TO BE EMBARGOED UNTIL DELIVERY.
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REFORMING PAKISTAN: CHALLENGES, STRATEGIES AND PROSPECTS

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The popular image of Pakistan portrayed in the international media is that of a dangerous place to visit, a nuclear state caught up in domestic political and social turmoil, fighting externally on its borders with Afghanistan and India, crowded by religious extremists and fundamentalists, ruled by a military dictator and embroiled in a judicial crisis. Private International market in nuclear proliferation is also believed to have emanated from this country.

In contrast to this image shown on the TV channels and depicted by the print media all over the world the international financial markets gave a thumping vote of confidence to Pakistan's sovereign Eurobond issue just two weeks ago. The bond was oversubscribed seven times ($3.5 billion vs $500 million) at fine margins of 202 basis points over 10 year US Treasury bonds. The response of this paper was broad based - one third investor demand originated from the US, one third from Europe and one third from Asia & Middle East. The other Pakistani bonds in markets have traded as low as 148 basis points almost identical to investment grade sovereigns. Foreign Direct and Foreign Portfolio investment have so far recorded a 68 percent increase compared to last year amounting to $6 billion or 4 percent of GDP. In 2000-2001 Foreign Investment flows were US$ 322 million only. China Mobile – one of the largest telecom has just acquired one of the local companies for over US$400 million. Temasek through its financial holding company has recently acquired a large integrated financial services institution for about US$370 million. Other international companies in telecom, banking, oil and gas, construction and real estate sectors are either acquiring, planning or locating their investment in Pakistan.

There is no doubt that Pakistan's decision to participate in the war against terror has created a lot of serious difficulties and problems for us. The powerful elements sympathetic to Al-Qaeda and Taliban have reacted violently to the actions taken by the Pakistani forces on Afghan-Pak border. They have hit back with vengeance and triggered suicide bombings at several places. However, their activities are limited to the belt around the Tribal Areas with an odd bombing incident in Islamabad, Karachi or Peshawar. Those who have physically visited Pakistan come back with an entirely different picture than the fear and apprehension they had at the beginning of their journey.

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The question that arises is: if the political and security situation was so bad as portrayed by the international media how the country could achieve a sustained average growth rate of 7 percent a year for over last four years. This is the same period in which the perception of Pakistan has taken a deep dive. No country perceived to be so fragile, strife ridden, politically unstable and crisis prone can demonstrate such remarkable levels of economic activity and attract foreign investors from all parts of the world. These investors have many alternatives for their capital in more than 100 developing and emerging countries. Why should they prefer Pakistan? I would like to share my own analysis as to why Pakistan, despite these negative perceptions, remains such an attractive place for business.

First of all, Pakistan is a country of 160 million people which is growing at an average growth rate of 6-7 percent for the last five years. Twenty to Thirty million Pakistanis earning US$10,000 - $15,000 (PPP terms) constitute a large and solid market for purchase of goods and services of all kinds. There are very few markets except China, India and Indonesia that are underpinned by the size and scale that the fast growing Pakistani middle class offers. Projections show that if the current growth rates are attained for the next ten years, Pakistan's per capita income will double in real terms by 2020. At that time the size of the middle class will rise to 40 to 50 million enjoying purchasing power incomes of average $20,000 - $30,000 - equivalent to those of some of the European countries today. Goldman Sachs has placed Pakistan in the next eleven category of largest economies among developing countries for its long term projection. The requirements of energy, infrastructure, goods and services of these 50 million people will have to be met at world class standards. Multinational firms and holders of capital with excess liquidity, eyeing these prospects in emerging countries and observing market saturation in advanced economies, are rethinking their strategies and repositioning themselves. Pakistan along with other Asian countries is one of the beneficiaries of this strategy. The changing demographics of a youthful population and labor force in Pakistan staring against the stark reality of ageing population in Europe, Japan, and US and after a while China reinforce these promising prospects for the future. Of course, none of this will be either automatic or easy. Good policies, good governance and good luck will be needed to realize the scenario sketched above.

Second, the economic performance in terms of macroeconomic stability, growth, poverty reduction and employment generation has been stellar. Economic growth rates have risen from 1.8 percent in 2000/01 gradually to average 7 percent a year in the last four years making Pakistan one of the fastest growing economy in the Asia region. For Pakistan these rates are not spectacular but a reversion to mean. The average growth rate of GDP over 50 year period of Pakistan has been 5.2 percent per annum. Manufacturing sector output growth was over 15 percent, exports have doubled in US dollar terms in these five years, and an open trade regime has allowed imports from all over the world to triple. Tax revenues have risen by 14 percent a year reducing fiscal deficit which used to average 7 percent a year in the 1990s to average 4 percent. Current account turned around from chronic deficit to a surplus for three successive years mainly due to renewed export growth and resurgence of workers' remittances. Although it has become negative since 2005/06 due to phenomenal growth in imports of machinery and equipment and increase in world oil prices it is being fully financed by non-debt creating foreign capital flows. Inflation rate during the first four years of the current government remained below 4 percent but oil price pass through and food shortages have led to 8 percent on average since 2004-05. External debt burden has been halved from 52% to 26% of GDP and is projected to be on a declining path. The country's capacity to service its debt has considerably improved as debt servicing ratio which used to preempt almost 60 percent of public revenues is now down to 28 percent. Poverty incidence has fallen from 34 percent to 24 percent and unemployment rate is down to 6.5 percent from 8.4 percent. These movements are in the right direction but they are not acceptable as one in every fourth Pakistani is still living below the poverty line. Table I summarizes the changes in the key economic indicators between October 1999 and June 2006.

Third, the basic premise of policy reform agenda was that macroeconomic stability will remain short lived if it was not accompanied by structural reforms to remove microeconomic distortions and by bringing about improvement in economic governance. These reforms are described in some detail later on in this paper. Pakistan has successfully implemented the first generation of structural reforms that have made the economy more efficient and resilient to face unanticipated exogenous shocks. The main thrust of these reforms was to allow greater freedom to the private sector to own, produce, distribute and trade goods and services while gradually withdrawing the public sector from this arena. Pakistan is promoting public private partnership in large infrastructure projects as a policy initiative. This policy is likely to overcome some of the problems that are inherent in private infrastructure projects while easing the financing constraints faced by the public sector. The role of the state in Pakistan has been redefined as a facilitator, enabler, protector and regulator rather than directly managing and presiding over the commanding heights of the economy. Government intervention is justified for social protection of the poor, provision of public goods or when there is a clear case of market failure, that is, externalities, imperfect market structure, etc.

Fourth, Pakistan occupies a key strategic location that links India with Iran, Afghanistan and the Central Asian States, provides access to sea for land locked countries of Central Asia, Afghanistan and Western China, acts as the energy and transit corridor and opens up to the oil rich Gulf States next door. This strategic location along with the completed and new investments in ports, highways, pipelines, etc. will throw up vast new opportunities that can be highly attractive. Risk-return relationship in these projects is highly favorable and a number of foreign firms are keen to take the first mover advantage by locating their investment particularly in Gawadar port area. As you are aware, the Port Authority of Singapore has been awarded the contract for the operation of Gawadar Port and we are confident that they will turn this port around.

Before I get into the challenges, strategies and prospects of Pakistani economy let me recapitulate the major structural reforms and measures to improve economic governance that have been completed during the last seven years or are in the process of implementation.

STRUCTURAL REFORMS

Pakistan has made significant efforts in unilaterally liberalizing its trade regime since the 1990s. The maximum tariff rate has declined from 225 percent in 1990-1 to 25 percent; the average tariff rate stands at just 9 percent compared to 65 percent a decade ago. The number of duty slabs has also been reduced to four. Quantitative import restrictions have been eliminated except those relating to security, health, public morals, religious and cultural concerns. The statutory orders that exempted certain industries from import duties or provided selective concessions to privileged individual firms have been phased out and import duties on 4,000 items were reduced. Protection to domestic industry is no longer a policy objective and a uniform, across – the board, transparent regulatory regime with level playing field has been put in place. These measures have brought down effective rate of protection, eliminated the anti-export bias and promoted competitive and efficient industries. A number of laws have also been promulgated to bring the trade regime in conformity with World Trade Organization regulations. These include anti-dumping and countervailing measures and protection of intellectual property rights. This unilateral opening up to global trade has benefited the domestic firms in improving their efficiency and making themselves competitive.

Concurrently with the debt restructuring, the country embarked on the fiscal policy reforms and consolidation by raising tax revenues, reducing expenditures, cutting down subsidies of all kinds and containing the losses of public enterprises. Tax reforms were undertaken to widen tax base, remove direct contact between tax payers and tax collectors, introduce value-added tax as the major source of revenue, simplify tax administration and strengthen the capacity of the Central Board of Revenue. Although these reforms are still underway, the adoption of universal self assessment followed by random audit of selected tax returns, automation and reorganization of the tax machinery have begun to help improve tax collection. Tax-GDP ratio in Pakistan is lower in comparison to other developing countries and has to be raised in the next five years to reach the average level of comparator countries.

As one of the sources of fiscal problems was the losses and inefficiencies of public enterprises the Musharraf Government actively pursued an aggressive privatization plan whose thrust was sale of assets to strategic investors. The sectors where most progress has been made are oil and gas, banking, telecommunications and energy. Foreign investors were encouraged to participate in the privatization process and a large number of them have been successful. Pakistan's record on privatization since 1991 has been impressive but the transactions completed in the last few years have yielded $3 billion stopping the hemorrhaging of public finances that were used to underwrite the losses of state owned enterprises. The privatized banks are now contributing substantial sums to the national exchequer as they have all become profitable.

As Pakistan would continue to rely on foreign capital flows for augmenting its domestic savings it had to demonstrate its seriousness in encouraging foreign investment. There has been a major and perceptible liberalization of the foreign exchange regime. Foreign investors can set up their business in Pakistan in any sector of the economy – agriculture, manufacturing real estate, retail trade, services, banking etc., bring in and take back their capital, remit profits, dividends, royalties and fees etc., without any prior approvals. Foreign companies are allowed to raise funds from domestic banks and capital markets. They are treated equally with national firms in all respects and can bring in expatriate staff to run their businesses. This liberal regime is paying off as seen from the volume of actual flows coming into Pakistan.

Foreign Portfolio Investors (FPI) can also enter and exit the market freely without any restrictions or prior approvals. In the Karachi Stock Exchange with a market capitalization of US$50 billion and over 650 listed companies' corporate earnings were on average in 20-25 percent range much higher than those in most emerging countries. This makes Pakistan an attractive place to invest for foreign portfolio investors too. As part of this liberalization, non-residents and residents are allowed to maintain and operate foreign currency deposit accounts, and a market-based exchange rate is at work in the inter-bank market.

An efficient financial system and economic growth are empirically linked. Financial sector reforms in Pakistan were initiated early in the 1990s when new banking licenses were granted to private domestic banks to set up their shops along with the nationalized commercial banks and foreign banks. Although these reforms were implemented with fits and start, they were accelerated since 1997. The Central Bank was granted autonomy and the control of the Ministry of Finance over banking institutions was diluted. More deep rooted reforms were undertaken since 1999 when net non-performing loans of the banking system were brought down to less than 3 percent of total advances and loans, minimum capital requirements were raised to $100 million and the quality of new loans improved. Mergers and consolidation of financial institutions have eliminated a number of weaker players and the range of products and services offered by the banks widened. But the most crucial policy action taken by the Government, in my view, was the privatization of Habib Bank, United Bank, and Allied Bank - three large nationalized commercial banks of the country. As a result of these reforms, the share of the private sector ownership of the banking assets has risen to 80 percent and the banking sector is facing a healthy but strong competitive environment. The banks are highly profitable and the average lending rates have declined considerably as automation, on-line banking and multiple channels of delivery have improved the efficiency of services in response to market competition.

Banking System has started to meet the financing requirements of sectors such as Agriculture, SME, salaried classes, and the poor who had no access in the past. The borrower base of the banking system has multiplied from over 1 million to 4.5 million households in last five years. The middle and lower middle class consumers are now enjoying car loans, mortgages, credit cards, consumer durables. Small farmers are using bank credit for buying chemical fertilizers, certified seeds, insecticides, small implements and hiring tractor services. Small and medium entrepreneurs are expanding their fabrication and manufacturing capacities and upgrading technology. Landless labor and poor women in the rural areas are receiving micro loans for poultry, small livestock, sewing machines, etc. The main beneficiaries of these reforms are the customers of financial services although it must be recognized that market determined deposit rates have also declined significantly. But as the lending rates are surging upwards, deposit rates are also going to depict an upward movement with time lag. The outreach of banking sector is still very sparse outside the urban areas and has to be extended to cover at least 50 percent of rural households if any meaningful results are to be achieved in poverty reduction and urban – rural income inequalities.

Deregulation of oil and gas, telecommunication and civil aviation sectors have also brought about significant positive results. Oil and gas exploration activity has stepped up in recent years and constant discovery and production from new gas fields operated by private sector companies have added new capacity to meet the growing energy needs of the country. Independent power producers - both domestic and foreign private companies - have played a critical role in filling in electricity generation requirements of Pakistan since 1996. Telecommunication has witnessed a boom since the private sector companies were allowed licenses to operate cellular phones. One million new cellular phone connections are being added every month and the number of phones has already reached about 50 million or a penetration rate of almost 33 percent. Long distance international and local loop monopoly of Pakistan Telecommunications Corporation has been broken and new licenses including for wireless local loop have been issued. The customers are reaping rich dividends as the prices of phone calls - local, long distance, international - are currently only a fraction of the previous rates. One of the advantages of privatization of the state monopoly, i.e., the PTCL would be felt in form of higher bandwidth penetration that has lagged behind other Asian countries.

These structural reforms are unlikely to be sustainable if the economic governance structure is not put right. Although Pakistan has a long way to go in improving governance some measures have been taken to move in this direction.

ECONOMIC GOVERNANCE

The reforms in some of the most important federal institutions - the Central Board of Revenue (CBR), Securities and Exchange Commission (SECP), the State Bank of Pakistan (SBP) and Pakistan Railways - initiated some years ago - are already beginning to take some hold and making a difference as far as governance is concerned. Discretionary powers have been significantly curtailed but corruption at lower echelons of the Government is still widely rampant. Freedom of press and access to information has had a salutary effect on the behaviour of decision makers but this has not trickled down to the lower bureaucracy yet where implementation of the policies takes place. The post 2003 period has witnessed some decline in the Transparency International ratings of Pakistan compared to the 1999-2002 period.

The cornerstone of the governance agenda is the devolution plan which transfers powers and responsibilities, including those related to social services from the federal and provincial governments to local levels. This plan was put into effect in 2001. The main premise of the devolution plan is the belief that development effort at the local level should be driven by priorities set by elected local representatives, as opposed to bureaucrats sitting in provincial and federal capitals. Devolution of power will thus strengthen governance by increasing decentralization, de-concentration, accountability and people's participation in their local affairs. However, in the meanwhile the transition has created its own set of dislocations and disruptions in the delivery of services that need to be addressed.

Other essential ingredients for improving economic governance are the separation of policy and regulatory functions which were earlier combined within the ministry. Regulatory agencies have been set up for economic activities such as banking, finance, aviation, telecommunications, power, oil, gas etc. The regulatory structures are now independent of the ministry and enjoy quasi-judicial powers. The Chairman and Board members enjoy security of tenure and cannot be arbitrarily removed. They are not answerable to any executive authority and hold public hearings and consultations with stakeholders.

The National Accountability Bureau (NAB) has been functioning quite effectively for the last five years as the main anti-corruption agency. A large number of high government officials, politicians and businessmen were sentenced to prison, subjected to heavy fines and disqualified from holding public office for twenty-one years on charges of corruption after conviction in the courts of law. Major loan and tax defaulters were also investigated, prosecuted and forced to repay their overdue loans and taxes.

Civil service reforms aimed at improving recruitment, training, performance management, career progression, right sizing of ministries and attached departments, and improving compensation for government employees are part of the second generation reforms of the government for building strong institutions in the country. Proposals have been developed to depoliticize recruitment, promotions and career development, enhance the independence and responsibilities of the Federal Public Service Commission (FPSC) and systematically introduce merit based recruitment and promotions. The Civil Service Act has to be amended to reflect performance based career progression enabling the government to reward efficient and competent civil servants. The public sector educational training infrastructure is also being restructured to strengthen skill based training of civil servants at all levels. These are highly demanding reforms and a consensus has to be built among the stakeholders before they can be accepted and implemented.

Reforms in access to justice, under implementation since 2001 will deal with delays in the provision of justice, case management, automation, and court formation systems. In addition, human resources, management information systems and the infrastructure supporting judicial system are being revamped and upgraded. Small Causes Courts have been established to provide relief to the poor who have small claims. Alternate Dispute Resolution mechanisms have proved to be successful in bringing expeditious disposal of commercial and tax disputes and are being replicated for wider application.

Macroeconomic stability, structural reforms and improved governance have helped the economy to make an impressive turnaround. But the challenges facing Pakistan are still quite formidable and should not be underestimated.

CHALLENGES

Like any developing country struggling to improve the standards of living for the majority of its people there are innumerable challenges for Pakistan also. I would only dwell on a few of them.

The negative perception about Pakistan cannot be changed unless domestic turmoil and hostilities at our western borders come to an end. I do not suggest, for a moment, that the present adversities and uncertainties caused by the war on terror are not a real pain to Pakistan. For the continued expansion of the economy, for the security of person and property of its people, for social cohesion and harmony, for peace and tranquility in the region these acts of hostilities and violence have to be brought to an end sooner than later. The investor sentiment and mood may be strong today but this may change in the future. Thus Pakistan along with its neighbors and international community has to work hard to find a durable solution to this problem. This is the biggest challenge we face.

The second challenge is the upgrading of skills, education and training of our youthful labor force. This demographic dividend can only be achieved if the 100 million strong workers are educated, made productive, remain healthy and become adaptable to the changing market conditions. Pakistan can not only exploit this competitive advantage relative to other countries where the ageing population is likely to become a serious constraint but also become a hub for labor and mid level skill intensive economic activities in the global supply chain. We have no pretension that we will be able to compete with Korea, Taiwan, Singapore in high knowledge – intensive activities but we can become the gap filler for the middle of the chain. Human resource development on these lines will require huge investment, innovative methods of delivery, private-public partnerships and better internal governance of our education, health and population sectors.

Pakistan’s growing needs for water, energy and infrastructure can become a brake on the accelerated pace of growth if they are not tackled immediately and not properly planned for the medium and long term horizon. Pakistan is highly dependent on irrigation for production of its food and fiber crops that provide sustenance to a very large segment of our population and supply raw material to our manufacturing industries. The construction of water storage dams and reservoirs assumes high priority. The environmental consequences, resettlement issues, lumpy investment and internal distribution of water are some of the issues that have not yet been sorted out. These dams and reservoirs are also a relatively cheap source of hydropower to meet the country’s energy needs. This set of issues related to energy-water-infrastructure nexus is the third big challenge we face.

As pointed out earlier we have embarked upon improvement in our governance structure. One of the reasons as to why our poor are at a relative disadvantage in obtaining access to public goods and services is the outdated system of public administration. We would very much like to learn from the Singapore experience and take your public management as the benchmark. The whole food china of recruitment, training, career progression, compensation of civil servants, the structure of Federal, Provincial and District governments and business processes need to be completely overhauled. Attitudinal changes and soft skills have to be imbibed among lower functionaries. Automation and information technology tools will have to be used for ease of convenience and transparency. The challenge of introducing good governance has to be met forcefully and decisively.

Pakistan has made considerable progress in the last few years in normalizing relations with India. A composite Dialogue framework has been agreed upon by both sides and proposals have been initiated for resolving the core dispute of Kashmir. Studies have shown that bilateral trade between the two countries can rise five fold to US $ 5 billion within a short span of time if the restrictions and hesitation are out of way. Both countries will emerge better off and Pakistan can reap the peace dividend by taking advantage of the spillovers from the dynamic Indian economy. The successful completion of Iran-Pakistan-India gas pipeline will be a major break through. How to bring this dialogue to fruition and amicably resolve Kashmir dispute is another big challenge for us?

The Government is aware of these challenges and has chalked out strategies to meet these challenges.

STRATEGIES

The strategies for Pakistan's future development are embedded in the Long term Vision 2030 and translated into action under Poverty Reduction Strategy for the period 2005-10 in alignment with the Medium Term Development framework.

Vision 2030 envisages Pakistan to become an active participant in global economy and take advantage of the enhanced opportunities offered by globalization while minimizing its adverse effects. Pakistan should emerge as a middle-income country with a per-capita GDP of around US $ 4000 by the end of the third decade of this century. The economy is expected to grow around 7-8 percent per annum and this high growth rate would be sustained through developing human resources and by putting in place the necessary physical and technological infrastructure. A sizable middle class will reinforce the growth momentum and will, in turn, be the major beneficiary of the distribution of gains from this high growth. Greater access to quality education as well as basic amenities like health, water and sanitation will be made available to all citizens irrespective of their status, caste, creed, gender etc. Freedom of enterprise and enlarged opportunities will transform the lives of the majority through the acquisition, dissemination and assimilation of knowledge and new techniques of production and new processes. The benefit of social protection will be spread and targeted as to provide sufficient cushion to the most vulnerable in the society. To attain this vision the institutions and supporting structures of the state will need to be transformed and redefined.

The Poverty Reduction Strategy aims to bring down the incidence of poverty in the country to 15-16 percent by 2015 thus meeting the millennium development goal. The main pillars of this strategy are (a) accelerated economic growth and macroeconomic stability – the main drivers of growth will be riding the globalization wave in export markets, developing mega cities, building rural infrastructure and strengthening rural markets (b) enhancing the role, capabilities and productivity of private sector firms by intensifying Deregulation, Privatization and Liberalization while promoting competition and contested markets (c) Harnessing the potential of the people by investment in human resource development, mainstreaming gender, empowering women, generating employment and sharing prosperity (d) Further deepening of the financial sector by broadening access to lower and middle income classes, mobilizing and rewarding saving and allocating capital in an efficient way and developing debt and equity capital markets (e) Building world class infrastructure by leveraging the water resources, ensuring energy security and energy efficiency, modernizing the logistics chains and the national trade corridor (f) Fostering effective governance and management by civil service, judicial and police reforms, reinforcing devolution to local governments and ensuring effective social service delivery.

These elements of the poverty reduction strategy, if fully implemented, will still leave a sizeable number of the poor and the vulnerable without incomes and access to basic needs goods and services. For them targeted Social Safety nets and social transfers are the only means through which they can be assisted. The currently programs such as Zakat, Baitul Mal, Food Support Program, Microcredit reach less than 1% of the country's population or 4 percent those living below poverty line.. These programs have to be scaled up to reach out a larger group of intended beneficiaries and new programs such as labor intensive public works program that generate employment and build rural infrastructure have to be put in place.

The macroeconomic framework for Poverty Reduction Strategy (2005-2010) has been prepared with a view to sustaining the ongoing growth momentum in a stable macroeconomic environment. The overall investment is projected to move up in the range of 21-23 percent of GDP with private sector taking the lead and public sector focusing on human and infrastructure development.

PROSPECTS

The year 2007 will be critical for Pakistan as the elections are completed for the Parliament, Provincial assemblies and President of Pakistan. Let us draw the parallel from our neighboring country. The credibility of the Indian reforms in the minds of international community and domestic investors was established only after BJP won the elections in 1996 and persisted with the economic reforms introduced by the Congress Party in 1991. The election results of 2007 in Pakistan will also be the turning point. Any political party or coalition of parties that wins the 2007 elections and continues with the economic reforms and the policy direction laid out in the PRSP and Medium Term Development Framework for the next five years will tip the balance of risks in favor of Pakistan. The lingering doubts in the minds of skeptics about the sustainability of reforms, robustness of economic policies and existence of broad based political support for the reforms will be set to rest. Pakistan is likely to have a smooth ride towards economic stability and high growth trajectory thereafter other things remaining the same.

It may, be recalled that the initiative for economic reforms – Deregulation, Privatization and Liberalization – was taken by the government of Prime Minister Nawaz Sharif in 1991. Significant changes were made in the economic landscape of the country and they were embodied in a legal instrument – Economic Reforms Order of 1992. The same set of policies were pursued and followed by all successive governments including that of Prime Minister Benazir Bhutto during 1994-1996 period. The two major political parties which assumed power on two different occasions in the period 1988-99 were largely preoccupied with their political survival and hence their implementation of economic reforms was not as vigorous as it ought to have been. President Musharaf continued with the same policy direction but intensified the execution, improved governance and insisted on achieving tangible results. The difference this time around was that the continuity and consistency of policies over a stretch of seven years and strong leadership of President Musharaf produced a perceptible impact. There is no doubt in my mind that all major political parties in Pakistan are committed to the same overall policy direction but naturally they will have different styles, priorities, nuances and implementation strategies given the past track record of Pakistan. The risk of complete reversal or abandonment of the ongoing economic policies and direction under any future political set up appears to me quite negligible.

Some other important legislative and institutional developments that have taken in the last few years will also help in staying the course. The bane of Pakistan's economic problems stemmed from fiscal indiscipline over a decade that plunged Pakistan into a debt trap. This root cause had therefore to be surgically removed so that it does recur in the future. A Fiscal

Responsibility Law has been approved by the Parliament, which keeps a lid on the future governments' propensity to borrow their way out. Debt / GDP ratio has to be reduced by 2.5 percentage points each year and the Debt/ GDP ratio cannot exceed 60 percent. Any deviation has to be explained to the Parliament and need its approval. This law will hopefully act as a major restraint on fiscal recklessness in the future.

Monetary policy is now operated by an independent central bank keeping the objective of price stability, financial stability and growth in mind. Although it involves a fine balancing act and inflationary pressures have surfaced during the last two years the Central Bank is committed to pursue a monetary policy that keeps inflation under control. Indirect market-based policy instruments have replaced credit ceilings, caps on deposit and lending rates, preferential treatment to government and directed credit to priority sectors. Interest rates and exchange rates are market determined and credit allocation decisions are made by the individual banks based on objective criteria but guided by prudential regulations.

Pakistan was a debt-distressed country in the late 1990s and was almost on the brink of default on its commercial and market loans in 1999. Therefore a major restructuring of the country's external debt portfolio was undertaken to align it with the country's debt servicing capacity. By re-profiling the stock of official bilateral debt, substituting concessional loans for non-concessional from international financial institutions, pre-paying expensive loans and liquidating short term liabilities. Public debt ratio has fallen from 100 percent of GDP to 56 percent in five years time. External Debt/ GDP ratio has declined from 52 percent to 26 percent that places Pakistan within safe limits. This restructuring of debt has put Pakistan on a firm footing as the debt and debt servicing ratios are on a declining path. This important step has provided scope and enlarged the capacity of the country to meet all its future foreign exchange liabilities and obligations without much difficulty. Credit worthiness indicators have all improved and Pakistan is no longer that vulnerable to external shocks as it was in 1998 at the time of the nuclear tests.

Trade liberalization has been successfully implemented in Pakistan for over a decade. The World Bank has categorized Pakistan as one of the least restrictive countries in South Asia along with Sri Lanka. This policy has provided incentives to exporters to increase their market share in the global markets. Exchange rate policy is pursued to maintain stability in the foreign exchange markets while at the same time keeping the competitiveness of Pakistani exports intact. Large accumulation of foreign reserves played an important role in stabilizing the exchange rate and cushioning the economy from the adverse and abrupt exogenous disturbances. One of the tests that the country successfully met in the last two years was to absorb the oil price hike from $ 25/ barrel to $ 75/ barrel without any serious dislocation of economic activity or any loss of foreign reserves. Five years ago if this escalation had happened the exchange rate would have tumbled and inflation rate would have hit double digits.

CONCLUSION

The performance of Pakistani economy in terms of per capita income growth, poverty reduction, employment generation and macroeconomic stability has been quite impressive since the beginning of this decade.

Pakistan has successfully withstood several major exogenous shocks – the drought of 2000-2002, mobilization of Indian troops on its borders in 2003, war against terror on its Afghan borders, oil price shock of 2004-2006 and the earthquake of 2005. The resilience of Pakistani economy suggests that the structural reforms, good economic management and favorable external environment have all helped Pakistan to overcome some of its weaknesses and vulnerabilities. There is, however, hardly any room for complacency. Per capita income is still quite low, poverty levels are unacceptably high, Human Development Indicators are weak, Infrastructure facilities are deficient and governance needs a lot of improvement. These are formidable challenges but with perseverance, hard work and international cooperation I have no doubt that we can meet them.

<u>TABLE I</u>: CHANGES IN KEY MACROECONOMIC INDICATORS

	October 1999	**June 2006**	**Change in the Indicator**
GDP Growth Rate	4.2%	6.7%	Positive
Inflation	5.7%	7.9%	Negative
Fiscal Deficit /GDP	-6.1%	4.2%	Positive
Current Account /GDP	-4.1%	3.9%	Positive
Public Debt / GDP	100%	57%	Positive
External Debt/GDP	52%	28%	Positive
Interest Payments/ Govt. Revenues	50%	22%	Positive
Remittances	US$ 88 million per month	-US$ 385 million per month	Positive
Exports	US$ 7.8 billion	US$ 16.5 billion	Positive
Tax Revenues	Rs. 391 billion	Rs. 712 billion	Positive
Rupees- Dollar Parity	Depreciating	Stable	Positive
Foreign Direct Investment	US$ 1.6 million	US$ 3.5 billion	Positive
Foreign Exchange Reserves	US$ 1.6 billion	US $ 13.3 billion	Positive
Poverty Incidence	33%	24%	Positive
Unemployment	6%	6.5%	Negative

<u>Note</u> : All indicators in Column 1 pertain to 1998-99 or October 1999. All indicators in Column 2 pertain to 2005-06 or June 2006.