Pakistan

Economic growth in Pakistan in 1995, though an improvement on that in 1994, was still lower than the trend growth rate achieved over the previous decade. The agriculture and services sectors accounted for the bulk of the increase while industrial output, especially large-scale manufacturing, grew very slowly. The macroeconomic position was not favorable. Inflation, already high in 1994, increased further, while money supply growth showed little reduction and was well in excess of the target. The fiscal deficit was well above the target previously agreed with the IMF in accordance with the ESAF. Progress in tariff reform also failed to meet ESAF targets.

However, in October 1995, the Government implemented a series of major economic measures, including currency depreciation, interest rate increases, and the imposition of additional import duties designed to improve the trade balance which had deteriorated sharply. This action was largely in line with the spirit of the IMF policy goal and, subsequently, the Government and the IMF reached an agreement on further IMF credit.

Progress was made in the implementation of the Social Action Program (SAP), which was launched by the Government in 1993. Despite fiscal constraints at both the provincial and the federal levels, the Government allocated more financial resources to the SAP. Although it is premature to assess the actual impact of the SAP, the financial allocations and policy reforms indicate that the program is being implemented effectively.

Recent Trends and Prospects

Growth, Investment, and Employment. Economic growth in Pakistan in 1995 improved to 4.7 percent from 3.8 percent the year before, primarily because of good performance by the agriculture and services sectors.

Agricultural output increased by 4.9 percent, as the average production of major crops rose by 6.4 percent. There was good recovery in the output of both wheat and cotton following declines in 1994. However, cotton production continued to be adversely affected by pest attacks and unfavorable weather conditions. Livestock production, which accounts for one third of agricultural output, continued to increase strongly although at a slightly lower rate than in 1994.

Several policy reforms were undertaken in agriculture during 1995. The Task Force on Agriculture made a number of recommendations to be implemented over the next two years such as eliminating export duties on agricultural commodities, particularly cotton; increasing the credit allocation to agriculture; establishing a farmers bank; improving the management of water resources; and providing certified seeds. A crop insurance scheme is being finalized and 20,000 tractors were provided to small farmers under the Awami Tractor Scheme to promote farm mechanization. Several relief measures, especially the rescheduling of loans, were introduced for farmers affected by floods in 1995.

The growth of industrial output in 1995, which was affected by lower growth in

1995 refers to fiscal year 1994/95, ending 30 June.

Table 2.17 Major Economic Indicators: Pakistan

		1993	1994	1995	1996	1997
Gross Domestic Product[a]	% change	2.3	3.8	4.7	5.5	5.8
Agriculture	% change	-5.3	2.9	4.9	6.0	4.5
Industry	% change	5.6	4.7	5.0	5.7	7.0
Services	% change	4.6	3.8	4.4	5.1	5.7
Gross Domestic Investment	% of GDP	20.7	19.5	19.1	19.3	20.6
Gross Domestic Saving	% of GDP	14.6	16.8	15.8	16.0	16.5
Inflation Rate	% change in CPI	9.4	12.5	12.9	13.0	11.0
Money Supply Growth	% change	18.0	16.9	16.6	15.0	16.0
Merchandise Exports	$ billion	6.8	6.7	7.9	8.5	9.7
	% change	0.3	-1.4	17.9	8.0	14.0
Merchandise Imports	$ billion	10.0	8.7	10.1	11.7	13.6
	% change	11.7	-13.6	16.7	15.0	16.5
Current Account Balance	$ billion	-3.3	-1.7	-2.1	-3.0	-3.1
	% of GDP	-6.4	-3.2	-3.5	-4.7	-4.3
External Debt Outstanding	$ billion	26.2	29.6	31.9	34.5	34.0
Debt-Service Ratio	% of exports	25.2	34.8	33.4	32.4	24.7

[a] Based on constant 1981 factor cost.

Note: All data, except for that on external debt and debt-service ratio are on a fiscal year basis. Data on inflation and trade may differ from the series contained in the Statistical Appendix (see Statistical Notes).

Sources: Government of Pakistan, Economic Adviser's Wing, *Economic Survey 1994–95*; World Bank, *World Debt Tables 1996*, Vol. 2 (Washington, DC, 1996); and staff estimates.

manufacturing, was barely above the relatively depressed level of 1994. Although construction and power generation picked up, large-scale manufacturing growth was well below that in 1994 because of a delay in commencing sugarcane crushing, the closedown of some textile mills because of high cotton prices, and capacity constraints in petroleum refining. Small-scale manufacturing, however, which accounts for about 21 percent of industry output, continued to grow strongly. The manufacturing sector has been encountering the task of adjusting to an environment of internal and external competition stimulated by deregulation, the opening up of the overall economy, and reduction of tariffs. As a result, some industrial units have had difficulties in adjusting to more competitive market conditions.

The services sector grew by 4.4 percent in 1995, showing improvement over growth in 1994 of 3.8 percent. The transport, storage, communications, and trade sectors recorded improved rates of growth compared with achievements in 1994.

Total investment outlays are estimated at Pakistan rupees (Rs) 356.9 billion in 1995 compared with Rs305.5 billion in 1994, an increase of 16.8 percent in nominal terms. Fixed investment grew by 17 percent. The share of total investment in GDP fell to 19.1 percent of GDP during 1995 compared with 19.5 percent in 1994. This was largely because of the depressing impact of civil unrest in the Karachi area on investment plans. Real investment grew by 2.8 percent in 1995 compared with a decline of 0.9 percent in 1994. Real investment in electricity and gas, which was 19.7 percent of real gross fixed investment, recorded an increased rate of 29.6 percent, whereas construction and transport and communications showed a decrease of 17.8 percent and 13.4 percent, respectively. Public sector investment grew more rapidly than did private sector investment spending. While small-scale manufacturing increased its real investment by 6.8 percent during 1995, large-scale manufacturing declined by 1.8 percent, resulting in a decline of 0.3 percent in total real investment in the manufacturing sector.

The ratio of gross domestic saving to GDP declined from 16.8 percent in 1994 to 15.8 percent in 1995. A fall in public saving was partially offset by an increase in private saving as economic growth increased and incentives to save were improved. The resource gap was 3.3 percent of GDP, a level slightly higher than that recorded in 1994.

Agriculture is still the primary employer – nearly 50 percent of the work force is employed in the sector. Manufacturing and construction account for less than 20 percent of the work force. Only 36 million people are in the labor force. The labor force participation rate in Pakistan is low at less than 30 percent, primarily because of the very low participation rate for women, at 8.6 percent. Wage earners constitute only about one third of employment and are mainly urban based.

The official unemployment rate was 4.7 percent or 1.7 million workers in 1995. This was a decline from the previous year when the rate was 5.8 percent. Partly reflecting the migration to the cities, unemployment in urban areas is 5.9 percent, while in rural areas it is about 4.3 percent. It is likely that unemployment is underestimated and underemployment is substantial. However, there are no firm estimates of its extent.

The Government continued to implement several schemes aimed at creating employment. In particular, the Self-Employment Programme, which promotes small businesses with government-subsidized credit, was expanded further in 1995, and created employment for about 140,000 persons. Also, under the SAP, 33,000 female health workers in rural areas were trained and subsequently employed; while under the Youth Investment Promotion Society, employment was generated for 14,000 persons during the year.

GDP growth is projected to increase to 5.5 percent in 1996 and further to 5.8 percent in 1997. The agriculture sector will continue to play a major role in boosting economic growth during that time. Progress has been made in dealing with the cotton virus which has adversely affected cotton output in the past few years and output of 9.5 million bales is projected in 1996. A further increase to over 10 million bales in 1997 is expected. Output of the other major agricultural crops is projected to be satisfactory. As a result, agriculture sector growth is expected to be a robust 6 percent in 1996, followed by a more modest but still very strong growth of 4.5 percent in 1997.

During 1994 and 1995, a poor cotton crop had a depressing impact on the output of cotton-based textiles. However, early signs suggest a good cotton harvest in 1996. Together with government measures to encourage the textile industry, this should boost manufacturing, despite the possible continuation of the difficult law and order situation in Karachi. Both mining and construction are expected to perform better over the next two years, as the economy continues to pick up. As a result, industry is forecast to grow by 5.7 percent in 1996 and 7 percent in 1997. The services sector is also projected to continue recovering over the next two years, partly because of the expected expansion in industrial production and partly because of the increased role to be played by the private sector under a more deregulated economic system. However, the financial sector, particularly the capital market, is likely to be adversely affected by civil unrest in Karachi, which had a negative impact on equity prices in 1995 and early 1996. Services activities relating to foreign trade and investment may also be sluggish. Hence, the services sector is forecast to grow by 5.1 percent and 5.7 percent in 1996 and 1997, respectively.

Gross domestic investment as a proportion of GDP is expected to rise to 19.3 percent in 1996 as the Government's policy of encouraging private sector investment begins to bear fruit. Private sector investment will be concentrated in manufacturing, housing, and agriculture while public sector investment priorities will continue to be in power, transport and communications, and the social sectors. It is expected that approximately 80 percent of the investment will be financed by national saving, and the remaining 20 percent by foreign sources. Along with the economic recovery and financial deregulation, both household and government savings rates are expected to increase. Government saving should improve, given commitment to the stabilization program over the next two years. Given these developments, gross domestic saving will rise slightly to 16 percent in 1996 and further to 16.5 percent in 1997.

The labor market situation should improve over the next two years as a result of the economic recovery and the Government's strong efforts to foster human resource development. As economic growth returns to a rate of 5–6 percent, the number of new jobs generated will increase. Under the SAP and involving expenditure of over 2 percent of GDP to promote human resource development, the Government will be continuing its efforts to reduce population growth and to improve the education, skills, and health conditions of the labor force.

Budget, Money, and Prices. The consolidated budget of the Federal Government and provincial governments for 1995 provided for a reduction of the fiscal deficit from 5.9 percent of GDP in 1994 to 4 percent in 1995. This was to be achieved mainly by a substantial increase in tax revenue through new tax measures and improvements in tax administration. The actual budget outturn resulted in a deficit of 6 percent of GDP, mainly as a result of a shortfall in revenue collection owing to budget concessions and tax rollbacks and an unsatisfactory collection rate during the first half of the year. To increase the tax effort, the general sales tax was expanded in 1995 to encompass an additional 277 items. The Government also launched a three-year program of tariff reforms. Under the ESAF/Extended Fund Facility (EFF), certain fees, duties, and surcharges were combined with customs duties, resulting in a drop in the maximum tariff rate. Income tax concessions for women were increased and the corporate income tax rate was decreased by a few percentage points. Concessionary rates of taxation were applied to the power and petroleum sectors with a view to encouraging investment in these sectors, and a five-year tax holiday program was accorded to the fruit processing and toy-making industries to promote exports of these products.

The larger-than-expected fiscal deficit contributed to monetary expansion. Money supply (M2) increased by 16.6 percent, well above the target of 11.8 percent, which reflects the increase in net foreign assets, Government borrowing from the banking system, and increased credit to public enterprises.

Inflation, as measured by the consumer price index (CPI), was 12.9 percent in 1995 compared to the original target of 7 percent. Besides the influence of monetary expansion, prices for a number of food items, such as vegetable oil, increased and shortages of some foodcrops and higher prices for petroleum, gas, and electricity also put additional upward pressure on the price level. There were also increases in support prices of agricultural crops such as rice, and a rise in energy tariffs which further contributed to inflation.

To improve macroeconomic stability, which had deteriorated drastically in early 1995, the Government agreed to a standby credit program with the IMF in December 1995. In line with this program, the Government is aiming for a fiscal deficit target of 4.6 percent of GDP in 1996 compared with 6 percent in 1995. Considering that the GDP share of tax revenue is likely to remain relatively inflexible, the major emphasis in reducing the deficit will be on public expenditure, mainly reduced allocations for development spending. Measures announced by the Government include a 7 percent devaluation of the rupee, an imposition of 10 percent regulatory duty on all dutiable imports, and a 7 percent increase in domestic prices of petroleum products. Together with other measures in line with the IMF credit program, especially privatization of the state-owned enterprises, these actions will contribute to a lowering of the budget deficit/GDP ratio in the next two years. Considering that additional fiscal measures may be forthcoming, it is expected that the deficit will be reduced further to about 4.5 percent and 4 percent of GDP in 1996 and 1997, respectively.

To lower inflation, a fairly tight monetary policy will be pursued in 1996 and 1997. Monetary policy will slow the growth of domestic liquidity by tightening credit policy and raising interest rates and by restructuring government borrowing from the banking system. However, given a lag in the adjustment process, the inflation rate is expected to increase slightly to 13 percent in 1996 before falling to 11 percent in 1997. Growth in money supply (M2) is likely to remain close to 1995 levels over the next two years. Public borrowing continued to increase in the first three months of 1996, while currency depreciation will further contribute to inflationary pressure.

External Trade and Payments. The international demand for Pakistan's exports, which remained depressed in 1994, showed a sharp increase in 1995 as exports rose by 17.9 percent. Rice, cotton yarn, cotton cloth, carpets, textile products, sporting goods, and leather products all did well. Merchandise imports,

which had fallen by over 13 percent in 1994, also rebounded by 16.7 percent mainly due to higher imports of major food items, machinery, chemicals, and petroleum products. Remittances from workers abroad rose by nearly 30 percent in 1995. However, this represented a recovery from the position in 1994 when remittances declined by over 7 percent because of political uncertainties associated with the elections in October 1993 (Figure 2.22). Despite a significant increase in exports and remittances, the current account deficit in 1995 widened slightly to $2.1 billion or 3.5 percent of GDP compared with 3.2 percent of GDP in the previous year.

The net inflow of long-term capital increased by 18.3 percent, mainly owing to a rise of 28 percent in private capital inflows. Portfolio investment also increased. Nonetheless, there was a decrease in net capital inflows, especially of medium- and short-term loans and foreign currency deposits (for nonresidents), and increased outflows of official short-term capital. This resulted in a reduction in the capital account surplus from $1.6 billion in 1994 to $242 million in 1995. International reserves stood at $2.4 billion, equivalent to about three months of imports. The debt-service ratio, as a percentage of export earnings, declined to 33.4 percent in 1995 from 34.8 percent in 1994 as a result of the sharp increase in exports combined with a modest increase in debt-servicing costs.

The prospects for exports in 1996 are mixed. During the first three months of 1996 (July–September 1995), merchandise export receipts dropped by 5.1 percent compared with receipts over the same period in the previous year. Earnings from major export items, including carpets, synthetic textiles, leather products, sporting goods, and fabrics, all decreased sharply. By contrast, an increase in the value of imports of machinery, fertilizer, and insecticides resulted in an expansion of total import payments by 21.6 percent during the same period. As a result, the cumulative trade deficit in the first three months in 1996 soared to $989 million, 126 percent higher than in the corresponding period of the previous year. This deficit was not fully offset by capital inflows and, as a consequence, international reserves fell to about $1.3 billion at the end of October 1995, the equivalent of only one-and-a-half months of merchandise imports. To address these imbalances, the Government, as noted earlier, took important economic measures at the end of October 1995, including a 7 percent depreciation of the Pakistan rupee and increases in interest rates, fuel prices, and import duties. Accordingly, the Government obtained standby credit from the IMF of $596 billion in December 1995 to be released over the following 15 months.

It is likely that the abovementioned economic measures will have a favorable impact on the trade balance by encouraging exports and discouraging imports. Exports should be further boosted by an improved cotton crop. Imports will be discouraged by higher prices following depreciation of the rupee, although more rapid growth will boost demand for imports of machinery and intermediate materials.

Overall, exports are projected to increase by 8 percent in 1996 and 14 percent in 1997, while the forecast for imports is for an increase by 15 percent in 1996 and 16.5 percent in 1997. The current account balance is projected to deteriorate further to 4.7 percent of GDP in 1996 and 4.3 percent of GDP in 1997; however, it is expected that capital inflows will be sufficient to offset this deficit and also to build external reserves to a more comfortable level than they are at present.

Policy and Development Issues

Although economic growth in Pakistan has improved in recent years, inflation has increased, the balance of payments has deteriorated, and the overall fiscal deficit remains high. Addressing these macroeconomic imbalances is a major task facing the Government.

Fiscal reform must be the cornerstone of macroeconomic adjustment efforts. The overall fiscal deficit has to be lowered through increasing revenues, in combination with containment of government spending. This requires major reforms to remove structural weaknesses in the tax system, such as the existence of exemptions and concessions which adds to uncertainty and opens the way for tax evasion, and the excessive reliance on import tariffs which introduces bias against exports and fosters inefficient domestic industry. Although incomes from agriculture, long exempt, are now formally subject to direct taxation, tax administration and compliance in this area is very weak. A consumption tax, roughly corresponding to a value-added tax, has been introduced; however, it needs to be broadened to include all consumption expenditure, and simplified documentation procedures need to be established to improve compliance and administration and minimize evasion.

To reduce expenditure, the Government could increase its efforts to reduce unnecessary and costly intervention in the economy, including privatization of the SOEs in the power, rail, air transport, telecommunications, and banking sectors. Current expenditure priorities also need to be restructured. Defense and debt-servicing spending together now constitute over 60 percent of current expenditure, crowding out other current expenditure that is vital for socioeconomic progress, such as on primary education, basic health, water supply, and sanitation. In this regard, the Government should make greater efforts to redefine the respective roles to be played by the Government and the private sector.

Short-term measures adopted to reduce the fiscal and current account deficits, such as currency depreciation and high customs duties, have not addressed the more fundamental problem of international competitiveness and economic efficiency, a problem which is rooted in the legacy of an inward-looking macroeconomic strategy and which entailed protection and Government intervention in the economy. In this regard, a comprehensive economic program to boost exports is an urgent task for the Government. This would include a new policy regime which would continue trade liberalization measures begun earlier and stress greater competition and openness. Reform of the import tariff structure is needed to reduce the overprotection of domestic industry which has created a weak and inefficient industrial base.

It is now widely acknowledged that the long-term development potential of an economy is severely constrained by a poor state of human resource development. Unfortunately, Pakistan’s social indicators remain among the worst in the world. A concerted effort is needed to raise life expectancy and educational attainment, reduce infant mortality, and improve the economic and social status of women.

The Government has already begun this task with its comprehensive five-year SAP covering 1993–1998. The SAP concentrates on four key concerns: primary education, primary health, population welfare, and rural water supply and sanitation. Although it is too early to assess the status of the SAP, implementation so far appears to have been satisfactory. However, more detailed evaluation is necessary if informed decisions are to be made about the future direction and expenditure needs of this important program.