the very same light manufacturing activities and looking to exports as a way of scaling up production.

Hence, not every country engaging in this exports' arms race will emerge a winner. If the export push fails, a revival of import substituting industrialization (ISI) is a risk that developing nations need to avoid. It proved to be a costly dead end in the1960s and 1970s. There is likelihood that an attempt to industrialize at any cost would be no less burdensome in the 2020s.

2. Investment spending is trending down

Gross fixed investment Political and policy uncertainties in Organization for Economic Co-operation and Development (OECD) countries plus a short-term outlook are taking their toll particularly on investment in long-lived productive assets. Globally, gross fixed investment grew by 10% per annum in 2010 slowing down to 3.5% by 2016.

Gross fixed investment has remained stagnant or been on a decline in advanced economies since 2000. This hurt growth and trade especially of capital goods. More surprisingly it has been on a downward slope even in Emerging Markets and Developing Economies (EMDE). Capital formation in Pakistan was 19.6% in 2006; by 2017, it had dropped to 16.1%.

The reasons for this are several: Exporters of primary commodities (such as raw cotton) have been battered by terms of trade shocks (fluctuations in world market of export prices). Moreover, the rising indebtedness of private firms is discouraging investment in some EMDEs. A sense of uncertainty has prevailed since the 2008-09 Financial Crisis, exacerbated by the outcomes of elections and referendums in the West and in some of the middle-income economies.

There are other reasons as well. The increasing importance of software and intangibles may reduce the need to invest in fixed capital and firms may end up putting their resources to other uses.

Whatever the mix of causes, a vital driver of growth is playing a less prominent role. However, this need not dampen growth so long as the declining contribution of capital is offset by increased total factor productivity i.e. efficiency with which inputs are utilized to produce outputs. But this too has been heading downward in both developed and developing countries, putting long-term growth prospects at risk.

Foreign direct investment Global FDI has been falling since 2016 (see Figure 2), following a flattening and subsequent decline after 2010 and an upturn in 2015. In 2018, FDI was down to $1.2 trillion from $1.47 trillion in 2017. The good news is that FDI in Asia rose to $502 billion in 2018 as East and Southeast Asian economies retain attraction for investors. Whether this stability will persist and how much FDI will flow to South Asia, in particular to Pakistan, remains an open question.

The experience of Singapore, Malaysia, Thailand and Taiwan suggests that in the earlier stages of development, FDI can play an important catalytic role. In addition to providing capital, it transfers technology and skills. This however requires accompanying policies to foster these transfers.

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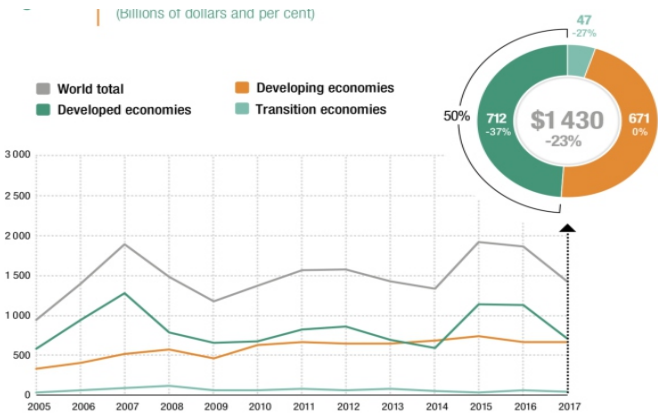
Even at this stage, FDI might be essential to enable Pakistan to develop tradable services and to hook these services to markets in high-income countries. Domestic policies that attract FDI and manage its composition to promote tradable activity will thus remain a critical element of a productivity and employment enhancing strategy.

Figure: 2. FDI Flows 2007-2018



Source: UNCTAD[1]

In the current environment, to compete more aggressively for foreign capital, Pakistan will need to improve its business environment and deal with policy and security issues that have deterred investment to date.

3. Industrialization is peaking earlier

Almost all high-income economies owe their prosperity to industrialization. Prior to the 1980s, manufacturing was the primary driver of growth, it created a multitude of jobs and these jobs – direct and indirect – served as the foundation of the middle class. Manufacturing technology once codified, was easily learned. And exports readily absorbed the light manufactures produced by developing economies. However, the very productivity of manufacturing relative to services (and the falling relative prices of manufactures) has resulted in a rapid decline in the share of manufacturing in GDP in the majority of lower and upper middle income countries.

4. Automation and diffusion of digital technologies is speeding up

Another development with long term implications for employment, productivity and trade is the diffusion of digital technologies and the effective use of Big Data, advanced data analytics, cloud computing, advances in machine learning, automation of work, and the maturing of additive manufacturing. All these advances promise to deepen the skill and capital intensity of production, increase productivity, and gradually eliminate the advantage conferred on countries in South Asia and elsewhere by low labor costs. There will remain pockets of labor intensive, light manufacturing for example in the garments subsector, footwear, the manufacture of toys, leather goods, wood products, furniture, and commodity based manufacturing serving local demand, but in these also, the tempo of automation has been picking up as the advantages of using smart machines rather than human labor mount.

While anywhere between one third and one half of all jobs might be susceptible to automation in advanced economies, the percentage of jobs at risk is much higher in developing and emerging economies.

Rapid automation not just of manufacturing but also of routine services (some embedded or embodied in manufactures) and others demanding limited cognitive inputs is both feasible and becoming cost-effective. Once highly automated workplaces become the norm in upper- middle and high-income countries, lower middle-income ones that largely rely on technologies perfected in advanced economies, will need to follow suit in order to remain competitive.

Conclusion

These developments are not the only ones that will affect employment, productivity and growth in Pakistan. Down the road, other developments such as climate change will also start to eat into agricultural productivity, impacting the structure of the economy.

But arguably, the developments discussed in this article do rank uppermost and should be factored into a growth strategy that can learn from the experience of the East Asian tigers such as Korea.

The lessons from the East Asian experience, however, will need to be substantially modified to accommodate these developments. At the same time, structural imbalances will need to be addressed, keeping in mind the political factors that are likely to constrain policymaking.

[1] Https://Unctad.org/en/pages/newsdetails.aspx?Originalver sionID=1980