FOREIGN RESERVES AND THE COMMON MAN

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The most oft-repeated remark one hears these days in Pakistan is: What good is this $12 billion of foreign reserves when the plight of the common man is not improving. A lot of so-called learned economists have also opined that this money should be spent by the Government on increasing expenditure for reducing poverty. This paper attempts to address these issues and clarify the confused thinking that gives rise to such observations.

First, how have these reserves been accumulated? Have we borrowed and added to our debt or raised them through non-debt creating flows? The higher reserve accumulation has largely resulted from a reduction in trade imbalances (from $2 billion in 1999-00 to $400 million in 2002-03), from diversion of workers' remittances through banking channels (from $1 billion to $4.2 billion) reduction in debt servicing payment obligations (due to reprofiling of debt and pre-payments of expensive debt) and official assistance. In other words, this has occurred through higher external non-debt creating capital flows. At the same time, the overall level of external debt and liabilities has, in fact, declined although new soft term loans have been contracted from the IMF, World Bank and Asian Development Bank.

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Second, it is also important to outline the means through which the State Bank of Pakistan (SBP) has accumulated these reserves. It should be noted that all foreign exchange transactions now take place through an Inter-bank market. Inter-bank foreign exchange market receives all the export earnings, workers' remittances, investment flows and other foreign exchange and sells these foreign exchange receipts to importers, individuals for travel and education, etc., firms, multinational companies for profits, dividends, interest and other payments; to government and public sector bodies for meeting debt servicing and other foreign exchange obligations. The net surplus of foreign exchange after all these transactions have taken place is then purchased by the SBP for which an equivalent amount of rupees is released to the authorized dealers i.e. the commercial banks. The commercial banks, in turn, pay these rupees to those who had surrendered their export earnings or the families of workers who had remitted from overseas, etc. Leaving such huge rupee liquidity in the banking system can intensify inflationary pressures. The Central Bank, therefore, mops up bulk of these rupees by issuing government securities to the banks. The residual billions of rupees with the banks can then be used by the recipients and their banks for investment, deposits or as liquid assets.

Third, the reserves do not belong to the Government but to the whole nation. Any Pakistani who wishes to acquire foreign exchange for the purposes of importing machinery, goods and services or paying interest on foreign debt or dividends or payments or other permissible purposes has full access to these reserves and can purchase foreign currencies required by paying the equivalent rupees. The same principle applies to the Government. The only way they can lay their hands on these reserves is by paying equivalent amounts of rupees or raising debt of equivalent amount from the SBP. For example, when they purchased $1.17 billion from the SBP to pre-pay their loans to ADB, they borrowed Rs. 67 billion from the SBP to make this payment.

As the objective of Government policy is to reduce its debt burden, additional borrowing from the reserves will run contrary to this stated goal and increase its debt servicing liability. It is with great effort that the Government has been able to reduce its debt servicing from 66 percent of revenues to 31 percent in the current fiscal year. The amount saved has been utilized for increasing development expenditure from Rs. 100 billion to Rs. 160 billion. The other disadvantage of this additional borrowing will be that the credit available to private sector will have to shrink to make way for Government borrowing keeping the overall monetary aggregates intact. Alternatively, the interest rates will have to go up raising the cost of capital to the economy. Is this what we want to do by allowing the Government to borrow the reserves and increase spending? The only plausible way that poverty related expenditures could be expanded is by increasing revenues and reducing non-development expenditure including debt servicing.

Now, we turn to the interesting question: How can the common man then benefit from the reserves accumulated? There are several direct and indirect ways in which an ordinary Pakistani has benefited from this policy.

1. Despite some mopping up, the Central Bank has left excess liquidity with the banks which has driven down the cost of credit to historically low levels of 5 percent average. The banks are, therefore, reaching out to new customers particularly the middle and lower income groups by providing them agriculture credit, SME loans, mortgage loans and consumer loans. This is the most direct way the reserve accumulation is benefiting the common man. About 2 million borrowers have taken loans for Agriculture, SME, mortgage, consumer durables and microfinance. Indirectly, the incomes of these recipients of agriculture and SME loans will rise over time as they utilize them for increasing output. Housing and allied industries such as cement, steel, etc. automobiles and consumer electronics industries are also reaping the benefits through higher sales and higher production.

2. Reserves have helped the domestic business as financing costs of the businesses have been cut down by almost two-thirds allowing them to earn higher profits. Corporate firms listed are declaring dividends for the shareholders. This decline in financing costs has also allowed inflation to remain under control.

3. Adequate reserve build-up has allowed the Central Bank to pursue a flexible exchange rate policy, which helps the exporters of Pakistan to maintain their competitiveness and earn increased foreign exchange for the country. Export industries then expand their business and employ more labour.

4. In Pakistan, low level of reserves had led to dollarisation of the economy. As rupee was constantly depreciating, the market participants and, even ordinary savers, were converting their liquid rupees assets into dollars. The high levels of reserves have reversed these expectations and the speculators are no longer able to create volatility and instability in the foreign exchange market. Stability in the exchange rate has prevailed for the last three years allowing the exporters and importers to plan their costs with certainty. Petroleum products, edible oil, pulses and other imported goods would have cost the ordinary consumers at least 10-15 percent in higher prices if rupee had depreciated as in the past.

5. Cut in interest rates have made it possible for the Government to reduce its debt servicing obligations and boost its development expenditure which was low to begin with and is still low in relation to the country's requirement. But it is gratifying to note that debt servicing no longer pre-

empts two thirds of government revenues as it was the case for the last 15 years.

Why then is there such a widespread perception that that the common man is not gaining much from this so called economic turn around? The toughest challenge facing the country today is high level of unemployment which is hurting a large number of families. There are several reasons for such high unemployment in the country and for lack of access to basic services to the common man.

First, public sector used to be the main conduit for absorbing unemployed educated. This is no longer happening because the restructuring of public sector corporations and privatization is resulting in shedding of surplus employees. New employees are not being hired and the quotas for filling the job, which were allocated to the politicians in 1990's, are no longer available. This has eased the fiscal problem as the operational losses of these corporations have come down significantly but the employment in the public sector has come to a halt. The impact of this is being felt by the families of those who want their sons and daughters to be employed in these corporations or in the government jobs.

Second, Job Security – a concept that has been enshrined in our culture for a long time – has been associated with Government or public sector job or "pukki naukri". The new jobs that are being created are mostly in the private or nongovernment sector. Private telecom companies offering value added services, internet service providers, cable service providers, private TV Channels and production companies, event managers, fashion designers and boutiques, plethora of fast food chains and restaurants, car rental services, information technology companies, security companies, architectural firms, consultancy firms and individuals, non-governmental organizations, rural support programs, foreign donor agencies and missions, private educational and health institutions are becoming main sources of employment. These opportunities did not exist even a decade ago. But the selection of jobs in these new businesses is largely based on individual competency and potential not on connections and sifarish. Moreover, it is perceived as "kacchi naukri" and can be terminated at any time for lack of performance. This combination of lack of job security and competency-based selection is quite new and will take some time before it can be digested and accepted in our culture.

Third, the traditional private sector in Pakistan was nurtured and thrived on rent seeking, protection, non-repayment of loans, evasion of taxes, theft of electricity, resorting to selective SROs and a host of similar tactics. As the economy is becoming more competitive, rents are dissipating, protection is eroding, banks are no longer providing fathom loans, NAB has become quite vigilant and the opportunities for old type of investment are fast disappearing.

Globalized world requires a new set of skills – ideas, knowledge, research and innovation. We are not yet equipped with these skills. That is why we are stuck with $12 billion of low technology intensive exports. Those who have caught on to this new game are doing quite well, but they are very few. Others are found moaning and complaining in the name of the common man.

Fourth, there has been no reform of Government institutions and agencies at the provincial and district levels where most of the basic services are delivered to the common man. Water, transport, electricity, schools, clinics, Police, Patwari, lower Judiciary are still operating in their old mold. Indifference, inertia, indecision, passing the buck, corruption, sifarish and nepotism are the operating principles. Under such a scenario, no wonder the common man does not get any services from the state.

But the paradox is that those who cry on the top of their voices that the common man is suffering are the same individuals who are the main beneficiaries of these state institutions. They get the officers of their choice appointed to key positions when they are in power and manipulate them for their own aggrandizement. As soon as another set of rulers come to power, these individuals start crying foul play and all of a sudden interests of the common man become uppermost in their thoughts and speeches. But the same merry-go-round now takes place with the new set of rulers. We have to depoliticize these institutions and hold those in-charge accountable for results and impact of their activities on the common man.

Fifth, the surcharges on petroleum, gas, electricity, have proved to be quite regressive and impose unbearable burden on the middle class families. Direct tax net should be expanded to bring in well-to-do segments within the society who are not paying their dues to the exchequer. As tax collections from these sources rise, the surcharges should be gradually phased out. This will be a big relief to several millions of ordinary citizens of Pakistan.

The second generation reforms should, therefore, address these burning issues by (a) restructuring our civil service, police, judiciary and public services, giving a decent wage to their employees but holding them accountable for results, (b) by removing the surcharges of all kinds and replacing them by revenues generated through widening of the tax net (c) increasing development expenditures particularly poverty related (d) making devolution really work by providing administrative and financial powers to the district governments (e) incentivizing financial sectors to channel credit to agriculture, SMEs, housing and construction which will create jobs in the economy.