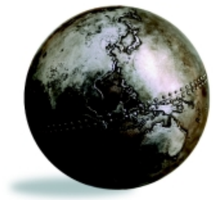


Pakistan

The economy has been slowly recovering since the second half of 1999 because of improved agricultural performance. However, the balance of payments remains fragile and the long economic stagnation hampers the government's efforts to reduce rampant poverty. Medium-term economic prospects depend on political stability, structural reforms, and capital inflows.

RECENT TRENDS AND PROSPECTS

Pakistan faced a challenging year in 1999, with GDP growth declining to 3.1 percent from 4.3 percent in 1998. Following nuclear tests in late May 1998, economic sanctions imposed by G7 countries seriously affected the economy. Economic growth declined steeply as investors lost confidence, private capital flows virtually ceased, and the new official development assistance was suspended. Consequently, Pakistan faced a severe foreign exchange crisis with foreign exchange reserves declining to $415 million in November 1998 (two weeks of import equivalent). To prevent sovereign default, the government adopted short-term emergency policies that included freezing foreign currency deposits held by both residents and nonresidents in domestic banks, adopting a dual exchange rate system, and delaying servicing of foreign debt.

In January 1999, the economic sanctions were partially waived, and international financial institutions subsequently revived their assistance. At a meeting of the Paris Club later that month, the government and bilateral creditors agreed to reschedule official debt worth $3.3 billion. In early July 1999, Pakistan concluded an agreement with the London Club for rescheduling $877.3 million in commercial loans. All these activities helped build up foreign exchange reserves and revive economic growth. By the end of June 1999, foreign reserves reached $1.7 billion (two months of imports).

Both savings and investment rates declined because of slow economic growth and collapse of investors' confidence. Gross domestic investment dropped from 17.1 percent of GDP in 1998 to 14.8 percent in 1999. The decline in investment in manufacturing, construction, and energy sectors offset the rising fixed investment in agriculture, transportation, and telecommunications by the private sector. Poor stock market performance also contributed to the slower growth in investment, although public sector investment increased by 12.6 percent in nominal terms. Gross national saving as percentage of gross national product

1999 refers to fiscal year 1998/99, ending 30 June.

also slowed from 14.2 percent in 1998 to 11.1 percent in 1999.

The fiscal and monetary areas, however, showed encouraging signs. Structural reform measures to reduce the fiscal deficit included: (a) increasing the general sales tax rate from 12.5 to 15 percent, (b) increasing petroleum product tax rates, (c) reducing budgeted current consumption expenditures, and (d) reducing the federal subsidy on wheat. Consequently, the fiscal deficit declined from 6.3 percent of GDP in 1997 to 5.6 percent in 1998, and further to 3.7 percent in 1999. While the customs duty collection declined sharply because of a reduction in tariff rates and negative import growth, an increase in general sales tax revenues helped boost tax collection. Nontax revenue collection also increased. Meanwhile, public expenditures were held in check, and total expenditure as a percent of GDP increased only marginally. Actual development expenditure was 17 percent lower than the budget target for 1999.

Because of tight monetary policy, the growth of broad money (M2) remained at 6.3 percent in 1999, slower than most years in the past decade. The government retired PRs68.4 billion of domestic debt because of a lower fiscal deficit and debt rescheduling. However, because of weakened investors' confidence and the recovery campaign for defaulted loans, credit expansion to the private sector was much slower than the previous year. Tight monetary policy, coupled with prudent fiscal management and slower growth in aggregate demand, helped weaken inflationary pressures. The inflation rate declined to 5.7 percent from 7.8 percent in 1998.

Imports and exports in 1999 contracted by 10.7 percent and 6.7 percent, respectively. The Asian financial crisis adversely affected exports, while government policy measures pursued after the economic sanctions and slow growth in the industry sector contributed to a sharp decrease in imports. In the service sector, workers' remittances and foreign currency account deposits dropped sharply. Overall, the current account deficit was $1.8 billion or 2.7 percent of GDP, the same level as in 1998.

Economic performance in the first half of 2000 exhibited a slow but fragile recovery. While industrial growth remained sluggish because of low investment,

Table 2.17 Major Economic Indicators, Pakistan, 1997-2001
(percent)

Item	1997	1998	1999	2000	2001
GDP growth[a]	1.9	4.3	3.1	4.5	5.0
Gross domestic investment/GDP	17.7	17.1	14.8	15.1	15.9
Gross national savings/GNP	11.3	14.2	11.1	12.5	13.0
Inflation rate (consumer price index)	11.8	7.8	5.7	5.0	6.0
Money supply (M2) growth	12.2	14.5	6.3	10.0	9.0
Fiscal balance/GDP	-6.3	-5.6	-3.7	-3.7	-3.5
Merchandise exports growth	-2.6	4.2	-10.7	8.0	9.0
Merchandise imports growth	-6.4	-8.4	-6.7	9.5	9.0
Current account balance/GDP	-5.6	-2.7	-2.7	-2.5	-2.0
Debt-service ratio	24.7	—	—	—	—

— Not available.

a. Based on constant factor cost.

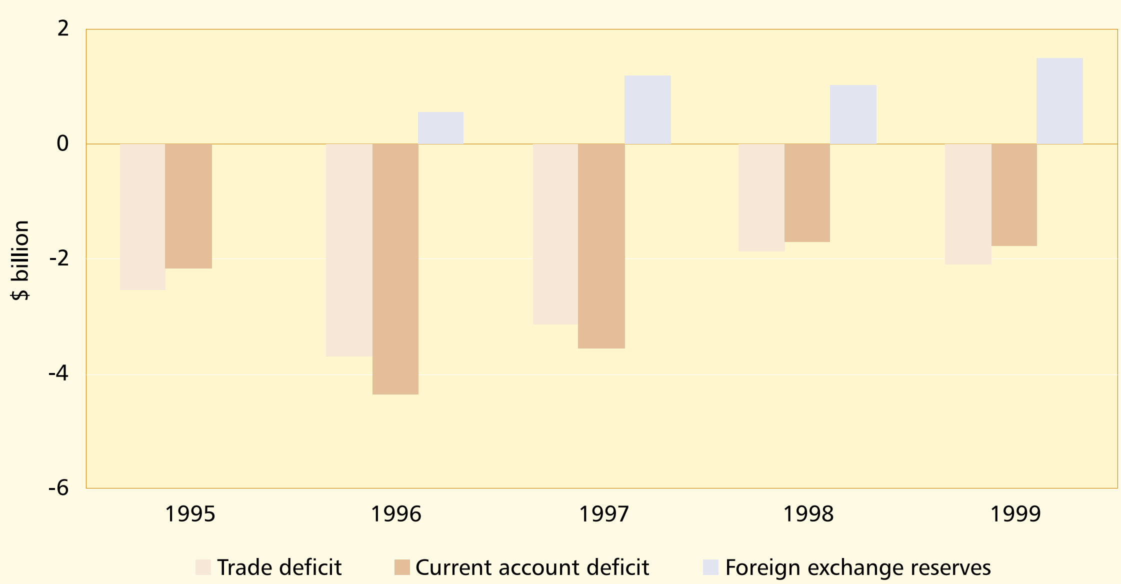
Sources: IMF (2000); State Bank of Pakistan (1999); Government of Pakistan (1999); staff estimates.

an improvement in agriculture sector performance partially offset it. The cotton crop reached 10.5 million bales, about 20 percent higher than the previous year, and the rice crop improved as well. Revenue collection in the first five months was about 20 percent higher than the previous year and slightly above the target level. Because of tight monetary policy and sluggish economic growth, from July to December 1999 the inflation rate remained low at 3.4 percent, in contrast with 6 percent during the same period in 1998.

Despite sustained improvement in trade and current account balances, the balance of payments remained fragile. Export earnings during the first half of 2000 picked up by 7.4 percent, but imports increased significantly by 11.5 percent, mainly because of the sharp rise in world market prices of petroleum products. Consequently, the trade deficit reached $783 million during the first half of 2000, compared with $563 million during the same period the previous year. The current account deficit narrowed to $1.8 billion in 1999, owing to a substantial reduction in services payments and imports. The foreign exchange reserves stood at $1.5 billion in January 2000 (two months of imports), and the exchange rate remained stable (see figure 2.16).

The medium-term outlook depends critically on political stability and the pace of economic reforms. If the government promptly implements major structural reforms and maintains macroeconomic stability, GDP growth is projected to be 4.5 percent in 2000 and 5 percent in 2001. While industry growth may remain stagnant because of slow investment growth and some structural adjustment measures—such as increases in tax rates and input prices—the agriculture sector could rebound because of increased agricultural investment by the government. Inflation is expected to rise in the second half of 2000 as money supply increases. Because of the expected increase in tax collection, the fiscal

Figure 2.16 Trade and Current Account Deficits and Foreign Exchange Reserves, Pakistan, 1995-1999



Note: Foreign exchange reserves data are not available for 1995.
Source: State Bank of Pakistan (1999).

deficit is forecast to decline to 3.7 percent of GDP in 2000 and 3.5 percent the next year. Resolving several export issues, such as financing for letters of credit, would maintain robust growth of exports, which are projected to grow by 8 percent in 2000 and 9 percent in 2001. Imports may grow at a slightly higher rate. The current account deficit is projected at 2.5 percent and 2 percent of GDP in 2000 and 2001, respectively.

ISSUES IN ECONOMIC MANAGEMENT

Although Pakistan emerged gradually from the worst phase of the crisis, the economic situation remains fragile. Some of the emergency measures taken over the last two years have long-term adverse implications for economic development. Credibility with official and private creditors was seriously damaged because of freezing foreign currency accounts and delaying servicing of foreign debt. A significant decline in public spending on development programs could also harm the long-term growth potential.

The primary area of concern remains the balance-of-payments position. The traditional sources of capital inflows—foreign aid, short-term commercial lending, and portfolio investments—are expected to weaken in coming years. The deterioration in the terms of trade threatens the ability to achieve the trade deficit target of $1.2 billion in 2000. While the debt rescheduling provides a two-year relief period for debt service, in January 2001 the government will have to resume a substantial repayment of foreign debt. Because foreign aid is the only reliable source of capital inflows, increasing disbursement of foreign aid projects and fulfilling policy reforms promptly are crucial for improving the balance of payments. In particular, export sector issues need to be vigorously addressed, including providing export finance for indirect exporters and small and medium-size enterprises, improving product quality and marketing, and allowing better access to technical information to increase industrial competitiveness. Resolving the ongoing dispute with independent power producers is vital for restructuring the power sector and regaining foreign investors' confidence.

The high interest rates of about 10 percent in real terms discourage private investment. To encourage demand for bank credit from a private sector that is facing a high input cost structure, the nominal average interest rate needs to be reduced at least 3-4 percentage points. This may require a corresponding reduction in deposit rates on the National Savings Scheme. The sustained large budget deficit, financed by government borrowing from financial markets, is the major cause of these high real interest rates. It crowds out financial resources available for lending to the private sector and increases the cost of borrowing. Therefore, reducing the budget deficit is essential.

POLICY AND DEVELOPMENT ISSUES

Pakistan has once again approached a crossroad. The new government faces difficult challenges that include slow economic growth; extremely low private sector confidence; unsustainable domestic and foreign debt obligations; and a rapid rise in the number of the poor, both in rural and urban areas.

The new government urgently needs to undertake fundamental reforms. Aside from speeding up economic growth and structural reforms, Pakistan must address social issues and improve governance, with special attention to social development and protecting poor and vulnerable groups.

Weak governance, both structural and systemic, has contributed to poor economic performance and weak social development. Laws and regulations are inadequately enforced and public control over major institutions is ineffective. Another major cause is politicization and corruption, which weaken the civil service and cause mismanagement of public resources. Furthermore, the government policy has not been effective in vital functions, such as raising fiscal revenues, targeting and implementing programs to assist selected groups or regions, ensuring that public assets are efficiently used and well-maintained, and protecting the citizens' lives and livelihood. Finally, improvised and inconsistent policies contribute to economic instability and unpredictability, discourage long-term investment, and create problems related to lack of transparency.

To address these issues, the following areas need urgent policy attention:

- Implementing transparent public management procedures and regulations to ensure accountability

- Enforcing laws and regulations, particularly those regarding taxation, debt recovery, and human rights
- Undertaking judicial and legal reform to promote social justice, economic development, and investors' confidence
- Enacting public administration reforms, including downsizing the civil service and establishing incentive and control systems based on performance
- Improving corporate governance and speeding up privatization of state-owned enterprises
- Improving public resource management, particularly public expenditure control and debt management
- Decentralizing the government structure and encouraging local governments to adopt policy innovations that improve efficiency.

During the past eight years, the Social Action Program (SAP) has improved social services. SAP was introduced in the early 1990s to expand basic social services, including primary education, basic health, family planning, and rural water supply and sanitation. SAP has increased the primary school participation from 69 to 73 percent, contraceptive use from 14 to 22 percent, access to safe water from 47 to 55 percent of the population, and average life expectancy from 58 to 62.5 years. In its second phase, SAP II continues to emphasize better provision of these basic services as well as population control. These can be accelerated through decentralizing decisionmaking and project implementation, and rigorously supervising the use of SAP resources.

In the current difficult economic situation, public investment for strengthening and expanding social service delivery under SAP II runs the risk of being reduced. Protection for its funding is necessary, and greater efforts are needed to involve nongovernment organizations in designing and providing social services. An improved policy environment and new mechanisms for government–nongovernment organization cooperation are needed. While nongovernment organizations can contribute much to the social and economic development, they need external assistance to improve institutional capacity, cost effectiveness, accountability, and transparency. Because the poor are adversely affected by drastic structural reforms, strong measures are needed in the short term to protect them.

In the longer term, structural issues affecting the delivery of basic social services and other poverty interventions should be addressed. Given the strong link between poverty and human development, especially in the rural areas, basic social services in education, nutrition, health, and population control need improvement. Participatory integrated rural development programs are needed, including rural infrastructure development, microfinance improvement, and employment generation.