Pakistan: Growth Set Back by Structural Rigidities

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This article has five parts. The first provides an overview of major structural weaknesses in the Pakistani economy—I call them faultlines. The following three parts describe the programme of stabilisation and structural reform introduced by the caretaker administration of Prime Minister Meraj Khalid. This government was in office for 104 days, from November 5, 1996 to February 17, 1997. On February 17, the government headed by Prime Minister Mian Nawaz Sharif took office. The fifth part provides a brief assessment of what lies in Pakistan’s future if the problems created by delayed structural reforms are not addressed adequately and on time.

A. A DOZEN FAULTLINES

The faults and fissures that exist below the structure of the Pakistani society and economy did not materialise suddenly. Some of them may have appeared recently but several of them have been around for a long time. I emphasise this point not to shift the responsibility from one administration to another, or from one political party to another, or even from one political system to another. An important fact about the way Pakistan’s economy has been managed is that ever since its birth, there has been a tendency on the part of the decision-makers to concentrate on solving immediate problems rather than reflect on and deal with structural issues. The reason for this approach, adopted by our decision-makers time and time again, is perhaps a simple one: Pakistan has faced more crises—political, social, and economic—than was the case for the countries that have attained long-term sustainable growth.

My list of faultlines reads as follows:

- A severe fiscal imbalance—or budget deficit—which continues to persist despite the efforts made by several governments to contain it.

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The above article is an enlarged version of the Quaid-i-Azam Memorial Lecture delivered by Mr Burki at the Twelfth Annual General Meeting of the Pakistan Society of Development Economists.
• A monetary system that does not operate independently of the political system. On the contrary, it has provided resources to indulge the often extravagant behaviour on the part of those who were in power.

• A poorly developed financial system and a banking sector which remained under considerable strain ever since the nationalisation of financial institutions in the early 1970s.

• Low rates of domestic savings, a problem that has persisted since the birth of Pakistan and created a habit of dependence on external savings—capital flows.

• A high and growing burden of external and internal debt, the result of careless borrowing from external and internal creditors.

• Low rates of investment and equally low rates of return on them, occasioned by disregard for committing resources to only those projects that had a high social pay-off.

• Rapidly deteriorating physical infrastructure.

• Poorly developed human capital.

• Rapid population growth.

• The inability of the government to provide basic services to the poorer segments of the population.

• Re-emergence of poverty.

• A legal system in which the people do not have a great deal of confidence.

(i) Fiscal Imbalance

By far, the most important problem Pakistan faces today is a serious fiscal imbalance. Fiscal imbalances have been around for a while but the point has been reached where they cannot be sustained at their present level for much longer. The debate over the budget presented by the government of Ms Benazir Bhutto in June 1996 and the one put forward by the administration of Mian Nawaz Sharif in June 1997 has highlighted one significant fact about the fiscal situation in Pakistan: there is almost a total absence of political consensus on how the government should balance its books.

No government, whether it belongs to the left or the right of the political spectrum, can afford to ignore the simple arithmetic that must support and underpin all budgetary calculations. This arithmetic has a bottom line: the governments must not spend much more than they earn. If they do—as they have done for years in Pakistan—the economy is left with a debt burden that is hard to shoulder and, even worse, tends to increase over time.
There are basically two ways of handling budget deficits. One, to borrow from the markets the funds the government needs to balance its books. Two, to balance the books by printing money. Both approaches have negative consequences for the markets. The first is called “crowding out”, since government borrowing will be at the expense of the credit needed by the private sector. If the government borrows large amounts, interest rates will increase and become unbearable for the private sector. In other words, private entrepreneurs will be crowded out of the credit markets. Since the overall rate of return on government expenditure is almost always lower than that realised by the private sector, large amounts of borrowing by the government has the effect of lowering the rate of economic growth. Government borrowing also creates a debt burden which eats into future earnings. At times governments in Pakistan have paid very generously to their creditors. That was the case with the “khas deposits,” introduced in the early 1980s, which have contributed massively to the burden of debt the government now carries. This is a subject to which I will return in a moment.

(ii) Lax Monetary Management

The second way of financing budget deficits is even more costly in terms of the impact on the economy in general and on the poor in particular. The governments are often tempted to print money to pay for budgetary shortfalls. This is especially the case when the central banks that have the authority to create money are beholden to the governments. This is also the reason why so many programmes of economic reforms aim to provide autonomy to the central government. The caretaker administration of Moeen Qureshi included the granting of autonomy to the State Bank in its programme of structural reform. Not unexpectedly, this move did not win favour with the political government that succeeded the one headed by Qureshi. Ms Bhutto, once again, brought the State Bank under the control of the Ministry of Finance and the Ministry, in keeping with past practices, turned to the Bank to finance a significant proportion of the budgetary deficit by expanding the money supply.

Printing money has its costs: the most obvious one is inflation, the result of too much money chasing a limited supply of goods and services. The economists call the resort to printing more money “inflation tax.” It is well known that the burden of “inflation tax” falls on the less well-to-do. Since economies are expected to grow and since developing countries are constantly monetising some parts of the economy, it is legitimate for the central bank to print more money than is required to replace the existing stock. But it is important to stay within reasonable limits. If these limits are crossed, the result would be inflation. The fact that Pakistan is currently experiencing the levels of price increases that are not in line with its historical experience is largely the consequence of allowing—or forcing—the central
bank to expand the monetary base. The way we have managed monetary policy has created the second of my twelve faultlines in our economy.

What can, or should, the government do to close this fiscal gap? There are basically two options, but they are not mutually exclusive: to raise government revenues and lower expenditures. Both options are politically difficult. As the budget of 1996-97 clearly demonstrated, sharp increases in tax burden are difficult to sell to the people especially when the people perceive that they are being asked to shoulder a burden well beyond their capacity to carry. If the imposition of additional tax burden comes with the perception that many influential groups are being let off the tax hook, the result is voter anger. The Nawaz Sharif government, in developing its budgetary proposals, put faith in two changes. First, reviving the economy and hoping that with an increase in the rate of growth of gross domestic product, government revenues would also increase. Second, a fairly significant cut in current as well as capital expenditures by the public sector.

(iii) A Dysfunctional Financial System

The structure of the financial sector has produced the third faultline. In the late Fifties and most of the Sixties, Pakistan had begun to lay the basis for the creation of a robust financial system. Private commercial banking system was developing rapidly; investment banks set up in the public sector were performing reasonably well; National Investment Trust and the Investment Corporation of Pakistan had created viable vehicles for mobilising household savings and directing them into industry, finance, and commerce; Karachi Stock Exchange had developed into one of the more vibrant capital markets in the developing world. These impressive developments were unfortunately interrupted by the massive nationalisation undertaken by the government of Zulfikar Ali Bhutto in 1972-74.

Bhutto’s nationalisation had three extremely adverse consequences. First, it brought to a sudden halt the development of private commercial banking. Pakistan lost precious banking skills developed during the Ayub Khan period. A number of bankers who had learned their skills on the job migrated to the Middle East, Europe, and North America. Second, it politicised the banking sector. With the government now controlling all banks, the stage was set for their misuse by politicians. The fact that public sector banks do not perform well and contribute to the corruption of the political system is a lesson that was to be learned time and time again by several developing countries, particularly those in Latin America. If we are to be guided by some of the recent crises in Latin America, we can be certain that the cost of restoring health to the banking sector in Pakistan will be very large, possibly of the order of 10 to 15 percent of the gross domestic product. It would be extremely difficult to find this amount of resource in an already tight budgetary situation. Third, as a result of Zulfikar Ali Bhutto’s nationalisation, all kinds of inefficiencies
crept into the banking sector. To take one simple example by way of illustrating this point, the public sector banks were not able to adequately serve the expatriate community. Large amounts of remittances sent by the Pakistanis working in the Middle East flowed through the hundi system rather than via the banks. If the banks had remained in the private sector, there is no doubt that they would have found ways to serve the Pakistani Diaspora and, at the same time, they would have expanded their presence outside Pakistan.

(iv) Low Rates of Domestic Savings

A very poor state of government finance coupled with a poorly performing financial sector have kept domestic savings at a very low level. Pakistanis save much less than Indians; they save considerably less than the citizens of the “tiger” economies of Southeast Asia. In 1995, the last year for which comparative data are available, domestic savings rate in Pakistan was estimated at 16 percent of the gross domestic product as compared with 22 percent in India, 36 percent for Thailand and 36 percent for Korea. A low savings rate translates into a low rate of investment; it also adds to the burden of debt, if the country has a large resource balance. In Pakistan the resource balance—the difference between the rate of investment and savings—was estimated at 3 percent in 1994. I should point out though that this level of resource balance is considerably less than the double-digit imbalances registered earlier; in 1980, for instance, the gap between investment and savings was equivalent to 12 percent of the gross domestic product. However, Pakistan no longer has external savings available for financing such a large resource gap. Worker remittances have declined; official development assistance has also become scarce; and Pakistan is not favoured as a destination by private capital.

(v) Growing Debt Burden

The resource balance discussed above is not the only gap that economic decision-makers in Pakistan must worry about. They have also to take cognisance of the growing difference between external earnings and expenditures. In 1995-96, Pakistan had a current account deficit of well over $4 billion, a record amount, considerably larger than the previous high of $3.37 billion registered in 1992-93. The current account deficit has more than quadrupled in the last ten years—the average for the first half of the 1980s was only $945 million. While the current account deficit reached a record level in 1995-96, it was less than the peak when measured in terms of its proportion of the gross domestic product. In 1983-84, Pakistan’s current account deficit was equivalent to 5.4 percent of GDP compared to an estimated 4.4 percent in 1995-96. But, as we shall see presently, not much comfort can be drawn from this fact since Pakistan no longer possesses the means to sustain this level of deficit.
At the same time, the more liberal trade policy adopted by the governments since 1990 has resulted in a significant increase in imports. The value of imports increased to over $10 billion in 1992-93, nearly 12 percent higher than in the previous year. However, imports declined to only $8.7 billion in 1993-94 but jumped back to $10.1 billion in 1994-95. They are estimated to be over $11 billion in the year that ended on June 30, 1995. Contrary to the general impression, the value of exports has kept pace with the increase in imports. The result is that the trade balance—the difference between the value of imports and exports—has remained unchanged for several years at about $2.5 billion a year. But the problem is that a negative balance of this magnitude year after year can only be sustained if the country has resources to pay for it. This it did for about a decade and half, from 1975 to 1990, when sharp increases in the flow of workers’ remittances and in the availability of concessionary assistance from a number of donors paid trade imbalance. Now with these two sources of funds providing fewer dollars, Pakistan has been paying for a persistent trade imbalance by borrowing on commercial and near-commercial terms. As indicated above, the most important of these factors is the sharp decline in workers’ remittances. In the first half of the Eighties, Pakistan received on average $2.48 billion from its citizens working abroad. In the first half of the Nineties, however, the level of remittances declined to only $1.65 billion.

Pakistan has relied very heavily on borrowing in order to cover the two gaps—between domestic savings and investment, and between external earnings and expenditure—that have persisted almost since the country’s birth. The consequence of this has been a sharp build up in both external and internal debt. The Government of Pakistan estimated outstanding external debt at $31.92 billion on June 30, 1995. According to the World Bank, the net present value of external debt had reached the level of 42 percent of GDP in 1994. However, it is not the stock of debt that is a problem but the terms on which it has been obtained. The end of the Cold War has reduced the incentive to provide economic assistance, particularly to those countries such as Pakistan that were deeply engaged in the conflict between the west and the Soviet Union. In the case of Pakistan, official development assistance has declined precipitously, from 5.1 percent of GDP in 1980 to barely 3.1 percent in 1994. With the sources of concessional funds drying up, Pakistan has relied on borrowings on near-commercial terms (from the IMF, the World Bank and the Asian Development Bank) and on commercial terms from international capital markets. During difficult periods—when there was either a sharp decline in international reserves or some large payments were due to external creditors—it has borrowed heavily short-term money from commercial banks at high rates of interest. Consequently, in the last few years, the term profile of external debt has deteriorated. The result of all this is a growing burden of debt servicing. The government estimates that in the last five years the share of debt service in export earnings has been increasing steadily. Debt service now claims one-quarter of the value of exports.
The burden of internal debt has grown even faster than that of external debt. For the last two decades, governments of various political persuasions have shown one common propensity: to turn to their own citizens for financing their deficits. Politicians did not care to explain to the people that to pay for government services by borrowing rather than by taxing means shifting the burden from the present to the future generations. A certain amount of inter-generational transfers make sense in rapidly growing economies. The assumption is that the present generation is too poor to be able to pay for investments that will bear fruit in the future. For such investments—resources committed to education, health, physical infrastructure—it is appropriate to borrow and delay the payment to the time when benefits begin to flow. This argument is difficult to apply to the case of Pakistan since much of the government’s deficit results from current expenditures.

The government estimates that by 1994-95 outstanding internal debt was equivalent to 42 percent of the gross domestic product, twice as much as in 1980-81. This burden has increased steadily in the last fifteen years. In 1994-95 interest payment on internal debt amounted to Rs 103 billion or 22 percent of total government expenditure.

(vi) A Low Level of Investment

We have already seen that Pakistan is investing a relatively smaller share of its gross domestic product as compared to other poor countries. The countries that have grown rapidly did so by saving and investing more than a third of their current income—most of the “tiger economies” of Southeast Asia invested nearly two-fifths of their GDP while Pakistan has managed to invest no more than one-fifth of its gross domestic product. What is even more troubling in the case of Pakistan is the trend in the rate of growth in investment. From 1980 to 1990 gross domestic investment increased at the rate of 5.9 percent a year. Since then the rate of increase has declined to 4.7 percent. Not only does Pakistan invest a smaller proportion of its gross domestic product, what it invests is less productive than in the rapidly growing economies of Southeast Asia. Reliable estimates of productivity trends in Pakistan are not available, but considering the state of physical infrastructure and human capital, it would be correct to suggest that the level of productivity has not increased.

(vii) Poorly Developed Physical Capital

Included in my list of “faultlines” are two important characteristics of Pakistan’s current economic and social situation: poorly developed physical and human capital. We do not need a great deal of data and information to highlight the constraint that the lack of appropriate physical capital is now imposing on economic growth. Roads in all major cities are clogged with traffic. A recent study estimated “crawl rates”—the rate at which the traffic moves—for various cities in Asia. Both
Karachi and Lahore were among the worst performers. Inter-city highways in Pakistan are grossly inadequate for the traffic they carry. In the last twenty-five years there was a remarkable ten-fold increase in the number of vehicles plying on the roads of Pakistan, from 364,000 in 1970 to 3.75 million in 1995. At the same time, total road length increased less than three-fold, from 73,000 km in 1970 to 205,000 in 1994-95. There are now 18 vehicles per kilometer of paved road in the country, compared to only 5 in the early Seventies. It is not surprising, therefore, that Pakistan has one of the highest rates of deaths in the world caused by road accidents. However, the highway sector is not the only one to have been given a low priority. Pakistan has also seriously neglected the development of railways, particularly for long-haul freight traffic. It has added less than two hundred kilometres to the length of railways in the last thirty years. In the mid-Fifties, the railways carried 11 million tons of freight. The amount carried peaked in 1974-75 when the system hauled 15 million tons. In 1994-95, the amount of freight carried declined to only 8.11 million tons.

(viii) Poorly Developed Human Capital

Paralleling the neglect of physical infrastructure is the lack of attention given to the development of human capital. By now the story has been told a number of times and is fairly well known. For a country at its level of development—particularly when income is measured in terms of “purchasing power parity”—Pakistan should have a much higher level of social development. It should have an infant mortality rate of no more than 30 per one thousand births; instead it loses close to one hundred out of every 1000 children born before they reach the age of one. It has one of the highest rates of maternal mortality in the world. Some 600 women die during child-birth for 100,000 live births compared to 200 in the Philippines and Turkey. Pakistan has done even less well in terms of education. It is inexcusable that two-thirds of its adult population is still classified as illiterate as compared with much lower proportions in other large countries of Asia. In 1994, 49 percent of the adult Indian population was deemed to be illiterate, while China had reduced the level of illiteracy to below nineteen percent of the adult population.

It is also well known that Pakistan does not treat its women with the same amount of care it shows to its male population. In every area of social development—health, education, participation in labour markets, equality before the law—women are way behind men. A number of statistics—rates of infant, child and maternal mortality, the extent of malnutrition among children, incidence of disease, enrolment in primary and secondary education, participation in the labour force—clearly demonstrate the backwardness of women. Even with exceptionally serious efforts directed at improving women’s welfare, it will take a long time before the women of Pakistan can match the men in terms of their social development. This is
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bad not only on humane grounds. It is now well-known that by keeping its women backwards a society condemns itself to eternal backwardness. Pakistan cannot be an exception to this rule.

(ix) An Exploding Population

Next on my list of faultlines is the increasing burden of population. A high rate of population, which continues to persist despite a significant increase in per capita incomes over the last three decades, is the consequence of two things. Whereas some improvement in infant, child, and maternal mortality rates has increased the life expectancy at birth—from 54 years in 1965 to 63 years in 1995—total fertility rates remain very high. This translates into a high rate of population growth. When Pakistan celebrated its fiftieth anniversary on August 14, 1997, its population was about 136 million, four-and-a-quarter times larger than the size of the population at the time of its birth. In the last fifty years, Pakistan has added 104 million people to the population of 32 million it inherited on August 14, 1947. “When Allah causes a human being to be born, it also gives him two feet to walk, two hands to work with,” is a common Pakistani saying. But Allah also asks its creation to use their thinking faculties. Pakistan’s current population is close to reaching the country’s carrying capacity. But even if a miracle occurred to reduce the fertility rate, demographic inertia will carry forward Pakistan’s population for many more decades. My guess is that we will double our population within 32 years; by the year 2030, we will have 265 million people living in the country. When we celebrate our first centennial in 2047, Pakistan’s population will have reached 350 million: twelve times the size of the population with which the country was born.

One important way in which the population explosion will manifest itself is by the creation of a number of mega-cities. Karachi already has more than 10 million people; another 6 to 7 million live in Greater Lahore. In the next decade, Faisalabad, Rawalpindi, Multan, and Hyderabad will cross the 5 million mark. Some people say that Karachi is already ungovernable and that Lahore is reaching that point. Four to six cities may join the difficult-to-govern classification by the early part of the next century.

(x) A Dysfunctional State

In part because of the enormous expansion of the country’s population, in part because of the concentration of a significant proportion of the population in a few cities, and in part also because of the scarcity of resources available to the state, the government is finding it increasingly difficult to deliver basic services to the poorer segments of the population. The Pakistani state is becoming increasingly dysfunctional. The government’s inability to meet the basic needs of the people is a
one of the faultlines I would like to highlight. It generates not only disillusionment but also breeds mafias that take it upon themselves in various different ways to service the people, but at a higher cost. There are cities all over the developing world in which mafias deliver water, haul away solid waste, provide law and order, operate lines of credit, deliver food and medicine. In some slums of urban Brazil, mafias also operate schools. They provide these functions not because they want to do good, but because they obtain a high rate of return from their investment in these services. A dysfunctional state that allows its functions to be assumed by criminal groups is courting disaster.

The Pakistani state is rapidly becoming dysfunctional in the sense that it no longer has the resources, institutional capacity, the political will, and the confidence of the people to deliver basic services to the people. The state’s failure is particularly palpable in the country’s major cities. In the cities, as the state withdraws, mafias advance. In many cities the advance of the mafias is being kept in check, not by the state, but by the private sector. In urban Pakistan, security services provided by the private sector now stand as the only protection between the increasing power of the mafias and the citizens.

(xi) The Return of Poverty

When we combine a number of the faultlines I have already mentioned—the high rate of population growth, low levels of social development, inability of the government to provide basic services, low rates of investment and, therefore, a low rate of growth, a sharp decline in foreign remittances flowing to the poor—it should not come as a surprise when I say that poverty is returning to Pakistan. For a while, largely because of the very large flow of remittances to the country, Pakistan was able to reduce very significantly the incidence of poverty. My guess is that in the mid-1980s the number of people living in absolute poverty had declined to no more than one-fifth of the total population. If this impression is correct, then Pakistan had about 20 million absolutely poor people in 1985. I would not be surprised if we end this decade by witnessing a sharp increase in the proportion of absolute poor. In the year 2000, our population will be above 150 million and if one third of this is absolutely poor, the poor will number 50 million by the year 2000. This arithmetic suggests that we have added another 30 million people to the stock of poverty in a period of a decade and a half. The gains made in the decade and a half between 1975 and 1990 and are now being rapidly dissipated.

(xii) A Dysfunctional Legal System

My final faultline is related to the problem created by an antiquated legal system that cannot adequately service a modernising economy. An underdeveloped
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legal system can become—in the case of Pakistan it has already become—a serious obstacle for economic growth. A fully functional legal system must be able to enforce contracts. It must also provide people proper resources to settle their claims on the government as well as on all economic agents. When legal systems remain backward they will inhibit the arrival of foreign capital and entrepreneurship.

What I have provided above is a list of the dozen faultlines on which Pakistan has erected its economic structure. The weaknesses they cause in the economic structure built over time need to be overcome or else we face a very uncertain economic future. I will now turn to the subject of what was done by the caretaker administration that took office on November 5, 1996 under the leadership of Prime Minister Meraj Khalid. I was called from Washington to take charge of economic policy-making for this administration.

B. THE CARETAKER’S ECONOMIC PHILOSOPHY

As the head of the caretaker’s economic team, I chose to focus not only on the immediate but also on the long-term; to bring about not only economic stabilisation but to introduce long-term structural changes as well. This two-track approach was reminiscent of the one adopted by the government of Moeen Qureshi in the summer of 1993. The adoption of this approach raised the same questions that had been asked three years earlier: Did the caretakers have the mandate to undertake deep structural reforms? Was not their mandate confined to steadying the economy, conducting the elections, and transferring power to whichever person and political parties had the largest support in the national assembly?

This restricted role on the part of a caretaker administration may have been implied by the provisions introduced by the eighth amendment in the Constitution of 1973. That notwithstanding, in 1993, as well as in 1996, Pakistan faced very serious economic crises. The caretaker administrations that took office in July 1993 and again in November 1996 had to deal with serious economic problems, urgently and with dispatch. Having said that, it is useful to emphasise that the nature of the economic crisis Pakistan faced in November 1996 was palpably different from the one it confronted in 1993. In 1993, Pakistan had to deal with a serious liquidity problem, particularly on the external front. There was a sharp deterioration in the level of reserves and Pakistan faced the possibility of default on external payment obligations if urgent remedial actions were not taken. In 1996, the country had also run out of reserves and, once again, was faced with the possibility of defaulting on international obligations. What made the 1996 crisis organically different from the one faced three years earlier was that it came with a systemic collapse. The style of governance practised by the administration that was dismissed on November 5 had caused institutional decay on a scale unprecedented in the country’s history. Public sector banks, non-bank financial institutions under the control of the government,
and public corporations were all massively bankrupt and threatened with extinction. Provincial governments and the federal government were spending money as if they had access to an unlimited supply of financial resources. On November 5, 1996, Pakistan’s economy did not just need a blood transfusion; it required open heart surgery and an organ transplant.

Before I go on to describe the programme of stabilisation and structural change introduced by the caretaker administration, I should answer one other question that was asked repeatedly in the first few days and weeks after November 5. There were many serious people—some of them within the ranks of the caretaker administration itself—who took the position that a 90-day period was not long enough to tackle the problems that had led to the dismissal of the government of Mohtarma Benazir Bhutto. Ehtasab before Intekhab (Accountability before Election) became the slogan of those who believed that Pakistan needed a thorough cleansing of the political and economic system. A period of 90 days was clearly not long enough to accomplish this herculean task. However, the President, the Prime Minister and most cabinet members took the position that any attempt to stretch the 90-day period would mean a fundamental re-interpretation of the constitution. Such an approach would further complicate an already difficult political situation. In retrospect, the President feels that the result of the elections of February 3, 1997 has vindicated his position. The people have carried out an ehtasab of their own; they have, to a remarkable and unanticipated extent, cleansed the political system of the people responsible for its corruption.

I believe there is also a socio-economic argument for having confined the life of the Meraj Khalid caretaker administration to only 90 days. Most of Pakistan’s economic and social problems—dealt with in Section A above—can be traced to a serious lack of political consensus on a number of fundamental issues. What is the appropriate role for the government in Pakistan? What proportion of the gross domestic product should be collected by the government as taxes? What proportion of government revenues should Pakistan spend on defence? What are the appropriate amounts of household, corporate, and public savings that Pakistan should aim to raise? What kind of relations should Pakistan forge with international financial institutions? How much devolution of authority should be permitted to the governments at the sub-national level? The answers to these questions—if and when they are found—should be acceptable to most segments of society. This can happen only if there is a serious and informed debate in the country. By postponing elections and stretching the life of the caretaker administration beyond 90 days would have shifted the debate to an entirely different arena. The Pakistani people, once again, would have been consumed by a discourse on the form of the political system rather than on the role of the government.
The two-track approach pursued by the caretaker administration in managing the economy was premised on the belief that stabilisation would have a very short-term impact unless structural reforms were undertaken simultaneously. External reserves can be built over the short-term, but only at a high cost if structural change is not introduced at the same time. Fiscal deficits can be curtailed somewhat by reducing government expenditures and bringing about some improvements in the collection of taxes, but long-term stability can only be achieved if the role of the government is clearly defined and the tax base enlarged. The last two are structural and not stabilisation measures.

C. EFFORTS TO STABILISE THE ECONOMY

Let me now turn first to the stabilisation measures adopted by the caretaker administration soon after taking office. These measures fall into three categories: one, restoration of confidence; two, reviving relations with the International Monetary Fund; three, reducing government expenditures and improving tax collection. I will deal with each one in turn.

When I was summoned back to Pakistan by President Farooq Leghari and Prime Minister Meraj Khalid to become the leader of the new economic team, it was clear to me that I had to re-establish the confidence of the international community in Pakistan’s long-term economic prospects. This confidence had been eroded very seriously. The first manifestation of this was the down-grading by Moody’s, an influential rating agency, of the potential of investments in Pakistan. I learnt of this action in London on November 8 during a brief stop-over en route to Islamabad from Washington. The news came from some investment bankers I met in London who were interested in committing some of their resources to Pakistan but were concerned that such investments were now at considerable risk. The Transparency International report of the summer of 1996, which ranked Pakistan as the second most corrupt country in the world after Nigeria, had not helped in creating a positive investment climate in the country. Downgrading by Moody’s had exacerbated the situation. It was clear to me that, in the eyes of the international financial community, a number of question-marks hung over Pakistan. Since I have been a believer for a long time in the inherent strength of the Pakistani economy, I thought it would be useful to focus on the positive rather than the negative aspect of the Pakistani economic situation. There was no alternative available to us; we had to convince the world that Pakistan was not a failed economic state.

On the flight from London to Islamabad, I wrote a plan of action that the caretaker administration must implement in order to restore not only the confidence of the international financial community in Pakistan’s economic future; such a plan was also needed to set Pakistan on the course for sustained economic development at
a rate of growth which would address the problem of poverty and bring about the long-postponed structural changes in the economy.

Within a few hours of arriving in Islamabad, I met with President Farooq Leghari for several hours and discussed with him the need for a broad-based approach towards managing the economic crisis. The President agreed with me that we had to handle both stabilisation and structural reform simultaneously. At the same time, he emphasised that we must not neglect the real sectors of the economy. He was particularly concerned about the massive deterioration that had taken place in our irrigation system, Pakistan’s most precious economic resource. He believed that, largely because of the collapse of the government structure and also because of increasing corruption, Pakistan was not deriving the benefit from an irrigation system that had been built over several decades. The President was right. As a result of a number of unfortunate developments—some bureaucratic, some political—we were running our irrigation system well below capacity. Mismanagement of the elaborate system built over a century had reduced its carrying capacity to 75 to 80 percent of the amount of water it could deliver.

The following day—on November 10—I gave a largely attended press conference at which I announced the caretaker administration’s intention to proceed simultaneously on stabilisation and structural change. I covered a great deal of ground in this conference. Some of what I said was to be the subject of a great deal of criticism by the press for most of the time I was in Pakistan.

First, by announcing a detailed programme of reform, both stabilisation and structural, within 60 hours of having returned to Pakistan, I gave the impression that I had come with the recipe developed in Washington. That I had been a student of the Pakistani economy for three decades; that I did not have to be influenced by the international financial institutions such as the International Monetary Fund and the World Bank in order to develop a programme of economic recovery and growth for my country; that Pakistan had to undertake serious economic, financial, and economic reforms to be counted as a responsible participant in the international financial and economic community were some of the arguments lost upon the participants in the conference. Neither were these points reflected in the reporting on economic issues during the life of the caretaker administration.

Second, I caused a run on the Industrial Development Bank of Pakistan (IDBP) by suggesting that this was one of the institutions earmarked by the new government for either merger or liquidation. I had assumed that my audience was familiar with the fact that under the legislation promulgated by the government of Prime Minister Zulfikar Ali Bhutto in 1974, all deposits in financial institutions, both commercial and investment, were fully secured by the government. My statement did cause a run on IDBP. I realised later that the information available to the people operating in the market was not always at par with what the government had decreed. This was another reflection of the lack of economic literacy among the citizens.
In the eyes of some of my beholders, although not in my own eyes, my third mistake, for which I was to be pilloried for a long time, was to try and create the impression that Pakistan would be able to weather the storm created by the mismanagement of the government of Benazir Bhutto. In my first press conference, I talked of the positive responses I expected from institutions such as the International Monetary Fund (IMF), the World Bank, the Asian Development Bank (ADB), and the Japanese Overseas Economic Cooperation Fund (OECF). I had held consultations with the first two before starting out from Washington and I had been led to believe that a significant amount of support would become available if we had appropriate stabilisation and structural reform programmes in place. The promised level of support did not materialise for two reasons. First, both institutions became concerned as to whether the policies being adopted by the caretaker administration would be pursued by the successor political government. They had every reason to be cautious: after all, none of the policies put in place by the government of Prime Minister Moeen Qureshi in 1993 was implemented by the administration of Prime Minister Benazir Bhutto. Second, the Pakistani press played an extraordinary role in sowing the seeds of doubt about the real intentions of the caretaker administration and the long-term prospects of the Pakistani economy.

By highlighting the extent of support that might become available from the IMF, the World Bank, the ADB, and the OECF, I was not being unrealistically optimistic. My only motive was to signal to the international financial community the fact that Pakistan could gain access to some one billion dollars of additional capital inflows if we set our house in order and regained some of the confidence lost by our principal donors. Unfortunately, only about $450 million of this amount became available to us while I was in office.

All these doubts notwithstanding, we were able to stem the haemorrhage that had begun to take a heavy toll on our external accounts in the final days of the government of Benazir Bhutto. Several hundred million dollars were lost in a period of six to eight weeks as nervous depositors began to draw down their holdings in external accounts. Had that trend continued, Pakistan would not have been able to honour its obligations to foreign account holders that they could redeem their deposits at the time of their choosing. The fact that the run on these deposits was reversed during the tenure of the caretaker administration could be counted as one of the major achievements of this period.

After stemming the loss of confidence in our ability to service our debt, including the ability to service foreign exchange deposits, we had to deal with the serious problem that had been created by the deterioration of our relationship with the International Monetary Fund. A great deal of journalistic ink was used in condemning the Fund and what its critics perceive to be its approach towards economic development. “Why don’t you save us from the clutches of the Fund?” is a
question I was often asked. The Fund—and its sister organisation the World Bank—are terribly misunderstood in Pakistan and in many other developing countries as well.

The IMF’s policies in Pakistan have been subject to a great deal of criticism, particularly on the part of the press. What has the Fund asked Pakistan to do: to reduce fiscal deficit and, as a corollary, to bring current accounts deficits under control; to reduce the resort to bank financing (printing of money) in order to finance budgetary deficits; to adopt a trading regime that would make Pakistan more competitive in the rapidly evolving global trading system; to develop financial institutions (banks, investment companies, insurance companies) that would help the real sectors of the economy. It is impossible to quarrel with any of these prescriptions, especially when their adoption is accompanied by a flow of resources that help the balance of payments situation. In addition, without the IMF’s “good house-keeping seal of approval”, Pakistan would find it difficult to access the world’s capital markets. No investment or commercial bank would be prepared to lend to Pakistan if the Fund is not actively involved in advising the country. We would invite an enormous amount of difficulty for ourselves by walking out of an arrangement with the IMF. In the discussions I held with am very pleased that Prime Minister-elect Nawaz Sharif and Sartaj Aziz, his principal economic advisor, I emphasised the importance of a good working relationship with the IMF. They accepted my arguments: arriving at an arrangement with the Fund was to become an important plank in the programme of economic reform launched by the Sharif government after it took office in February, 1997.

The last part of the caretaker’s stabilisation effort was to reduce government expenditures. Over the years—in particular from 1993-1996—governments in Pakistan have used the state to provide employment for their political followers and for the development programme to accommodate schemes and projects of dubious economic value to the economy and society. To bring the run-away government expenditures under control, the caretaker administration cut both current and development expenditures. The axe fell more heavily on the development budget; the allocation for the annual development programme for 1996-97 was reduced by 19 percent, from Rs 105 billion to Rs 85 billion. With this reduction, Pakistan scored another low in its economic history in terms of the proportion of gross domestic product committed to development. With development claiming only 3.4 percent of GDP—two percentage points less than the expenditure on defence—the government in Pakistan is not providing basic services to its population. However, given the serious shortfall in resources, we had no choice but to cut down development expenditures.

In addition to reducing government expenditure, we also made a serious effort to improve tax collection. This was done by bringing in a new team of managers to
the Central Board of Revenue (CBR); to monitor, on a weekly basis, the performance of the CBR; to terminate the contract of foreign companies that were hired by the Bhutto government to value imports; and to close a number of loopholes that were used by tax payers to avoid meeting their obligation to the state. These efforts provided good results: tax collection in December, 1996 exceeded our targets by a significant amount. These efforts persuaded the IMF to release a tranche of $80 million from the Stand-by Arrangement amount promised to Pakistan in October, 1996.

No sooner had the caretaker administration left office than the new government had to announce a series of additional measures to stabilise the economy. Prime Minister Nawaz Sharif appealed to all citizens of Pakistan, whether they were living and working in the country or abroad, to help the new government by putting their savings in especially designed funds. The Prime Minister also announced another set of measures to cut down on government expenditures. His first address to the nation after assuming office sent an unambiguous signal that Pakistan continued to face a serious economic situation. If that were the case, had the caretakers failed in their mission?

The answer to this question is most definitely no. There are two reasons why I would suggest that we succeeded in our objective to stabilise the economy. First, we should compare the health of the economy on February 17, not to what should have been the case, but to what the situation was on November 5, 1996. We stemmed the decline in reserves; we paid all our bills while bringing about a modest improvement in our reserves. We stopped the erosion of the financial viability of public sector commercial banks. We stopped useless government expenditures. We set the stage for achieving fiscal stability. In short, we pulled the economy from a nose dive. However, when we left, the economy had not gained much altitude; it was still cruising close to the ground.

Second, in order to address Pakistan’s short-term problems—the problems that surface every two to three years and cause a serious crisis—we must bring about a deep structural change in our economy. The beginning of such a change was made during the tenure of the caretaker administration headed by Prime Minister Meraj Khalid. That is the subject of Section D of this article.

D. BEGINNINGS OF STRUCTURAL TRANSFORMATION

Three months is too short a period for addressing the problems created by long-postponed structural reforms. The faultlines that had appeared under the structure of the economy could not be adequately repaired, let alone removed in the time available to the caretaker administration. And yet, I was convinced that we had to begin the process of structural change. Structural reforms had to accompany economic stabilisation. In the long meeting I had with President Farooq Leghari
shortly after arriving in Islamabad, I did not have any difficulty in having him accept this position. We agreed that I would work on a programme of comprehensive economic reforms to be announced by the President after the caretaker administration had completed half of its mandated tenure. We settled on December 25, 1996—the Quaid-e-Azam’s birthday—as an appropriate day for the announcement of the reform.

My first task was to quickly assemble a group of people who could work with me to undertake this massive task. The economic team I assembled included Hafiz Pasha, Deputy Chairman of the Planning Commission; Salman Shah, Chairman of the Privatisation Commission; Moeen Afzal, Secretary, Finance; and Javed Burki, Secretary, Economic Affairs. We met every morning at eight in my room in the Secretariat. Sometimes Zubair Khan, Commerce Minister, and Muhammad Yaqub, Governor of the State Bank, also attended these meetings.

Our starting-point was the document I had produced while I was flying from Washington to Islamabad. My document, in turn, had built upon the Faultlines articles Dawn had published in August, 1996.

We decided to cluster our programme of structural reform in four broad areas. By far the most important was the reform of the fiscal system.

(i) Fiscal System

The problems with the fiscal system had been diagnosed for a long time: they included a very narrow base of the system, inelasticity of government revenues and the enormous leakages that occurred from all levels within the system. The leakages could only be addressed by putting in a system of accountability. That was being done by some other members of the caretaker administration. Their efforts resulted in the promulgation of the Ehatasab (Accountability) Ordinance by the President.

Our effort at expanding the tax base was concentrated at extending income tax to agriculture. Zulfikar Ali Bhutto had exempted agriculture from federally mandated taxes. This provision had been incorporated in the constitution of 1973 and had resulted in many distortions in the fiscal system. Other than sheltering the powerful landed interests from income tax, it had also opened a vast loophole, used with impunity by many wealthy families. Although it was clear that agricultural incomes could not be exempt from tax, the constitution presented a major obstacle in the way of needed fiscal rationalisation. The only way out was to persuade provincial administrations to levy a tax on agriculture—something allowed by the constitution. This is what we proceeded to do.

There was intense debate even within the ranks of the caretaker administration about the desirability of bringing agricultural incomes within the fiscal system. The matter was ultimately resolved in a meeting chaired by President Leghari and attended by the Chief Ministers and Finance Ministers from the four provinces. Chief Minister Mumtaz Ali Bhutto was the most reluctant to accept this initiative. “I
don’t accept that agriculturists don’t pay taxes”, he told me in the cabinet meeting. “After all, we are charged for water and we pay land tax”. I reminded the Chief Minister that water charge was not a tax but a very small payment for a vital input for agriculture. Textile mill owners buy cotton for their factories. We made a modest entry into this difficult area. The tax introduced by the caretaker administration in the forms of a land productivity tax, if fully collected, would amount to only 2 percent of agricultural incomes or 0.5 percent of gross domestic product.

The other important fiscal measure adopted by the administration was also in the nature of rationalisation. By the time we took office, general sales tax (GSA)—a form of value-added tax (VAT)—had become a major source of government revenue. An ideal VAT does not permit exemptions (the Pakistan GSA was not levied on a number of items) and is charged at the same rate (the Pakistani GSA had a number of rates). However, the principal system would not have permitted the complete rationalisation of the GSA. That notwithstanding, we brought some, previously exempted items, under the tax’s purview.

We also sought to rationalise public utility charges and petroleum and petroleum product prices. The purpose was not only to raise additional government revenues. It was also our intention to introduce optimum pricing for the products produced and services provided by the public sector. Given the share of the public sector in the gross domestic product, whimsical (or politically inspired) pricing introduces serious distortions. The pricing regime in the public sector also imposed a heavy burden on such corporations as WAPDA, PSO, Sui Northern and Sui Southern Corporations, and PIA.

These adjustments in taxes and prices were expected to contribute to a reduction, over time, in the budgetary deficit. In the agreement we negotiated with the International Monetary Fund, we fixed the budgetary deficit target at 4 percent of gross domestic product—the same target included in the programme negotiated with the IMF by the administration of Ms Benazir Bhutto in December 1995. There was some pressure on me to opt for a higher deficit target and I believe that the IMF may have accepted a target of 5 percent deficit. However, it was my firm belief that Pakistan had to make a serious effort at fiscal adjustment and that it was appropriate to opt for an ambitious programme of deficit reduction. In any event, the administration of Mian Nawaz Sharif, decided that a relentless pursuit of deficit reduction aimed to yield a budgetary deficit of 4 percent of GDP, would have sent the economy into a deep recession. The Fund argued with that position.

(ii) Revival and Rebuilding of the Financial and Capital Systems

There was only one way to revive the financial system, damaged by years of perverse interference by the politicians and the bureaucracy. The only way to deal with the system’s problems was to hand over the commercial and investment banks
to the private sector. However, the privatisation of banks, unless accompanied by the establishment of a robust supervisory and regulatory system, could create monopolies that would create an entirely new set of problems. There were many examples from other countries that suggested that the transfer of banks from the public to the private sector was a process that demanded a great deal of preparation and exercise of care in carrying it through. Mexico had privatised public sector banks in a great hurry in the early 1990s. Most of them were purchased by industrial groups who paid three to four times the book value of the banks they acquired. Having paid a higher price for their acquisition, the “grupos” wanted to rapidly turn a profit. They went on a lending spree with little care given to ascertaining the quality of the assets they were accumulating. When Mexico was hit by the “peso crisis” in December 1994 interest rates went through the roof and property prices crashed through the floor. The Mexican banks discovered that they could not get their customers to service their loans. For many bank borrowers, the yearly payments they had to make to their lenders were much greater than the value of the assets they had pledged. The borrowers launched a movement under the banner of “El Barzon” (meaning yoke) to obtain relief from the government and to stop the banks from foreclosing on the properties pledged as collateral by the borrowers. Even without the movement, the Mexican legal system was not strong enough to help the banks in their efforts to secure payments from their borrowers.

There was a widespread fear that the difficulties being experienced by individual banks could produce a systemic financial crisis. The government had only one recourse available to it: it intervened and effectively renationalised a number of banks it had privatised not too long before. More than two years after the first signs of crisis appeared in Mexico, the banking sector continues to drain government resources. The accumulated cost to the exchequer for handling the crisis is estimated at 12 to 15 percent of the country’s GDP.

I had personal experience of dealing with the banking crisis in Mexico. Under my supervision the World Bank helped the Mexican Government develop a plan of rescue. The Bank provided the Mexicans a loan of $1 billion in the Spring of 1995, the largest operation it had ever mounted in its history.

In many ways, Pakistan’s financial system—or, more accurately the part that was under the control of the public sector—was even more fragile than that of Mexico in December 1994. That notwithstanding, the caretaker administration decided to proceed with great caution. There were three elements in our programme to restructure the banking sector. First, we equipped the Privatisation Commission to exercise “due diligence” in preparing the banks for sale to the private sector. Second, we strengthened the bank regulatory capacity in the State Bank of Pakistan, the country’s central bank. Third, we decided to set up a public sector entity—we called it the Resolution Trust Corporation (RTC)—to take over the non-performing assets
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from the books of the banks to be sold. The RTC’s *raison d’etre* was to deal with that part of the banking sector assets that the press in Pakistan had come to label as “stuck-up loans”. The decision to set up the RTC was the most novel part of our operation and the one that was the most difficult to explain even to the officials of the State Bank.

The State Bank wanted the banks to be privatised without their bad assets being separated from those that were still performing. On the basis of some earlier privatisation—in particular those of the Muslim Commercial Bank and the Bankers Equity Limited—the officials of the State Bank argued that it was better to leave the task of collecting bad debts to the new owners.

Drawing upon Pakistan’s own experience—and also on that of other countries that had dealt with banking crises—I was convinced that an RTC type of structure would save the government a great deal of money. It would also encourage foreign banks to increase their presence in the country. After all, the attempt made by the government of Ms Benazir Bhutto to sell United Bank Limited (UBL) had resulted in a near fiasco. The UBL was loaded with bad loans at the time it was offered for sale: the sale offer produced a poor response. There was only one relatively serious offer and that too came with so many strings attached that it made little sense either for the Bhutto administration or for the caretaker government to go forward with the sale.

Placing the privatisation of the public sector banks on the fast track and establishing the Resolution Trust Corporation to deal with the bad debts acquired by the public sector after years of corruption and mismanagement were the only significant structural reforms introduced by the caretaker government that were not fully implemented by the Nawaz Sharif administration. Most other reforms introduced by us were included in the economic measures adopted by the Sharif government.

I also sought to introduce privately managed pension funds in Pakistan as a part of our efforts to develop capital markets. An underdeveloped, poorly regulated, and poorly managed capital market was one of the contributing factors for the very low household savings rate in Pakistan. Once again, I borrowed from my experience in Latin America to bring reform ideas to Pakistan. Chile had seen a remarkable impact on its savings performance after it introduced private pension funds. Other Latin American countries had studied the Chilean experience and had concluded that what had worked for their neighbour should also work for them. Argentina, Bolivia, Colombia, Mexico, Peru and Uruguay allowed the private sector to set up pension funds and began to register a change in the saving behaviour of their citizens as well.

Pakistan does not have a contractual savings industry—a category of institutions that includes pension funds. There are only two forms of “savings” available to families—children and real estate. Since the poor do not have the
resources to commit to real estate, they opt for large families in order to secure some old age security for themselves. The rich can—and do—invest in real estate. There is little that can be obtained in the form of social good by investment in savings and real estate. It is important to bring about a change in saving behaviour and pension funds, that allows the people to set aside a small amount of money every month or every quarter. This can make a significant contribution to reducing the size of poor families and to also providing potential investors with a reliable source for long-term capital.

The caretaker administration set up a task force under the chairmanship of Naseem Mirza, a highly respected business executive, to prepare a plan for the establishment of contractual savings institutions in the country. The plan offered by the task force dealt at great length with the reform of the workers’ benevolent fund managed by the government. It did not take up the issue of creating contractual savings institutions. Since we were occupied with a number of other concerns, this aspect of structural change remained unaddressed.

We also introduced a number of reforms aimed at removing the distortions in the tax regions that applied to the capital markets. The markets had done poorly ever since Ms Bhutto ran into problems with the IMF. The buoyancy in the markets during the first two years of her administration was on account of the flow of foreign capital into the Karachi exchange. The problem with the Fund not only stopped new money coming into the country, nervous investors, uneasy about Pakistan’s economic prospects, withdrew their investment. The result was a virtual collapse of the market.

It was our expectation that the reforms introduced by us would revive investors’ confidence. The reforms were well received but the markets did not respond. The continuous political uncertainty was too large a factor in the calculations of the investor community for our reforms to produce a significant positive effect.

(iii) Autonomy for the Central Bank

By the time the caretaker administration led by Prime Minister Meraj Khalid took office, Pakistan had been pursuing with impunity almost total political control over the State Bank, the country’s central bank. The Ministry of Finance could order the State Bank to cover its deficits. This control over the central bank did not do great damage if the Ministry of Finance was managed well; which was the case during the Ayub Khan and Zia-ul-Haq periods. However, during the first Nawaz Sharif administration and the last two years of the government of Benazir Bhutto, the Ministry of Finance openly interfered in the conduct of monetary policy by the State Bank. The result was excessive monetary expansion and a sharp increase in inflation.
The first real attempt to establish an autonomous central bank was made during the time of another caretaker administration, the one headed by Moeen Qureshi. That attempt came in the form of a presidential ordinance issued in September 1993. However, Benazir Bhutto’s government, which took office following the PPP victory in the elections held in October, allowed the ordinance to lapse. Our administration not only revived the ordinance, we put more teeth into it. According to the provisions incorporated in the presidential ordinance of January 1997, the State Bank was to conduct monetary policy without any interference from Islamabad. The Governor of the State Bank was required to manage monetary policy keeping in view the growth and inflation targets established by a five-member board of which he was a member. If the government could not cover its expenditure from its revenue receipts, the government was not obliged to come to the assistance of Islamabad by expanding money supply.

(iv) Human Development, Poverty Alleviation, and Improving Income Distribution

The fourth area in which the caretaker administration sought to bring about some structural improvement was that of human development, poverty alleviation and income distribution. We recognised at the very outset that the time available to us was too short to make a palpable difference in any of these related issues. We could, however, set in place policies that could make contributions over the medium term. If some of the policies we adopted are followed—and, also, built upon by the government that took office in February 1997—significant improvements could occur in improving the welfare of the common citizens of Pakistan.

In the area of human development, we addressed the problems posed by the rapid polarisation of the education sector. While the private sector is providing adequate education at all levels to the children of those who can afford to pay, the poor have been badly neglected. The failure of the public sector to deliver reasonable education to the poor is hurting them enormously. Increasingly, the poor are turning to religious schools—the madrasas—for education. The present structure of the education sector, therefore, has the making of a social tragedy that could engulf Pakistan quickly—as quickly as the embrace of the Talibaan, educated in madrasas, over Afghanistan.

We sought to restore some balance to this rapidly polarising situation by empowering the education authorities in Islamabad and in the provinces to tax the well-to-do who were sending their children to private schools. Such a tax could be levied on the tuition paid to the privately managed schools, colleges, and universities and the receipts from it could be placed in a scholarship fund to provide access to private institutions by those families who need some financial assistance.
At the same time, we took steps to encourage the further expansion of the private sector’s presence in education. We removed most constraints on the establishment of private institutions. Accreditation authorities were established in the federal capital and in the provinces to grade private sector institutions. Some assessment of the performance of these institutions was needed to help households make appropriate choices.

Our poverty-alleviating efforts recognised that the state in Pakistan did not have the institutional strength to target subsidies to the poor. The private sector, on the other hand, had developed considerable capacity to do this. Accordingly, we created a Poverty Fund to be managed by a consortium of non-governmental organisations. The Fund was to receive contributions from the government and would also be eligible for receiving the support of the international donor community. The Fund managers were to apply simple tests to determine beneficiary eligibility.

Finally, we recognised that bringing about significant improvements in income distribution requires time and political will. There was little we could do in this respect. It was our expectation that by levying a tax on agricultural incomes we could create conditions which, over time, would bring about some redistribution of land through the market.

That the Government of Mian Nawaz Sharif, which came into office with a majority unprecedented in Pakistan’s history, continued with most of the structural reforms introduced by the caretaker administration shows that there is now consensus in the country on most economic issues. That is fortunate since, as we discuss below, Pakistan does not have the luxury of time.

**E. THE FUTURE**

There has been a perceptible slow-down in Pakistan’s growth rate over the past seven years. Since 1990, the gross domestic product has increased at an annual rate of 4.2 percent, compared with 5.7 percent over the 1950-90 period. To what should we attribute this one-and-a-half percentage point decline in growth?

This is an important question to which there is a simple answer. For the various reasons discussed in the first section of this article, the faultlines that lie under the structure of the economy have begun to take their toll. It was once believed—and I shared that belief—that Pakistan’s structural growth rate was of the order of 5 to 6 percent a year. This meant that if the country was not subjected to extraordinary exogenous shocks, it could continue to grow at 5 to 6 percent year after year. The fact that the rate of GDP increase in the forty-year period following independence fell in this range supported this view. On many occasions I extrapolated this rate of increase in GDP and argued that Pakistan was on the threshold of becoming a middle-income country. That view reflected not only optimism but a lack of full understanding of the true structure of the economy. I had
Pakistan’s structural problems did not slow down the rate of GDP growth for two reasons. For four decades, the country’s inability to generate enough resources to have a rate of investment that could support a growth rate of 5-6 percent was compensated by the availability of foreign savings. There were two important sources of finance to which Pakistan had access: concessional funds from both bilateral and unilateral donors that were provided to Pakistan in large part because of its geopolitical situation and the flow of remittances sent by Pakistanis working abroad to their families. The availability of external savings helped the country to sustain high levels of current account and budgetary deficits over a long period. The sharp reduction in external capital flows in recent years leaves Pakistan with two options: either to go on living with large imbalances or to induce a reduction in the rates of investment and the government’s current expenditures. Pakistan would court disaster with either of these options. A current account deficit of more than a couple of percent of GDP is not sustainable—even a deficit of 2 percent can be financed if the country is able to provide a sizeable increase in imports. The option of large-scale commercial borrowing to which Pakistan has increasingly resorted in recent years not only postpones the problem, it seriously compounds it. As discussed in Section A of this paper, the burden of external debt has already reached uncomfortable levels. It should not be allowed to increase.

Living with a rate of GDP growth of 4 percent a year means an increase in per capita income of just over 1 percent a year. This is too small an increase for the purpose of dealing with the situation of poverty. In fact, a GDP growth rate of only 4 percent a year will exacerbate the level of poverty.

The only feasible option is to continue with the structural transformation of the country on the lines undertaken by the caretaker administration.
Comments

I apologise to the audience for my third successive appearance on the podium in this meeting. I would have been flattered if I had achieved a similar hat-trick in the cricket field, but unfortunately not all of us, including perhaps Mr Burki, are as versatile as his illustrious cousin, Mr Imran Khan.

Since the late 1970s Pakistan has undergone a series of structural adjustments and reforms, largely carried out with the assistance of international financial institutions, especially the IMF and the World Bank. Even a cursory survey of Pakistani structural reforms, which is omitted for reasons of time is that they have been undertaken too fast and too soon, rather than too little and too late and without any serious attempt to analyse and foresee their consequences before their adoption. For instance, during the last five years Pakistan economic reforms have opened the country’s stock markets to foreigners. Unlike in some neighbouring countries and even some ASEAN countries, access to Pakistan’s stock markets is easy and international investors have complete freedom to buy and sell any share without limit on investment and can fully repatriate their capital and profits. However, while Pakistan benefited from the 1993 boom in worldwide emerging markets, it also suffered from the sell off in developing markets after the upward trend in interest rates in the United States in February 1994. Again in December 1994, the Mexican financial crisis figured a second wave of emerging market selling which have plunged the country’s three stock exchanges into a long recession.

The government’s efforts to privatise state-owned banks and industries have had mixed results. Only two of the five major nationalised banks have yet been privatised. Foreign investors’ enthusiastic response to the government’s offer to invest directly in the power sector, which is scheduled to be privatised of which will begin this year, resulted in MOUs worth over US$ 20 billion, although they never got reflected in the official records of flows of direct or portfolio investments. Nevertheless, the Government became a victim of self-delusion and went on a spending spree disregarding the covenants signed with the IMF and World Bank. Indeed, one of the then close advisers of the former Prime Minister and her husband, the renowned financial expert, Mr Salman Taseer, argued strongly that the new window of private portfolio and direct investments obviated the need for borrowings from IMF and the World Bank, which imposed strict and unrealistic conditionalities. Even if the wildest dreams of Mr Shahid Hasan Khan and Mr Salman Farooqi had come true it is difficult to see how Pakistani stock markets, with a market capitalisation of only about $10 billion, would have been able to absorb such massive infusions of foreign capital in a short period of time without the Pakistani economy getting seriously exposed to a Mexico-like situation.
Mr Burki’s task as the saviour of the economy from a possibly imminent fiscal and financial collapse is indeed unenviable an inevitable necessity and should no doubt receive precedence over other economic issues. One can only wish him Godspeed. However, it would be a grave error on the part of the economic team he is heading if the attention is restricted to crisis management issues alone and gives insufficient attention to the deeper malaise that the economy and society suffer from.

Nor should corruption, loan defaults and accountability be the sole watchwords of the current reforms. By succumbing to the rhetoric that legitimises the present regime, like Islamisation legitimised Ziaul Haq, the present regime can lead the country into the quagmire of vindictive politics without achieving any substantial improvement in the economy. Consider the contrafactual scenario in which the mindboggling billions attributed to corruption and loan defaults—or at least a significant part of them—were somehow reinvested by the beneficiaries into productive activities and the wild dreams about massive foreign capital inflows had in part been realised. The country would have been jogging along the road to tigerhood and middle income group status and all would have been forgiven and forgotten and perhaps even glorified both by the media, if not the people at large, and the international agencies.

There is, of course, the need to maximise efforts to recover long-standing loans and curb corruption within the present institutional parameters, it is obvious also that real progress, however slow, can only be made if our institutional structure is strengthened. Some shock therapy is certainly in order, but Mr Burki, who was incharge of the China desk in the World Bank before assuming his responsibilities for Latin America, must be well aware of the virtues of gradualism in the reform process.

Attention needs to be turned from defaults to the faults in the economy on which Mr Burki wrote impassionately in the Pakistani press a few months back. One may not agree with Mr Burki’s list of a dozen faultlines in the economy, but it is clear that the imbalances in the economy that have accumulated over the years through mismanagement and neglect need to be cognised through detailed research and analysis and their solutions arrived at and debated in a transparent and unrestrained manner.

Being an experienced traveller both across space and time, Mr Burki prefers to travel with a light intellectual baggage, jettisoning that which may become a liability. The package of reforms being pursued under his stewardship as a prelude to the conclusion of the proposed new FSAF loan for $ 2.5 billion with IMF seems to have a teo-point agenda, viz. the reduction of the fiscal deficit to 4 percent of GDP and the augmenting of the foreign exchange reserves to the level of another mystical figure of $ 1 billion. There is no point in agreeing to a set of conditionalities which are agreed to under economic duress without adequate analysis of their implications and
transparent discussion of their feasibility and consequences, as has been done in the past.

The current economic crisis in Pakistan clearly has its linkage with the political crisis. Although both parties have fully endorsed the liberalisation policies and economic reforms carried out in the past five years—in fact these were initiated during the previous regime when the political party currently in opposition was in power—the continuing struggle for power has considerably eroded the environment of political stability which is crucially needed for implementing these reforms and for them to bear fruits. The current political and constitutional impasse has further aggravated the situation. Without a firm consensus not only on the current economic reform agenda, both in the social and economic sector, but also on implementing it in an impersonal and non-partisan manner, the current political uncertainty will continue to erode business confidence, especially of the foreign investors. Pakistan’s current impasse emphasises the need for stronger institutional base and broader national reconciliation, rather than fragmenting its body politic, to take full advantage of the opportunities that the changes in the global economy and its unique geographical position have made it possible.

The acid test of the stabilisation package being proposed by Mr Burki will be the equitable burden it will impose on different groups, with the poor receiving a negative burden. Pakistan’s business community is hardly a paragon of virtue and business ethics, having been nurtured in the past by official patronage of its many rent-seeking activities and needs to be weaned away from its parasitic culture of fiscal and financial frauds and induced into undertaking productive activities as much as the bureaucrats and other elites need to be weaned away from the VIP culture. But the foremost gauge on which the stabilisation and structural reforms will be judged is the extent to which resources can be mobilised from the affluent farmers. If the package succeeds in mobilising 20 billion rupees as agricultural income tax, it will be seen as an incontrovertible success, given the current feudal hold on the power structure. If half of that sum is devoted to education and other social services, Mr Burki’s package will earn a place in history. Despite my great professional sympathies with Mr Burki and his team, I do not think that they will even remotely be able to approach these goals.

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