

## **Ishrat Husain: Why do perceptions about the Pakistani economy differ?**

Address by Dr Ishrat Husain, Governor of the State Bank of Pakistan, to the English Speaking Union in Karachi, 5 July 2001.

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An extremely important question has been raised by several commentators and observers of Pakistan economy: Why is it that the external donors believe that Pakistani economy is doing well while the public and press in Pakistan think otherwise? This question needs to be analysed carefully and dispassionately in order to identify the factors responsible for such differing perceptions. I have dwelt on this subject earlier also but I thought I should deal with it at some length once again.

We should begin by specifying the initial expectations of the two groups. The external donors had concluded that successive Pakistani Governments had entered into agreements during the last 10 years with promises of serious structural reforms but failed to deliver on most of these promises. In their view Pakistan suffered from a serious credibility gap and, until and unless, the present Government demonstrated a strong commitment and delivered most of those unfulfilled promises upfront, there was no way Pakistan could qualify for any medium-term assistance. Pakistan, therefore, was asked to prove its seriousness by first completing all those actions the previous governments had promised but not fulfilled. These actions covered the entire range of economic activities and sectors and affected every segment of the population. There were many actions which were required to be taken and I have spelled them out elsewhere and will therefore not repeat them here.

It is not implied that these actions did not make any economic sense or were not justified in Pakistan's own economic interests but the important point to note is that all these actions had to be completed within a period of 12-15 months in order to qualify for the Stand-by-Arrangements (SBA), balance of payments support loans from ADB and World Bank and rescheduling of external debt owed to bilateral creditors. The timing, sequencing and phasing of these reforms were not necessarily those which the Pakistani authorities would have preferred had they complete say in the matter.

The Government of Pakistan has either completed or is implementing most of the above actions. This has established a favorable track record and restored the country's credibility among the international financial community and bilateral donors. IMF has already released two tranches under the SBA and the third tranche is likely to be released by mid-July. The World Bank has released the Structural Adjustment Credit which would add \$ 350 million to the country's foreign exchange reserves. The ADB has so far provided \$ 333 million. The country has been able to reschedule \$ 2.8 billion which it had to pay to external creditors this year. Despite this relief, it maybe pertinent to mention that the country still had to pay \$ 4 billion in cash foreign exchange out of its own resources to service its external debt. The Pakistan Development Forum gave a resounding endorsement to the reforms Pakistan is undertaking. Credit rating of Pakistan has improved. Overall, there is a perceptible and positive change in Pakistan's standing with the international financial community. This is, therefore, the genesis for the improved perception of external donors about Pakistan's economy.

In addition to the IMF program implementation there are some key reforms this Government has embarked on its own – survey and documentation of the economy to widen the tax net and improve tax compliance, devolution of power to the grass root level whereby the common people are empowered and the old bureaucratic system is dismantled; accountability of those who had looted national wealth in the past; recovery of bank loans from defaulters, utility bills and evaded taxes. These measures, on the top of others implemented as part of the IMF program, have created their own dynamics and shaken the foundations of the rent seeking culture prevalent in the economy for such a long time. But the sad part is that the rent seekers, who were keeping the overall economy buoyant have withdrawn from the scene. Consumption expenditures emanating from the rent-seeking class are much lower than what they used to be in the past. Their investment activities have come to a halt. Most of them are trying to find safe havens abroad for their wealth.

While the Group of external donors is pleased that the country had taken all the tough decisions which were postponed by the previous governments for such a long time the same decisions and other measures adopted by the Government, have created hardships domestically for several classes of economic agents. What were the expectations of the various domestic classes? It may be pertinent to recall that the expectations from the present Government were quite high as the country had faced an atmosphere of uncertainty and despondency for a long time and the Military was considered as a

savior of the economy. The urban educated unemployed felt that new employment opportunities will be created to absorb them. The fixed income groups thought that the wages, salaries and pensions frozen since 1994 will be raised. The traders and service sectors were looking for a higher demand for their goods and services translated into higher incomes for them. The rural income groups wanted the prices of their agriculture output raised. The large industrialists clamored for more concessions and exemptions in order to expand their operations.

As far as the press was concerned a number of those who write on economic issues are either retired government officials subsisting on pensions and income from National Savings Schemes Certificates or those earning salaries. Their incomes have remained fixed and thus eroded in real purchasing power terms while the burden of higher expenditure particularly the utility bill charges hit them hard. These columnists and reporters extrapolate their own experiences and those of their peers to depict the adversity hitting the common man. They are therefore unsympathetic and unconvinced about any good emanating from this reform package.

Against these expectations what were the ground realities and what options were available. The preceding five year period had resulted in stagnant per capita incomes, no new large scale investment, rising unemployment and underemployment, worsening incidence of poverty, declining public expenditures and expanding fiscal deficits, an exceptionally high debt servicing burden, and dysfunctional public sector corporations hemorrhaging public finances. Under these conditions, the new Government was faced with two choices. The first option was to adopt a populist approach and use large scale public expenditures to create new employment opportunities, contracts for private sector, raise the level of aggregate demand and subsidise electricity, petroleum and gas prices so that the consumers are protected from increase in prices. In order to do so, an expansionary fiscal policy and an accommodating monetary policy were required to be pursued. In the short-term this set of policies would have won the applause from all classes domestically. From the viewpoint of the present Government, which was in office for three years, this would have been an attractive and expedient solution because the disastrous consequences of these actions over the medium term would have been faced by their successors and not by them.

What would have been the consequences of following this policy option? The country would have been forced to default on its external debt, fiscal deficit would have been around 10 per cent of GDP financed by borrowing, inflation rates would have hit the roof hurting the poor more than any one else, external and public debt burdens would have escalated, and private investors would have found an environment of macroeconomic instability. The international financial institutions would have shunned Pakistan as a pariah economy and Pakistan would have been isolated from global economy.

But this Government instead chose the second but more difficult option as it felt that strong fundamental structural reforms had to be put in place, the institutional decay had to be arrested through better governance, transparency, and debt relief had to be obtained from international creditors to revive the economy on a sustainable basis and to reduce dependence on the International Monetary Fund in the 3-5 year time horizon. The country can reassert its economic sovereignty and get out of the stranglehold of the IMF programs by adopting a strategy in which it can generate sufficient resources to take care of its financing needs over this period. What are the elements of this strategy? First, we must establish our credibility, secure some fiscal space to undertake employment generating development expenditure, avoid contracting short-term expensive debt, and augment our foreign exchange earning. The rulers were also of the opinion that the benefits of economic revival should be shared by a wide majority of the population and not by a chosen few. This simultaneous pursuit of macroeconomic stabilization, structural reforms, improvement in economic governance and poverty alleviation required a course of action for which the rescheduling of external debt and assistance from the international financial institutions was a *sine qua non*.

The tough measures taken by the present government, though quite right and desirable, are hardly expected to be welcomed. How can the simultaneous burden of higher utility prices, rising petroleum prices, increase in prices of imported goods due to depreciating exchange rate and lowering of returns on National Savings Scheme be borne by a class whose household incomes are at a standstill? Thus the reaction of the wage earners, salaried class, the pensioners and other fixed income groups who form the bulk of our middle class is quite understandable and their perception about the economy is quite different from those of the outsiders. To the educated youth, who were expecting the present government to revive the economy quickly so that employment opportunities could become available to them, the curtailing of development expenditure for attaining the fiscal deficit target was a disappointment. Neither the employment opportunities through higher public expenditures could be expanded nor the crowding-in of private investment could take place.

But the more troubling aspect is that those who are engaged in spreading and disseminating the negative perception and sentiments about the economy are the interest groups who were the beneficiaries of the old system and are likely to be big losers, if the proposed structural reforms are fully implemented and take hold. The main line of resistance comes from these particular groups. Let us examine how their interests are going to be compromised. Most of the “people” who are vocal against the current reforms belong to the class populated by politicians, bureaucrats, business leaders, land owners, traders and professionals. It should be clarified that we are not including all persons who pursue these professions but only those who have been the beneficiaries of the old system of the past. Each one of this vested group is hurt by the deep-rooted structural reforms which the present government is attempting to undertake. This group of politicians and bureaucrats strongly believe that their power and privileges will be eroded if the devolution to district governments takes place according to the plan. Some of the former and prospective members of the provincial and national assemblies consider the nazims and deputy nazims as their potential rivals in which the latter are likely to have more administrative and financial authority and will thus divert the public attention and importance away from the MPAs and MNAs. The award of development projects and government contracts, the postings and transfers of key officials which they could easily manipulate with the active connivance of a few bureaucrats, will no longer be possible. The Deputy Commissioners and their class are unhappy that they had joined the civil service to wield undivided authority over the population in their jurisdictions. It is unpalatable to them to take orders from half literate elected nazims – many of whom would have had difficulty in getting an appointment from the Deputy Commissioner under the existing set-up. The officials of other 13 departments who will now formally report to the District Coordination Officer are resentful that they will no longer be able to evade responsibility which they presently can under the loose and undefined supervisory arrangements in place.

Those business leaders, who had amassed wealth not by dint of hard work, enterprise or innovation but by evading taxes, defaulting on bank loans, stealing electricity and getting SROs issued to favour them selectively have indeed stopped “investing”. But to think of it, was it real investment or a hand out from the public exchequer to chosen few which was then invested in their own names. Those chosen under one political set up had to wait out for a couple of years while other chosen few availed of their turn. The accountability, tax survey and recovery of loans and utility bills are pinching them for the first time. They are being forced to part with some of the ill-gotten gains they had made and their reaction is that of wrath and hostility.

The big landlords have, also for the first time, been unsuccessful in thwarting the imposition of agriculture income tax. The avenue for leakages in non-agriculture income tax has been closed by clubbing the incomes from both sources. So this is a double whammy for a very influential group which has so far enjoyed the corridors of power without any restraint on their wealth accumulation or sharing it with the State.

The traders and professionals in the service sector are unhappy because they have also been brought under the tax net through GST. But it is not the GST, which they can pass on to the consumers in full that is bothering them, but the disclosure of their sales and profits upon which income tax can be levied. If you have gotten away by not paying any taxes for that long, won't you resist this new dispensation.

Thus it is obvious that the losers from the structural reforms underway are identifiable, alive and kicking while the winners are to emerge in some distant future provided these reforms are continued and sustained over an extended period of time. For example, several thousand workers will immediately lose jobs as a result of the restructuring and downsizing of the nationalized commercial banks. The benefits to the economy will occur over time when the lending and deposit rates are improved and service standards upgraded. The difficulties and problems the businesses are facing in relation to tax administration will be resolved when the reforms pertaining to the restructuring of CBR are completed. This will take some time to show results but the exporters are facing liquidity problems today. The limited efforts to target the poor through rural and urban Khushali Program, the Food Support Program, the Micro-credit Bank and Zakat, are so diffused and wide spread and their beneficiaries are so disorganized and inarticulate that they do not make any perceptible difference.

It must be conceded that there are adverse consequences of these perceptions held by the domestic constituents. Private sector investment and consumption spending will not resume until businesses and households change their perceptions and regain confidence. Unfortunately, exogenous factors such as severe drought and consequential slump in agriculture production, high international prices of petroleum products and decline in unit prices of textile exports have made the situation even more difficult. A less than 3 per cent rise in GDP is hardly inspiring to regain confidence in the economy.

How can the perceptions of these two groups be ever reconciled or would they continue to differ? No Government – Civilian or Military – can afford to ignore the genuine aspirations of its domestic constituents. But there is a transition period before which the new goal of shared and equitable growth can be achieved. In a society where sifarish, connections and exchange of favors have propelled the governance of the country for such long time it is very difficult to change the mind set or the prevailing value system. Equally difficult is to convince that any ruling class can take decisions which are not based on their personal interests. For the next three to five years, Pakistan has to stay the course, continue on the reform path it has set for itself steadfastly and bring about fundamental structural changes in our governance and institutional structure. This hard struggle is the only sure way to reduce our vulnerabilities and dependence on the IMF. Why can't this be done now or earlier? Because the resource generation capacity of the economy is still and will remain below the debt servicing obligations for several years. Once we have attained the stage where our fiscal and external accounts are no longer in such a state of chronic imbalances as they are today we will be able to attain our economic sovereignty. This will provide the Government ample fiscal space for increasing development expenditures, expanding infrastructure facilities and thus enabling the private sector to reduce its cost of production and distribution, and most importantly allow public sector to invest in technology, skill development, training and other aspects of high level manpower upgradation which will help our competitiveness in global market place. At the same time, the rules of game for the private sector have to be changed where privileges, protection and pampering of a chosen few should give way to a level playing field for all where work ethic, enterprising behavior and productivity enhancement are rewarded. The community and non-government organizations should also engage along with the local governments in promoting primary education, basic health services, potable water supply and sanitation to the vast majority of the population. This public-private-community partnership will lead Pakistan into the era of self-reliance, economic growth and social stability and poverty alleviation.

There are those who argue that alternative solutions which gives primacy to growth should have been adopted. As an economist I am not quite sure as to how this can be done on a sustainable basis. Economic management involves trade offs and choices among various competing demands. Government can, of course, inject a lot of money to give a jump start the economy and create employment throughout the country. This was indeed done until the mid 1990s and what were the results – burgeoning fiscal deficits, increased domestic and foreign borrowing, inefficient and dysfunctional institutions and inability today to service our debts fully. Is this what we want again?

We can insulate the consumers of electricity, gas and petroleum by freezing the prices they pay. Again, the utility companies will have no funds to invest in expansion, modernization, maintenance. We will have outages, shortages, shutdowns at a much larger scale hurting our agriculture and industry. Alternatively, the Government may have to provide subsidies out of the budget. But given the fact that it can hardly meet its current expenditures out of its revenues, it will have to borrow and increase our indebtedness. Is this a good choice for the country?

To sum up, the differing perceptions have arisen due to mismatch in timings of reforms undertaken by the present government. The international financial community is pleased that we have undertaken within a short span of time all those tough measures which were committed by the previous governments but were never implemented. Thus our credibility in their eyes has been restored. But the impact of these measures in an environment of stagnant incomes, declining investment for past several years and limited fiscal space was quite severe on domestic economic agents. This has been further exacerbated by some other fundamental structural reforms which have hurt the interests of the traditional rent-seeking classes in the country. The benefits from these reforms will accrue after a lapse of at least 3-5 years. The losers are visible right now but the gainers will emerge in distant future. The perception of the people and press in Pakistan should, therefore, be viewed in this context.