Shamshad Akhtar: Pakistan – an investment friendly destination

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Pakistan Investment Conference organised by Euromoney, Islamabad, 22 February 2007.

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I. Introduction

Pakistan has undergone significant economic and political transformation. Sound macroeconomic management, backed by market oriented policies and a conducive incentive regime, together with political stability and effective regulatory framework have enabled Pakistan to emerge as a viable and investment friendly destination.

Today, I propose to (i) review recent developments and their implications on macroeconomic stability, which has been the subject of much debate with the rising fiscal and current account imbalances; (ii) share the story of Pakistan's economic turnaround and transformation and the factors driving it – this turnaround has helped the country achieve a higher sustainable economic growth that has raised income levels while making some inroads into poverty reduction and employment generation; and (iii) finally offer a perspective on what lends confidence in sustainability of high economic growth, while underscoring that this is possible only if key challenges are effectively addressed to unleash the full economic potential of the country that offers lucrative opportunities for foreign investment.

II. Macroeconomic management

Macroeconomic stability is here to stay. After a period of low fiscal deficits which scaled down to its lowest level (2.4 percent of GDP) in FY04 and emergence of a surplus on external current account, of 4.9 percent of GDP, in FY03 Pakistan opted to concentrate on stimulating broad based growth and dealing with its increasing infrastructure and social constraints that, unless dealt with immediately, threatened growth prospects. To achieve these goals, Pakistan has had to offer fiscal and monetary stimulus over FY02-FY04, which did complicate macroeconomic management. Indeed, a widening of macroeconomic imbalances relative to the FY04 period was inevitable as the country had to break away from the past to put the economy on a more robust and sustainable path.

To set the economy on this course, the Government launched an all time high and aggressive public investment program of $7.3 billion (allowing it to grow by 32.2% in real terms) that constituted 28% of total expenditures. A significant part of these development expenditures was devoted to completing ongoing and launching new development initiatives for physical and social infrastructure. At the same time, liberal and diversified availability of private sector credit stimulated growth across the board in a number of sectors. The growing investment and consumption demands and requirements have widened trade deficit as imports grew by over 35% in the preceding two years (FY05-06). While macroeconomic imbalances enhanced demand pressures, they have stimulated economic growth to 7.4% on average over FY05-07.

Macroeconomic stability was managed by a combination of policies and availability of foreign inflows supported by enhanced investor confidence and presence of global liquidity. Firstly, the central bank has adopted a hawkish monetary stance for almost two years which has now paid dividends as inflationary pressures emerging from rising aggregate demand have been mitigated – CPI and core inflation on a year-on-year basis is down from 11.1% and 7.8% in FY05 to 6.6% and 5.3%, respectively effective January 2007 – an all time low relative to June 2004. Secondly, higher remittances inflows (rising from $1.1 billion in FY01 to $5.5 billion in FY07) have helped finance, on an average, 98% of trade deficit. Thirdly, the privatization program was pursued effectively along with a drive to attract foreign direct investment – both of which mobilized cumulatively $10.0 billion and helped finance 75% of the country's external current account deficit during FY05-FY07. Fourthly, the reduction in debt/GDP ratio in line with the dictates of the *Fiscal Responsibility Act* has helped enhance the sustainability of macroeconomic imbalances. Finally, due to strong foreign inflows coupled with effective reserve management Pakistan has, over 6 years, built up its SBP reserves, which are set to reach over $14 billion by end June 2007 thereby offering more than 6 months of import coverage. Positive economic developments over the past few years have facilitated Pakistan's return to international credit markets and all the sovereign issues have been over subscribed with tight spreads – enabling establishment of a yield curve in a remarkably short time.

Together, these developments have jolted up the investment/GDP levels, which are expected to grow to 21% in FY07, after stagnating at the level of 17% over the previous five years. These achievements appear more significant if viewed in context of Pakistan's proven economic exogenous shocks such as the rising international oil prices which accounted for 1.9% of GDP (and 20% of the trade deficit), and expenditure demands for earthquake related relief and rehabilitation efforts that accounted for another 0.8% GDP. Continued economic vigilance on emerging trends is however critical to strike a balance between growth and macroeconomic sustainability.

III. Economic turnaround and transformation

High economic growth is accompanied by structural changes. Compared to the rest of Emerging Asia, recent economic growth track record puts Pakistan's GDP growth rate in the top half of the region's fast-growing economies. Underlying this has been a significant, albeit slow, structural transformation. The main features of this transformation have been:

(i) The emergence of a vibrant and buoyant services sector, which grew by 8.8% in FY2006 and now accounts for 52.3% of GDP – this has been led by developments in the finance & insurance, wholesale & retail trade, transport, storage and communication sub-sectors.

(ii) Growth in large scale manufacturing sector (over 14% on average over past three years compared to average growth of 3.5% in the 1990's) led by textile sector, which benefited from opportunities emerging from post MFA regime, 36.8% growth in automobiles, 45.5% in electrical goods, 19.6% in cement, and 32.1% in fertilizer etc. in the last three years. Besides new capacity additions, this growth was stimulated by rising real consumption expenditure and construction demand. Capacity enhancement and utilization is at an all time peak. Industrial growth is accompanied by a degree of industrial diversification and emergence of new entrepreneurial class, though more effort is warranted to move Pakistani industry away from its traditional dependence on resource-based and low technology based processes.

(iii) Having achieved self-sufficiency in major crops well in 1980's, Pakistan's agriculture sector has benefited from improvements in pricing regime for major crops, deregulation of inputs and trade liberalization. Excluding crop failures due to bad weather, agriculture grew on average in last 3 years by over 3.8%. According to Food and Agriculture Organization (FAO) Pakistan is ranked 4th in cotton, 5th in sugar, 9th in wheat and 12th in rice production in the world. In addition, Pakistan is ranked among the top ten producers in several of the minor crops, which are mostly fruits and vegetables. The remaining half of the agriculture value addition is contributed by non-crop sector mainly livestock, which has helped Pakistan rank as the 5th largest producer of milk.

IV. Factors contributing to economic turnaround

Enhanced market orientation and openness. Opening its markets in late 1980s, Pakistan has amplified and deepened its structural reforms over the last 5 years. Keeping aside ideological or philosophical consideration and the Government's fiscal compulsions, industrial, trade and price liberalization has infused high degree of competition which is auguring well for efficient allocation and use of resources. Private sector is allowed in all strategic sectors such as oil, gas, telecommunication and other services sector on a competitive basis which are supported by sound sector policies.

Service providers in telecom are emerging as large giants and have enhanced country's wireless penetration to reach 29% in November 2006 with the total cellular subscribers at 46 million. Moreover, the intense competition has also reduced call costs, increased outreach and offered increased services to the customers. The increasing penetration will invariably play a part towards increasing the market potential of a host of other activities conducted through cell phones such as banking, remittances etc.

Since early 1990s, Privatization Commissions has processed 161 privatization transactions resulting in sell off of public assets of Rs. 378 billion. All manufacturing sector, 80% of the banking assets and strategic stakes of utility companies have been sold off to private sector. With scaling back of government's role, the share of private sector in investment has risen steadily from merely 7.8% of GDP in 1980's to over 13% of GDP in FY 2006. At the same time the share of public consumption expenditure has reduced over time to less than 10% and now private consumption expenditure accounts for more than 90%.

Banking sector is catalyzing real sector development. Banking sector reforms are far reaching. Aside from their impact on depth and efficiency of financial intermediation, the profitability of banks has allowed them to earn high returns, which has attracted foreign interest and encouraged existing owners to expand and/or strengthen their businesses. Banks have not only cleaned up their own balance sheets but have impacted real sector development in a number of ways. The private credit growth in last few years has been significant reaching over 30% in FY06. Private credit grew from insignificant levels to over Rs. 400 billion in FY06. The credit expansion fuelled economic activity, while reviving and enhancing industrial and other capacities. Credit diversification has helped achieve a degree of economic diversification too. While the corporate sector accounts for almost half, within it all segments of industry received higher credit. Of the total outstanding, agriculture credit constituted 6.4% but more phenomenally, it grew by almost 4-5 times. Credit was also made available to non-crop sector by laying down guidelines for promoting credit access to livestock, fisheries and dairy sector. Improved access to SMEs was also possible and its share in total outstanding grew to 16.1%. Consumer financing, which was not available in the past, rose to 14.3% of the total outstanding. Companies' access to required level of financing, foreign loans, swaps and derivatives etc. have all been accommodated to allow market to innovate and expand. There is considerable scope for banks to enhance their business through extending financial penetration and outreach both across country and sectors.

Banking sector has grown both in size and strength and is positioned well to meet economy's requirements as it grows. Ownership and structural changes in banking system will facilitate this process. Foreign interest and presence has grown and at present foreign stake comes to 47% of total paid-up capital of all the financial institutions regulated by State Bank of Pakistan. Structural changes have been significant. Besides higher standards of corporate governance at management and board level, the banks are adhering to SBP prudential regulations which are consistent with BIS standards. Technology is being fast adopted and over 45% of bank branches are connected with head office, along side growth in ATMs, debit and credit cards.

Foreign investment is flowing in. Economic activity has and will be further boosted by efficiency gains once the full impact of foreign investment is realized after the completion of projects financed by FDI. During FY04-06, Pakistan has cumulatively attracted $8 billion foreign investment flows – 26.5% was sale proceeds of public assets and 49.2% from FDI, with remaining coming from foreign portfolio investment. These foreign inflows have come into banking, telecom and oil and gas sectors primarily. Prospects are that Pakistan will attract about US$6.0 billion in FY07 – an all time high annual flow. Going forward, foreign investment is expected to be more diversified and will support infrastructure development, manufacturing, tourism and hotel industry etc. The strong interest in Pakistan stems from (i) growing investor confidence in the economy, (ii) comfort to foreign investors that they are treated at par with domestic investors (and in some respects even better), (iii) high returns on investments as evident from exceptional corporate and banking profitability and (iv) supportive and stable policies.

Besides full foreign ownership, investors can repatriate their capital, dividends and profits and there is no restriction on the level of royalty payments. Foreign investors are eligible for low import duties between 5 and 10% on plant and equipment and a first year tax allowance on profits of between 50 and 90% of the cost of plant and equipment. Measures have also been taken to introduce an Intellectual Property Rights regime compatible with the WTO. Rules governing FDI have been significantly liberalized. Furthermore, the investment climate has improved as a result of policy initiatives such as the streamlining of procedures required to start a business and the measures taken to minimize the time that businesses spend dealing with government inspections. To facilitate foreign portfolio investment, Special Rupee Convertible Account (SCRA) has been established to allow remittances and non-residents to bring money in and out of Pakistan. The amount accumulated in this account can be used for purchasing as well as trading shares quoted in the stock exchange as well as other approved securities. Foreign exchange regime has also been liberalized and exchange controls have been lifted.

Business processes are being rationalized and simplified. Reforms, both of incentive and administrative regime, have helped Pakistan to improve its ranking in the Survey conducted by the World Bank on 'Doing Business in 2007.' Pakistan now ranks 51 in the time to import (which has reduced from 39 days to 19 days) as trade logistics and customs procedures were streamlined and scores well on the indicators related to starting a business (54th out of 175) and protecting investors (19th out of 175).

V. Growth sustainability and prospects

Pakistan's real GDP growth rate has risen in recent years, averaging 7.4% in the preceding three years. This is well above the long-term (50 years) average growth rate of 5 percent. The strong growth momentum has stressed the productive capacity of the economy as evident in macroeconomic indicators such as rising inflationary pressures and a widening external current account deficit. These developments naturally raise questions regarding economy's potential to sustain this momentum.

The current growth momentum in the range of 7% can indeed be maintained, though this requires: careful calibration of macroeconomic management and removing bottlenecks that are impeding growth and economic diversification. With declining poverty[1] and growing employment opportunities, viability of Pakistani market is further enhanced as domestic private consumption has been supported by improved incomes and remittances.

To ensure sustainable economic growth, Pakistan will need to maintain macroeconomic stability by gradually reducing the twin deficits. Besides prudent expenditure management, this will require broadening of the tax base to effectively finance growing expenditure obligations. Sustainability of external current account deficit calls for raising exports earnings to finance the increasing imports requirement. Imports will remain strong as the economy's requirements for capital and intermediate goods for industry grow. Balance of payment position will benefit from industrial diversification which is critical for export diversification as well as for encouraging import substitution (particularly in food commodities) where Pakistan has competitive advantages. Any pressures on aggregate demand because of slippages will need monetary tightening as central bank would remain committed to the objective of price stability.

To realize these goals, Pakistan needs to now direct investment flows, both domestic and foreign, to areas which can help stimulate industry and its diversification, and help remove gaps and bottlenecks in the infrastructure. Pakistan offers opportunities to exploit gas and coal reserves suitable for power generation and hydroelectricity generation. The geographical proximity to energy rich regions, Iran and Central Asia, position Pakistan to emerge as a regional hub for energy. The investment requirements for the development of energy sector are in the range of $20 billion in medium term to around US $150 billion by 2030. National Trade Corridor Plan (NTCP) equally offers opportunities to connect all major physical infrastructures such as ports, roads, railways, aviation etc. Besides connecting Pakistan with its neighbors it will enhance trade and improve market access, while saving fuel and transport costs. Pakistan has set up an infrastructure Project Development Facility to facilitate initiation of these projects through credit enhancement and financing institutions are geared up to adopt different approaches and modalities to leverage and intermediate financing flows for infrastructure.

Opportunities also exist to enhance production by enhancing productivity, efficiency and economic diversification. To diversify, Pakistan has to make inroads into the medium and high-end technology products such as electronic goods, automobiles, engineering goods etc. and to look for newer markets. In agriculture, implementation of mega water resources projects will enhance crop yields. Besides increasing value-addition, market-based pricing (e.g. as done for rice and wheat), improvements in transmission of pricing signals to farmers (e.g. through introduction of a commodity futures market), development of crop insurance (particularly to encourage the raising of new cash crops such as oilseeds) and improvement in transportation and storage infrastructure will contribute to enhancing agricultural productivity. Development of agro-based industry and processing and packaging of products would further stimulate export of these products to the neighboring Middle Eastern markets.

With a strong base of economically active population, Pakistan has an edge as it is a low wage economy – average wage is close to $75-$100 a month for unskilled workers, $100-$200 for skilled and for managerial workers, it ranges from $200-$500 a month. To enhance skills, an aggressive technical education and skill development program exists under the Medium Term Development Framework. Investment climate will benefit further from the ongoing efforts and strong commitment to rule of law, developing a competent and efficient government sector, less cumbersome regulations and control of corruption.

[1] The overall poverty has reduced from 34.46% in 2001 to 23.90% in 2005. The percentage of population living below the poverty line in rural areas has declined from 39.2% to 28.1% while that in urban areas has declined from 22.7 percent 14.9 percent. In other words, rural poverty has declined by 11.2 percentage points and urban poverty has reduced by 7.8 percentage points.

Finally, besides banking sector, the large financing requirements of infrastructure and of agriculture sector (ranging above Rs130 b) can be met but require financial diversification. The long-term domestic debt market is still under-developed and corporate debt issues account for less than 1% of GDP. Similarly, Pakistan boasts an extremely liquid equity market but it remains dogged by high degree of speculative transactions that have led to periodic bouts of instability and claims of market manipulation. Given the importance of long-term debt markets to support investment, particularly in infrastructure projects, to increase domestic savings, and improve the risk profile of commercial banks (which currently face mismatches in lending and deposit profiles), Pakistan needs to foster development of long-term institutional savings industry (pension and provident funds, mutual funds, etc.), implement capital market reforms aimed at encouraging investment rather than speculation, and improve risk management in the financial sector to ensure financial sector stability.

Conclusion

In conclusion, Pakistan offers endless possibilities with its vast untapped resources. The country is set to grow at a rate of 7% per annum which should help to further raise its per capita income from US$847 per annum to US$ 1557 by 2015. Demand is expected to get stronger as incomes rise further and assuming current population growth trends persist. Pakistan's strategic geopolitical position, due to its proximity to India and China as well as to the oil rich Middle East and untouched central Asia with vast natural resources, potentially carries opportunities which to date have not been properly exploited. Promising for private sector would be the large infrastructure projects which would offer high return in long term but would help enhance access and efficiency in movement of goods within and outside Pakistan.

If done right, Pakistan can easily integrate itself into the export value added chain of the region as there is adequate room for further growth; investment in these sectors is thus highly feasible. For example, Pakistan still stands relatively low in terms of motorization when compared globally and even within the region. Automakers need to take this into account as the demand clearly exceeds supply. Likewise the supply of electronic goods is still short of the potential demand and any increases will be absorbed by the population which is growing and expected to double over the next 25 years.

In future, the demand for energy, cement, fertilizer, and leather products is expected to increase. The energy demand over the next five years is expected to grow at a rate of 7.4 percent per annum and over the next 25 years it is expected to be 7 times the present demand.2 Thus the sectors, particularly those discussed above, remain attractive for foreign investors due to strong consumer spending patterns and rising industrial activity depicted by past trends and strong future demand. Likewise, banking sector has to position itself to extend its outreach, which will play a key role in sustainability and in diversifying risks. For long term sustainability and to maximize the development impact, small and medium enterprises should be encouraged and further developed as they will be able to fast restructure themselves as and when warranted and will play a more critical role in employment generation.

Besides bringing in much needed capital, increased foreign presence is expected to help Pakistan integrate better globally and regionally, enhance skills and techniques and transfer and increase usage of technology. It is our belief – so far reinforced by experience – that private sector participation and foreign investment are going to be the cornerstone of our future economic strategy.

[2] According to Planning Commission, presently the energy demand measured in MTOE was around 50 MTOE in 2004 which will increase to 79 MTOE by 2010 and 361 MTOE by 2030.