ECONOMY OF PAKISTAN: PAST, PRESENT AND FUTURE

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In this shrinking global village internet chats, cable TV, talk shows and transmissions through satellite dishes have made perceptions more powerful than realities in influencing public opinion. There is a widely held perception in Pakistan – right or wrong - that the popular American view of the U.S.S.R. as an evil empire and communism as a threat to economic and social stability of the world is beginning to resonate itself with Islam replacing communism and Pakistan and other Muslim countries, standing in for the USSR.

Those who hold this perception point out, as an example, to the recent Council of Foreign Relations – Asia Society Task Force Report which aptly sums up the popular American view about Pakistan in the following sentence: "Pakistan presents one of the most complex and difficult challenges facing US diplomacy. Its political instability, entrenched Islamist extremism, economic and social weaknesses and dangerous hostility towards India have cast dark shadows over this nuclear-armed nation".

It is in this context that the Woodrow Wilson Center deserves our commendation for organizing this Conference to explore in depth one of the elements of this newly emerging conventional wisdom about Islam and Pakistan

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– although each one of the components of the above statement deserves further analysis and discourse to sift out the facts from myths.

I hope that the candid discussion today will enlighten many of us, clarify a number of issues and debunk some of the popular myths surrounding Islam and Pakistan's economic direction.

I have chosen to focus my remarks today on the one aspect of Pakistan and Islam that is, in my view, hardly discussed, least known but creates a lot of jitters in the U.S. This issue has received increased importance since the elections of October 2002 when an alliance of religious parties won power in the province of NWFP. I propose to walk you through the past and current trends of Pakistani economy, sketch the future direction and offer my own assessment of how the adoption of an Islamic economy, if it indeed happens, will affect Pakistan's future.

This paper is divided into six sections.

The first section deals with the past achievements and failures of Pakistan's economy. The second section presents a synopsis of economic performance during 1999-2003 – a period of intensive restructuring and reforms of the economy.

Section III distils the policy lessons learnt from the historical and most recent experience of Pakistan's economic management. Section IV attempts to lay down the contours of the future direction of Pakistan's economy based on the lessons learnt and development experience gained from in-country and cross-country record.

Section V assesses as to how the attempts to introduce Islamic economic model in the country, if successful, will impact upon this future direction. The final section provides insights into the economic prospects of Pakistan in the medium term.

SECTION I

PAST ACHIEVEMENTS AND FAILURES:

Pakistan was one of the few developing countries that had achieved an average growth rate of over 5 percent over a four decade period ending 1988-89. Consequently, the incidence of poverty had declined from 40 percent to 18 percent by the end of the 1980s. Table I lays down the main economic and social indicators in 1947 and compare them with 2003. The overall picture that emerges from a dispassionate examination of these indicators is that of a country having made significant economic achievements but a disappointing record of social development. The salient features of Pakistan's economic history are:

- A Country with 30 million people in 1947 couldn't feed itself and had to import all its food requirements from abroad. In 2002, the farmers of Pakistan were not only able to fulfill the domestic needs of wheat, rice, sugar, milk of 145 million people at a much higher per capita consumption level, but also exported wheat and rice to the rest of the world.

- An average Pakistani earns about $500 in 2003 compared to less than $100 in 1947. In US current Dollar terms the per capita income has expanded more than five fold and in constant terms three times.

- Agriculture production has risen five times with cotton attaining a level of more than 10 million bales compared to 1 million bales in 1947. Pakistan has emerged as one of the leading world exporter of textiles.

- Pakistan hardly had any manufacturing industries in 1947. Five decades later, the manufacturing production index is 12,000 with the base of 100 in 1947. Steel, cement, automobiles, sugar, fertilizer, cloth and vegetable ghee, industrial chemicals, refined petroleum and a variety of other industries manufacture products not only for the domestic market but in many cases for the world market too.

- Per capita electricity generation in 2003 was 10,160kwh compared to 100 in 1947. Pakistan's vast irrigation network of large storage reservoirs and dams, barrages, link canals constructed during the last five decades has enabled the country to double the area under cultivation to 22 million hectares. Tubewell irrigation provides almost one third of additional water to supplement canal irrigation.

- The road and highway network in Pakistan spans 250,000 km – more than five times the length inherited in 1947. Modern motorways and super highways and four lane national highways link the entire country along with secondary and tertiary roads.

- Natural gas was discovered in the country in the 1950s and has been augmented over time. As of now, almost 26 billion cubic meters of natural gas is generated, transmitted and distributed for industrial, commercial and domestic consumption.

- Private consumption standards have kept pace with the rise in income. There are 30 road vehicles for 1000 persons in 2001 relative to only one vehicle for the same number of population in 1947. Phone connections per 1,000 persons have risen to 28.6 from 0.4. TV sets which were non-existent adorn 26.3 out of every 1,000 houses.

These achievements in income, consumption, agriculture and industrial production are extremely impressive and have lifted millions of people out of poverty levels. But these do pale into insignificance when looked against the missed opportunities. The largest setback to the country has been the neglect of human development. Had adult literacy rate been close to 100 instead of close to 50 today, it is my estimate that the per capita income would have reached at least $1000 instead of $500.

Pakistan's manufactured exports in the 1960s were higher than those of Malaysia, Thailand, Philippines and Indonesia. Had investment in educating the population and upgrading the training, skills and health of the labour force been up to the level of East Asian Countries and a policy of openness to world market would have been maintained without any break, Pakistan's exports would have been at least $100 billion instead of paltry $12 billion. Had the population growth rate been reduced from 3 percent to 2 percent, the problems of congestion and shortages in the level of infrastructure and social services would have been avoided, the poor would have obtained better access to education and health and the incidence of poverty would have been much lower than what it is today.

But as if this neglect of human development was not enough, the country slacked in the 1990s and began to slip in growth, exports, revenues, and development spending and got entrapped into deep morass of external and domestic indebtedness. As a result the incidence of poverty rose from 18 percent in 1988-89 to 33 percent by the end of the 1990s. This was due to both fundamental structural and institutional problems as well as to poor governance and frequent changes in political regimes. With short life spans, succeeding governments were hesitant, if not outright unwilling, to reform the rent-seeking activities of the ruling elite- consisting of a small class of politicians, bureaucrats businessmen, feudal landlords and other vested interests and desisted from taking tough unpopular economic decisions to set the economy right. Understandably, they were more preoccupied with the imperatives of retaining political power and making such decisions could have further exposed them to the risk of removal from office. Moreover, the average lifespan of two to three years was clearly inadequate for meaningful policy or institutional change. The external environment was also unfavourable as the inability of successive governments to meet their commitments with international financial institutions led to a serious credibility gap among the donors and intermittent withdrawal of assistance. The event of May 1998, when Pakistan conducted its first nuclear test, and its aftermath led to further economic isolation of Pakistan and a considerable erosion of confidence by domestic and non-resident Pakistanis. Economic sanctions were imposed against Pakistan by the western governments. By the late 1990s Pakistan had entered almost a critical state of paralysis and stagnation in its economy particularly in its external sector. The freezing of foreign currency accounts had resulted in a significant drop in workers' remittances, export growth was negative, IMF programme and World Bank assistance were suspended, bilateral donors had terminated their aid while debt payments due were in far excess of the liquid foreign exchange resources the country possessed. Pakistan was almost at the brink of default on its external payments.

SECTION II

ECONOMIC PERFORMANCE 1999 - 2003:

It was at this stage that the military government under General Pervez Musharraf assumed power in October 1999. The initial period was devoted by the economic team of the new government in managing the crisis and making sure that the country avoided default. A comprehensive programme of reform was designed and implemented with vigour and pursued in earnest, so as to put the economy on the path of recovery and revival. The military government did not face the same constraints and compulsions as the politically elected governments. It was therefore better suited to take unpopular decisions such as imposing general sales tax, raising prices of petroleum, utilities and removing subsidies so badly needed to bring about fiscal discipline and reduce the debt burden. The IMF and the World Bank were invited to enter into negotiations on new stand-by and structural adjustment programmes.

Although the canvas of reform in Pakistan was vast and corrective action required on a number of fronts, there was a conscious effort to focus on achieving macroeconomic stability, on certain key priority structural reforms and improving economic governance. The structural reforms included privatization, financial sector restructuring, trade liberalization, picking up pace towards deregulation of the economy and generally moving towards a market-led economic regime. A stand-by IMF programme was put in place in November 2000, which was successfully implemented followed by a three-year Poverty Reduction and Growth Facility (PRGP), which will expire in November 2004.

What have been the outcomes of the economic reforms undertaken during the past four years?

Macroeconomic Stability:

There has been considerable progress in achieving macroeconomic stability. Strong fiscal adjustment has led to primary budgetary surplus and significant reduction of the fiscal deficits. Current account has turned around from chronic deficit to a surplus of more than 5 percent of GDP, mainly due to renewed export growth and resurgence of workers' remittances. Monetary aggregates have been contained and inflation rate is below 4 percent. External debt burden has been reduced in absolute terms from $38 to $35 billion and as a proportion of GDP from 62.5% to 46%. The risk of default on external debt, which loomed large on the horizon in 1999 and 2000, was mitigated and the country's capacity to service its restructured debt has considerably improved. Exchange rate has not only stabilized but appreciated during the last two years. Table II shows the changes in the key economic indicators between October 1999 and September 2003.

Structural Reforms - Privatization, Deregulation, Liberalization:

The Musharraf Government actively pursued an aggressive and transparent privatization plan whose thrust was sale of assets in the oil and gas industry as well as in the banking, telecommunications and energy sectors, to strategic investors, with foreign investors encouraged to participate in the privatization process. This plan is being followed by the newly elected government under Prime Minister Jamali.

To demonstrate the seriousness of the government in encouraging foreign investment flows in Pakistan; there has been a major, and perceptible liberalization of the foreign exchange regime. Foreign investors can now bring in and take back their capital, remit profits, dividends and fees etc., without any restrictions. Foreign Portfolio Investors (FPI) can also enter and exit the market without any restrictions or prior approvals. In the Karachi Stock Exchange with a market capitalization of $15 billion, over 700 listed companies showed average returns of 15 per cent that were higher than those in most emerging countries. This makes Pakistan an attractive place to invest for foreign portfolio investors. As part of this liberalization, non-residents and residents are allowed to maintain and operate foreign currency deposit accounts, and a market-based exchange rate in the inter-bank market is at work.

Allied to this effort, the trade regime has been opened up and the maximum tariff rate has been cut down to 25 per cent with only four slabs and the average tariff rate is down to 14 percent.

The financial sector too, has been restructured and opened up to competition. Foreign and domestic private banks currently operating in Pakistan have been able to increase their market share to more than 60 percent of assets and deposits. The interest rate structure has been deregulated and monetary policy uses indirect tools such as open market operations, discount rates etc. Domestic interest rates on lending have dropped to as low as 5 percent from 20 percent substantially reducing financial costs of businesses.

Central to the economic reforms process has been a clear progression towards deregulation of the economy. Prices of petroleum products, gas, energy, agricultural commodities and other key inputs are determined by market. Imports and domestic marketing of petroleum products have been deregulated and opened up to the private sector. The markets do not always function effectively. Independent regulatory agencies have been set up to protect the interests of consumers and end-users of utilities and public services. Despite this movement towards a liberalized and deregulated regime, old habits die-hard. Bureaucratic hassles at lower levels continue to be irritants for the business community.

Tax Reforms:

Taxation reform has figured prominently on the government's agenda, as this is another area where the business community has innumerable grievances and dissatisfaction with the arbitrary nature of tax administration. Tax reforms are aimed at broadening the tax base, bringing in tax evaders under the tax net, minimizing personal interaction between tax payer and tax collector, eliminating the multiplicity of taxes and ultimately reducing the tax rate over time. A massive survey and documentation drive was undertaken to widen the tax base, extend incidence to all sectors of the economy and develop the data for purposes of assessment. Despite these reforms, the business community remains dissatisfied with the performance and attitude of tax officials particularly at the lower level. Complaints of delays in refunds of sales tax persisted throughout the three-year period. The Central Board of Revenue (CBR) is being restructured to improve tax administration including taxpayer facilitation.

Economic Governance:

The most dramatic shift introduced by the military government is in promoting good economic governance. Transparency, consistency, predictability and rule-based decision-making have begun to take roots. Discretionary powers have been significantly curtailed. Freedom of press and access to information has had a salutary effect on the behaviour of decision makers. The other pillars of good governance are, (a) devolution of power to the local governments who will have the administrative and financial authority to deliver public services to all citizens, and (b) an accountability process which will take to task those indulging in corruption through a rigorous process of detection, investigation and prosecution.

Despite these positive outcomes and their impact on the business community and other stakeholders, within the country as well as abroad, the incidence of poverty is still quite high and unemployment rates are worrisome. The challenge therefore for the next phase of the reform process is to accelerate growth rate and reduce poverty and unemployment.

SECTION III

POLICY LESSONS LEARNT:

I now turn to the policy lessons learnt from the experience of last 50 years and the success achieved in reforming and restructuring Pakistan's economy during the last four years. With experiments running from state controls, liberalization, socialism, reversal to market mechanism, deregulation and privatization, there is today almost a consensus on the broad contours of economic policy in the country although the modalities, policy instruments and nuances differ as they ought to. My reading of the last 15 years suggests that the general thrust of Pakistan's economic policies broadly reflects the following lessons learnt from the past:

(a) Central planning has been a failure as it leads to low productivity, lack of innovation, lack of incentives, poor quality goods and services and low investment in human resources. Bureaucratic judgment is a poor substitute for market's judgment on allocation of scarce resources.

(b) Licensing to open, operate, expand, close business by the government functionaries is a sure way to promote rent-seeking in the economy for the benefits of a few while keeping the majority poor. The basic business decisions should not be made for the businessmen by the bureaucrats.

(c) Public sector ownership and management of business, production, distribution and trade do not capture the commanding heights but lead to a fall into the deep morass of inefficiency, waste and corruption.

(d) Import substitution behind high tariffs not only protects a few thousand inefficient producers but also penalizes the millions of consumers with shoddy and expensive goods, which they do not particularly want. Profits at world prices are negative in these protected industries thus leading to inefficient utilization of capital and labour.

(e) Over regulation, controls and inspection of all kinds on the private sector not only hike up the cost of doing businesses, subdues entrepreneurship but also make a few wily politicians and bureaucrats rich at the expense of the prosperity of the country. Private monopolies and oligopolies were nurtured under the cover of these controls.

(f) High tax rates on individuals and corporates are counter-productive as they raise costs, discourage effort and initiatives and lead to widespread tax evasion and have unintended consequences of lowering overall revenue collection.

(g) Banks and financial institutions owned and managed in public sector offering cheaper credit and/or directed credit have a pernicious effect on economic growth as credit decisions are made on the basis of political connections rather than on the merit of the proposal. Value subtracting enterprises are set up while real opportunities for businesses that contribute to output and employment are missed.

(h) Administered prices of key commodities and utilities are the worst possible means of insulating the poor segment of the population from the onslaught of market forces. Instead these prices create shortages in the economy and hit the poor hardest by denying them access to essential commodities or services.

(i) Subsidies on inputs such as fertilizers, seeds, electricity, water, gas, petroleum, etc. incur heavy budgetary costs but benefit the well-to-do classes and highly influential individuals rather than those for whom the subsidies are intended.

(j) Foreign investment and multinational corporations are not evils that should be shunned but are the most important conduits for transfer of technology, managerial skills, organizational innovation in addition to much needed capital and foreign exchange. They should be welcomed and made to feel comfortable in their operations.

SECTION IV

FUTURE DIRECTION:

The lessons learnt from its historical experience, the development literature based on Cross-Country record and the imperatives of globalization have led to emergence of a broad consensus on some key policies and parameters.

These views are shared by majority political parties, military, businesses, bureaucracy and other stakeholders in Pakistan. It will be fair to surmise that investors in Pakistan should feel confident that the future direction of economic policy making will be guided by the following principles although in a dynamic and ever changing world, economic management will have to be responsive to the needs of the time and events.

i. Outward-looking strategy that promotes exports and integrates Pakistan into the world economy is in the best interest of the country for accelerating growth and reducing poverty. Tariff reductions have been quite drastic from 220 percent to current maximum of 25 percent helping the businesses to become cost competitive. Anti-export bias has been significantly removed and export promotion is the stated policy objective.

ii. Private sector is the main vehicle for producing and exchanging goods and services for the domestic economy as well as the rest of the world.

Prices should be determined by the market forces but monopolies regulated by independent agencies.

iii. The role of the state is to provide security of life and property, have an independent judiciary that can arbitrate disputes and enforce contracts, build physical infrastructure, nurture human skills and train manpower and maintain an enabling macroeconomic and regulatory environment in which businesses can flourish.

iv. Public sector enterprises and government trading houses should be privatized through a transparent process so that the Government can focus its attention on its basic responsibilities to the citizens. Selling these enterprises to private entrepreneurs has stopped the hemorrhaging of government finances.

v. Pakistan will continue to have a liberal foreign exchange and low tariff regime without recourse to any non-tariff barriers. Raw materials, components, machinery and equipment, consumer goods can enter the country free of restrictions. Foreign investors are free to bring in and repatriate capital, dividends, profits, remittances, royalties, etc. without any approvals.

vi. The value of Pakistani currency in relation to other foreign currencies will be determined through supply and demand in the foreign exchange markets and not by administrative fiat of the Central Bank. A free-floating exchange rate policy is being pursued at present and will continue in the future.

vii. The Central Bank or the Government no longer controls interest rates on government securities, corporate borrowing, deposits, etc. They are totally deregulated and the banks are free to charge the spreads according to risk assessment of the borrowers. There are no priority sectors to which credit is directed. Government is not allowed to borrow from the banking system beyond a specified limit.

viii. Foreign companies, individuals, multinational corporations can own 100 percent shares in locally incorporated or unincorporated firms. They can raise equity through national stock markets, borrow from the local banking system and sell their goods or services abroad or domestically. They enjoy a level playing field with the domestic investors and do not face any barriers to entry or exit. They can expand capital or wind up business without permission from any government department.

ix. Consumers have choices to purchase foreign goods or domestically produced goods. This has compelled the domestic manufacturers to improve the quality and reduce the prices of their products or face extinction at the hands of imported goods. The competitiveness of industry has been boosted by the unhindered availability of foreign goods.

SECTION V

IMPACT OF ISLAMIZATION ON THE FUTURE DIRECTION:

I now turn to the main theme of the Conference today. The basic premise of this Conference is that there are many protagonists in Pakistan who are pushing the country towards adopting an Islamic economic system. Western analysts and observers view such a move with apprehension and feel that this will lead to Pakistan's decoupling from the global economic system and its isolation from mainstream economic thinking. In their minds such behaviour will create greater instability and amplify risks for the rest of the world.

Pakistan is a moderate and progressive Islamic country that is committed to the war against extremism and terrorism and, thus, any suggestion that it will adopt policies that may be risky for the rest of the world is untenable. President Musharraf is already paying a high price in combating the menace of terrorism and extremism in the country. These policies may have short- term costs but are essential to set the country on its course of enlightened moderation.

Unfortunately, most of the assumptions and premises on which the hypotheses about the Islamic economic system have been constructed are seriously flawed. Pakistan is and will remain a responsible member of international community and is committed to utilize the vast opportunities provided by globalization and financial integration of world markets for the benefit of its population. There is no suggestion whatsoever by any significant group of people or political parties in favour of isolation or withdrawal from international economic system. Secondly, the pre-conditions for a robust and well functioning Islamic economic system are missing in Pakistan. The Islamic moral values that emphasize integrity, honesty, truthfulness and full disclosure and transparency are not yet widely practiced by Pakistani businesses. Once these pre-conditions are established the adoption of a real Islamic economic system will lead to superior welfare outcome for the majority of Pakistani population.

How can the Islamization of the economy affect this future direction of Pakistan economy and improve the welfare of its people compared to the present system? The extensions that the true practice and application of Islamic economic model can bring about will, in fact, help in overcoming the weaknesses inherent in the capitalist model of economy. Before that, let us recapitulate the basic principles upon which Islamic economic system is built upon.

Unlike positive economics the entire edifice of Islamic economy is built upon a set of objectives or maqasid. In other words, Islamic economics is normative in nature with the objective of the Shariah being to promote the well being of all mankind which lies in safeguarding their faith, their human self, their intellect, their posterity and their wealth.

At the micro level, the precepts of profit maximization and utility maximization are retained intact but are supplemented by a set of interlinked objective functions. Islamic system tries to promote a balance between market, family, society and the state. It does so by promoting both the material and the spiritual urges of the human self, foster peace of mind, enhance family and social solidarity. Some western thinkers and anti-globalization activists decry the western economic model as being suppressive of collective human rights, community and social well being, disruptive of family values and too much focused on selfish individual interests. Behavioral economists have also begun to challenge the assumption of rationality in the choices and preferences an individual makes in day-to-day life. Thus, the merit of Islamic economic model therefore lies in its extension of western model in some fundamental and beneficial ways. It introduces into the objective function an additional argument which keeps self interest within the bounds of social interest by limiting individual preferences to conform with social priorities and eliminating or minimizing the use of resources for purposes that frustrate the realization of the social vision. This may help promote harmony between self-interest and social interest.

This second argument complements the market mechanism by making the allocation and distribution of resources subject to a double layer of filters. It attacks the problem by first changing the behaviour and preference scale in keeping with the demands of the normative goals. Claims on resources are then exposed to the second filter of market prices. In this process, the influence that initial resource endowments are able to exercise in the allocation and distribution of resources may be reduced substantially. Faith tries to accomplish this by giving self-interest a longer-term perspective – stretching it beyond the span of the world to the Hereafter. This interest in Hereafter cannot be served except by fulfilling his or her social obligations. This may induce individuals to voluntarily hold their claims on resources within the limits of general well being and thus create harmony between self-interest and social interest even when the two are in conflict.

The promotion of simple living and the reduction of wasteful and conspicuous consumption may help reduce excessive claims on resources and thereby release a greater volume of resources for need-fulfillment by others who are not so well off. It may also help promote higher savings and investment and thereby raise employment and growth.

At the macro level, Islamic economic model in its ideal form tends to combine the positive aspects of the capitalist economy and socialist economy while minimizing their negative consequences. Capitalist economy based on private property and market mechanism allocates resources efficiently but as it takes initial resource endowment as given, equity considerations do not figure in this system. Socialist system is very much concerned with equity and welfare of its population and ensures benefits from cradle to grave for its citizens. But as it relies on state ownership and bureaucracy it is poor in allocating resources thus creating inefficiency, waste and value subtraction. Islamic System overcomes the deficiencies of both the systems as it is solidly based on private property and market mechanism but has also explicitly built in equity and distribution through compulsory deduction of Zakat i.e. transfer payments from the asset holders to the poor segments of the population. The western economic model is criticized today as it is unable to address the issues of unemployment, poverty and income inequities in developing countries. Islamic economic model addresses the distribution issues explicitly <u>after</u> market has allocated the gains. It does so by a compulsory deduction of 2.5 percent of tangible wealth and net asset holdings from the incomes generated by the market mechanism for transfer among the vulnerable, sick, handicapped, indigenes and poor segments of the society. Although the deduction is compulsory the transfers are made voluntarily by the well-to-do to their poor relatives, neighbours and other whom they know to have legitimate needs. Thus the leakages, waste and corruption that are inherent in a state administered system of welfare payments are conspicuous by their absence under this system. Only really deserving persons and families or mustahaqeen receives these payments. In Pakistan, it is estimated that private transfers made voluntarily to the poor account for 2 percent of GDP annually. These welfare payments are a potent force in reducing poverty, helping the vulnerable to earn their own livelihoods and lower income disparities.

At the sectoral level, the introduction of Islamic banking should result in deepening of the financial sector. There are believers in Islamic Faith who do not use the Conventional banking system because of their strongly held views that this system is based on riba. They will willingly deposit their savings into Islamic banks and borrow from these banks for expansion of their businesses or new investment. Thus a significant segment of population that is currently outside the organized financial sector will be brought into its fold deepening financial markets.

The primary principle of Islamic Banking is the prohibition of Riba (usury), which is believed to be a means of exploitation of the masses. Trade is the preferred mode of business in Islam. The goal of the banking is the general economic improvement of the public at large rather than of few groups.

What are the characteristics of the Islamic bank?

- One of the most distinguishing features of Islamic banking is that being part of a faith-based system, it is obligatory on Islamic banks from pursuing activities that are detrimental to the society and its moral values. Thus Islamic banks are not allowed to invest in casinos, nightclubs and breweries, etc. It is pertinent to note that casinos are one of the prime vehicles used for money laundering and dealing with them could expose the conventional banks to such risk.

- The second distinguishing feature of the Islamic banking is that in addition to the rules and regulations applicable to the conventional banks, the Islamic banks have to go through another test, i.e. fulfill exhaustive requirements to be Shariah compliant. This requires that the clients of Islamic banking must have business that should be socially beneficial for the society creating real wealth and adding value to the economy rather than making paper transactions. Therefore, a stringent Know Your Customer (KYC) policy is inherently an inbuilt requirement for an Islamic bank since the Islamic bank has to know the customer and his business before getting into a socially responsible Shariah compliant transaction. KYC is the first line of defense against money laundering in any banking system.

- Third, by their very nature, Islamic mode of financing and deposit taking discourages questionable/undisclosed means of wealth that form the basis of money laundering operations. The disclosure standards are stringent because the Islamic banks require the customers to divulge the origins of their funds in order to ensure that they are not derived from un-Islamic means e.g. drug trade, gambling, extortion, subversive activities or other criminal offences. On the financing side, the Islamic banks must ensure that funds are directed towards identifiable and acceptable productive activities. Most Islamic financing modes are asset backed, i.e. they are used to finance specific physical assets like machinery, inventory, equipment, etc.

- Fourth, the role of the bank is not limited to a passive financier concerned only with timely interest payments and loan recovery. The bank is a partner in trade and has to concern itself with the nature of business and profitability position of its clients. In the case of loss in business, the Islamic financier has to share that loss. To avoid the loss and reputational risk, the Islamic banks have to be extra vigilant about their clientele.

To sum up, it can be said that banks that judiciously follow Islamic banking principles are less likely to engage in illegal activities such as money laundering and financing of terrorism than conventional banks. However, the existence of rogue elements cannot be ruled out in any type of organization. It is the duty of the state and the regulators to ensure that despite these in-built safeguards, there are adequate pieces of legislation, regulations, and enforcement mechanisms to take action against the potential offenders.

Pakistan has taken a policy decision that it will allow both the Conventional and Islamic banking systems to operate in parallel. The choice will be left to the consumers whether they wish to migrate from the Conventional to the Islamic system or stay with the Conventional system. The State Bank of Pakistan has a transparent system of licencing, regulating and supervising the Islamic banks in Pakistan. There are three ways in which this type of banking can be set up (a) through a stand-alone exclusive Islamic bank (b) the existing

Conventional banks establishing a subsidiary or (c) earmarking some of their branches for Islamic banking.

A Shariah Board consisting of scholars, economist, accountant and banker as members will determine whether the products and bankers as members will determine whether the products and services offered by these institutions are compliant with Shariah or not.

The MMA Government in NWFP has earmarked one of the branches of a Provincial Government owned bank as Islamic bank and only on the basis of the experience gained they will gradually move to convert other branches to this mode. You can therefore see that contrary to the alarmists' cries the Provincial Government has been extremely prudent and responsible in moving gradually in this direction. They have fulfilled all the standard requirements which the Central bank had stipulated and no exception was made in granting the licence for this branch. Business and Commercial considerations will determine the future evolution of Islamic banking in the province.

To sum it up, Islamization, if adopted and practiced in its true form, at any time in the future will strengthen the economy particularly income distribution and poverty alleviation which have proved elusive under the present economic model. This will, in fact, eliminate the sources of instability, violence and propensity towards terrorism arising from a sense of deprivation.

SECTION VI

ECONOMIC PROSPECTS IN THE MEDIUM TERM:

As the full fledged operation of a true Islamic economic system in any of the Muslim Countries and particularly Pakistan is far from realization in the near future, only gradual and slow changes will take place. Thus, the burning issues of poverty, income distribution and unemployment will remain to preoccupy the attention of economic managers and policy makers – as the remedies available under the Islamic economic system to resolve them are unlikely to be applied. Under this scenario what does the future hold for the Pakistan economy and what are the prospects for addressing these issues?

Empirical evidence from the past history of Pakistan suggests that there is a direct relationship between rapid economic growth and poverty reduction. After the annual economic growth rate crosses the threshold of 6 percent or more on a sustained basis there is a strong probability that the incidence of poverty will begin to decline.

There is little doubt that GDP growth rate can recover to the historic levels of an average of 6 per cent and more provided structural reforms are continued and further deepened, productivity gains in agriculture sector are achieved and a set of non economic factors including governance are put in place. This will not only reduce the incidence of poverty but also unemployment and to some extent regional disparities. It is also projected that the inflation rate will remain contained within the 6-8 per cent range provided appropriate monetary and fiscal policies are followed. The latter is geared to bring the budgetary deficit down to 3 per cent of GDP in the next three years; increasing the Tax-GDP ratio to over 15 per cent, containing the growth in non-development expenditure but raising the share of social and poverty-oriented programmes.

What is the agenda for getting back on this trajectory? The realization of the projections outlined above will depend upon the interplay of evolution in political and social developments, economic policies to be pursued, the quality of governance and institutions, external environment and most important, investment in human development. It has become quite obvious from both Pakistan's own history and the experience of other developing countries that sustained economic growth and poverty reduction cannot take place merely on the strength of good economic policies. Political stability, social cohesion, supporting institutions, and good governance are equally important ingredients coupled with a benign external environment for achieving economic success. The economy will suffer from temporary shocks, both domestic and externally induced, but will develop resilience to tolerate these shocks with minimum disruption and dislocation if these ingredients are present. So what do essential ingredients for transforming Pakistani economy entail? What are the pillars on which the foundations of Pakistan’s rapid economic development will be built in the future?

Pakistan's chequered and uneven record on political instability and lack of democracy has deprived the country of a long-term vision, direction and continuity of economic policies. The rapid turnover of governments and the actual and imminent threat of the dismissal of governments through extra constitutional means have certainly proved to be an inhibitor to investment, innovation and institutional development. Democracy in Pakistan is still interpreted in a fairly narrow sense, i.e. holding general elections and allowing political parties to compete. While this is necessary, other pre-requisites of a well functioning democracy, i.e. rule of law, civil liberties, freedom of expression, checks and balances on the powers of different organs of state and religious and ethnic tolerance have not yet taken root. Parliamentary elections are not meant to provide licence to those elected to rise above the law and do whatever pleases them. Separation between executive and legislature, with the latter exercising effective controls on the former, is still missing due to the entrustment of executive powers to the ruling party in the legislature. As there is no other countervailing mechanism, excesses committed by the executive have only been corrected by dismissals or extra-constitutional measures. These extraordinary steps create uncertainty and unpredictability, which are inimical to long-term economic growth. Thus an effective watchdog legislature and a vigilant judiciary-enforcing rule of law including enforcement of contracts and protection of private property will obviate the need for frequent changes in the government. Political parties themselves have to shift the emphasis on dialogue to broad-based strong growth rather than narrow-minded slangs and personality-oriented cults. A stable and orderly political system ingrained and practicing all the elements of democracy is the first pillar for transforming the economy.

Although democracy does mediate between different ethnic, religious and regional groups, Pakistan has witnessed growing polarization and division along sectarian, ethnic, linguistic, and cultural lines in the decade of 1990s particularly after the defeat of the Soviet forces in Afghanistan. Social capital, which is a glue for fostering economic development has been depleting. Although Islam teaches us tolerance and harmony, the violent sectarian killings and the consequential law and order problems need to be curbed effectively. Social cohesion, trust and tolerance and inter-provincial harmony on the back of a true participatory and well functioning democracy, a vibrant civil society and a shared sense of fair play in allocation of national resources are the second pillar for robust economic transformation.

Recent empirical evidence and common sense strongly suggest that sound economic policies cannot make any difference to the lives of the common citizens if the country does not have strong institutions to implement those policies. Pakistan had inherited a strong civil service, judiciary, and police, which could meet the demands of thirty million people. But as population expanded, and the nature of problems became more complex, the capacity of these institutions did not keep pace with the emerging demands of the economy. On the contrary, these institutions were politicized and captured by a small elite group to serve their own narrow interests and those of their masters. The consideration of common good was replaced by self-aggrandizement and the process of institutional decay crept in and gradually eroded the foundations of most of these institutions. These dysfunctional institutions were unable to deliver the basic services to ordinary citizen.

Crude estimates suggest that if institutions and legal system were working well Pakistan's GDP would grow at least by two percentage points faster e.g. if the land titles were clear, actively traded, mortgaged and exchanged without much hassle; if tax assessment, tax code and tax collection methods were simplified, made less arbitrary and free from discretion of tax officials, the tax base would be much wider and Tax-GDP ratio much higher; if the court system is unclogged the enforcement of contracts would be quicker and reduce transaction costs substantially.

The fourth pillar is good governance. There is an overlap between the other three pillars described above and good governance. Rule of law, transparency, predictability are the essential elements of good governance. Authoritarian governments have relatively better record of governance in Pakistan, but these gains have proved to be short lived. Only democratic governments with clear rules of transition and strong functioning institutions can provide the platform for embedding good governance in the work ethic. It has to be demonstrated during the next five years that democracy and good governance are not mutually incompatible and that a democratically elected government can also serve collective interests in contrast to their personal interests, and that the quality of governance can be better. The interplay of voice and accountability, civil liberties and free media, which form the core of democracy reinforce the quality of governance.

Three recent steps, devolution of powers to local governments, National Anti-Corruption Strategy and National Accountability Bureau and encouragement of private-public-community partnerships, will fill in the missing gaps in effective implementation of governance.

The devolution of powers to local governments since 2001 is undergoing a phase of consolidation and is facing some teething problems. But this devolution has an in-built capacity to respond to the demands of the common man for obtaining basic services such as security, education, health, water supply, sanitation, etc. This system is facing fierce resistance from all those groups who had vested interests in the old centralized, highly personalized top-down system of Administration. The system needs to be carefully nurtured, monitored, its structural and operational deficiencies and weaknesses removed, but any attempt to dislodge it or make it impotent will adversely affect the access of the poor and disenfranchised to public expenditures and public goods.

Finally, most important among all the factors that will impinge upon the future shape of Pakistan's economy is accelerated investment in human development. In fact, this underdevelopment of human capital is the most daunting challenge facing Pakistan. High population growth – one of the fastest in the world – has given rise to a young dependent population and increased unemployment among the youth. One half of the population is illiterate making it more difficult to impart new skills to the ever-burgeoning labour force. The average years of schooling remains quite low. Investment in higher education, science and research has been almost insignificant and has hurt the competitiveness of Pakistani firms in world market. Low level of female education and literacy have made one half of the population less than adequately prepared to participate in the domestic labor markets and deprived the country of many externalities that arise from a literate female population.

A comprehensive package of educational sector reforms, a medium term health strategy, fiscal restructuring and devolution of administrative and financial powers to local government, public-private partnership in delivery of social services, community involvement and participation are some of the ways that need to be put in practice with full commitment.

The above survey of Pakistan's past, present and future should reassure the Western Community that if and when Islamization of the economy takes place it will not pose a threat to Pakistan's journey towards stability, growth and poverty reduction. Along with good policies, good governance and good luck it will create conditions that are conducive for growth and poverty reduction Pakistan is very much and will remain integrated into the world economy and fully utilize the opportunities thrown open by globalization to benefit its population.

TABLE I

Long-Term Structural Change and Growth

		1947	1970	2001
Population	In million	33	60	146
Income	GDP (current m.p.) Rs.bln	58	151	3,231
	GDP (US $)billion	3.8	10.8	72.3
	Per Capita Income (Constant Rs.)	1,638	2,541	5,383
	Per Capita Income (US $)	85	170	495
	Per Capita Income (Current Rs.)	405	809	28,980
Agriculture	Production Index	100	219	530
	Fiber Production Index	100	172	921
	Water Availability (MAF)	55	76	97
	Wheat Production (m. tons)	3.3	7.3	19.2
	Rice Production (m. tons)	0.7	2.4	4.8
	Cotton Production (m. bales)	1.1	3.0	10.4
	Fertilizer per ha. Crop (kg)	0	23	212
Industry	Manufacturing Production Index	100	2346	12,633
	Steel Production (000 tons)	0	0	2203
	Cement Production (000 tons)	292	2656	11,000
	Chemical Production (000 tons)	0	130	445
	Sugar Production (000 tons)	10	610	3686
	Veg. Ghee Production (000 tons)	2	126	743
	Cloth Production (000 Sq. meter)	29,581	60,544	576,000
Infrastructure	Per Capita Electricity Generation (Index)	1000	1950	10,160
	Per Capita Electricity (kwh)	6	63	520
	Road Length (km)	50,367	72,153	249,959
	Area under Canal Irrigation(mill. ha)	7.9		18.0
Consumption	Natural Gas billion cu. Meters	0	2.9	26.1
	Road Vehicles per 1000 Persons	1	3	30
	Phone Connections per 1,000 Persons	0.4	2.5	28.6
	TV Sets per 1,000 Persons	0	1.5	26.3
Social indicators	Primary Enrolment Rate	5	22	74
	Population per Doctor	23,897	4,231	1,484
	Population per Nurse	369,318	13,141	3,560
	Literacy Rate	11	20	51
	Infant Mortality Rate	N.A.	117	84
	Total Fertility Rate	N.A.	6.3	4.7
	Population with Access to Safe Water	N.A.	25	85
	Under Five Mortality Rate	N.A.	181	109

TABLE – II

CHANGES IN KEY MACRONOMIC INDICATORS

	October 1999	September 2003	Change in the Indicator
GDP growth rate	4.2%	5.3%	Positive
Inflation	5.7%	3.3%	Positive
Fiscal deficit/GDP	-6.1%	-4.0%	Positive
Current account/GDP	-3.2%	+5.0%	Positive
Domestic Debt/GDP	52.0%	43.4%	Positive
External Debt	$ 38 billion	$ 35 billion	Positive
Remittances	$ 88 million per month	$ 300 million per month	Positive
Exports	$ 7.8 billion	$ 12 billion	Positive
Tax Revenues	Rs. 391 billion	Rs. 510 billion	Positive
Rupee-Dollar Parity	Depreciating	Appreciating	Positive
Foreign Direct Investment	$ 472 million	$ 500 million	Positive
Foreign Exchange Reserves	$ 1.6 billion	$ 12.0 billion	Positive
Poverty Incidence	33%	Data not available but perhaps rising	Negative
Poverty related expenditure	Rs. 133 billion	Rs. 161 billion	Positive
Unemployment	6%	8%	Negative

Note: All indicators in Column 1 pertain to 1998-99 or October 1999. All indicators in Column 2 pertain to 2003-04 or end September 2003.