Ishrat Husain: Pakistan's economic turnaround - an untold story

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Pakistan has come a long way since 1998/99 crisis when the country was on the brink of default and international reserves had been depleted, economic growth was anaemic, debt ratios were alarmingly high, confidence of the investor community was at its lowest ebb and credibility among international financial institutions was eroded.

In a critical and fragile regional and domestic environment with constant threats to security, (as a result of playing a key role as frontline state in the war against terrorism), a prolonged and severe drought and high oil prices Pakistan has made an impressive economic turnaround within a short period of five years.

Economic growth rate has reached solid 6 percent plus, inflation has been contained to 5 percent or so, exchange rate has been stabilized, fiscal deficit has been drastically reduced, domestic interest rates have declined dramatically, international reserves have jumped twelve times their 2000 level, debt ratios have fallen significantly and investment is booming. Pakistan's creditworthiness has been upgraded to B+ by S&P. It is one of the few developing countries that has graduated from a successful completion of an IMF program to directly accessing international financial markets.

How has this remarkable turnaround taken place? Amidst the hot news of Al-Qaeda, Osama bin Laden, assassination attempts on President Musharraf, nuclear proliferation by Dr. Abdul Qadeer Khan and tension with India, the story of Pakistan's economic achievement remains confined to a small segment of informed observers around the World.

This turnaround has not occurred all of a sudden but is the outcome of deliberate and carefully designed program of economic reforms undertaken over last five years, some of them still ongoing. The comprehensive strategy announced by President Musharraf in December 1999 consisted of four key elements:

(a) Restoration of macroeconomic stability and Pakistan's relationship with the international financial institutions.

(b) Structural reforms to remove distortions.

(c) Improving economic governance and reviving key institutions.

(d) Poverty alleviation through targeted interventions and social safety nets.

The interconnection between economic growth, poverty reduction, structural reforms and improved governance is fairly strong in the case of Pakistan. Macroeconomic stability and the consequent rapid economic growth help reduce poverty in conjunction with investment in social sectors, targeted interventions and social safety nets. Structural reforms are needed to strengthen the underpinning of macroeconomic policies and to remove microeconomic distortions affecting key sectors of the economy thus paving the way for accelerating economic growth. Improved governance affects the quality of growth by allowing realization of higher returns on investment and is also conducive to poverty reduction through better delivery of social services to the poor. Poverty reduction, as we know by now, can be achieved with rapid economic growth, structural reforms and improved governance.

Macroeconomic stability

Macroeconomic stability has been achieved through reduction in fiscal deficit, acquiring a surplus on the current account balance of payments, lowering of inflation, and a transformation of external debt profile. These have been brought about partially through the support of international financial institutions and the Paris Club bilateral creditors which significantly eased the external payments position that had been a major and consistent risk to the economy since 1998.

Fiscal deficit was reduced by pursuing a combination of four set of policy measures (i) mobilizing additional tax revenues (ii) reducing subsidies to public enterprises and corporations and (iii) bringing about a significant decline in debt servicing payments and (iv) containing defence expenditures.

Monetary policy was kept reasonably tight during the first two years with money supply growth at about 9 percent. Expansion in private sector credit, in the subsequent years, did not put much pressure as the government borrowing was limited to a manageable level. As the monetary conditions improved the interest rate came down gradually to a single digit and demand for credit by the private businesses picked up resulting in higher capacity utilization in manufacturing and increased industrial production.

External debt management focused on (a) reprofiling of the stock of official bilateral debt, (b) substituting concessional loans for non-concessional from international financial institutions, (c) pre-paying expensive loans and (d) liquidating short term liabilities. Debt ratio was thus reduced from 100 percent of GDP to 60 percent in five years time.

Trade policy in Pakistan has been categorized by the World Bank as one of the least restrictive in S. Asia along with Sri Lanka and this policy has gradually provided incentives to exporters to increase their market share in the global markets. Exchange rate policy was pursued to maintain stability in the foreign exchange markets while at the same time keeping the competitiveness of Pakistani exports intact. Large accumulation of foreign reserves played an important role in stabilizing the exchange rate.

Structural reforms

Tax reform

Tax reforms have attempted to widen the tax base, strengthen tax administration, promote self-assessment, eliminate whitener schemes, reduce multiplicity of taxes and tackle the culture of tax evasion and corruption. A new Income Tax Ordinance has been introduced in 2001, which allows for universal self-assessment, uniform tax rates, removal of non-adjustable withholding taxes,

elimination of exemptions and detailed audit. Moreover, the tax survey and documentation drive during 1999-2000 has allowed the CBR to bring in additional income tax payers and new sales tax payers in the tax net. It has also profiled 600,000 tax payers which will help enhance the effectiveness of tax assessment, and help detect tax evasion and under-reporting.

Tariff reforms

Pakistan made significant efforts in liberalizing its trade regime during the 1990s. The maximum tariff rate has declined from 225 percent in 1990-1 to 25 percent; the average tariff rate stands at just 11 percent compared to 65 percent a decade ago. The number of duty slabs has also been reduced to four.

Quantitative import restrictions have already been eliminated except those relating to security, health, public morals, religious and cultural concerns. The number of statutory orders that exempted certain industries from import duties have been phased out by June 2004 and import duties on 4,000 items were reduced. These measures have brought down effective rate of protection, eliminated the anti-export bias and promoted competitive and efficient industries.

A number of laws have also been promulgated to bring the trade regime in conformity with World Trade Organization regulations. These include antidumping and countervailing measures intellectual property rights.

Privatization

Public sector corporations have been a constant source of burden on the budget as well as quasi-fiscal accounts. As much as one-third of the fiscal deficit could be directly attributed to the losses of public corporations. In addition, nationalized commercial banks had been carrying a large burden of these corporations. A new law was promulgated under which privatization can take place. This step was necessary to ensure transparency, provide an institutional and legal framework, avoid unnecessary delays and litigations, and outline the process through which the transactions are to be carried out.

Three major banks along with several other key public sector units have already been sold to strategic investors in the private sector. Shares of large companies such as Oil and Gas Development

Company Ltd. and Pakistan Petroleum Ltd have been divested through public offerings. Plans to sell the Pakistan Telecommunications Co. Ltd (PTCL) and Pakistan State Oil (PSO) - the two giants - are under implementation.

Deregulation

As Pakistan has embarked on the process of creating competitive markets and eliminating direct or implicit consumer and producer subsidies, a number of steps have been taken to deregulate prices and trading in various sectors. The most far-reaching reform has taken place in the oil and gas sector. Imports and pricing of petroleum products have been deregulated and the private sector is now free to import and fix prices. An automatic price adjustment formula for consumer prices of petroleum products linked with international prices has been adopted. Price distortions in natural gas have also been eliminated and new pricing framework has been put in place.

The government has freed up agricultural prices by moving towards market based pricing. With a view towards allowing farmers to receive international prices for their produce, all restrictions on the import and export of agricultural commodities have been removed. Wheat procurement and trade, which was until recently an exclusive monopoly of the state, has been opened up to the private sector. Exports of wheat and wheat products have also been allowed to the private sector.

Financial sector reforms

Financial sector has made the farthest progress by transforming itself into a market oriented, private sector dominated sector performing efficient intermediation. The regulatory and supervision functions of the State Bank of Pakistan have been significantly strengthened, and strict enforcement of prudential regulations have led to widespread recapitalization and a consequent improvement in the efficiency and profitability of banking system. More than 80 percent of banking assets are now owned and managed by the private sector.

The ratio of net Non-Performing Loans (NPLs) to total advances in Pakistan, has been brought down to less than 5 percent through a variety of strategic measures. An asset management company, the Corporate and Industrial Restructuring Corporation (CIRC), has taken over a large volume of non-performing loans of NCBs and DFIs at a discount and disposed them off to third party buyers.

Development Financial Institutions (DFIs) have been restructured through mergers and acquisitions, closure, liquidation and reorganization. Auction of Pakistan Investment Bond (PIB) for tenures of five to ten years government paper and a burgeoning corporate bond market has begun to emerge bringing together long term institutional investors and borrowers interested in long term sources of financing.

Governance and institutions

The cornerstone of the governance agenda is the devolution plan which transfers powers and responsibilities, including those related to social services from the federal and provincial governments to local levels. This plan was put into effect in 2001. The development effort at the local level is expected to be driven by priorities set by elected local representatives, as opposed to bureaucrats sitting in provincial and federal capitals. Devolution of power will thus strengthen governance by increasing decentralization, transparency, accountability of administrative operations, and people’s participation in their local affairs.

Other essential ingredients for improving economic governance are the separation of policy and regulatory functions, which were earlier combined within the 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 quasijudicial 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.

The National Accountability Bureau (NAB) has been functioning quite effectively for the last five years as the main anti-corruption agency. A large number of high government officials, politicians and businessmen have been sentenced to prison, subjected to heavy fines and disqualified from holding public office for twenty-one years 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.

Institutional reforms

Civil service reforms aimed at improving recruitment, training, performance management, career progression, right sizing of ministries and attached departments, and improving compensation for government employees are the reforms that have been initiated for building strong institutions in the country. In order to depoliticize recruitment, promotions and career development, the independence and responsibilities of the Federal Public Service Commission (FPSC) have been enhanced and is now fully in charge of meritbased recruitment and promotions. The Civil Service Act has been amended to reflect performance based career progression and would enable the government to retire civil servants who are inefficient and/or corrupt. The public sector educational training infrastructure is also being restructured to strengthen skillbased training of civil servants at all levels.

The reforms in some of the most important federal institutions – the Central Board of Revenue (CBR), Securities and Exchange Commission (SECP), the State Bank of Pakistan (SBP) and Pakistan Railways - initiated some years ago - are already beginning to take some hold and making a difference as far as governance is concerned.

Reforms in access to justice will deal with delays in the provision of justice, case management, automation, and court formation systems. In addition, human resources, management information systems and the infrastructure supporting judicial system are being revamped and upgraded. Small Causes Courts have been established to provide relief to the poor who have small claims.

Extensive police reforms have been introduced to separate the law and order, investigation, and prosecution functions of the police and promote functional specialization. Public Safety Commissions have been set up at the federal, provincial and district levels, which will institutionalize public accountability of Pakistan's Police Force. To improve the overall performance of the policy, enhancing efficiency, logistics, communication, mobility and training are being given greater emphasis. The example of motorway police in this respect is illustrative of the quick turnaround that can be brought about through better incentives and logistic support.

Poverty reduction

Pakistan's economic growth rate has picked up to 6.4 percent in 2003-4 (population growth rate is 2.0 percent). A key element of the poverty reduction strategy is to sustain this high rate of economic growth. Towards this end, the government has identified four major areas; agriculture, SMEs, oil and gas sector, and information technology as the drivers of growth. With relatively low investment, these sectors are likely to generate higher employment opportunities and thus have direct impact on poverty reduction.

Poverty targeted interventions

Economic growth is a necessary, but not a sufficient condition for poverty reduction. Where poverty is endemic, high economic growth must be accompanied by direct poverty alleviation measures. Towards this end, poverty targeted intervention programs consisting of several major elements are being introduced. These elements include: (i) integrated small public works programme in both urban and rural areas (Khushal Pakistan Programme), and the (ii) development of microfinance sector to help improve credit access of the poor.

Public works

Khushal Pakistan program had generated economic activity in the country through local public works. The provinces, in close collaboration with the local authorities and communities, completed almost half a billion dollar of small projects creating about 1 million job opportunities along with essential infrastructure in rural and low income urban areas. The program has resulted in construction of farm-to-market roads, rehabilitation of water supply schemes, repair of existing schools, small rural road, streets, drains, and storm channels in villages. Moreover, the program has been supplemented with the schemes for lining of watercourses and laser land leveling, desilting canals, and provision of civil amenities in towns, municipal committees, and metropolitan corporations.

Microfinance

The role of microfinance in poverty alleviation and employment generation has been widely accepted. The government has established a micro-credit bank (Khushali Bank), as a prototype institution for providing credit access to poor households. This bank has so far reached out to 200,000 poor households throughout the country. The work of this bank has been reinforced by the Pakistan Poverty Alleviation Fund, which through a network of partner organizations in non-governmental sector has reached out to another 300,000 poor families.

Education and health

Pakistan's poor educational outcomes have become a major constraining influence on its quest for integration in the global economy. High rates of illiteracy, particularly among women, low educational attainment of the labour force, and lack of qualified technical and scientific manpower have impeded economic growth.

The strategic thrust of Education Sector Reforms (ESRs) consists of (a) achieving universal primary education and adult literacy; (b) improving the quality of education; (c) renewed focus on technical and vocational education. Higher education and Science and technological research capacities are also being bolstered in the country. Madarassahs are being brought into the mainstream educational system so that their products can find gainful employment in the economy. The National Commission on Human Development is mobilizing community volunteers to bring out-of-the school children into the system. Female educational enrolments have jumped in the province of Punjab since the girl students were awarded monthly stipends to support their education.

The new health policy follows a "health for all" approach based on accessibility, affordability and acceptability of health services by the general population. The health strategy places greater focus on a continuous shift from curative services to preventive health services by improving the primary health care system. Improvements in health status are taking place mainly through maternal and child health, communicable and infectious disease control and elimination of nutrient deficiencies. The budget for the Expanded Program of Immunization has been increased and coverage is being expanded in rural areas as well as among women. A sound tuberculosis control program, HIV/AIDS program, and anti-malaria program are also under implementation.

The shift of public expenditures from tertiary to primary and secondary health care and devolving and decentralizing financial and administrative powers to local tiers form the crux of the health sector reforms. This new approach provides a clear signal that preventive rather than curative health care will be given priority in allocation of expenditures.

Poor access to water supply and sanitation are often associated with poor health outcomes. At present only 63 percent of the country's population has access to safe drinking water, whereas proper sanitation facilities are available to only 39 percent of the total population. The government is planning to increase water supply facilities and sanitation facilities to reach 100 percent of population as part of Millennium Development Goal. Construction of drinking water supply and sanitation facilities is already receiving prime importance under the Khushal Pakistan Program.

Social safety nets

As part of Social Safety net programme, the government has launched direct cash-transfer programmes for poor families through medical assistance, and educational stipends from the Bait-ul-Maal (a public welfare programme). The Food Support Programme covers 1.2 million of the poorest households with monthly incomes of up to Rs.2,000 per family (US$35). A system of needstesting has been adopted for the identification of beneficiaries by linking the programme with the zakat system.

The zakat programme that targets widows, orphans and the disabled has been strengthened. About two million beneficiaries received assistance from the Zakat Fund, of which 0.5 million receive assistance on a regular basis. It is envisaged that an additional 1.5 million will be added to the list of zakat recipients through rehabilitation schemes, which will provide micro loans of Rs.10,000 (US$160) to Rs.50,000 (US$800) each for starting up small businesses. An allocation of Rs.5 billion (US$80 million) has been made for these schemes in addition to the normal stipends to mustahqeen (the needy) out of the Zakat Fund. It is estimated that zakat contributes 10-15 percent to the government's poverty reduction programme.

The school feeding programme for female students (Tawana Pakistan Programme), which was successfully piloted in a few districts will be replicated throughout the country. This programme will help address malnutrition in female students as this has resulted in low enrolment, high absenteeism/dropout rate and low cognitive achievement. It is estimated that community mobilization will strengthen ownership of this programme and lead to a 30 percent decrease in the dropout rate.

The Employees Old-age Benefits Institutions (EOBI) and provincial social security institutions provide pension and medical care benefits to private sector employees. Sindh and Punjab provide medical care benefits to about 700,000 beneficiaries and their dependents. Similarly, the Workers Welfare Fund provides social security support to workers and their families.

Moving ahead

Despite the progress made during the last five years the challenges ahead remain daunting. To meet these challenges and the MDGs by 2015, Pakistan remains committed to keep the momentum of structural reforms high, to maintain prudent macroeconomic management, to further reduce the debt ratios to keep the current account in balance to improve revenue performance without any relaxation of fiscal stance but to expand education and health services. The thrust of the monetary policy would be not to allow inflationary expectations to become entrenched while providing credit and liquidity to private sector. The efficiency of the energy sector will be enhanced by privatizing the distribution companies encouraging private investment in low cost generation projects and laying cross border gas pipeline. The efforts to attract foreign direct investment particularly export oriented industries and services will be stepped up by further improving the business climate and governance. The judicial framework will be strengthened to enforce property rights and contracts. Investment in human capital to upgrade the quality of labor force and improve the opportunities of employment for the poor would remain a priority. The quality of institutions will be improved through reforms of civil service and law enforcement agencies.

The current policy stance of an open trading regime with low tariffs and non-existent non-tariff barriers, a liberal foreign investment environment with no restrictions or prior approvals of any kind, a market-based financial sector working under competitive structure, a dynamic private sector producing goods and services with an enabling public sector providing infrastructure and social services will remain in place.