



Pakistan

In addition to a declining growth rate and stagnant production, investment and savings performance continues to be weak, export growth is decelerating dramatically, and governance is weak and inefficient.

RECENT TRENDS AND PROSPECTS

GDP growth was only 3.1 percent in 1997. Agriculture grew by just 0.7 percent because of low productivity coupled with untimely rainfall and cotton viruses. Manufacturing showed poor growth of 1.8 percent, largely as a result of negative growth in the large-scale manufacturing subsector, which made up three quarters of total manufacturing. This can be attributed to limited financial resources, reduced exports, and outdated equipment. Growth in the service sector also fell in 1997. During 1996 and 1997 foreign exchange reserves were at a precarious level, equivalent to an average of only about four weeks worth of imports.

Two factors are responsible for the low growth and the accompanying high macroeconomic instability. The first is the political situation, which has included frequent changes of government and an unstable law and order situation in Karachi. Although the three-month-long political crisis ended in December 1997, its economic consequences have persisted. The second factor is structural bottlenecks, such as persistent fiscal imbalances, limited financial resources, and inadequate infrastructure. Lengthy legal procedures and poorly organized regulatory systems aggravate the situation. To deal with these weaknesses, the government has undertaken a series of broadly based policy reforms

that include adopting major tax and tariff reforms in March 1997, which substantially lowered tax and tariff rates across the board. The purpose of reducing tax and tariff rates was to boost private sector industrial activity, enhance productivity, and promote new production techniques. Furthermore, a wide range of financial sector reforms that cover capital markets, the central banking system, and commercial banks are either under way or on the drawing board. Although these reforms have produced some favorable outcomes in recent months, such as a small increase in exports, major effects may not be visible for one or two years.

In 1997 investment and saving rates remained extremely low. Total investment as a percentage of GNP fell to 18.4 percent in 1997 because of financial and foreign exchange constraints, low growth in exports, policy conflict with the International Monetary Fund (IMF), and frequent government changes. The continued decline in national savings since 1994 exacerbated the effect of these factors on investment.

Official unemployment was reported at 2 million, or 5.4 percent of the labor force, in 1997. However, given the definition of employment in the labor force survey, that is, a person who works for at least one hour during the reference period is considered employed, actual underemployment is substantially higher.

1997 refers to fiscal year 1996/97, ending 30 June.

Budgetary deficits have long impaired efforts to achieve macroeconomic stability. In an effort to reduce the deficit, in 1997 the government streamlined development plans and projects and cut the Public Sector Development Plan budget by 19 percent. It also restructured the tax system to tax agricultural income more efficiently. However, these efforts met with limited success, as the consolidated budget deficit remained at 6.3 percent of GDP, the same as in 1996. This led to substantial domestic borrowing from financial markets, which financed more than 80 percent of the deficit.

Government borrowing for budgetary support is a main contributor to domestic credit expansion. The banking and financial sector also suffers from extensive levels of loan defaults, which by 1997 amounted to 7 percent of GDP. The authorities pursued a tighter monetary policy in 1997 and the rate of M2 growth decelerated to 13.1 percent. However, inflation was 11.6 percent, about 2.6 percentage points above the government's target, as a result of fiscal laxity in 1996.

Commodity exports declined by 2.7 percent in 1997, mainly because excessive rains curtailed

cotton production. Other major products whose exports suffered included raw leather, medical instruments, and chemicals and pharmaceuticals. Persistent inflation, a low-technology industrial base, and a shortage of financial resources hindered any recovery in exports. Imports were 5 percent lower than in 1996. The rise in capital goods imports was offset by the decline in imports of food (except for wheat and rice), chemicals, and metals. As a result, the trade deficit improved marginally in 1997. And despite the widening of the deficit on the services account because of increased debt servicing, the current account deficit narrowed to 6.5 percent of GDP. However, there was a significant drop in the capital account surplus, which led to a considerable decrease in foreign exchange reserves.

If the government continues both its economic and governance reforms and no severe natural disasters take place in the next two years, Pakistan's macroeconomic prospects are likely to improve. GDP growth is projected to be a little more than 5 percent in both 1998 and 1999. The agriculture sector, after its minimal growth in 1997, is forecast to grow faster. With the government's support for private

Table 2.15 Major Economic Indicators: Pakistan, 1995-1999
(percent)

Item	1995	1996	1997	1998	1999
Gross domestic product, growth ^a	5.2	4.6	3.1	5.1	5.5
Gross domestic investment/GNP	18.3	18.7	18.4	20.0	22.0
Gross national saving/GNP	14.2	11.6	11.4	12.5	13.5
Inflation rate (consumer price index)	13.0	10.8	11.6	10.0	10.2
Money supply (M2) growth	16.6	14.9	13.1	14.2	15.0
Fiscal balance/GDP ^b	-5.5	-6.3	-6.3	-5.0	-5.0
Merchandise exports growth	16.1	7.1	-2.7	6.0	9.0
Merchandise imports growth	18.5	16.7	-5.0	0.5	10.0
Current account balance/GDP ^c	-4.1	-7.1	-6.5	-5.1	-5.2
Debt-service/exports	34.9	33.9	37.0	35.0	34.0

Note: All data are on a fiscal year basis.

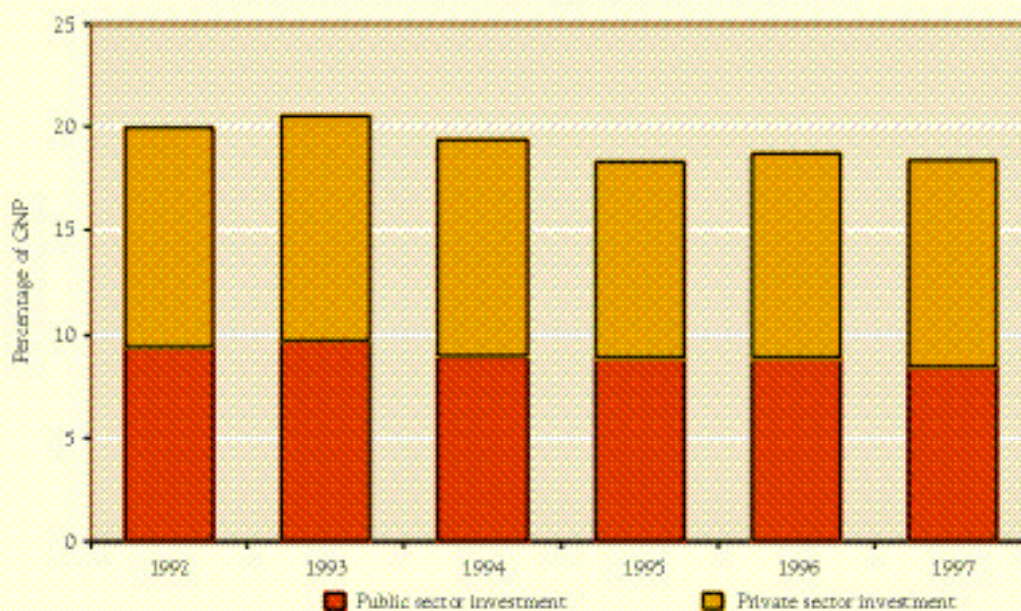
^a At constant factor cost.

^b Based on consolidated federal and provincial accounts and including surplus of autonomous bodies.

^c Excluding official transfers.

Sources: Economic Adviser's Wing (1997); State Bank of Pakistan (1997, 1998); Asian Development Bank (1997b); and staff estimates.

Figure 2.11 Gross National Investment: Pakistan, 1992-1997



Sources: State Bank of Pakistan (1997) and staff estimates.

sector-led industrialization, industrial output is also expected to increase. Likewise, the service sector is projected to grow because of a gradual recovery in the financial sector. Projections also indicate that exports will increase because of improved industrial activity in 1997 and that imports are likely to increase only marginally because of increased imports of petroleum products and chemical products. Therefore, the current account deficit is expected to decline further to a little more than 5 percent of GDP in 1998 and 1999.

CRITICAL ISSUES IN SHORT-TERM ECONOMIC MANAGEMENT

Pakistan suffers from a number of macroeconomic imbalances and structural problems, which in the past were frustrated by slippages in policy implementation. As a consequence, in October 1997 the IMF approved SDR1,137.3 million (\$1,558 million) under two of its programs (the Extended Fund Facility and the Enhanced Structural Adjustment Facility) for macroeconomic adjustments and reforms. Under these programs Pakistan is to rein in the inflation rate and current account deficit.

An important issue in short-term economic management relates to the government's ability to

meet the accompanying IMF macroeconomic targets. A critical issue in this context is revenue collection. According to estimates by independent tax experts, revenues are expected to fall some 15 to 20 percent short of the target during 1997. Thus to adhere to the budget deficit target prescribed by the IMF the government needs to broaden the tax base, revamp tax administration, and rationalize government expenditures.

The level of foreign exchange reserves has also been a source of concern. This will probably reduce Pakistan's ability to import capital and intermediate goods, thereby prolonging the industrial recession of 1996 and 1997, when 4,000 factories closed down. A high priority is the need to increase the growth of exports and rationalize imports.

POLICY AND DEVELOPMENT ISSUES

Economic growth has barely kept pace with population growth, and the debt-service ratio reached 37 percent, the highest in Asia. To revive economic dynamism, Pakistan must promote investment and exports.

The two 1997 IMF programs require a number of medium-term reforms needed to revitalize the economy. To promote growth the government is to

strengthen the private sector and rationalize the public sector. The privatization program is to be given a new impetus by privatizing public assets in the manufacturing, power and gas, and telecommunications sectors. This program is to be extended to the financial sector, complemented by efforts to strengthen supervisory and regulatory institutions. Although the two IMF programs focus on fiscal and balance of payments areas, education, health care, population welfare, and family planning are also addressed. Therefore expenditures on the social sectors will rise in the near term.

Promoting Investment and Saving

Gross national investment has been low: as a percentage of GDP it stood at around 18 percent during 1995-1997, while such high-performing Asian countries as Indonesia and Malaysia were investing more than 30 percent of their GDP. To achieve a growth rate of 6 percent per year will require an investment ratio of about 25 percent, which implies that the savings rate must rise. However, a low savings rate is one of Pakistan's major problems. The national savings rate hovers at about 12 percent of GNP, one of the lowest levels in Asia. Pakistan's financial sector, which is dominated by nationalized banks, is ineffective in mobilizing savings. The 360 national savings centers are primarily designed to help finance public sector deficits. Specialized private savings institutions are nonexistent, the insurance industry is small, and the growth rate of quasi-money is far slower than in other Asian economies. The result is that financial institutions have developed little in the past two decades. If this situation is remedied, savings performance will improve.

As households with fewer dependents save more and family size is gradually declining in

Pakistan, the savings rate may rise in the medium term. An increase in the real interest rate would also improve savings performance. Evidence from other Asian economies indicates that a relatively small rise in the interest rate can lead to a large increase in savings.

Encouraging Exports to Revive the Economy

As noted earlier, exports contracted in 1997, causing low utilization of industrial capacity. The decline in Pakistan's exports can be attributed in part to an unfavorable commodity composition. Most exports are either primary, for instance, rice, for which demand has not been growing rapidly, or manufactured products, for which market access is limited, for example, the Multifibre Arrangement currently restricts Pakistan's textile exports. Export promotion policies should therefore address production as well as marketing.

The potential for upgrading the major export industries is vast. For instance, local firms should be encouraged to capture some of the world's fashion garments and leather product markets by developing joint ventures with firms in the industrial world. As concerns textiles, the emphasis should be on producing ready-made textiles and high-end fabrics. There is a large market in Asia and Africa, as well as in the industrial economies, for embroidered cloth, lace, and so on. By developing a large production base of such high value-added items (which are also labor-intensive), Pakistan could develop a reasonably large export market. To this end, the government should not only encourage appropriate incentives, but should ensure the presence of the physical and institutional infrastructure necessary for a smooth supply of required imported materials and other inputs.