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## Addressing the real economic challenges facing Pakistan

Mushtaq Khan, November 21, 2016

### The world in turmoil

There appears to be a certain momentum to global events, which hints at where the world is headed. First was the shock Brexit vote, followed by Trump's equally shocking elevation to US President-elect. To follow are the rise of right-wing parties in Western Europe (starting with France), the demise of the Euro, and the gradual fragmentation of Europe. If that isn't enough, globalization will be reversed as existing multilateral trade agreements are replaced by more customized arrangements between strategically aligned countries.

While the fall of the Berlin Wall in 1989 ended the Cold War (and shifted the world to a unipolar order), 2016 could well be remembered as the year when things started to shift back towards a multipolar world, one which is driven more by regional concerns than global commercial interests.

### What's happening in India?

Closer to home, the right-wing Modi government that is aligned with an equally right-wing US government, cannot go unnoticed. Neither can the China-Pakistan Economic Corridor (CPEC). While it appears that South Asian countries are positioning themselves in the new global order, they also realize that this is not just a matter of political preference- to flex political muscle, these countries also need to upgrade their economies to play a more assertive role in the global order.

It is therefore surprising that the Modi government has demonetized currency notes, which has effectively plunged the country into chaos. With India being viewed as the darling of the global economy (the engine that could replace China), why would Modi's government shock the system so completely? Other than the stress and anxiety created for the average Indian, some claim demonetization could reduce Indian GDP growth by 2-3 percent in real terms.

Indian officials have offered a bunch of reasons for this shock decision. They cite the need to undermine the black economy (i.e. expose the hoarding of currency notes generated by the black economy); the need to clampdown on counterfeit currency notes; the need to deepen the Indian banking system; the need to go cashless; and to better document all economic transactions in the country.

Although these are sound reasons to proceed with demonetization, the risks are equally real. The pains the Modi government took to explain why this move had to be a surprise, reveal that it was aware of the potential costs and possible political backlash that could result from demonetization.

India's policymakers would have been aware of: (1) the public anger that could cost them political support; (2) the fact that this could disrupt its impressive economic performance; (3) the anger of the commercial elite that have political influence in state and local governments; (4) how this move coupled with the likely increase in Fed rates, could see a sharp reversal in India's external sector; and (5) how this "anti-corruption" drive could actually turn India's corrupt government machinery against Modi's government.

Given the global uncertainty created by the political transition in Western Europe and the US; the growing assertiveness of Putin; the uncertainty about NATO's future; the threat to India by OBOR

(specifically CPEC); and China's growing military presence in the South China Sea, it would have made more sense for India to postpone this policy shock.

There are simply too many things going on to risk further uncertainty.

In our view, Modi may have realized that since India is poised to become a significant player in global affairs (eclipsing Europe and Latin America), it needed to shock its system. Since independence, India has adopted a socialist, government-driven economic set-up, which transitioned towards free-market capitalism in the 1990s. In both eras, the undocumented sector continued to thrive, which undermines the effectiveness of its economic policies.

To gear up for a possible transformation into an economic powerhouse, which could sustain an equally powerful military presence (to stand up to China), India has little choice but to weed out economic agents that insist on operating outside the ambit of India's policymakers. The idea is to prove that there is no longer any place for unknown (undocumented) economic forces that have political power, which can be used to influence India's economic policies.

If this is true, then next on the to-do list is tackling corruption in government offices; restructuring state-owned enterprises; strengthening India's banking system; increasing tax revenues to finance massive infrastructure spending; and encouraging more Indian corporations to become global players.

To project power beyond its borders, a country must have strong economic foundations, transparent enough to instill confidence in both domestic and foreign investors.

If India has taken this decisive step, Pakistan must follow.

### **The real (non-IMF) economic issues**

Instead of going down the list of the usual ills that are still plaguing Pakistan's economy, let us focus on the more pressing issues that are often ignored.

1. Pakistan's undocumented economy is now the real engine of growth. Estimates vary, but the informal economy could be as large as the documented sector:
  - a. These sectors cannot avail bank credit, and are largely short-term investments in services and cottage industries;
  - b. This directly hits tax revenue collection, which means infrastructure and social sector spending is severely constrained;
  - c. This unending fiscal struggle means the government must rely on debt finance, which makes Pakistan even less attractive for foreign investors; &
  - d. As non-payment of taxes becomes a social norm, investments are diverted away from the documented sector into more profitable undocumented investments.
2. Household savings have been shifting away from productive investments (e.g. term deposits in banks), into real estate, gold and hoarded currency (PKR or Dollar). We believe real estate, gold/jewelry, and livestock could account for as much as 80-85 percent of Pakistani household wealth. Banks are no longer channeling savings into investments, but relying on salaried accounts and transaction balances to finance short-term trade and working capital needs. This means Pakistan's banking system will remain shallow and concentrated – its biggest borrower being the government itself.
3. Since real estate and gold/jewelry is either undisclosed or grossly undervalued, most Pakistani wealth (even within the country) goes undetected. Yet, this wealth keeps appreciating, making Pakistanis

richer, which is reflected in their spending patterns. In effect, the government's economic policies are unable to shape economic behavior, and the resulting trajectory of the Pakistani economy.

Although India's economy has similar problems, we believe the situation here is much worse. We would list the following issues as key:

- The need to address the high currency-to-deposit ratio;
- The need to have more accurate real estate valuations across the country;
- The need to discourage capital flight;
- The need to make it difficult to move or invest money generated via corruption; and
- The need to create a comprehensive database, which links: bank accounts; real estate holdings; travel; motor vehicles; occupation; family/staff identification; business interests; shareholdings; and all financial assets and liabilities associated with a specific person (or family).

### Conclusion

Modi has taken a bold step, one which could irrevocably change the manner in which India's economy functions. While demonetization is a very risky decision, it does reveal the desperate need to upgrade India's economy so it can be a powerful force in the global economic order.

Given their common past, Pakistan's economic system is in many ways similar to India's. For example: (1) the excessive reliance on cash to sustain a vibrant undocumented economy; (2) a cultural aversion to being documented and to paying taxes; (3) understating asset holdings and wealth; (4) limited reach of banking services to the rural sector; (5) powerful business lobbies that can tweak economic policies to suit their business interests; (6) a cumbersome government machinery where rent-seeking is the norm; (7) legal infrastructure that is intentionally cumbersome and is manipulated by business interests, politicians and other insiders; and (8) weakly enforced labor laws and widespread moonlighting.

While state-provided welfare services like old-age pensions and healthcare, are also missing in South Asia, there is a view that individuals must take care of themselves and their parents – they themselves will be taken care of by their children. While we feel this social safety net is far superior to any system the Anglo-Saxon countries have, it cannot excuse citizens from paying their taxes, nor allow the government to tolerate a dysfunctional judicial system.

If South Asian countries are to be global players in the 21<sup>st</sup> century, the *Social Contract* between the people and their leadership, will have to be redefined. While demonetization is an event where the state is flexing its power, it cannot be a one-way street. As stated above, Modi will have to address the list of grievances that Indians have, and implement tangible reforms to show that the state is forcing change upon itself, just as it is requiring a behavioral change in the people.

This may appear to be a tall order, but there is a need to follow India's lead in clamping down on the informal economy, as the undocumented sector in Pakistan is even larger as a share of its formal economy.

If there is interest, we would be happy to bring together a group of people to brainstorm a potential plan for Pakistan. As stated earlier, Pakistan needs to move on several fronts simultaneously to seal off options that undocumented wealth-holders may seek if they sense that the government is indeed serious about formalizing their operations.