# STRUCTURAL REFORMS IN PAKISTAN'S ECONOMY

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Pakistan is one of the few developing countries that was able to attain an impressive record of economic growth and poverty reduction in the first forty years of its existence. GDP growth rate until late 1980s averaged about 6 percent per annum and the incidence of poverty was lowered from 46 percent to 18 percent. Inflation remained low and despite high population growth per capita incomes had almost doubled. This favorable situation was reversed in the decade of the 1990s. Growth rates tumbled to an average 3 to 4 per cent and poverty resurged to 33 percent of the population. Inflation was in double digits, large current account and fiscal deficits escalated debt – GDP ratios to over 100 percent. The country's foreign exchange reserves fell to less than $1 billion, exports were stagnant, tax collection efforts were lackluster. The country was almost on the verge of a default crisis on its external payments in

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October 1999 when President Musharraf took over the reigns of the Government.

He assembled an economic team of technocrats under the leadership of Shaukat Aziz to formulate and implement a strategy that prevented not only the payments crisis but also led to the revival of the economy. The team was given full support and a free hand in its work. I do not wish to dwell on the actual course of events but suffice to say that the outcome of the implementation of this strategy during the last six years is quite remarkable. GDP growth in 2004-05 reached 8.4 percent after recording upward moving growth rates in the preceding three years; inflation during the first five years of the present regime was lower than 4 percent, only in 2004-05 it exceeded 9 percent; manufacturing sector output growth was over 15 percent, exports have doubled in US dollar terms in these five years, tax revenues have risen by 14 percent a year although Tax-GDP ratio is still low. Consolidated Fiscal deficit is down to 3.3 percent of GDP. Current account was in surplus for three consecutive years turning to a modest deficit of 1.5 percent of GDP in last fiscal year due to oil price shock. Workers' remittance flows have multiplied four-fold to over $4 billion annually and Foreign Direct Investment has witnessed a sharp escalation to $1.5 billion, about 1.5 percent of GDP.

Public sector enterprise losses have been curtailed substantially. Foreign exchange reserves are twelve times their level of 1999 at over $12 billion and cover nine months of imports. Debt-GDP ratio has declined to 56 percent and the savings on debt servicing have allowed the Government to triple its public sector development program from almost $1.7 billion to $5 billion investing in infrastructure and human sector development. Pakistan has successfully entered international capital markets and raised over $1 billion at extremely fine pricing that was better than the investment grade sovereigns. Both sovereign bond issues were subscribed four times and are at present trading at much tighter spreads than the EMBI average. The most recent survey of doing business in the world conducted by the World Bank and IFC has placed Pakistan as one of the ten top reformers and Pakistan ranked 60 in the  case of doing business – quite a high position among the developing countries surveyed.

How was this turnaround achieved in such a short period of time? Our strategy was to launch a multifaceted attack that combined macroeconomic stabilization, reduction in debt burden, fundamental structural reforms and improved governance. We felt that pursuing simply stabilization was not enough as it would have turned out to be a short term palliative and the risks and vulnerabilities of relapse into crisis situations would have remained elevated. What were the ingredients of this strategy and what was the sequencing and phasing of the various policy actions taken to implement this strategy?

The first and foremost measure was to find a durable solution to the external debt problem as it was the major cause of stress to the economy. Bulk of the debt was owed to multilateral institutions and the bilateral official creditors. The former was unassailable and thus the focus was centered on the bilateral debt reprofiling. To make any headway on that front, the country had to come to terms with the IMF. The problem here was that in the decade of the 1990s, Pakistan had entered into successive agreements with the Fund but never implemented any one of them beyond the first or second tranche release. This had created a credibility gap for Pakistan among the international financial institutions. To resume any meaningful relations with the IMF, we had to establish a track record of performance before they could agree to debt restructuring. In 2000, Pakistan entered into a nine-month stand-by arrangement which involved a large number of prior policy actions, performance criteria and structural conditions. Only after the stand-by program was completed well before September 11, 2001 to the full satisfaction of the IMF authorities that Pakistan was able to secure a long-term restructuring of its Paris Club debt. The popular notion that the Sept. 11 events helped Pakistan obtain favorable terms on its Paris Club debt is contrary to the facts. We had already reached an agreement well before Sept. 11 with the Fund on a three-year Poverty Reduction and Growth Facility (PRGF) of which the debt restructuring was an integral part. The success on the external debt front was absolutely essential for macroeconomic stability and we worked assiduously for almost a year prior to the approval of PRGF to fulfill all the conditions pre-requisite for obtaining debt reprofiling on a long term basis. The short term consolidation of debt was rejected as an alternate and therefore the country had to suffer the harsh and onerous conditions specified by the IMF under its stand-by program.

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 have begun to help improve tax collection although tax-GDP ratio has not yet improved.

The next major thrust of the reform program was privatization of state-owned enterprises. Fortunately, the privatization process was initiated in 1991 under the Nawaz Sharif Government, continued under the Benazir Government, and further intensified under the Musharraf Government. Thus, there is a wide political consensus and support for privatization because of an underlying belief that the Government should not be in the business of running businesses but regulating the markets and laying down policies. Pakistan's record on privatization has been impressive and this has helped in stopping the hemorrhaging of public finances and easing the pressures on fiscal deficit.

Financial sector reforms in Pakistan were also initiated early in the 1990s when private domestic banks were allowed to set up their shops along with the nationalized commercial banks. Although these reforms were implemented with fits and start, they were accelerated in 1997 when the Nawaz Sharif Government brought in professional managers and boards of directors consisting of reputable persons from the private sector to manage and oversee the nationalized commercial banks. The Central Bank was granted autonomy and the control of the Ministry of Finance over banking institutions was diluted. Excess labor was shed off through voluntary golden hand shake schemes and unprofitable branches were closed down. Further reforms were undertaken since 1999 when the non-performing loans were tackled in a decisive manner, minimum Capital requirements were raised, the quality of new loans was improved, mergers and consolidations of financial institutions took place and the range of products and services offered by the banks was widened. But the most crucial policy action taken by the Government, in my view, was the privatization of Habib Bank, United Bank, and Allied Bank – three large nationalized commercial banks of the country. As a result of these reforms, the share of the private sector ownership of the banking assets has risen to 80 percent. The banks are highly profitable and the average lending rates declined to as low as 5 percent as automation, on-line banking and multiple channels of delivery have improved the efficiency of services and a healthy competitive environment has set in. Agriculture credit, SME financing, consumer loans and microcredit have become mainstream products of the banking industry and diversified their risks.

The middle and lower middle class which had been completely shut off from access to banking services are now enjoying car loans, mortgages, credit cards, consumer durables. Small farmers have found themselves using chemical fertilizers, certified seeds, insecticides and weedicides, small implements and hiring tractor services. Small and medium entrepreneurs are expanding their fabrication and manufacturing capacities and upgrading technology. Landless labor and poor women in the rural areas are receiving loans for poultry, small livestock, sewing machines, etc. The main beneficiaries of these reforms, in my opinion, are the customers of financial services although it must be recognized that market determined deposit rates have also declined significantly. But as the lending rates are surging upwards, deposit rates are also going to depict an upward movement.

Trade liberalization has been undertaken in Pakistan for the last 15 years and the maximum tariff rate which was as high as 250-300 percent has been brought down to 25 percent while the average tariff rate is about 9 percent. Non-tariff barriers and para tariffs have been eliminated and the culture of providing selective concessions, exemptions and privileges to individual firms has given way to an across-the-board uniform rules and regulations. Protection to domestic industry is no longer a policy objective as in the globalized world efficiency can improve only under a competitive environment. The breaking down of these artificial barriers has led to significant productivity gains and manufactured exports now account for 90 percent of the total exports. Imports of all kinds of goods – capital, consumer, raw materials – are freely allowed into the country at negligible import duty rates.

Foreign investment regime in Pakistan is also highly open and liberal. There are no restrictions or ceilings or prior approvals required for foreign investors to set up their business in Pakistan for any sector of the economy – agriculture, real estate, retail trade, manufacturing, services, banking, insurance and other financial services. As long as they bring in their initial foreign investment and register it with the Central Bank, the foreign investors are free to repatriate their profits, dividends, royalties, technical fees, debt servicing, etc. through their bankers without any prior approval. Foreign companies are allowed to raise funds from domestic sources, including bank loans, without any restrictions. They are treated equally with national firms in all respect and can bring in and out expatriate staff to run their businesses.

Deregulation of oil and gas telecommunication and civil aviation sectors have also brought about significant positive results. Oil and gas exploration activity has stepped up in recent years and constant discovery and production from new gas fields operated by private sector companies have added new capacity to meet the growing energy needs of the country. Independent power producers – both domestic and foreign private companies – have played a critical role in filling in electricity generation requirements of Pakistan. 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 about 15 million. Long distance international and local loop monopoly of Pakistan Telecommunications Corporation has been broken and new licenses including 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.

Since the government recently announced the policy of allowing the private operators to fly on international routes, there has been a big uptake in the aviation business. Domestic airfares have been cut by PIA which had almost a monopoly and seat load factor has reached an all time high. PIA and the private airlines are all scrambling for new planes to meet the pent up demand for air travel.

Despite these reforms, Pakistan is facing many difficult challenges. One third of the population still lives below the poverty line. Human Development Indicators remain low as almost half of the population is illiterate, infant and maternal mortality rates are high, access to quality education and health care particularly by the poor is limited, income and regional inequalities are widespread, infrastructure shortages and deficiencies persist, skill shortages are taking a toll in the economy’s productivity while at the same time, there is high unemployment and underemployment. Most worrying to me is that Pakistan’s image abroad is quite negative. Foreigners are reluctant to visit Pakistan as they perceive the country to be a dangerous place. The worldwide preoccupation with the large economies of China and India and the ever-increasing quest to enter these markets is also working to the disadvantage of countries such as Pakistan. But the lesson we have learned is that there is no point in complaining and whining about this but to get on with the job, to work even harder, to overcome these deficiencies and constraints and to hope for the best.

Thank you.

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