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Pakistan's Economic Challenges: Lessons from Other Country Experiences

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1. Introduction

Pakistan is not a unique case. A number of countries have encountered broadly similar economic challenges, implemented appropriate policies, and have restored self-sustaining rapid growth with internal and external stability over the medium term. Notwithstanding the debilitating impact of the recent floods, there is no reason why – if appropriate policies are implemented – Pakistan cannot get out of the current economic malaise and resume sustainable growth without excessive dependence on external handouts. After wasting valuable time in 2007-08, the Pakistani authorities have struggled to develop a coherent adjustment program; policy implementation has also remained inadequate. Critical differences between Pakistan and countries that have recently adjusted successfully – such as Chile, Brazil and Turkey – lies in Pakistan's inability to grasp the seriousness of the economic crisis and lack of commitment to the needed policy reform, that is, poor governance. It would be instructive to know as to what drove other countries– notwithstanding their political constraints – to improve governance and steadfastly implement difficult, but necessary, policy reforms and, thus, determine what Pakistan can learn from their experience to improve governance.

Considerable work has already been done to trace factors behind the current economic malaise in Pakistan. After briefly reviewing factors that led the economy to the current sorry state (next section), this note will focus on the experience of selected countries (Chile, Brazil, and Turkey) in formulating and implementing policy reforms (Section 3), and – based on the experience of the three countries – draw possible recommendations for improving reform implementation in Pakistan (Section 4).

2. Pakistan: Current status

The deterioration of Pakistan's economy over the past three years can be attributed to the continuation of inappropriate macroeconomic policies of the past five years that focused on credit-financed consumption demand and imports to promote growth as external resource pressures were eased by debt relief and increased

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foreign aid. The external current account deficit started to widen as export growth slowed on account of the inappropriate exchange rate and poor competitiveness, while dependence on uncertain external capital inflows grew. Concurrently, private sector investment stagnated while public sector investment was not adequately focused on addressing the looming shortages of infrastructure – particularly electricity and water – and improving competitiveness. Fiscal deficits started to widen and, given the overly expansionary monetary policy, inflation picked up briskly. External indebtedness increased while domestic public debt mounted in the face of limited domestic resource mobilization by the government. The deteriorating economic situation was worsened by the sharp increase in the world oil prices in 2007/08 and decline in external demand following the global financial crisis.

In the event, growth fell in 2007/08 to about 4 percent from an average of over 6 percent during the previous four years, the budget deficit shot up to over 7 percent of GDP, money supply increased sharply on account of borrowing from the SBP to finance the budget deficit, resulting in a doubling of the inflation rate. Savings fell to the all time low of less than 14 percent of GDP, and despite a modest fall in investment, the external current account deficit rose to an unsustainable level of over 8 percent of GDP as imports continued to rise. The exchange rate came under pressure and external reserves fell precipitously. The new government failed to grasp the deteriorating economic situation and it was not until late 2008 that a credible attempt was made to address it through a program supported by a standby arrangement with the IMF. Implementation under the program remains inadequate, which reflects deteriorating governance. The recent unprecedented floods have worsened the economic outlook and need for domestic adjustment has increased as external financing capacity has shrunk.

Pakistan is encountering two inter-related problems: (a) macroeconomic imbalances and inflationary pressures which reflect an expansionary and dysfunctional fiscal policy supported by a compliant monetary policy; and (b) low domestic savings which, given the increasing strains on external debt sustainability and a poor outlook for private capital inflows, are inadequate to sustain investment that is needed for a higher growth rate. Even if energy shortages were to be addressed and the fiscal position is less onerous than at present, there is a high risk that the economy may permanently fall below the potential growth path, estimated at about 6-7 percent per annum. The obvious fallout would be increased unemployment pressures which, in turn, will spur political instability and militancy. The viscous circle would grow more intractable.

A new strategy is needed that will not only change the sources of growth but also alter the mode of implementing policies. The economy should be rebalanced toward higher investment and exports and away from consumption, particularly of the public sector. This will call for not only correcting the macroeconomic imbalances, but – more importantly – significantly increasing domestic savings in a sustainable fashion, reducing dependence on uncertain and addictive foreign assistance (which appear to have had perversely negative effects on domestic savings), and shifting investment to export-oriented activities.

There is also an increasing recognition that the deteriorating official capacity to formulate and implement policy reforms – worsening governance – has become a primary impediment which is building on itself. Above all, there is no convergence among the interests of the ruling elites, leading to a lack of national consensus and, thus, policy gridlock. Inaction has continued to build upon itself, fueling corruption, and progressively reducing the effectiveness of policy responses. The current adjustment program that is supported by an IMF stand-by arrangement is essentially tentative and needs to be better integrated with a longer term growth strategy.

3. Other country experience

The three country cases examined below are aimed at developing common threads in their successful transition from economic instability and low growth to self-sustaining growth with internal and external stability in a globalized world economy. Adjustment programs are summarized and factors underlying their effective implementation, such as institutions, and unquantifiable elements including cultural and political characteristics – the so-called X-Factors – are reviewed to draw conclusions. The choice of these countries is deliberately based on the fact that, even though they had broadly similar problems – domestic and external disequilibria leading to slower growth and external unsustainability – factors underlying these imbalances were different.

Chile

As noted by Massad (2003), the widespread disenchantment of Chilean people with policies and outcomes in much of the latter part of the twentieth century set the stage for a major shift in policies in the last two decades of the century. It was the institutional factors that allowed the authorities to sustain good policies over a long and particularly difficult period for Chile and many of its neighbors.

The core of the changed policy stance was the combination of fiscal discipline under a tight monetary policy and an open trade policy regime, coupled with carefully sequenced financial liberalization, and a deepening of the domestic capital market within a strengthened regulatory framework (Kaltor et al., 2004) These policies have been sustained, notwithstanding the opposing domestic and external forces, because of carefully designed institutional arrangements that encouraged policies to be oriented toward long-term success, and shielding policymakers from temptations to look for narrow and short-term gains at the potential cost of long-term stability. In the event, the chosen policy framework has protected Chile’s economy from the negative impact of speculative capital flows that accompanied financial globalization for many other emerging economies, including Pakistan. It is for this reason that the country was little affected by the financial crises that hit the region over the past decade and the global financial meltdown of the past two years.

Design of the reform program

Notwithstanding important institutional reforms over the past two decades, the Chilean economy encountered a serious recession in 1989-90. The external current account deficit widened in response to surging aggregate domestic demand, a drop in copper prices, and a depreciating Peso. These factors, combined with turbulent global financial markets, weakened investor confidence in Chile. Real GDP contracted, inflation picked up, and unemployment rose dramatically. Although official external debt remained low, total external debt rose to over 50 percent in 1999. Budgetary deficit rose by more than 50 percent to above 4 percent of GDP.

In response, the authorities implemented major macroeconomic policy reforms under a program that switched from adjustable peg to a freely floating Peso, instituted strict inflation targeting, progressively removed capital account controls, and introduced measures to further develop domestic financial markets. More importantly, the authorities introduced a rule-based fiscal balance approach: the program targeted a structural fiscal surplus equal to one percent of GDP on an annual basis for the entire six-year tenure of the government in order to contain monetary expansion and provide signals to the market of policy continuity. A new law on tax evasion and tax avoidance was implemented to reinforce the structural budget target. Finally, prohibition of Central Bank lending to the government – at all levels, including to state enterprises – remained in place and fully enforced.

The program was fully implemented and, within two years, the economy recovered along a sustainable growth path with low inflation and broad external equilibrium. So much so that Chile has successfully confronted the current global financial meltdown; growth rate has remained high and the financial sector continues to be robust.

Institutional developments and reform implementation

Institutional arrangements were set to create a more certain macroeconomic environment. Sound economic policies were carried out within an incentive-based institutional framework to avoid their reversal when they became inconvenient or costly in the short run (Kaltor et al., 2004). Inter alia, institutional arrangements reduced the incentives problem that have elsewhere – as in Pakistan – led to a chronic lack of fiscal discipline, complex and distorted trade policies, and runaway moral hazard in the financial system.

Areas in which institutions played a central role in Chile in facilitating implementation of the adjustment program included fiscal policy discipline, mechanisms to maintain price stability, structural reforms to promote financial stability, and an open trade policy regime. Pre-existing constitution and political framework were crucial in setting up institutional barriers to policy indiscipline, thus, promoting favorable decision making by the public and private sectors. Below, the focus is primarily on fiscal discipline and price stability (for details of measures in other areas, see, Kaltor et al., 2004).

The Chilean institutions have been effective in circumventing the two commonly encountered problems with respect to fiscal discipline: (a) the common pool problem – lack of centralized budget decision-making which allows particular groups to lobby for public sector actions to their own benefit without internalizing the associated costs and (b) inter-temporal problems such as time insistency issues and the resulting "deficit bias" and the so-called myopia of policy makers without adequate incentives to be concerned about the future implications of their decisions.

The problem of fiscal indiscipline by sub-national governments was kept to the minimum by the constitutional prohibition on such governments from borrowing. At the same time, the central government sought to tie its own hands under the annual budget law: borrowing by the government was made subject to congressional approval and public sector borrowing from the Central Bank was prohibited. The Central Bank independence insulated it from pressures. At the same time, the constitution and the budget process provided greater discretion to the executive over the legislature with respect to the budget. Combined with the structural fiscal balance target, these institutional measures facilitated tight fiscal policy implementation.

Price stability and containment of inflation was primarily enforced by Central Bank independence with a clear mandate to promote price stability; fiscal discipline also played a key role in stabilization of prices. Inflation targeting became the primary instrument for not only price stability but also the foundation for monetary policy. It also anchored inflation expectations which, in turn, facilitated price stability. The inflation-targeting framework in Chile has evolved to consist of: (a) pre-specified continuous inflation target band; (b) a pre-announced "policy horizon"; and (c) timely communication of the authorities' inflation forecast, the rationale for their policy decisions, and the reasons for any temporary deviations from the inflation target. The constitution specifically prohibits the Central Bank from granting guarantees or acquiring documents issued by the state, its agencies, or companies. There is sufficient evidence that Central Bank independence, in turn, reinforced fiscal discipline.

X-Factors in reform implementation

Chile, in particular, benefited from "ground realities" that reinforced institutions in effective implementation of the reform program. First, the authorities took advantage of the historic disenchantment of people with past government failures to take difficult decision to develop a solid foundation for the future. Second, the evolving political culture resisted temptations for short-term gain over longer term sustainability, thus allowing policy reforms sufficient time to bear durable results. Third, political framework encouraged the development of institutions or – at least--did not stand in the way of their development. Fourth, the need to take advantage of the expanding global economy allowed for consensus building among disparate interest groups. Fifth, technical expertise and benevolence of policy makers played a central role in sustaining focus on appropriate policies through hard times, including distrust by neighbors and global institutions. Finally, strong leadership at the helm – initially dictatorial, followed by democratically elected leaders-- protected technical reformers, which helped develop a longer term vision rather than short-term gimmicks.

It is noteworthy that these reforms were carried out without an arrangement with the IMF or with any other multilateral agency.

Brazil

Brazil's case is quite different from that of Chile. Since 1980, Brazil has been characterized by low savings/GDP ratio and a high external current account deficit, with growth being funded essentially by private capital inflows. Domestic demand grew sharply and annual inflation exceeded 100 percent during 1980-94. A series of abortive macroeconomic programs failed spectacularly. Indexation became pervasive which allowed the financial and the corporate sectors to continue functioning in the short run (Cardoso, 2004). The exchange rate was kept competitive, thus allowing export growth. Little efforts were made at structural reforms to raise domestic savings, reduce fiscal imbalances, and eliminate inflation psychosis.

In 1994, the “Real Plan” was introduced. Under this Plan, fiscal containment was combined with monetary reforms and the use of exchange rate as a nominal anchor. Current expenditures were cut, provincial and other sub-national governments’ access to credit was drastically curtailed. All prices, wages, and exchange rate were linked to an escalator, and a new currency was introduced. Inflation fell sharply, and growth picked up. However, real wages and real interest rates rose sharply with the fall in inflation. Fiscal deficits reappeared, including quasi-fiscal deficits of sub-national governments. Banks’ balance sheets weakened owing to bad loans to sub-national governments, and total public debt rose sharply. The Real Plan’s strategy to contain inflation by using monetary and exchange rate policies further reduced domestic savings and created unsustainable current account deficits. Given the high real interest rates, speculative capital inflows led to currency appreciation which clouded the authorities’ perception of the maturing crisis. The dramatic worsening of the international financial environment in 1997-98(Asian and Russian crises) brought the capital account under pressure. There was a loss of confidence in maintaining the exchange rate anchor which led to dollarization; the Real collapsed, growth came to a halt with rising unemployment, and inflation resurged with mounting external current account deficits.

Moment of truth was reached but domestic political imperatives – presidential and congressional elections – delayed response until the end of 1998. A new comprehensive reform program – supported by the IMF, World Bank, Inter-American Bank, and the US was initiated by the new government at end 1998 to replace the Real Plan.

Design of the reform program

Unlike Chile, Brazil followed a flexible approach to the development of the adjustment program. It was revised several times in response to changing challenges and to ensure that long-standing structural deficiencies were addressed in an environment of social tensions. Given the uncertain and inhospitable external financial environment at the end of the 1990s, the program aimed to raise national savings to finance the additional investments needed to increase productivity, competitiveness, and employment opportunities. Inflation was to be reduced drastically, while the external current account deficit was to be reduced to levels that would be consistent with a broadly unchanged external debt/GDP ratio and about half of it financed by foreign direct investment. Initially, the primary focus was on tight fiscal and monetary policies while the maintenance of the existing exchange rate was supposed to contribute to keeping the rate of inflation consistent with Brazil's trading partners.

The primary focus was on a substantially front-loaded fiscal adjustment, targeting a rising surplus in the primary balance of the consolidated public sector over the next three years. A comprehensive set of expenditure-reducing and revenue-raising measures equal to 3 percent of GDP in 1999 were envisaged at the federal level alone. Revenue measures included the introduction of a nationwide value added and other indirect taxes were to be rationalized. The ongoing privatization and dismantling of state monopolies was to contribute to revenues while improving competitiveness. It was understood that any potential negative impact of a policy action on the budget will have to be made up by additional measures elsewhere so as to remain on the adjustment path. The states and municipalities were to contribute to the overall fiscal target by ensuring primary budget surpluses and restructuring their debts. Finally, a progressive lengthening of maturities of domestic public debt was undertaken to reduce gross refinancing requirements.

Initially, monetary policy was aimed at maintaining the existing appreciated exchange rate so as to keep inflation low. For this purpose, the Central Bank was to continue using the policy of continuously increasing interest rate to support the "Real" while safeguarding foreign exchange reserves. It was expected that as adjustment restored confidence, interest rates would decline.

The maintenance of high interest rates to sustain an appreciated "Real" negatively affected growth, the budget, and exports. In the event, the initial strategy did not work and market pressures continued to build, growth did not pick up and unemployment rose. External reserves fell, and the authorities had to abandon targeting exchange rate. The "Real" was allowed to float and depreciated significantly, improving the external position. Concurrently, monetary policy was directed to inflation targeting, thus allowing flexibility of interest rates.

To address inadequate budget correction, a Fiscal Responsibility Law was introduced to enforce fiscal discipline and eliminate the capacity of sub-national governments to negatively impact fiscal target. The Law set limits on federal, state, and municipal governments' debt stock, borrowing authority, and personnel expenditures. Specifically, gross borrowing could not exceed capital expenditures of the government. The federal government was banned from bailing out debt-redden states.

The design of the program had to be revised once again in 2001 in response to the deterioration in the external environment and domestic energy shocks as supply of electricity shrank – not unlike in Pakistan. A new stand-by arrangement was agreed with the IMF. The monetary program was tightened further, fiscal restraints were intensified, and a National Energy Program was introduced to curtail demand and investment was increased to raise electricity supply, while regulatory framework in the electricity sector was revamped. Finally, privatization of federalized state banks became part of the reform strategy.

Steady implementation of the revamped adjustment program through 2005 led to a restoration of growth; external vulnerabilities fell, public sector debt declined steadily, and its composition improved; the primary budget surplus exceeded the target; financial market's confidence increased; inflation was contained at less than 7 percent; the external current account surplus rose to about 2 percent of GDP; external debt fell by about 10 percentage points to about 34 percent of GDP; and sovereign debt spreads narrowed dramatically. Reflecting strong economic recovery, Brazil's declining vulnerabilities, and a benign external environment, financial conditions turned out to be the best by 2005 in several decades.

Institutional factors in reform implementation

The adoption of inflation targeting led to the independence of the Central Bank, thus, allowing for rigorous adherence to a clearly defined and effective monetary policy (which facilitated the use of interest rate for growth) and a floating exchange rate – two most critical elements of the adjustment program. This led to the development of technical capacity in the Central Bank to implement inflation targeting and the development of models of the transmission mechanisms of monetary policy (Blejer, et al., 2000).

The Law of Fiscal Responsibility (2000) was perhaps one of the most important institutional reforms that facilitated implementation of reforms. It set limits to fiscal indiscretion at all levels of the government and, thus, reinforced the impact of inflation targeting and the floating exchange rate, leading to a reduction in debt/GDP ratio and the restoration of market confidence. This Law limits government indebtedness, bans the federal government from bailing out debt-ridden sub-national governments, and bans politicians from leaving their successors a stack of unpaid bills. The expenditure targets and corrective measures are legally binding and non-complying officials are subject to prosecution and even jail. In the process, the authorities finally took steps to reduce expenditures which – given the wage bill rigidities and social security payments – had been the hardest nut to crack and had required inordinately higher burden on tax policy. However, tax reforms, especially relating to the indirect tax system, remain incomplete and have been a drag on growth.

Although in the pipeline prior to the intensification of macroeconomic adjustment, privatization became a central element of the reform process and helped reduce the mounting fiscal burden. The privatization sequence involved autonomy, control, and finally sale. The remaining state enterprises were made subject to stringent financial conditions and enforced self-sufficiency, thus, drastically limiting subsidies through the budgetary process.

Financial intermediation was fostered by lowering the cost of investment (through a gradual replacement of turnover taxation); providing tax incentives for long term savings and investment; supporting bank risk management and the development of credit markets through the creation of new instruments to lower spreads; reducing informational asymmetries and fostering competition; and improving the legal environment to reduce conflict resolution costs, strengthen property rights, and reduce informational asymmetries (IMF, 2005).

Finally, Brazil moved aggressively at alleviating poverty by increasing the efficiency of social assistance under "Bolsa Familia" which facilitated acceptance of difficult fiscal and monetary reforms.

X-Factors in reform implementation

After the failed attempts at reform by authoritarian regimes – a la Argentina – there was considerable consensus among the political elites and interest groups – corporate sector, politicians, and trade unions – about the need to reform Brazil. As luck would have it, a seemingly socialist government in early 2000s – the Workers' Party – was called upon to advance the reform agenda which was actually the locus of the original reform drive of the political opposition, hence commonality of interests.

Political commitment for economic and financial reforms at the highest level of the government has been a major determinant of economic transformation in Brazil. The charismatic President Lula who presided over much of the reform process during early 2000s not only continued to pursue policies initiated by the Cardoso Administration but also exhibited single-minded approach to keeping an eye on the longer term economic sustainability and avoiding short-term political gains. Elected by an absolute majority, Lula's Government could build a strong coalition for getting unpopular reforms – especially Fiscal Responsibility Law – through. The strong leadership and focus on reform gained popular support and confidence in the global capital market. Interestingly, highly competent and non-political minister of finance and a strong Central Bank Governor provided the much needed implementation.

The role of the State – government – changed from being an allocator of resources to a regulator, ensuring an efficient market and improving employee-employer relationship. While the role of the state contracted somewhat, the capacity to intervene and the quality of its intervention improved. Increased attention to equity and alleviating poverty helped implementation of difficult reforms, especially in the labor market and energy.

Finally, prospects of significant benefits from the Brazil-initiated plans for the South American Free Trade Area focused the Government's attention on reforms and improving governance. The reforms adopted to rationalize the state, limit intervention in the economy, liberalize trade and economic activity, and provide for fiscal adjustment were considered of vital significance to the integration process and critical to Brazil's leadership in the region.

Turkey

Turkey's case is particularly relevant for Pakistan. The Turkish economy has been characterized by sequences of booms and busts, associated with short term capital flows, under half-hearted attempts at adjustment during 1980-2000. The turning point came in the aftermath of financial crises in 2000-2001. Though still somewhat vulnerable to extreme external shocks, Turkey's experience over the past decade has important lessons for Pakistan.

Over the 1980s and 1990s, a lopsided pattern of growth had developed which was heavily dependent on the accumulation of domestic and external debt and inflows of short-term capital. This pattern led to the development of a powerful rentier class, whose fortunes became increasingly dependent on lending to the government at high interest rates and increasing implicit subsidies for the large corporations (both private and public). High interest rates with capital account freedom encouraged capital inflows, Lira appreciation, and higher imports. By the end of 1990s, with chronic fiscal deficits and high rates of inflation, the Turkish economy was clearly on an unsustainable course (Onis and Senses, 2009). Dollarization was rising.

Notwithstanding the absence of an immediate balance of payments problem, Turkey was forced into an adjustment program in late 1999, supported by a stand-by arrangement with the IMF, which focused on reduction in the fiscal deficit and structural reforms to ensure budgetary sustainability over the medium term. However, the coalition government was unwilling to take difficult steps, including to improve regulation of the banking system and undertake privatization.

And, then Turkey was hit by the twin crises in 2000-01 as global capital market confidence was sharply weakened and the September 11 events worsened the impact. Economic recovery halted, GDP fell by over 6 percent, disinflation effort faltered, the external current account weakened sharply, the Lira collapsed, and most banks had to be rescued. It became clear that without a dramatic improvement in regulatory reforms and correction of the fiscal mess, the Turkish economy could go into a deep decline and lose all hopes of joining the EU. There was a shift in the political economy balance of power and the coalition government was forced into transforming its "reluctant partnership" with forces for reform – both domestic and foreign (EU, IMF, and the US, in particular) into true collaboration. The next four years, 2002-05, under a re-vitalized IMF-supported program, became the turning point in the reform of the economy as domestic and foreign forces combined together to transform the Turkish economy. The "virtuous cycle" of reform became embedded.

Design of the reform program

The new policy framework, effective 2001 – underpinned by financial support from the IMF, World Bank, the US and the EU – was anchored to the aim of sharply reducing inflation to single digit levels from over 50 percent, strengthening fiscal accounts – amounting to about 9 percent of GNP improvement in the primary balance surplus over 2001-03; reduction in the external current account deficit from over 4.5 percent of GNP in 2000 to less than one percent of GNP during the subsequent three years (2001-03), and GNP growth to average about 5 percent per year. These objectives were to be achieved through floating of the Turkish Lira; inflation targeting as the basis for monetary policy combined with the independence of the Central Bank; sharp tightening of the fiscal position through a comprehensive reform of the tax system – both direct and indirect – in order to put revenues on a sustainable path, and reduction in expenditures by drastically cutting off-budget outlays and restraining public sector wages and employment. In addition, the growth rate of primary expenditure was to be kept well below that of GNP growth and reducing state enterprise spending dramatically, thus slowing the growth of domestic debt. The program called for a significant improvement in the primary fiscal position of state enterprises – moving from a deficit of 1.5 percent of GNP in 2000 to a broad balance in 2001 and surpluses thereafter. Many of these policies and underlying objectives were modified in line with changing global conditions; however, the primary thrust remained unchanged.

Since the uneven growth in Turkey largely reflected a lack of confidence stemming from structural weaknesses, the credibility of macroeconomic reform depended fundamentally on the strength of structural reforms. Therefore, farreaching and decisive actions were taken to address weaknesses, especially, of state-owned banks in order to ensure systemic stability, improved monetary control, and a lowering of interest rates. In addition, state-owned banks underwent financial and operational restructuring to ensure their future profitability with the aim of privatization or liquidation. In the private banking sector, recapitalization was carried out to counter the effects of high interest rates, depreciation of the Lira, and a slower economic growth. Fiscal transparency was improved and expenditure management strengthened through the elimination of special budgetary funds, and explicit rules were instituted to regulate contracting of government debt. Finally, despite political resistance and in sharp contrast with the past attempts, large scale privatization of state enterprises, including of state-owned banks, was resumed.

Institutional factors in reform implementation

A major institutional development that spurred reforms elsewhere in the economy was the law providing for de jure independence of the Central Bank in 2001. The law facilitated "implicit" inflation targeting during 2002-05 and explicit targeting from 2006 onwards under an independent Monetary Policy Council. In the process, it became possible for the Central Bank to focus primarily on one objective and avoid the pursuit of potentially conflicting objectives. It was, therefore, possible for the Central Bank to establish a credible reaction function, thus, providing confidence to the market.

Public Financial Management and Control Law was enacted to set out a clear framework for budget preparation, execution, and control. In addition, the State Enterprise Reform Law was introduced to improve governance and reduce the role of line ministries, introduce performance management, and external audit of enterprises. As public debt rose and its maturity weakened, a debt management law was passed, establishing an independent Debt Management Committee which ensured that borrowing decisions were consistent with the overall macroeconomic program and in compliance with risk and cost limits. In order to improve incomes policy, the Labor Code was passed which introduced important changes in the regulation of labor, protecting against arbitrary work termination. However, the government found it difficult to reduce public sector employment.

Concerned about the supervisory weaknesses that had allowed emergence of serious vulnerabilities in the banking system, the authorities introduced a new legal and regulatory framework consistent with EU and international standards. It was supported by a new banking law that strengthened loan classification, loan loss provisioning, and collateral valuation rules. An independent Banking Regulation and Supervision Agency was established to ensure implementation of new laws and regulations. An Investment Advisory Council was established to promote foreign direct investment to promote growth and put external current account financing on firmer footings.

X-Factors in reform implementation

Of the three countries under review, Turkey’s success, perhaps, owes most to the unquantifiable “X-factors”. The very fact that Turkey suffered an economic meltdown of massive proportions in 2000-01 – GNP contracted by almost 6 percent, the Lira collapsed, bank failures that cost one-third of GNP, and the massive increase in public debt from 38 percent to 74 percent of GNP – focused attention of all competing forces in the country to come to grips with it. Notwithstanding a weak coalition government (not unlike presently in Pakistan), a broad national consensus emerged among the political parties, military, the corporate sector, and the trade unions for a painful but necessary reform effort.

Second, the depth of the 2000-01crisis helped radically change the balance of power in Turkey’s political economy in favor of the coalition of transnational and domestic actors favoring further liberalization, with an increased constructive advisory and financing roles of external actors – IMF, World Bank, EU, and the US. The EU decision, in principle, to consider Turkey as a member provided it reformed its economy, crucially focused the authorities’ attention to seek the potential economic benefits of EU membership. The redefinition of Turkey’s relations with the EU helped the process of reform and helped the IMF and other multilateral organizations in breaking the resilience of anti-reform forces and constituting a powerful new element of domestic-external reform anchor (Onis and Senses, 2009).

Third, on the domestic front, there was a dramatic improvement in economic governance in the post-crisis period when Kemal Dervis, a highly respected and no-nonsense former Senior Vice President of the World Bank, took over as a technocratic – rather than an elected/politician – minister of economy. He was accorded considerable autonomy by the weak coalition government to lead a top-down process of restructuring. Thus, the changing balance of power involved not only a shift in the powers of external reforming forces, but also a shift in the power and autonomy of the technocrats working domestically on the reform process.

Fourth, the political climate changed because of the economic crisis and led to the election of a singe party – AKP – government not beholden to the whims and caprice of coalition partners, thus allowing a more resolute support for reforms. The new government retained the reform strategy of the previous government. Effective 2002, capitalizing on its broad-based political support, the government accelerated the pace of economic and political reforms with mutually reinforcing consequences. The combination of powerful external pressures and the display of strong political leadership and will at home helped to produce an environment sharply different from that at the time of the twin crises in 2000-01.

Turkey appears to have made a break with the past and is on a sustainable path. Macroeconomic balance has been restored with rapid growth and lower volatility, inflation has fallen, and the financial sector is robust enough to withstand the recent global meltdown. However, growth has not reduced unemployment appreciably, and debt burden remains relatively high. Fiscal adjustment, unless supported by continued structural reforms, could unravel. Similarly, investment remains stagnant and would need to increase if high growth is to be sustained over time. Finally, debt financing costs could potentially go up, negatively affecting fiscal sustainability. Thus, adjustment is work in progress.

4. Lessons for Pakistan

The experience of the three countries points to a number of common determinants of successful reform implementation:

- Pursuit of short-term relief from internal and external imbalances without commitment to a longer-term path of adjustment and resource allocation is counter-productive.
- Formulation of an objective adjustment program is an important starting point and not an end in itself. Flexibility to accommodate changing domestic and external environment is a virtue as long as eye is not taken off the underlying objectives.
- A sustained increase in domestic savings to serve as the primary source of investment is central to self-sustaining growth and adjustment. Foreign direct investment, rather than debt creating inflows, is the preferred mode of financing external current account deficit. Since savings are endogenous and follow income growth, tax policy is crucial in the initial stages for mobilizing domestic resources for growth and to contain external imbalances.
- Assigning multiple and conflicting objectives to specific policy instruments is counterproductive. In particular, monetary policy must not be directed at more than one primary objective.
- Successful macroeconomic reforms call for an independent Central Bank with primary focus on containing inflation, preferably, through inflation targeting. The ensuing monetary policy anchoring inflation has a supportive effect on

fiscal policy, discourages debt accumulation, ensures exchange rate stability, and promotes market confidence. However, successful inflation targeting itself calls for fiscal restraint and restraint on government borrowing.

- Successful implementation of a reform program calls for explicit national consensus and full political support. Good governance – objective commitment to implementation of difficult policy measures – is the single most important ingredient of successful reform. A popularly elected government with a wide electoral base has a better chance of supporting reforms.
- Good governance implies not only absence of corruption, but also – and more importantly – not leaning against market forces unless there is an explicit case of market failure. Regulation, including of the financial sector, should aim at improving resource allocation, not turning the state as allocator of resources.
- Personalities matter. Unstinting and sustained support at the highest level of the government for politically difficult, but necessary, reforms is critical.
- X-factors – the unquantifiable factors influencing implementation of reforms – are quite important. Ideally, these should involve a combination of external – creditors – and domestic actors – technocratic reformers – to provide incentives sufficient to spur and sustain the reform process. Where X-Factors do not appear to exist, there is a need to “create” them so as to inject incentives for reform.

Are these conclusions relevant for Pakistan?

The design of the current adjustment program has evolved over the past two years or so. Although still not fully integrated with a national medium term reform strategy which should stress increased export-oriented investment financed primarily by higher domestic savings, the program, if fully implemented, has the potential to break the viscous circle and allow reforms to take hold. It appropriately aims at tightening fiscal policy so that monetary policy can cope with inflation, put revenue growth on a sustainable path, stabilize the exchange rate, and reduce structural rigidities, particularly in the energy sector, so that growth could pick up.

However, the program has so far not had the intended effect because of poor implementation owing largely to weak governance. Little progress has been made on reducing inflation because of the massive increase in SBP financing of the mounting budget deficit as government has failed to get the tax reforms moving or contain spending. Domestic debt (including energy related financing overhang) has increased to dangerous levels. With little progress on a structural strengthening of external accounts, any recovery of growth or increase in global oil prices and interest rates would likely widen the current account deficit and adversely affect external debt sustainability. Foreign financing requirements are increasing at a time when availability of such financing is shrinking for Pakistan. With crowding out, little progress in solving the energy Gordian Knot, and market uncertainty, private sector recovery remains in doubt. With economic slowdown, banking sector balance sheets are coming under pressure and nonperforming loans are increasing. There could not be a more pressing time for getting serious about implementing the program. However, the apparent lack of leadership at the political as well as at the technocratic levels let the moment slip. The question is: how can the pace of program implementation be accelerated?

The experience of the three countries reviewed above, provides important lessons for Pakistan. What is proposed below is not new but is reinforced by evidence from the three countries where economic conditions were turned around by broadly similar actions.

1. Develop a realistic medium-term macroeconomic framework and ensure that the annual reform programs are consistent with it. It should have a broad-based support from major stakeholders so that political changes do not derail it. It is critical that major external stakeholders – bilateral creditors, IMF, World Bank, ADB, and “strategic partners’ – must also be on board and buy into it. The cost of “walking away” from the agreed framework should be high enough to keep it intact. A clearly defined timeframe, perhaps a five year period, should be agreed over which domestic resource mobilization would replace exceptional external financing in a sustained fashion. In order to ensure broad public support, which is critical for its success, the framework along with the consequences of reneging on it should be widely disseminated.
2. Partly, in order to ensure that fiscal policy does not slip and add to the inflationary woes, the State Bank of Pakistan should be accorded full independence in formulating monetary policy and protection from intervention. Such independence must be guaranteed not only by law but also by stakeholders. The primary role of the State Bank should be a rapid reduction in inflation to low single digits through inflation targeting. The SBP is reported to have the institutional capacity to undertake inflation targeting. Such SBP independence could help break the viscous circle that has militated against reforms in general. By eliminating unbridled credit to the government, inflation targeting will – as in Brazil and Turkey – help stabilize the exchange rate and facilitate reductions in interest rates in the period ahead, while improving market confidence.

3. Though appropriate, current efforts at raising government revenues through the reform of the GST have not worked because of perceived unequal treatment of interest groups and stakeholders. Even if the RGST is approved, it will not address the underlying conflict among these groups and there could be renewed demands for exemptions and related impediments to collection. As shown by the experience of both Brazil and Turkey, a broad-based tax reform strategy had the support of interest groups while focus on specific tax measures had limited political support. It would seem advisable to develop a broader tax reform plan that could be viewed as equitable – as part of the national consensus as suggested in (1) above. Agreement on an explicit timetable for bringing the hitherto under-taxed sectors in the tax net could make the approval of RGST easier.
4. Subjecting state enterprises to rigid budget constraints and privatization have had salutary effects in all the three countries reviewed above. In addition to reducing the fiscal burden, such measures led to increase in productivity and competitiveness. Pakistan would benefit significantly from actions along the same line.
5. Above all, as in the case of the three successful cases considered above, resolute political support for the implementation of the agreed reform program over the medium term is critical. It is important that, once the program has been agreed, there should be no impediments to its implementation. For operational purposes, a team of unimpeachable technocrats with strong leadership should be created – as in the case of Brazil, Chile, and Turkey – to implement the program. The team should be guaranteed protection against political interference so that it (in conjunction with their external counterparts including lenders and strategic partners) could provide the much-needed X-Factor for effective implementation.

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