FUTURE OUTLOOK AND CHALLENGES FOR PAKISTAN'S ECONOMY

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H.E. Dr. Maleeha Lodhi, Mr. Anjum Iqbal, Distinguished Ladies and Gentlemen,

I am delighted to be back once again in your midst this year and wish to thank you for inviting me this evening to share my views about Pakistan's economic prospects with this distinguished gathering.

I would like to address the following three questions that are of great interest to every Pakistani, whether living in Pakistan or abroad. (a) What has been accomplished so far? How sustainable these reforms and policies are? (b) What is the future outlook and prospects for Pakistani economy? and (c) What are the challenges and risks facing the economy?

Accomplishments Made So Far:

There is a general agreement both within and outside Pakistan that there has been a remarkable turnaround in the economy during the last five years. What are the main accomplishments that have laid the foundations for sustainable growth and poverty reduction in the future? I would list at least eight such factors that have made a significant positive difference in the economic landscape of our country.

1. **Fiscal Discipline:** The major cause of Pakistan's economic ills lay in the imprudence of fiscal policy where the governments indulged in excessive spending in relation to their revenues and incurred deficits in the range of 6 to 7 percent of GDP. These persistent imbalances led

Address delivered at the Seminar organized by the Pakistan Bankers Association U.K. at London on January 17, 2005 to accumulation of public debt that reached unsustainable level of 100 percent of GDP by 1999-2000. The Musharraf Government has taken tough measures to introduce fiscal discipline in the country and has been successful in bringing fiscal deficit down to 2.4 percent last year. How has this been achieved? There are three ingredients responsible for this outcome. First, revenue mobilization has doubled from almost $300 billion to $600 billion in this period through a combination of improved tax administration, reducing the discretion of tax collector and minimizing interaction between tax payer and tax collector, rationalizing the tax rates and structure and widening the tax base to some extent. Universal self assessment system for income tax has increased both the number of voluntary filers as well as tax collection.

Second, the burden of debt servicing has been radically lowered. Five years ago, more than 50 percent of government revenues were pre-empted by interest rates. But, the carefully designed strategy of debt management implemented during this period has led to decline in this ratio to almost 25 percent with a downward moving trend. This has not only allowed lowering of fiscal deficit but provided fiscal space for doubling development expenditure. Third, the hemorrhage caused by the losses incurred by the public sector enterprises has been stopped and either these enterprises are being privatized or their performance has improved as a result of good governance and tighter management.

2. **<u>Financial Sector Reform and Restructuring:</u>** The financial sector has become the lynchpin of the revival of economic growth in Pakistan. Not only that the sector has become sound and healthy and strong enough to withstand exogenous shocks but has played a major role in broadening access to the middle class and lower income groups. Average bank lending rates have come down to 6 percent from 15-16 percent five years ago and 21-22 percent in the 1990s. This decline is

a result of lower demand for credit by the public sector as it reduced fiscal deficit and plugged in losses; the competition between the private sector owned and managed banks who now hold 80 percent of the banking assets; the removal of drag of non-performing loans by tackling them in a decisive way; the lowering of corporate tax rate on the banks; the assumption of affairs of banks by professional management and a vigilant role played by the Central Bank in supervision and regulation of the system. Lowering of interest rates gave a kick start to the private sector credit that, in turn, led to better capacity utilization and higher output in manufacturing sector recording growth rate of 17 percent last year. Higher manufacturing growth contributed towards the achievement of 6.4 percent GDP growth last year and is making similar contribution this year. Pakistan's banking system by opening its doors for mortgage, automobile, consumer, credit cards, SMEs, agriculture and microfinance has broadened the borrower base and brought in its fold firms, farmers and individuals who had never used bank credit for their productive activities or financing needs. This movement is still in its infancy and a lot of efforts have to be made in order to maintain this momentum.

3. **Macroeconomic Stability:** Even the worst critics of the present government do admit that Pakistan has been able to achieve macroeconomic stability although according to them the benefits have not trickled down to the common man. Macroeconomic stability that had eluded us for a long period of ten years in the 1990s is the foundation for sustainable economic growth. All indicators, whether current account balance, inflation, fiscal balance, exchange rate, interest rates, foreign exchange reserves, point clearly to a positive direction. The challenge for the economic managers is to maintain this stability so that private investors can make investment decisions with full knowledge of the expected profitability in an environment where

there is little turbulence or swings in the key prices. The continuity, consistency, predictability and transparency of economic policies are essential to foster this environment. In this complex world of interdependence and interconnections there would be moments of tension and uncertainty but better communication, fuller disclosure of facts and information to the markets and regular interaction with the economic players will keep things under control.

4. **External Debt Vulnerability:** Along with high fiscal deficits, Pakistan was faced with rising and unmanageable external debt burden. By 1999/00 the external debt as a ratio of GDP had reached almost 52 percent. The new Government that assumed power took upon itself the task to bring down this burden to an acceptable level. It designed a strategy of debt management that consisted of a long term reprofiling of Paris Club bilateral debt, substitution of non-concessional loans from IFIs by concessional loans, early repayment of expensive commercial and short-term debt and fiscal consolidation. This strategy has been successfully implemented and the absolute stock of external debt and liabilities has, in fact, gone down from $38 billion to $35 billion. The ratio of external debt to GDP in 2004-05 is likely to be around 33-34 percent and is on a downward trajectory. Average interest rate on the stock of debt has more than halved and external interest payments as a proportion of foreign exchange receipts have gradually dwindled to less than 25 percent providing a breathing space and freeing the country from the undue pressures of crisis management.

5. **Deregulation:** in a number of areas such as petroleum, natural gas and agriculture inputs and outputs the prices and trade have been completely deregulated. Market forces determine the prices that are no longer controlled or administered by government decrees or regulations. Although the mindset of the administrators has not

changed and instances of petty harassment and extortions by these officials are rampant, the government policy has been quite clearly articulated. For example, the cotton farmers are free to export their produce without any taxes or duties if there is excess supply domestically and no permits or licences are required. Similarly, the spinners are at liberty to import cotton at the prevailing international prices without any duties or barriers if they believe that the domestic crop is short. Government no longer imports petroleum and petroleum products but the task has been assigned to the private sector. Nor are the fortnightly prices of local POL products determined by the Ministry of Petroleum but by the distributors themselves. Subsidies on fertilizers have been removed and most of the production, marketing and imports or exports are carried out by the private sector. The prices of end products rise and fall according to the dynamics of supply and demand. Trading Corporation of Pakistan does step in on occasions but its main task is to intervene in the market where shortages or excesses threaten orderly market conditions in essential commodities.

The most successful experience of deregulation has taken place in the telecom sector. The monopoly of the state owned PTCL has been broken and new licences have been issued for Local Loops, Long Distance and International Lines. Cellular telephone segment has shown highly impressive growth during the last few years and two new international investors have purchased licences through open auction. The subscriber base in cellular phone has jumped from 3 million to 7 million in the last one year and it is expected by 2005 the number will cross 15 million – an unprecedented feat.

6. **Privatization:** The Government has made it clear that it is not in the business of running enterprises and it is, therefore, divesting its interests in state owned enterprises by selling them to strategic

investors in the private sector. Most of the banks, industrial companies, etc. have already been transferred to the private sector. The shares of some utilities and infrastructure companies have been floated through stock exchanges. But now is the turn to sell large ticket items such as PTCL, PSO, Power distribution and generation companies, integrated power utility such as KESC. The calendar for future privatization is quite crowded and it is expected that most of these companies will be off the books of the government by the end of year 2005. The efficiency gains, tax revenues accruing to the government instead of subsidizing their losses, improved customer service and expansion through new investment are some of the direct and indirect benefits to the economy from privatization.

7. **Trade Liberalization:** Pakistan was known for its extremely high tariff rates that were used to raise government revenues and also to protect domestic industries. In the early 1990s the maximum tariff rate was more than 100 percent. These higher tariff walls, in fact, had highly pernicious effect as wide spread smuggling discouraged domestic production and promoted imported goods. Pakistan's tariff rates have been gradually brought down to the current maximum rate of 25 percent. The average tariff rate is as low as 13-14 percent and should be further lowered. Contrary to conventional wisdom the reduction in tax rates has not only ended smuggling of a large number of imported goods and stimulated domestic production, but has also raised custom duty collection. Lower tax rates and absence of discretionary measures by the customs officials have, in fact, created disincentives for tax evasion and helped accurate declaration and classification of imported goods. It is seldom realized that high tariffs act as a tax on exports that are not able to obtain the required imports and raw materials for meeting their production in a cost effective manner.

8. **Financial Sovereignty:** Pakistan had lost control on its economic management and thus virtually conceded the right to design policies to international financial institutions particularly the IMF. We had lost our credibility as a serious development partner because we entered into successive agreements and made commitments on policy reforms and institutional changes. But, we were good at drawing down the first tranche of the loan and then abandoning the programme. It is only since the year 2000 when Pakistan entered into a stand-by arrangement with the IMF (successfully completed in 2001) followed by a three-year PRGF programme that the country has shown serious mindedness and a commitment to fulfill its obligations. By the end of 2004 Pakistan had drawn down 12 tranches in succession on time without any hiatus and decided to forego the remaining two tranches voluntarily after the review was completed by the IMF Board. Pakistan has thus been able to regain its financial sovereignty and is no longer dependent on the whims and caprices of the international financial institutions or large bilateral creditor countries who control these institutions.

Sustainability of Reforms and Policies:

How can one be sure that these reforms and policies will be sustained in the coming years? To address this question, let us first look at the history of economic policies and reforms pursued by different political parties who come to power in the 1990s and at their party manifestos to gain some insight into the future direction of policies. The most comprehensive reforms aimed at liberalization, deregulation and privatization of the economy were initiated by the Nawaz Sharif Government in 1991 and institutionalized under the Protection of Economic Reforms Act 1992. These same policies were followed subsequently by Benazir Government, the second Nawaz Sharif Government, the Interim Governments, the Military Government of 1999-2002 and the Elected Governments since 2002. There has been uneven or slow implementation of these reforms , there has been economic mismanagement but, at no stage, these policies were rejected, derailed or abandoned. The Economic Reforms Act of 1992 is still in force after 12 years of its inception. The manifestos of all political parties subscribe to the same set of policies although their priorities, sequencing, phasing, points of emphasis are different and more nuanced. Thus, there should be little fear in the minds of anyone about the reversal of these reforms and policies by any future government in Pakistan.

There have been some irreversible changes that have set in the country's economic landscape that augur well from sustainability and continuity perspective. The Parliament is expected to pass a legislation called Fiscal Responsibility and Debt Limitation law which will limit fiscal deficit and target reduction in debt-ratios every year. As fiscal indiscipline has been the bane of Pakistan's economic problems in the past, this particular initiative will restrain the successive governments from indulging in reckless spending and excessive borrowing. The Country's Parliament rather than the IMF will act as the watchdog on the Government's finances and it will be difficult for any Government to deviate from this path unless there are cogent reasons to do so.

Fiscal transparency has also been entrenched as the Federal and Provincial Governments are obligated to publish audited quarterly statements of accounts. These statements are available to the public at large and can trigger questioning of fiscal policy decisions taken by the Government. The Auditor General is an independent and constitutional position who submits an annual report to the Public Accounts Committee (PAC) of the National Assembly on financial irregularities and the officials concerned are answerable to the PAC for their actions and decisions.

The Central Bank has been made autonomous and given constitutional protection. Its affairs are supervised and controlled by an independent Board of Directors consisting of nine eminent members of stature drawn mainly from the private sector and having only one representative from the Ministry of Finance. The Ministry's Representative does not enjoy any veto power and all decisions are taken by a majority vote. Neither the Governor nor the Board Members can be removed arbitrarily by the Federal Government. The State Bank of Pakistan (SBP) has acquired core competencies and technology to perform its functions and submits Quarterly and Annual Reports to the Parliament on the State of Economy regularly.

Similarly, the Securities and Exchange Commission of Pakistan (SECP) and the Central Board of Revenue (CBR) have been reformed, strengthened and made autonomous to promote corporate governance and tax mobilization respectively. These key economic institutions will thus carry out their obligatory functions in a professional manner insulated from the interference of the government.

The Nationalized Commercial Banks (NCBs) had acted as the main conduit for political favors in the financial sector. Most of the appointments of Chief Executives and the Boards of Directors were not made on considerations of merit and competence, but for their loyalty to the Prime Minister of the day. Consequently, most of the loans were approved to favour individuals and firms connected with the ruling party. This state of affairs had led to large accumulated losses, huge non performing loans and weak governance. As almost all the NCBs except one have been privatized, this linkage between the Government and the financial sector has been severed. Healthy competition among the banks has infused high standards of professionalism in the banks and the financial sector has become strong and efficient. It is unlikely that any future government will ever attempt to bring about status-quo ante and nationalize the banks.

Pakistan has entered international capital markets which will also be watching and monitoring the economy as the investors in Pakistani Bonds have developed stakes in economic well being of the country. Any wrong policy actions or poor governance will be severely and instantaneously penalized by the markets and Pakistan will have to bear the adverse consequences of this fall out. Governments will therefore have to be extremely careful and responsible in their management of the economy.

Pakistan has also entered into a multilateral trade agreement with the WTO and committed that it will keep its markets open to goods and services, liberalize trade regime, remove non tariff barriers and provide equal and non-discriminatory treatment to all countries. These commitments provide a solid assurance about the stability and transparency of trading regime in Pakistan in future.

Finally, the media – print, as well as, electronic – in Pakistan has emerged as a fierce and independent watchdog on the activities of the government. Poor economic governance was the other key factor responsible for Pakistan's weak economic and social outcomes in the 1990s but there is greater awareness today that we cannot afford to slip into the past mode. Any wrongdoing or malpractice is exposed by the media and thus helping spread of good governance in the country.

Outlook for the Future:

Pakistan's past economic history suggests that rapid economic growth has been associated with poverty reduction. Once GDP growth rate persists over 6 percent per annum over a long period of time the incidence of poverty begins to decline.

GDP growth rate is projected to rise to 7 percent in the current fiscal year with inflation rate hovering around 7 percent. The next five years plan envisages an average GDP growth of 7 percent reaching a level of 8 percent in 2010 and inflation contained to average 5 percent. With the population growth rate declining to 1.5 percent, this growth rate will translate into 6.5 percent rise in per capita incomes which should double at this rate in the next 10 to 11 years.

Empirical studies indicate that the best way to achieve higher rates of economic growth is to raise investment and to improve the quality of institutions. An increase in investment ratio by 5-6 percentage points over the next 5 years and improving the quality of institutions could result in the postulated increase in the per capita growth. What are the prospects for raising investment?

The successful implementation of Debt Management Strategy in the last five years has not only brought the debt burden down to sustainable levels in the future, but also reduced interest payment out of the budget significantly. The public sector investment programme that was constrained due to these high interest payments is now expanding. As a result, development expenditure will continue to rise – both in absolute terms and as a ratio of GDP – pushing up the overall investment rate for Pakistan. As the private sector is able to obtain the infrastructure services and the social services it needs, the cost of production will become lower for capacity expansion or investment in new areas of business. The recent experience suggests that investment rate will rise and productivity of investment will improve, making it possible to attain 6 to 7 percent GDP growth rates.

Pakistan has committed itself to bringing the incidence of poverty down to 16 percent by 2015 under the Millennium Development Goals (MDGs). Other MDGs for Pakistan are: (i) Literacy rate of 86 percent and Gross enrolment ratio of 100 percent; (ii) Ratio of literate females to males reaching 0.93; (iii) Infant mortality rate down to 40 with under five mentality to 52 and more than 90 percent of children fully immunized (iv) 100 percent coverage by lady health workers of target population (v) Sustainable access to safe water available to 93 percent of population with 55 percent having access to sanitation.

These goals have been incorporated in the Poverty Reduction Strategy Paper (PRSP) as well form part of the next five year plan. The achievement of per capita growth targets and Millennium development goals will very much depend upon political stability, sound leadership committed to growth and poverty reduction and to the extent the challenges facing us are tackled successfully by the government, private sector and the civil society together. These challenges though formidable are by no means insurmountable.

Challenges for the Future:

Despite the impressive studies made on several fronts in the recent past Pakistan has a number of challenges to reduce incidence of poverty to half its current level by 2015. This will require sustained GDP growth rates of 7 to 8 percent per annum, targeted poverty interventions and accelerated investment in human development. Some of these challenges are listed below:

1. **Diversification of Export Base:** Two thirds of Pakistani exports are based on Cotton textiles while in the world market textiles are not a dynamic commodity. Technological base of Pakistani exports is low and the share of engineering goods is almost negligible. Not only the share of engineering goods in the world market is almost 50 percent but is rate of growth is above average. Thus the need for diversifying away from textiles to medium technology exports is quite obvious. Greater emphases on technical and vocational education as well as integration into world supply chains are critical for this diversification. Reliance on a single commodity based exports is neither desirable nor beneficial in the long run and is prone to serious risks.

2. **Development of Human Resources:** It has been well established and there is a broad consensus that among all the factors that will make a difference to Pakistan's economic and social goals is the extent to which we are able to step up investment in human development. Indeed this is

the single most dominating factor that has kept the country below its potential. High population growth has given rise to a young dependent population and increased unemployment among the youth. The average years of schooling of labor force (3¼ years) remains quite low making it difficult to impart new skills to the burgeoning labour force. Raising this by 1½ - 2 years could have raised real per capita economic growth rate by about ½ percentage points per year. Investment in higher education, science and research, vocational and technical education, female education thus should be the highest priority for the next ten years. This can only be achieved if there is a strong public – private – community partnership in the governance and provisioning of education and health. Investing in human development through better education and health care benefits the poor directly but these should be well targeted.

3. **Investment in infrastructure:** Higher economic growth rates can be sustained on a long term time horizon only if the bottlenecks, shortages, disruptions and breakdown in supplies, in power, gas, oil pipelines, ports, railways, and congestion in roads and highways are removed. This requires huge investment in each of these areas. Public Sector development program can finance only one half of the annual requirements of US $ 3 billion. The remaining requirements will have to be filled in by the private sector.

4. **Regional Hub:** Another reason for large investment in physical infrastructure is to exploit the potential of Pakistan's strategic location as a regional hub for the Middle East, Central Asia and Western China and South Asia. Gwadar port is being developed to take advantage of this potential but developing a network of highways, warehouses and terminals, oil and gas pipelines, power generation plants, facilitation of cross – border trade, harmonization of tariffs and duties are some of the ingredients that will pave the way for meeting this objective. Peaceful

relations with the neighboring countries and greater cooperation in areas of trade and transit will lay the solid foundations.

5. **Productivity Increase in Agriculture and Industry:** Compared to the countries in East Asia and China that should serve as the benchmark for Pakistan's competitiveness we lag behind in total factor productivity as well as productivity gains in commodity producing sectors. Although the yields per hectare of major crops have risen over time these are still lower than those in Indian Punjab and Haryana. Except for export industries the productivity levels in manufacturing are sub optimal. On-the-job training and injection of new skilled workers are some of the short term measures that can help but in the long term, emphasis on technical and vocational education rather then producing graduates with generalized education will yield the desired results.

6. **Judicial and Legal Reforms:** It is believed that the financial sector and real sector of the economy will benefit immensely if land titles were clear, coded, actively traded, mortgaged and exchanged without much hassle; if the court system is unclogged and the enforcement of contracts is much quicker with low transaction costs and if the poor have equal access to the Police and the judiciary for redressing wrongs done to them. In Pakistan, the slow and cumbersome legal system combined with unequal access to the poor to the system have to be put right both for efficiency gains as well as for attaining a just and equitable distribution.

7. **Widening the Tax Base:** The tax administration that has been practised in Pakistan has deployed indirect means, presumptive assessment and compulsory withholding taxes to collect most of the taxes. This system has not only kept the tax – GDP ratio stagnant but also restricted the growth of tax base and tax payers. The recent reforms of the Central Board of Revenue give some hope that tax base will be widened so that

tax – GDP ratio can rise and a more equitable incidence of burden takes place. A natural corollary of this widening of tax base is that the tax rates particularly for individual income tax and corporate tax can be reduced gradually and thus discourage the incentives to evade taxes. Tax collection in Pakistan has been much higher when the rates are low supporting the supply side hypothesis.

Risks to the Future Outlook

Several observers of Pakistan economy appear to be overly obsessed with the political risk arguing that the country may end up with a situation in which the Islamic extremist parties or their sympathizers in the Army wrest control over the country's nuclear arms. The victory of the MMA in the NWFP and Balochistan and their apparent anti-American stance have fortified the beliefs of these observers mostly in the western think tanks and the media. Both the main components of the Alliance – Jamaat-e-Islami and Jamiat Ulema Islam – have no history or links with religious extremist groups who have created violence in the country. This risk is also highly exaggerated as more than 88 percent of Pakistani population voted for the mainstream moderate political parties at the most recent elections. Pakistan Army is a highly disciplined, organized and modern force and the support for the extremist parties in the ranks of Army is almost non-existent. These western observers have very little familiarity with the strength and resilience of Pakistan's polity. Pakistan's nuclear assets will remain safe as country has developed an effective command and control system.

The geopolitical risks facing Pakistan have also been mitigated as a composite dialogue has been opened with India and the relations with the Karzai government in Afghanistan have been normalized and strengthened. The first democratic elections in Afghanistan took place peacefully reflecting the cooperation and support of Pakistan government. The intensity in exchange of people, cultural troupes, sporting teams, media representatives between India and Pakistan has brought about a new atmosphere of harmony and goodwill in the two countries.

Although the political and geopolitical risks remain paramount in the minds of the western observes there are residual risks that can possibly slow down the trajectory of high economic growth and poverty reduction.

First, it is assumed above that the country will continue to face a benign external environment and will remain free from major upheavals and unanticipated exogenous shocks. In case the external environment becomes hostile or some other major internal disturbance takes place, it is unlikely that the high growth momentum can be maintained.

Second, the implementation capacity and weakness of institutions are still major obstacles. The need to inculcate professionalism, expertise, competence and systems to make the civil services meet the realities of the 21st century is being met through reforms but will take some time. In the meanwhile, the nature of the government has dramatically changed; public expectations have heightened while implementation capacity of government policies, programs and projects as well as the delivery of public services has been seriously impaired. Sound policies can see the light of day only if the institutional capacity is strengthened and reoriented. Public-private-community partnership provides a way forward to mitigate this risk. The reform of civil service is on the agenda but needs to be expedited.

Third, the legal and judicial system is out-of-sync with the requirements of modern business practices. Contract enforcement, sanctity of property rights and dispute resolution mechanisms leave much to be desired. Congestion of courts, cumbersome and time-consuming procedures, inadequate training of judges in commercial and banking laws and physical infrastructure facilities are some of the constraints for the present state of affairs. Reforms of laws and judiciary have to be given priority attention by political leaders. The Asian Development Bank (ADB) is assisting the government through its Access to Justice programme.

Fourth, the most important missing link in Pakistan's competitive edge and what is posing as a serious threat to its economic progress are the poor indicators of human development. Adult literacy and the skill level of the labour force are low, health status is precarious with low productivity, high absenteeism and gender disparities are large. The country has to devote more attention and resources to invest in education, health, nutrition and gender programmes to equip the labour force to excel in its area of specialization.

Finally, Pakistan has embarked on a program to devolve administrative functional and financial powers to local tiers of government. This experiment is extremely critical for providing essential public services at the doorsteps of the poor people. The teething problems and legal snags confronting the local governments if unresolved, could create a potential difficulty in reaching out to the poor.

These risks, except those arising out of adverse or unanticipated exogenous shocks, can be mitigated through a series of reforms. Institutional capacity can be strengthened, judicial and legal processes can be revamped, human development can be accelerated and devolution of powers can be expedited. The balance of risks therefore suggests that given a benign global economy and domestic political stability, Pakistan can move forward in its march towards meeting its economic and social goals.