Shamshad Akhtar: Pakistan – economic sustainability

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the JP Morgan – Pakistan Corporate Access Forum, Dubai, 5 March 2008.

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Pakistan has withstood series of endogenous events, including political uncertainty as a lead up to election, and the unprecedented exogenous shocks that have ranged from financial markets turmoil to climbing global commodity prices. On domestic political front, with elections now over the country is well on its way to a smooth transition gearing for a fully democratic system. Leading parties' efforts to cement a coalition augurs well for confidence building; smooth functioning of legislature and their inbuilt accountability, while ensuring representation of public voice in steering the formulation and implementation of the future economic agenda. Ruling and opposition parties will need to rise above personal agenda to ensure sustainability of democracy.

After a period of benign global economic environment, world economic outlook since August 2007 has been adversely impacted by subprime mortgage meltdown and its ripple effects on financial markets. Advanced countries are facing slowdown in economic activity. To mitigate the ensuing recessionary pressures, easing of monetary policy by the United States are to compound the already high inflationary pressures emerging from the exceptional rise in the global commodity prices, in particular of products such as oil, gold and wheat.

Thus far Pakistan, like other Asian economies, remained immune to these shocks. Economic and financial markets remained calm in Pakistan as they had limited exposure to the US subprime market and other related products. With financial market turmoil deepening, the slowdown in economic growth and consequent reduced demand of advanced countries triggered greater uncertainty and induced vulnerabilities in international equity markets. These developments have begun to cast shadow, impacting emerging economies equity markets softening their growth prospects, albeit they remain set to grow strongly and.

Pakistan, like other emerging markets, faces a key question regarding sustainability of its economic achievements. Abstracting from political debates, there is widespread confidence that Pakistan has achieved a significant economic turnaround. While short terms challenges and stresses have magnified, I propose to provide perspectives that the turnaround achieved is sustainable provided it is urgently backed by a well designed macroeconomic stabilization package and deeper structural reforms. In my presentation I make the case that Pakistan has strong economic growth potential given the country's inherent dynamics. Second, restoring macroeconomic sustainability, despite disruption in FY08 trends, has to be on top of economic agenda and is feasible given scope for domestic resource mobilization and improved debt management. Third, there is need to deepen investment incentives and climate have to improve.

Finally, Pakistan is and has to build momentum to diversify agriculture, industry as well as export base, and develop infrastructure. Implementation of this agenda will augur well for country's long term economic growth prospects while offering wide range of investment opportunities that make Pakistan an attractive destination.

Economic performance and potential

Pakistan average economic growth rate was 6.3% for fiscal years (FY) FY03-07: during these 5 years economic growth was above 7% in two years and 9% in FY04-05 confirming rise in *trend* growth rate and capturing well the real economic potential. In productive sectors growth has been broad-based but accompanied by underlying structural shifts. Services sector has been the most buoyant and constitute over 53% of the overall GDP, with agricultural sector's share declining from 25.9% in FY00 to 20.9% in FY07 and industrial sector's contribution rising from 23% to 27% over this period.

Rising domestic consumption demand has been the main driver of growth; accompanying rise, albeit somewhat slow, in investment rate. After averaging around 18.6% over the FY03-06, investment rate grew to 23% in FY07 – reflecting a 4.4% percentage point growth in investment/GDP ratio in one year. This was expected to be boosted further by significant growth in public investment in FY08, though given fiscal exigencies a part of this may not be realized.

Pakistan's rich and large landscape offers a sizeable domestic market that is likely to double, reaching a population base of 230 million by 2030. Being at the crossroads of South Asia, Central Asia and West Asia with close proximity, both by air and sea, to the Gulf region makes Pakistan a promising regional hub and market for nurturing intra and inter-regional trade and investment. Recognizing these considerations, Multinational Corporations several years back set up businesses here. As confidence in Pakistan's economy grew, there has been a significant growth in foreign capital inflows, cumulatively estimated to be around $13.5 billion (including global deposit receipts flows) over the last five years. The telecom sector, the major recipient of foreign investment close to $4.6 billion, is under private ownership and management; among other achievement the number of mobile subscribers is now over 80 million. Similarly, close to half of banking assets are now under foreign ownership as close to $2.7 billion foreign equity was injected in the sector and oil and gas sector has attracted $1.4 billion. Pakistan is now a well tested destination for foreigners. Corporate and banking companies' returns have been high and investors, be domestic or foreign, are being well compensated for whatever risk premium they attach to Pakistan.

Restore macroeconomic stability; despite the disruption caused by 2007 events

Economic growth of Pakistan has benefited from macroeconomic stability. Containing macroeconomic imbalances helped generate (i) external current account surpluses in two of the preceding five fiscal years while (ii) fiscal deficit was below 4% in three of the five preceding fiscal years supported by surplus or zero primary balances (reflecting an effort to balance current revenues with current expenditures).

Pakistan however now faces renewed economic vulnerabilities. Among others, compulsion to subsidize food, oil products and power & gas tariffs by preventing full pass through of international price hikes and to raise public investment to address infrastructural and skills gaps, essential to maintain growth path, have together disrupted progress in fiscal containment. Corrective policy actions, taken in the last few weeks, including rise in petroleum products, electricity and gas prices and cuts in development expenditures will at best ease marginally fiscal strains.

Notwithstanding, the growing aggregate demand pressures in face of rising per capita income, six-fold increase in remittance, set to reach $6.5 billion for FY08, and exceptional rise in private credit, high import growth of petroleum products and capital, intermediate and raw material goods have compounded these vulnerabilities. Underlying demand pressure and threefold increase in import oil bill coupled with slow down in export growth has also widened external current account deficit.

Keeping strong vigilance on the economy, the central bank took a lead in containing the aggregate demand pressures. Incrementally, monetary policy was tightened through three rounds of raising the SBP policy rate (by 300bp) since April 2005 to 10.5%, raising the reserve ratio, and improving liquidity management through open market operations. Monetary policy in Pakistan has benefited from the independence and strong accountability of the central bank as well as from the central bank's conscious efforts to ensure transparency in public communications of monetary policy stance and perspective on the economy. Monetary policy has managed to keep inflationary pressures in check by managing to lower core inflation; slippages in inflation target were inevitable given the uptrend in the global commodity prices as well as structural complexities and inefficiencies of wholesale and retail markets.

Global and domestic cyclical events will undoubtedly pose frequent challenges for small and open economies, like Pakistan. Recognizing this, the new Government will need to strengthen the Medium-Term Macroeconomic Stabilization Program and front load it, while accelerating the implementation of structural reforms to realign deficits to sustainable levels. Keeping this in perspective, the Government's broader economy strategy for the next few years will need to include:

i. Increasing domestic resource mobilization to raise revenue/GDP ratio by at least 5 percentage points of GDP. This is possible given the scope for enlargement of tax base: the existing tax regime collects almost 68% of taxes from manufacturing and corporate sector, while agriculture and services sectors (aside from banks) are exempt and segments of economy are outside tax net;

ii. Nation-wide campaign to raise saving levels through continued efforts to raising awareness and deepening financial markets;

iii. Restricting large proportion of new resource mobilization for public investment, while prioritizing the recurrent expenditures through a major overhauling of the Government machinery;

iv. Restoring the momentum of privatization of state-owned enterprises, which has been one of the most successful in Asia. The Government has sold off cumulatively almost $7 billion of assets over FY00-FY08 and there are around 61 state entities in the pipeline;

v. Providing more autonomy to public sector organizations, with effective leadership and management, to improve their operational and financial efficiencies accompanied by a program to strengthen their balance sheets which should allow them to graduate from budgetary allocations to seeking funding from the market; and

vi. Raising private investment/GDP from 23% to at least 28% which involves significant tapping additional resources both from domestic and international financial markets.

Although this is an ambitious macroeconomic framework, but launching and adhering to it is attainable and critical. To position itself, Pakistan plans to further enhance its policy framework and tap its economic potential by mobilizing additional foreign capital that is likely to be attracted as the country offers lucrative investment opportunities across all sectors.

Deepening of liberal incentive and investment regime will help economic sustainability

Broad based deregulation and liberalization of investment and pricing regime, Pakistan attracted cumulatively $13.5 billion investment across all strategic sectors. This has been facilitated by easing entry of domestic private sector and foreign equity with flexibility to fully own businesses. Long standing liberal and partial capital account convertibility allows individuals, firms or companies to freely undertake all international transactions through the interbank market. Aside from allowing 100% foreign equity, there are no bars on repatriation of capital, profits, royalty etc. Exchange rate stability has been supported by prudent exchange rate management.

Recapitalization and restructuring/privatization and induction of professional management, banking sector has been the most dynamic sector. Liberal entry requirements and huge market potential given the current low financial penetration ratio have encouraged entry of global players. Foreign investors are allowed to hold up to 49% of the foreign equity in the banking sector, while banks with global Tier-1 capital is US$ 5 billion or more or institutions from the regional cooperation organizations (ECO) can hold up to 100% foreign equity in a banking institution in Pakistan. Companies acquired have to over the years be incorporated as wholly owned subsidiary or opening a branch in Pakistan. Even in those cases where foreign equity up to 49% is permissible, a higher percentage of foreign equity ownership is allowed by SBP on a case-to-case basis depending on the strength of the incoming institution.

Companies have further benefited from access to private credit which grew at an average rate of 25.5% for FY03-07. This growth has been supported by structural changes in banking sector which is largely private sector run. Over the last five years, profitability of banking sector has surged reaching $1.70 billion in 2007, return on equity growing to 20.0% by Sept 07 and net NPLs ratio reducing to 2.3%. Capital market has benefited from the growth in stock market capitalization from $7.51 billion to $65.9 billion by the end-2007 and rise in P/E ratios have attracted foreign portfolio investment.

To promote competition and efficiency corporate tax rate has been lowered and trade has been liberalized. Average tariffs are 7.6% and tariffs on import of plant, machinery & equipment for industrial sector has been reduced to 5% and for agriculture sector to zero percent while 50% Initial Depreciation Allowance is allowed. Nontariff barriers have been removed. Pakistan has Free Trade Agreements with the People’s Republic of China, Sri Lanka, Malaysia, Iran and Mauritius; negotiations are underway with Singapore and the Gulf Cooperation Council to be concluded in 2008, and preferential trade arrangements are also underway with Afghanistan, Bosnia, Bangladesh, Canada, Russian Federation, Serbia, Syria, Switzerland, Laos, Thailand, Indonesia etc.

Future prospects for economic sustainability depends on building momentum of structural reforms – I will however dwell on the most strategic elements here.

Agriculture and food self sufficiency

With global commodity prices on the rise and alternate uses of corn and other products as bio-fuels in vogue, enhancement of crop productivity and area under cultivation will be critical for stabilizing food prices and curbing recourse to imports that have induced fresh external vulnerabilities. Given also the country’s rich and diverse landscape, Pakistan has good potential to serve the GCC and Middle East at large and exploit export potential of its agro-based sector. Renewed efforts will need to be launched by the Government to improve yields of major crops by intensifying research and extension, application of right type of seed and other inputs and mechanization.

Comparative advantage in agriculture gives an edge in the development of agro-based industry, value-addition chains and processing and packaging of products and offer huge potential for growth and investment. Besides increasing value-addition, the Government has promoted private sector involvement; except for setting procurement price for wheat – to maintain strategic reserves – market-based pricing mechanism prevails for all agriculture produce. Efforts are underway for 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. The proximity to the rich Middle East states, which are widely dependent on import of vegetable products, provides a strong market for agriculture-based products. The ancillary requirements to boost agricultural products exports also require massive investment in mass storage and transportation activities.

Industrial and export growth and diversification

Manufacturing sector has been growing at 8.4% and its share rose from 14.7% in FY00 to 19.1% by FY07. To realize its growth targets, industrial sector’s share in GDP has to rise to

30% and must be export led. The corner stone of industrial growth and diversification strategy is to set in place programs to:

- Move up the value added chain in all key industries by developing capacities, skills and attracting strategic partnerships and technology;
- Exploitation of mineral and other strategic resources of the economy;
- Modernization, enhancement and design innovation in the textile industry. Scale enhancement could be achieved through foreign investment and joint venture/merger and acquisition. This would enable the textile industry, currently accounting for one-fourth of Pakistan's output and 69% of exports, to withstand aggressive regional competition; and
- Developing backward and forward linkages of large scale industry with small and medium industry that will help in improving productivity and competitiveness.

Export growth has been quite impressive, more than doubling to $18 billion over FY01-07. Export Plan for 2006-2013[1] envisages a rise in export/GDP ratio from around 13% to 15% to generate almost $40-45 billion of export revenues. The principal thrust of this strategy will be to promote export diversification to reduce industry and exports vulnerability to textile sector. Substantial exploration is underway to exploit Pakistan's potential to promote:

- Agriculture exports efforts are underway to promote growth of minor crops and noncrop sector particularly dairy sector where Pakistan is now the world's fifth largest producer. Aside from developing innovative guidelines for credit flows to the sector, efforts are underway to improve agriculture marketing, grading and quality; establishment of agriculture export processing zones with public-private partnership; encouragement of livestock development through cross breeding, artificial insemination and embryo transfer technology. Also, there is scope for expanding inland fish farms and developing in public: private partnership fish harbors etc.
- Pakistan, being the fourth largest cotton producer in the world after China, India and US, has strong raw material and experience-edge in textiles. To augment capacities, industry invested $5.5 billion over the FY99-FY05. There is further scope for a three to fourfold increase in spindle and looms capacity and to diversify product (knitwear, bed ware and ready-made garments) and market base and improve quality and design.
- In view of the relocation of industry and changing production and subcontracting networks/hubs and alliances as newly industrialized economies move out of labor intensive industries, Pakistan has an opportunity to serve as an alternate production center for electronic, electrical, and engineering industry.
- Pakistan has made some inroads into the medium and high-end technology products such as electronic goods and this area could be explored further.
- Mineral is another sector where Pakistan has large potential given its copper, high quality granite and marble and gem reserves.
- Finally, information technology (IT) and other services sectors which constitute 55% of GDP have a role to play in enhancing exports and can be nurtured by promoting venture capital and private equity funds and enhancing the skill base of population in this area.

[1] Government of Pakistan, Planning Commission: Export Plan – Pakistan Inc. 2007.

Infrastructure

To enhance the competitiveness of Pakistan's industry and exports, it is however critical to bridge infrastructure gaps. The Government has developed a broad based strategy and short, medium and long term plan for energy sector. Pakistan has good domestic reserves of oil, gas and other fuels and hydro potential. The investment requirements and opportunities arising from a well designed and integrated energy security plan that offers an Asian Energy Corridor are enormous. Potential within this corridor exists for mega projects that involve development, sharing and trading of energy resources between the largest producers of oil and gas in the Central Asian Republic and Middle East to the deficit countries including China, India and Pakistan.

To ensure energy security and sustainability, Pakistan's energy plan recognizes the growth in domestic demand for energy that has to be catered by exploitation and development of balanced energy mix with maximum reliance on indigenous and environment-friendly resources, besides tapping the regional resources. Recognizing this, Pakistan plans to

i. Optimize energy mix between hydel: thermal from existing levels of 28:72 to 39:61 in the years ahead by exploiting all key sites with substantial hydel generation potential – this program will help in fuel substitution and energy efficiency resulting in savings of oil imports;

ii. Enhance exploration and development of gas reserves. Gas supplies are to be supplemented by exploiting cross border energy transaction through Iran-Pakistan-India pipeline, Turkmenistan and Qatar-Pakistan pipelines and import possibility of LNG;

iii. Unleash coal potential given the large measured reserves estimated to 3,300 million tons with substantially large inferred reserves. Major deposits are in Sindh province in Thar though other pockets also are showing promising signs; and

iv. Exploit renewable energy resources.

Investment requirements for key infrastructure programs were estimated to be in the range of $39 billion for 2005-2010. Over the long term, investment requirements will be staggering as, by some estimates, the aggregate power generation requirements alone will be around 143,310 MW during 2005-2030. Since 1994, generation has been largely in private sector and WAPDA – the largest utility company of Pakistan – has been unbundled by spinning off the regional distribution companies which are to be privatized. Given fiscal constraints, Pakistan has scope for limited public investments so bulk of the new development projects is to be available for private investment. The Private Power Infrastructure Board has floated 45 projects of 12 GW in pipeline, involving cost of close to $11 billion.

Independent Power Producers (IPP) are generating 6005 MW, with remaining 13,083 MW MW generated by WAPDA and KESC. IPP have made significant progress (excluding Hubco outside Power Sector Policy framework) though 66% of the total capital requirements were met from official debt sources. Drawing from the lesson learnt of past power sector policy, the 2002 Power Sector Policy set prices based on cost structure of the project as determined by the regulator. Pricing policy allow pass through of items such as the fuel price, interest rate and exchange rate.

Pakistan needs $1 billion per year for new dams and related infrastructure, and $5 billion per year for transport infrastructure etc. In road sector, the Medium Term Development Program includes plans to improve 14000 km of existing road and construct 7000 km of new road. Pakistan has managed to promote public-private partnership for a highway project on BOT basis for Lahore-Faisalabad 4 lane divided express way on 25 year concession agreement. The National Trade Corridor is one of the strategic integrated projects that aims to develop trade route from ports in south of Pakistan to northwest towards Afghanistan and Central Asian Republics and will carry 500 million tons of freight up the north-south route and another 50 million tons of international freight. Aside from expansion of two ports in Karachi city, commissioning of Gawadar port, awarded to Port of Singapore for management and operation. Located at the mouth of the Persian Gulf and outside the Straits of Hormuz, this port will serve as a regional hub for energy transportation.

The Government has now developed a policy and legal framework for the Public Private Partnership (PPP) which will be supported by the Infrastructure Project Financing Facility (financed by the Government and Multilateral Development Banks). A Project Development Fund will help identify, prepare and procure PPP projects to support economically viable projects, mobilize private capital resources and float the corporate and infrastructure bonds. To support delivery of basic services, public funding will complement and replace user fee to the extent feasible to facilitate viability gap funding along with a supportive risk management framework.

Improving productivity

Pakistan is structuring a number of initiatives to allow for enhancement in total factor productivity growth which has been key driver of East Asian economic growth. Besides encouraging higher enrollment accompanied by improvement in standards in each of the education tier, investments are being made to (i) enhance vocational and technical education which thus far only caters for requirements of one percent of 15-23 years age cohort; (ii) open six foreign sponsored Universities to augment supply and quality of higher education in the country; and (iii) enhance SME and industry entrepreneurial skills. Supplementary efforts are underway to develop strong integrated linkages between technology and R&D needs of industrial sector and science and technical education.

Conclusion

Pakistan has great potential, both in terms of its natural and human resource, and has developed fairly good forward looking development agenda and plans. A major breakthrough in industrial and export diversification depends, among others, critically on reinvigorating agriculture sector and ensuring adequate availability of infrastructure to meet the growing economic requirements. Given huge domestic demand and high returns in virtually every sector, there has been a strong interest in Pakistan's economy as illustrated by the strong foreign investment that has come from both GCC and West. The region given its diversity and richness of resources – with Gulf countries accounting for large proportion of world's oil and gas proven reserves and now holding sizeable world foreign exchange reserves – along with Pakistan's large agriculture and growing industrial base, domestic market, skilled labor force which, if effectively, exploited offers opportunities for deepening collaboration and cooperation for mutual advantage. The new Government given its strong political backing has the opportunity to restore macroeconomic stability disrupted in last couple of years which should help restore investor confidence and allow country to attract non-debt creating flows critical for development of industry and infrastructure sectors and to ease the balance of payments situation.