exports of IT products. India has excelled in this field and its exports of IT products alone are greater than our total exports. There is reportedly great potential in Pakistan to develop this sector. All possible efforts should, therefore, be made to increase the exports of IT products.

Since increase in agricultural, livestock and industrial production would require marked improvement in electricity supply, the Government should expedite power generation from coal, start construction of small and mega dams and power generation from wind and solar energy may also be expedited.

Pakistanis living abroad are sending remittances to Pakistan through banking as well as through other channels. According to the State Bank of Pakistan, during financial year 2008, Pakistan received $6.5 billion through banking channels in the form of remittances. It is necessary to expand the network of banks to facilitate the overseas Pakistanis to send the remittances through banking channels as it is estimated that around $9 billion are sent by overseas Pakistanis annually through both regulated and non regulated channels. The key market players like stock exchanges, mutual funds and non-bank financial sector of Pakistan has historically played an important role in the mobilization and channeling of savings. But high inflation rates and the increase in interest rates has made it difficult to attract investment in these sectors. To bring down the markup rates it is necessary that the banking spread should not be more than 3.5 per cent.

In order to curb macroeconomic imbalances, investment needs to grow at a faster pace in developing countries. In this regard, foreign investment has played a crucial role in acting as an impetus for macroeconomic stability. Foreign direct investment (FDI) has emerged as a major source of private external flows for Pakistan amidst a widening savings-investment gap.

Privatization and disinvestment of public enterprises has become an important channel for attracting foreign investment into many emerging economies. In Pakistan, FDI reached a high of $5.15 billion in 2008 compared to $5.14 billion in 2007. In 2007 the country attracted $1.82 billion under foreign portfolio investment - this figure dropped to $19.3 million in 2008.

There are a number of benefits of FDI. Foreign investment normally has a direct impact on improving the standard of living of the common man. Foreign investment provides an opportunity for higher rates of economic activity and employment than could be achieved from domestic levels of savings. Foreign direct investment also provides access to new technology, management skills and overseas markets. When this occurs as a major investment stake in manufacturing or services, it can lead to a qualitative change in technology and processes be they related to production, management or marketing.

Due to deteriorating law and order situation foreign investors have been reluctant to invest despite being offered attractive incentives. Further, the economic slowdown in developed economies will result in a decline in high value exports. As demand for these high value exports declines, the Government needs to offer incentives to the industry so that the industry is able to produce goods at a lower cost.

The Government should also cut its non development expenditures, in order to bring down the heavy government borrowings from State Bank of Pakistan. In order to reduce its fiscal deficit and borrowing, Government should cut down on its expenditures related primarily to subsidies on petroleum products and other non developmental expenditures.

Additionally, the capital markets have remained amongst the largest contributors of taxes to the Government of Pakistan in the form of taxes on cash dividends, CVT and other taxes and corporate tax paid by the Karachi Stock Exchange, Central Depository Company of Pakistan and the National Clearing Company of Pakistan. If the rate of CVT and other Withholding Taxes are reduced by 25 percent, then trading volumes may increase considerably and thus may result in increased contributions to the national exchequer. In such a scenario it is anticipated that the average price may also rise, resulting in the increase in traded values and increase in CVT and tax collection.

The reduction in tax rate may benefit the country through the following:

- Increase in market capitalization of Karachi Stock Exchange
- Inflow of Foreign Investment
- Prevention of outflow of local investment
- Stabilization of Pakistani Rupee
- Increase in market diversification and market depth
- Enhanced image and acceptability in international markets
- Easier accessibility of bond placements in international markets and listing of securities such as GDRs at good investment grade levels
- Improvement in overall rating of Pakistan

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On the Road to Recovery

Muhammad Farid Alam

Like most other global economies, Pakistan is currently facing severe economic pressure, with all major economic indicators pointing to the dire state of the economy. Both price and exchange rate stability have been lost, with CPI inflation spiking to 25 percent in October 2008 and the value of the rupee eroding by 28 percent YTD vis-à-vis the US dollar. Balance of payments distress has reached unsustainable proportions due to the sharp rise in external deficits and deceleration in capital inflows exploiting Pakistan's structural weaknesses. Real GDP growth has slumped to 5.8 percent from 7 percent plus average growth during the period 2004 to 2007 and looks set to further slow down within the range of 3-4 percent over the next two years. Under these circumstances, with no other viable options in sight, Pakistan once again finds itself under an IMF financial bailout in order to ward off an imminent default on its external debt.

The obvious questions that merit attention are: what went wrong and why and is Pakistan on the road to recovery? This article attempts to provide a comprehensive economic analysis in an attempt to investigate these questions and discuss policy responses necessary for revival of the economy.

What went wrong and why

A prolonged government transition during the global commodity price spike derailed Pakistan's economy. The resultant increase in the twin deficits and drying up of investment inflows has created a balance of payments crisis while domestically the price level spiraled as cost and imported inflation trickled down through the economic system. Simultaneously, the country experienced radical shifts in the socio-political landscape as well as a breakdown in the law and order situation in the tribal areas of the country. In this backdrop, passive policy response, structural weakness and inaction during and post government transition further undermined the country's economic fundamentals. The resulting economic fallout includes a rapid expansion in the country's twin deficit where the trade and current account deficits expanded to US$21billion and US$14billion, respectively in 2008. This coupled with a reduction in investment inflows exacerbated the balance of payments situation, causing a rapid depletion in the country's Forex reserves that fell from a high of US$16.5 billion in October 2007 to US$6.7billion in October 2008.

Furthermore, with 2008 being an election year, populist measures undertaken by the previous government included shielding domestic consumers from the commodity price super spike affecting the overall economic balance. These measures created:

- An unsustainable rise in the subsidy burden creating today's circular debt
- Fiscal slippages
- High borrowing from the Central Bank and a subsequent rise in monetary aggregates and inflationary pressures.

Fixing of essential commodity support prices at a higher level disregarding international prices was also an extreme measure which will continue to have an impact on inflation, for e.g. wheat support price was fixed at PKR 950 per maund. The international market has come down almost 40 percent since fixation of support price.

The Capital Inflow cover has declined

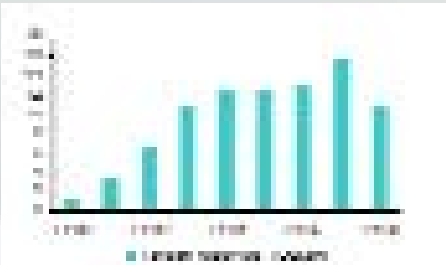
	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Remittances	1.10	2.40	4.20	3.80	4.20	4.60	5.50	6.50
Foreign Investment	0.18	0.48	0.82	0.92	1.68	4.49	8.43	5.19
Trade deficits	1.30	0.30	0.40	1.30	4.50	8.40	9.90	19.90
Remittances (% of trade deficit)	85%	800%	1050%	292%	93%	55%	56%	33%
Foreign Inv. (% of trade deficit)	14%	158%	205%	71%	37%	53%	85%	26%
Capital inflows (% of trade deficit)	99%	958%	1255%	363%	131%	108%	141%	59%
Forex Reserves (annual change)	1.9	3.1	4.4	1.6	0.3	0.2	2.9	-4.4

Source: SBP

The Twin Deficits have risen sharply

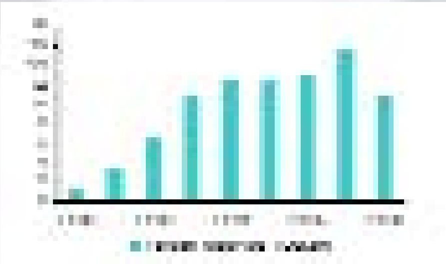
Source: SBP

Forex reserve cover has fallen



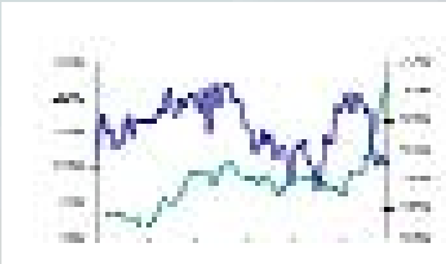
Source: SBP

Fiscal slippages have increased



Source: Federal Bureau of Statistics

Both CPI and M2 growth has spiked



Source: SBP

At the same time, structural weaknesses in the economy started manifesting in the shape of stark energy shortages as circular debt levels reached unmanageable levels. This created reactive policy action by the Central Bank in tightening its monetary stance to lower imbalances, inflationary pressures and restore PKR stability. State Bank actions to contain imported inflation through excessive tightening of monetary policy also undermined the investment climate in the country. I am of the view that monetary policy tightening cannot reduce the inflationary impact of the high international oil and food prices.

On the flipside, a sharp increase in interest rates (6M KIBOR currently at 15.67 percent) coupled with high inflation and power crisis caused an increase in the cost of doing business, crowding out of private investment and a severe credit crunch in the financial system. All these combined resulted in a slowdown in economic activity, with real GDP growth declining to 5.8 percent in 2008 as compared to 7 percent plus growth achieved during 2004 to 2007 while manufacturing sector growth declined to just 5.4 percent in 2008. The deterioration in economic fundamentals is visible from the following table which shows, on a positive note, that the current economic indicators are still relatively better than those in 1998 when Pakistan was on the verge of default.

Erosion in the country's external liquidity position as measured by SBP's Forex reserves has prompted sovereign ratings cuts by credit rating agencies Moody's and Standard & Poor's (S&P). Moody's has lowered Pakistan government's bond rating from B2 to B3 while retaining a negative rating outlook. Current ratings by Moody's and S&P for Pakistan signify a high likelihood of sovereign default.

Current economic indicators are better than those in FY98

		June'98	June'08	
1.	Real GDP growth %	3.5	5.8	positive
2.	Nominal GDP US$ bn	76.0	160.0	positive
3.	Per Capita Income $	483.0	1,050.0	positive
4.	Forex Reserves bn US$	1.7	11.3	positive
5.	PkR/US$	44.7	67.4	Negative
6.	M2 growth %	14.5	10.5	Positive
7.	CPI inflation	7.8	11.2	Negative
8.	Discount rate	18.5	12.0	Positive
9.	10Y PIB	15.0	13.4	positive
10.	12M T Bill	16.0	11.7	positive
11.	Foreign debt as a % of GDP	28.6	28.1	Neutral
12.	Total Domestic Debt as a % of GDP	42.3	30.0	positive
13.	Total Public Debt as a % of GDP	70.9	58.1	positive
14.	Total debt servicing as a % of GDP	10.4	4.0	positive

Source: SBP

Is Pakistan on the road to recovery?

Since the start of the current fiscal year there have been some improvements on the economic front which certainly predict gradual but persistent economic recovery going forward. This has been primarily caused by a downturn in international commodity prices, especially oil where international price has plunged by 61 percent from peak levels. Similarly, price of palm oil and rice has fallen to US$524 per ton and US$560 per ton, respectively. This has helped ease inflationary pressures, where the year on year CPI inflation has peaked at 25 percent in October 2008 and is expected to decline in the coming months. Similarly, monetary tightening, though excessive and certainly unjustified, has led to a contraction of 1.8 percent in broad money during 4M 2009 which should help lower overall demand pressures.

On the external side, import growth has declined substantially, down from 59.3 percent in April 2008 to 2.54 percent year on year in October 2008. At the same time export growth has also declined, down from 31 percent in June 2008 to 7.8 percent year on year in October 2008. Export weakness explains why the twin deficits have again started to increase after falling post April 2008. The CA deficit has spiked to US$2.08 billion in October 2008 as compared to US$1.64 billion in April 2008. Similarly, the trade gap though relatively lower has remained high at US$1.94 billion in October 2008 as compared to US$2.3 billion in April 2008. As the decline in international prices continues the external deficits will contract in the coming months, a process which should speed up in second half of 2009. On a positive note, remittance inflow has kept on growing at a robust average monthly rate of 19.5 percent year on year partially helping in curtailing the current account deficit.

On the fiscal side the government has introduced an austere regime, which includes cutting of around PKR100 billion in development expenditures and a substantial reduction in the subsidy burden on fuel and power. In this regard, it is very important to highlight that the subsidy on fuel has been completely removed while a cushion in the form of Petroleum Development Levy on domestic petroleum and oil prices reduces the risk of incremental subsidy related debt. Reduction in the subsidy burden and the additional tax revenues through the collection of PDL ought to help the government to refrain from any further inflationary Central Bank borrowing in 2009. In addition, the re-establishment of fiscal discipline should also help resolve the circular debt issue and ease the power crisis in the country which has had an adverse impact on the manufacturing activity.

Subsidy burden expected to decline substantially

PkR mn	FY08B	FY08A	FY09B
Current Subsidies	100,420	377,985	260,204
Oil Refineries/OMCs/Others	15,000	175,000	140,000
R&D support to Textile Sector	-	19,000	-
Power	72,489	133,254	88,412
Food	10500	48,300	29,300
Development Subsidies	13,500	29,500	35,000
Fertilizer	13,500	29,500	35,000
Total Subsidies	113,920	407,485	295,204
Subsidies as a % of total expenditures	8%	22%	15%

Source: Ministry of Finance

In addition, the IMF executive committee recently approved a financial package of US$7.6 billion (500% of Pakistan's quota) under a 23-month Stand-By agreement. This has resulted in the immediate release of US$3.1billion to the State Bank of Pakistan, while the remaining amount will be released in equal quarterly installments through the Fast Track Emergency Financing Mechanism. Financing from the IMF and other multilateral and bilateral sources ought to lend stability to the Forex reserves and to the PKR exchange rate. This should improve investor confidence in the economy and remove any possibility of sovereign default. In addition, an IMF policy regime would also include the implementation of the second generation of economic reforms. This would include developing high quality institutions with a measure of political and economic governance which is transparent, accountable, and efficient. Institution building which lowers corruption and encourages fiscal transparency ought to provide long term growth dividends for the economy.

In addition, considering that domestic demand has reduced as a result of tight fiscal and monetary policies while international commodity prices have plunged, Pakistan's external imbalances are anticipated to shrink rapidly in second half of 2009. Moreover, in light of Pakistan's healthy external debt profile, financial assistance from the IMF, and other IFIs will most likely help replenish the country's Forex reserves and restore PKR stability in the medium term. A reversal in Pakistan's credit ratings is anticipated as the economy stabilizes over the next twelve months which will improve the investment environment in the country.

Pakistan's external debt profile is extremely healthy

Components	% Share (as on June'08)
Paris Club	31.6
Multilateral	46.9
Short Term	1.3
Private Non-Guaranteed	5.4
IMF	3.1
Other Bilateral	6.2
Forex Liabilities	2.9

Source: Ministry of Finance

At the outset, sentiment change is required to bring back stability and restore confidence in Pakistan's economy. The political leadership has to make positive statements and exhibit a sense of ownership to tackle the current economic headwinds.

Although Pakistan is on a gradual path to economic recovery, comprehensive structural reforms if effectively implemented by the Government of Pakistan can certainly accelerate the process of recovery. These include:

- Aligning the fiscal and monetary regimes
- Developing a proactive, integrated energy policy
- Implementing export oriented policies
- Improving the inventory management system

First of all, in the backdrop of stagnating economic activity and severe liquidity crunch in Pakistan's financial system, there currently exists no room for continuing with a tight monetary regime in the country as this can have severe negative repercussions for the economy. Policy makers have to realize and understand that inflation is a thing of the past and to overcome the current economic hardships, the cost of doing business has to be reduced. I personally believe, that for real time economic recovery, policy makers must prioritize growth over inflation, an objective that has been visible across the globe. This view is premised on the fact that a nation of over 165 million people, in which over half of the population is under the age of 25, can not survive without stable growth.

The tight domestic liquidity situation and high cost of doing business have further undermined overall confidence where we have seen exorbitantly high interbank overnight call rates and a virtual logjam in the lending cycle. The need of the hour is a reduction in domestic interest rates, which are currently stifling the domestic economy. Now that incremental core inflation is showing a consistent monthly decline, economic growth should become the foremost concern of the policy makers. In addition, we have to concur with the analysis presented by John P. Calverley, Chief economist American Express Bank, in his book *Bubbles And How To Survive Them* who says that amidst deepening economic slowdown a central bank's role is to remain ready to provide lending at very low rates to banks facing liquidity issues and maintain a steady growth in monetary aggregates in the economy. In Pakistan, paradoxically, interest rates have been jacked up while the quantum of broad money has shrunk by 2 percent in 4M 2009. This explains the prevailing severe liquidity crunch in the financial system.

The need to reverse the monetary policy stance becomes even more important in light of the rapid buildup of high inventory levels within the industrial and retail sectors due to a slump in domestic demand. This has resulted in a tie up of liquidity preventing its natural flow within the system and hence further exacerbating the liquidity crunch. Market reflective prices would increase formal sector sales thereby easing working capital financing requirements and ensuring easy liquidity flow within the system. In this regard it is essential that the government takes measures to carry out effective inventory management in the country in which state enterprises can play a very important role. In addition, the government through the Monopoly Control Authority should play its due role to limit cartelization and monopolization in the retail, manufacturing and other sectors of the economy so that the price mechanism is allowed to function in an unhindered manner.