

Chapter 1

Performance of Pakistan Economy 1999-2007

Pakistan has lived through difficult times in the recent past. Our economy was fragile, fiscal as well as current account balances were under great stress, debt burden had reached to the unsustainable level and country was at the verge of default in 1998. At that point of time, Pakistan needed a sustained macroeconomic stability, financial discipline and consistent and transparent policies.

Today, Pakistan is a stable economy. Fiscal discipline is maintained and transparent and consistent policies are pursued. Pakistan has experienced a tremendous growth in its economy and its economic environment since 1999. In spite of the higher international oil prices and devastating Earthquake 2005, the **economy has grown** on an average **7.5 percent** during the last four years. This year, 2006-07, by achieving growth rate of 7 percent, the GNP would reach

to \$ 146 billion and per capita income be \$ 926. The growth to a large extent remained broad-based. Large scale manufacturing has grown close to double digits and the growth in services sector was robust.

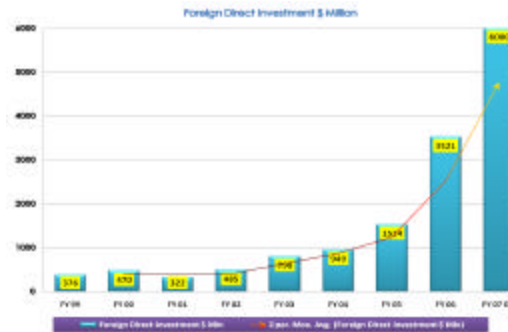
In recent years total **investment** has increased on an average at the rate of 25 percent. Improved business confidence, rising inflows of FDI and availability of fiscal space are the major contributing factors.

Foreign Direct Investment has been rising every year. On an average, it increased by 38 percent over the last eight years and be around \$ 6 billion, 4.1 percent of GDP in FY07 - the highest in South Asia.

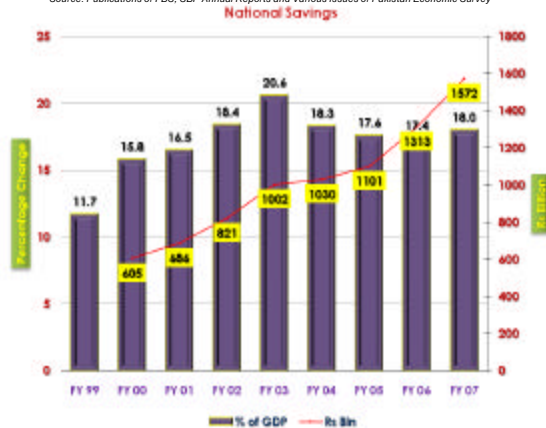
National **Savings** on the other hand, on an average are increasing at the rate of 15percent. This year 2006-07, the



Source: Publications of FBS, SBP Annual Reports and Various Issues of Pakistan Economic Survey



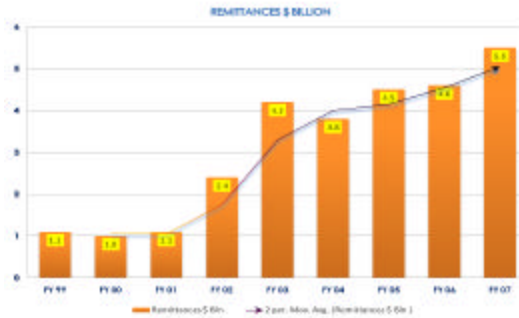
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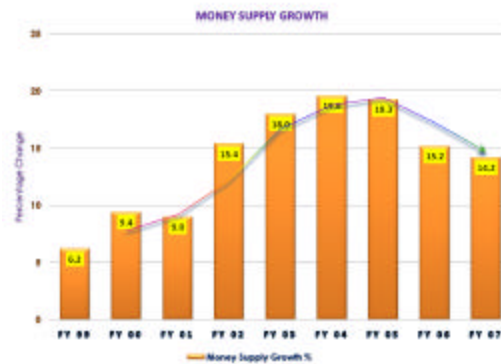
investment level would be \$ 33 billion and that of national savings \$ 26 billion.

The **worker remittances** an important component of national savings has increased tremendously at the rate of 30percent per annum during the last eight years and be around \$ 5.5 Billion by June, 2007. With higher increase in worker remittances and rate of return on deposits the level of national savings would increase further.



Source: Publications of FBS, SBP Annual Reports and Various Issues of Pakistan Economic Survey

Money supply annually increased by 15 percent mainly emanated from credit to the private sector. The cumulative credit to the private sector in the last four years was about \$ 23 billion compared to less than \$ 10 billion in the previous ten years. As higher increase in money supply is considered to be the main factor fueling inflation, contractionary monetary policy is now being pursued. The decline in credit to the private sector as well as inflation has been observed. However, the inflationary trend from demand side and declining trend in the credit to the private sector would be arrested.



Source: Publications of FBS, SBP Annual Reports and Various Issues of Pakistan Economic Survey

The **stock market** continues to maintain new records during 1999-2007. The KSE-100 index at 1005 in 1999, touched the all time high mark of 12,369 in April 2007. More than tenfold increase, therefore, has been observed. Similarly the total market capitalization has also increased around eleven times from Rs 286 billion in 1999 to Rs 3603 billion (\$ 59 billion) in April 2007. The government’s consistent and transparent economic policies, privatization process and capital market reforms - risk management, governance and transparency - helped in promoting a fair and efficient capital market and building investors' confidence.

The **fiscal accounts** have considerably improved in recent years. Revenues are buoyant, expenditures are rationalized, revenue deficit is eliminated and public debt and fiscal deficit has been brought to a sustainable level. The **tax collections** by the Central Board of Revenue during the last eight years have increased by 132 percent. It reached to Rs 835 billion in FY07.

Strong GDP growth and tax reforms have maintained double-digit growth in tax revenues. Non-tax revenue continues to yield significant income.

Total **expenditure** increased annually by 12 percent. It has attained the level of RS 1536 billion in FY07. Current expenditure during the last eight years increased by 9 percent. As the Government is pursuing pro-growth and pro-poor fiscal policy, the phenomenal increase in development expenditure to the tune of 20 percent per annum has been observed. Higher development expenditures were made in social

and physical infrastructure sectors. Education, skill development, transport & communication and oil & gas are the prime investment growth sectors. The pro-poor expenditure has increased by 27percent annually from Rs 180 billion FY02 to Rs 464 billion in FY06. In terms of GDP, the expenditure during this period has increased from 4percent to 6percent. A milestone has also been established by setting the unprecedented level of PSDP size to the tune of Rs 435 billion in FY07.

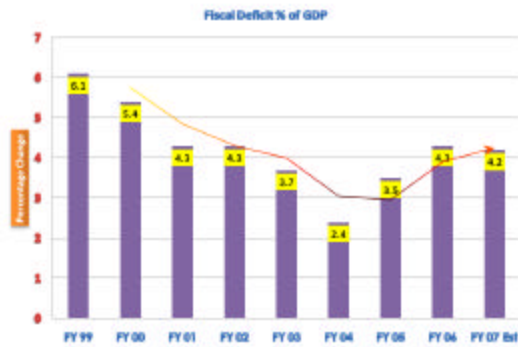
The **fiscal deficit** as a percentage of GDP is likely to decline from 6.1percent in FY 1999 to 4.4 percent in FY 2007.

Similarly during the same period **public-debt** as a percentage of GDP has also declined from 100percent to around 50 percent.

On external front, the **exports** though have doubled since 1999, is not increasing at the desired level. In fact, imports have increased at a higher rate of 14 percent compared to exports at 11percent. In recent years yawning gap between imports and exports is visible.

The **trade deficit** now stands at \$ 10 billion in FY 07. Exports consist mainly of textiles, leather, surgical, sports goods and rice. The stagnant exports growth is mainly attributed to low quality and lack of competitiveness in the global trade.

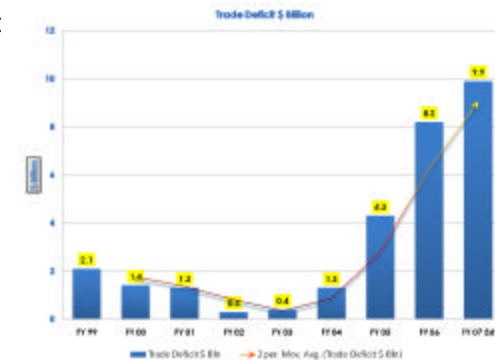
The recently approved **Export Strategy 2007-13** prepared by the Planning Commission would bring in the directional change in increasing the exports and bridging the trade gap. Exports would be promoted through enhancing productivity and competitiveness, quality production, diversification of markets and products and provision of state of the art physical, scientific and technological infra structure. The **current account** except for the period 2002-04 remained deficit. In recent years the level of deficit stayed around 4 percent of GDP. The deficit is mainly attributed to oil price shock and almost 50 percent



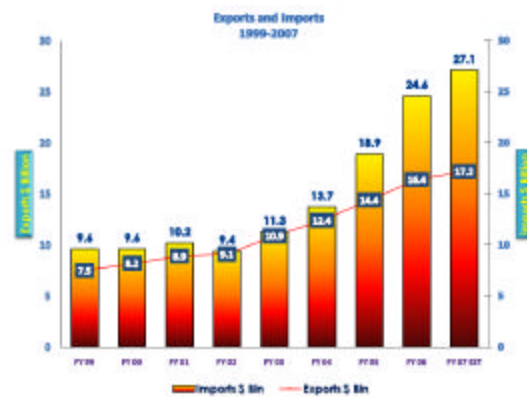
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increase in **imports** of machinery and equipment. Trade level remains low. However, the trade to GDP ratio reflecting openness of the economy has increased to 33 percent

The higher increase in non-debt creating inflows, foreign investment and private capital flows - workers' remittances and other current transfers touching \$ 9 -10 billion annually have considerably ease the pressure on **balance of payments**.

External Debt and liability as a ratio of GDP has declined from 52 percent to 27 percent and as a percentage of foreign exchange earnings declined to 112 percent from 335 percent since 1999. **Foreign Exchange Reserves** stand around \$ 14 billion representing about six months of imports and provide much needed stability to the exchange rate. Dependency on official foreign assistance is reducing overtime.



Source: Publications of FBS, SBP Annual Reports and Various Issues of Pakistan Economic Survey

Pakistan has successfully entered into international capital markets in early 2004 and has received enthusiastic response every year since then. Every single sovereign bond issue was over subscribed manifold. International credit rating has improved. B+ for foreign currency, BB for local currency for long term rating and B for short term sovereign ratings (Standard and Poor December, 2006).

Strong macroeconomic policies, high growth rates, increases in pro-poor spending, higher worker remittances and employment generating - Rozgar, Aik Hunar Aik Nagar and microfinance schemes have contributed to sharp **decline in poverty** from 34.5 percent in FY01 to 23.9 percent in FY05. In urban areas, it has declined from 22.7 percent to 14 percent and in rural areas from 39.3 percent to 28.1 percent. The number of poor fell by 12 million from 48 million to 36 million, of which 10 million belongs to the rural areas. **Unemployment rate** has also declined from 8.3 percent in FY02 to 6.2 percent in FY06. However, mismatch between skill gap of labour demand and its supply needs to be reduced further.



Source: Publications of FBS, SBP Annual Reports and Various Issues of Pakistan Economic Survey

The **income inequality** has however worsened. Income ratio of the highest 20 percent to the lowest 20 percent has increased from 3.76 in FY01 to 4.15 in FY 05. The upper and middle income groups have benefited disproportionately from the consumer booms in autos, consumer durables, real estate and the stock markets. Lucrative jobs have gone to those possessing skills in demand.

The **social sector indicators** have also improved during 2000-07. Population growth rate has declined from 2.1 percent to 1.8 percent. Literacy rate has improved

from 45 percent in 1999-00 to 53 percent in 2004-05. Immunization coverage of children (12-23 months) increased from 53 percent in FY02 to 77 percent by FY05. Infant mortality rate also improved from 83 per 1000 persons in FY99 to 77 per 1000 in FY06.

Trends of some of the key socio-economic indicators reflecting performance of the economy during the period 1999-07 are presented in the Annexure 1.1 .

How was this turnaround achieved in such a short period of time? This has been the result of a comprehensive strategy formulated in December 1999 and wide-ranging structural reforms introduced thereafter. Some of the major reforms that have been implemented include: debt management, financial sector reforms, capital markets reforms, tax and tariff reforms, reforms in tax administration, fiscal transparency, reforms in privatization program, governance reforms particularly with respect to devolution and capacity building and maintaining financial discipline by pursuing rule-based fiscal policy emerged through Fiscal Responsibility and Debt Limitation Act 2005.

External debt was causing stress on the economy. Its resolution was accorded the priority. In 2001 Pakistan entered into a 9-month stand-by arrangement with IMF which it successfully completed in September 2001. It restored IFIs trust in Pakistan. This enabled Pakistan to secure a long-term restructuring of its Paris Club debt and reached an agreement with IMF on a three year Poverty Reduction and Growth Strategy (PRGS).

Fiscal policy reforms were introduced in relation to raising tax revenues, reducing expenditures, cutting down subsidies 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, adoption of universal self assessment, and strengthen the capacity of the Central Board of Revenue. Automation and reorganization of the tax machinery have begun to help improve tax collections. Fiscal deficit as a percent of GDP is slowly declining. At the same time, outlays on public sector development expenditure quadrupled in this period, accelerating investment in social, technological and physical infrastructure. That also imparts dynamism to the development of the **private sector**. Emphasis is being placed on development of water resource and power generation, transport and logistic chains and energy and trade corridors.

Privatization of the state owned enterprises was the next priority area of the reforms agenda. Wide political consensus exists for the privatization program where public sector should formulate the policies and regulate the markets and business enterprises be left to the private sector. Pakistan has successfully privatized the banks, telecom and other public enterprises to the tune of \$ 3.2 billion in the last six years. It has thus provided a fiscal space to the government to spend more on poverty alleviation and other development activities.

Financial Sector Reforms introduced in early 1990s continued. Further, reforms were introduced since 1999 where net non-performing bank loans are brought down to 3 percent of total advances and loans. Minimum capital requirement is raised to \$ 100 million, merger of financial institutions eliminated a number of weak players and the range of products and services offered by the banks is widened. Automation, online banking and multiple channels of delivery improved efficiency of bank services. Banking became profitable, competitive environment set in and the average

lending rate at one point of time declined to as low as 5 percent. Agriculture, SME and consumer loans and micro credit are now the main products and the borrower base of the banks has increased from 1 million to over 4 million households. Transparency and accountability is promoted whereas legal infrastructure of the banking system strengthened. Further, liberalization of financial services in compliance with TRIMs and observance of international standards are ensured to meet the challenges arising from global financial restructuring.

Trade Liberalization was also initiated in early 1990s and the maximum tariff rates have been brought down from 250-300 to 25 percent while the average tariff rate falls in the range of 5-10 percent. Non-tariff barriers have been eliminated and the selective concessions have been replaced with across-the-board uniform rules and regulations to foster competitive environment.

Foreign Investment Policy is open and liberal. All economic sectors are open to FDI. No prior approval is required to set up business. Foreign companies are treated equally with local firms. 100 percent foreign equity is allowed and they can raise funds from domestic sources. Attractive / tariff incentives package exists. Remittance of royalty, technical and franchise fee, capital, profits and dividends is allowed. Foreign investment is fully protected under law. Bilateral agreements have been signed with 46 countries to protect investment and with 52 countries to avoid double taxation.

Deregulation of oil and gas, telecommunication and civil aviation has also brought about significant positive results. Telecom has witnessed a boom where during 1999-2007, mobile phone number has increased dramatically from 0.3 million to 35 million, internet connection from 0.2 to 2.4 million and around 2400 cities have been internet connected. Bandwidth has gradually been increased along with higher penetration. Tele-density during the same period has also increased from 2 percent to 26 percent. The range of telecom services has been increased and duties and taxes on them have been reduced. Further, charges on national and international calls have also been reduced. The fundamental reform of the government is the devolution plan initiated in 2001. It devolves authority with responsibility from the federal and provincial governments to local bodies. The devolution of power is continuously strengthening governance by increasing decentralization, transparency, accountability of administrative operations, and people's participation in setting priorities and implementation of development projects and delivery of social services.

To improve **regulations**, policies and regulatory functions of the government agencies has been separated. The quasi judicial regulatory agencies have been established in the areas of banking, finance, aviation, telecom, electronic media, power, oil, gas etc. They hold public hearings and consultations with stakeholders in deciding regulatory and tariff issues.

As **corruption** among others, reduces investment and increases the capital cost and delays in implementation of development activities, the government has set up the National Accountability Bureau (NAB) to fight against corruption. Assets, loan and tax scams were investigated. Defaulters were prosecuted in the court of law and were forced to repay overdue loans, taxes and ill-gotten money.

Poor **governance** mainly stems from low level of human resource development and weak institutions. The Devolution Plan was announced in 2000, where the district bureaucracy was made responsible to the elected representatives. More operational autonomy in terms of administrative and financial powers was ensured at the district

level. Another hallmark of the devolution process was the encouragement for villagers to establish Citizens Community Boards (CCBs). Till 2006 nearly 25,000 CCBs were registered with the local government.

In the area of capacity building, the government has launched major initiatives; prominent among those are reforms in civil service, judiciary, police, rightsizing of institutions, e-government and compensation/pension. The responsibility of the Federal Public Service Commission (FPSC) has been enhanced to ensure merit based recruitment and promotions. The Civil Service Act has been amended to reflect performance based career progression. The public sector educational training infrastructure is also being restructured to strengthen skill based training of civil servants at all levels. The National Commission for Government Reforms (NCGR) is also working on providing a modern, efficient and accountable system of governance on a sustainable basis.

To improve efficiency and effectiveness of some important federal government organizations; restructuring of - the **Central Board of Revenue (CBR)**, **Securities and Exchange Commission (SECP)**, the **State Bank of Pakistan (SBP)**, **Planning Commission**, **Pakistan Railways**, **Monopoly Control Authority** and **Central Directorate of National Savings** - has been initiated some years ago.

The **Planning Commission**, the think tank of the country, was restructured in April 2006, to play an effective role in policies and plan formulation. The Prime Minister is chairman of the Planning Commission, which apart from the Deputy Chairman is manned with members of professional repute in the fields of science, engineering, economics, social sciences, energy, agriculture and public policy. Advisors of high caliber in the specialized fields are also placed on board to provide technical support in policy formulation and informed decision making. An effort is also underway to staff the Planning Commission with best brains, and transform it into a modern organization with the support of IT and changed work environment and culture. Human resource development and performance-based compensation are also the priority areas of reform. The process of restructuring of institutions is beginning to take some hold. Improvement in their performance and dynamism in their functioning is emerging fast.

The **civil service reforms** an on going process where major progress has been made in enhancing the capacity of our civil servants through training within and outside the country. The **Police reforms** initiated through Police Order 2002 inter alia include creation of public safety commissions, financial and administrative autonomy, and separation of investigation from watch and ward functions. Some progress has been made which will make police more efficient and accountable to the people. **Judicial reforms** 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. On **pension reforms**, contributory Provident / Pension Fund Scheme is being introduced. The pension payment gap between old and new pensioners is being gradually bridged.

Improving **competitiveness** is a cornerstone of economic reforms agenda. Infrastructure, project development facility with public - private partnership has been established to strengthen the country's physical infrastructure in relations to supply of gas, power, working of ports, roads, rail linkages, telecom network and water availability. Competitive support fund has also been established to bring competitiveness in the forefront of decision making. It provides venture capital

funding, match making facilities and help foster cooperation between government & educational institutions in the private sector.

A number of **social sector reforms** have been undertaken to address socio-economic issues facing the country. The emphasis is to achieve Millennium Development Goals (MDGs) well ahead of time. **Education reforms** have been introduced to reduce inter-provincial and gender disparity through National Commission for Human Development (NCHD), restructuring schools and formal education centers, integration of education system, improving quality and relevance of education, up gradation of Education Management Information System (EMS), National Education Assessment System (NEAS) and strengthening of Higher Education Commission. **Health reforms** are initiated mainly to enhance the equity, efficiency and effectiveness of health service delivery. Quality and affordability of health services are ensured through better utilization of health physical facilities and enhancement of institutional capacity.

Social sector development expenditure has increased from Rs 103 billion in FY02 to Rs 228 billion in FY06 reflecting an increase of 22 percent per annum. In addition, substantive funds have also been spent on skill development, vocational training and scientific and technical education to exploit the benefits of **demographic dividend** and foster **knowledge based economy**. For gender mainstreaming, measures initiated mainly by National Commission on Status of Women (NCSW), national and provincial Gender Reform Action Plans (GRAPs) are assertively addressing the issues of gender equality and empowering women.

Despite these achievements and reforms, much more needs to be done in face of new unforeseen challenges. One fourth of the population still lives below the poverty line. An integrated social protection system does not exist. Financial assistance to the poor around 1 percent of the GDP is inadequate. And that too, reach to only 10 percent of the population. Social Development Indicators remain low as almost half of the population is illiterate, infant mortality rates are high, access to quality education and health care particularly by the poor is limited. Income, regional and gender inequalities are widespread. Skill, social and infrastructure deficits, persistently affecting the productivity and competitiveness of the economy.

In the coming years, some of the additional **challenges** to be addressed are: reaping the benefits of the demographic dividend, managing mega cities, developing educational, IT, industrial and technological clusters, ensuring energy security and efficiency, developing national trade and energy corridors and modernization of logistic chains, improving governance and capacity building and devising and implementing an integrated social sector development and social security strategy.

Annex 1.1

Key Socio-Economic Indicators

	Unit	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07 Est
I Real Sector										
Real GDP Growth	%	4.2	3.9	2.0	3.1	4.7	7.5	8.9	6.6	7.0
Agriculture	%	1.9	6.1	-2.2	0.1	4.3	2.3	6.5	2.5	5.0
Industry	%	4.9	1.3	4.1	2.7	4.2	16.3	12.1	5.9	6.8
LSM		3.6	1.5	11.0	3.5	7.2	18.1	19.9	10.7	8.8
Services	%	5.0	4.8	3.1	4.8	5.2	5.9	8.5	8.8	8.0
GDP (mp) Current Prices*	Rs Bln	-	3826	4210	4453	4876	5641	6257	7547	8716
GDP (mp) Current Prices*	Rs Bln	-	3778	4155	4476	5027	5765	6391	7697	8877
Investment	Rs Bln	-	659	716	738	817	935	1153	1650	2004
	% of GDP	15.6	17.4	17.2	16.6	16.8	16.6	18.1	21.9	23.0
National Savings	Rs Bln	-	605	686	821	1002	1030	1101	1313	1572
	% of GDP	11.7	15.8	16.5	18.4	20.6	18.3	17.6	17.4	18.0
Inflation		5.7	3.6	4.4	3.5	3.1	4.6	9.3	8.0	7.7
Food		5.9	2.2	3.6	2.4	2.9	6.0	12.5	7.0	10.0
Non-food	%	5.6	4.7	5.1	4.3	3.2	3.6	7.1	8.8	6.5
Core		4.5	3.5	4.2	2.0	2.1	3.0	7.0	7.1	6.0
II Fiscal Sectors										
Revenue Collections (CBR)	Rs Bln	3.9	347	396	404	462	519	591	712	835
Fiscal Deficit	% of GDP	6.1	5.4	4.3	4.3	3.7	2.4	3.3	4.3	4.2
Public Debt	% of GDP	100.3	94.8	82.8	77.7	72.7	67.7	64.9	57.2	51.1
Foreign Debt	% of GDP	53.0	45.8	42.3	40.8	36.7	32.0	30.6	26.8	23.9
Debt Servicing	% of Total Revenue	73.2	72.4	62.5	70.3	41.6	37.9	36.6	30.2	27.8
III Monetary & Capital Market										
Wt Avg. Return on Deposits	%	6.5	5.5	5.3	3.6	1.6	0.9	1.4	2.9	3.9
Wt Avg. Return on Advances	%	14.8	13.5	13.6	13.2	9.4	7.3	8.8	10.7	11.8
Credit to Private Sector	Rs Bln	103	18	49	53	168	325	438	402	350
Money Supply (Growth)	%	6.2	9.4	9.0	15.4	18.0	19.6	19.3	15.2	14.2
Stock Market (KSE 100 Index)	1991=1000	1055	1521	1366	1770	3403	5279	7450	9989	12369**
Market Capitalization	Rs Bln	286	392	339	408	746	1358	2037	2766	3603*
	\$ Bln	5.7	6.7	5.8	6.8	12.8	23.4	34.3	46.1	59.50**
IV External Sector										
Exports (f.o.b)	\$ Bln	7.5	8.2	8.9	9.1	10.9	12.4	14.4	16.4	17.2
Imports (f.o.b)	\$ Bln	9.6	9.6	10.2	9.4	11.3	13.7	18.9	24.6	27.1
Trade Deficit	\$ Bln	2.1	1.4	1.3	0.3	0.4	1.3	4.3	8.2	9.9
Remittances	\$ Bln	1.1	1.0	1.1	2.4	4.2	3.8	4.5	4.6	5.5
Current Account Balance	\$ Bln	-2.4	-1.1	-0.5	1.3	3.2	1.3	-1.8	-5.6	-7.1
Foreign Direct Investment	% of GDP	-3.9	-1.6	-0.7	1.8	3.8	1.7	-1.7	-4.5	-5.0
	\$ Mln	376	470	322	485	798	949	1,524	3,521	6,000
External Debt & Forex Liabilities	\$ Bln	38.9	37.9	37.1	36.5	35.5	35.3	35.8	37.3	38.8
External Debt & Liabilities	% of Forex Earnings	335.4	297.2	259.5	236.8	181.2	164.7	134.3	120.6	111.7
Foreign Exchange Reserves	\$ Bln	1.7	1.3	3.2	6.3	10.7	12.3	12.4	13.3	14.0
USD Exchange Rate	Rs Per \$	50.05	51.77	58.44	61.43	58.50	57.57	59.36	59.86	60.53
V Social Sectors										
Population***	Mln	134.5	137.5	140.4	143.2	146.8	149.6	152.5	155.4	158.4
Unemployment Rate	%	6.1	6.0	-	8.3	-	7.7	-	6.2	-
Literacy Rate 10+	%	45.0	47.1	48.0	50.5	51.6	53.0	53.0	54.5	56.0
Infant Mortality Rate	1000 persons	83	85	-	85	83	80	-	77	-

*National Accounts base was changed in 1999-2000

April 2007 *Population as of 1st January of the year.

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