ECONOMY OF PAKISTAN: AN OVERVIEW

Ishrat Husain

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 2004. 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:

- Pakistan is self sufficient in most food production.
- Per capita incomes have expanded more than six-fold in US Dollar terms.
- Pakistan has emerged as one of the leading and successful producers of cotton and cotton textiles.
- Pakistan has developed a highly diversified base of manufactured products for domestic and world markets.
- Physical infrastructure network has expanded with a vast network of gas, power, roads and highways, ports and telecommunication facilities.

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 US$1200 instead of US$640.

Keynote address at the Expo 2005 Conference held at Karachi on February 3, 2005

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 US$100 billion instead of paltry US$13-14 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 external and domestic indebtedness. 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 take tough and unpopular economic decisions to set the economy right. Moreover, the average lifespan of two to three years was clearly inadequate for implementing meaningful policy or institutional changes. The external environment had also become unfavorable after the event of May 1998, when Pakistan conducted its first nuclear test. The aftermath of this test 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. There was 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. Economic growth was anemic, debt ratios were alarmingly high, and the incidence of poverty had once again risen to 32 percent.

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 (PRGF), which was successfully completed in December 2004. It is a matter of pride that Pakistan decided not to draw down the last two tranches although it was eligible to do so. The IMF has also decided that Pakistan will not be subject to the usual post-program monitoring due to its good economic standing.

Pakistan's economic turnaround during the last five years is even more impressive because the country was faced with a critical and fragile regional and domestic environment with constant threats to security (a result of playing key role as a frontline state in the war against terrorism) a prolonged and severe drought, tensions with India and high oil prices.

Macroeconomic Stability:

Macroeconomic stability has been achieved through reduction in fiscal deficit, acquiring a surplus on the current account balance of payments, lowering of inflation, and a transformation of external debt profile. These have been brought about partially through the support of international financial institutions and the Paris Club bilateral creditors which significantly eased the external payments position that had been a major and consistent risk to the economy since 1998.

Fiscal deficit was reduced by pursuing a combination of four set of policy measures (i) mobilizing additional tax revenues (ii) reducing subsidies to public enterprises and corporations and (iii) bringing about a significant decline in debt servicing payments and (iv) containing defence expenditures.

Monetary policy was kept reasonably tight during the first two years with money supply growth at about 9 percent. Expansion in private sector credit, in the subsequent years, did not put much pressure as the government borrowing was limited to a manageable level. As the monetary conditions improved the interest rate came down gradually to a single digit and demand for credit by the private businesses picked up resulting in higher capacity utilization in manufacturing and increased industrial production.

External debt management focused on (a) reprofiling of the stock of official bilateral debt, (b) substituting concessional loans for non-concessional from international financial institutions, (c) pre-paying expensive loans and (d) liquidating short term liabilities. Debt ratio was thus reduced from 100 percent of GDP to 60 percent in five years time.

Trade policy in Pakistan has been categorized by the World Bank as one of the least restrictive in S. Asia along with Sri Lanka and this policy has gradually provided incentives to exporters to increase their market share in the global markets. Exchange rate policy was pursued to maintain stability in the foreign exchange markets while at the same time keeping the competitiveness of Pakistani exports intact. Large accumulation of foreign reserves played an important role in stabilizing the exchange rate.

Current account has turned around from chronic deficit to a surplus, mainly due to renewed export growth and resurgence of workers' remittances. Inflation rate during the last four years remained below 4 percent. External debt burden has been reduced in absolute terms from US$38 to US$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. Table II shows the changes in the key economic indicators between October 1999 and October 2004.

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 was followed by the elected Government under Prime Minister Jamali and by the present Prime Minister Shaukat Aziz.

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 US$33 billion, over 650 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.

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 80 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.

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. Universal self assessment system has been introduced for tax collection whereby the returns submitted by the tax payers are taken as final settlement of their tax liabilities. Only a random sample of returns is picked up for audit. This system has been welcomed by the tax payers. The Central Board of Revenue (CBR) is being restructured to improve tax administration including taxpayer facilitation.

Tariff Reforms

Pakistan made significant efforts in liberalizing its trade regime during the 1990s. The maximum tariff rate has declined from 225 percent in 1990-1 to 25 percent; the average tariff rate stands at just 11 percent compared to 65 percent a decade ago. The number of duty slabs has also been reduced to four. Quantitative import restrictions have already been eliminated except those relating to security, health, public morals, religious and cultural concerns. The number of statutory orders that exempted certain industries from import duties has been phased out by June 2004 and import duties on 4,000 items were reduced. These measures have brought down effective rate of protection, eliminated the anti-export bias and promoted competitive and efficient industries. A number of laws have also been promulgated to bring the trade regime in conformity with World Trade Organization regulations. These include anti-dumping and countervailing measures intellectual property rights.

Financial Sector Reforms

Financial sector has made the farthest progress by transforming itself into a market oriented, private sector dominated sector performing efficient intermediation. The regulatory and supervision functions of the State Bank of

Pakistan have been significantly strengthened, and strict enforcement of prudential regulations have led to widespread recapitalization and a consequent improvement in the efficiency and profitability of banking system. More than 80 percent of banking assets are now owned and managed by the private sector.

The ratio of net Non-Performing Loans (NPLs) to total advances in Pakistan has been brought down to less than 5 percent through a variety of strategic measures. An asset management company, the Corporate and Industrial Restructuring Corporation (CIRC), has taken over a large volume of non-performing loans of NCBs and DFIs at a discount and disposed them off to third party buyers.

Development Financial Institutions (DFIs) have been restructured through mergers and acquisitions, closure, liquidation and reorganization. Auction of Pakistan Investment Bond (PIB) for tenures of five to ten years government paper and a burgeoning corporate bond market has begun to emerge bringing together long term institutional investors and borrowers interested in long term sources of financing.

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.

Pakistan's history provides ample evidence that foreign enterprises have never been expropriated or taken over by any government during the last 57 years. Even when the Z.A. Bhutto government nationalized domestic manufacturing, banks, insurance companies, etc. the foreign companies were exempted and left untouched. Thus, the risk of expropriation of foreign capital is almost zero in Pakistan.

Foreign investors are treated at par with domestic investors for purposes of equity ownership, access to domestic financial market, tax and tariff regime and legal rules and regulations. This level playing field is one of the strong and distinctive features that make Pakistan an investor-friendly country.

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.

The cornerstone of the governance agenda is the devolution plan which transfers powers and responsibilities, including those related to social services from the federal and provincial governments to local levels. This plan was put into effect in 2001. The development effort at the local level is expected to be driven by priorities set by elected local representatives, as opposed to bureaucrats sitting in provincial and federal capitals. Devolution of power will thus strengthen governance by increasing decentralization, transparency, accountability of administrative operations, and people's participation in their local affairs.

Other essential ingredients for improving economic governance are the separation of policy and regulatory functions, which were earlier combined within the ministry. Regulatory agencies have been set up for economic activities such as banking, finance, aviation, telecommunications, power, oil, gas etc. The regulatory structures are now independent of the ministry and enjoy quasi-judicial powers. The Chairman and Board members enjoy security of tenure and cannot be arbitrarily removed. They are not answerable to any executive authority and hold public hearings and consultations with stakeholders.

The National Accountability Bureau (NAB) has been functioning quite effectively for the last five years as the main anti-corruption agency. A large number of high government officials, politicians and businessmen have been sentenced to prison, subjected to heavy fines and disqualified from holding public office for twenty-one years on charges of corruption after conviction in the courts of law. Major loan and tax defaulters were also investigated, prosecuted and forced to repay their overdue loans and taxes.

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.

Concluding Remarks:

Pakistan today meets most of the essential requirements that the foreign businesses and investors are looking for. Macroeconomic stability, deep-rooted structural reforms, high standards of economic governance, outward looking orientation, liberalized trade and investment regime, easy access to policy makers, low production costs, sophisticated financial sector and its location as a regional hub make it a highly attractive country for business and investment.

Investors' concerns about security, law and order are being addressed and the situation is improving gradually. But the negative perception that prevails about Pakistan abroad due to the hype created by the median can only be removed if the potential businessmen and investors visit Pakistan and make on-the-spot assessment for themselves.

TABLE I

LONG-TERM STRUCTURAL CHANGE AND GROWTH

		1947	1970	2004
Population	In million	33	60	151
Income	GDP (current m.p.) Rs. billion	58	151	5,458
	GDP (US$)billion	3.8	10.8	92.5
	Per Capita Income (Constant Rs.)	1,638	2,541	5,767
	Per Capita Income (US$)	85	170	640
	Per Capita Income (Current Rs.)	405	809	37,495
Agriculture	Production Index	100	219	591
	Fiber Production Index	100	172	866
	Water Availability (MAF)	55	76	97
	Wheat Production (m. tons)	3.3	7.3	20
	Rice Production (m. tons)	0.7	2.4	5
	Cotton Production (m. bales)	1.1	3.0	10
	Fertilizer per ha. Crop (kg)	0	23	212
Industry	Manufacturing Production Index	100	2346	17,047
	Steel Production (000 tons)	0	0	2203
	Cement Production (000 tons)	292	2656	12,957
	Chemical Production (000 tons)	0	130	758
	Sugar Production (000 tons)	10	610	4021
	Cloth Production (000 Sq. meter)	29,581	60,544	657,887
Infrastructure	Per Capita Electricity Generation (Index)	1000	1950	9,924
	Per Capita Electricity (kwh)	6	63	520
	Road Length (km)	50,367	72,153	255,856
	Area under Canal Irrigation(mill. ha)	7.9		22.0
Consumption	Natural Gas billion cu. Meters	0	2.9	26.1
	Road Vehicles per 1000 Persons	1	3	33
	Telephone Connections per 1,000 Persons	0.4	2.5	33.4
	TV Sets per 1,000 Persons	0	1.5	26.3
Social Indicators	Primary Enrolment Rate	5	22	84
	Population per Doctor	23,897	4,231	1,397
	Population per Nurse	369,318	13,141	3,261
	Literacy Rate	11	20	54
	Infant Mortality Rate	N.A.	117	80
	Total Fertility Rate	N.A.	6.3	4.0
	Population with Access to Safe Water	N.A.	25	90
	Under Five Mortality Rate	N.A.	181	102

TABLE – II

CHANGES IN KEY MACRONOMIC INDICATORS

	October 1999	October 2004	Change in the Indicator
GDP Growth Rate	4.2%	6.4%	Positive
Inflation	5.7%	4.6%	Positive
Fiscal Deficit/GDP	-6.1%	-2.4%	Positive
Current Account/GDP	-4.1%	+1.4%	Positive
Public Debt/GDP	100%	68%	Positive
External Debt/GDP	52%	37%	Positive
Interest Payments/Govt. Revenues	50%	25%	Positive
Remittances	US$ 88 million per month	US$ 300 million per month	Positive
Exports	US$ 7.8 billion	US$ 13 billion	Positive
Tax Revenues	Rs. 391 billion	Rs. 600 billion	Positive
Rupee-Dollar Parity	Depreciating	Stable	Positive
Foreign Direct Investment	US$ 472 million	US$ 950 million	Positive
Foreign Exchange Reserves	US$ 1.6 billion	US$ 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 2004-05 or end October 2004.