Mobilizing Savings for Sustainable High Growth: Lessons from Asia for Pakistan

Presentation at PIDE, Islamabad, August 29, 2007
by Henri Lorie, IMF

Box 1:   **Growth performance, 1975-2007**

4-year period ending in	average growth rate in the period
1978-79	4.8
1982-83	7.0
1986-87	6.2
1990-91	5.4
1994-95	4.9
1998-99	4.0
2002-03	3.4
2006-07	7.5

Source: FBS

1. A remarkable recovery

- Pakistan' s economic growth has averaged 7.5 percent annually in the past four years.

- Domestic demand has been the main driver of growth, mainly domestic consumption, but also investment.

- Still, financing of the external current account deficit has not been a problem.

- Nevertheless, the reliance on foreign inflows to sustain domestic demand and economic growth raises two key issues.
  - The first is that such reliance makes Pakistan more vulnerable to external shocks, including a possible stop or reversal in capital inflows.
  - The second relates to the inter-temporal solvency constraint in an open economy.

2. Investment and Growth

- Most growth regressions suggest that investment is a key determinant of economic growth.
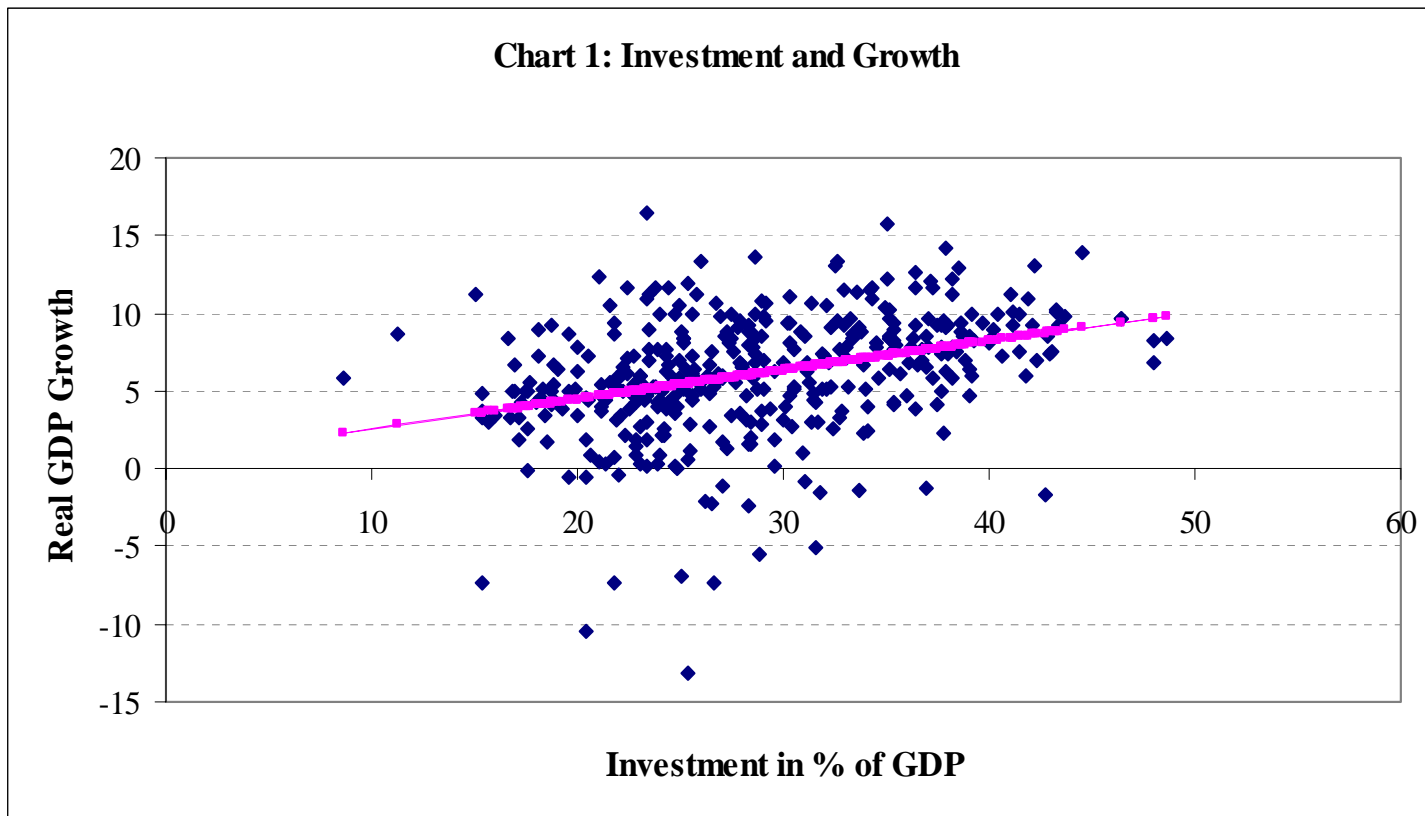

Chart 1: Investment and Growth

Table 1 – GDP Growth and Investment

	Constant	Coefficient	R-squared
GDP growth on Investment [random effects]	1.1 (1.2)	0.18*** (6.3)	0.10
Investment on GDP growth [fixed effects]	26.3*** (49.5)	0.40*** (5.3)	0.48

Granger causality test	Probability
GDP growth does not Granger cause investment ***	0.00
Investment does not Granger cause GDP growth **	0.05

Figures in parenthesis are t-statistics; *** indicates significance at 1 percent confidence interval, ** at 5 percent, and * at 10 percent.

- In Pakistan, investment has risen over the past three years from a stagnant and low 17 percent of GDP prior to 2003-04 to an estimated 23 percent of GDP in 2006-07.

- While this is a notable development, it still places Pakistan behind the average for most economies of Asia since their take-off.

- There seems little doubt that sustaining the high rates of economic growth experienced recently in Pakistan will require the country to move closer to those Asia averages.

	Real per capita GDP Growth in %	Savings in % of GDP			Investment in % of GDP			Current Account [3/]
		Total	Public [2/]	Private [2/]	Total	Public [2/]	Private [2/]	
Asia	**4**	**27**	**4**	**23**	**27**	**8**	**20**	**0**
	(5)	**(25)**	**(4)**	**(21)**	**(28)**	**(8)**	**(19)**	**(-3)**
Japan (1955)	3	32	5	27	30	2	30	2
	(9)	(32)	(...)	(...)	(32)	(...)	(…)	(0)
NIE (1967)	**6**	**35**	**8**	**27**	**30**	**12**	**23**	**4**
	(6)	**(29)**	**(8)**	**(23)**	**(32)**	**(9)**	**(28)**	**(-3)**
Hong Kong	5	31	5	26	26	…	…	6
	(6)	(30)	(6)	(24)	(24)	(…)	(…)	(6)
Korea	6	29	8	24	30	7	26	-1
	(6)	(24)	(8)	(20)	(28)	(6)	(25)	(-5)
Singapore	6	43	11	32	35	17	19	7
	(8)	(34)	(11)	(24)	(43)	(12)	(31)	(-9)
ASEAN	**4**	**24**	**6**	**18**	**27**	**8**	**18**	**-3**
	(4)	**(21)**	**(5)**	**(16)**	**(27)**	**(8)**	**(16)**	**(-6)**
Indonesia (1973)	4	24	(…)	(…)	31	(...)	(…)	-7
	(4)	(18)	(…)	(…)	(30)	(…)	(…)	(-12)
Malaysia (1973)	4	28	13	15	29	13	17	-1
	(4)	(22)	(12)	(11)	(29)	(13)	(16)	(-7)
Phillipines (1973)	1	18	0	19	22	4	16	-4
	(1)	(19)	(-2)	(20)	(24)	(...)	(...)	(-5)
Thailand (1973)	5	27	7	20	29	7	22	-2
	(4)	(21)	(5)	(16)	(26)	(7)	(18)	(-4)
Vietnam (1990)	6	23	4	19	25	8	18	-2
	(6)	(24)	(5)	(19)	(25)	(8)	(18)	(-2)
China (1979)	8	40	3	37	38	19	21	2
	(8)	(37)	(7)	(30)	(38)	(...)	(...)	(0)
India (1982)	4	25	1	25	26	8	18	-1
	(4)	(25)	(0)	(24)	(25)	(8)	(17)	(-1)
OTHER SOUTH ASIA (1990)	**3**	**19**	**0**	**20**	**21**	**5**	**17**	**-2**
	(3)	**(19)**	**(0)**	**(20)**	**(21)**	**(5)**	**(17)**	**(-2)**
Pakistan	2	16	-1	17	18	4	14	-2
	(2)	(16)	(-1)	(18)	(18)	(4)	(14)	(-2)
Srilanka	4	20	-2	22	24	3	21	-4
	(3)	(20)	(-3)	(23)	(24)	(3)	(21)	(-4)
Bangladesh	3	22	3	19	21	7	14	1
	(3)	(21)	(2)	(19)	(21)	(7)	(14)	(1)

Source: WEO, IMF.
1/ Numbers are the averages for the whole period of the take-off. Numbers in parathesis are averages for the first 15 years of the take-off period.

2/ Numbers on public and private savings and public and private investment for some countries are not available for some sub-periods. For this reason the averages do not add up to the reported total average savings and investment
3/ External current account after grants.

3. The External Current Account Deficit

- Since the external current account deficit equals national savings minus investment, it would be reassuring, from the point of view of *both* growth *and* the intertemporal solvency constraint, if the widening of the external current account deficit in Pakistan in recent years to almost 5 percent of GDP in 2006-07 reflected *mostly* the rise in investment. And indeed, this appears to have been the case.

Box II. **Origins of current account deterioration since 2004**

	National savings	- Investment	= CA
	(in percent of GDP)		
2003-04	18.4	16.6	1.8
2004-05	17.7	19.1	-1.4
2005-06	17.8	21.7	-3.9
2006-07	18.1	23.0	-4.9

- But unless the higher level of investment in Pakistan necessary to match the average of economies of Asia since their take-off is accompanied by an increase in domestic savings, the external current account deficit would further worsen.

- The example of economies of Asia since their take-off suggests that large external current account deficits have by no means been the norm. This is because high savings have accompanied high investment

- Admittedly, there seems to be a need to distinguish between the whole period of take-off, and the early years of take-off.

- In contrast, national savings in Pakistan have averaged only 16 percent since 1990, negative -1 percent of GDP public savings and 17 percent of GDP private savings. These aggregates were only marginally higher in 2006-07.

3. Savings and Investment

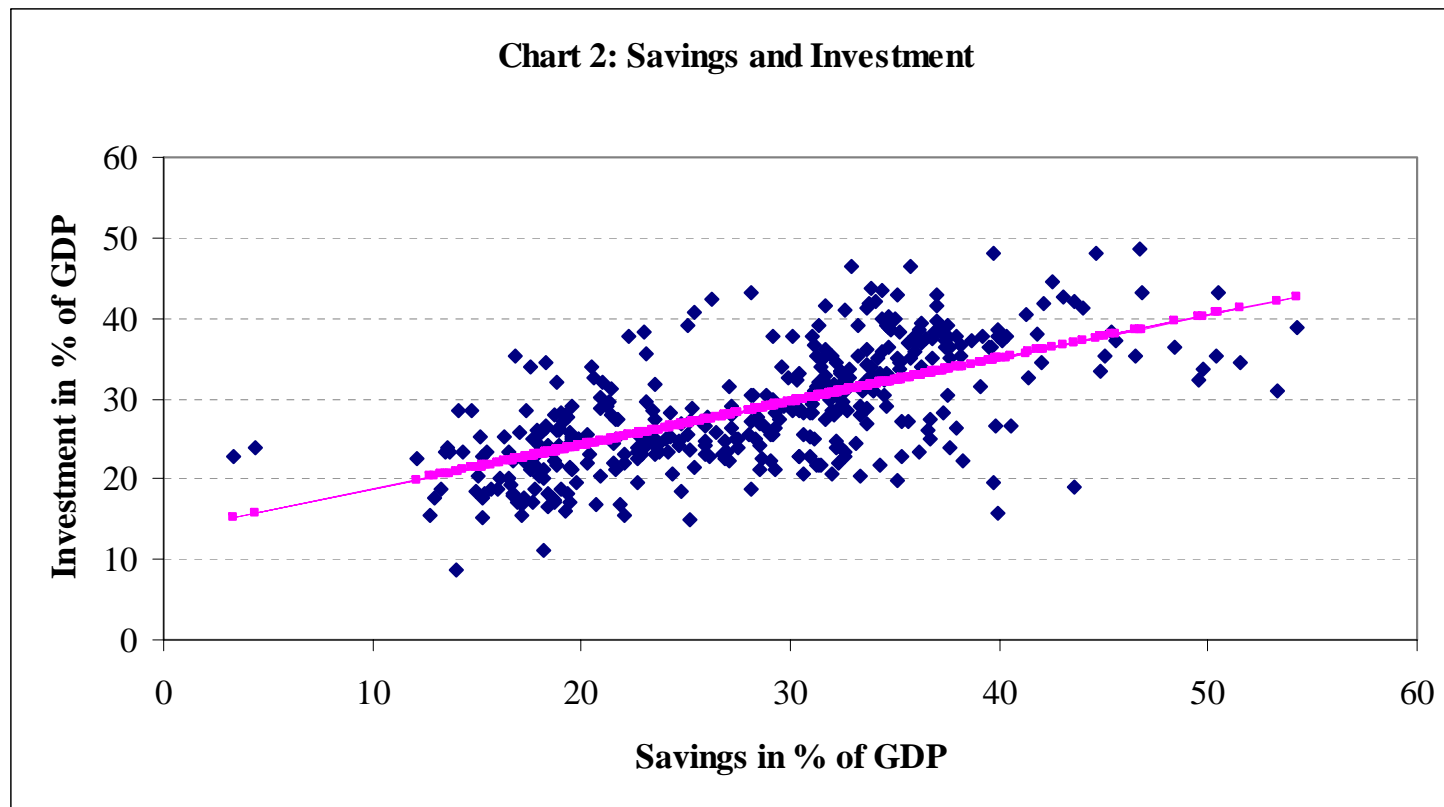- National savings and investment have been highly positively correlated in Asia.

Chart 2: Savings and Investment

Table 1 – GDP Growth and Investment

	Constant	Coefficient	R-squared
Investment on National savings [random effects]	14.1 ***	0.50 ***	0.26
	(10.5)	(12.2)	
National Savings on Investment [fixed effects]	15.2 ***	0.46 ***	0.70
	(12.2)	(10.7)	

Granger causality test	**Probability**
GDP growth does not Granger cause investment * **	0.00
Investment does not Granger cause GDP growth	0.25

Figures in parenthesis are t-statistics; *** indicates significance at 1 percent confidence interval, ** at 5 percent, and * at 10 percent.

- The positive correlation between national savings and investment appears to have persisted despite increasingly globalized financial markets where emerging countries have access to foreign savings.

4. Savings and Growth

- One could interpret the insights from the analysis so far as follows: Investment, and the productivity gains associated with its embodied technological progress, cause GDP growth. National savings cause investment because they are critical to finance investment under constrained access to international capital markets. And this is why growth would be correlated with national savings.
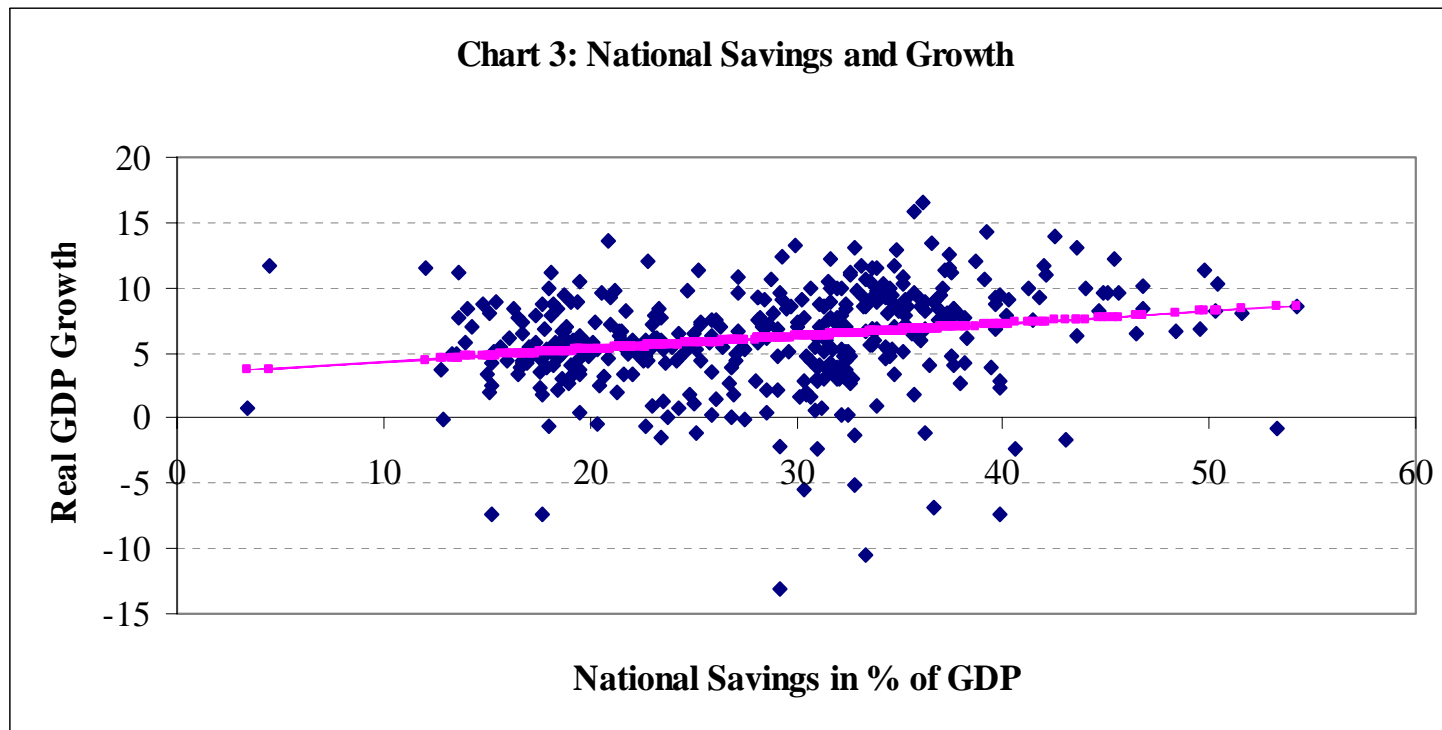
Chart 3: National Savings and Growth

Table 4– Growth and Savings

	Constant	Coefficient	R-squared
Growth on National savings [panel least squares] 1/	1.1 **	0.14 ***	0.05
	(1.9)	(4.3)	
Growth on National savings [fixed effects]	5.4 ***	0.02	0.15
	(5.5)	(0.7)	
National savings on Growth [panel least squares]	2.5 ***	0.14 ***	0.05
	(19.7)	(4.6)	
National savings on Growth [fixed effects]	28.1 ***	0.05 ***	0.62
	(52.2)	(0.7)	
Granger causality test			**Probability**
Growth does not Granger cause national savings ***			0.00
National savings does not Granger cause growth			0.36

Figures in parenthesis are t-statistics; *** indicates significance at 1 percent confidence interval, ** at 5 percent, and * at 10 percent.
1/ Adjusted for serial correlation

- Does it follow from the above interpretation of results so far that improved access to foreign savings would reduce the importance of mobilizing national savings? I'll argue that this conclusion might be incorrect.

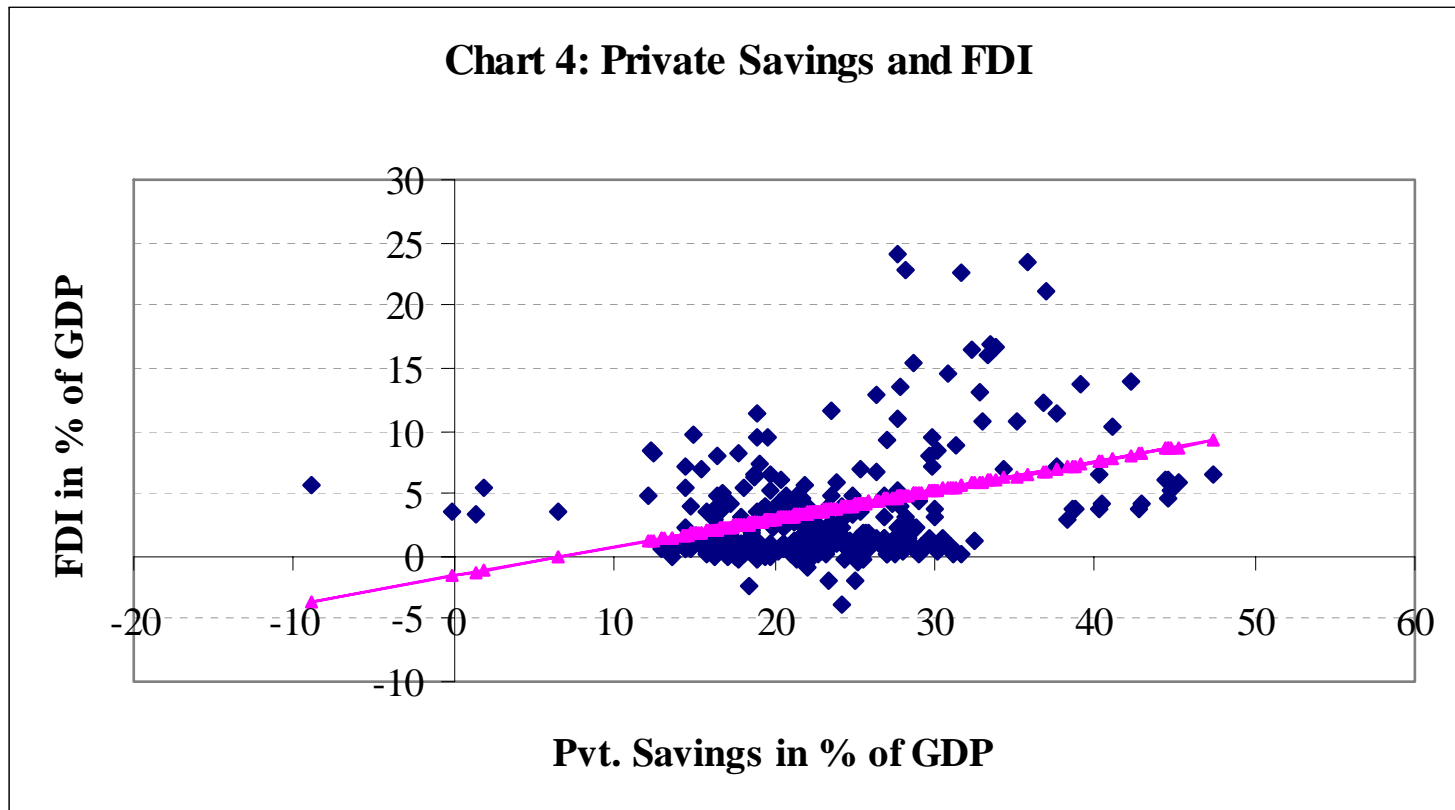- Specifically, private savings and inward FDI appear to have been positively correlated in Asia.

Chart 4: Private Savings and FDI

Table 4 – FDI and Private Savings

	Constant	Coefficient	R-squared
FDI on private savings [random effects]	1.8	0.11 ***	0.02
	(1.1)	(2.2)	
Private savings on FDI [random effects]	22.9 ***	0.14 ***	0.04
	(14.7)	(2.1)	

Granger causality test	Probability
GDP growth does not Granger cause investment ***	0.00
Investment does not Granger cause GDP growth	0.25

Figures in parenthesis are t-statistics; *** indicates significance at 1 percent confidence interval, ** at 5 percent, and * at 10 percent.

4. High national savings as a positive sign for sustained high growth

- High national savings as much as FDI itself might well be a positive sign in emerging markets that prospects for sustained high growth are excellent.
  - Necessary domestic contribution to foreign savings, including co-financing
  - Domestic savings and foreign savings are *complementary* rather than *substitute*
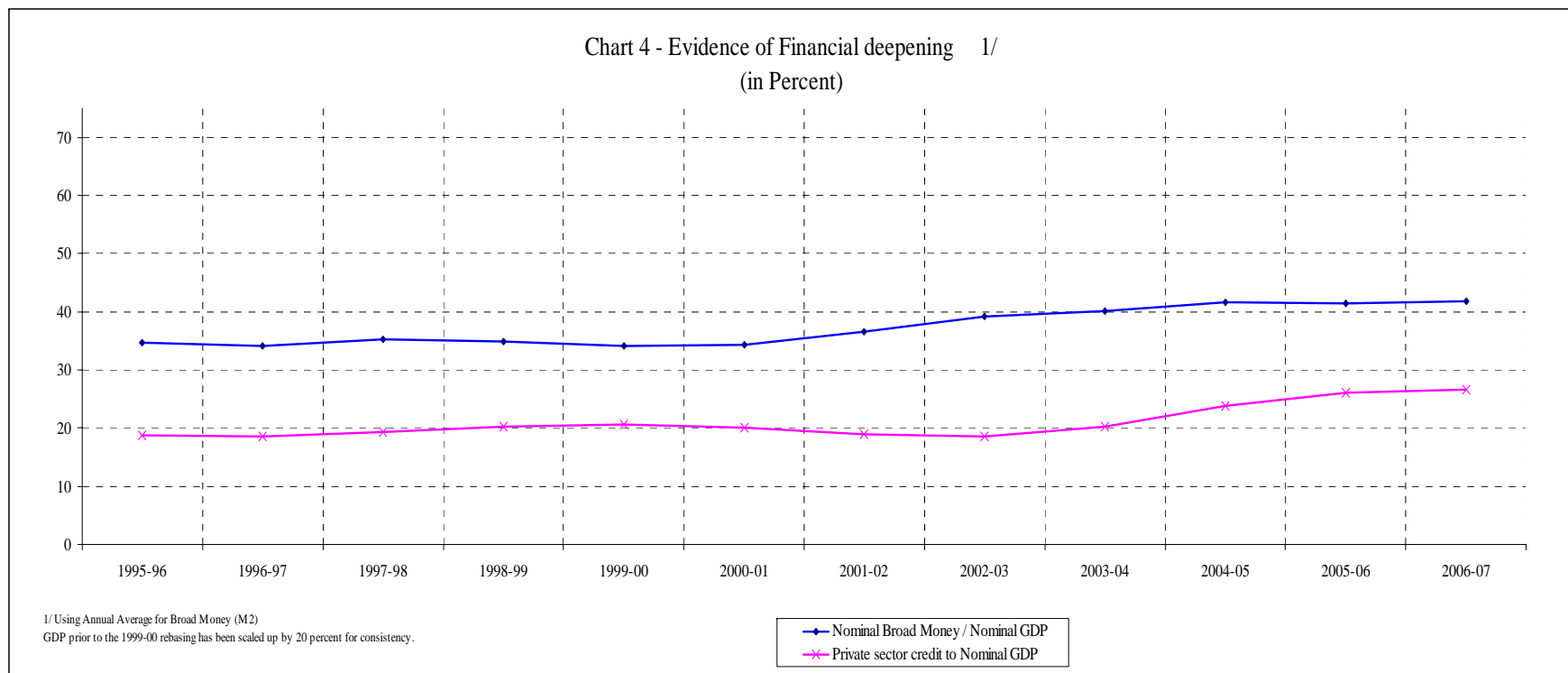
5. Where does Pakistan stand?

- Recently, Pakistan has witnessed a surge in FDI which appears to have supported the observed rise in overall investment. At the same time, the national savings rate has remained low, on account of both public and private savings. Hence, the widening of the external current account deficit.

- How to interpret the private savings developments in the broader context of the findings of this paper?
    - Savings rates may of course differ systematically across countries for reasons not directly related to the themes discussed here.
    - The recent rapid development of the financial sector, seemingly well ahead of the other sectors of the economy, and the accommodative monetary and fiscal policies may also have led to unintended distortions.
    - The possibility that the foreign investors' confidence in Pakistan is so high that joint ventures can proceed without significant domestic contribution nor the collateral associated with the co-financing does not seem plausible.
    - Besides the expansionary macroeconomic policies, a likely explanation for the developments in private savings is that the conditions which would yield high national savings, high investment, and high growth in a sustainable way are not yet fully in place.

6. Policy implications

- There are two types of policy implications of the above analysis for Pakistan:

- First, monetary and fiscal policy have to be appropriately counter-cyclical through supporting national savings.
  - Attractive positive real interest rates
  - Government needs to increase its savings

- Second, structural reforms must support private domestic as well as foreign investment and savings and address Pakistan' s structural savings deficiency.

– Financial deepening needs to be further encouraged.

Chart 4 - Evidence of Financial deepening   1/
(in Percent)

1/ Using Annual Average for Broad Money (M2)
GDP prior to the 1999-00 rebasing has been scaled up by 20 percent for consistency.

Nominal Broad Money / Nominal GDP
Private sector credit to Nominal GDP

- Since the analysis suggests that national savings, domestic investment, and FDI are positively correlated, further improving the overall business environment and investment climate should encourage *both* investment and national savings.

- Changes in the corporate sector seem required as well. The family-controlled corporate structures and behaviors in Pakistan have been biased against outsiders (foreign as well as domestic). Therefore, the enhancing of domestic savings for the purpose of co-financing promising joint ventures is likely to have been inhibited.

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Box III   Dividend Pay-out Ratios

                               Averages, in percent

Emerging Asia 1/   (2003-2004)              24.6

Pakistan  (2004-2005, KSE)                  57.7
    Business groups (2001-2002)             45.8
    Non-business groups  (2001-2002)        21.9


Sources: KSE, Ghani and Ashraf (2005), and IMF.

1/ China, India, and ASEAN.
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– Full enforcement of the Code of Good Corporate Governance by the SECP, the Courts, and the stock exchanges, in particular the provisions facilitating the exercise of ownership and independent judgment by *all* shareholders (including institutional and minority) should help promote the greater *corporate dynamism* necessary for a virtuous savings- investment cycle to take place.

– Finally, and critically as well, further steps need to be taken to fill the human capital gap, which has also contributed to low productivity measured as output per worker, and thus investment.