NATIONAL ECONOMY AND IMPACT OF FOREIGN AID

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OUTLINE:

I. Types and Forms of Aid/Loans

II. Role of Donor Agencies and their Conditionalities

III. Impact of Foreign Aid on National Economic Policy

IV. Current state of the Economic Policy

V. Prospects and Challenges

I. TYPES AND FORMS OF AID/LOANS

Foreign economic assistance broadly falls under the following two categories:

A) Foreign grants
B) Foreign loans and credits

A) Foreign Grants:

Foreign grants provided by the donor countries/agencies comprise the following:

i) **Project Assistance -** covers the cost of machinery and equipment for projects.

ii) **Commodity Assistance -** represents imports of industrial raw material and essential consumer goods.

iii) **Technical Assistance -** includes Experts/Advisory Services, training facilities abroad and Supply of equipment for purposes of training and demonstration.

iv) **Other Grants -** such as Relief Aid, foreign aid received in cash.

B) External Debt:

External Debt can broadly be viewed from three angles:

a) By Borrower Type

i) Central Borrowing – Loans contracted by the government.

[1] Lecture delivered at No. 18 Air War Course at PAF Air War College, Karachi on May 20, 2005

ii) Guaranteed Loans – Loans contracted by the regional/provincial governments; autonomous bodies/corporations; financial institutions, credit agencies and industrial concerns etc. in the private sector guaranteed by the government.
iii) Private Non-Guaranteed – external obligation of a private debtor.

b) By Utilization:

i) Project loans - to finance the cost of machinery, equipment and technical services for a specific project.
ii) Non-project commodity loans or program loans - to finance imports of industrial raw material and essential consumer goods and are always contracted by the national government.

c) By Creditor Type

i) Official Creditors – includes multilateral (World Bank, ADB, IDB etc.) and bilateral loans (including governments and their agencies). This is also termed as Capital Aid or Official Development Assistance (ODA). These cover the cost of capital goods, machinery and equipment for the projects.
ii) Private Creditors – it mainly includes Suppliers' credits from manufacturers, exporters, or other suppliers of goods; loans extended by private banks and other private financial institutions.

II. ROLE OF DONOR AGENCIES AND THE CONDITIONALITIES IMPOSED BY THEM/INFLUENCE OF AID ON ECONOMIC POLICY

There are three leading multilateral agencies viz. IMF, World Bank and the ADB that provide loans and credit on soft and hard terms. The core function of IMF is to provide support to countries facing acute imbalances between their external payments and receipts. The World Bank or the ADB, unlike the IMF, are development banks dedicated purely for poverty reduction and improving the living standards of people. Nevertheless, all the three institutions pursue a common objective of promoting economic growth and reduce unemployment.

For Pakistan all the three agencies have contributed significantly in providing assistance and almost 50 percent of our external debt is owed to these to these institutions.

a) International Monetary Fund (IMF):

The IMF was established in 1945 to promote international monetary co-operation, facilitate the expansion and balanced growth in international trade, promote exchange rate stability and orderly exchange arrangements among members, assist in the establishment of a multilateral system of payments in respect of current transactions, give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, etc. The Fund provides financial resources to its members to overcome temporary balance of payments difficulties through a variety of facilities and policies, which differ mainly in the type of BOP need they address and in the degree of conditionality attached to them.

IMF and its Conditionalities:

- The primary objective of conditionalities in an IMF program is to restrain budget deficit and reserve money growth to address the macroeconomic imbalances faced by a country.

- The guidelines attached by the IMF with its credit programs generally include: *adopting policies of fiscal and budgetary austerity; exchange rate devaluation; "getting the prices right", stimulating investment instead of consumption; cuts in real wages; cuts in public expenditure; prioritizing external debt service; and import liberalization*. Indebted states are required to comply with these guidelines in return for balance of payments assistance.

- IMFs conditionalities are criticized for a number of reasons among which are:
    - imposing too many conditions on debtor countries in a time frame that is not always realistic.
    - The robustness of assumptions on which conditionalities are based is questionable.
    - Imposition of a large number of conditionalities that do not conform to the political economy conditions of the borrowing country generally results in higher probability of failure, deviations and slippages.

- The IMF has been the target of criticism for a number of years and it was heavily criticized in the wake of the 1997-98 financial crises for failing to predict these crises and its ensuing crisis management in the Asian countries.

- In case of Pakistan, it had to take a dozen prior actions, fulfil 30 performance criteria and structural benchmarks over a 15-month period in 2000-2001.

- The measurement of actual outcomes of conditionalities is quite difficult and problematic because of the role of exogenous variables.

<u>Pakistan and the IMF:</u>

- Pakistan entered into nine different Agreements with the IMF during the period 1988-2000. There are one programs (SBA: Nov. 2000 to Sep. 2001) and the PRGF (Dec. 2001 to 2004), which were fully implemented. Although in the case of PRGF the Government chose not to draw down the last two tranches to which they were entitled.

- Pakistan did not accept the last of the 12 tranche PRGF program and seek any successor arrangement. The program was discontinued by the Government of Pakistan given the strong state of the economy and the foreign exchange reserves.

- The major factors which contributed towards the motivation of obtaining loans from IMF included: need to obtain financial resources for BoP problem, secure access of funds from other IFIs and bilateral donors, to get debt relief and rescheduling in the post 1998 period.

- During the period 1988-2000, the prolonged uses of Fund resources in Pakistan can be characterized as less successful in achieving the desired objectives. One of the major reasons was that the successive governments used foreign resources to fix the external payment imbalances but they did not adopt complementary policy reform.

Macroeconomic management was not prudent which resulted in high external debts and debt servicing problems.

- After 2000, the Stand-by Arrangement (SBA) was fully implemented and its progress on the poverty reduction has also been on track. This was mainly because of the concordance between ownership and conditionality as the agenda designed by the Government has the right mix of policy actions which can be reinforced and strengthened by conditionality of the IMF.

b) <u>International Bank for Reconstruction & Development (IBRD):</u>

The IBRD was established in 1945. Initially, it was devoted to post-war reconstruction in Europe and afterwards its aim has been to assist the economic development of member nations by making loans where private capital is not available on reasonable terms. In 1980, the Bank introduced an element of structural adjustment lending, which supports programs and changes necessary to modify the structure of an economy so that it can restore or maintain its growth. Subsequently, it enhanced efforts to alleviate poverty, mitigate the social effects of economic adjustment programs, promote productive employment, and provides the poor greater access to health care, education and physical infrastructure, environmentally sustainable development and to improve conditions of women.

<u>The World Bank's Role in Pakistan:</u>

- The World Bank has played an important and essential role in the development process of Pakistan particularly in modifying the structure of the economy to restore growth through the structural adjustment-lending program introduced in 1980.

- The Bank Group's assistance strategy focuses intently on supporting the government's development strategy and is organized around three mutually reinforcing pillars which are: Strengthening Macroeconomic Stability and Government Effectiveness, Strengthening and Enabling the Investment Climate and Supporting Pro-poor and Pro-gender Equity Policies.

- The Bank has contributed to alleviate poverty, mitigate the social effects of economic adjustment programs, and provides the poor greater access to health care, education and physical infrastructure, environmentally sustainable development and to improve conditions of women in Pakistan.

- The government of Pakistan has shown a strong commitment to reducing poverty and is receiving support from the World Bank through around US$ 1.2 billion in financing for 18 active projects and, over the past five years, an additional US$ 1.5 billion in adjustment lending to strengthen the government's broader reform programs.

- The Country Assistance Strategy (CAS), endorsed by the Bank in 2002, was designed to support Pakistan's reform program, which aimed at engendering growth, reforming governance, creating income-generating opportunities, and improving human development.

- The World Bank is the main financer of Pakistan's Poverty Alleviation Fund, which provides assistance to poor communities throughout the country. The Fund has been working with nearly 40 local organizations and has extended micro-credit loans to more than 275 thousand borrowers, of which 45 percent are women.

- Recently, Pakistan has sought additional soft-term loan facility from the World Bank for its infrastructure development and poverty alleviation efforts through a long-term development partnership to transform the country and facilitate second generation reforms.

c) Asian Development Bank (ADB):

The ADB, functioning since December, 1966, has been engaged in promoting the economic and social progress of its developing member countries in the Asia-Pacific region. The Bank's principal functions are: (i) to make loans and equity investments for the economic and social advancement of developing member countries, (ii) provide technical assistance for the preparation and execution of development projects and advisory services, (iii) promote investment of public and private capital for development purposes, and (iv) respond to requests for assistance in coordinating development policies and plans of member countries. The Bank's operations cover the entire spectrum of economic development, with particular emphasis on agriculture, energy, capital market development, transport & communications and social infrastructure.

ADBs Role in Pakistan:

- ADB in Pakistan is presently undertaking various initiatives to promote social protection and social safety mechanisms, capital market reforms, reforms at the Provincial level, support for Devolution, etc.

- Eleven loans totaling US$870.7 million were approved in 2003 to (i) implement a public sector reform program in the province of Punjab, (ii) develop the road sector network in Balochistan, (iii) enhance social service provision in Sindh, (iv) reform the regulatory structure for small and medium enterprises, and (v) develop basic urban services in Southern Punjab. Twenty technical assistance projects totaling US$10.0 million, including co-financed grants, were also approved.

- Cumulative ADB lending to Pakistan as of 31 December 2003 was US$13.55 billion in the form of 213 public sector loans. Of this amount, $6.4 billion was from the concessional Asian Development Fund (ADF) and $6.8 billion from Ordinary Capital Resources (OCR).

- The ADB public-private infrastructure finance (PPIF) project is the first major effort of any institution to help accelerate infrastructure development through increased private sector participation in infrastructure development in Pakistan.

III. IMPACT OF FOREIGN AID ON THE NATIONAL ECONOMIC POLICY:

- Let us examine the facts about foreign aid and its importance in Pakistan's economy and particularly the widely held impression that we got a big bonanza after September 11, 2001. As I explained, foreign aid consists of loans and grants. Table I shows the picture about net resource flows and net transfers from all official sources – bilateral and multilateral. You can notice that the net flows as percentage of gross national income have gradually declined from 4.3% in 1970 to 1.5% in 2003 and net transfers from 3.6% to 0.7%. The deduction from this evidence is quite obvious – Pakistan's dependence on foreign aid is so low and insignificant that it won't make much of a difference to our national economy.

- The popular myth that the economic turnaround in Pakistan can be attributed to September 11, 2001 events can be exploded by looking at the net flows and net transfers for 2002 and 2003. For both these years they have actually declined as proportion of national income compared to 1999.

- Looking at external debt and debt servicing, it can be seen that there was a big jump between 1990 and 1999 and 2003. In terms of external debt indicators the burden has actually fallen in the last four years. The ratio for 2004 is even much lower.

- Similarly, there has been a big drop in the debt servicing as the country has to pay only 16 percent of export receipts as debt servicing compared to almost 29 percent in 1999. Foreign reserves which in actual fact demonstrate the strength of a country's capacity to manage its external payments now account for almost one third of the total external debt and liabilities. Four years ago this ratio was so precarious that we were not in a position to meet all our obligations. This strength has actually allowed us to say good bye to the IMF and regain our economic sovereignty.

IV. <u>CURRENT STATE OF PAKISTAN'S ECONOMY:</u>

- At the time of 1998-99 crises, Pakistan was facing multidimensional challenges which included: restoring investors' confidence, reinvigorating growth, restoring macroeconomic stability, serious external payments crisis threatening imminent default, reducing poverty, improving social indicators and improving governance.

- Since 1998-99, Pakistan has traversed the road from a difficult default situation on its external payments to a vigilant program under the IMF and finally reestablished access to international capital markets. This was possible mainly because of structural reforms, which included: tax and tariff reforms, privatization, deregulation, financial sector reforms and high standards of economic governance.

- Pakistan's economy has gained more strength, underpinned by a buoyant private sector during the current fiscal year. Acceleration in growth accompanied by a sharp pick up in industrial production, a strong upsurge in investment, and a further strengthening of the external balance of payments have been the hallmarks of performance of Pakistan's economy in the current year.

- After a remarkably successful Euro bond issue in FY04, Pakistan re-entered the international capital markets with a US$600 million offering in January 2005 named as Sukuk bond. The bonds have a five-year maturity period, ending 2010. This Issue was the first offshore sovereign debt offering from Asia in 2005 and this floatation is the largest Islamic bond ever issued internationally.

  ⇒ To put Pakistan's name on the radar screen of the International capital market to enable international investors, credit rating agencies, and research analysts etc. to observe Pakistan's economic performance on a permanent basis and to test Pakistan's sovereignty in the financial global market, expand investor base, attracting the Islamic funds.
  ⇒ Pakistan selected Sukuk to capture funds from international capital market because globally, the demand for Islamic products and financial instruments is currently growing at 15 percent a year. The present, globally accumulated investment in Islamic instruments is estimated at $ 270 billion.

Significant Achievements:

⇒ **GDP** growth rate has exceeded 6 percent,
⇒ **Inflation** had remained under control for four out of five years,
⇒ **Fiscal deficit** has been reduced significantly,
⇒ **Public debt ratios** have declined,
⇒ **External debt burden** has been lowered,
⇒ **Exchange rate** has remained stable,
⇒ **Exports** have almost doubled,
⇒ **Tax revenues** are recording double digit growth,
⇒ **Interest rates** had never been at such low levels in the history,
⇒ **Remittances** of Pakistanis overseas have multiplied by a factor of four,
⇒ **Foreign exchange reserves** have expanded twelve times from their 1999 level.

Can these impressive achievements be sustained in the years to come? It would depend how we would be able to tackle the future challenges.

V. PROSPECTS AND CHALLENGES FOR THE FUTURE:

- At present there are two major challenges in the short and the long run – to fight inflation (short run) and to eradicate poverty (long run).

- While inflation recently touched the double digit level, the persistence on inflation at higher levels during FY05, could fuel the inflationary expectations. Major reasons for the current hike include: rise in aggregate demand due to an unprecedented rise in private sector credit the oil price spike and the food shortages.

- Another challenge in the short run, though not as worrisome as inflation, is the increasing trade deficit. The trade deficit is widening due to an unprecedented rise in imports due (i) higher trade deficit and (ii) increase in imports of machinery. The higher oil import bill due to higher international oil prices is a source of concern but is beyond our control. The higher machinery import, on the other hand, is still welcome as it is a reflection of the growing capacity of the economy.

Other Long Term Challenges Include:

- Investment in developing human resources, which is the single most dominating factor that has kept the country below its potential. Technical and vocational education should be given priority to produce the skills that are required by the economy.

- Investment in infrastructure: Higher growth rates for an extended period of time in the range of 7 to 8 percent annually are possible only if energy, water resources and infrastructure needs are fully met.

- Growth alone will not suffice to reduce the incidence of poverty. It has to be accompanied by poverty-targeted interventions and social safety nets.

- We need to diversify our export base and export markets to insulate from fluctuations and volatility especially in cotton and textile output and trade.

- Judicial and legal reforms: Institutions Civil Service, Judiciary and Police need to be restructured and their capacity strengthened because these key institutions affect a common man’s daily life.

- Widening the tax base: There is severe need to introduce tax reforms especially to widen the tax base in the country.

CONCLUSION:

- Although Pakistan has achieved major successes on the socio-economic front, the progress made so far is not commensurate with the country's considerable potential. Going forward, consistency and continuity of sound macroeconomic policies along with a credible reform program will be an absolute necessity to realize our full potential.

- The second-generation reforms aimed at strengthening the country’s institutions and their capacity to deliver basic services and investment in human development and infrastructure will be able to steer the country on the right course.

TABLE I

Net Official Development Assistance to Pakistan

US$ Million

	1970	1980	1990	1999	2001	2002	2003
Net Flows	433	1,021	1,228	1,071	1,622	1,066	1,247
Net Transfers	369	819	778	263	525	511	596
Net Flows/Gross National Income	4.3	4.0	2.9	1.5	1.7	1.5	1.5
Net Transfers/Gross National Income	3.6	3.2	1.9	0.4	0.8	0.7	0.7

Source: World Bank

TABLE II

Pakistan's External Debt and Debt Service

US$ Million

	1970	1980	1990	1999	2000	2001	2002	2003
Total External Debt	3,407	9,931	20,663	33,891	32,779	31,704	33,672	36,342
Total Debt Service Paid	259	869	1,902	2,935	2,854	2,996	2,850	3,028
External Debt/Gross National Income	33.6	38.8	49.5	54.3	45.9	45.7	48.7	45.4
Debt Service/Exports	33.6	16.2	21.3	28.9	25.2	24.6	17.9	16.0
Reserves/External Debt	5.7	15.8	5.1	6.2	6.4	13.3	26.1	32.5

Source: World Bank