# Does Pakistan need an Industrial Policy?

**Mushtaq Khan & Danish Hyder, January 5, 2017**

The popular discourse on Pakistan's economic challenges often focuses on uncompetitive exports; a growing external deficit funded by expensive foreign debt; persistently below-target revenue collection; frequent power outages; and the poor state of public sector enterprises (PSEs) like PIA, Pakistan Railways and Pakistan Steel Mills. CPEC has recently figured in the public consciousness, but the assessment is rather mixed.

While these concerns are valid, the fundamental *problems* in Pakistan's economy are not limited to economic policies per se. The proper list should include: corruption (both in the private and public sectors); weak state institutions; deep income inequality; unemployment; lack of public services (education, health); the preference to stay undocumented; an ineffective judiciary and law-enforcement framework; short-term policies; and a politicized bureaucracy.

These are the very foundations of any economic order, and addressing them will certainly not be easy. Over the past several decades, Pakistan's economy has been guided by the Washington Consensus that advocates free-market policies, deregulation and privatization. Implicit in this ideology, is the view that government intervention in the economy is a recipe for disaster. One must however realize that the same international financial institutions (IFIs) had once championed a planned development agenda in the 1960s and 1970s.

Pakistan's brief experimentation with 'directed development' fell out of favor when the IFIs themselves discovered the benefits of market-driven economics. By the 1980s, IFI credit-lines that had created and sustained development finance institutions (DFIs) like the National Development Finance Corporation (NDFC) and the Pakistan Industrial Development Corporation (PIDC), had dried up. Efforts to substitute long-term consumer deposits to shore up these institutions, were able to sustain the more dynamic DFIs for a while. However, with poor oversight and political lending becoming more common, these DFIs ceased to exist. Part of their legacy was a gaping hole in their balance sheets, which were absorbed by a large public-sector bank.

But NDFC and PIDC were not just avenues for political patronage. In fact, their contribution to economic development in the country is not controversial. Further, directed development has been instrumental in the economic rise of various countries. So, should Pakistan's policymakers reconsider a more direct role for the government in reviving the country's industrial base?

## Asia Rising

In the 1960s, South Korea had only nine shipyards producing steel vessels, and by the mid-1970s, demand for new ships had crashed due to the oil shock. Furthermore, the US withdrew its troops from South Korea in 1976, despite ongoing tensions with China and North Korea. In response, the South Korean government persisted with its decision to push industrial investment (shipbuilding), since it was viewed as essential to its national security.

The Hyundai Construction Company (HCC) was granted a license to build ships, with the state providing support in the form of cheap credit and financial guarantees for first orders, and encouraging investment in complementary industries like steel. Daewoo and Samsung followed HCC, and also received state help. Today, HCC is the world's largest shipbuilding company and a profitable private enterprise.

 

Japan's steel industry had been decimated during World War II, with only 25% of its plant capacity still functional in 1949. The Japanese government decided to rebuild this sector, while protecting domestic producers from cheaper imports; it also provided financial support to upgrade plants, and encouraged mergers to create economies of scale. MITI, the ministry responsible for trade policy and certain local industries, played an instrumental role in driving Japan's industrialization in the 1950s and 1960s.

Finally, we have Singapore. In 1965, a newly independent Singapore faced high unemployment and poverty, with one in every two Singaporeans illiterate. The government established the Economic Development Board (EDB) to make Singapore the prime destination for FDI in the region, while the Trade Development Board was established to aid locals build export markets. In both cases, tax incentives were used.

The EDB marketed Singapore as a platform for re-exports for multinational companies. Of particular note is the government's focus on Singapore's legal system – not just in terms of comfort for foreign investors, but also the effectiveness of its law enforcement agencies. Based on the British Common Law, in 2010, Singapore's legal system was ranked by the World Bank as having the best framework in Asia for the arbitration of commercial disputes; in 2013, Singapore was ranked 3rd globally by the Political and Economic Risk Consultancy for the best legal infrastructure.

For a country with severely limited natural resources, Singapore played by a strategy that made it the envy of the world.

**Asia explained**

Free market fundamentalists would take the above cases to be exceptions, not the rule. But many economists now reject the neoclassical disdain for the government's role in the economy. These economists think the state is an important check on a market economy, since experience shows that free, deregulated markets are prone to bubbles and crises. Joseph Stiglitz, the Nobel-prize winning economist, believes that the state has an indispensable role in building and maintaining institutions, which are necessary to ensure the proper functioning of the market economy.

While this should sound alarm bells for free market fundamentalists, two issues need to be made very clear.

First, economic activities require supporting institutions like an effective judiciary and regulatory structure, which are able to ensure that private parties play by the rules. Second, industrial development requires a pool of semi-skilled workers, who can be put to work after basic job-specific training. However, as Pakistan has lagged behind most South Asian countries in terms of social indicators, industrial investment (development) would also have to carry the burden of housing, health, education and skill development of blue-collar workers. This would only be possible via long-term employment contracts that have legal cover under a formal labor policy.

Many of these steps were taken by Asian countries back in the 1970s and 1980s. This was the base that South East Asian *miracle* countries were able to build upon to gear up their export potential, which eventually was referred to as the globalization of world trade. During the 1990s, Asia became the export hub for the rest of the world, which was complemented by record foreign direct investment in the region before the onset of the Asian Crisis in 1997.

 

**Role of DFIs in Pakistan**

DFIs such as Pakistan Industrial Development Corporation (PIDC), Pakistan Industrial Credit and Investment Corporation (PICIC) and National Development Finance Corporation (NDFC) played a dominant role in Pakistan's economy starting in the 1970s. They provided long-term lending to the private industrial sector, and incubated complex, investment-heavy industries before transferring them to the private sector. They focused on specific sectors, with this focus set by the government. For instance, NDFC and PIDC were central to the development of the capital goods sector. Major NDFC projects included the Heavy Machine Corporation, Heavy Engineering Corporation and Pakistan Steel in the public sector, as well as Hub Power, Pakland and Dhadabhoy Cement in the private sector.

The phasing out of DFIs and special credit schemes resulted in a serious lack of long-term finance for industrial projects which persists today.

**Does Pakistan need an industrial policy?**

Given changing views about globalization, and the sustainability of an export-driven domestic economy, many would argue that an industrial policy in Pakistan is *too little, too late*.  While China's shift away from exports will take time to materialize, we believe this intent has already been revealed in the form of the One Belt One Road (OBOR) initiative.  China's dependency on infrastructure development and exports, is giving way to upgrading infrastructure in neighboring Asian countries, and creating new trade partners in Central Asia, Pakistan, Iran, the Middle East and Africa.

Since the China-Pakistan Economic Corridor (CPEC) is the first stage in the ambitious OBOR initiative, Pakistan should revisit the concept of an industrial policy, to piggy-back on China's growth strategy for the 21$^{st}$ century.  Moreover, Pakistan is too populous a country to rely on agriculture or services to gainfully employ a growing number of people.  Given a domestic market of over 200 million people, there is sufficient scope for the manufacturing sector to target new export markets and simultaneously substitute away from imports by encouraging overseas manufacturers to set up their production units in Pakistan.

To promote industrial development in Pakistan, several issues need to be addressed: (1) poor physical infrastructure and utilities; (2) the lack of dependable and affordable power supply; (3) the shortage of a semi-trained and disciplined labor force; (4) uncompetitive exports of mediocre quality; (5) a weak (and inefficient) regulatory and judicial infrastructure; (6) inadequate protection for property and intellectual property rights; and (7) economic policy changes to suit insiders.

Unlike the service sector, where investments can become commercially viable soon after being launched, fixed investment in industry entails a long gestation period and requires years, not just for commercial success, but also to become profitable innovators (e.g. Samsung and Toyota).  Hence, to facilitate industrial investment in Pakistan, one would have to address the issues listed above.  Compared to the Asian miracles in the years leading up to their meteoric rise, Pakistan lags behind in terms of social indicators and skill levels, an adequate regulatory/judicial infrastructure, and a poor image from an investor perspective.

This means Pakistan's industrial policy, would have to be even more comprehensive than those of East Asian countries, to have a chance of succeeding.

**Is CPEC the solution?**

CPEC entails a string of power projects; an ambitious network of intercity roads/pipelines; developing Gwadar Port; plans to build several industrial cities (that are connected to the road network); and creating training institutions and schools to complement these hard investments.

Without framing it as such, these key components of CPEC could become the blue-print for Pakistan's industrial policy. While the initial stages of CPEC have already taken root without any domestic financing, some observers (and banks) are wondering how CPEC-related projects and CPEC-spillover projects will be financed.[1]

The issue therefore boils down to the following: even without a full-blown industrial policy, should Pakistan's policymakers revisit whether a development finance institution (DFI) needs to be created again. If so, perhaps leading Pakistani banks should become equity-partners, as they currently lack project financing skills. To enhance the credibility of a new DFI, a reputable foreign investor could be engaged and the federal government must be a stakeholder.

**Wishful thinking**

For decades Pakistan has been unable to upgrade its menu of exports. Low-end garments and yarn still dominate, while non-traditional exports like leather products, sports goods, surgical instruments, jewelry/gems, and processed foods, still remain cottage-based or size-bound.

Perhaps the industrial cities envisaged as part of CPEC could be a harbinger of change. Pakistani labor is now cheaper than in many Asian countries, while the scale of our textile sector is dwarfed by our neighbors. With suitable in-house training and long-term employment contracts (which entail a package of social and housing services), the country could channel its under-utilized labor force into the manufacturing sector. In addition to textiles and garments, Pakistan could focus on processed agricultural produce, footwear, marble products, and consumer electronics.

Gwadar Port could be used to target markets in Africa, Central Asia, Eastern Europe and the Middle East.

While this scenario may appear too good to be true, one must realize that some manufacturers in Pakistan (e.g. Engro, ICI, oil & gas exploration companies, etc.) have been using such cities for decades with commercial success. This model could be replicated in joint-ventures (JVs) with foreign companies, starting with the Chinese. However, Pakistan's authorities must ensure that such FDI is focused specifically on export sectors.

If this happens, this would be the first time that Pakistan is able to attract FDI into our export sector – just this should go a long way to break away from export stagnation. The example of the early Asian powerhouses (Japan and South Korea) shows2 that performance-based government policies can create comparative advantages for exports. As in East Asia, this could be a decisive moment in Pakistan's economic development.

[1] CPEC-related projects include capacity-enhancing investments in cement, steel, bulk chemicals, heavy machinery, storage facilities, etc., that are necessary to support the various projects listed in the $ 46 billion undertaking. CPEC-spillover entities, on the other hand, are smaller businesses that are likely to mushroom around the larger 'anchor' projects. This entails restaurants, shops, a variety of services, entertainment, transport and mechanics, etc., that may require SME financing. Commercial banks are likely to step up to the need for SME financing, as the commercial viability of the anchor project, should be a source of comfort for participating banks.

**Conclusion**

While Pakistan may not have the institutional capacity to launch a full-blown industrial policy, CPEC could facilitate a similar solution. To ensure that CPEC has longevity, China realizes it must give Pakistan (as a country and a collection of commercial enterprises) a material stake in the project. Mutual economic dependency (and not just a security arrangement) is the best assurance that CPEC will succeed.

Dovetailing CPEC with the rebuilding of Pakistan's industrial base, could be a win-win situation for both countries. However, our policymakers must also do some of the heavy lifting: other than deciding whether Pakistan needs a development bank that specializes in large-scale project finance, they must realize that past failures with DFIs can be traced to how these institutions were staffed and managed – and not any inherent flaw in the model itself.