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**Macroeconomic Stability of Pakistan:
The Role of the IMF and World Bank (1997–2003)**

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Program in Arms Control, Disarmament,
and International Security

University of Illinois at Urbana-Champaign

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INTRODUCTION

In 2004, Pakistan's economy has reached a stage where it enjoys self-sufficiency in food, an unprecedented stock of foreign exchange reserves, declining budget deficits, increasing industrial production, and is approaching an overall growth of over 5 percent per annum. The economy has achieved fundamental macroeconomic stability amid general improvement in economic indicators. On the other hand, Pakistan is still faced with challenges like boosting investment, eliminating public sector deficits, creating new infrastructure, and expanding social sector development. The tasks of poverty alleviation and employment generation remain formidable, requiring both direct and indirect initiatives. While macroeconomic stability has been achieved, the economy is still at the take-off stage, with much room for improvement.

In the last decade, Pakistan has faced a number of challenges in order to achieve macroeconomic stability, due to variety of factors. To begin with, Pakistan has been struggling to achieve internal political stability, which has a direct bearing upon economic stability. A country cannot achieve macroeconomic stability unless it has a strong political system. Pakistan's checkered and uneven record on political stability and democracy has deprived the country of a long-term vision, direction, and continuity of economic policy. The rapid turnover of governments, and actual and imminent threat of the dismissal of the governments through extra-constitutional means, has certainly proved to be an inhibitor to investment, innovation, and institutional development. To a considerable extent, politics was responsible for the wide fluctuations in the performance of the main sectors of the economy.¹

Second, the diverse ethnic composition of the country has not only affected resource distribution, but also affects policy continuity. Pakistan is composed of various ethnic groups, like Punjabis, Sindhis, Pashtuns, Mohajirs, etc.—a fact that creates certain problems. For example, when there was a government from Punjab or from Sindh, the other provinces voiced feelings of resentment at perceived exclusion and deprivation.² The friction between Punjabis, Sindhis, and Balochis and the vociferous dismissal of dissenting opinions and viewpoints even by educated Pakistanis are manifestations of intolerance. Economic development requires free mobility of labor and capital throughout the nation-state. But if the Sindhis are scared to move and work outside their own district, or *tehsil*, for fear of discrimination; or the Mohajirs would like to confine themselves to activities within Karachi, Hyderabad and Sukkur; or certain tribes in North West Frontier Province (NWFP) and Balochistan would like that only their areas should be given the monetary benefits accruing from exploitation of minerals, gas, and hydroelectric power; or if the Punjabis keep on insisting on population as the sole basis for the distribution of fiscal revenues, then the country suffers from huge inefficiencies in the allocation and utilization of resources.³ Furthermore, every time a new government took office, it changed the policies of the previous government, which not only affected the economic environment, but also increased the cost of most projects.

Externally, the changing geo-strategic environment and Pakistan's evolving relationships with International Financial Institutions (IFIs) have affected the country's macroeconomic stability. The war on terror in Afghanistan and Pakistan's status in that conflict as a "front line-state" has greatly affected the country in many ways. First, the slower pace of economic activity in Pakistan's major trading partner countries (the United States and European Union, in particular) reduced their demands for Pakistani products, and as a result Pakistan's exports remained lower than targeted. Furthermore, increases in freight rates and imposition of war risk insurance increased the cost of imports and made Pakistani exports more expensive. Second, cancellation of air cargo flights by foreign airlines disrupted the trade flows. Third, manufacturing units had to maintain higher inventories because of the risk of instability. Fourth, the departure of expatriates from the country and the suspension of visits by foreign buyers did not allow the country to maintain normal trade relations. Furthermore, revenue collection also suffered due to lower imports, while the continuous influx of Afghan refugees placed further pressure on Pakistan's already limited resources and infrastructure. According to the Finance Ministry, the cost incurred by the economy due to these factors was on the order of \$2 billion.⁴ Furthermore, the terrorist attack on the Indian parliament in December 2001 and subsequent troop deployments on the international border between India and Pakistan has affected foreign investment and the trade balance of Pakistan.

In recent years, the role of international financial institutions has also been very crucial to the economic stability of Pakistan. The assistance from the International Monetary Fund (IMF) and World Bank (WB) merits special mention in this regard. During 1997–2003, relations were improved with the IMF and Pakistan

successfully completed most of its agreements. Furthermore, Pakistan also received support from the IMF for the purpose of improving its Balance of Payments (BOP) deficits. The World Bank assisted Pakistan in introducing major changes in the structure of the economy, as well as helping Pakistan address the areas of poverty alleviation, improving governance, and reforming the social security sector.

There have been many ups and downs in the economy of Pakistan during the 1990s, with numerous fluctuations in the basic macroeconomic indicators. The Gross Domestic Product (GDP) growth rate has been under 4 percent during the second half of the 1990s, which is lower than the growth rate in earlier decades.⁵ The incidence of poverty remained high and affected large segments of society. The poor quality of governance aggravated the problems, as most of the reforms were hindered by bureaucratic rigmarole. The worsening law and order situation in the country further compounded the problems. The current account balance remained in deficit most of the time due to decreases in the country's export levels. Successive governments in Pakistan allocated major chunks of the budget for non-development purposes, which resulted in budget deficits. Debt servicing and defense expenditures have consumed a major part of the resources, affecting social sector development. There has been an increase in the debt of the country, with a major part of the GDP being consumed by debt servicing. Governments in Pakistan have frequently acquired foreign aid and debt to meet their current expenditures. The balance of trade throughout the period remained in deficit due to decreases in exports. The main sector of exports (i.e., agriculture, including rice and cotton) decreased because of the long drought in the country. However, in recent years this balance has been improved due to heavy rains that helped increase agricultural production. Developing countries like Pakistan need foreign direct investment to aid in that development. But Pakistan has not been fortunate enough to attract much foreign direct investment due to a variety of factors. These include the worsening law and order situation in the country, the unfriendly attitude of the Nawaz Sharif government towards foreign investors in 1998, complications to foreign relations due to Pakistan's acknowledged nuclear tests, and a lack of incentives provided to foreign investors.

This paper is divided into five sections. Following this introduction, the Part One deals with selected macroeconomic indicators of the economy and their performance in the selected period. Part Two discusses the role of the IMF and World Bank in the economic revival of Pakistan. In Part Three, an attempt is made to draw a future horizon of the country. In the last section, I present my conclusions on the topic.

PART ONE

Selected Macroeconomic Indicators and Their Performance

In February 1997, Nawaz Sharif became Prime Minister of Pakistan. He made improving the economy his top priority, emphasizing liberalization and privatization of the economy. During his previous term in office (1990–93), Nawaz Sharif began the process by successfully privatizing eighty small- and medium-size factories. But many sectors of the economy were still state controlled in 1997, so economic revival was not an easy task for Sharif's government. Among the biggest challenges faced by the new government was the question of relations with the IMF, which were severely strained under Benazir Bhutto because of corruption and economic misgovernance by her government. Prime Minister Sharif was able to improve relations with the IMF, but they remained cordial only for a short period of time. The second biggest challenge for Sharif's government was to avoid default on its foreign obligations. When Benazir Bhutto's second government was dismissed in November 1996, foreign exchange reserves had sunk to below \$630 million, or just enough to finance a little over four week's imports. This was in contrast to debt repayment of just over \$600 million due in December 1997. In order to cope with this precarious situation, Sharif made a direct plea to Pakistanis living abroad to make foreign exchange deposits to help tide the country over with its debt obligations. The third challenge for the Sharif government was to control the rising domestic debt, which reached 90 percent of the GDP in 1996–97. The fourth challenge was to control the accelerating trends in poverty, which were on the rise in the 1990s.

Towards the end of 1997, Pakistan again found itself in political crisis.¹ This political instability greatly affected the economy and had an especially great impact on foreign investment. Domestic businessmen put investment decisions on hold. In addition, several necessary, but sensitive, decisions were postponed. The government had done nothing to act on its commitment to reduce the number of federal government employees from 300,000 to 200,000 by the end of November. The government also promised international agencies that it would protect public sector power corporations—such as the Water and Power Development Authority (WAPDA), Karachi Electric Supply Corporation (KESC), and Sui Northern Gas Company—from imminent bankruptcy by raising utility rates from 20 to 50 percent. But Sharif balked at taking such decisions in the politically charged environment that prevailed in the country.

At the beginning of 1998, Nawaz Sharif's government claimed that the country's economic prospects were improving. But in reality, the economic scene remained cheerless, if not bleak, and negatively affected by the deteriorating law and order situation in the country. Several other factors also undermined confidence. The government, despite its electoral mandate, had shied away from taking tough, but necessary, fiscal decisions. In addition the government did little to achieve the macroeconomic targets set out in its loan program with the IMF.

In May 1998, Pakistan conducted nuclear tests, which resulted in economic sanctions from the international community. These sanctions greatly affected the already poor economy. However, the situation changed at the end of the year when the United States began to relax the sanctions and encouraged international financial institutions to provide help to Pakistan. In November, the United States lifted some of the economic sanctions on India (which also tested nuclear weapons in 1998) and Pakistan after securing their commitments to practice non-proliferation. However, according to the Economist Intelligence Unit (EIU):

The sanctions imposed on Pakistan by the USA are not significant in terms of potential American assistance to Pakistan; in fact, the US government has not given any economic loans or grants to Pakistan since the USA aid was cut off to Islamabad in 1990 following Pakistan's refusal to freeze its nuclear program. However, they have indirectly affected other resources of assistance: the IMF, World Bank and Asian Development Bank will not resume economic assistance until the US and other G8 countries have signaled that they will not block approval.²

It was again towards the end of 1998 that Pakistan faced another severe political crisis. Sharif enforced his *Shariat* Bill to impose Islamic law, which prompted widespread opposition from minorities, human rights groups, and even some Islamic groups, who complained that it would undermine rights guaranteed in the 1973 constitution while simply serving to distract from more important issues.³ Civil strife increased in Karachi and the Mutthida Quami Movement (MQM) ended its coalition with the Pakistan Muslim League Nawaz (PML-N) party. Subsequently, Sharif dismissed the government in Sindh and imposed central government rule in the

province. Furthermore, the army chief resigned amid rumors about an imminent military coup in the country, which was followed by an intensification of the political crisis in October 1999, when the military took over the reins of government. All these factors adversely affected the economy as political uncertainty led to the evaporation of foreign investors' confidence.

Reflecting on the results of Nawaz Sharif's second government, now an attempt will be made to analyze the performance of Pakistan's economy based on analysis of its macroeconomic indicators.

Poverty

The most common way to measure poverty is based on income or consumption levels. A person is considered poor if his or her consumption or income level falls below a minimum level necessary to meet basic needs. This minimum level is usually called the poverty line. The World Bank uses reference lines set at \$1 and \$2 per day in the 1999 Purchasing Power Parity (PPP) terms (where PPPs measure relative purchasing power by comparison to other countries). It was estimated that in 1999, 2.2 billion people worldwide had consumption levels below \$1 a day—23 percent of the population of the developing world, with an additional 2.8 billion living on less than \$2 a day.⁴ In Pakistan, 31 percent of the population lives on less than \$1 a day, while 85 percent lives on less than \$2 a day.⁵ Furthermore, Pakistan has a per capita income of \$420 a year. Recently the World Bank began including many other factors besides income levels to measure poverty. These non-income indicators include health, education, and access to basic services.⁶ In these terms, Pakistan has, for example, an adult literacy rate of 42 percent for males and 71 percent for females.⁷ In the health sector, nearly one in ten children die before reaching the age of five.⁸

The government of Pakistan uses a different yardstick for measuring the poverty in the country and sets its own poverty line. Instead of applying the universal formula of one dollar a day of earnings per capita to count the absolute poor, it now considers a monthly income of PRs 748, enough to afford 2,350 calories a day, or almost PRs 1,000 less, as being poor. Those having less than that income are held as too poor now. What that means is that, instead of an income of PRs 1,710 a month on the basis of PRs 57 for a dollar for 30 days, one has to get PRs 25 per day or PRs 748 in a month not to be regarded as poor.⁹

The incidence of poverty increased in Pakistan during the 1990s.¹⁰ A report from the Asian Development Bank, "Country Strategy and Program 2002–2006, Pakistan," outlines the economic reversal that occurred in the 1990s. Poverty increased from 26.6 percent in 1992 to 32.2 percent in 1999, with the total number of poor increasing by more than 12 million people. Poverty is most intense in rural areas, where about three-fourths of the poor live. The failure of economic growth to keep up with a burgeoning workforce (growing at an average rate of 2.4 percent a year) exacerbated these trends. Structural causes of economic failure, such as an expanding foreign debt and economic mismanagement, were joined by a failure to invest in growth in human development, in areas like education, health care, and other basic social services. Private investment faltered also, driven by political uncertainty.¹¹ According to some studies, caloric-based poverty in effect doubled from 17.4 percent in 1987–88 to 32.6 percent in 1998–99.¹² As a result, Pakistan became less competitive as economic globalization expanded in the 1990s.

The government of General Pervez Musharraf made poverty alleviation its top priority, a platform it supported by the allocation of more resources for poverty reduction.¹³ The first pillar of this strategy is macroeconomic stabilization and resumption of economic growth. In the past, Pakistan has struggled to achieve macroeconomic stability. The country faced a debt payment crisis in 1998, investor confidence was at the lowest ebb, links with the international community were disrupted, and financial reserves were so low that the country was at the brink of default. By 1999, the public debt of Pakistan became unsustainable, with debt servicing pre-empting more than half of revenues, and external and domestic debt exceeding the country's GDP. The government of General Musharraf rectified this worsening economic situation in the next three years and, as a result, in 2002 inflation had fallen to less than 4 percent, the fiscal deficit was brought down to 5 percent, external debt indicators improved, public debt servicing declined, the exchange rate stabilized, and exports were growing at the rate of 16 percent. Foreign currency reserves reached \$10 billion. This improvement in all the macroeconomic indicators enhanced the image of the country internationally.

The second pillar of Musharraf's poverty alleviation strategy is improved governance. Governance has improved due to reform of the public sector. The government especially emphasized accountability,

transparency, and predictability in decision-making. The government introduced a political devolution plan whereby administrative, functional, and financial responsibilities for the delivery of social services are delegated to district governments. Discretionary powers of government officials have been reduced and placed under the administrative control of the elected representatives of the people.

Structural reforms constitute the third pillar of the poverty alleviation strategy. Broad based reforms in tax administration, trade liberalization, and the financial sector form the core. In tax administration, the Central Board of Revenue is being restructured, while the tax base has been widened. Trade liberalization has resulted in tariff rationalization, removal of various restrictions on exports and imports, and deregulation. Financial sector reforms have already resulted in a sound and healthy banking system, a buoyant stock market, a growing corporate debt market, and the strengthening of regulation and supervision.

The fourth pillar of the strategy is poverty-targeted interventions. Prominent among these are education sector reforms, healthcare for all, population planning, *Zakat*, the *Khushali* program for employment generation through public works, a food support program, and the *Khushali* bank.¹⁴ The *Zakat* system has been revamped to provide financial grants to the beneficiaries to start small enterprise or other income generating activities. The food support program subsidizes wheat flour for those below a certain threshold of monthly income. *Khushali* program funds are allocated to local governments to create and improve the physical infrastructure, while creating employment. The *Khushali* bank is a micro-finance institution, which provides small loans to the poor under supervised group guarantee schemes.¹⁵

Governance

Good governance is an important element of economic stability and growth. It provides a system in which people have access to justice and the writ of the law is enforced. Along with other factors, poor governance breeds corruption and hinders economic development. It would be pertinent to mention at this juncture one definition of good governance. According to the World Bank, governance is “the exercise of authority, control, management, power of government.”¹⁶

The World Bank emphasizes that good governance is central to creating and sustaining an environment that fosters strong and equitable development, and is an essential component of sound economic policies. Government plays a critical role in the provision of public goods and services. It establishes the rules that make markets work efficiently and, more problematically, it corrects for market failures. In order to play this role, governments need revenues to produce public goods and services. This in turn requires the system of accountability, adequate and reliable information, and efficiency in resource management and the delivery of public services.¹⁷

Pakistan failed in all of the areas associated with good governance since 1947, in general, and in the 1990s, in particular. The civilian governments played havoc with the governance indicators. Weak governance has been an important source of macroeconomic difficulties, particularly in the 1990s. It contributed to slowing Pakistan’s economic growth; reduced the effectiveness of public expenditures; weakened the overall macroeconomic management; undermined investor’s confidence; encouraged tax evasion, loan defaults, and non-payment of utility bills; and fostered corruption. Furthermore, key governance problems included poor fiscal performance, mismanagement of domestic and external debt; social exclusion of the poor, women, and minorities from access to basic services; poor public sector performance; inefficient and ineffective intergovernmental relations between the federal government and the provinces; marginalization of local governments; and a loss of trust by the common citizenry in public institutions, especially in the administration of justice and police.

Corruption and poor governance have deeply affected the economy of Pakistan. Past civilian governments were corrupt and made money through illegal means, thereby increasing instability in the country. In 1997, under the caretaker government of Meraj Khalid, a team was formed to provide estimates of economic loss to Pakistan during the regime of Benazir Bhutto (1993–96). The team headed by Shahid Javed Burki and assisted by Hafiz Pasha “estimated the cost to the country of political corruption and inefficiency at 20 to 25 percent of its 1996–97 GDP. Translated into monetary terms, this was equivalent to some \$15 billion.”¹⁸ This cost was estimated on the basis of the losses incurred by the most important sectors of the economy, such as banking and public sector corporations like WAPDA and KESC.

When General Pervez Musharraf took over in October 1999, there was a dire need to take measures to improve governance and introduce structural reform in the basic governance infrastructure. These governance reforms were also long desired by the international financial institutions. In order to improve governance in the country, General Musharraf implemented a wide range of structural reforms, including:

- Restructuring and right-sizing of the civil services
- Rationalization of pay and pensions finalized
- Increased autonomy granted to Federal Public Service Commission (FPSC)
- Strong focus on training and improved procedures for performance assessment
- Devolution of political power to the grassroots level
- Judicial reforms
- Police reforms
- National anti-corruption strategy
- Freedom of information act promulgated
- Pakistan Public Procurement Authority established¹⁹

As a result of reforms in governance, Transparency International (a German-based organization) in its recent report on government corruption clearly stated, “corruption at the top levels of government has very significantly declined.”²⁰ The World Bank also supports reforms initiated by the Government to improve its effectiveness at federal, provincial, and district levels. The ongoing Project to Improve Financial Reporting and Auditing (PIFRA) has enabled the government to develop a new accounting model, which consists of revised forms, principles, and methods of accounting and financial reporting to establish an integrated financial management system in Pakistan. The PIFRA project also provides for the introduction of a double entry computerized General Ledger System for all government financial transactions in a phased manner. The basic purpose of this system is to make government bookkeeping more effective and efficient, reducing opportunities for corruption. It will make the financial business of the government more transparent and timely.

Governance reforms have been opposed by a powerful status quo of vested interests and severe fiscal constraints that put additional restraints on the reform agenda. However, the government’s record of implementing reform commitments made in 1999—in particular providing a legal basis for devolution and police reforms, ensuring the complete separation of judicial and executive powers, and completing the local government elections on schedule—suggests readiness to confront issues that have plagued the country since independence.

Debt Burden

The debt burden has long been a very serious problem for Pakistan, but was especially so in the 1990s.²¹ The civilian governments not only amassed large amounts of foreign debt, but also used this debt for meeting the current expenditures of government. In 1998, Pakistan was hovering on the brink of default. Its foreign exchange reserves, which were \$1.3 billion on the eve of the May nuclear tests, fell to \$400 million by mid November 1998. A confidential report prepared by State Bank of Pakistan outlined the precariousness of the debt profile. According to the report, “in 1998–99 (fiscal year ending June 30th), Pakistan’s external debt repayments total \$7.9 billion, including \$5.6 billion in debt amortization and \$2.2 billion in interest payments; of this amount, \$1.6 billion was payable to non-Muslim countries, \$1.1 billion to IMF and World Bank and the rest was paying for short term borrowing.”²² The report also noted the precarious position of reserves at \$930 million at the end of June, meaning the country would have to default on international debt, if the allied Muslim countries were unable to inject cash resources to keep Pakistan afloat until the sanctions were lifted.

Pakistan’s debt situation reached an unsustainable level by 1999 because of the persistence of the current account and fiscal deficits during the 1990s. These twin deficits resulted in explosive accumulation of both domestic and external debt.²³

Domestic debt was growing at an annual average rate of 16 percent during the period 1990–99, reaching almost 52 percent of GDP by 1999–2000, up from 44.1 percent in 1990–91. In other words, the domestic debt grew by fourfold—rising from PRs 488 billion to PRs 1,642 billion in one decade. Pakistan’s total debt and external liabilities grew by an average rate of 6.4 percent per annum during 1990–99. It stood at \$23 billion in 1990–91 and reached almost \$38 billion by 1998–99. This sharp increase in the total debt resulted in the increase of debt servicing liabilities in the 1990s. In 1990–91, almost 40 percent of revenues were consumed by debt servicing, while in 1998–99 debt servicing was consuming 63.5 percent of the national budget, leaving 36.5 percent to be spent on defense, civil administration, and development works.²⁴

The main reasons for this accumulated debt can be described as follows:

- The rising trends in the non-development expenditures (debt servicing and defense) have been the cause of rising debt. The major chunk of the budget is consumed by these elements.
- The persistence of the low growth rate of the economy also compelled the successive governments to resort to external debt. Throughout the decade of 1990s, Pakistan’s growth rate remained under 5 percent.
- Economic mismanagement and corruption by the civilian governments resulted in the loss of public exchequer. In order to fulfill their agendas, the civilian governments resorted to external debt.
- Corruption by successive governments in Pakistan also compelled the country to opt for foreign borrowing to meet the current expenditures of the government.

Table 1.1: Trends in External Debt and Foreign Exchange Liabilities (US\$ billion)

Year	Total External Debt	Foreign Exchange Liabilities	Total External Debt and Foreign Exchange Liabilities
1989–90	19.2	2.7	21.9
1990–91	20.0	3.2	23.2
1991–92	21.9	4.5	26.4
1992–93	23.9	5.7	29.6
1993–94	26.9	7.1	34.0
1994–95	28.7	7.3	36.0
1995–96	29.8	9.1	38.9
1996–97	29.5	11.0	40.5
1997–98	30.3	12.4	42.7
1998–99	33.5	4.1	37.6
1999–2000	32.2	5.7	37.9
2000–01	32.1	5.0	37.1
2001–02	33.4	3.1	36.5

Source: Ashfaque Hasan Khan, “Economic Performance during 1999–2002,” Ministry of Finance, Government of Pakistan, http://www.finance.gov.pk/summary/99_2002.pdf, 7.

Table 1.2: Debt Servicing

	As % of GDP	As % of Current Expenditure	As % of Total Revenue
1989–90	7.0	36.3	37.9
1990–91	6.4	33.3	39.8
1991–92	6.9	36.3	38.6
1992–93	7.8	38.1	43.4
1993–94	8.4	44.5	48.3
1994–95	7.5	40.5	44.1
1995–96	8.2	41.0	47.2
1996–97	8.7	46.4	54.9
1997–98	9.8	49.4	60.9
1998–99	10.1	54.4	63.5
1999–2000	11.2	53.8	65.7
2000–01	9.5	49.6	59.1
2001–02	9.0	44.7	49.7
2002–03	7.8	43.6	44.0

Source: Ashfaque Hasan Khan, “Economic Performance during 1999–2002,” Ministry of Finance, Government of Pakistan, http://www.finance.gov.pk/summary/99_2002.pdf, 9.

As shown by Tables 1.1 and 1.2, the rising trend in both domestic and external debt resulted in a serious problem for Pakistan in a number of ways.

First, it crowds out public finances by pre-empting 56 percent of budgetary revenues, necessitating cut backs on essential public expenditures for promoting growth and poverty reduction. Second, it forces the economic managers to continue borrowing for meeting even the non-development and recurrent expenditures to run the state. Third, the annual external debt service payments falling due every year amount to \$6-7 billion, which consume more than two-thirds of export earnings. This burden is totally disproportionate to the capacity of any developing country in the world, since Pakistan will pay most of its earnings to its creditors and will have very little left for imports of goods and services.²⁵

For the reasons mentioned above, the government of Pakistan must find a solution to its debt problem.

When General Musharraf came to power in October 1999, external debt and foreign exchange liabilities stood at \$38 billion. It should be pointed out that the Musharraf government has done well on the debt management side. It has not only slowed down the pace of acquiring new or additional debt, but also brought down the level of debt servicing, thereby increasing foreign exchange reserves. The military government formulated a debt management strategy, which had the following features:

- Seeking debt relief from lenders and using the savings solely for poverty reduction programs
- Reserving privatization proceeds exclusively for retirement of public debt
- Reducing the cost of borrowing through lowering of the interest rates on government schemes
- Gradually eliminating all borrowings for non-development expenditures

- Privatizing public sector corporations in the oil and gas sector to achieve greater efficiency, provide for investment resources, and generate funds for debt retirement
- Constituting a high level debt management committee, under the chairmanship of an expert, with the governor of the State Bank and other senior government officials as members, to suggest measures for establishment of an efficient debt management system and for reducing the debt servicing burden
- Increasing the flow of remittances through official channels
- Relying on non-debt creating inflows (e.g., grants and foreign direct investment)²⁶

As a result of this debt management strategy, domestic debt declined from 51.7 percent of the GDP in 1999–2000 to 47.0 percent in 2001–02, a reduction of 4.7 percentage points of the GDP. The external debt and foreign exchange liabilities now stand at \$36.5 billion, down from approximately \$38 billion in 1998–99—a reduction of \$1.5 billion or from 62.3 percent of the GDP to 58.8 percent. Debt servicing as a percentage of total revenue, which stood at 63.5 percent in 1998–99, declined to 49.7 percent in 2001.²⁷

Gross Domestic Product (GDP) Growth Rate

Although it lagged behind East Asian countries (the so-called “tigers”) and China during the last two decades, Pakistan’s growth rate remained high in comparison with the other countries of South Asia until the 1980s. Pakistan’s growth rate also exceeded many African and Latin American countries.²⁸ However, Pakistan’s GDP growth rate became sluggish during the 1990s.²⁹ As against an average growth rate of 6.1 percent in the 1980s, it slowed down to 5.1 percent and then to 4 percent during the first and second half of the 1990s, respectively. On the other hand, the population growth rate remained high, leading to a decline in the per capita income of the country.

In part, the variability in the GDP growth rate is because Pakistan’s economy still has a large agriculture component. Although this sector only contributes about 25 percent of the GDP, it employs half of the workforce. Pakistan’s major exports (textiles, finished fabric goods, and yarn) are dependent on the outcome of the cotton crop. Weather variability, pests, disease, and other natural calamities contribute to volatility in agriculture production levels. Wide variations in policies for government support to agriculture, compounded by economic difficulties that restrict availability of key inputs like seeds and pesticides, exacerbate nature’s obstacles to crop production. With agriculture such a significant part of the economy, agricultural production is highly correlated to Pakistan’s overall economic performance.³⁰ When the agricultural sector has performed well, the GDP has been high. Agriculture is extremely important not only for its contribution to the GDP, but also because of its importance for the manufacturing sector.

In addition to agricultural factors, other principle causes of the slow-down in the growth rate were the continued low rates of savings and investments; governance problems hindering the effective use of public resources; structural problems in large-scale manufacturing; and considerable financial and political instability. Macroeconomic policies failed to halt the growing imbalances in the budget and external accounts, and policymakers did not realize the economic dangers of growing financial vulnerability.³¹ Recent growth rate trends in the GDP are given on the next page in tabular form.

Table 1.3: GDP Growth Rate Trends

	FY97	FY98	FY99	FY00	FY01	FY02
Real GDP	1.9	3.5	4.2	3.9	2.5	3.6
Agriculture	0.1	4.5	1.9	6.1	-2.6	1.4
Major Crops	-4.3	8.3	0.0	15.4	-9.8	-0.5
Manufacturing	-0.1	6.9	4.1	1.5	7.6	4.4
Large Scale	-2.1	7.6	3.6	0.0	8.6	4.0
Services Sector	3.6	1.6	5.0	4.2	4.8	5.1

Source: Various issues of *Economic Survey of Pakistan* (Islamabad: Ministry of Finance, Government of Pakistan).

Foreign Investment

In recent years, developing countries—such as China, India, Hong Kong, Malaysia, Indonesia, and Thailand—have attracted a lot of foreign direct investment (FDI). The inflow of FDI to Pakistan has, however, remained far from encouraging despite numerous incentives offered to foreign investors, particularly after the initiation in 1992 of the liberalization program. In the early 1990s, the country began to attract a respectable amount of foreign capital, a significant amount of it for the development of the power sector. Taking note of the large size of the Pakistani population, transnational corporations came in to develop markets for beverages and fast food. Today, the most important areas of FDI in Pakistan are energy, chemicals, foods and beverages, machinery, construction, textiles, and the power sector. Attractive incentives apart, Pakistan's population of about 149 million offers vast potential for the marketing of both consumer and durable goods. At the same time Pakistan's geographic contiguity with Central Asian republics also has the potential to serve as a gateway to foreign investors for extending their marketing activities into the countries of that region.

Despite all of these factors, FDI in Pakistan has been on the decline. These declining trends in FDI have resulted from public policy and the changing geo-strategic environment of Pakistan. According to the Economist Intelligence Unit's 2001 report on Pakistan:

Among the major reasons for the poor position with regard to foreign investment is the generally negative perception of Pakistan in international business circles. Images of gun-toting, anti-western Islamic fundamentalists, sectarian warfare and rumors of war with India are common enough. Nor does it help to know that there is an unaccountable military regime in office, while the judiciary appears incapable of delivering independent judgments in the event of clash of interests between the foreign or the domestic investors on the one hand and the government on the other. Finally, the significant exodus of indigenous capital and entrepreneurs to Canada, the US, and elsewhere in the last few weeks is hardly encouraging for potential foreign investors.³²

Furthermore, the war in Afghanistan and Pakistan's status as a frontline state against terrorism create fears of instability among foreign investors. Other important factors for the declining trends in Pakistan's FDI include: the East Asian financial crisis of 1997; economic sanctions and the freezing of foreign currency accounts after the May 1998 nuclear tests; crises with the independent power producers (IPPs),³³ particularly the way these issues were handled by the Sharif government; the low level of foreign exchange reserves and threat of default on external payment obligations; and disarrayed and unstable relations with international financial institutions.³⁴

On November 24, 1997, the Sharif government launched a new investment policy. It was aimed at improving the business environment and opening up new sectors to foreign investment. Until then, only the manufacturing sector, which accounts for 20 percent of the GDP, was open for foreign investment. However, the new policy opened up for foreign investment in other sectors like infrastructure, housing and real estate, agriculture, health and education, and wholesale and retail trading.³⁵ Furthermore, the government extended tax

and tariff concessions to foreign investors in these areas. In addition, foreign investors were granted immunity from disclosing the sources of their capital and all the local and foreign investors were granted exemptions from customs duties and sales tax on imports of machinery not manufactured in Pakistan. The new policy divided the industry into four categories—value-added or export industry, high technology, priority, and agriculture-based.³⁶ The government hoped to attract at least \$5 billion in private foreign investment in the following three years as a result of this policy. However, political instability and perceptions of rising violence remained as deterrents to investors, as do lackluster macroeconomic conditions. Moreover, the investment policy violated the terms of the agreement signed with the IMF, under which no tax holidays or exemptions were to be granted.

The total foreign investment during the 1996–97 fiscal year was \$950 million, a 27.3 percent decrease from the previous year's level. Of this, FDI accounted for only \$682 million, compared with \$1.1 billion in the previous year.³⁷ Despite the efforts of the Sharif government, foreign investors did not respond to the government incentive program designed to appeal to them. The then US ambassador to Islamabad, Thomas Simon, highlighted impediments to capital flow, citing “frequent reviews of power generation policies of the government, frequent changes in the policy planning, a bad law and order situation, and uncertainties at the macro-economic level.”³⁸

The most important event regarding foreign investment during the Sharif regime was the prime minister's attack on the independent power producers (IPPs). The government's main charge was that IPPs were offered high power supply rates and profit margins because Benazir Bhutto and her husband Asif Ali Zardari took commission and kickbacks from the companies involved. As a result, Sharif claimed that Water and Power Development Authority (WAPDA)—which is obligated to buy power from IPPs—is facing bankruptcy because it cannot afford to buy private power at the prohibitive rates negotiated with them.

A second event that had a major impact on foreign investment in Pakistan was the nuclear tests of May 1998. Following the tests, the Sharif government announced the freezing of all domestic and foreign exchange accounts. These accounts were worth around \$11 billion, of which \$7 billion belonged to resident Pakistanis, \$2.5 billion to non-resident Pakistanis, and \$1.5 billion were institutional swap funds with private sector banks.³⁹ Sharif argued that with external reserves of only \$1.3 billion, he could ill-afford a potential run on foreign currency deposits following a loss of confidence caused by the sanctions. However, this decision of the government backfired and had two repercussions. First, the decision pushed the rupee/dollar exchange rate from PRs 46:\$1 to PRs 49:\$1. Second, foreign exchange remittances by expatriate Pakistanis plunged from an average of about \$4 million a day to under \$1 million a day, leading to a rapid decline in reserves.

Furthermore, foreign investment was also affected by the “Kargil crisis” between India and Pakistan in 1999. The crisis created an environment of instability in the South Asian region due to the imminent threat of war between India and Pakistan. Foreign investors were particularly concerned with the situation, putting their investment decisions on hold. This is evident from the fact that during fiscal year 1998–99, foreign direct investment in Pakistan totaled just \$296 million, compared with \$436 million in the previous fiscal year. Thus, the major factors for decline in foreign investment in Pakistan during fiscal 1998–99 were the IPPs dispute, the nuclear tests, and the Kargil crisis. Furthermore, the imposition of certain foreign exchange controls and delays in processing foreign exchange demands also caused problems for foreign companies invested in Pakistan.

Faced with these crises, the government of General Musharraf successfully tackled the issue of improving the atmosphere for foreign investment in the country. It resolved issues with the IPPs, negotiated a softening of economic sanctions with the United States, and improved Pakistan's credibility with the IFIs. On December 15, 1999, Shaukat Aziz, Pakistan's finance minister, announced specific measures to restore business confidence. The salient features were:

- All existing tax exemptions were to be withdrawn in the June 2000 budget.
- The tax was to be simplified in the June budget by stressing transparent and voluntary self-assessment schemes.
- A retail General Sales Tax (GST) and agriculture income tax were to be imposed in the June budget.
- Foreign exchange remittances of profit, dividends, and royalties were once again to be allowed without prior permission of the State Bank of Pakistan.
- Central excise duty was withdrawn on credit card and other business transactions.

- Only foreigners were to be allowed to open foreign exchange deposit accounts in local banks in an effort to assist the dollarization of the economy.
- Foreign exchange bearer certificates were discontinued and income tax immunities available to government bondholders were withdrawn in order to stop money laundering.
- Tax rates on government securities and bonds were cut.
- Pakistan's Euro-bond debt was successfully rescheduled.⁴⁰

In early 2001, the government successfully resolved its dispute with Hub Power Company (HUBCO). This was a welcome step, and since then the flow of foreign investment into the country has increased. This improvement was particularly encouraging given that it is an accepted fact that raising foreign investment from a low and declining path to a higher and sustainable path is a daunting task. The flow of foreign investment does not increase overnight. Foreign investment stood at \$475 million in 2001–02, higher than the \$403 million figure of 1998–99. Details of Pakistan's foreign investment performance are presented graphically in Table 1.4 below.

Table 1.4: Foreign Investment

Year	Foreign Investment (US\$ million)
1995–96	1307
1996–97	950
1997–98	823
1998–99	403
1999–2000	543
2000–01	182
2001–02	475
2002–03	1000

Source: Ashfaque Hasan Khan, "Economic Performance during 1999–2002," Ministry of Finance, Government of Pakistan, http://www.finance.gov.pk/summary/99_2002.pdf, 24.

Ten main factors—which might be called the ten checkpoints or "Ten Commandments"—govern a country's ability to attract foreign investment. In the case of Pakistan during the 1990s, all these factors were lacking or were weak in some way. These factors are:

- 1) Political stability
- 2) The law and order situation
- 3) Economic strength
- 4) Government economic policies
- 5) Government bureaucracy
- 6) A positive local business climate
- 7) Physical infrastructure
- 8) Quality of labor force
- 9) Quality of life

10) Welcoming attitude⁴¹

Substantial improvement in the above-mentioned factors occurred during the government of General Musharraf. The military government pursued sound economic policies, which restored macroeconomic stability in the country. This led to improvement in the country's credibility among international donors and restored foreign investor confidence. Consequently, foreign investment increased in Pakistan. But, in order to compete with the other developing countries in the areas of foreign investment, Pakistan must continue improvement in each of these areas.

Foreign Trade

There exist strong relationships between export growth and overall economic growth, in general, and manufactured export growth and overall economic growth, in particular. Those countries that have been most successful in expanding their manufactured exports have not only achieved higher economic growth, but also succeeded in alleviating poverty. This has indeed been the case in East Asia. Pakistan's exports fluctuated widely during the last fifty years. Exports received little or no attention during the 1950s, registering an average decline of 5.7 percent per annum. Exports recovered in the 1960s and grew at an average rate of 10.7 percent per annum. The 1970s witnessed acceleration in export growth, to an average rate of 22.3 percent.⁴² The 1980s and the 1990s then saw a decline in export rates in comparison with the 1970s.

When viewed against the experiences of many successful developing countries, Pakistan's export performance during the 1990s has been lackluster.⁴³ The main reason for this is that, unlike many East Asian countries, Pakistan has not adopted an effective trade liberalization regime. Another reason for the fluctuating export rate has been the variation in agricultural production, which is largely dependent upon weather conditions. The decline in agricultural production not only affected exports, but also had a great bearing upon the manufacturing sector. Furthermore, changing geo-strategic conditions after the September 11 terrorist attacks greatly affected exports. For example, the war on terrorism in Afghanistan made Pakistani exports vulnerable, and the continuous tension and threat of war with India has similar effects. For these reasons, Pakistan's trade deficit has remained and continues to be among the most important areas of concern for successive governments.

When Sharif became prime minister in 1997, he introduced tariff reforms. These reforms were aimed at the liberalization of the economy. Furthermore, these reforms provided for tariff cuts on imports, reducing the top rates for customs duties from 65 percent to 45 percent. Automobiles were the only exception where the previous rates remained in force. Duties on imported machinery for industry were also fixed at standard 10 percent. These tariff reforms were aimed at achieving three objectives:

- 1) To discourage smuggling, estimated to cost the Pakistani economy at least PRs 100 billion (~\$2.5 billion) annually
- 2) To force industry to become more competitive
- 3) To meet part of the requirements put forward by the IMF for gaining new loans⁴⁴

On July 17, 1997, the then commerce minister, Ishaq Dar, unveiled an ambitious new trade policy to increase exports from \$8.26 billion in 1996–97 to \$9.58 billion in 1997–98, and to reduce the merchandise trade gap from \$3.4 billion in 1996–97 to \$2.3 billion in 1997–98.⁴⁵ The new trade policy also reduced the interest rate for exporters, whereby 50 percent of the admissible duty drawbacks to exporters will be paid within three days of presentation of the documents; and import duties on a host of raw materials for export of finished goods were reduced or eliminated altogether. The import of a few items like chilies and pharmaceuticals were allowed from India. Furthermore, the new trade policy removed the restrictions on importation of gold and silver. Sales tax exemptions were granted to imported raw materials and components to be used by the export suppliers against international tenders.

According to Ishaq Dar, as a result of this trade policy, exports rose by 5 percent in dollar terms in the first seven months of fiscal year 1997–98, while imports contracted by 8 percent. Consequently, the merchandise trade gap narrowed by about \$780 million in the first seven months of 1997–98.⁴⁶ However, the narrowing trade gap was not all good news. Falling machinery imports suggest that industrial growth remained lackluster, while the contraction in the petroleum bill reflected a softening in international oil market prices.

On June 15, 1998, the government introduced its trade policy for fiscal year 1998–99. The main purpose of the policy was to reduce the trade deficit by increasing exports and reducing imports. In the new policy, the export target was set at \$10 billion, up by 17.6 percent compared with an estimated \$8.5 billion in the last financial year. The imports for 1998–99 were projected to remain at approximately the same level as the prior year, i.e. \$10.05 billion, thereby eliminating the merchandise trade deficit in 1998–99. The government claimed that it would achieve its export goals by “improving and modernizing export incentives” and “strengthening institutional export mechanisms” for its export regime. Among the export incentives offered were:

- Exporter refund claims were to be settled within thirty days.
- Export refinance funds for at least PRs 25 billion (\$570 million) were made available by the State Bank of Pakistan (SBP) at 8 percent interest instead of the existing 11 percent interest rate.
- Companies classed as export processing units (those exporting 70 percent of their production) were allowed to import inputs without payment of customs duties.
- A ban on exports of fifteen particular items was lifted.⁴⁷
- The private sector was allowed to export coke, rock salt, and caustic soda which were previously exportable by the public sector only.
- Restrictions on export quotas were lifted on maize, grains, soda ash, breeding camels, native birds, and cement.⁴⁸

The trade policy also introduced certain measures for rationalizing the import regime. The main features of these measures have been given below:

- Import duties on gold were to be reduced by 40 percent.
- Import of scrap plastic was banned.
- Import of diagnostic/testing/analytical equipment was allowed to non-resident Pakistanis paying in foreign exchange.
- Import of second-hand machinery, except computers, was banned.
- Maximum import duties on many items were reduced from 45 percent to 35 percent.⁴⁹

According to the Federal Bureau of Statistics (FBS), exports fell by 10.5 percent in the fiscal year 1998 to \$7.72 billion from \$8.63 billion in 1997. Meanwhile, imports contracted by 8.2 percent, from \$10.12 billion to \$9.29 billion, causing the trade deficit to widen slightly by \$79 million to \$1.57 billion.⁵⁰

According to the IMF’s “International Financial Statistics” report, merchandise exports rose by 6 percent in the first half of 1999, from PRs 190 billion to PRs 202 billion. Imports, however, rose by nearly 23 percent from PRs 206 billion to PRs 252 billion. In dollar terms, exports fell by 0.7 percent, year to year, while imports rose by almost 15 percent.⁵¹ Petroleum products and machinery dominated imports, while the main exports remained cotton fabric and rice.

In 2001, the military government of General Musharraf took two important measures in the area of foreign trade. These measures were to explore different markets and diversify trade and, secondly, to reduce imports. In the area of trade diversification, Pakistan improved its trade ties with different countries. Some results, even if small, were evident: Pakistan’s exports to China went up by 75 percent; to the United Arab Emirates (UAE) and Saudi Arabia by 25 percent each; to Bangladesh by 20 percent; to Indonesia by 161 percent; and to Korea and Australia by 9 percent each.⁵² Other than the UAE and Saudi Arabia, all other countries are referred to as non-traditional markets in the context of Pakistan’s previous export patterns. Furthermore, efforts were made to improve trade relations with Kenya, Nigeria, and Syria. In addition, the military government provided the following incentives to exporters:

- Exporters who posted at least a ten percent growth over the prior year’s exports were allowed to retain 50 percent of the additional exports in their local foreign currency account. They could use this amount for the purchase of machinery, equipment, raw materials, and payment of commissions and promotional expenses.
- Export development charges were waived on additional exports.

- Exporters who demonstrated better performance were given monetary rewards. An “incentive scheme” that sought to reward three categories of exporters (large, medium, and small) for increases in overall exports, entering new markets, value addition, etc., was devised. An amount of PRs 2 billion was allocated for this project.⁵³

With regard to trade liberalization, on June 30, 2002, the maximum trade tariffs were reduced from 30 percent to 25 percent.⁵⁴ The government established three tariff categories with duty rates of 25 percent, 15 percent, and 5 percent. However, Pakistan’s trade policy in 2002 continued to ban thirty items, mostly on religious, environmental, security, and health grounds. Automobiles continued to face high duties ranging between 80 percent and 200 percent. But there remains a great need to continue efforts for trade liberalization and diversification of exports for the economy’s improvement. As a result of these measures introduced by the government, Pakistan’s exports reached \$9 billion in 2000–01 for the first time ever. Imports remained stable at \$10 billion in the same period, thereby reducing the trade deficit. Details of Pakistan’s imports and exports since 1990 are given below in Table 1.5.

Table 1.5: Foreign Trade (US\$ million)

Year	Exports	Imports	Trade Deficit	Trade deficit as % of GDP
1990–91	6131	7616	1488	3.3
1991–92	6904	9252	2348	4.8
1992–93	6813	9941	3128	6.1
1993–94	6803	8564	1761	3.4
1994–95	8137	10394	2257	3.7
1995–96	8707	11805	3098	4.9
1996–97	8320	11894	3574	5.7
1997–98	8628	10118	1490	2.4
1998–99	7779	9432	1653	2.8
1999–2000	8569	10309	1740	2.8
2000–01	9202	10729	1527	2.6
2001–02	9135	10340	1205	2.0
2002–03	11,160.3	12,220.3	1060	-

Source: Ashfaq Hasan Khan, “Economic Performance during 1999–2002,” Ministry of Finance, Government of Pakistan, http://www.finance.gov.pk/summary/99_2002.pdf, 23. See also State Bank of Pakistan, Economic Data, <http://www.sbp.org.pk/ecodata/eimports.pdf>.

Summary of Pakistan’s Macroeconomic Performance

In recent years, Pakistan has made considerable progress in achieving macroeconomic stability. There has been a considerable improvement in all the macroeconomic indicators. It is evident from the primary budgetary surplus; reduction of quasi-fiscal deficits; turnaround in the current account deficit to a surplus; improvement in tax collection; renewed export growth rate; lowering of the inflation rate; increase in the GDP growth rate; reasonable amount of foreign exchange reserves; decline in trade deficit; and reduction in external debt of the country. In addition, monetary aggregates have been contained, the exchange rate has been stabilized, and worker remittances have been improved significantly. The risk of default on external debt, which loomed large on the horizon in 1999 and 2000, has been mitigated and the country’s capacity to service its restructured debt has improved. However, the economy of Pakistan is still at the take-off stage and faces many daunting

challenges. Poverty and unemployment are still high, posing serious challenges to the policy makers in Islamabad. The government of Pakistan has launched a poverty alleviation strategy with the help of the IMF and the World Bank; still, 33 percent of the people live below the poverty line. The rising population and lack of employment opportunities create persistent unemployment problems in the country. In addition to unemployment, underemployment is even higher in the country. There is a need to devise a comprehensive employment strategy to tackle this gigantic problem. For the purpose of brevity, the performance of the major macroeconomic indicators is given below in Table 1.6.

Table 1.6: Changes in Key Macroeconomic Indicators

	October 1999	June 2003	Change in the Indicator
GDP Growth Rate	4.2 %	5.1 %	Positive
Inflation	5.7 %	3.3 %	Positive
Fiscal Deficit/GDP	-6.1 %	-4.0 %	Positive
Current Account/GDP	-3.2 %	+ 7.1 %	Positive
Domestic Debt/GDP	52.0 %	43.4 %	Positive
External Debt	\$37 billion	\$35 billion	Positive
Remittances	\$88 million per month	\$350 million per month	Positive
Exports	\$7.8 billion	\$11.1 billion	Positive
Tax Revenue	PRs 391 billion	PRs 460 billion	Positive
Rupee-Dollar Parity	Depreciating	Appreciating	Positive
Foreign Direct Investment	\$472 million	\$800 million	Positive
Foreign Exchange Reserves	\$1.6 billion	\$9.9 billion	Positive
Poverty Incidence	33 %	Data not available but perhaps rising	Negative
Poverty Related Expenditure	PRs 133 billion	PRs 161 billion	Positive
Unemployment	6 %	8 %	Negative

Source: Ishrat Husain, "Economy of Pakistan: Past, Present and Future," a paper presented at the seminar on Pakistan Ideology held by Pakistan Study Center, University of Sindh, at Karachi on August 12, 2003, [http://www.sbp.org.pk/about/speech/2004/eco_of_pk\(past_present_future\).pdf](http://www.sbp.org.pk/about/speech/2004/eco_of_pk(past_present_future).pdf).

Having described the macroeconomic performance of Pakistan during the last six years (1997–2003), in the next part an attempt will be made to analyze the role of the IMF and the World Bank in the economy of Pakistan. The role of the IMF and World Bank has been crucial in the macroeconomic stability of Pakistan from 1997–2003 for a variety of reasons. These institutions provided assistance to Pakistan in carrying out its reform programs. The IMF has helped Pakistan in achieving balance of payments stability and fighting poverty, the two major macroeconomic indicators. Meanwhile, the World Bank has supported the government in restructuring the economy by supporting the structural reforms taken by the military government. In addition, the World Bank has supported the government's good governance reforms and provided material and technical support to carry out financial sector reforms in the country. As a result of the improved relations between the IMF, the World Bank, and Pakistan, the IFIs have increased their assistance to Pakistan.

PART TWO

Pakistan, the IMF, and the World Bank

The International Monetary Fund (IMF) and the World Bank (WB) were created in 1944 under the Bretton Woods agreement as institutions to promote economic and financial cooperation among member countries. These sister organizations perform different functions. The IMF is concerned with macroeconomic issues like balance of payment adjustments and poverty. It has a competent and experienced cadre of economists, a wealth of international and country-specific knowledge acquired over time, and research capability to advise on macroeconomic policies. The World Bank is concerned with structural reforms, reconstruction, and development programs in WB member countries. It focuses on issues such as privatization, governance, civil service, the financial sector, and human development, and—similar to the IMF—has “intensive country specific knowledge and continuous presence in the country.”¹

The experience of developing countries with IMF and World Bank involvement in their economies has shown mixed results. The proponents of these institutions argue that IMF and World Bank assistance is necessary in solving the economic problems of the member countries. They assert that a country unable to solve its own economic problems requires external involvement in order to keep its economy afloat. But opponents of the IMF and World Bank roles in the economies of developing countries make a case that these institutions have created more problems for the member countries than they solve, condemning their failure to alleviate poverty. They argue that these institutions are politicized and in turn make decisions based on political considerations, rather than on the economic conditions of particular member countries.² They especially criticize the “conditionalities” that these institutions attach to loans to debtor countries.³ To them, these conditionalities are a major impediment to human development in the member countries, because they emphasize large-scale cuts in such expenditures. They argue that conditionalities are often self-contradictory and complicate the economic environment of member countries. Pakistan is a case in point. “On the one hand, the IMF and the World Bank expect Pakistan to do much for the alleviation of the poverty, whose one manifestation is a high rate of unemployment, and are ready to fund such efforts, and on the other, they insist on downsizing and rapid privatization of public sector enterprises along with deep cuts in public spending.”⁴ Furthermore, opponents criticize the IMF and World Bank for pushing Pakistan to adopt the “Washington Consensus” agenda that emphasizes economic liberalization and deregulation of the economy, compounding its economic problems.

Multilateral lending institutions have played a major role in providing both financial and policy advice to Pakistan over the last half-century. Pakistan resorted to IMF- and World Bank-led programs to cope with the debt crisis of the 1980s. There was heavy involvement by the IMF and World Bank in the design of economic reforms and adjustment programs undertaken after 1988.

In the 51 years since 1952, the International Bank for Reconstruction and Development and the International Development Agency, both World Bank agencies, have approved 84 loans and 119 credits for Pakistan amounting to \$6.97 billion and \$7.71 billion respectively. The World Bank has funded another \$1.23 billion in 15 main projects, of which \$416 million remains to be disbursed.⁵

These programs have so far fallen short of resolving Pakistan’s economic problems. Poverty has increased in Pakistan, rather than declined. External debt has increased since the IMF and World Bank became involved in Pakistan. Unemployment increased in the country as a result of a downsizing policy adopted by the government under the guidelines of these institutions. This part is divided into two sections, which examine the role of the IMF and the World Bank, respectively, in Pakistan’s economic development.

Pakistan and the IMF

The IMF, directly and indirectly, has played a crucial role in the macroeconomic stability of Pakistan since 1988. On the one hand, it has provided direct bilateral support to Pakistan in order to cope with its macroeconomic imbalances like balance of payment deficits. On the other hand, the IMF has indirect influence on lending by other donor agencies. This is evident from the fact that whenever Pakistan enjoyed good relations with the IMF, other lending agencies also provided money to Pakistan and vice versa. The IMF credit rating of a borrowing country is taken very seriously by other donor agencies. The IMF also influences policies of lending countries to a great extent. According to Dr. Ishrat Husain:

The IMF enjoys excessive concentration of power and has a virtual monopoly of knowledge and ideas in prescribing as to what are the right policies a country ought to follow. It has disproportionately large influence on financing provided by other players—development banks, fund managers, debt relief by Paris and London Clubs and syndicate lending by commercial banks...A negative assessment by the IMF or even a failure to complete on time places the reputational capital of the borrowing country at great risk, erodes its credibility in the financial markets and reduces financial flows into the country. There are instances where this created a snowball effect amplifying the disequilibrium in macroeconomic balances as the IMF and other financiers collectively withheld their assistance.⁶

Since 1988, Pakistan has not enjoyed smooth relations with the IMF, because of the latter's dissatisfaction with the economic performance of Pakistan. Pakistan signed several agreements with the IMF, but due to a variety of factors most of them remained incomplete, with the IMF refusing to lend the full amounts to Pakistan. It must be remembered that in the 1990s, the nation suffered many losses on the economic front and the era is thus considered a "lost decade" for the economy of Pakistan. All macroeconomic indicators showed poor performance, bringing Pakistan to the brink of default. Moreover, the IMF's relations with Pakistan were further strained by 1997 due to the policies of former Prime Minister Benazir Bhutto. Large-scale corruption by her People's Party and its resistance to structural reforms irritated the IMF and World Bank.

The Sharif Government

When the new government of Nawaz Sharif took office in 1997, positive relations were somewhat revived between the IMF and the government of Pakistan. As a result of previous negotiations, the IMF had already resumed its assistance to Pakistan, agreeing to restore a stand-by loan program in December 1996 after a six-month halt. It also increased the total of these loans to \$831 million from the original \$600 million.⁷ However, the resumption of IMF lending brought new conditionalities and forced large-scale budget cuts of PRs 45 billion (\$1.13 billion) between October 1996 and January 1997. Almost 90 percent of these cuts were in the annual development budget, which affected economic performance in the short run. In March 1997, relations with the IMF again worsened. The breakdown in the relations stemmed from IMF concern over Pakistan's economic performance. The IMF was particularly concerned with "the large increase in official rupee borrowings from domestic banks during the current fiscal year (July 1996–June 1997), which rose to PRs 73 billion (\$1.8 billion) by end-March 1997, up from a target of PRs 44 billion (\$1 billion) for the whole fiscal year, and the burgeoning budget deficit, which was expected to reach 6 percent of GDP at the end of the fiscal year ending in June 1997, against an earlier target of 4 percent."⁸

The relationship between the IMF and government of Pakistan brightened when Sharif promised to introduce economic reforms to the country. The reforms included "cuts in the top rate of import tariffs by 20 percent, bringing them down to a maximum of 45 percent. He also lowered personal income tax rates across the board. Corporate tax rates for publicly listed companies were lowered to 30 percent, down from 33 percent, rates for non-listed companies to 35 percent from 43 percent and for banks to 55 percent from 58 percent."⁹ Furthermore, the reforms emphasized a reduction in the general sales tax to a maximum rate of 12.5 percent from 18 percent and 3 percent tax on retail units. The purpose of these reforms was to improve tax collection and reduce the budget deficit to meet the 4 percent of GDP target in the fiscal year 1997–98, compared with the unfavorably viewed 6 percent deficit in fiscal year 1996–97. The IMF appreciated the reforms, but concluded that only after successful implementation of reform measures and accompanying macroeconomic improvements would the fund consider renewing its concessional Enhanced Structural Adjustment Facility (ESAF) and Extended Fund Facility (EFF) with Pakistan.¹⁰

On October 20, 1997, Pakistan reached an agreement with the IMF for a three-year, \$1.6 billion Structural Adjustment Loan (SAL) package. About \$935 million was committed to an ESAF, a concessional loan bearing interest of only one-half percent aimed at supporting a medium-term reform program. The first disbursement worth \$208 million occurred in October 1997.¹¹ This loan package also provided crucial balance of payment support at a time when export growth was lackluster, foreign exchange reserves were below \$1.3 billion, and external debt was high.

At the beginning of 1998, the IMF agreed to give Pakistan the second disbursement (worth another \$208 million) of the \$1.6 billion SAL agreed to the previous October. This was made possible by hard negotiations and last-minute pledges by the government to adhere to the tough conditionalities attached to the loan. These included, among many others, an emphasis on reduction of the budget deficit, improving access of foreign

investors to the oil and gas sector, and the imposition of a Goods and Services Tax (GST), and the privatization of public sector organizations.

However, the government failed to impose the 3 percent sales tax on selected retail trade that continued to figure high on the IMF's list of conditionalities, which created resentment among IMF officials. At the beginning of 1999, the IMF agreed on the renewal of its lending program, paving the way for short-term stabilization with a Balance of Payments (BOP) loan. Under the new package, Special Drawing Rights (SDR) of \$575 million were immediately disbursed. This included a \$37.9 million SDR installment under the concessional ESAF, an \$18.97 million SDR extended arrangement under EFF, and a \$352.7 million SDR under the Compensatory Contingency Finance Facility (CCFF).¹² The ESAF/EFF loans were made on comparatively soft terms as part of the restored \$1.6 billion SAL program agreed to by Pakistan and the IMF in 1997. The CCFF was extended on commercial terms to compensate for shortfalls in export earnings in 1998. These packages constructed by the Fund were accompanied by tough economic performance targets for Pakistan for 1998–2001, including:

- Doubling of the GDP growth from the 3-4 percent range to 5-6 percent
- Halving of the current account deficit from 3 percent of the GDP in 1998–99 to less than 1.5 percent in 2001–02
- Reducing inflation from about 9 percent to 6 percent in 2001–02
- Increasing the rate of domestic savings from 12 percent of GDP to 16 percent
- Stabilizing the ratio of public debt to GDP¹³

The IMF, in pursuance of the above-mentioned targets, asked Pakistan to tackle several long-standing structural problems as well as rescind some recent policy changes. The immediate policy requirements included:

- Further phased reduction in electricity rates
- Unification and devaluation of the exchange rate
- Imposition of a Goods and Services Tax (GST) on services, petroleum, electricity, and agricultural inputs
- Broadening of the tax base
- Restructuring of public sector enterprises in preparation for privatization
- Reduction of the government payroll through massive staff reduction¹⁴

In May 1999, relations between the IMF and Pakistan again soured. The IMF sent a five-member commission to Islamabad to review the economic performance of the country. The commission reported that the government of Pakistan had failed to meet several IMF conditionalities. Disputes over the pricing of electricity were complicated by continuing conflict over how to resolve charges of past corruption and rate-gouging during the Bhutto government. The government pledged that it would apply a flat-rate GST before March 31, 1999 in order to boost revenue and reduce the fiscal deficit; instead, it abandoned plans to impose a GST on retail trade. Furthermore, Pakistan also delayed settling its dispute with the Independent Power Producers (IPP).¹⁵ Consequently, the IMF postponed the release of a \$280 million disbursement to Pakistan, which was due in July 1999, because of noncompliance by the government with IMF conditionalities.

Sharif's government failed to meet IMF conditionalities throughout its tenure (1997–99). Negative international reaction to the 1998 nuclear tests only aggravated an already difficult financial situation. The growth rate of the economy remained below the target. Pakistan's fiscal deficit also remained above the target, as the government was unable to control non-developmental expenditures. Despite the budget deficit remaining high, the government was unable to implement the 15 percent GST on all goods, including agriculture. Furthermore, privatization and deregulation of the economy remained an unfulfilled dream given Sharif's earlier support for privatization, as most of the public sector remained under the control of government. As a result, the relationship between the IMF and Pakistan remained tense.

The Musharraf Government

After the October 12, 1999 military coup, Pakistan's economy continued in crisis. In the initial days of General Pervez Musharraf's government, the international community suspended assistance to Pakistan and imposed coup-related sanctions on the country. The IMF was no exception, likewise suspending aid to Pakistan. The restoration of economic assistance was made conditional on the restoration of democracy in the country. However, this public stance soon changed. As a result of a meeting between General Musharraf and the US ambassador to Pakistan, William Milam, the United States indicated it would likely support further IMF aid, if General Musharraf continued to recognize certain elements of democracy, such as human rights and press freedom.¹⁶ The Musharraf government, from the beginning, appealed to the IMF for restoration of economic assistance and showed its willingness to meet the associated conditionalities.

The IMF responded by noting a number of key conditionalities it required of Pakistan in order for the new government to demonstrate good faith. Even if these actions were taken, IMF management only recommended a ten-month Stand By Agreement (SBA) for Pakistan and the resumption of the medium term ESAF/EFF program.

Around a year after the military government of General Musharraf took power in Pakistan, the Executive Board of the IMF approved a Stand-by-Credit of \$596 million. The program was to run until the end of September 2001, supporting the government's economic program for 2000–01. The SBA was focused on moving Pakistan to high, sustainable growth by strengthening its balance of payments position, building reserves, and reducing public sector indebtedness.¹⁷

At this critical period in the economy of the country, Pakistan was left with very few options, as default on its external debt appeared quite imminent. Thus, an agreement with the IMF was essential in order to obtain rescheduling of Pakistan's Paris Club debt. The government paid a heavy price for reestablishing the country's lost credibility and was forced to take some immediate and very tough measures. Fulfillment of these requirements triggered approval of the SBA by the IMF board. Subsequently, the government implemented an equally tough set of additional measures to meet the performance criteria and structural benchmarks during the next ten months.

IMF conditionalities for Pakistan under the SBA included:

- The GST was to be extended to agriculture by the end of 2001
- The GST was to be implemented by retail outlets with turnovers in excess of PRs 5 million
- The budget deficit was to be reduced from 6.4 percent of GDP to 5.2 percent of GDP
- Petroleum prices was to be adjusted in line with international market changes
- The number of tariff steps was to be reduced from 5 to 4 in July 2001, to 3 in January 2002, and the maximum import tariff from 35 percent to 30 percent by June 2001, and to 25 percent by June 2002

The SBA was fully implemented and all the allotted funds were disbursed. Pakistan addressed most of the conditionalities and met the IMF targets. As a result, relations between the IMF and government of Pakistan improved and the IMF approved a three-year Poverty Reduction and Growth Facility (PRGF) loan to Pakistan in December 2001 to help fight poverty. The PRGF is a package initially valued at \$1.3 billion. So far, this program is going well and, as of September 2003, Pakistan had received six (totaling \$738 million) out of a scheduled twelve disbursements.¹⁸

Elected civilian governments in Pakistan since 1988 had resisted IMF conditionalities and reforms. This was one of the main reasons behind the lack of a cordial relationship with the IMF. According to Dr. Ishrat Husain, the military government of General Musharraf implemented unpopular reforms because:

- The country was on the verge of serious financial crisis and the new government had assumed power with a commitment to avert this crisis
- These reforms fitted in well with the strategic vision of President Musharraf
- The team of technocrats commissioned to carry out the reforms possessed the requisite capacity and commitment to design a home-grown program

- An improved governance structure facilitated the reform process
- Stakeholder consultation provided a vehicle to broaden ownership in the formulation of the Poverty Reduction Strategy Paper (PRSP).¹⁹

The reforms suggested by the IMF during the Musharraf government revolve around correcting the arrears of fiscal prudence; reducing indebtedness; competitively pricing outputs, inputs, and public utilities; widening and strengthening tax administration; removing concessions, exemptions, and privileges; extending a level playing field to all economic agents; instituting greater reliance on market mechanisms, rather than administrative discretion, in allocation of resources; and privatizing state-owned banks, energy companies, and other large enterprises.

A summary of IMF assistance to Pakistan during the period 1997–2003 is given below in Table 2.1.

Table 2.1: Pakistan and the IMF, 1997–2003

Regime	Period	Program Type and Agreed Amount (in US\$ million)	Amount Drawn (in US\$ million)	% Undrawn
Benazir Bhutto / Meraj Khalid / Nawaz Sharif	Dec. 95–Mar. 97 (Sept. 97)	SBA 562	295	48
Nawaz Sharif	Oct. 97–Oct. 00 (May 1999)	ESAF 682	265	61
	Oct. 97–Oct. 00 (May 1999)	EEF 455	113	75
Pervez Musharraf	Nov. 00–Sept. 01	SBA 465	465	0
	Dec. 01–2004	PRGF 1,410	6 disbursements out of 12 total	Currently in process

Sources: Ishrat Husain, “Pakistan and the IMF: 1988–2002,” <http://www.sbp.org.pk/about/speech/2002/2-Jul-02.pdf>; IMF, “IMF Completes Fourth Review of Pakistan’s PRGF-Supported Program, Approves US\$118 Million Disbursement to Pakistan,” <http://www.imf.org/external/np/sec/pr/2003/pr0326.htm>.

As shown by Table 2.1, Pakistan entered into a number of different agreements with the IMF. Except for the Musharraf government’s Stand-by Agreement (SBA), these were not fully implemented and consequently almost half of the agreed amount remained undrawn. There are many reasons for this. First, the IMF’s dissatisfaction over the economic performance of Pakistan in the 1990s and the unwillingness on the part of civilian governments to implement the conditionalities was the major cause of undrawn funding. Second, political instability in the country in the 1990s was an important cause of the breakdown in the relationship between the IMF and Pakistan, leading to disruption in the continuity of economic policies. Third, efforts to correct economic mismanagement and political corruption in Pakistan were seen with skepticism in IMF circles. As explained in Part One of this paper, the elected civilian governments were involved in corruption and failed in all areas of economic management. The fourth hypothesis can be termed what Dr. Ishrat Husain called the “Blame the IMF syndrome.” According to Dr. Husain:

The proponents of this hypothesis argue that the diagnosis of the economic problems carried out by the IMF staff is partial and incomplete. As they do not have any grounding in the specific political realities or awareness of the institutional capacity, their technical analysis is sound but does not capture the full feasibility of implementation of reforms. More damaging is the indictment that the design of the

program is driven too much by dogmatic and ideological agenda of the Washington Consensus, i.e., liberalization, privatization, and deregulation. The IMF holds a uniform set of universal economic precepts to be valid across countries and the initial conditions, market imperfections, structural rigidities, immobility of factors, and other peculiar features of developing economies do not seem to figure in the design and formulation of the programs.²⁰

Indeed, the critics of IMF-led programs in the member countries argue that this institution adopts a uniform set of policies across the countries irrespective of the diverse economic conditions of countries across the globe. “The conditionalities enforced on countries as diverse as Rwanda and the Philippines are broadly similar, regardless of particular specificity or local conditions,” asserts one journalist.²¹ Opponents of IMF involvement in Pakistan argue that the “one size fits all” formula of the IMF has complicated economic problems of the debtor countries, instead of solving them.

The question that comes to mind is why did successive governments in Pakistan opt for the IMF programs? The reasons, in the opinion of Dr. Ishrat Husain, are as follows:

- To obtain the financial resources for resolving the balance of payment problems
- To secure access to funds from other financial institutions and bilateral donors
- To obtain a “seal of approval” for seeking commercial and export credit facilities
- To shift the blame for some politically unpopular decisions to external pressures and compulsions
- The desire of reformist economic managers to restrain and block the pursuit of populist policies of political leaders
- In the post-1998 period, to pursue debt relief and rescheduling²²

It can be concluded that political instability, economic corruption, large-scale budget deficits, balance of payment deficits, and increasing debt led to Pakistan’s engagement with the IMF after 1988. The IMF provided different loans to Pakistan, all of which were accompanied by conditionalities. Most of the time, civilian governments resisted these conditionalities, causing a souring of Pakistan’s relationship with the IMF. The relationship between Pakistan and the IMF improved after the 1999 coup, when General Musharraf took over the government. The main reason for this improved relationship was the military government’s willingness to implement the IMF-imposed reforms.

Pakistan and the World Bank

Unlike the IMF, which provides only temporary balance of payments support, the World Bank (WB) provides long-term development assistance. While the IMF focuses on fiscal adjustments and macroeconomic framework, the WB concerns itself with issues such as trade policy, energy pricing, agriculture pricing, agricultural commodity prices, and cost recovery in agriculture. It works closely with the government on reform of the financial and banking sectors, privatization, and public sector expenditure priorities and it supports large social action programs.²³ The major functions of the Bank are to assist in reconstruction and development programs of the member countries; to promote private foreign investment by means of guarantees or participation in loans and other investments made by private investors; to promote the balanced growth of international trade; and to maintain an equilibrium in the balance of payments of member countries.²⁴

The World Bank has been the largest provider of development assistance finance to Pakistan since 1952. The WB financed around 15 percent of the public investment program in this fifty-year partnership. During this period, the WB approved 242 loans, amounting to \$13 billion, of which 146 are interest-free International Development Assistance (IDA) credits, i.e., they carry only a service charge of less than 1 percent with maturity in thirty-five years. These loans account for around 20 percent of Pakistan’s total external public debt. Over 85 percent of WB funds have been used for expanding and rehabilitating physical infrastructure in the areas of transportation; Indus Basin irrigation and drainage system; the Pakistan Water and Power Development Authority (WAPDA) and the telecommunications network; primary education and health facilities; improving the national highway system and provincial roads; water and sanitation in major cities, towns, and rural areas; improvements to the port of Karachi; gas production, transmission, and distribution; and oil production and refining. The remaining 15 percent of the loans have been in the form of balance of payment adjustment loans in support of structural reform in the following areas: the banking system; the energy sector; fiscal and financial

management; and public sector management.²⁵ The World Bank has remained actively involved in Pakistan in recent years. In 1997, the World Bank provided a loan of \$250 million, for undertaking reforms in the banking sector. The goal of the World Bank is to encourage high quality loans and to make nationalized commercial banks more efficient and profitable.²⁶

In June 1999, the World Bank approved a \$90 million credit to support the Pakistan Poverty Alleviation Fund (PPAF). Its aim is to empower the urban and rural poor by providing them access to resources and services, such as micro-credits and grants for community-oriented infrastructure and capacity-building.²⁷ This WB-financed program is considered a success and was followed with an additional pledge of a further \$368 million program announced in December 2003.²⁸ Furthermore, the WB is also assisting Pakistan in improving literacy and health facilities.

However, when General Musharraf came to power in October 1999, Pakistan's relationship with the World Bank, like that with the IMF, was also strained in the initial days. The WB initially showed reluctance to provide assistance to Pakistan. But when the military government restored some elements of democracy, the World Bank, like the IMF, likewise restored assistance to Pakistan.

The WB's assistance was on two levels. First, at the federal level, the WB aimed to support the homegrown structural reforms introduced by the military government. In June 2001, it provided a loan of \$350 million to support the government's efforts to improve the tax system and repair battered investor confidence.²⁹ This amount was delivered as a Structural Adjustment Credit (SAC). After the successful completion of SAC-I, the World Bank approved SAC-II in 2002, which also focused on supporting government efforts for structural reforms. However, the SAC programs imposed additional conditionalities on the government of Pakistan, emphasizing:

- Accelerating electric generation and distribution sector reforms with a view to restoring the sector's financial viability. In this regard, the World Bank particularly emphasized reforming WAPDA and the Karachi Electric Supply Corporation (KESC). Both organizations have faced long-term deficits and the WB has emphasized privatization of these organizations.
- Revamping the tax administration system to improve governance and increase revenues. In this context, the World Bank has supported the government in Central Board of Revenue (CBR) reforms.
- Improving the policy framework in the oil and gas sectors to attract domestic and foreign investment.
- Improving effectiveness in the delivery of social services through civil services reform, enhanced transparency, and accountability in the use of public resources.
- Accelerating implementation of education and health sector reforms.
- Establishing monitoring and evaluation systems to assess progress in implementation of the poverty reduction strategy.

Like the IMF, the World Bank also has a list of conditionalities attached to the lending. In the case of Pakistan, the World Bank conditionalities emphasized financial sector reforms and restructuring of the government.³⁰ If one analyzes the conditionalities imposed by the World Bank, it becomes clear that the WB, like the IMF, has emphasized financial discipline, "right-sizing" the government, tax reform, and privatization of public sector enterprises. The results of WB conditionalities are mixed. For example, in the power sector, the two big organizations, WAPDA and KESC, are still controlled by the government and are still operating at a deficit. In the financial sector, the WB has been more successful in imposing its conditionalities. For example, the banking sector conditionality has helped Pakistan privatize its nationalized banks.

In addition to the assistance at the federal level, the World Bank also encouraged reform of the provincial government sector. In July 2002, the World Bank approved SACs for two provinces (Sindh and North West Frontier Province) totaling \$190 million. This credit was extended to support the provincial governments in their efforts for fiscal transparency, resource management, and provision of public services by local governments and communities.³¹ Furthermore, at the provincial level, the WB assists Pakistan in community development through empowering people at the grass-roots level under a political devolution plan.

The World Bank has increased its influence in Pakistan as its assistance has increased. The WB disbursed \$1.226 billion in fiscal year 2003—the highest level ever disbursed in the history of Pakistan.³² The WB's Country Assistance Strategy (CAS) for fiscal years 2003–05 focuses on supporting Pakistan's homegrown

reforms through a program comprised of advisory and analytical services; institutional capacity building; and demand-driven lending.³³ Presently, the World Bank is supporting Pakistan in the areas of macroeconomic stability, improving the investment climate, and poverty alleviation. Details of World Bank support to Pakistan are provided in Table 2.2.

**Table 2.2: Current World Bank Lending to Pakistan (US\$ million)
Active Loans/Credits total \$1.226 billion as of June 2003**

Areas	Amount
Financial Sector	416.5
Rural Sector	306.1
Energy and Mining	350.0
Health, Nutrition, and Population	57.1
Public Sector Governance	28.8
Environment	23.1
Education	22.2
Social Development	20.0
Transport	3.0

Source: World Bank, *Pakistan Country Brief* (June 2003), <http://lnweb18.worldbank.org/sar/sa.nsf/083c4661ad49652f852567d7005d85b8/e446d9087f72838e85256b02006cbff4?OpenDocument>.

As demonstrated by Table 2.2, the major portion of World Bank support goes to the financial sector. This covers lending for banking sector reforms, accounting and auditing reform, and reform of the Central Board of Revenue (CBR). The basic purpose for such assistance is to improve the financial system in Pakistan to bring about macroeconomic stability. The WB also provides assistance in the poverty alleviation sector, which is aimed at improving the level of human development in the country. In addition, the WB has especially emphasized improved governance.

Most of the recent lending by the World Bank is meant to carry out structural reforms and institutional development in Pakistan, improving the economic environment. The financial, structural, administrative, capital market, and tax reforms undertaken in the last three years have enabled Pakistan to absorb economic shocks. According to WB Vice-President Mieko Nishimizu, “Had these reforms not been pursued, Pakistan today would have seen a higher unemployment, higher poverty and higher inflation which in turn would have impaired not only the government and its economy, but the poor man, too.”³⁴ Yet, these reforms have so far been unable to reduce poverty and generate employment in the country. These daunting tasks still remain.

A thorough and in-depth analysis of World Bank- and IMF-supported programs in Pakistan reveals mixed results. On the one hand, these programs have been helpful in bringing about macroeconomic stability in the country. WB-supported programs in Pakistan emphasize financial discipline, reduction in budget deficits, and poverty alleviation, and education and health improvements. Furthermore, the structural reforms introduced by the government under these programs have improved the governance level in the country. On the other hand, IMF- and WB-led programs have also created many economic problems for Pakistan. Critics argue that although WB- and IMF-supported programs are designed to alleviate poverty, they have in fact been exacerbating the problem because fiscal discipline has reduced government spending on social development and “right-sizing” in public sector institutions has increased unemployment. IMF and World Bank conditionalities are sometimes harsh for member countries. But as far as Pakistan is concerned, the IMF and the World Bank have been quite helpful in supporting government efforts to bring about macroeconomic stability in the country

in the 1990s. The IMF and World Bank reforms after 1999 were major factors in strengthening Pakistan's economic environment.

PART THREE

Future Prospects for Pakistan's Economy

The key to ensuring Pakistan's future macroeconomic stability lies in strengthening other institutions that can complement and support broad economic development. To quote Dr. Ishrat Husain, a leading economist and governor of the State Bank of Pakistan:

Pakistan's long term prospects will depend upon the interplay of evolution in political and social developments, economic policies to be pursued, the quality of governance and institutions, and most important investment in the human capital. It has become quite obvious from both Pakistan's own history and the experience of the developing countries that sustained economic growth and poverty reduction cannot take place merely on the strength of economic policies. Political stability, social cohesion, supporting institutions, and good governance are equally important ingredients coupled with both external environments for achieving economic success.¹

Pakistan must strive to maintain its present level of macroeconomic stability. The most important thing needed is the will power of the ruling elite and the continuity of structural reforms undertaken by the military government. The country is now on the path to macroeconomic stability and is less vulnerable to external shocks than it was a decade ago. There has been improvement in all of the major macroeconomic indicators. The growth rate of the economy, which was under 4 percent during the 1990s, has shown considerable improvement.

Governance has improved in Pakistan as a result of the structural reforms undertaken by the military government, although some resistance to these reforms persists from those with vested interests. The accelerating debt situation has been contained within manageable limits. Furthermore, Pakistan has retired some of its debt in recent years. Although poverty still remains high in Pakistan, it is hoped that the present reforms will help to reduce the poverty level. Likewise, there has been improvement in Pakistan's trade balance in recent years, with the trade deficit declining by more than a billion dollars. Although the trade balance has not reached a surplus level, exports have grown. The level of foreign investment has grown in comparison to previous years because the government is taking measures to encourage foreign investors. However, the worsening internal security situation after the U.S.-led war in Afghanistan continues to make foreign investors wary about Pakistan, as threats and attacks on foreigners affect the investment environment.

Before 1990, Pakistan was among those few developing countries with very bright prospects for economic growth. This optimism was dashed in the last decade. During this period the country became politically unstable, with frequent changes in the corridors of power. Civilian governments fell amid charges of corruption and economic mismanagement. Though elections were held in Pakistan in 2002, it has yet to achieve political stability. The coalition government of Mir Zafar Ullah Jamali is facing stiff resistance from the opposition benches on issues such as the Legal Framework Order (LFO) and other constitutional reforms. If Pakistan is to achieve macroeconomic stability, it must become politically stable by strengthening the institutions of democracy. There is no denying the fact that Pakistan achieved higher growth rates under military governments, but questions remain about whether it can sustain such growth rates in the long run without a more stable political system. A country can only achieve a sustainable, high growth rate if it is democratic, because democracy and free markets together provide the self-regulating mechanism that is essential for nurturing sustained economic growth.

In the present situation, Pakistan has two options to achieve macroeconomic stability. The first option is to depend upon external actors like the IMF and World Bank, along with other international financial institutions, to assist Pakistan in achieving macroeconomic stability. But historical evidence has shown that the IFIs have been unable to solve all of Pakistan's economic problems. There has been abundant criticism of IFI lending conditionalities in Pakistan. I do not deny the role of these institutions in the economic development of Pakistan, but argue for less dependence on these institutions.

The second option for Pakistan, which could be more realistic and rational, is for it to put its own house in order to achieve macroeconomic stability. Pakistan has the potential for economic stability, provided sound fiscal policies are pursued, economic governance is improved, political stability is achieved, internal differences

among different segments of the society are mended, and the law and order situation is improved. The following steps are suggested to improve Pakistan's macroeconomic stability.

Strengthening Institutions

Recent empirical evidence suggests that sound economic policies cannot make any difference in the lives of the common citizens if the country does not have strong institutions to implement such policies. Pakistan inherited a strong civil service, judiciary, and police, which satisfied the demands of millions of people. But as its population expanded, the nature of governance became more complex and the capacity of these institutions did not keep pace with the emerging demands of the economy. These institutions were weakened by a succession of corrupt governments.² The police became politicized, the judiciary was corrupted from the lower level to the upper level, and the civil service also failed to provide adequate service to the population. Pakistan can improve its economic governance provided its institutions are strengthened.

To begin with, there is an urgent need to continue addressing the internal security situation. Police and the judiciary are the guardians of law and order. The military government has already introduced reforms in the security services through a new police ordinance. Yet the police are still over-burdened and corruption remains a problem. The success of recent reforms is largely dependent on moving toward full implementation of the new ordinance.

In the judicial system, there is a need to introduce reforms to address the adequacy of staffing, the guarantees needed to preserve the independence of the judiciary, and the availability of remedies for the public, including the need for an efficient and well structured subordinate judiciary as well as examining possible alternative dispute resolution mechanisms.³ There should be a defined time period for the resolution of civil and criminal cases in the courts in order to achieve the credible enforcement of justice in the country.

Second, there is a need to strengthen local government institutions introduced under the controversial political devolution plan. This plan, although a new one, is really very effective and provides a mechanism that fulfills the governance needs of the public at the grass-roots level. To implement devolution, the government has introduced training courses for successful local government candidates, but a need remains to improve and institutionalize this system. The plan for devolution of power is still facing resistance from vested interests who lost power in the process. If the government continues to implement the devolution policy, it is hoped that these problems will be solved soon.

Third, institutions of accountability (like the Auditor General's Office) must be strengthened, as they are the constitutional watchdog of government revenues and expenditures. Presently, these audits are far from satisfactory, with widespread corruption prevailing. The Auditor General's Office is ill equipped to carry out its work. The AGO's staff lacks adequate infrastructure, making them dependent upon the audited organization and compromising their integrity and honesty. There is a need to strengthen this office in order to implement effective financial governance in the country.

Fourth, there is need to bring about reform throughout Pakistan's largely underpaid civil service. Salaries are often not enough to meet basic needs and the pay of government employees has failed to match increases in inflation. These low salaries represent a significant temptation to corruption. The salary structure of government employees must be increased in order to curb the crisis of corruption.

Finally, there is a need to improve the institutions of inter-provincial harmony to help in eradicating inter-provincial competition and jealousy. The Council of Common Interest, National Economic Council, and National Finance Commission are three institutions that are concerned with the distribution of the resources among the provinces. If these institutions were strengthened, policies that favor one province over another would not be adopted, which has been quite common in the past.

The military government of General Musharraf introduced major institutional reforms in the governance sector. Merit-based recruitment, performance-linked promotions, adequate compensation, and continuous upgrading of skills and knowledge are some of the essential ingredients of these reforms. The new government of Zafarullah Khan Jamali needs to continue these reforms in order to strengthen these institutions. There is no denying the fact that these reforms face stiff resistance from vested interests, but unless these reforms are maintained and strengthened, these institutions will again become the graveyards of democracy.

Achieving Good Governance

The experience of Pakistan and other developing countries in the 1990s suggests the importance of good governance. Components of effective governance, such as the rule of law, transparency, accountability, and predictability, should all be strengthened. Authoritarian military governments have a relatively better record of governance in Pakistan, but these gains have proven short-lived. Only democratic civilian governments with clear rules of transition and strong, functioning institutions can provide the platform for good governance. It must be demonstrated during the next five years that democracy and good governance are not mutually incompatible, that democratically elected governments can also serve collective interests, in contrast to purely personal interests, and that the quality of governance can be improved. The interplay of voice and accountability, civil liberties and free media—which form the core of democracy—reinforce the quality of governance.

Recent initiatives, including devolution of power to local governments, a national anti-corruption strategy, establishment of a national accountability bureau, and the encouragement of public-private community partnerships are welcome steps in the improvement of governance. The devolution of power plan, which came into force in 2001, is facing problems from the bureaucracy and from politicians representing vested interests. However, devolution remains a good plan with the potential to fulfill public demands for political participation at the local level. The success of these steps depends upon the quality of enforcement of these reforms in the future.

Expanding Human Development Initiatives

Human development and economic development are highly interlinked.⁴ Pakistan has a poor record in the area of human development, which in turn has impacted its economic development efforts. Pakistan's Human Development Index on a global scale has been slipping year after year. In 2001 it stood at 144 among 173 nations, far behind many African countries.⁵ In fact, this under-development of human capital is the most daunting challenge faced by Pakistan. High population growth—one of the fastest in the world—has given rise to a growing dependent population and increased unemployment among youth. One-half of the population is illiterate, making it more difficult to impart new skills to the ever-burgeoning labor force. Expenditures on education are insufficient, with only 2 to 3 percent of the budget allocated for these needs. Thirty-three percent of the population lives below the poverty line. The government must reorient its expenditures to place an increased priority on education.

The government implemented a comprehensive package of education reforms, a comprehensive poverty alleviation strategy, a medium-term health strategy, fiscal restructuring, and devolution of administrative and financial powers to the local government, forging a public-private partnership for the delivery of social services. There is still much room for improvement in these sectors. In the education sector, technical education should be a top priority. In the health sector, efforts should be made to introduce health facilities in remote areas. In the poverty sector, the major emphasis should be on generating employment, increasing the economic growth rate, and, most importantly, controlling the population growth rate. Presently, Pakistan's population growth rate is 2.5 percent, which is very high among the developing countries. It is estimated that, if present trends in population growth continue, Pakistan's population will double in twenty-five years. This is a very dangerous trend because the economy is not growing at the same rate as the population. Devolution of power to local governments is a welcome step in this direction. Its aim is empowerment of people at the grassroots level to make choices about essential services such as education, health, water supply, farm-to-market roads, land leveling, and watercourse improvement. The military government introduced these reforms, but effective change will depend upon continuation and expansion of implementation of these reforms.

Increasing Foreign Direct Investment

Pakistan must increase Foreign Direct Investment, if it intends to enhance the growth of its economy. The experience of the developing countries is that FDI is directly related to economic growth. Two recent examples from the developing world are China and India. Shahid Javed Burki, a leading expert on the economy of Pakistan, argues that FDI flows from private sources have driven economic development in the last two decades.⁶ In recent years, developing countries such as China and India have attracted large amounts of FDI.

Typically, these countries attracted the attention of foreign investors because of their large market size. In addition to market size, the following factors have proven to be critical for attracting foreign investment:

- World-class physical infrastructure
- A secure law and order situation
- Skilled and productive labor
- Innovative capacities
- Agglomeration of efficient suppliers, competitors
- A well-developed institutional infrastructure⁷

Many factors make Pakistan an attractive place for foreign investments. First, the Pakistani economy has developed resilience and response capacity to meet exogenous shocks and mitigate event risks. Pakistan's vulnerability indicators have made a positive turnaround. During recent years, its economy could have potentially experienced downturns in response to four major regional or global events—the May 8, 2001 bombing of French technicians in Karachi; September 11 and the subsequent Afghanistan war; the attack on India's Parliament on December 13, 2001 leading to mobilization of Indian troops; and the 2003 war in Iraq. The economy faced all of these shocks calmly and without any sign of volatility. Thus, foreign investors can be assured that they can carry out business in a stable and certain environment.

A second enticement for FDI is the fact that Pakistan has a population of 149 million, which provides a large market for consumer goods. One-third of Pakistan's population lives below the poverty line, but there is a growing middle class with adequate purchasing power, "comparable in average per capita income with the countries in Southern Europe."⁸ Moreover, Pakistan can provide foreign investors with low-cost labor, reducing the cost of production. Furthermore, Pakistan's proximity to Central and South East Asia provides a strategically located base for foreign investors to introduce, produce, and distribute their goods to these regions.

Pakistan also has a world-class physical infrastructure, which is necessary for investment. It inherited strong institutions from the British, meeting the demands of millions of people. It provides adequate communication infrastructure for foreign investors.

Finally, there is also a strategic consideration for increasing FDI in Pakistan, with implications for global security. The reconstruction of Afghanistan can be more easily facilitated if foreign investment grows in Pakistan. There is no denying the fact that Pakistan's domestic situation, in recent years, was unsatisfactory. The country has faced crises such as political instability, a deteriorating security situation, institutional decay, and sectarian violence, which have inhibited foreign investment in Pakistan. In part, this situation has been exacerbated by the war on terror in Afghanistan and its impact on Pakistan. But now, with the dust settling in Afghanistan, the situation is also improving in Pakistan. Law and order has improved and the country is moving out of political crisis. Pakistan's democratic process is restored and a civilian government is at the helm.

In the present circumstances, the government should take the following measures to accelerate the level of FDI. First, Pakistan has a large pool of unskilled labor, which is a burden on the economy. Neglect of attention to technical education in the educational system contributes to this problem. The government must place increased emphasis on technical education at the secondary school and college level. The advantages of increased technical education in stimulating economic growth are demonstrated by the Indian experience. India invested in technical education in the 1970s and is now enjoying the fruit of that investment.

Second, the government must make efforts to improve Pakistan's image in the international community. It has suffered in recent years because of the rise of anti-Western fundamentalism in the country. In particular, the international media have played a role in shaping this concern. More attention needs to be drawn to the positives of Pakistan.

Third, Pakistan must strengthen its judicial system, which will have two advantages. On the one hand, it will continue to strengthen domestic security in the country. On the other hand, a legal system that deals even-handedly with commercial interests will contribute to enforcing the sanctity of contract. By taking the above-mentioned steps, Pakistan can improve its attractiveness to foreign direct investment.

Enhancing and Sustaining a Growing GDP

There have been two problems with the GDP growth rate in Pakistan. First, Pakistan has not been able to sustain growth over the long term. Sometimes Pakistan grows at a rate of around 7 percent and sometimes it retreats to a 3 percent growth rate. Second, the growth rate of the economy in Pakistan has not been linked to improvement in human development factors. Basic indicators like education, health, poverty, safe drinking water, etc., have been neglected in Pakistan. The “trickle down theories” and market forces of the 1970s and 1980s have failed to provide relief for the general public. A need exists to link the growth rate of the economy to improvement in human development. The basic argument is that a higher growth rate is of limited utility if it does not benefit the population as a whole, including the poor.

How can Pakistan improve and sustain its growth rate? The answer lies in the following proposals:

- Production in agriculture must be enhanced because of its large share of the GDP. Agricultural production can be improved by taking two kinds of measures. First, the government must provide facilities to small and medium landowners to cultivate their lands. These facilities may include the provision of seeds, fertilizers, machinery, and water. Second, the government must play an important role in determining the prices of the goods produced in the agriculture sector. It is really discouraging to farmers when they are not getting adequate prices for their products, exacerbating rural flight to urban areas.
- In the industrial sector, the government must place emphasis on the development of small and medium industries. The government can facilitate this by providing targeted loans to this sector. Pakistan can substantially increase export earnings from light industry in the areas of carpet and textiles, sports equipment, dairy products, etc. The sick heavy industrial units promoted in the past should be rationalized, because they have become a burden on the economy. India is a classic case study of effective transition in this regard.
- Continuity in economic policy is an essential component for sustained growth. Pakistan’s track record has been such that one government has completely changed the policies of its predecessor. Some examples of such fickle policies are those dealing with privatization, construction of the Lahore-Islamabad motorway, and various agreements with power companies.
- There is a need to create inter-provincial harmony in Pakistan. In the past there has been a perception of deprivation and exploitation of the smaller provinces by the larger ones. Inter-provincial tensions have revolved around issues of resource distribution, investment and employment, water issues, etc. These factors hinder the growth rate of the economy. Pakistan needs to create inter-provincial harmony to achieve better growth.

Given the present growth rate of the economy, i.e., around 5 percent, there are bright prospects for Pakistan in the future. The central challenge is to sustain the present growth rate, instead of succumbing to the fluctuations of the past. Continuity in economic policy, improvements in the agricultural and industrial sectors, and sustaining reform in the governance environment will determine the growth rate of the country in the future. A report published by the World Bank, “Global Economic Prospects 2004,” projected average growth rates in South Asia. The report forecasts that growth rates in the region will continue to accelerate to an average of 5.4 percent in 2003, assuming positive trends in agricultural production, recovery in external demand, and improvements in political and regional stability continue.⁹ These conditions for higher growth rates in the region are equally applicable to Pakistan.

Achieving a Favorable Trade Balance

Pakistan’s trade balance has been in deficit most of the time since the country’s independence. Despite much effort by successive governments to liberalize trade, Pakistan’s trade regime still has many barriers that are preventing it from being successful. Pakistan has faced various problems in trying to integrate its economy with world markets. The opponents of economic integration with world markets argue that it will lead to de-industrialization of Pakistan. Pakistan will not be able to compete with the giant economies of China and India because they possess economies of scale and are endowed with superior technological and human resource bases.¹⁰ The basic problem for Pakistan is that its exports are mostly raw materials, which are subject to severe price fluctuations in international market prices. The main exports of Pakistan, cotton and rice, are less

competitive in international markets. Given these inhibitors, the following steps should be taken by the government to enhance the competitiveness of the country's exports:

- Pakistan's main exports are dependent upon the agriculture sector and there is a strong correlation between growth in agriculture production and exports. In order to increase export earnings, there is a need to improve the agriculture sector.
- Pakistan must take measures to diversify its export base by moving to develop the production of value-added manufactured goods. As the steel and auto industries increase their efficiency, complementary downstream and upstream industries should be established. Within the textile sector, production of clothing and other value-added products should be expanded. One pound of cotton converted into finished fabric earns \$1.61 on the world market, while the same amount of cotton converted into finished garments raises the income on the same pound of cloth to \$4.17. Increased worldwide demand for blended fabric calls for investment in this sector.¹¹
- Pakistan needs to increase labor productivity through education, on-the-job training, continuing education for the workforce, and dissemination of new knowledge and techniques. This will translate into increased productivity and lower unit labor costs.¹²
- Measures must be taken to attract foreign investment for export-oriented joint ventures in Pakistan and establish joint ventures with countries such as China. Foreign partners have played a role in production relocation in the clothing sector through outsourcing. Brand name merchandisers and large retailers of standardized products should be targeted. Foreign joint ventures can provide marketing, design, logistics, and financing, while production can be handled by domestic firms. This will require greater transparency and disclosure by Pakistani firms aspiring to joint venture relationships.¹³
- Pakistan should try to export finished, or at least semi-finished, products. Recently, there has been improvement on this front. In 2002, the textile sector earned nearly \$8 billion out of total export receipts of \$11 billion.¹⁴
- Further measures must be taken to liberalize the trade regime and minimize tariffs. This will generate competition and reduce monopolies in the domestic market, as well as improve the quality of production. The classic example in this regard is South Korea. More recent examples are China and India.
- Export tariffs must be reduced, which will help in boosting Pakistan's exports. The military government did well in this regard, with tariffs being reduced from 35 percent to 25 percent.

Managing the Debt

Presently, Pakistan's external debt and foreign exchange liabilities are approximately \$32 billion, which is very high relative to its GDP. Debt service consumes a major portion of the country's economic resources, thus limiting resources for the social sector and human development. The present debt management strategy of the government has helped the country to reduce its debt. As a result of this strategy, Pakistan's foreign debt has decreased from \$38 billion in 1999 to \$32 billion in 2002–2003. Still, the amount of debt is very high and remains a great burden on the resources of the country. The external debt can be managed by taking the following policy measures:

- Controlling the non-development expenditures of the government, which are currently consuming around 70 percent of public revenue
- Controlling fiscal deficits, which are still very high. In the past, Pakistan kept on borrowing internally and from international financial institutions to bridge this gap. The government needs to introduce fiscal discipline in order to reduce the deficit. This does not translate into squeezing government expenditures, but rather a reallocation towards human development and social sector expenditures, along with more effective tax collection.
- Accelerating and sustaining the GDP growth rate
- Improving tax collection in the country, which has been historically inefficient. The Central Board of Revenue is always falling short of its revenue targets. On the other hand, there exists a strong mistrust

between the tax administration and taxpayers, which exacerbates tax evasion. Many people do not pay taxes because of the uncertainties about the use of that revenue. Thus, the need exists to improve this environment, building an atmosphere of trust and confidence between tax collectors and taxpayers.

- Introducing an effective judicial system that strengthens accountability. This will help in reducing economic corruption and mismanagement.
- Continuing austerity measures and containing current expenditures on the part of the government.
- Providing more incentive to Pakistani citizens abroad and foreign residents of Pakistan to transfer their currency into the country. Foreign remittances will help in building up the foreign exchange reserves, thereby reducing the demand on the public debt.

If the declining trend in debt is maintained, then it is projected that in the next ten years Pakistan will make significant progress in reducing its external debt. To achieve that, the present strategy of debt management has to be continued. Government expenditures must be controlled and revenues must be increased.

The role of international financial institutions is crucial to the economy of Pakistan. The IFI's have assisted Pakistan in undertaking structural reforms in major areas of the economy. Governance reforms, financial sector reforms, social sector reforms, tax reforms, and police reforms have all been sponsored by the IFIs. Presently, the IMF is providing Pakistan with help for poverty alleviation under its Poverty Reduction and Growth Facility (PRGF) project, which will be completed by the end of 2004. The government of Pakistan has announced its decision not to seek further financing from the IMF thereafter.¹⁵ Pakistan will thus join the 70 percent of IMF member countries with whom the IMF presently has no lending relationship. Given present trends in macroeconomic indicators of the economy, it is hoped that Pakistan will emerge from the burden of international financial pressure. To retain this expected financial independence, Pakistan will have to sustain its economic growth and macroeconomic stability in future.

CONCLUSION

Pakistan's economy is in a much better position these days than it was prior to 1997. It has achieved macroeconomic stability as revealed by the performance of all relevant indicators. The GDP growth rate has shown substantial improvement and has reached the historic landmark of more than 5 percent. In the past, Pakistan's human development has not matched its growth rate. Now there is a critical need to link growth of the GDP to human development, because growth without development is a recipe for social and political instability. A strong correlation between economic growth and human development is essential for a successful and peaceful Pakistan.

The pace of accelerating debt has been slowed and brought within manageable limits. This is a result of the strict fiscal discipline adopted by the military regime headed by General Musharraf. There has been improvement in Pakistan's balance of trade. Although the government still operates at a deficit, the gap between revenues and expenditures has been reduced in recent years. Governance has improved thanks to reforms undertaken by the military government, although these are still at the initial stage and face stiff resistance from vested interests. Opponents to political devolution, whether bureaucrats or politicians who lost power in the process of reform, are creating problems with the proper implementation of these reforms. Positive economic performance with an equitable distribution of its gains is the surest way to silence those in opposition.

Despite improvement in all sectors of the economy, it is at the take-off stage and faces many challenges that still need to be addressed. Pakistan's poverty rate continues to rise. Unemployment in Pakistan has been aggravated due to constraints on public expenditures in recent years. Rising unemployment not only creates economic problems, but also has social consequences for society as a whole. A major contributing factor to growing impoverishment is Pakistan's population growth rate of 2.6 percent per annum that will lead, according to one estimate, to a doubling of the population by 2020. Controlling the population growth rate is fundamental to improving per capita income.

In the future, the performance of Pakistan's economy will depend upon the interplay of domestic, regional, and international factors. First, on the domestic front, the performance of the economy depends upon the continuity of structural reforms imposed by the military government of General Musharraf. These reforms overhauled the major sectors of the economy and are the beginning point for strengthening the institutions of economic governance in the nation. Success in continuing implementation of governance reforms, police reforms, banking sector reforms, administrative reforms, civil service reforms, and so on, will determine the future course of action. Pakistan's economy has shown a fair degree of improvement since General Musharraf's initiatives in these areas, but the possibility remains that it may again fall victim to vested interests, returning the country to an institutional graveyard of inefficiency and corruption.

Second, political stability is a determining factor for macroeconomic stability. Although democratic civilian governance is restored, there remains a need to improve the institutions of democracy in Pakistan. The political parties, parliament, the independent press, and a fair and impartial judiciary all need to be strengthened in order to achieve and sustain higher growth rates. High growth rates occurred under military governments, but sustained high growth rates can only be achieved in a strong democracy, which has a built-in system of checks and balances necessary for development.

Third, there is need to foster inter-provincial and inter-sectional harmony in Pakistan to sustain a proper climate for overall economic development. Smaller provinces must be given a fair, adequate recompense of their tax contributions as a share of federal resources. Political leadership in these provinces must stop inciting the population against the central government and other provinces, as well as avoiding incitement of the violent religious sectarianism that has undermined public security. An improving law and order situation will help in attracting foreign direct investment in the country.

Finally, the international image of the country needs improvement. In recent years, Pakistan's image in the international community has been damaged due to the rise of violent extremist and fundamentalist elements in the society. These elements have been involved in kidnapping and killing foreign nationals in the country, resulting in a deteriorating image of Pakistan worldwide. This has aggravated the decline of foreign investment in Pakistan.

Regionally, improvement in the political stability of Afghanistan will be an important determining factor for macroeconomic stability in Pakistan. Pakistan received a lot of economic help from the United States as compensation for its cooperation in the war on terrorism. If the dust settles in Afghanistan and the United States turns its attention away from Pakistan as its ally there, as it did following the 1989 Soviet withdrawal, it will again affect Pakistan's economic security. Pakistan needs to attract continued US investment in order to sustain long-term growth. Within the region, relations with India are an important determinant for the economic environment of Pakistan. If conflicts like the 1999 Kargil crisis with India recur in the future and the situation remains tense along the Indo-Pak border, it will undermine the stability needed to encourage trade and investment. It is evident that Pakistan's economy was adversely affected by the war on terrorism in Afghanistan and the crisis with India in 2002. These events and their aftermath resulted in a lessening of foreign investor confidence in Pakistan.

Globally, the relationship with the United States and international financial institutions remains crucial to the performance of Pakistan's economy. As far as the United States is concerned, there is need for Pakistan to cultivate a long-term, cooperative relationship. This will help Pakistan in receiving US investment, but also is a key determinant for Pakistan's relations with the IFIs. It is evident that whenever Pakistan's relations with the United States were positive, it received substantial assistance from the international community. When there was friction in the US-Pakistan relationship, the situation was reversed. To maintain a positive long-term relationship with the United States, Pakistan must control extremist elements in its society and continue its cooperation in the war on terrorism, the central US foreign policy concern at this time. Many extremist organizations were banned by the Musharraf government, which is a step in the right direction, but there still is a need to monitor such elements closely in the future. Finally, the issue of nuclear proliferation must be resolved. The lack of control implied in the diversion of strategic defense resources undermines Pakistan's national security, as well as needlessly raising tensions between Pakistan and the international community.

In recent years, there has been improvement in Pakistan's relations with international financial institutions due to sound economic policies pursued by the military regime. Pakistan successfully completed a stand-by agreement with the IMF in 2001 (i.e., the first ever, fully completed agreement between the IMF and Pakistan since 1988), with the Poverty Reduction and Growth Facility project in process and scheduled for completion at the end of 2004. The IMF and the World Bank have shown satisfaction with Pakistan's economic performance in recent years. Both these institutions have agreed to enhance their assistance to Pakistan in different sectors of the economy provided the stabilization program remains in place. The improved relationship with the IMF will help Pakistan in poverty alleviation and macroeconomic stabilization. Likewise, the World Bank will help Pakistan in continuing and maintaining structural reforms in the major sectors of its economy. Ongoing assistance from both the IMF and World Bank, not only through lending but also economic policy advising, will enable Pakistan to continue to raise the standard of living of its citizens, and help to ensure the country's political and macroeconomic stability as its importance in the global community increases.

NOTES

INTRODUCTION

¹ For detailed analyses of politics and macroeconomic stability in Pakistan see Shahid Javed Burki, *Pakistan: Fifty Years of Nationhood* (Boulder, CO: Westview Press, 1999), 100-108; and Ishrat Husain, *Pakistan: The Economy of an Elitist State* (Karachi: Oxford University Press, 1999).

² Mary Anne Weaver, *Pakistan in the Shadow of Jihad and Afghanistan* (New York: Farrar, Straus, and Giroux, 2002).

³ Ishrat Husain, "Economy of Pakistan: Past, Present and Future," a paper presented at the seminar on Pakistan Ideology held by Pakistan Study Center, University of Sindh, at Karachi on August 12, 2003, [http://www.sbp.org.pk/about/speech/2004/eco_of_pk\(past_present_future\).pdf](http://www.sbp.org.pk/about/speech/2004/eco_of_pk(past_present_future).pdf).

⁴ Shahid Javed Burki, "Economy after September 11," *Dawn*, November 27, 2001, <http://www.dawn.com/2001/11/27/op.htm>.

⁵ Pakistan was one of the few developing countries that achieved an average growth rate of over 5 percent over a four-decade period ending 1988-89.

PART ONE

¹ The prime minister developed differences with the president over the passage of the 13th amendment and with the judiciary over the establishment of special "anti-terrorist" courts. The crises were ultimately ended by covert military intervention, which resulted in resignation of President Sardar Farooq Ahmad Khan Leghari and marginalization of the role of Chief Justice of Pakistan, Sajjad Ali Shah. For details, see Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (November) 1997, 7.

² Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (November) 1998, 23; "Wealthy Nations Cut Aid to Pakistan over Nuclear Tests," *New York Times*, May 29, 1998.

³ The Shariat Bill was a step towards the Islamization of Pakistani society and initiation of an interest-free economic system. It was opposed by the banks, whose business is totally dependent upon interest earnings.

⁴ World Bank, "Understanding and Responding to Poverty," <http://www.worldbank.org/poverty/mission/up2.htm>. Also see M. Irfan, "Poverty in South Asia," *Pakistan Development Review* (Islamabad: Pakistan Institute of Development Economics) 39, no. 4 (2000).

⁵ Emma Clark, "Pakistan's Economic Gamble," BBC News, September 2, 2002, http://news.bbc.co.uk/2/hi/in_depth/world/2002/september_11_one_year_on/2204816.stm.

⁶ For details, see World Bank, "Attacking Poverty," 2000, <http://www.worldbank.org/poverty/wdrpoverty/report/index.htm>.

⁷ *Ibid.*, <http://www.worldbank.org/poverty/wdrpoverty/report/tab2.pdf>.

⁸ *Ibid.*, <http://www.worldbank.org/poverty/wdrpoverty/report/tab7.pdf>.

⁹ Sultan Ahmed, "Coming to Grips with Poverty," *Dawn*, December 11, 2003, <http://www.dawn.com/2003/12/11/op.htm>.

¹⁰ "The Economic Survey of Pakistan says that those living below the poverty line fell from 29 percent in 1986-87 to 26 percent in 1990-91 and then rose by five percent in 1992-93. And it now has reached 38.1 percent." For details of poverty in Pakistan, see Sultan Ahmad, "Coming to Grips with Poverty."

¹¹ Asian Development Bank, "Country Strategy and Program 2002-2006: Pakistan," <http://www.adb.org/Documents/CSPs/PAK/2002/csp0103.asp?p=ctrypak>.

¹² Caloric based poverty is measured by the daily intake of calories. In this context the poverty line is around 2550 calories per day by an adult. Those people who take in below 2550 calories a day are considered to be poor. Ishrat Husain, "Impact of Globalization on Poverty in Pakistan," 1, http://www.sbp.org.pk/about/speech/2001/Impact_of_globalization_Mahboobul_Haq.pdf

¹³ Presently, Pakistan is spending 4 percent of its GDP on poverty reduction, which is higher than in previous years. For details see, "World Bank President James D. Wolfensohn meets Pakistan President Pervez Musharraf," <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:20117173~menuPK:34463~pagePK:34370~piPK:34424~theSitePK:4607,00.html>.

¹⁴ *Zakat* is an Islamic method of taxation whereby the wealthy people spare an amount of their money for the poor people in a given society. By Islamic law the amount of *Zakat* should be 2.5 percent of the total wealth. The government provides *Zakat* to the people from the funds in a *Bait-ul-mall* (a collective fund). The *Khushali* is an Urdu language word, which means prosperity. So the *Khushali* program of the government is aimed at the prosperity of the people.

¹⁵ Ishrat Husain, Concluding remarks at the World Bank Seminar on Pakistan Poverty Assessment held at Karachi on January 7, 2003, 3-6, <http://www.sbp.org.pk/about/speech/2003/8-jan-03.pdf>.

¹⁶ Shahid Javed Burki, *Pakistan: Fifty Years of Nationhood* (Boulder, CO: Westview Press, 1999), 177.

¹⁷ *Ibid.*

¹⁸ *Ibid.*, 174.

¹⁹ Ashfaq Hasan Khan, "Economic Performance during 1999–2002," Ministry of Finance, Government of Pakistan, http://www.finance.gov.pk/summary/99_2002.pdf, 27.

²⁰ Ibid. Transparency International is a non-governmental organization "devoted to fighting corruption." See <http://www.transparency.org/>.

²¹ The total external debt of Pakistan including foreign exchange liabilities nearly doubled from less than \$17 billion in 1988 to \$32 billion in 1998 just before freezing of the foreign currency accounts. Asian Development Bank, http://www.adb.org/Documents/Books/Key_Indicators/2000/rt_35.xls.

²² Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (November) 1998, 21.

²³ The term "twin deficits" is used to denote current account deficit and fiscal deficits. During the 1990s, Pakistan experienced large-scale twin deficits. Pakistan on average sustained current account and fiscal deficits of almost 7 percent and 5 percent of GDP, respectively between 1990 and 1999.

²⁴ Khan, "Pakistan Economic Performance During 1999-2002," 4-5.

²⁵ Ishrat Husain, "Strategy for External Debt Management: 1999-2004," <http://www.sbp.org.pk/about/speech/2002/6-mar-02.pdf>, 2.

²⁶ Tariq Hassan, "A Plan for Debt Management and Retirement," a paper presented at the *News Pre-Budget Seminar 2000-01* on May 9, 2000 at Pearl Continental Hotel, Lahore, <http://www.finance.gov.pk/law/publications/debtManagementRetirement.pdf>, 6.

²⁷ Khan, "Pakistan Economic Performance during 1999-2002," 11.

²⁸ Syed Mubashir Ali and Faisal Bari, "At the Millennium: Macroeconomic Performance and Prospects," in *Pakistan 2000*, ed. Charles H. Kennedy and Craig Baxter (Lanham, MD: Lexington Books, 2000), 35. For comparison of Pakistan with East Asia, see Omar Noman, *Economic and Social Progress in Asia: Why Pakistan Did Not Become a Tiger* (London: Oxford University Press, 1997), 33-51. The present South East Asian tigers have a number of characteristics that set them firmly apart from Pakistan. They have: (1) more rapid output and productivity growth in agriculture; (2) higher rates of growth in manufactured exports; (3) earlier and steeper declines fertility; (4) higher growth rates of physical capital supported by higher rates of domestic savings; (5) higher levels of human capital; and (6) higher rates of total factor productivity growth. But all these factors are relatively weak in Pakistan. For details, see Robert Looney, "IMF Stabilization Programs and the War on Terrorism: Conflicting or Complementary Objectives in Pakistan?" <http://www.ccc.nps.navy.mil/respResources/si/dec02/SouthAsia2.pdf>.

²⁹ The Gross Domestic Product or the entire national income of Pakistan is \$64 billion. Pakistan suffered under an average growth rate of 2.5 percent in the 1990s after having achieved an average growth rate of over 6 percent in the decade of the 1980s.

³⁰ Ali and Bari, "At the Millennium: Macroeconomic Performance and Prospects," 26.

³¹ Parvez Hasan, *Pakistan's Economy at the Crossroads: Past Policies and Present Imperatives* (Karachi: Oxford University Press, 1998), 272.

³² Economist Intelligence Unit report on Pakistan quoted by Shahid Javed Burki, "Foreign Direct Investment: Has Pakistan Missed the Boat or Could It Play Catch-Up," a paper presented at a workshop sponsored by the Center for Strategic and International Studies (CSIS) on Pakistan's Future and US Policy options, Washington, DC, November 27, 2001, <http://www.csis.org/saprog/011127PKEvent.pdf>.

³³ Independent Power Producers (IPPs) are the power companies with whom Pakistan signed agreements for the purchase of electricity during the regime of Benazir Bhutto. When Nawaz Sharif became prime minister, he cancelled the contracts and started harassing IPPs, which led to crisis between the government and these companies.

³⁴ Khan, "Economic Performance during 1999-2002."

³⁵ The Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (November) 1997, 16.

³⁶ "Value adding units" are those which add at least 40 percent value while "export units" are those that export 80 percent or more of their production. These qualify for first year tax allowance on capital and reinvestment expenditures at the rate of 90 percent and 50 percent respectively. This means the profit will not be taxed until 90 percent of capital expenditure or 50 percent of the reinvestment have been recovered. Those industries that fall into the other category, mainly engineering and agriculture processing, qualify for first year tax allowance of 75 percent and 50 percent respectively.

³⁷ The Economist Intelligence Unit, *Pakistan Country Report*, First Quarter (February) 1998, 82.

³⁸ Ibid., 23.

³⁹ Economist Intelligence Unit, *Pakistan Country Report*, Third Quarter (August) 1998, 21.

⁴⁰ Economist Intelligence Unit, *Pakistan Country Report*, First Quarter (February) 1999.

⁴¹ Ashfaq Hasan Khan, "Foreign Direct Investment in Pakistan: Policies and Trends," in *Pakistan Development Review* (Islamabad: Pakistan Institute of Development Economics) 36, no. 4 (winter 1997). Also see the Economist Intelligence Unit report on Pakistan quoted in Burki, "Foreign Direct Investment: Has Pakistan Missed the Boat?"

⁴² Ashfaq Hasan Khan, "The Experience of Trade Liberalization in Pakistan," in *Pakistan Development Review* 37, no. 4 (winter 1998), 661.

⁴³ Developing countries with better economic performance than Pakistan over the course of the last several decades include India, China, Indonesia, Philippines, Thailand, Turkey, Brazil, Malaysia, Mexico, and Korea. For detailed analysis of the

export policies of these countries and their comparison with Pakistan see Ashfaq Hasan Khan, "The Experience of Trade Liberalization in Pakistan."

⁴⁴ Economist Intelligence Unit, *Pakistan Country Report*, Second Quarter (May) 1997, 19.

⁴⁵ Economist Intelligence Unit, *Pakistan Country Report*, Third Quarter (August) 1997, 17.

⁴⁶ Economist Intelligence Unit, *Pakistan Country Report*, First Quarter (February) 1998, 23.

⁴⁷ These items included animals, beef, mutton, blood meals, meat meals, arms and ammunitions, maps and charts, waste paper, oil and seeds, etc.

⁴⁸ Economist Intelligence Unit, *Pakistan Country Report*, Third Quarter (August) 1998, 30.

⁴⁹ Ibid.

⁵⁰ Economist Intelligence Unit, *Pakistan Country Report*, Third Quarter (August) 1999, 25.

⁵¹ Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (November) 1999, 27.

⁵² Ministry of Commerce, "Text of the Trade Policy of Pakistan" (Islamabad: Government of Pakistan, 2001).

⁵³ Ibid.

⁵⁴ For details of trade liberalization in Pakistan, see Khan, "The Experience of Trade Liberalization in Pakistan," and Ashfaq H. Khan and Zafar Mahmood, *Pakistan and Emerging Global Trading Environment: Challenges and Opportunities* (Lahore: Vanguard Books, 2000).

PART TWO

¹ Ishrat Husain, "Remarks made by Dr. Ishrat Husain as a panelist at the Seminar on Conditionality and Ownership organized by the IMF, World Bank and Commonwealth Secretariat at London on 23-24 July 2001," <http://www.sbp.org.pk/about/speech/2001/24-07-01.pdf>.

² Some critics argue that the G-8 countries and particularly the United States dictate the decisions and actions taken by the IMF and the World Bank. These institutions are owned by more than 180 member states, but the United States is the largest shareholder and has more influence over these institutions. The argument follows that these institutions have been used by the United States to reward its allies. For example, during the Gulf War, the first Bush administration pushed the IMF to open a lending window to assist allies, including Turkey and oil-dependent nations of Eastern Europe. The present administration has also used the IMF to reward its coalition partners in the war on terrorism after the September 11 attacks. For details see, "U.S. Enlists Lending Institutions as Lever to Turn Developing countries into Allies," *The Wall Street Journal* (Eastern edition), September 20, 2001.

³ An IMF conditionality is a term or condition attached to a loan provided by the Fund to the borrowing countries. Conditionality is comprised of three components. First, there are the "prior actions" that a country has to undertake before the loan is made available. Second, there are the quantified performance criteria, which are used to provide an objective indication of whether the agreed program of economic policy reform is on track. Third, there are more qualitative aspects of policy reform that are included in the letter on intent that a government signs in order to gain access to Fund financial support. However, the scope of the IMF conditionality has also been changing over a period of time. Until the 1980s, policy conditions were primarily limited to macroeconomic variables such as domestic credit creation and fiscal deficits. But starting in the late 1980s, there was a broadening of the scope of conditionalities. IMF conditionality came increasingly to be attached to structural reforms, including those intended to strengthen financial institutions, build a sound financial sector, and increase the efficiency of the economy. For detailed analyses of IMF conditionality, see Graham Bird, *The IMF and the Future: Issues and Options Facing the Fund* (London: Routledge, 2003), 114-127; Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W.W. Norton & Company, 2002), 44-52; Kenneth Rogoff, "IMF Strikes Back," *Foreign Policy* (Jan/Feb 2003), http://www.foreignpolicy.com/issue_jan/feb_2003/rogoff.html; Harold James, "From Grandmotherliness to Governance: The Evolution of IMF Conditionality," *Finance and Development* 35, no. 4 (December 1998), <http://www.imf.org/external/pubs/ft/fandd/1998/12/james.htm>; Alex Dreher, "The Development and Implementation of IMF and World Bank Conditionality," <http://econwpa.wustl.edu:80/eps/if/papers/0207/0207003.pdf>; and Mohsin S. and Sunil Sharma, "IMF Conditionality and Country Ownership of Programs," IMF Working Paper No. 01/142 (2001), <http://www.imf.org/external/pubs/ft/wp/2001/wp01142.pdf>.

⁴ "Tackling Unemployment," *Dawn*, November 10, 2003, <http://www.dawn.com/2003/11/10/ed.htm>.

⁵ Tallat Nosheen, "The IMF and Pakistan," *Asia Times*, November 12, 2003, http://www.atimes.com/atimes/South_Asia/EK12Df02.html.

⁶ Dr. Ishrat Husain, quoted in Jawaid Bokhari, "IMF Conditionalities Lead to 'Coercive Relationship,'" *Dawn*, September 8, 2001, <http://www.dawn.com/2001/09/08/abr8.htm>.

⁷ Economist Intelligence Unit, *Pakistan Country Report*, First Quarter (February) 1997, 13.

⁸ Economist Intelligence Unit, *Pakistan Country Report*, Second Quarter (May) 1997, 11.

⁹ Ibid.

¹⁰ The Fund started the Structural Adjustment Programs (SAP) with Pakistan in 1988. These were the three programs for the period of 1988–2000. The basic purpose of these programs was to control the budgetary deficits to 8.5 percent of GDP in 1987–88; reduce the balance of payment deficit and create a market-friendly environment; rationalize the tariff structure;

liberalize imports; broaden the sales tax net; deregulate investments; reduce subsidies; and foster privatization. See A.R. Kamal, "Structural Adjustment, Macroeconomic Policies, and Poverty Trends in Pakistan," a paper delivered at the Asia and Pacific Forum on Poverty: Reforming Policies and Institutions for Poverty Reduction, organized by Asian Development Bank in Manila, February 5–9, 2001, http://www.adb.org/Poverty/Forum/frame_kemal.htm, 17.

¹¹ Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (December) 1998, 19.

¹² Economist Intelligence Unit, *Pakistan Country Report*, First Quarter (February) 1999, 21.

¹³ *Ibid.*, 22.

¹⁴ *Ibid.*, 23.

¹⁵ Economist Intelligence Unit, *Pakistan Country Report*, Second Quarter (May) 1999, 22–23.

¹⁶ "Investors' Interest in Pakistan is Growing—American Firms Take Heart in Pledges by Military to Rebuild Economy," *The Wall Street Journal* (Eastern edition), October 19, 1999. Also see Economist Intelligence Unit, *Pakistan Country Report*, Fourth Quarter (December) 1999, 20.

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PART THREE

¹ Ishrat Husain, "Economy of Pakistan: Past, Present and Future Perspective," a paper presented at the Seminar on Pakistan Ideology held by the Pakistan Study Center, University of Karachi, August 12, 2003.

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