ECONOMIC CHALLENGES FACING PAKISTAN

DR. ISHRAT HUSAIN

There is almost a consensus that the major economic challenges facing Pakistan are rising poverty and unemployment, heavy external and domestic indebtedness, high fiscal deficit and low investment. The debate has so therefore focussed on the means to face these challenges and particularly on the ways to bring about economic recovery.

The current debate about economic recovery in Pakistan has surprisingly boiled down to a number of simplified observations. A group of commentators place the blame squarely at the doors of the IMF and World Bank and this Government's sense of docility, submissiveness and helplessness against this powerful instrument of Western (read: American) domination. Another group of ever dissatisfied and perpetually critical writers who find every Government to be inept, attribute malafide motives and lack of decisiveness in taking bold measures. A third group of well-intentioned and economically literate observers, provide partial solutions which make perfect sense if each is taken in isolation but can break the back of the proverbial camel if they are lumped together. I would submit that there are no easy solutions and the decisions made in choosing any one of the possible options involve trade offs and choices, which in turn will create a different set of winners and losers.

I will like to focus today on a question which is uppermost on every body's mind: why have not things improved during the last 15 months according to popular expectations?

First the decade of 1990s was a lost decade as far as Pakistan's economic development was concerned. Frequent political changes and lack of continuity in policies, poor governance and the last May 1998 developments had together created very difficult economic conditions in the country by October, 1999. Per Capita economic growth rates had slided to 1 – 1.5 percent Investment rates had declined from 20 to 15 percent of GDP, poverty had doubled from 17 to 34 percent, external debt had doubled from $ 18 billion to $ 36 billion, debt servicing had risen to a level where it claimed 56 percent of revenues, fiscal deficits were averaging about 6 percent of GDP, Development expenditures, particularly on education and health, were curtailed by one half from 6 percent of GDP to 3 percent. In 1996 Pakistan was declared the second most corrupt nation in the world. The challenge of averting this slide and move the economy out of such critical conditions therefore was extremely daunting. The task was made even more difficult by the initial reaction of the international community to the change in the government and the conflicting demands of various segments of population. Accountability, whereby all those found guilty of corruption and malpractices in the past, was one of the major demands articulated by the public at large and the media. But this created a tension with the objective of economic revival as the businessmen and bankers felt threatened by such moves.

The lingering dispute with Hubco had during the preceding three years, damaged the investor friendly image of Pakistan. Foreign currency deposits of non-resident Pakistanis had been frozen in May, 1998 and had antagonized this

important class of investor. Thus investor sentiment did not take a turn for better and domestic and foreign investment which are key for economic revival did not flow in to the levels we had expected.

Second, we have to decide as to whose expectations we are talking about. Pakistan's credibility was quite low both externally and particularly among the International Financial Institutions and also domestically with the general public. This Government had to make a policy decision whether it will seek assistance from the International Financial Institutions or not. Until June 2000, the country was able to manage its finances without any recourse to International Financial Institutions. We serviced our debt and external obligations on time. We liberalized our foreign exchange regime and restored the conditions prevailing before May 1998 without receiving any assistance from abroad. The exchange rate remained stable without any major volatility. Interest rates were lowered by 4 percentage points. Despite this, domestic investors remained shy, private sector demand for credit was insignificant and the overall pace of economic activity did not pick up to make any dent in unemployment which had risen during the last three to four years.

The most difficult challenge faced by the country today in the short term is external liquidity problem i.e., the ability to meet its current obligations such as imports of goods and services and meet all debt service obligations at the same time. There is a gap between external receipts and external payments of about $ 2.5-3 billion annually for the next few years. To meet this gap Pakistan has to reschedule

its debt service obligations and find ways to obtain new concessional loans after curtailing its expenditures and maximizing its revenues.

Those who accuse the present economic managers of toeing the lines of the IMF, being totally submissive to their dictates and (in the eyes of some) acting as agents of these institutions forget a simple fact : Pakistan has had more than half-a dozen economic managers during the past 10 years, and some of them were popularly elected politicians, others were technocrats or former bureaucrats who had no past relationship whatsoever with the IMF or the World Bank. Unfortunately they had to enter into as many as 11 agreements with IMF during past 10 years, had to follow the same course of action and the same policy prescriptions, even at the time when we did not have the urgent need to reschedule Pakistan's external debt. These managers also had the luxury of using foreign currency deposits of residents and non-residents to finance the external deficit. They borrowed short-term commercial loans to build up reserves. I am not trying to be defensive but am laying out the facts that since May, 1998, the country has lost one important source of external liquidity i.e., foreign currency deposits. This Government has decided not to borrow short-term commercial debt for building up reserves. Home remittances through official channels are down by $ 500 million annually compared to the pre-May 1998 period. Foreign investment flows are down to less than $ 400 million compared to average flows of $ 1 billion. Oil import prices have shot up from $ 14-15 barrel to $ 28-$ 30 barrel and the oil import bill has doubled from $ 1.3 billion to $ 2.6 billion in just one year. During the first half of

the current fiscal year, we have already imported oil worth $ 1.7 billion. Despite the 15-20 per cent increase in volume of our textile exports, the unit value of our exports are down by 7-10 per cent on average. In this scenario, how can any one keep the wheel of the economy moving in an orderly manner without recourse to relief or injection by the International Financial Institutions. Japan and other bilateral donors have also not come to our help as they had before May 1998.

No economic manager worth his grain will like to have his hands tied down by external agencies, while he has to deliver according to the expectations of domestic constituents. The sooner we are able to ween ourselves off the IMF programmes the more liberated will be the economic managers of this country in pursuing an independent course of action, which balances the interests of the common man, the requirements of the global economy and, at the same time, follow a prudent growth – oriented set of policies. It is not that we are not committed to macro economic stabilization or removal of distortions from the economy. But we need the flexibility to do so. I can assure this audience that the present global environment in which we are expected to produce instantaneous results is highly constrained and does not allow much room for maneuver.

As the debt rescheduling period was coming to an end in December 2000, and the Government's capacity to fully service its external debt had not improved during the last 2 1/2 years period there were two options available – unilateral moratorium or further rescheduling. The option of unilateral repudiation or moratorium would have caused such enormous hardships for the country that it

would have been simply unbearable. How many of us could have tolerated the prospect of PIA planes being seized at international airports, the requirement that all our imports must be paid for in cash and the inflation rates running at 30-40 percent with scarcities and rationing all around. I do not think any Government would like its citizens to go through this scenario. We therefore rejected this option as we came to the conclusion that the situation would have been far worse and the overall suffering to the population would have been more severe.

The second option of approaching the IMF has been severely criticised. Many learned commentators have questioned why the economic team had to yield to all the conditionalities imposed by the IMF. Why did not the country negotiate softer conditions? As I mentioned our only motivation for entering into an agreement with the IMF was to secure rescheduling of Pakistan's external debt.

To retain its reputation as a vigilant watch dog, the IMF insisted, before reaching an agreement, on tougher measures and upfront actions from the government as we had displayed a poor track record in the past. Their management was of the view that Pakistan had very low credibility as successive governments had agreed on a number of conditions but these were either not fulfilled or partially fulfilled. They wanted the present government to implement all those conditions as prior actions before they could take the loan proposal to their Board. These prior actions consisted of the free float of rupee, (without intervention by the State Bank of Pakistan), agriculture income tax, GST on retail trade, GST on services, deregulation of petroleum imports, linking domestic POL prices to international

prices, increase in consumer prices of gas, adjustment in electricity prices, widening of the tax base, removal of the subsidies. Naturally the Government had little choice – if it did not take these actions an agreement with the IMF could not be reached and thus rescheduling would not have been possible. In other words, we had to make up for our past lapses – all in one go. There are many on-going time bound conditions that have to be met during the next 9 months, which are structural in nature such as privatisation, restructuring of public corporations, financial sector reforms and civil service reforms. While the fulfilment of these prior conditions and conclusion of agreement with the IMF has restored the credibility of Pakistan vis-a-vis International Financial Institutions, Paris Club and G-7 Governments and improved the market sentiment among credit rating agencies and fund managers abroad, I must confess that it has not been widely welcomed domestically.

The reasons for this domestic reaction are understandable. There has been very little investment in the country for the past several years with the result that unemployment has been rising. Fixed income groups – salaried class, pensioners etc., have not been granted any relief in the form of salary adjustments. Depreciation of the Rupee in the last several years has made imported goods and inputs quite expensive. Public sector investment has declined from 6% of GDP to 3% and lack of adequate tax revenues made it impossible to increase public spending and offset the slack created by low private investment. Government's highly desirable tax survey and documentation would widen the tax base and bring

in additional revenues but not immediately as it will take some time to complete the process and show results. The first year was devoted to get this survey accepted and put in place. In the meanwhile, those who were profiting from the untaxed black economy are running scared of documentation, finding ways to dodge the survey and withdrawing from economic activity. Thus trade, services, real estate, construction and transportation which were the main beneficiaries of untaxed income, are under severe strain. The businessmen who were habitual defaulters of bank loans are being asked to pay back. Tax payers who were registered but were evading taxes, are also finding it hard to find secure avenues for concealing their incomes and have thus slowed down their business activities. Utility companies have embarked on a vigorous campaign to detect theft of electricity and gas and recover dues from users. These structural changes during a short period of 12-14 months have altered the basic calculus of profitability and the sharing of costs and benefits between private businesses and the public exchequer. In the past, a large part of private investment including the equity of sponsors and profits were generated by obtaining loans from nationalised commercial banks and DFIs, which were seldom repaid in full, by evading taxes, concealing income and by underpayment to utility companies. Under these arrangements, the costs were borne by the public exchequer and the benefits accrued to those private businesses that indulged in these practices. Let me hasten to add that it is far from my intention to suggest that all businessmen were guilty of this malfeasance. Far from it, the majority of the businessmen want to work honestly. Neither do I wish to ignore the fact that this state of affairs was

taking place without the active connivance of public servants, tax officials, utility company employees and the staff of banks and DFIs. The point which I wish to make is that the post October 1999 period has witnessed, to some extent, a reversal of this past trend, however, this has been accompanied by a slow down in the desired pace of economic activity in the untaxed and informal sectors of the economy.

This does not mean that there has been no movement on the investment front. The three areas where investment activities are most brisk are Oil and Gas, I.T. and Textiles. Oil and Gas is highly capital intensive and thus the spill over effects to the rest of the economy will remain limited until such time that gas replaces fuel oil in power generation, cement and other industries. I. T. is highly skill intensive and is still in its infancy. It will create some employment opportunities for skilled and educated manpower both within the country and outside, but the overall impact on employment will again not be not very significant. Software exports are starting from such a low base that even 100% growth is unlikely to make much of a difference initially. The majority of young men and women in this country have obtained their higher degrees in Liberal Arts and Humanities with very few marketable skills – naturally they are not going to benefit. Textile industry is undergoing balancing, modernisation and replacement with the revival of a few sick and closed units. This industry will no doubt record productivity improvement as a result of this investment but will use the existing labour force without any demand for new labour. It is thus obvious that while investment is taking place in

some areas, its impact on overall employment, exports or import substitution in the short-term is likely to be limited. Although this will lay the foundation for a diversified economy in the future, but in the short run, the urban areas where most of the vocal elements reside, will not notice any perceptible improvement in their lot immediately.

The other area where substantial income generation has taken place during the last one year is in the agriculture sector. Bumper crops of wheat, rice and cotton, concomitant with higher producer prices, have transferred almost Rs. 100 billion to the rural areas. As most of the poor live in the rural areas, this transfer of purchasing power through higher demand for labour and the higher prices for cash crops and consumable products, has improved the well being of the rural population. This rise in rural incomes is beginning to translate itself in higher demand for consumer goods, agro-related inputs and equipment, and some durable goods. But the vagaries of weather and shortage of irrigation water this year may force the rural population to save some of their earnings as a precautionary measure to cope with the uncertainty of the future. In some districts, the Poverty Alleviation program is creating some employment for landless labour. But in the context of Pakistan, the rural population has always remained a silent majority – suffering quietly in bad times and living contentedly in good days. They do not fill in the op-ed pages of our leading newspapers and magazines, they do not make the rounds at the reception and dinner party circuits, and they do not articulate their

opinions forcefully and vehemently. So they aren't heard either in the corridors of power or in the spheres of opinion making.

Thus in this overall atmosphere of basic structural transformation, the implementation of conditionalities such as price increases in POL products, gas, electricity, transport, increase in prices of imported goods such as sugar due to depreciation of rupee, has not been well received well. If public sector expenditures and development projects were being initiated at the same time to give a kick start to revive the economy, then these conditions would have been perceived in a different light. But this Government is unable to do so because it has to meet the fiscal deficit target. Many public sector corporations and enterprises have to lay off excess workers (who were employed by the previous governments) to become financially viable. These policies, which have been welcomed by the International Financial Institutions, are naturally unpopular among the domestic constituents particularly those living in the big cities.

The second important reason as to why there is a gap between popular expectations and actual results, is that key economic institutions which are entrusted with the implementation of economic policies, are either unable or slow to deliver. They have been depleted of the competence, integrity and dedication of their staff. Most of these institutions are in financial disarray and have been saddled with non-professional manpower well in excess of their requirements. Top appointments were made on the basis of personal loyalty rather than merit and thus they have lost their direction and sense of mission.

The implementation of policies in Pakistan by these institutions has therefore been highly variable and uneven, as connections, sifarish and bribes had played the decisive role in final decision making. It is difficult for them to adjust to a more transparent and open system as it requires skills of a different kind – fact gathering, analysis and objective assessment. As they are unable to perform on these lines this particular class does not welcome changes and uses all possible pressure tactics (including liberal use of print media) to resist against the encroachment of their power and privileges.

Many of these key organisations such as CBR, WAPDA, Railways, Steel Mill are being restructured and transformed into efficient, viable entities with the objective of delivering the services to common man in a cost effective manner. But this cannot be accomplished in a short period of time as the mind set, attitudes and value system have to be changed. In the meanwhile, the general public has to pay the price for their inefficiencies, corruption and suffer humiliation at their hands. The present Government has directed that all appointments should be made on the basis of a merit based competitive system through Public Service Commission taking into account regional quotas. This new crop will hopefully enjoy a different value system that emphasizes service to the people, dedication to the job and integrity. But in the meanwhile we are stuck with the old value system.

Thus a combination of deliberate subversion and sabotage by the old guards and the lack of professional competence and integrity with almost no regard for public service, has slowed down the pace of implementation of many good policies.

I must confess that despite all the deregulation and liberalization, the bureaucratic hurdles and obstacles at the working level faced by the investors and common citizen in their day to day operations are still considerable. The maze of laws, regulations, rules and precedents under which our institutions operate, confer enormous discretionary powers to those who are to interpret and apply these rules. They can make you a millionaire or a pauper by a stroke of their pen. The redressal process is slow and cumbersome. The hierarchy is rigid and too inflexible. The supervision and oversight processes are weak and penalties for wrong doing or harassment are very rare.

The third factor, which in my view is responsible for the gap between the expectations and actual results, is the influence of unanticipated external and internal developments. All economic projections are based on a set of initial assumptions. As events unfold during the course of the year, some of these assumptions are not validated and diverge significantly from the original thinking. In our case, there have been three unanticipated developments. First, contrary to our expectations, oil prices did not show any decline but continued to show an upward trend touching $ 34 a barrel at one point earlier this year. This had adverse repercussions on the balance of payments of the country and also in terms of the periodic increases in domestic prices of P.O.L. products. As furnace oil is one of the main feed stock for electricity generation, these price rises also impacted the operations of WAPDA and KESC. The latter had to ration the supply of electricity to its consumers and resorted to load shedding. The impact of oil price escalation

was not limited to balance of payments or electricity generation but its linkage to transportation created upward pressures on the prices of domestic traded goods also.

Second, there has been a decline in the unit value of Pakistani exports. While favourable domestic policies and aggressive entrepreneurs can bring about increase in the quantity and quality of exportable goods, they have no control on the prices they can fetch. These prices are determined in the international markets. The narrow export structure under which two-thirds of our exports are cotton and textile based, does not allow new and non-traditional exports to offset the deterioration in the unit value of textile exports. While the cynics and pessimists may keep on moaning about the lack of an exportable surpluses in the country the fact is that the exportable surplus has been generated by the farmers and businessmen of this country, but depressed world prices have not allowed this to be translated into higher export earnings.

Another factor that has not so far helped us, is the non-resumption of Foreign Direct Investment inflows at the levels we had envisaged. The Hubco dispute has only recently been resolved, removing a long standing irritant to foreign investors. Oil and gas and I.T. investments have just begun to be finalised and will take some time to materalize. In the meanwhile there have been some disinvestments for global strategic non-economic reasons which were beyond the control of Pakistan's economic managers.

To conclude, the gap between expectations and the actual economic performance can be explained by a number of factors but the constraint imposed by global environment including the conditionalities of IMF, the inability of our key economic institutions in implementing policies and unanticipated external developments are the principal factors. This does not mean that we would like to absolve ourselves of the mistakes we have made or you should ignore the shortcomings in our decision making. But I can assure you that if this has happened it is purely unintentional because our commitment and dedication to turn things around for the betterment of the country is as strong and fierce as any one else's.