

**An Objective Appraisal**

This article is an attempt to present a dispassionate and objective analysis of the economic situation that attempts to try to sift facts from fiction and myths, separate analysis from emotions, present the strengths and weaknesses of the economy and draw conclusions based on evidence and analysis rather than popular rhetoric and half-truths. As there is a great deal of skepticism about the quality of the official data the sources used in this paper draw upon both internationally and nationally verified and authenticated numbers. At the international level, the IMF, World Bank, Asian Development Bank, UNDP, Merrill Lynch, JP Morgan, Goldman Sachs data has been used while that of the State Bank of Pakistan (SBP), Social Policy Development Centre, Institute of Public Policy, ABN Amro Bank, local research analysts in the private sector and other independent research reports have been used from domestic sources. This variety of data sources should offset the biases, if any. The period chosen for the review of the economy covers the entire eight years because until the whole context is taken into account the picture will remain incomplete or blurred. But this period is further sub-divided into three sub-periods (i) 1999/2001-01 (ii) 2002-03 – 2006/07 and (iii) 2007/08. The distinctive features of these sub-periods were macro-economic stabilization, growth acceleration and economic regress respectively.

**Legacy of the 1990s**

After an impressive record of economic growth and poverty alleviation during the 1980s Pakistan suffered serious setbacks in the 1990s in terms of most economic and social indicators. Economic growth rates decelerated, inflation rose to peak rates, debt burden escalated substantially, macroeconomic imbalances widened and worst of all the incidence of poverty almost doubled. Pakistan's credibility in the international financial community was at its lowest ebb as successive agreements concluded with the International Financial Institutions (IFIs) were not implemented. Confidence of the local investors was eroded when the hard earned foreign currency deposits of resident and non-resident Pakistanis, accumulated over a long period of time, were suddenly frozen. Foreign investors were unhappy as all the power purchase agreements were reopened, re-examined and criminal action was initiated against Hubco.

The annual growth rate during the 1980s was 6.3 per cent, which decelerated to 4.9 per cent during the first half of the 1990s, and further down to 4 per cent during the second half. While the agriculture sector showed remarkably satisfactory performance and recorded higher growth than in the 1980s a major setback occurred due to poor output by the manufacturing sector. As compared to an average record of 8.2 per cent the sectoral growth witnessed a sharp fall to almost 4 per cent in the 1990s. The services sector also could not keep up its historical pace and showed a relatively lower growth rate. Since this sector is a major source of employment generation, particularly in the urban and non-farm rural areas, it can easily be surmised that overall employment rate suffered as well.

Investment ratio moving in a downward direction since 1995 reached a low of 13.9 per cent in 1998-9. This backlog of investment made it even more difficult for the economy to resume a higher growth path. Financing to achieve higher investment rate was also problematic as foreign savings, which used to bridge the gap between national savings and investment dried up in the wake of the May 1998 events.

The persistence of fiscal and external deficits led to accumulation of large domestic and external debt throughout the decade. Total debt consequently rose from \$20 billion in June 1990 to a peak of \$43 billion in May 1998. Pakistan's external debt reached 47.6 per cent of GDP, having grown at an average annual rate of 8.1 per cent throughout the 1990s. The net present value of external debt as a percentage of exports was estimated at 230 per cent in 1998-much higher than the safe limit of 150 per cent. The burden of stock of external debt and foreign currency liabilities rose from 258 per cent of total foreign exchange earnings in 1990 to 364 per cent in May 1998. The ratio of debt service payment due to foreign exchange earnings rose from 23.3 to above 40 per cent in the same period. These ratios clearly suggest that external debt burden had become unsustainable.

Domestic debt growth was more rapid in the 1990s-13.7 per cent per annum, and this was a direct consequence of liberalization of interest rate and the need to finance growing fiscal deficit. Domestic debt accounted for 49.1 per cent of GDP. The structural burden of overall public debt thus became more

onerous. Public debt grew from Rs. 802 billion in 1990 to Rs. 2971 billion in June 1999. As a percentage of GDP the increase was 93.7 to 102 per cent, while as a proportion of revenue the burden rose from 470 to 625 per cent. Public debt service claimed as much as 61 per cent of total revenues in mid-1999 compared to 35.7 per cent in 1990 thus leaving very little fiscal space for development expenditure.

The burgeoning burden of debt service was reflected in the persistently high level of fiscal deficit, above 7 per cent of GDP, while primary deficit began to slide from 2 per cent of GDP in 1990-5 to 0.3 per cent in 1995-9. The other major contributory factors, besides the increased burden of debt servicing for fiscal imbalances, was lower tax effort. Tax-GDP ratio had moved up to 14.4 per cent by 1994-5 but since then it had consistently eroded and was down to 12.8 per cent by 1999-2000. As a consequence of this twin menace, development expenditure took a major hit and reached a low of 3 per cent of GDP from 8 per cent in the first half of the 1980s. The crowding-in of private investment could not take place as the beneficial effect of complementarity between private and public sector investment was not realized. Current expenditure excluding debt service and defence had to be contained thus squeezing social sector expenditures below the desirable level.

External sector deficit also jumped from 2.6 per cent of GDP in the 1980s to 4 per cent in 1990s. A major factor responsible for this trend was stagnation of exports and the loss of market share in world exports. In the first half of 1990s merchandise exports remained stuck at about \$6.8 billion. Then there was a significant discrete jump to \$8.1 billion in the fiscal year 1995 but this jump proved to be an aberration, and the annual average in subsequent years hovered around \$8.3 billion. This inability to expand exports in a buoyant world trade environment caused a loss of market share and made it more difficult to service external debt obligations. As foreign currency deposits of resident and non-resident Pakistanis were readily available to finance the current account deficit the policy makers were no longer pushed to take hard decisions on restructuring and reforming the economy. Despite the utilization of this ready source 'of financing, it may be recalled, the volume of external debt doubled during this ten year period.

Incidence of poverty also doubled during this decade, from 18 to 34 per

cent, primarily due to lower growth, higher inflation and limited access by the poor to basic social services. Although the multi-donor supported Social Action Programme was intended to help Pakistan improve its education, health care, nutrition, water supply and sanitation sectors the actual outcomes have been disappointing. Social indicators lag behind other countries in the region, and are much lower than the countries with similar per capita incomes.

The evidence presented above clearly shows that the 1990s was a lost decade in terms of stunted growth, increase in incidence of poverty, burden of debt, large fiscal and current account imbalances, poor social indicators, higher rate of inflation. But in all fairness the entire blame for this particular outcome cannot be laid on the economic managers and policy makers of that time.

There are at least four main factors, which can be put forward as determinants of the performance in the 1990s. First, political instability and frequent changes in the government followed by reversal of decisions taken by the preceding government created an environment of uncertainty, lack of predictability and discounting of policy implementation of programmes and projects. Second, there was widespread mis-governance by the two major political parties which alternated in ruling the country during this period. Personal, parochial and party loyalty considerations dominated decision making ; institutions were bypassed and individual whims and fancies reigned supreme with no checks and balances on discretionary excesses and corruption. Third, there was lack of political will to take timely hard decisions. The cumulative effect of avoiding and postponing such decisions and failure to correct the distortions at the right time proved too costly. Fourth, there were unforeseen exogenous shocks, for example, the nuclear testing in May 1998 which shook investors' confidence, accelerated flight of capital, led to the imposition of economic sanctions and disrupted external economic assistance.

The economic sanctions imposed as a consequence of Pressler amendment and an uneasy relationship with the international financial institutions throughout the 1990s did not allow much room for maneuver to pursue structural reforms that were badly needed for bringing the economy out of morass.

It must, however, be recognized that the decision taken by the PPP

Government to open power sector to private producers in 1994 that was widely criticized at that time turned out to be both right as well as timely. The power shortages that have severely hit Pakistan in the last few years would have been even worse if the capacity created by independent power producers was not available. Similarly, the Nawaz Sharif Government was criticized for constructing Lahore-Islamabad Motorway through private-public partnership. Subsequent events have not only vindicated this decision but the successor government initiated and completed several such projects.

### **Macroeconomic Stabilization period 1999/2000 – 2001/02**

The most difficult challenge faced by the military government in October, 1999 was external liquidity problem, i.e. its ability to meet its current obligations such as imports of goods and service, its debt service obligations and other payments at the same time.

After May 1998, the country had lost an important source of external liquidity i.e. foreign currency deposits. The erosion of confidence arising from the freezing of foreign currency deposits had repercussions on other sources of foreign exchange inflows. Workers remittances through official channels were down to \$ 1 billion. Foreign investment inflows were less than \$ 400 million. At the same time the demand for foreign exchange had risen. Oil import prices had shot up from \$14 - \$15 per barrel to \$28 - \$30 per barrel doubling the oil import bill from \$1.3 billion to \$ 2.6 billion in first year. Despite increase in the volume of textile exports, the unit value of exports were down by 7-10 percent on average and therefore the exports had actually fallen. Fresh sanctions were imposed upon Pakistan due to the installation of the military government in October 1999 and bilateral and multilateral official flows were suspended. Credit rating agencies had already downgraded Sovereign Credit of Pakistan to Selective Default Category and therefore the question of access to financial markets did not arise.

The country thus faced a gap between external receipts and external payments of about \$ 2.5 billion to \$ 3 billion annually for the next few years. To meet this gap and keep the wheels of the economy moving Pakistan had to get its debt service obligations rescheduled. In order to obtain external debt rescheduling or relief it was necessary to have an agreement with the IMF.

Pakistan therefore had no other choice but to enter into a stand-by arrangement with the IMF in 2000 for nine months period which was heavily front loaded with a number of stringent conditionalities to be met within this limited period of time. For the first time in the history of Pakistan the IMF was able to complete all the reviews successfully and all the tranches were released on time. As a consequence IMF agreed to follow-up with a three year Poverty Reduction and Growth Facility (PRGF). The credibility of Pakistan vis-a-vis international financial institutions was restored setting the stage for the re-profiling of Pakistan's external debt owed to Paris Club. Contrary to popular perceptions, Pakistan had reached an understanding with the IMF before Sept. 11, 2001 on the broad contours of debt stock re-profiling by Paris Club as it had successfully implemented the 09 month stand by program and became eligible for the medium term PRGF.

Out of Pakistan's total external debt and foreign exchange liabilities of \$ 37.8 billion at the end of the fiscal year 2001-01, Pakistan's bilateral debt to Paris Club was \$ 12.5 billion. On December 13, 2001 Pakistan was able to re-profile this stock of bilateral debt by reaching an agreement with Paris Club for repayment of ODA component debt over a thirty eight years period with a grace period of 15 years and non-ODA component of debt over twenty three years with a five year grace period. In addition, the US cancelled its bilateral debt by \$ 1 billion after September 11, 2001. The debt relief provided some fiscal space, allowed the government to reduce its fiscal deficit, and stabilize the economy. In addition, Pakistan started receiving new concessional loans from the IMF, World Bank and Asian Development Bank which helped in financing the current account and fiscal deficits.

During the years 1999/2000 to 2001/02 the economy was able to achieve the following results:-

- Fiscal deficit was reduced from 5.4 to 4.3 percent of GDP.
- Trade gap narrowed from \$ 1.6 billion to \$ 1.2 billion. Current account balance turned surplus to \$ 2.7 billion from a deficit of \$ 1.9 billion.
- Workers' remittances jumped 2.5 times from \$ 1,060 million to about \$ 2,400 million.
- FDI flows averaged \$ 400 million annually.

- Re-profiling of bilateral debt stock resulted in a saving of debt servicing of \$ 1 billion annually.
- Repayment of \$ 4.5 billion private, commercial and short term debt and liabilities reduced the stock of debt and thus extinguished future debt servicing obligations.
- IMF, World Bank, ADB and other donors provided concessional assistance of about \$ 2.5-3 billion annually while their hard term loans were repaid.
- Foreign exchange reserves held by State Bank of Pakistan rose from \$ 991 million FY 1999-2000 to \$ 1.677 billion in FY 2000-01 and \$ 4.333 billion by FY 2001-02.
- New foreign currency deposits of \$ 2.1 billion by resident and non-resident Pakistanis accrued to Pakistani banks.
- Pakistan's exports increased from \$ 7.8 billion to \$ 9.2 billion by June 2001.

**Table – I** summarizes the changes in key macroeconomic indicators that have taken place between 1998/99 and 2001/02.

### **Growth Acceleration period 2002/03-2006/07**

Pakistan's economic performance in this sub-period has been impressive in terms of income per capita, employment generation and poverty reduction. As a result of reasonably high GDP growth rate of about 6.3 percent a year for five years the per capita income in current dollar terms has risen to about \$ 1000. GDP growth that was 3.1 percent in 2001/02 rose to 7 percent in 2006/07. There is a general consensus that poverty was reduced during this period but the magnitude of reduction varies between 5 to 10 percentage points. Unemployment rate also fell from 8.4 percent to 6.5 percent and about 11.8 million new jobs were created in FY99-08 period. Gross and net enrolment at primary level have improved over these five years. Among the health indicators children immunization, incidence of diarrhea and infant mortality have shown favourable changes. The other significant outcomes recorded during 2002/03 to 2006/07 were:

- The stock of External debt and liabilities as percentage of foreign exchange earnings was reduced to 125 percent from 224 percent in 2001/02. As a percentage of GDP it came down to 28 percent from 46 percent. The country's debt servicing capacity improved

considerably as debt servicing declined sharply to 9 percent of foreign exchange earnings from 26 percent.

- Foreign exchange reserves rose to US \$ 14 billion covering six months' imports from \$ 6.4 billion in FY02.
- Exports of goods and services went up from \$ 13.6 billion to \$ 21.2 billion recording an increase of 55 percent.
- Revenue growth remained strong. Tax Revenues rose 14 percent annually doubling in five years.
- Fiscal deficit remained below or slightly above 4 percent of GDP, despite the post earthquake relief and reconstruction expenditures.
- Low interest rates that touched as low as 4 to 5 per cent encouraged investment and fuelled growth.
- Manufacturing sector recorded an increase in its share of GDP from 14.7% to 19.1% by FY07.
- Investment rate grew to 23% in FY07 from 16.8 per cent in FY02 reflecting about six percentage point growth in investment/GDP ratio.
- There was a significant growth in foreign capital inflows, cumulatively estimated to be around \$ 13.5 billion over this period.
- A six fold increase took place in workers remittances through official channels that reached \$ 6.5 billion for FY08. The foreign exchange companies that were brought under the regulatory framework of the State Bank of Pakistan contributed another \$ 3-4 billion of foreign exchange flows.
- Exchange rate remained stable throughout the period.
- Average tariffs have come down quite appreciably. Tariffs on imports average 7.6 percent and tariff on imports of plant, machinery

and equipment for industrial sector has been reduced to 5% and for agriculture sector to zero percent.

- Inflationary pressure that remained quite low in FY02-04 began to intensify since FY05 and food inflation touched double digits.
- Current account surplus turned deficit since FY05 and has been on rising curve since then.
- Overall unemployment decreased from 8.3 per cent in 2001-02 to 5.27 per cent in 2006-07 mainly because of a steep decline in women's unemployment from 13 per cent to 9 per cent (PRSP II, 2008).
- Monetary policy was managed to kick start the economy when it was trapped in low growth – low inflation equilibrium. The policy was subsequently tightened to put inflationary pressures in check by lowering core inflation. However, inflation target slipped due to the upward trend in the global commodity prices as well as inefficiencies of wholesale and retail markets.
- Private sector credit for financing fixed investment as well as working capital grew at an average rate of 25.5% in this sub-period.
- Profitability of banking sector surged reaching \$1.7 billion in FY07. Net NPLs ratio declined to below 2 per cent.
- Capital market capitalization had reached \$65.9 billion by end FY07 from \$7.51 billion. 60 new IPOs were listed on Karachi Stock Exchange.
- Agriculture Credit disbursements by banks multiplied six fold and most of the credit went to small farmers. Similarly, more than 1.2 million borrowers received micro finance loans without any collateral.

- Pakistan's total foreign exchange earnings almost tripled from \$16.8 billion in FY00 to \$46 billion. Excluding foreign loan disbursements and official grants the increase recorded was from \$14.3 billion to \$42 billion.

Table II presents a summary of the changes in key macroeconomic indicators over the period 2001/02 – 2006/07.

An analysis of the development that affected the economic outcomes during this period should be able to isolate the relative contribution of policy reforms, economic governance and external environment. Was it good policy, good luck or good management that was responsible for the economic performance in this period.

### **Policy Reforms**

The highest priority of the Military Government was a major restructuring of the country's external debt portfolio in a way to bring it in alignment with its debt servicing capacity. By re-profiling the stock of official bilateral debt through Paris Club, substituting concessional loans for non-concessional loans from international financial institutions, pre-paying expensive loans and liquidating short term external liabilities the government was successful in executing the strategy of external debt management in a two to three year period. This restructuring of debt put Pakistan on a firm footing as the debt and debt servicing ratios have been on a declining path and the capacity to meet the future foreign exchange liabilities and obligations without much difficulty has been enlarged. Pakistan was no longer vulnerable to external shocks as it was in 1998 at the time of the nuclear tests. Although the assistance and conditionalities agreed with the IMF were the pre-requisite for debt restructuring this lowering of debt burden, in fact, made it possible for Pakistan to exit from the IMF program well before the specified time. Pakistan became one of the few emerging market economies that was able to make a successful transition from IMF programme to international financial markets.

It must be clarified that it is not the absolute amount of debt that really matters. In a growing economy this amount will continue to rise in absolute terms. What is important to see is whether the burden of debt and debt servicing is rising, falling or is stagnant in relation to the national income, foreign exchange

earnings, exports and government revenues. All indicators of debt and debt servicing have recorded a downward movement between 2002 and 2007. Realizing that debt restructuring would prove short lived if it was not accompanied by macroeconomic stabilization measures, structural reforms to remove microeconomic distortions and improvement in economic governance the government initiated a reform program.

The main thrust of these reforms was to allow greater freedom to the private sector to own, produce, distribute and trade goods and services, while gradually withdrawing the public sector from this arena. The role of the state in Pakistan was redefined as a facilitator, enabler, protector and regulator rather than directly managing and presiding over the commanding heights of the economy. Government intervention was justified for social protection of the poor and the vulnerable, provision of public goods, infrastructure, Human Development, Science and Technology. Although the State has not always adhered to this new role assigned to it and has shown dominance in actual practice, there is a political consensus in the country on the boundaries between public and private sector. It is another matter that the state has neither been effective nor efficient in carrying out the functions assigned to it. The capabilities of the state functionaries and consequentially the capacity of the public sector institutions have gradually eroded.

Significant efforts were made in unilaterally liberalizing the trade regime. The maximum tariff rate has declined to 25 percent; the average tariff rate stands at just 9 percent. The number of duty slabs have also been reduced to four. Quantitative import restrictions have been eliminated except those relating to security, health, public morals, religious and cultural concerns. The statutory orders that exempted certain industries from import duties or provided selective concessions to privileged individual firms were phased out and import duties on 4,000 items were reduced. A number of laws have also been promulgated to bring the trade regime in conformity with World Trade Organization regulations. These include anti-dumping and countervailing measures and protection of intellectual property rights. A stable exchange rate policy helped maintain predictability and competitiveness of Pakistani exports.

Concurrently with the debt restructuring, the country embarked on the fiscal policy reforms and consolidation by raising tax revenues, reducing

expenditures, cutting down subsidies of all kinds and containing the losses of public enterprises. Tax reforms were undertaken to widen tax base, remove direct contact between tax payers and tax collectors, introduce value-added tax as the major source of revenue, simplify tax administration and strengthen the capacity of the Central Board of Revenue. Although these reforms are still underway, the adoption of universal self assessment followed by random audit of selected tax returns, automation and reorganization of the tax machinery will help improve tax collection. Tax-GDP ratio in Pakistan is lower in comparison to other developing countries and has to be raised in the next five years to reach the average level of comparator countries.

As one of the sources of fiscal problems was the losses and inefficiencies of public enterprises the Government actively pursued an aggressive privatization plan whose thrust was sale of assets to strategic investors. The sectors where most progress has been made are oil and gas, banking, telecommunications and energy. Foreign investors were encouraged to participate in the privatization process and a large number of them have been successful. The transactions completed in the last five years yielded \$ 3 billion. The privatized banks are now contributing substantial sums to the national exchequer as they have all become profitable.

There has been a major and perceptible liberalization of the foreign exchange regime. Foreign investors can set up their business in Pakistan in any sector of the economy – agriculture, manufacturing real estate, retail trade, services, banking, etc., bring in and take back their capital, remit profits, dividends, royalties and fees, etc., without any prior approvals. Foreign companies are allowed to raise funds from domestic banks and capital markets. In the globalised economy foreign investors not only bring capital but new technology, managerial skills and networking that helps the national economy to compete successfully and capture market share.

Financial sector reforms in Pakistan were accelerated in this period. The Central Bank was granted autonomy and the control of the Ministry of Finance over banking institutions was diluted. Net non-performing loans of the banking system were brought down to less than 3 percent of total advances and loans, minimum capital requirements were raised to \$100 million and the quality of new loans improved. Mergers and consolidation of financial institutions have

eliminated a number of weaker players and the range of products and services offered by the banks widened. The privatization of Habib Bank, United Bank and Allied Bank – three large nationalized commercial banks of the country has transformed the banking sector into an efficient, privately owned and managed sector but regulated by a strong and vigilant Central Bank. The share of the private sector ownership of the banking assets has risen to 80 percent and the banking sector is facing a healthy but strong competitive environment. The banks are highly profitable and automation, on-line banking and multiple channels of delivery have improved the efficiency of services in response to market competition. The widening of the banking spreads, however, remains an area of concern and shows that there are still inefficiencies in the system.

Banking System has started to meet the financing requirements of sectors such as Agriculture, SME, salaried classes, and the poor who had no access in the past. The borrower base of the banking system has multiplied from over 1 million to 4.5 million households in last five years. The middle and lower middle class consumers are now enjoying car loans, mortgages, credit cards, consumer durables. Small farmers are using bank credits for buying chemical fertilizers, certified seeds, insecticides, small implements and hiring tractor services. Small and medium entrepreneurs are using bank credit to expand their fabrication and manufacturing capacities and upgrading technology. Landless labor and poor women in the rural areas are receiving micro loans for poultry, small livestock, sewing machines, etc. The number of households who have borrowed microfinance loans has gone up from almost zero to about 1.5 million. The out reach for small and medium enterprises, agriculture and microfinance remains limited and has to be expanded particularly in the rural areas and backward districts.

Deregulation of oil and gas, telecommunication, media and civil aviation sectors have also brought about significant positive results. Oil and gas exploration activity was stepped up and constant discovery and production from new gas fields operated by private sector companies has added new capacity to meet the growing energy needs of the country. Telecommunication has witnessed a boom since the private sector companies were allowed licenses to operate cellular phones. One million new cellular phone connections are being added every month and the number of phones has already reached more than 90

million or a penetration rate of almost 50 percent. Long distance international and local loop monopoly of Pakistan Telecommunications Corporation has been broken and new licenses including those for wireless local loop have been issued. The customers are reaping rich dividends as the prices of phone calls - local, long distance, international - are currently only a fraction of the previous rates. Lower telecommunication costs and increased penetration have a favourable impact on the productivity in the economy.

The success of the policies pursued in this period can be gauged from the fact that Pakistan was able to regain its economic sovereignty from the IMF as early as 2004. The economy was able to stand on its own feet and developed the capacity to withstand external and internal shocks. Investor confidence was restored in Pakistan. Workers living abroad used official channels to remit their earnings. International financial institutions were forthcoming with their assistance because the country had established credibility. International financial markets responded to Pakistan's bond and equity issues with great enthusiasm. Pakistan ranks high among South Asian countries on the index of Ease of doing business although the rising costs, outages and interruptions have added to the difficulties in last year or so.

The veracity of the above analysis can be verified by looking at the research reports and analyses produced by the IMF, World Bank, ADB, J.P. Morgan, Deutsche Bank, Merrill Lynch, Goldman Sachs. The up-gradings that have taken place in Pakistan's credit worthiness by S&P and Moody's between 2000 and 2007, the inclusion of Pakistan in the emerging markets by the Economist in London and other emerging market indices are a testimony to the growing importance of Pakistan's economy.

If the foundations of the economy were built on a slippery slope and on propaganda and fudging of figures and not on sound fundamentals the globally established and well respected institutions, fund managers and multinationals would dare not invest a single penny in Pakistan. Nor Pakistani debt and equity papers would have received such rousing reception in international financial markets. After all, there is so much competition world wide for investors' money. They voted with their dollars to come and invest, lend and do business in

Pakistan despite the horrible image that is propagated by the international media everyday of the year.

It was also realized that these structural reforms are unlikely to be sustainable if the economic governance structure is not put right. Although Pakistan has a long way to go in improving governance, some measures have been taken to move in this direction.

### **Economic governance**

The cornerstone of the governance agenda was the devolution plan which transferred powers and responsibilities, including those related to social services from the federal and provincial governments to local levels. Development effort is driven at the local level by priorities set by elected local representatives, as opposed to bureaucrats sitting in provincial and federal capitals. Devolution of power, with passage of time and after overcoming initial teething problems will strengthen governance by increasing decentralization, de-concentration, accountability and people's participation in their local affairs. However, in the meanwhile the transition has created its own set of dislocations and disruptions particularly in law and order and security that needed to be addressed.

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

The National Accountability Bureau (NAB) was established under a new legal framework as the main anti-corruption agency. A large number of high government officials, politicians and businessmen were sentenced to prison, subjected to heavy fines and disqualified from holding public office on charges of corruption after conviction in the courts of law. Major loan and tax defaulters were also investigated, prosecuted and forced to repay their overdue loans and

taxes. Subsequent actions taken in response to political expediency have tarnished the image of NAB and compromised its integrity.

Some important legislative and institutional developments that have taken in the last few years should also help improve economic governance. The bane of Pakistan's economic problems stemmed from fiscal indiscipline over a decade that plunged Pakistan into a debt trap. This root cause had therefore to be surgically removed so that it does not recur in the future. A Fiscal Responsibility Law has been approved by the Parliament, which keeps a lid on the government's propensity to borrow their way out. Debt / GDP ratio has to be reduced by 2.5 percentage points each year and the Debt/ GDP ratio cannot exceed 60 percent. Any deviation has to be explained to the Parliament and need its approval. If strong enforcement mechanism is put in place and sanctions are imposed upon those not adhering to the limits, this law will hopefully act as a major restraint on fiscal recklessness in the future.

Monetary policy is now operated by an independent central bank keeping the objective of price stability, financial stability and growth in mind. Although it involves a fine balancing act and inflationary pressures have surfaced during the last two years the Central Bank is committed to pursue a monetary policy that keeps inflation under control. Indirect market-based policy instruments have replaced credit ceilings, caps on deposit and lending rates, preferential treatment to government and directed credit to priority sectors. Interest rates and exchange rates are market determined and credit allocation decisions are made by the individual banks based on objective criteria but guided by prudential regulations. The institutional capacity of the Central Bank has been strengthened although the law has to be revised to put mandatory ceiling on government borrowings from the SBP. The Federal Board of Revenue, Securities and Exchange Commission and Auditor General's Organization are being revamped and strengthened. A new Competition Commission has been established to deal with monopolies, cartels and collusive business practices. New regulatory agencies for telecom, oil and gas, power, electronic media have been set up with quasi-judicial powers but they are still at early stage.

The agenda of reforms in Economic Governance lost its steam in 2007 as the government got preoccupied with electoral politics and economic management was relegated to back burner.

## **External Environment**

In this period Pakistan had to suffer several external shocks in this eight year period. A prolonged drought resulted in shortage of irrigation water for agriculture, the tensions with India led to mobilization of troops on the border, the terrorist attacks on foreign nationals in Karachi, the Sept. 11 attacks on the World Trade Centre and the subsequent participation of Pakistan in the war against terror had serious consequences for the economy.

A favorable external environment following September 11, 2001 played a highly supportive role in the sub period 2002/03 – 2006/07. Economic sanctions were removed, increased bilateral and multilateral assistance flowed in, bilateral external debt was restructured and re-profiled, workers' remittances multiplied several fold, foreign direct investment poured in large volumes and access to international capital markets was established. The most controversial issue is that of impact of September 11, 2001 on the turn around of Pakistani economy. A fuller analysis of this event is therefore quite critical.

## **Impact of September 11 Events**

A large number of observers and casual empiricists both within and outside Pakistan have been making bold but untested assertion that it is the massive aid flows and debt relief resulting from Pakistan's participation in the war against terror after September 11, 2001 that has been responsible for the large reserve accumulation and economic turnaround. It is true that following this event workers' remittances were diverted from open market to inter bank, debt relief was provided and new loans and grants were received, official sanctions were removed, foreign direct and portfolio investment poured in large volumes, access to international financial institutions was much easier, bilateral donors became active. There were, however, also huge costs incurred by Pakistan. It is conveniently forgotten that thousands of innocent lives of Pakistani soldiers and civilians have been lost, a deep sense of in-security prevails in the country, foreign travel advisories have discouraged visits of businessmen, tourists and buyers, higher war risk premia are charged, shipping freights have gone up, insurance premia on Pakistani goods have escalated and export orders have been diverted. The frequency and ferocity with which suicide bombers are attacking the political leaders, installations and targets has added to the gravity of law and order problem in the country. Export orders of several billion dollars were

cancelled right after the event and the recovery has not yet taken place. As against continued growth in exports in other countries of the region there has been a significant slow down in Pakistani exports particularly textiles due to the uncertainty created in the minds of buyers abroad and their limited exposure to the actual conditions. IT industry, that was just taking off in 2001, has been badly hurt as all contracts for outsourcing were cancelled. Pakistan is no longer on the radar screen of the global IT industry which is expanding rapidly.

The data presented in Table III shows that even if it is assumed that all official transfers, debt relief and all foreign loans/credits represent the “gift” of September 11 to Pakistan, this combined amount represents only 10% of total Foreign Exchange Earnings of the country in FY-06. At its peak in FY-02, the amount of flows from foreign assistance was 21.6%. But this entire amount is not a direct fall out of September 11 because Pakistan has been receiving foreign loans and grants every year since the 1950s. For example, in FY-00 and FY-01, the two years prior to September 11, 16 per cent and 19.9% of Foreign Exchange Earnings were received in form of foreign loans and grants. The country had a positive overall balance and positive current and capital account balances in 2000-01 much before September 11, 2001 occurred. Even in FY 1999-00 the deficit on the overall balance was quite small – less than 1% of GDP. Pakistan’s reserves had started accumulating in FY01 and SBP’s own reserves had almost doubled after paying off foreign currency deposits of almost \$ 1.7 billion to the non-residents and institutional holders and \$ 2.8 billion in debt servicing to external creditors. Thus the perception that every thing good that has happened to the country is a direct consequence of September 11 is not only incorrect but highly exaggerated for the reasons described below.

It should be recognized that any external financial relief such as provided in the aftermath of Sept 11 would have dissipated quickly and thus remained temporary and transitory in nature until it was accompanied by fundamental structural reforms that clean up the economic landscape, unshackle the entrepreneurial energies of private economic actors, lay the foundations for competitive markets under the vigilant eyes of regulators and expand the productive and foreign exchange earning capacity of the country. As pointed out earlier it would not have been possible to take advantage of the benefits offered by Sept. 11 in absence of the reforms of financial sector, liberalization of trade

and tariff regime, improvement in tax policy and administration, deregulation of oil and gas and telecom sectors and privatization of state owned enterprises.

The data presented in Table-III clearly demonstrates that Pakistan's foreign exchange earning capacity has expanded from \$ 15 billion annually to \$ 46 billion during the last six years or 33% of GDP from 20% of GDP. Contrary to popular perception, it is the Pakistani businesses and nationals working abroad who provide the bulk of the foreign exchange earnings of the country. It is totally fallacious to argue that if the foreigners, particularly Americans withdraw their financial assistance then the country will be in dire trouble. About \$ 30 billion are generated by Pakistani businesses and nationals and the remaining amount accrues from foreign direct investment, privatization and international markets. If this pattern of foreign exchange earnings persist in the future the relative share of foreign assistance in form of grants or loans from United States, other friendly bilaterals and multilateral will continue to decline and will become insignificant in the next 5-10 years.

In order to further evaluate the veracity of the assertions of the theory of dependence of our economy on the US, four key indicators are selected (a) US assistance as percent of Pakistan's total budgetary expenditure (b) US assistance as percent of Pakistan's total foreign exchange receipts (c) US assistance as percent of total current account receipts of Pakistan and (d) US assistance as percent of total value of imports of Pakistan. These indicators have been carefully chosen to see as to how much damage will accrue to our balance of payments and fiscal accounts if the US for one reason or the other abruptly decides to withdraw its assistance of all types.

The results of this analysis shown in Table IV indicate that even under the worst case scenario of zero aid flows and no reimbursements for logistics services rendered in connection with the war on terror, the diminution in foreign exchange receipts or budgetary resources would be insignificant – varying between 4.5% of total foreign exchange receipts to 7.2% of total budgetary expenditures. The other two indicators, i.e. the proportions of total value of imports and current account receipts financed by U.S. assistance account for 6.4% and 5.8% respectively – not worrisome amounts. The common held belief that Pakistan's economic turnaround and sustained growth has taken place due

to massive foreign assistance from the U.S. as a reward for participation in the war against terror is un-substantiated by the above empirical evidence.

### **Economic Regress 2007/08**

The year 2007-08 has been a difficult year for Pakistan's economy. It must be conceded that the momentum of growth slowed down and a temporary derailment from the track has taken place. What has happened to the economy in this period can be gleaned from the following facts:-

- GDP growth rate was below the target, i.e. 5.8 per cent but was still quite respectable in view of the severe political and economic difficulties faced by the country.
- Fiscal deficit widened to 7.4 per cent of GDP breaching the limit prescribed in the Fiscal Responsibility Act.
- As public expenditure outpaced revenue collection, government borrowing from the State Bank of Pakistan jumped to a record Rs.688 billion compared to Rs. 112 billion in the previous fiscal year.
- The consequence of such excessive government borrowing was a sharp growth in reserve money fuelling inflationary pressures.
- In agricultural sector, cotton, wheat and rice crops did not perform well and together with increased prices of imported commodities, contributed to food inflation.
- Electricity and gas load shedding due to shortfall in generation had adverse impact on manufacturing and export sectors. Large scale manufacturing growth slowed down to 4.8 percent – almost one half of the rate recorded in FY07.
- A worsening trade imbalance fuelled external current account deficit to exceed 8.4 per cent of GDP.
- Foreign capital inflows that were required to finance the current account deficit dried up leading to depletion of foreign exchange reserves.
- The drawdown of foreign exchange reserves to meet the balance of payments deficit created pressures on Rupee-dollar exchange rates leading to a depreciation of about 25 per cent.

- Inflationary pressures have intensified largely due to exceptionally high food inflation that is hurting the poor and the fixed income groups badly. Inflation crossed 12 per cent.

The trajectory of high growth trends has been disrupted in FY08 because of political uncertainty, worsening of law and order situation, macro-economic instability and micro-economic inefficiencies such as energy shortages. Remedial action is required on all these fronts to put the economy back on track. The immediate issues are (a) tackling inflation (b) raising external financing to meet current account deficit (c) reducing fiscal deficit and repaying State Bank borrowings (d) managing energy shortages in a way that favours the manufacturing and export industries in allocation.

The widening fiscal and current account deficits continue to create complications and add to inflationary pressure. The combination of rising fiscal deficit and weak external receipts pushed the government borrowings from State Bank of Pakistan to a record level in FY08. This exceptionally high level of government borrowing has been instrumental in sustaining the growth of broad money for the period at 15.4 per cent significantly offsetting the Central Bank's efforts to tighten monetary policy.

In agriculture sector, the disappointing performance of cotton and rice crops and the likely shortfall in wheat crop did result in a dismal 1.5 per cent growth rate. Large scale manufacturing has been encountering relatively slower growth due to strong increases in the international commodity prices, domestic energy woes and dampened external demand for textile exports. Economic losses in the aftermath of December 27, 2007 further weakened prospects and the sector recorded almost half of the targeted rate of 10.9 per cent.

The relative slowdown in foreign inflows to Pakistan triggered both by the turmoil in international financial markets and protracted and complicated political transition put pressure on exchange rate, foreign exchange reserves and the differential between the inter-bank and open market rates.

The momentum of privatization that began to slow down in FY07 was almost lost in FY08 as none of the intended transactions was completed. 61

state entities that were in the pipeline remained untouched. On the other hand, the subsidies claimed by WAPDA, and PIA escalated substantially, the inter-enterprise circular debt that was completely eliminated in the earlier years resurfaced again, payments to oil marketing companies for price differential were delayed or only partially made and the independent private producers were not paid on time aggravating the energy shortages.

Food, oil products, power and gas tariffs were not fully passed through to consumers in the wake of international price hikes accumulating large fiscal imbalance. Support price for wheat was not announced on time and slight shrinkage in area under wheat cultivation was observed. Unprecedented increase in prices of DAP and shortages of irrigation water further exacerbated the situation. The doubling of world rice prices however, helped in a 60 per cent rise in the export earnings from rice.

The newly elected government has taken some measures to come to grip with the economic situation. It has entered into a 22 month stand-by agreement with the IMF that is aimed primarily at macroeconomic stabilization. On the production side in the real sector the main constraint being felt is the persistent energy shortages. In the short term the existing capacity of the IPPs and other generating units can be fully utilized if the problem of the circular debt is quickly resolved. External environment has, in the meanwhile, become more hostile in the aftermath of global financial crises and Pakistan's exports are likely to be hit. The good news is that a significant decline in world oil and commodity prices would help Pakistan in reducing trade imbalance and also fiscal deficit.

### **WEAKNESSES AND SHORTCOMINGS**

There is some truth that the benefits of the growth in this eight year period have not been widely shared. But it is the poor implementation capacity arising from a weak administrative structure in the country at all levels that is mainly responsible for this outcome. Policy decisions are taken but they are questioned, reopened, and their implementation is hampered unnecessarily, delayed or slowed down at the bureaucratic level. The lack of access of the poor to the basic public services arises due to apathy, indifference and corruption prevalent among the civil servants who deal with public at large. Civil Service Reforms, Judicial Reforms along with effective devolution of powers to local governments

are badly needed in the country. Both theoretical and empirical studies have clearly demonstrated that good governance and well functioning institutions are critical for sustained and equitable economic development. In Pakistan, the thrust of policy reforms has not been contested by any government – civil or military – for almost three decades. But it is the lack of implementation of policies due to weak governance, poor institutional capacity and malfunctioning structures and processes that has played havoc in meeting the goals and expectations.

Using a Growth Diagnosis framework developed by Hausmann, Rodrick and Velasco, Qayum et al have attempted to identify the constraints to growth in Pakistan. They found governance failure and institutional shortcomings are the heart of the matter. Corruption is rampant, judicial independence is low, educational institutions do not furnish the right kind of labour force, legal institutions do not protect the lenders against loan defaults, ambiguous land titles constrain, mortgage financing and construction activity, labour market institutions restrict hiring / firing. They identify three binding constraints to growth in Pakistan (i) poor state of governance (ii) poor state of institutions (iii) lack of competitive environment.

The other burning issues which confronted most Pakistanis during this sub-period were (a) high inflation (b) dissatisfaction with privatization of state owned enterprises (c) growing income inequalities (d) energy shortages (e) food security. These concerns are justified but there were cogent reasons behind each of these issues

The strong growth performance increased the incomes of the middle class. As a consequence, the higher purchasing power of a growing middle class translated into the increased demand for more goods and services. Some of these demands was higher imports but it also created shortages domestically in food and other essential commodities. Higher international prices of oil, food and other commodities have in fact, worsened the situation. The rising demand due to increasing purchasing power of an expanding middle class combined with international factors have intensified inflationary pressures. Tight monetary policy pursued since 2005 did reduce core inflation but the higher food inflation (food forms 40 percent of consumer basket) did not allow the overall inflationary pressure to be mitigated. The average growth of 25% in imports reflecting the increase in oil prices, higher machinery imports over FY 03-07 and commodities

out paced export growth of 13% leading to a widening external current account deficit. Until FY07 capital inflows funded fully the external current account deficit and helped in building foreign exchange reserves (growing by \$ 5.6 billion over FY 03-07) but the slowdown in inflows since then has caused anxiety.

During the period FY2000-08 the Government sold off cumulatively almost \$ 7 billion of assets and eased pressure on its budgetary resources as it no longer underwrote the losses of state owned companies and enterprises. For example, the Government had to inject Rs.41 billion to recapitalize Habib Bank and United Bank when it was under its control. After privatization not only the market value of the residual shares held by the government has risen significantly but these banks are paying hefty dividends and also taxes on their profits. The efficiency gains to the economy achieved after privatization have not been studied and therefore its impact has not appreciated. The Supreme Court judgment on Pakistan Steel Mills created some doubts about the transparency of the process and it is necessary to make suitable changes in the law and processes to allay these suspicions and fears once for all. The process of privatization should move forward and the public should be made aware of the relative costs and benefits of privatization to the economy.

The growing income and regional inequalities do pose some serious problems. This difference has arisen mainly due to the nature of the societal relationship that under pin various parts of the country. Southern Punjab, Rural Sindh, Balochistan outside Quetta, Northern and Southern districts of NWFP have not so far gained much from development activities relative to others because of the stranglehold of feudal and tribal traditions, remoteness and low literacy. The expanding inroads of urbanization and the communication revolution are likely to dilute these negative influences. In the meanwhile the Government took upon itself to invest heavily in infrastructure and connectivity in Balochistan. It is expected that these projects, when completed, will help in removing some of the constraints that impede the remote areas of Balochistan from participating in the economy. Consultations with and participation of local communities and stakeholders in the design and implementation of these mega projects may set at rest some of the resistance against these projects in Balochistan.

Energy shortages have resulted from a combination of factors such as unanticipated high growth in demand, substantial hike in international oil prices, poor planning and weak implementation capacity, lack of response from the private sector, convoluted tariff setting process, bureaucratic and inter-agency turf fighting and the accumulation of circular debt. Power shortages have inconvenienced the consumers and also caused serious problems for the businesses. Some of the projects in pipeline would be ready for commissioning in 2009-10 and ease the situation somewhat. In the meanwhile the industry, particularly the manufacturing sector is suffering gravely due to the electricity outages and gas load shedding. Priority has to be given to the industries in allocation of power and gas if the trend in production losses has to be reversed. The negotiations with Iran and India for Iran-Pakistan-India gas pipeline have become protracted and time consuming. A number of problems have been resolved in last one year but progress is still slow and has to be expedited.

Food security issues had assumed serious proportions in 2007 and 2008 because of global supply and price shocks of main food staples. International prices of wheat had jumped 92 percent in one year period and rice prices had doubled. The Pakistani markets could not remain insulated from these shocks despite the best efforts of the government. Wrong estimation of the surplus wheat crop led to erroneous decisions and the delay in fixing the support price causing uncertainty in the minds of the growers. The new Government has, however, taken decision to revise the support price and also imports have been allowed. These steps should help, along with targeted subsidies, in mitigating the hardships faced by the poor.

## **CONCLUSIONS AND THE WAY FORWARD**

The Military government which came to power in October, 1999 was faced with four main challenges (a) heavy external and domestic indebtedness; (b) high fiscal deficit and low revenue generation capacity; (c) rising poverty and unemployment; and (d) weak balance of payments and stagnant exports. In addition, Pakistan was perceived as a highly corrupt country with poor governance. Transparency International survey ranked Pakistan as the second most corrupt country in 1996. The situation was exacerbated by the initial negative reaction of the international community to the military takeover of the government as well by the high expectations of domestic populace and the media to hold those found guilty of corruption accountable. Further, the lingering

dispute with Independent Power Producers (IPPs), particularly HUBCO during the preceding three years had damaged the investor-friendly image of Pakistan. The distrust engendered by the freezing of foreign currency deposits of non-resident Pakistanis in May 1998 had not yet been erased. Thus investor confidence was at its lowest ebb.

Pakistan's credibility was quite low with international financial institutions since the track record of performance on agreements reached with them, over the preceding ten years, was dismally poor. There was little empathy for Pakistan among these institutions and bilateral creditor governments, while at the same time it was not in a position to service its external debt obligations without immediate rescheduling. The country faced a serious liquidity problem as its reserves were barely sufficient to buy three weeks imports and could not possibly service its short term debt obligations. Workers, remittances were down by \$ 500 million, foreign investment flows had dwindled by \$ 600 million, official transfers had turned negative and Pakistan had no access to private capital markets.

In the domestic sector, the declining Tax-GDP ratio and inflexible expenditure structure, whereby 80 percent of revenues were pre-empted to debt servicing and defence, constrained the government's ability to increase the level of public investment.

It was against this backdrop of imminent default on external debt and a heavy debt servicing burden in the budget that the military government had to design a strategy for economic revival in December, 1999.

The facts and the analysis presented above clearly show that Pakistan's economy has developed the strength and become resilient to withstand adverse shocks in relation to the situation prevailing in the decade of 1990s. Major structural reforms carried out between 1999/2000 – 2006/07, modest improvement in economic governance particularly key institutions and timely decisions paved the way for the turnaround and built the resilience of the economy. The fiscal space created by sound economic management as well as provision of international assistance allowed the Government to raise the level of development expenditure five fold during this period, i.e. from Rs.100 billion

annually in FY99-00 to Rs.525 billion in FY07-08. This massive expansion in development outlay allowed completion of many large projects and work on 90 other mega projects is in different phases of implementation. When completed these projects will bring large benefits to the economy. In the Education sector, the allocation to Higher Education sub-sector was raised ten fold from Rs.3.8 billion in 2001-02 to Rs.33.76 billion in 2007-08. President's Education Sector Reforms program was launched at a cost of Rs.100 billion to achieve universal primary education, strengthen science education and to promote public-private partnership. Health indicators have shown considerable improvements and population growth has decreased from 2.7% to 1.8%. This large public investment in infrastructure and social services will start to pay dividends to the economy in the coming years and contribute to growth momentum in the future provided rash decisions are not taken to discontinue or disrupt their implementation just because they were initiated by the previous government.

The lessons from the decade of 1990s clearly show that the policy pursued by the successive governments in abandoning the projects and programmes initiated by the previous regimes cost the economy huge losses in terms of lower output and incomes, increased poverty and unemployment. Of course, fine tuning and adjustments should be carried out by the incoming government to get rid of the weaknesses and deficiencies but whole scale rejection of the initiatives that make economic sense should be avoided. Devolution of powers to local governments, upgrading of higher education, adult literacy programs and health care delivery by involving volunteers and communities, Primary Education projects to achieve universal education, Private-Public Partnerships in infrastructure and Social Services, strengthening and expanding technical and vocational education, filtered water supply, lining of water channels, are some of the commendable initiatives that are in the midst of implementation. These can be reviewed and suitably modified but allowed to complete as costs have already been incurred but the benefits have yet to start accruing to the population.

No doubt that the economy has derailed from the track in 2007/08 but with proper management it can be brought back to the track. Both international and domestic factors have contributed to the setbacks, slippages and hence a deterioration in key economic indicators. The government's reluctance to make

gradual adjustments in the prices of oil, electricity and gas, particularly in response to the changing international conditions, the mismanagement of wheat situation, the postponement of new GDR and bond issues, the slowdown in further reforms particularly in the area of governance and devolution, the pre-occupation with political issues and judicial crises, the absence of effective social protection and social assistance framework accentuated the inflationary pressures, amplified the imbalances on fiscal and external current account, created shortages of wheat, electricity and gas and wrongly gave a widespread impression that the gains achieved in the previous seven years were illusory in nature based on fudged facts and figures. Nothing can be far from the truth. The seven year track record cannot be dismissed summarily as it has been verified by international financial institutions, international bond issuers, fund managers, research analysts and foreign investors who have invested more than \$ 14 billion in Pakistan's economy. What is true is that the original targets specified for 2007/08 could not to be achieved and the actual economic outcomes were worse than what was anticipated and prescribed in the beginning of the fiscal year. The motive for the understatement of domestic interest payments in the original budget estimates can be questioned. Whether it was sheer incompetence or deliberate attempt to put a lower number to contain fiscal deficit can be investigated, ascertained and disclosed to the public at large. But the non-achievement of many other targets and worsening of outcomes cannot be ascribed to across-the-board suppression or concealment of facts or fudging of figures but to the indecision and paralysis in management of the economy exhibited during the year by the previous elected government and the caretaker government.

Some of the weaknesses in economic planning and management manifested themselves in the last eight months. The first was the inability to cope with the looming energy shortages. The plans and projects of additional electricity generation, natural gas imports, alternative energy sources remained unfulfilled at the same time when the government was pushing the demand side through massive rural electrification, new gas connections, substantial increase in the use of air conditions and gadgets by a rising middle class and liberal consumer credit. Second the previous government did not develop a sound food security plan in which subsidies were targeted towards the poor and vulnerable segments of the population. Third, the Government did rightly increase public

expenditures on development particularly and social sectors but in many cases the cost overruns and delays in completion have not brought the benefits to the population.

The temptation to blame the previous governments should be tampered with caution and not carried too far. To the extent that it raises doubts about the country's financial and economic integrity, weakens the capacity to raise funds to meet the deficits and erodes investor confidence to bring in new investment the present government will have to bear the consequences. While a clear account should be placed before the public, the potential for the damage to the economy by indulging in scoring political points or attributing motives should also be considered.

Finally, the question of sustainability of growth in the future has to be addressed squarely. There is a legitimate concern among many quarters that the growth achieved in the past five years is unsustainable as it was driven mainly by consumption liberalization. The sequencing embedded in the economic strategy adopted in December 1999, emphasized macro-economic stabilization in the first phase and stepping up of growth in the next phase. It is quite possible that the first phase may have extended a few years beyond FY 02 if the external circumstances had not taken a turn for the better. Different options were considered to kick start the economy that was trapped in low level equilibrium of low growth and low inflation in FY 02. As the country was faced with a heavy public debt burden and the aim of stabilization was to bring fiscal deficit down, the fiscal policy stimulus option was ruled out. The improvement in financial intermediation process and low inflation rate motivated the policy makers to use monetary policy lever for the purpose of economic recovery. Low cost of capital enabled the banks to extend credit to a large number of businesses, SMEs, agriculture and also to the consumers for automobiles, mortgages and consumer durables. Large increase in private sector credit enabled an expansion in aggregate demand. Manufacturing industries which were operating at low capacity got a boost due to rising consumer demand and some of them were able to attain profitability because of the lowering of unit cost of production. Manufacturing sector recorded growth of 14 percent in FY04, 15.5 in FY05 and 10 per cent in FY 06 up from 4.5 per cent in FY 02 and 6.9 per cent in FY 03. As capacity was fully utilized in most industries, new investment was undertaken to

respond to this rising demand. The total fixed capital formation in manufacturing sector between FY 02 and FY 07 amounted to Rs.1300 billion due to double digit annual growth. Fixed investment level in the manufacturing sector jumped from Rs. 140 billion in 1999/2000 to Rs.404 billion. It is estimated that the textile industry alone invested about Rs.300 billion in import of new machinery and equipment during this period. Cement industry increased its capacity from 18 million tons to 34 million tons while in 2000/01 only 9 million tons were sold. Along with manufacturing, transport and communications sector was the recipient of investment totaling Rs.1320 billion. As most of this investment is in various stages of implementation the benefits will accrue over next five years at least. It is true that complementary investment in power and gas was missing in this period eventually leading to disruptive energy shortages and slow down in growth in the current year. But the cumulative public and public and private sector investment of Rs.8053 billion or US \$ 134 billion made in the last eight years still has to add to output stream in the coming years. Investment – GDP ratio had already moved up to 23 percent in FY 07 – almost five percentage points higher than the average rate of 18 percent. Political stability after 2008 elections should also confer some dividends in form of further improvement in this investment ratio. The popular notion that agriculture and manufacturing sectors were neglected during 1999/00 – 2006/07 period is factually incorrect. The share of the manufacturing sector in GDP has actually risen from 14.7 percent to 19.1 percent.

A new dimension has been introduced in the growth equation in the past one year, i.e. demand for food. If managed carefully and assiduously this demand can earn foreign exchange through exports of surplus food staples, while transferring increased purchasing power for the rural areas of Pakistan where most of the poor live. The rice export capacity has already exceeded 3 million tons and an average price of \$800 / ton can fetch almost \$2.4 billion. Similarly, the wheat and maize crops have the potential of producing surpluses if proper pricing and marketing incentives are provided to the farmers. In case it is mishandled, food shortages and price hikes can lead to riots like in other countries. The big question mark about the sustainability of growth in the future is as to how quickly and effectively the new government is able to tackle the issues of fiscal and current account imbalances, reassure the foreign and domestic investors about the direction of policies and governance and how the

energy shortages are mitigated. In case, the agreement with the IMF is faithfully implemented, the energy situation improves in the coming year the country should be able to resume its path on the growth trajectory that it has followed since FY 03. The economic fundamentals remain strong and only a course correction is needed.

### **Looking ahead**

There is no doubt that the year 2007/08 was a difficult year for Pakistan's economy. The incoming government has indeed inherited a difficult financial position. The momentum of economic growth has slowed down, macroeconomic stability has derailed from the tracks, investor confidence is in a state of hiatus and the tension between taking tough policy decisions to get the economy back on track by reducing the imbalances and providing immediate relief to the poor and the vocal fixed income earning classes poses serious political challenge for the new government. Externally, the environment is not favorable either. Turbulent financial markets and recession in the advanced economies make the task of economic management even more difficult. Internally political uncertainty, recalcitrant bureaucracy, truculent terrorists and rent seeking businesses have worsened the situation.

In the short term, the fiscal deficit has to be brought down by curtailing unproductive expenditures, slowing down the development projects that have not yet started and are not of critical nature, accelerating energy conservation and generation programmes, taxing the capital gains in stock market earned through short term trading, revaluing the urban property and recovering agriculture income tax from land owners beyond a certain limit, imposing taxes on services that are outside the net.

In the medium term, food and agriculture production, agro-processing industries, marketing, storage and warehousing, transport, retail distribution have to be paid highest priority along with agriculture credit, insurance, microfinance and upgrading of rural infrastructure. Devolution to local governments to allocate resources and manage their own affairs should be strengthened along with fundamental reforms in the governance structure.

In the long term, the reforms of institutions and governance structure will hold the key to sustainable and equitable growth in Pakistan. Inter-personal and regional inequalities have to be reduced, access to finance and education has to be ensured, property rights and contracts have to be protected and enforced. Industrial and export structure have to be diversified into more dynamic products such as engineering goods and services, steel, petrochemical complex, oil refineries that are essential ingredients upon which the new structure is to be based along with heavy investment in skilled and unskilled manpower development.

**TABLE-I**  
**CHANGES IN KEY MACROECONOMIC INDICATORS**  
**1999-2000- 2001/02**

	October 1999	October 2002	Change in the Indicator
GDP growth rate	4.2%	5.1%_/*	
Inflation	5.7%	3.1%	Positive
Fiscal deficit/GDP	5.1%	-3.8%_/*	Positive
Current account/ GDP	-2.6%	+4.9%	Positive
Public Debt /DGP	84.0	76.9_/*	Positive
Domestic Debt	Rs.1376 billion	Rs.1699 billion	Positive
External Debt GDP	47.6	40.5	Positive
Interest Payments /Govt. Revenues	47.0	32.8_/*	Positive
Remittances	\$88 billion per month	\$200 million per month	Positive
Exports	\$7.8 billion	\$11.2 billion_/*	Positive
Tax Revenues	Rs.391 billion	Rs.460 billion	Positive
Rupee-Dollar Parity	Depreciating	Appreciating	Positive
Foreign Direct Investment	\$472 million	\$800 million_/*	Positive
Foreign Exchange Reserves	\$106 billion	\$8.5 billion	Positive
Poverty Incidence	32.6%	34%	Negative
Poverty Related Expenditure	Rs.133 billion	Rs.161 billion	Positive
Unemployment	6%	8%	Negative

**Note:** All indicators in Column 1 pertain to 1998-99 or October 1999. All indicators in Column 2 pertain to 2001-02 or October 2002. Those marked with\_/ \* pertain to 2002-03.

**TABLE-II**  
**CHANGES IN KEY MACROECONOMIC INDICATORS**  
**2001/02-2006/07**

	<b>June 2002</b>	<b>June 2007</b>	<b>Change in the Indicator</b>
GDP Growth Rate	3.1%	7.0%	Positive
Inflation	3.5%	7.8%	Negative
Fiscal Deficit /GDP	-4.3%	-4.3%	None
Current Account /GDP	3.8%	-4.9%	Negative
Public Debt / GDP	82.91%	55.7%	Positive
External Debt/GDP	46.6%	27.8%	Positive
Interest Payments/ Govt. Revenues	44.7%	28.4%	Positive
Remittances	US\$ 200 million per month	-US\$ 458 million per month	Positive
Exports	US\$ 9.1 billion	US\$ 17.0 billion	Positive
Tax Revenues	Rs.404 billion	Rs. 890 billion	Positive
Rupees- Dollar Parity	Depreciating	Stable	Positive
Foreign Direct Investment		US\$ 5.1 billion	Positive
Foreign Exchange Reserves	US\$ 6.4 billion	US \$ 16.5 billion	Positive
Poverty Incidence	34%	24%	Positive
Unemployment	8.3%	6.5%	Positive

**TABLE-III****SOURCES OF FOREIGN EXCHANGE EARNINGS****FY 00 – FY 07**

\$ Million

	<b>FY 00</b>	<b>FY 01</b>	<b>FY 02</b>	<b>FY 03</b>	<b>FY 04</b>	<b>FY 05</b>	<b>FY 06</b>	<b>FY 07</b>
A. Exports of Goods & Services	9,574	10,284	11,056	13,686	15,103	17,801	20,254	21,202
B. Workers' Remittances	983	3,087	2,390	4,237	2,871	4,168	4,600	5,500
C. Other Private Transfers	2111	2,853	1,899	1,559	2,293	4,202	5,345	4,608
D. Official Transfers	940	842	1,500	1,051	634	398	679	528
E. Debt Relief	-	-	-	1,000	-	-	-	0
F. Foreign Direct Investment	472	323	485	798	951	1,096	1,981	4,873
G. Privatization Proceeds	-	-	-	-	-	363	1,540	267
H. Euro / Sukuk Bonds					500	600	800	977
I. Equity Securities	-	-	-	-	-	-	-	2,303
J. Foreign Loans / Credits	1589	2812	2,910	2,293	1,726	2,431	2,728	4,140
K. Others	158	175	164	271	199	1,642	2,527	1759
<b>TOTAL:</b>	<b>15,827</b>	<b>18,377</b>	<b>20,404</b>	<b>24,895</b>	<b>25,253</b>	<b>32,106</b>	<b>40,508</b>	<b>46,157</b>

**TABLE-IV**

**KEY INDICATORS OF US ASSISTANCE**

	2006-07
1. Annual US assistance (of all forms) as % of total budgetary expenditure (\$ 25 billions)	7.2%
2. Annual US assistance (of all forms) as % of total foreign exchange receipts (\$ 40 billions)	4.5%
3. Annual US assistance ( of all forms) as % of total imports (\$ 28 billions)	6.4%
4. Annual US assistance as % of current account receipts (\$ 31 billions)	5.8%

**TABLE-V****SOCIAL INDICATORS**

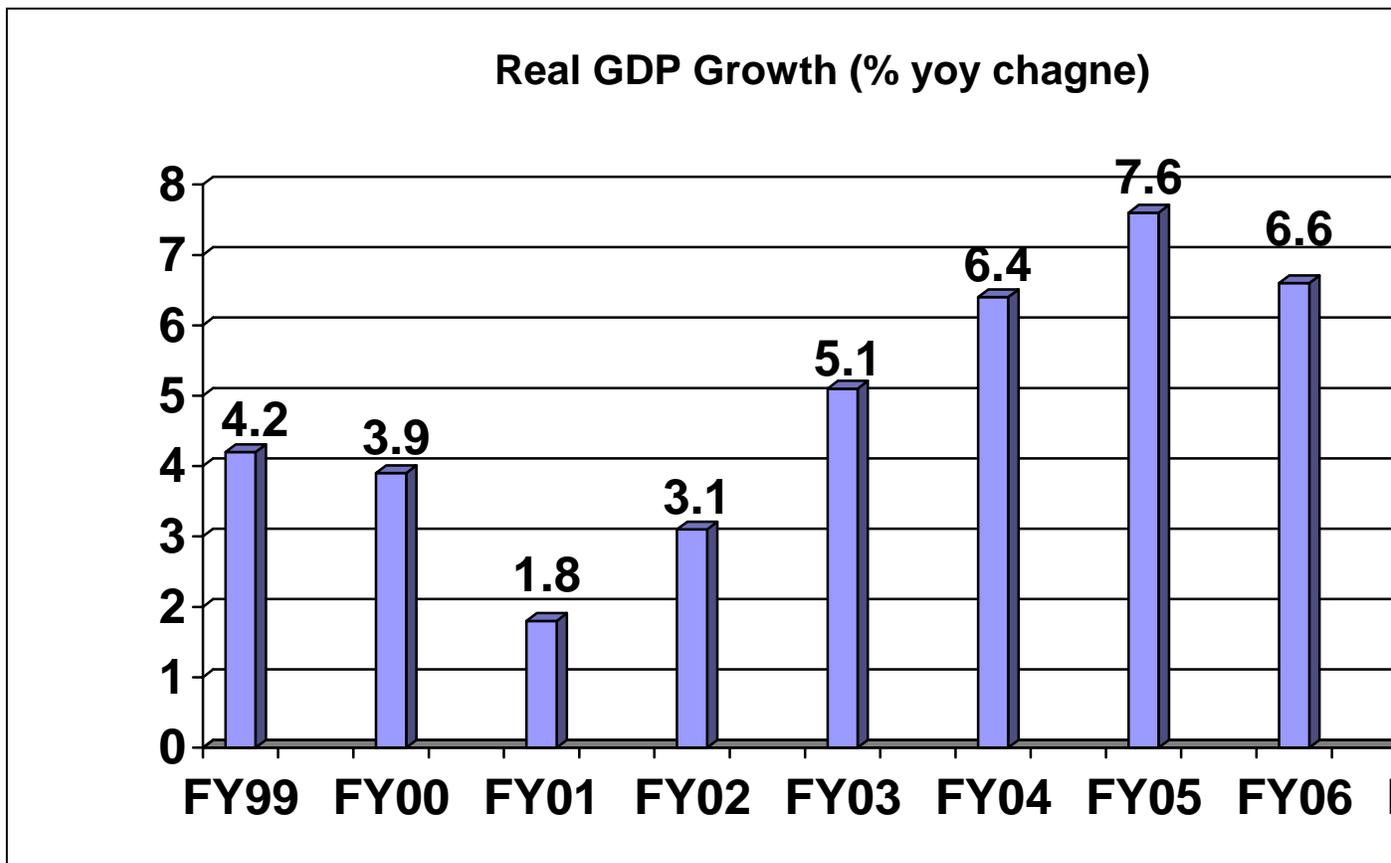
	<u>1999</u>	<u>2006/07</u>
Life expectancy (years)	62.7	63.9
Population growth rate (%)	2.7	1.8
Infant Mortality Rate (per 1000 live births)	85	77
Proportion of Fully Immunized children(%)	49	77
Expenditure on Education (% of Gdp)	1.82	2.43
No. of Education institutions	160,685	227,953
Literacy Rate (%)	44	56
Gross Enrolment Ratio at Primary level (%)	91	71
Gender Parity Index	0.763	0.834

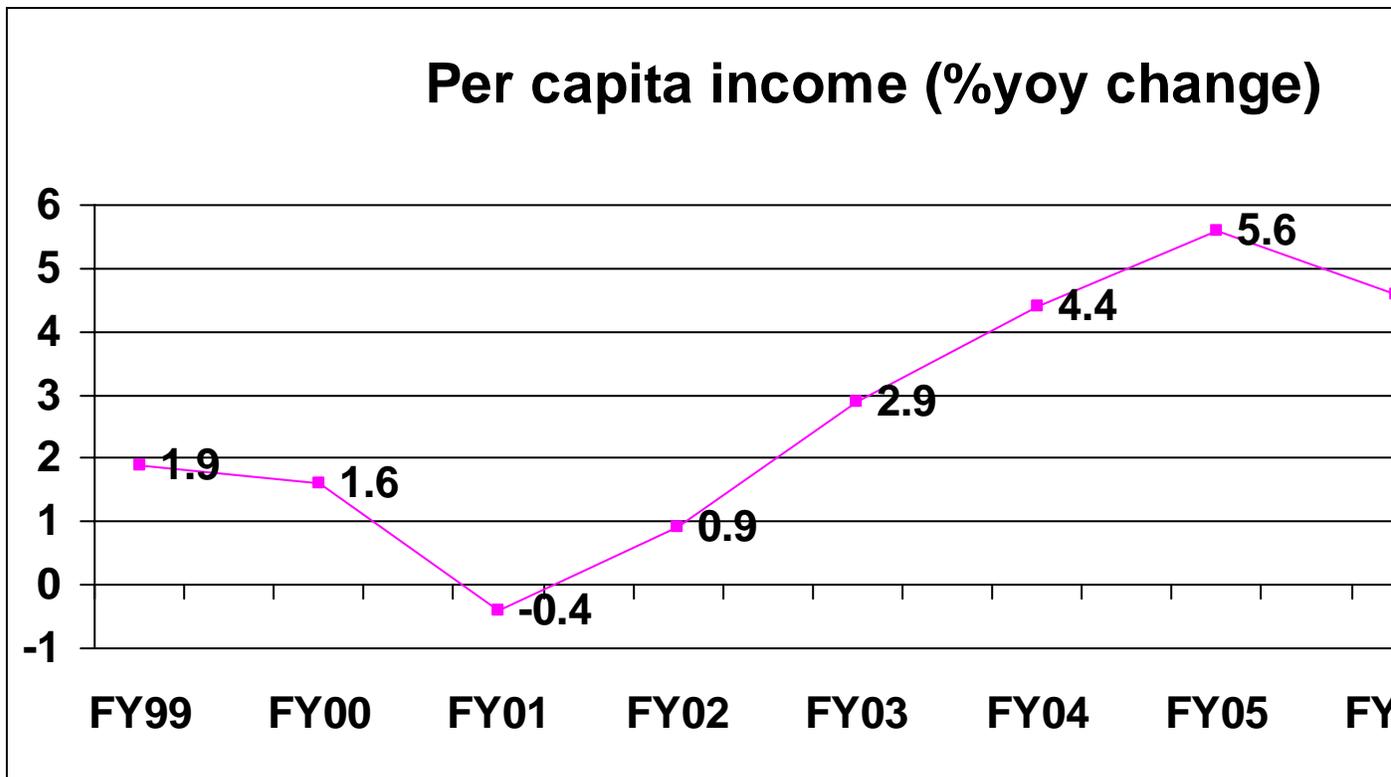
**TABLE-VI**Where has investment been made?1999/00- 2006/07

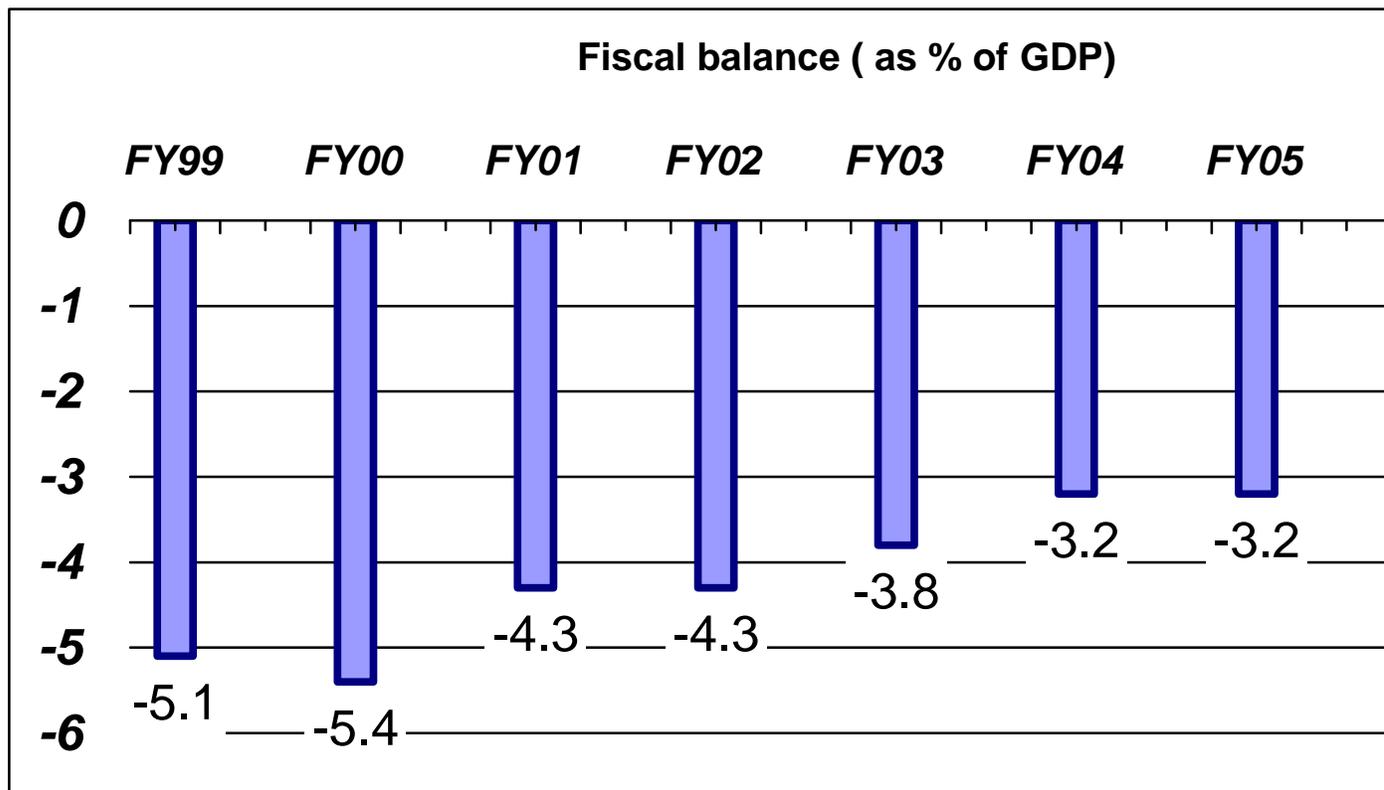
		<u>Rs. Billion</u>
		<u>% share</u>
Manufacturing	1797	22.3
Transport & Communication	1600	20.0
Dwellings	887	11.0
Agriculture	779	9.7
Services	658	8.2
Electricity & Gas	454	5.6
Mining	374	4.6
Finance	224	2.8
Trade	-146	1.8
Construction	136	1.7
Federal Government	312	3.9
Provincial Government	464	5.8
Local Government	225	2.8
<b>Current Prices</b>	<b>8055</b>	<b>100.0</b>
<b>Constant Prices 1999-00</b>	<b>5670</b>	

**TABLE-VII****FIXED INVESTMENT BY SECTORS**

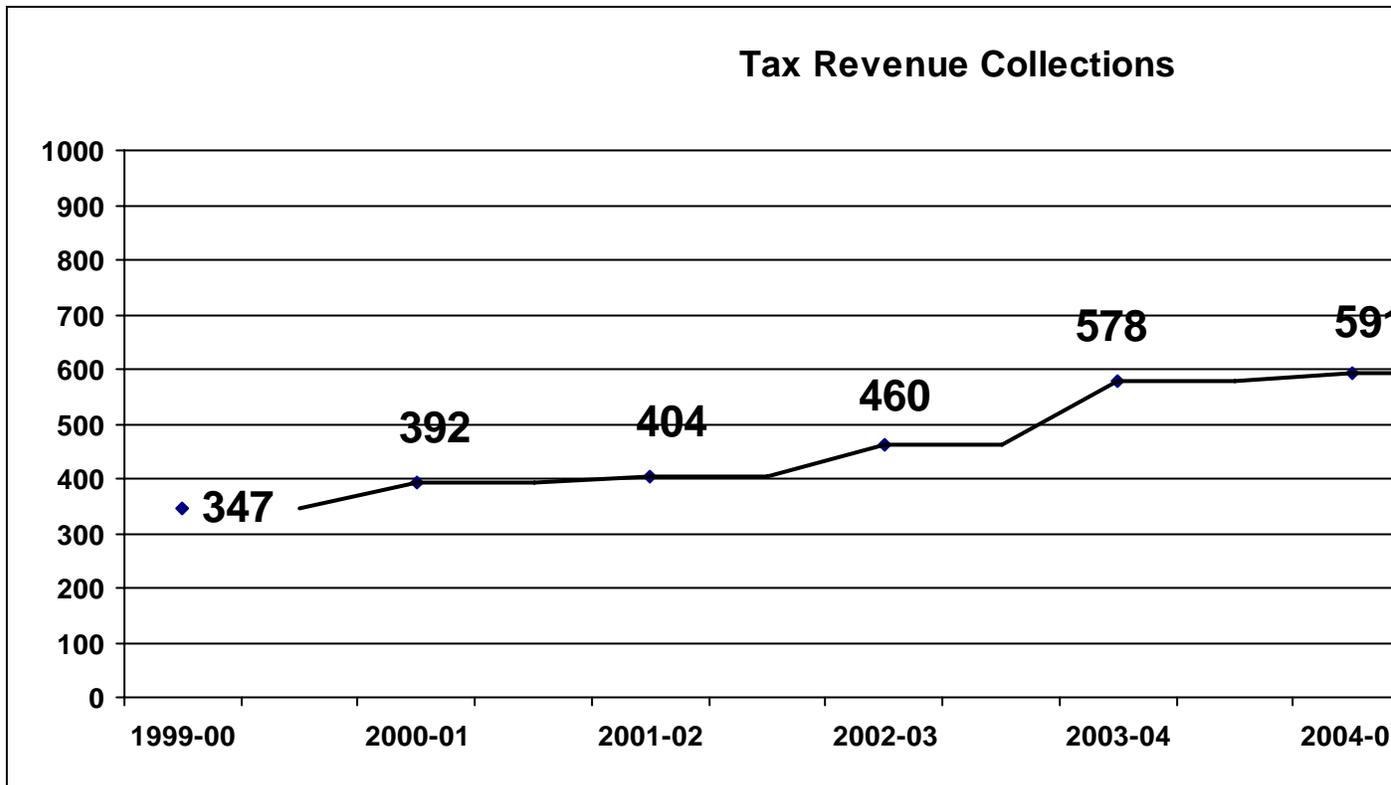
	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	Rs. Billion current prices Total	Per s
Manufacturing	14	151	168	165	204	247	318	404	1797	
Electricity	75	67	69	75	81	135	136	141	779	
Transport & communication	80	104	96	94	149	225	390	471	1600	
Construction	78	87	87	91	110	129	149	156	887	
Others	50	53	56	56	77	101	125	140	658	
Government	10	5	10	23	28	32	40	76	224	
Private	18	33	49	77	19	33	49	96	374	
Central	7	10	11	15	17	21	29	36	146	
State & gas	67	67	57	57	25	40	69	72	454	
Production	15	13	15	7	10	18	26	32	136	
Govt.	25	24	30	31	41	39	53	69	312	
Private	32	31	18	27	50	71	113	122	464	
Bodies	9	11	23	29	33	42	31	47	225	
	<b>607</b>	<b>659</b>	<b>680</b>	<b>736</b>	<b>844</b>	<b>1135</b>	<b>1530</b>	<b>1864</b>	<b>8055</b>	<b>1</b>

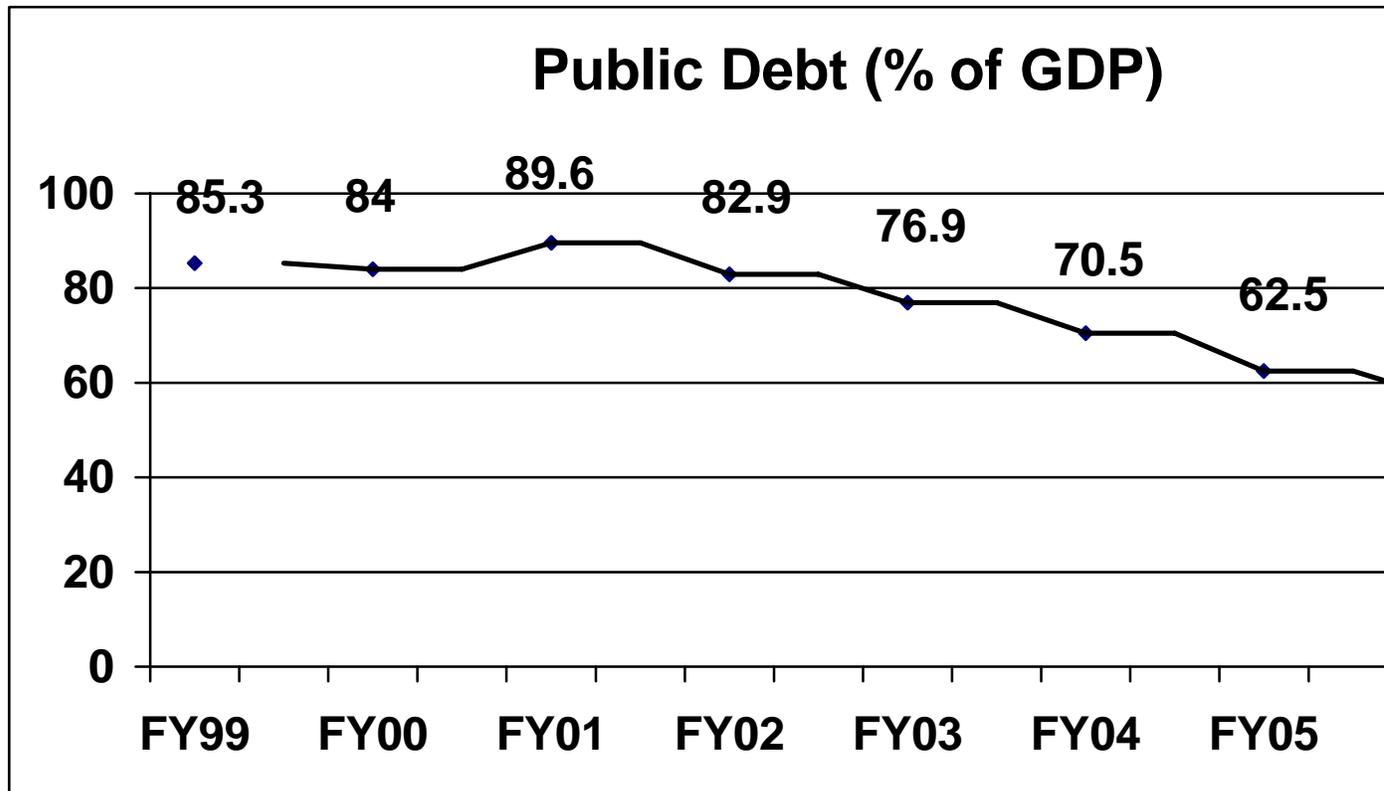
**CHART - I****Acceleration in Real GDP Growth****CHART - II****Rise in Per capita income**

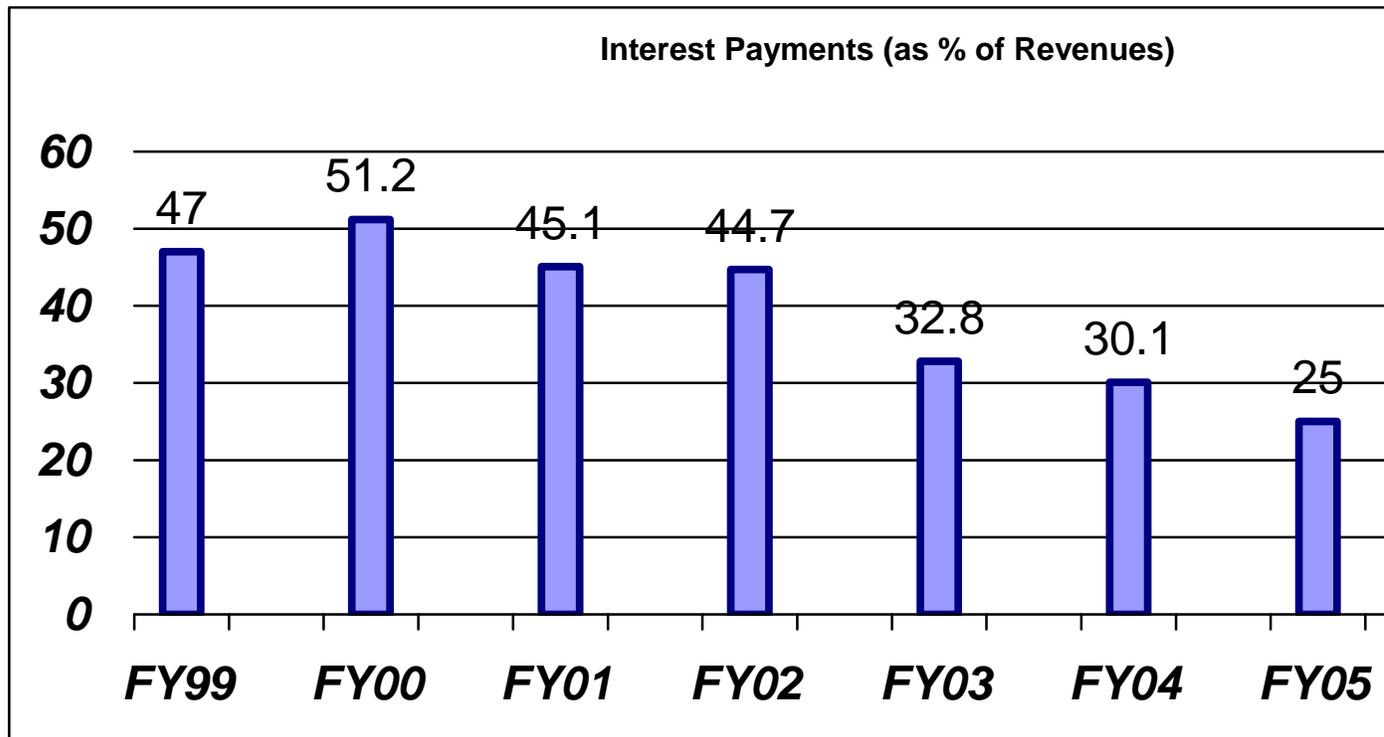


**CHART - III****Decline in Budgetary deficit**

**CHART - IV**  
**Rising Tax Revenues**

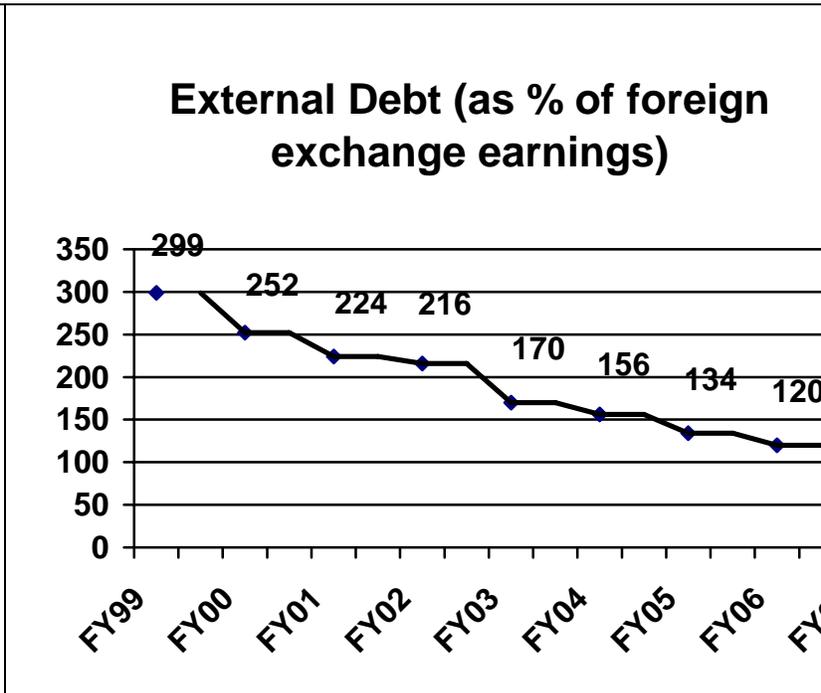
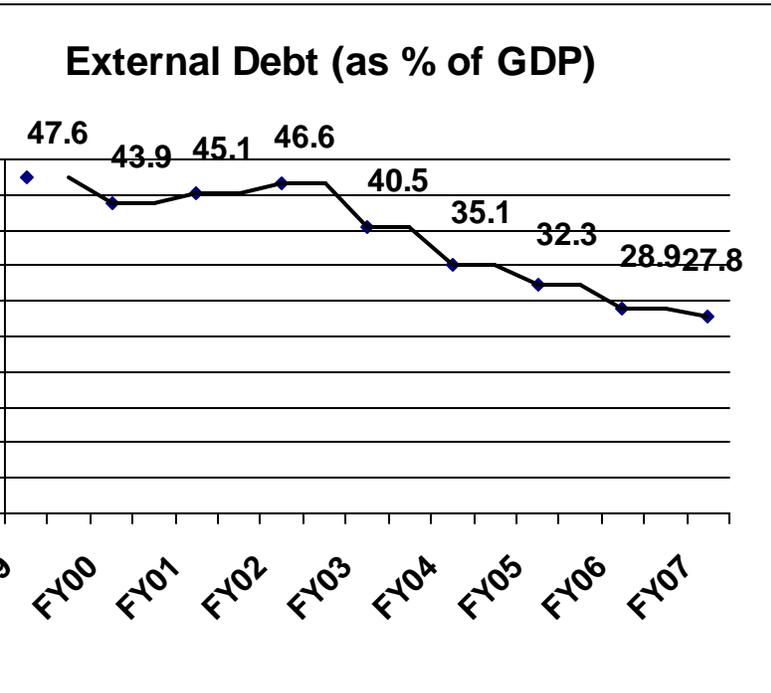


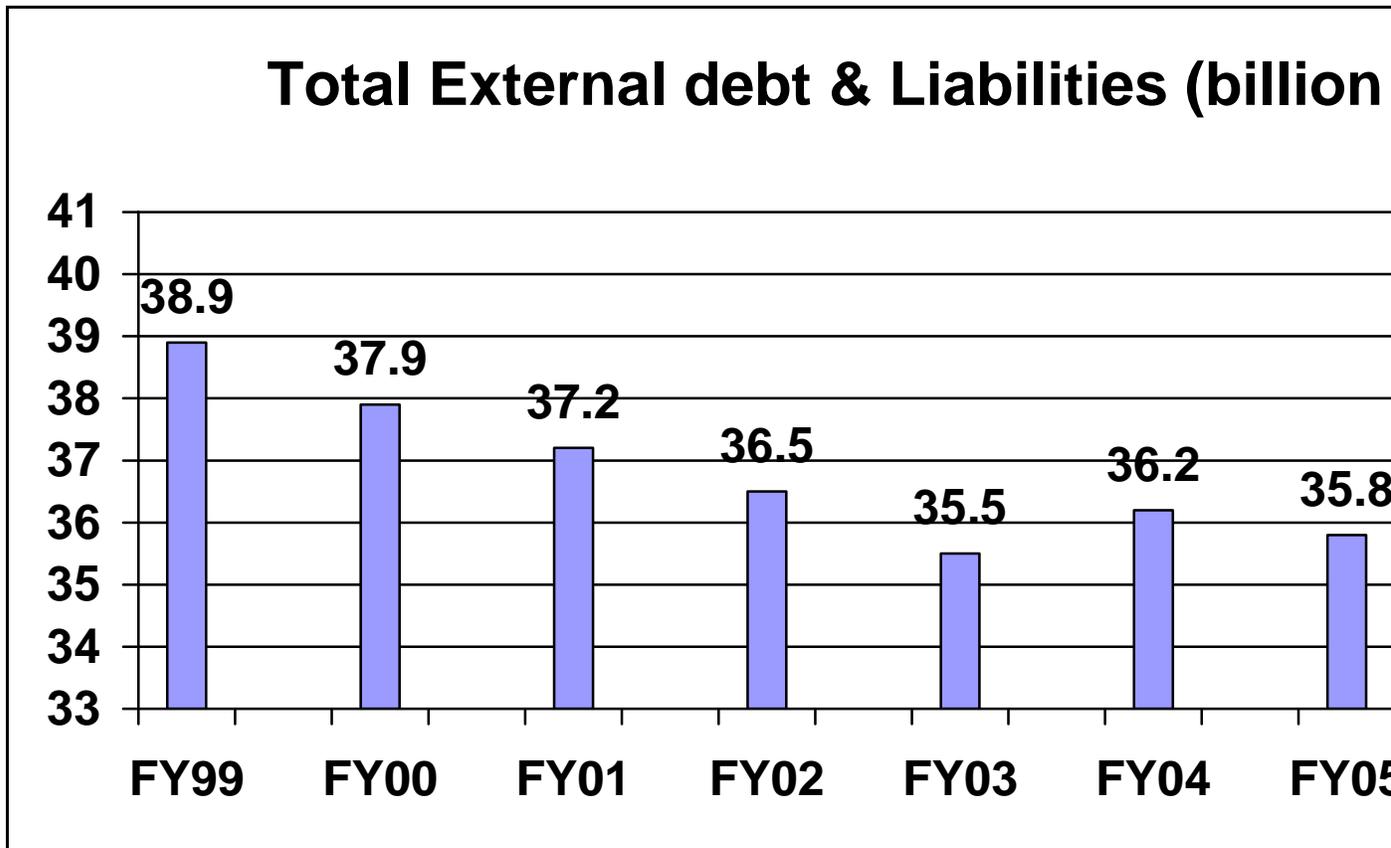
**CHART - V****Fall in Public debt**

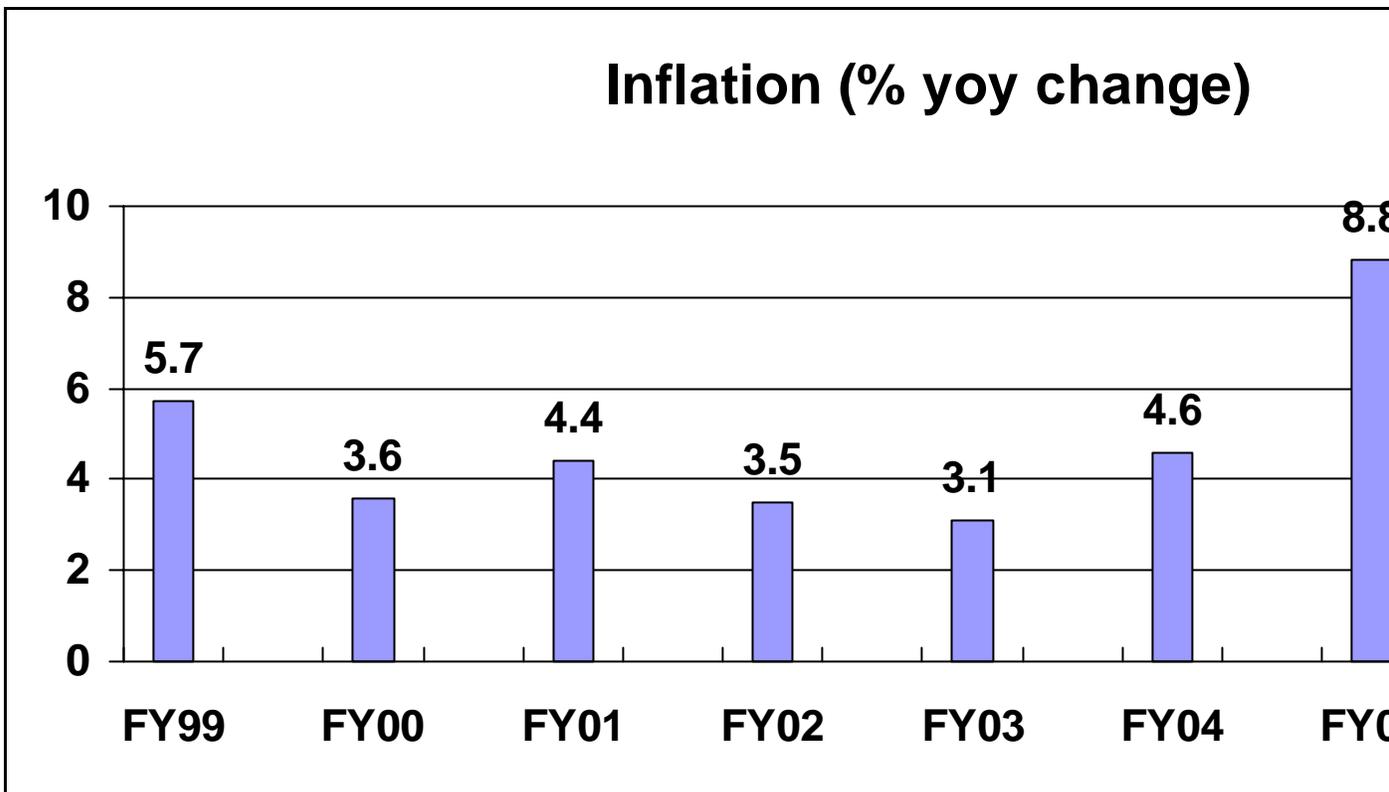
**CHART - VI****Improved Debt servicing capacity**

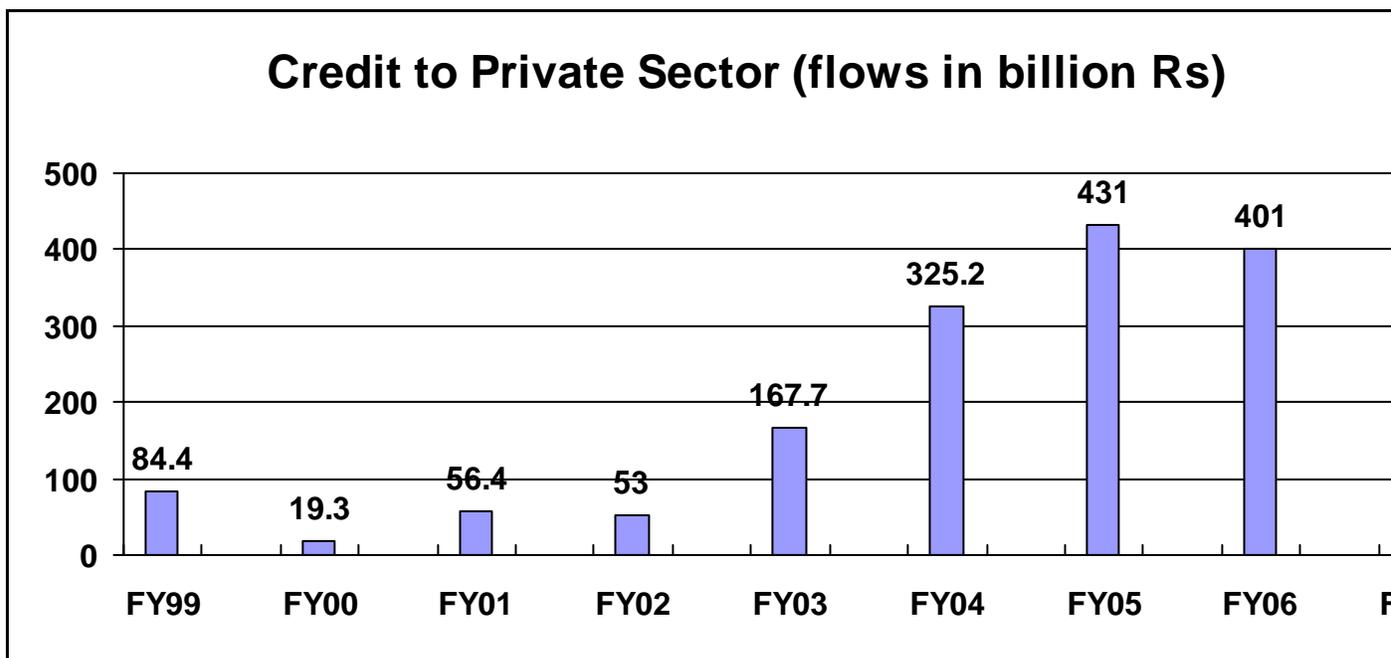
**CHART - VII**

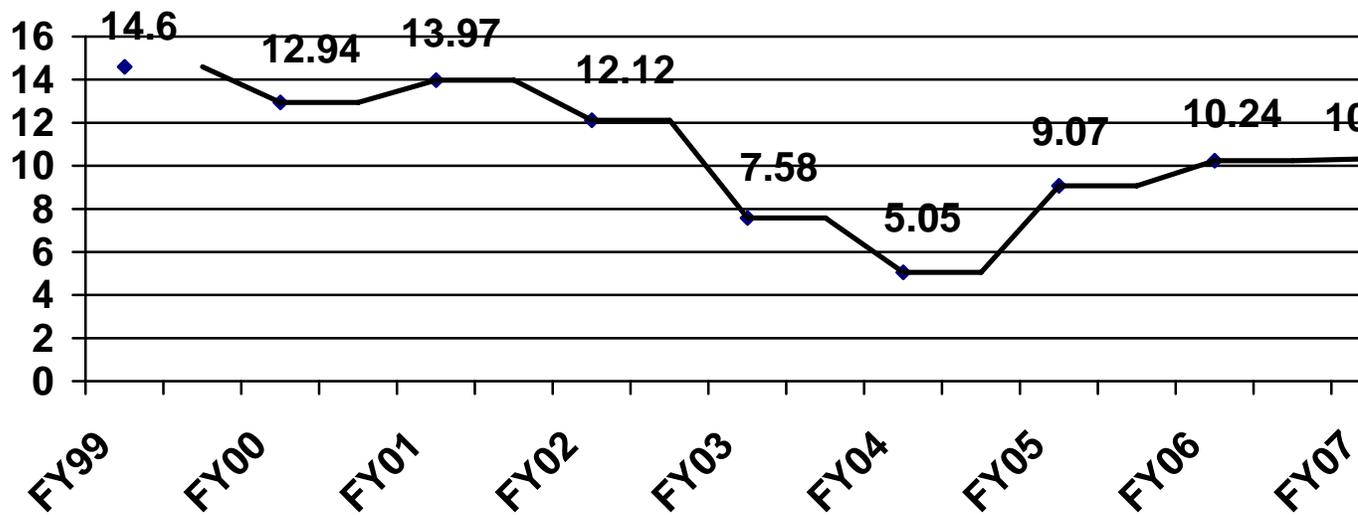
**Lower External Debt burden**

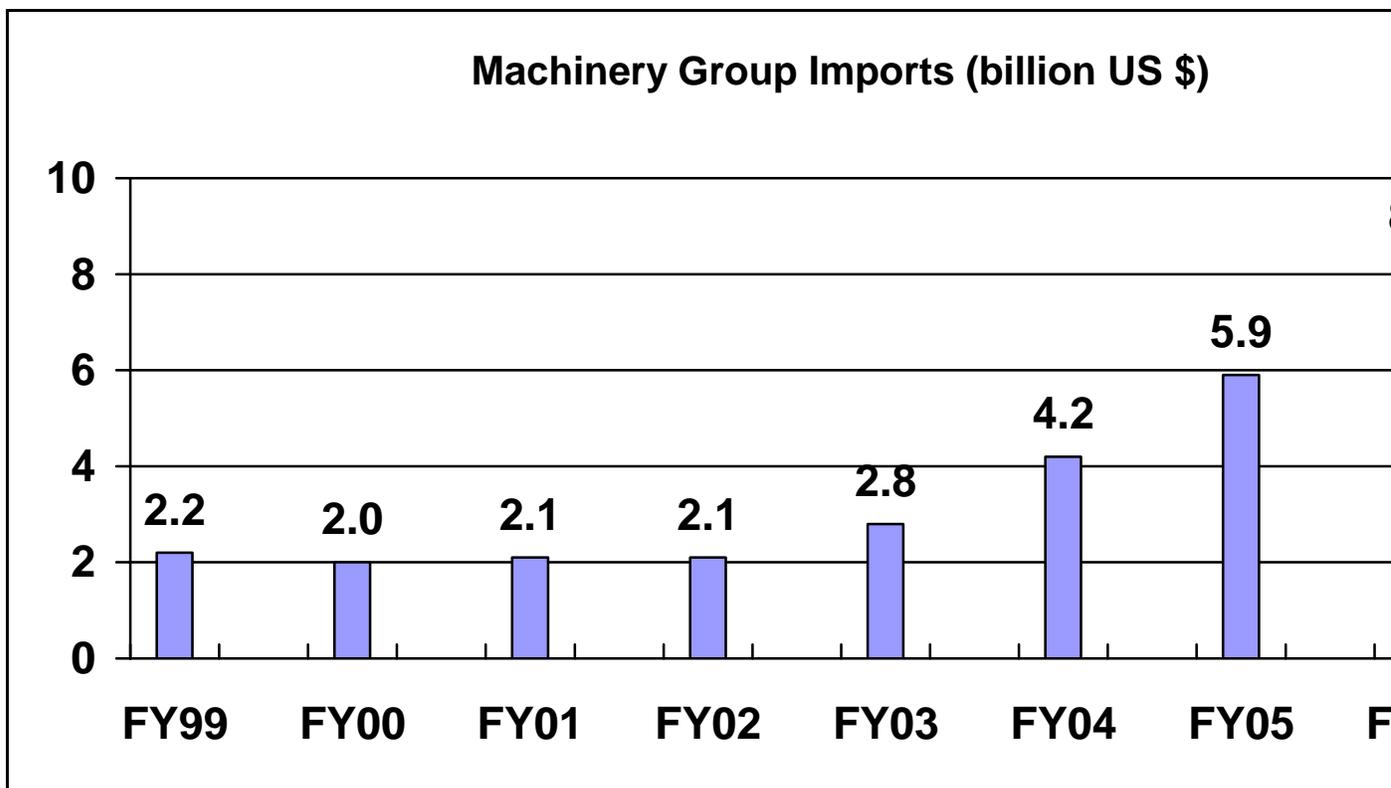


**CHART - VIII****Stagnant External debt & liabilities****HART - IX****Low Inflation for first five years**



**CHART - X****Large demand for Private sector credit**

**CHART - XI****Lower Cost of capital****Weighted Average Lending Rates (in %)****CHART - XII****Rise in Imports of machinery**



**CHART – XIII**

**Expansion in Exports**

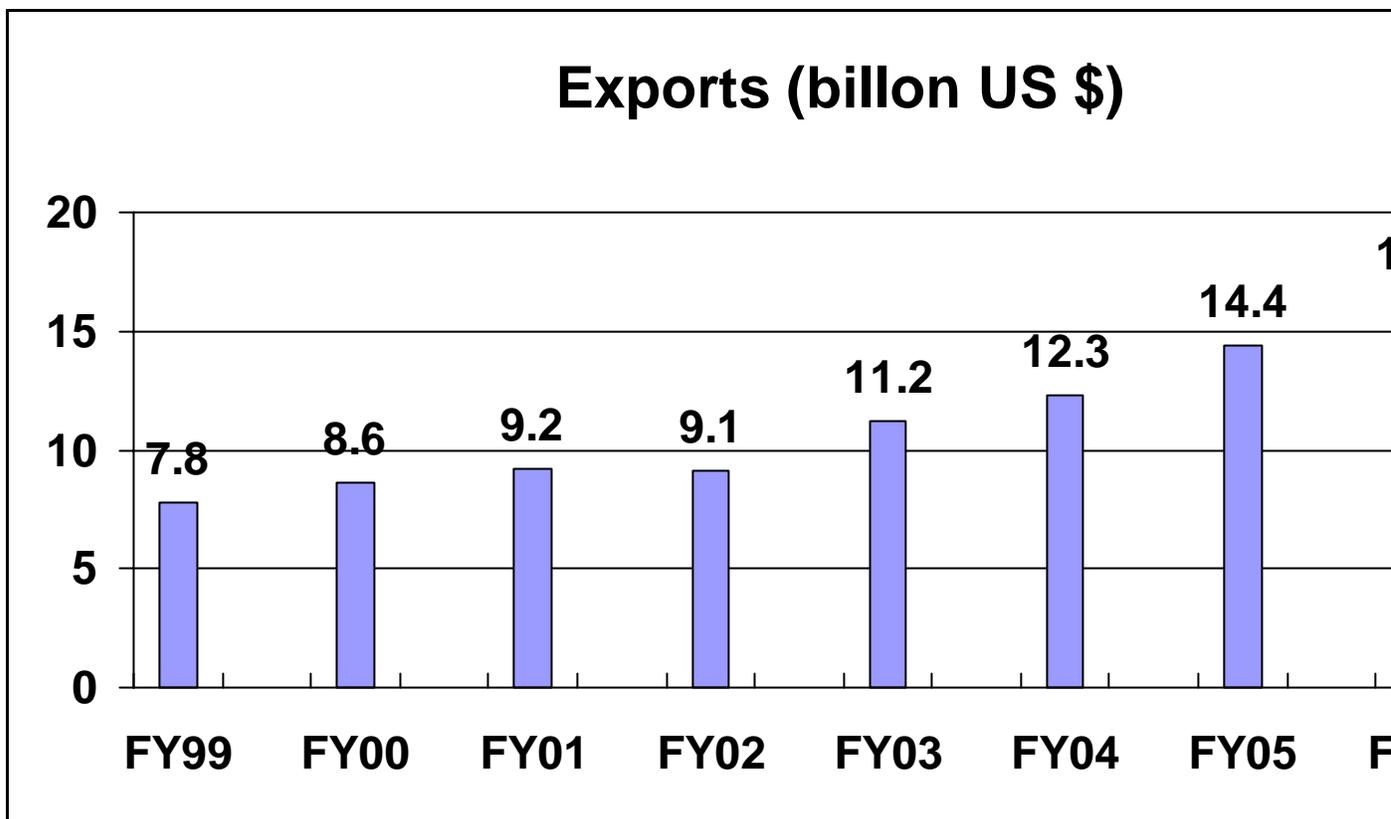
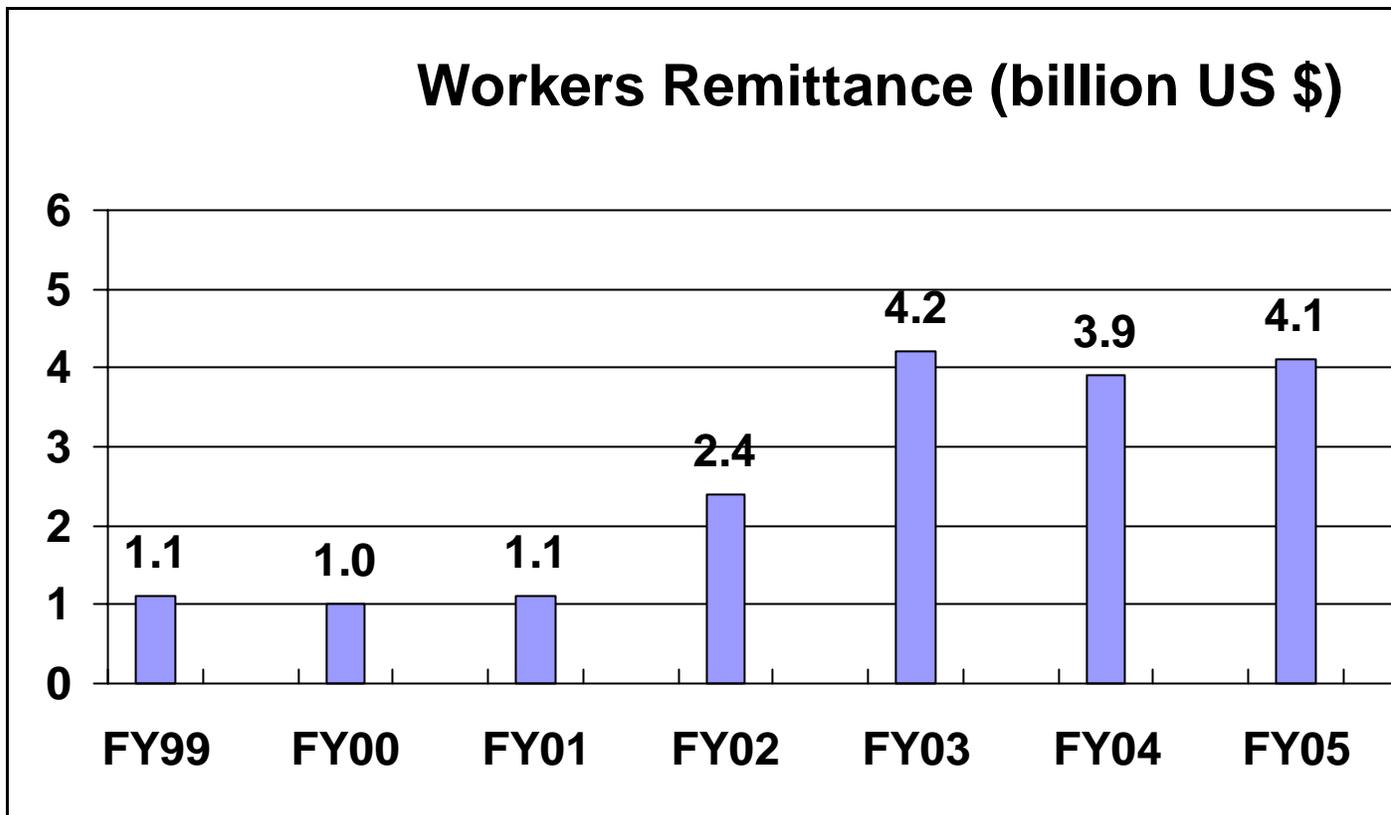


CHART - XIV

**Sharp increase in Remittances**



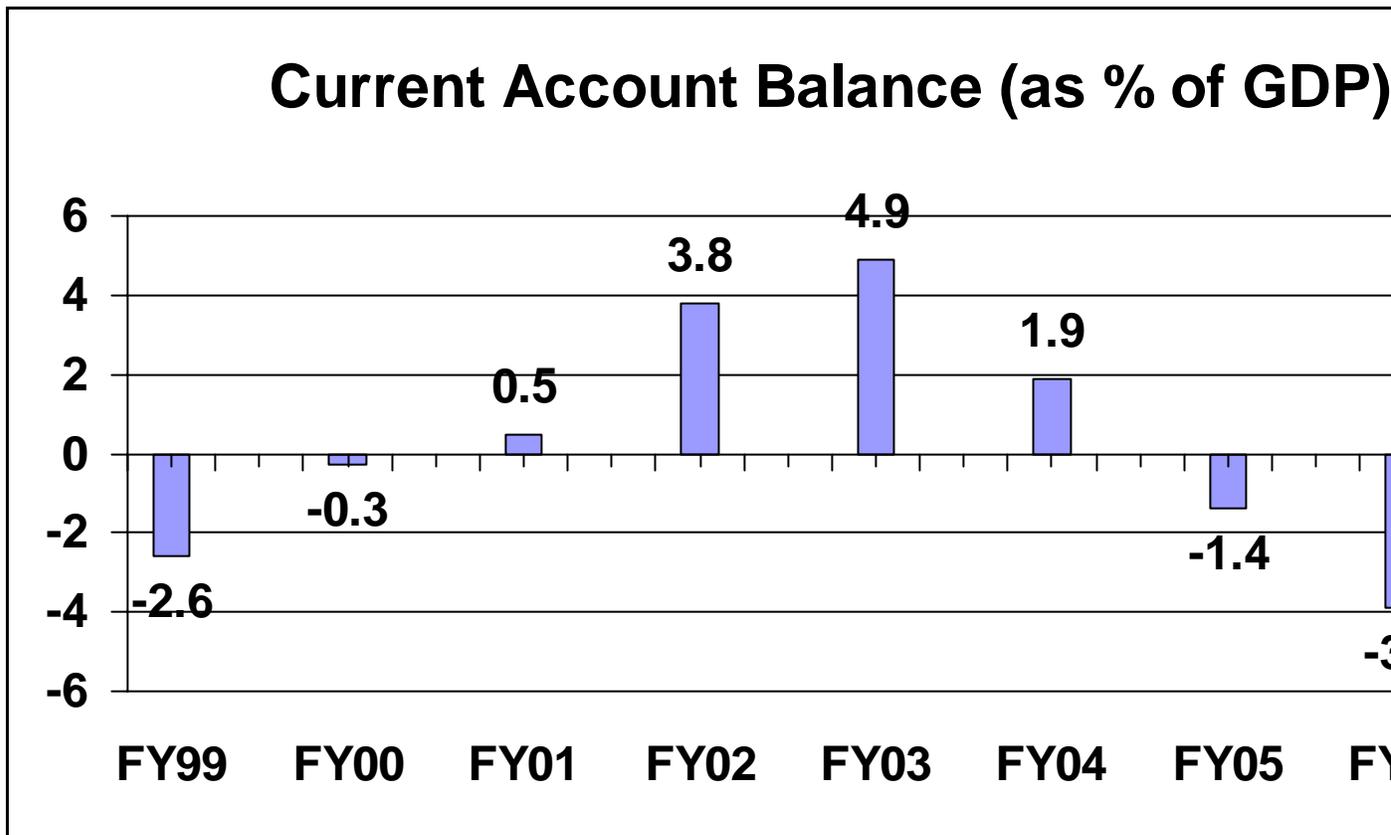
**CHART - XV****Surplus current account until FY 04**

CHART - XVI

**Strong Foreign Exchange Reserves**

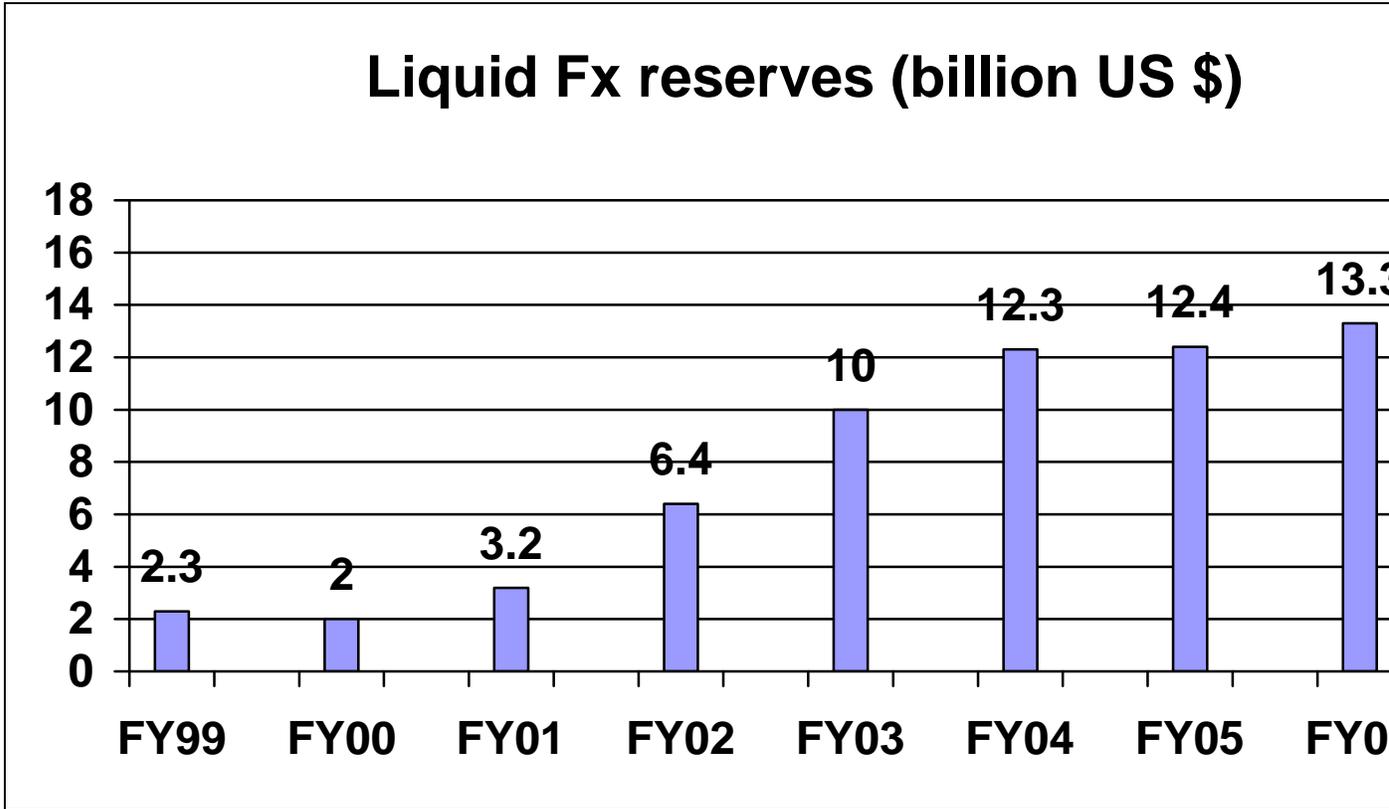


CHART - XVII

**Decline in incidence of poverty**

