<u>ECONOMIC CHALLENGES FACING PAKISTAN</u>

<u>THE ROLE OF THE UNITED STATES</u>

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Pakistan's new government which assumed office under President Musharraf in October 1999 was faced with four main challenges: heavy external and domestic indebtedness; high fiscal deficit and low revenue generation capacity; rising poverty and unemployment; weak balance of payments. In addition, Pakistan was perceived as a highly corrupt country with poor governance. A survey by Transparency International ranked Pakistan as the second most corrupt country in 1996. The situation was exacerbated by the initially hostile reaction of the international community to the military takeover of the government. Further, the lingering dispute with independent power producers – all foreign investors – had damaged the investor friendly image of Pakistan. The distrust engendered by the freezing of foreign currency deposits of non-resident Pakistanis had not been erased. Pakistan's credibility was at its lowest ebb 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. At the same time, Pakistan was not in a position to service its external debt obligations without immediate rescheduling as it faced a serious liquidity shortfall. The reserves were barely sufficient to buy three weeks worth of imports and were inadequate to service even short-term debt obligations. Workers' remittances were down by one-third, foreign investment flows had dwindled by almost 60 percent, official transfers had turned negative, exports had declined and Pakistan had no access to private capital markets.

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In the domestic sector, with 80% of revenues pre-empted to debt servicing and defence, the declining tax-GDP ratio and inflexible expenditure structure constrained the government's ability to increase the level of public investment. As a consequence, development expenditure had halved from its previous level.

What has been achieved during the last five years? A fuller documentation of the reforms undertaken is available elsewhere[1] but let me recapitulate the salient achievements:

The initial period was devoted by the economic team of the new government to managing the crisis and making sure that the country avoided default. A comprehensive programme of reform was designed and implemented with vigor and pursued in earnest to put the economy on the path of recovery and revival. The IMF and the World Bank were invited to enter into negotiations on new stand-by and structural adjustment programmes.

Although the canvas of reform in Pakistan was vast and corrective action was required on a number of fronts there was a conscious effort to focus on achieving macroeconomic stability, on certain key priority structural reforms and on improving economic governance. The structural reforms included privatization, financial sector restructuring, trade liberalization, increasing pace towards deregulation of the economy and generally moving towards a market-led economic regime. Keeping this in mind, one can ask what have been the outcomes of the economic reforms undertaken during the past five years?

Macroeconomic Stability:

There has been considerable progress in achieving macroeconomic stability. Growth rate has reached its historical average of 6 percent plus,

[1] Ishrat Husain, Economic Management in Pakistan 1999-2002 (Oxford University Press 2003)

leading towards a path of reduction in poverty. Inflation has been contained to below five percent. Strong fiscal adjustment has led to primary budgetary surplus and a significant reduction of fiscal deficits. The current account has turned around from chronic deficit to a surplus for three successive years, mainly due to renewed export growth and resurgence of workers' remittances. External debt burden has been reduced in absolute terms from $38 billion to $35 billion and as a proportion of GDP, from 62.5% to 46%. The risk of default on external debt, which loomed large on the horizon in 1999 and 2000, was mitigated and the country's capacity to service its restructured debt has considerably improved. Exchange rate has not only stabilized but appreciated during the last two years. Table I shows the changes in the key economic indicators between October 1999 and June 2004.

Structural Reforms - Privatization, Deregulation, Liberalization:

The Musharraf Government actively pursued an aggressive and transparent privatization plan whose thrust was on the sale of assets in the oil and gas industry as well as in the banking, telecommunications and energy sectors to strategic investors, with foreign investors encouraged to participate in the privatization process. This plan is also being followed by the democratically elected government since October 2002.

To demonstrate the seriousness of the government in encouraging foreign investment flows in Pakistan, there has been a major and perceptible liberalization of the foreign exchange regime. Foreign investors can now bring in and take back their capital, remit profits, dividends and fees etc., without any restrictions. Foreign Portfolio Investors (FPI) can also enter and exit the market without any restrictions or prior approvals. In the Karachi Stock Exchange, with a market capitalization of $20 billion, over 700 listed companies showed average returns of 15 per cent - higher than those in most emerging countries. This makes Pakistan an attractive place to invest for foreign portfolio investors. As part of this liberalization, non-residents and residents are allowed to maintain and operate foreign currency deposit accounts, and a market-based exchange rate in the inter-bank market is at work.

Allied to this effort, the trade regime has been opened up and the maximum tariff rate has been cut down to 25 per cent, with only four slabs, and the average tariff rate is down to 14 percent.

The financial sector too, has been restructured and opened up to competition. Foreign and domestic private banks currently operating in Pakistan have been able to increase their market share to more than 80 percent of assets and deposits as the government privatized state-owned banks. The interest rate structure has also been deregulated and monetary policy uses indirect tools such as open market operations, discount rates etc. Domestic interest rates on lending have dropped to as low as 5 percent from 20 percent, substantially reducing the financial costs of businesses.

Central to the economic reforms process has been a clear progression towards deregulation of the economy. Prices of petroleum products, gas, energy, agricultural commodities and other key inputs are determined by the market. Imports and domestic marketing of petroleum products have been deregulated and opened up to the private sector. The markets do not always function effectively. Independent regulatory agencies have been set up to protect the interests of consumers and end-users of utilities and public services. The movement towards a liberalized and deregulated regime is taking its own pace to set in.

Tax Reforms*:*

Taxation reform has figured prominently in the government's agenda. This is another area where the business community had innumerable grievances and dissatisfaction with the arbitrary nature of the tax administration. Tax reforms are aimed at broadening the tax base, bringing in tax evaders under the tax net, minimizing personal interaction between tax payer and the tax collector, eliminating the multiplicity of taxes and ultimately reducing the tax rate over time. A massive survey and documentation drive was undertaken to widen the tax base, extend incidence to all sectors of the economy and develop the data for purposes of assessment. Universal self-assessment scheme has been introduced for income tax and measures are under way to extend similar schemes for other taxes also. The Central Board of Revenue (CBR) is being restructured to improve the tax administration including taxpayer facilitation. Information technology tools are being used to simplify processes and reduce discretion.

Economic Governance:

The most dramatic shift introduced by the military government is in promoting good economic governance. Transparency, consistency, predictability and rule-based decision-making have begun to take roots. Discretionary powers have been significantly curtailed. Freedom of press and access to information has had a salutary effect on the behaviour of decision makers. The other pillars of good governance are, (a) devolution of power to the local governments who will have the administrative and financial authority to deliver public services to all citizens, and (b) an accountability process which will take to task those indulging in corruption through a rigorous process of detection, investigation and prosecution.

Pakistan has been able to establish its credibility as a serious player in the international financial community by successfully implementing the full IMF programmes without any delay or interruption over a period of four years. This is an unprecedented record in the history of economic management in Pakistan and has led to the upgradation of Pakistan’s credit rating from selective default in

1999 to B2 in 2003. This can safely be equated to an almost universal appreciation of our track record by bilateral and multilateral creditors. On the basis of this record, Pakistan entered the international markets to raise $500 million at fine prices. There was an overwhelming response to Pakistan's floatation and the issue was oversubscribed at four times the initial value.

THE CHALLENGES AHEAD:

The experience of the 1990s amply demonstrates that political instability, poor governance and frequent changes in the government were detrimental to Pakistan's economic progress. On the other hand, there has been remarkable improvement in the economy for the last five years under conditions that involve political stability, good governance and continuity and consistency in economic policies. The biggest challenge facing us, therefore, is the perpetuation of these conditions under which a democratic dispensation can be made compatible with good governance and rapid economic development. This nexus between democracy and good governance is what is needed by Pakistan in its journey forward. Too excessive preoccupation with the abstract principles of democracy alone or too much emphasis on good governance in absence of democratic institutions and checks and balances will not produce the desired results. An integrated package combining the elements of democracy and good governance will serve the economic interests well and create political stability.

Democracy is by far the best form of government as it is based on consensus, conciliation and compromise among the various conflicting interest groups. It is built upon broader participation by all segments of population. An orderly transition of government under democracy removes all elements of uncertainty among investors, lays down a predictable course for the future, clarifies the rules of the game under which business can be carried out and assures the rule of law. The ruling party or individual who is unable to deliver the goods according to the electorate's expectations is rejected at the time of polls.

This instrument, therefore, acts as a powerful tool for accountability. But, there exists a perceived tension between good governance and democracy.

Elected politicians wish to support a variety of 'relief packages' in the name of the common man. They want to give generalized subsidies out of the exchequer. They create artificial jobs for their supporters in public sector organizations – eventually turning the organizations into loss making bodies. These losses are then financed out of budgetary subventions, raising fiscal deficits further. Appointments in key civil service positions are made on the basis of loyalty rather than competence. At the same time they do not wish to raise the taxes that will fund these packages for fear that they will become unpopular among the public. When in office politicians indulge in massive deficit spending i.e. by borrowing money from the banking system, the Central Bank and external creditors. These policies give rise to unsustainable debt burden, inflationary pressures and crowding out of private sector from credit markets.

This combination of macroeconomic instability, low private sector investment and low growth brings disaffection and a bad name to the ruling party which is rejected at the next elections. This self destructive cycle is repeated constantly but the lessons learnt from this experience are not internalized.

Good governance requires that fiscal discipline is maintained, expenditures beyond a certain level are not undertaken, revenues are mobilized by extending tax cover to those outside the net, subsidies are targeted at the poor and the vulnerable only, employment is generated for productive purposes and given on merit to those who are qualified. This set of considerations appears to be at variance with the demands and actions of elected politicians. If we somehow succeed in reconciling these imperatives of good governance with the compulsions of elected politicians in a democracy, we will be able to steer steadily along the path of high growth that we aim to achieve in the coming years.

The second challenge facing any developing country and, particularly Pakistan, is the nature of its international economic relations both bilaterally and multilaterally. Pakistan has been a recipient of official bilateral assistance from the United States since the early 1950s, which was later interrupted in the 1990s. However, this assistance has been resumed since September 2001. Pakistan has also been supported by international financial institutions such as the IMF, the World Bank and the ADB. A few years ago the Paris Club agreed to re-profile the stock of official bilateral debt of Pakistan on a long-term sustainable basis. These gestures have been highly appreciated by Pakistan and have certainly helped the country in its pursuit of economic development.

But the time has come for a re-appraisal of this strategy. In the globalized economy, we need market access for our exports, lowering of barriers against trade, flows of foreign direct investment, transfer of technology, easy movement of labour and active collaboration in scientific education, research and development. Pakistan will benefit a lot if, for example, the United States allows our textiles and clothing to enter the U.S. markets on the same terms and conditions as given to Mexico, Central America, Caribbean and Sub Saharan Africa. This single gesture alone will generate hundreds of thousand new jobs in the economy, boost our foreign exchange earnings substantially and escalate our economic growth to new horizons. Pakistan would prefer to have greater access to the U.S. market compared to increased aid allocation. The textile firms in North Carolina, South Carolina, Georgia, Alabama who are going to be hit hard by the new agreement on clothing and textiles effective in January 2005 can also save some jobs by entering into joint ventures, strategic alliances, marketing partnerships, technical collaboration agreements with Pakistani firms. As the latter produce goods at low costs compared to their counterparts in the U.S., the specifications, designs, marketing, quality control, research and development can be assigned to the U.S. firms, while production can take place in Pakistan. The machinery in the U.S. can be shipped to Pakistan in lieu of equity in the joint ventures. In this process, the American consumer will buy clothing at lower prices, some of the American workers will be able to save their jobs and Pakistan will expand output, exports, employment and reduce poverty. This is a win-win situation for both the countries and does not involve U.S. tax payers' money that goes into aid.

Pakistan has opened up its economy as it allows 100 percent foreign direct investment in all the sectors. Tariffs are low and non-tariff barriers have been removed. There are no restrictions or prior approvals on the repatriation of capital, profits, dividends, remittances, royalties and technical fees. Financial sector is healthy and robust and is owned and managed mainly by the private sector. Pakistani banks make financing available – both long-term and short-term – to the foreign companies at the same terms as to local companies.

A country with a 30 million strong middle class enjoying per capita incomes (in purchasing power) of $8,000 - $10,000 is an attractive market for U.S. investors. The rates of return on equity and assets are much higher than what they can obtain elsewhere. There hasn't been any single case of expropriation of foreign investment in the entire history of Pakistan. Skilled and educated labour force is available at low wages. The legal system that is essentially based on the British system is predictable, although slow. Thus, American firms locating their investment in Pakistan either as the platform for exports to third countries or exploiting the vast domestic market will be most welcome.

Pakistan has decided to access international capital markets for meeting its external financing needs. Private equity and debt funds, hedge funds, pension funds, mutual funds and other investors can earn an above-average return by investing in Pakistani paper while being assured of safety and liquidity of their investment.

A third and more formidable challenge is to invest in human development as Pakistan's indicators in this field are sub-optimal. The neglect in education, training, skills and professional development for a very long period has seriously impaired Pakistan's capacity to march forward in the knowledge economy. Of course, the United States and the Middle East have been able to attract several million doctors, engineers, accountants, IT professionals, bankers and teachers from Pakistan, but the rates of accumulation remain low and the overall quality worrisome. Female education and female labour force participation rates are areas where Pakistan has begun to focus only recently. The agenda for poverty reduction and better income distribution can hardly make any headway unless investment in and management of education, health, nutrition, drinking water and sanitation take a discrete jump from their present levels. The public sector has been unable to meet this challenge. Recent experience has shown that public-private-community partnership can produce better results. The United States government and philanthropic institutions such as the Ford Foundation and the Rockefeller Foundation have played a very important role until the 1980s in the field of education, science, research and technology and trained thousands of civil servants, military officials and other professionals who have rendered invaluable services to their country. But the interruption in this facility since the Pressler Amendment in the early 1990s has proved to be very damaging. It has been realized by the present administration that investing not only in primary education but also in higher education, in the training of civil servants and in science and technology will not only improve the economic conditions of Pakistan, but also create a better understanding of the U.S. in Pakistan.

The myopic policy of refusing visas to students of high and upper middle class Pakistanis who get admissions to the top universities in the U.S. is increasing alienation among this influential group which has been traditionally the supporter and defender of the U.S. in the intellectual discourse. The discouragement of Pakistani students trying to enroll in hi-tech scientific disciplines is also, in my view, highly counterproductive. They eventually go to other places and avenues at the cost of the U.S. scientific establishment. Therefore, I will argue for a more pro-active collaboration between the U.S. and Pakistan – at the public, private, not-for-profit, organization levels in the field of human development.

The fourth challenge pertains to development of physical infrastructure – power, oil and gas pipelines and terminals, ports, railways, roads and highways and airports. Pakistan has huge investment requirements in each of these areas otherwise high growth will be stifled. Congestions and shortages are hiking up the cost of doing business and eroding the competitiveness of Pakistani exports. Public Sector Development Programme can finance only one half of annual requirements. The remaining requirements will have to be filled in by the private sector. U.S. companies engaged in these activities should seriously explore the possibility of investment in Pakistan's physical infrastructure projects as the rate of returns is high and the capital is safe.

Conclusion:

Pakistan had made headway in reviving its economy in the last five years by achieving macroeconomic stability, resuming the path for high growth, introducing deep-rooted structural reforms and improving governance. But the challenges facing the economy ahead are still very daunting. The United States can play a critical role in further helping Pakistan meet these challenges by shifting its support from conventional aid to market access, investment, technology transfer, education and training, scientific research and infrastructure development. This new relationship is in conformity with the demands of the globalized economy, the development aspirations of Pakistan and interests of the U.S. businesses.

TABLE – I

CHANGES IN KEY MACROECONOMIC INDICATORS

	October 1999	**June 2004**	**Change in the Indicator**
GDP Growth Rate	4.2%	6.4%	Positive
Inflation	5.7%	4.6%	Positive
Fiscal Deficit/GDP	-6.1%	-4.0%	Positive
Current Account/GDP	-3.2%	2.0%	Positive
Domestic Debt/GDP	52.0%	35.0%	Positive
External Debt	$ 38 billion	$ 35 billion	Positive
Remittances	$ 88 million per month	$ 300 million per month	Positive
Exports	$ 7.8 billion	$ 12 billion	Positive
Tax Revenues	Rs. 391 billion	Rs. 510 billion	Positive
Rupee-Dollar Parity	Depreciating	Appreciating	Positive
Foreign Direct Investment	$ 472 million	$ 950 million	Positive
Foreign Exchange Reserves	$ 1.6 billion	$ 12.0 billion	Positive
Poverty Incidence	33%	Data not available	Neutral
Poverty related expenditure	Rs. 133 billion	Rs. 208 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 2003-04 or June 2004.