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Tales of Success

In the past five financial years, post September 11, Pakistan's economy has experienced the longest spell of its strongest growth in years. Different schools of thought exist regarding what led to the current success of the economy where some believe that economic growth is largely underpinned by comprehensive structural reforms, prudent macroeconomic policies and financial discipline of the Musharraf and Shaukat Aziz regime while others grant credit to the 9/11 events after which foreign direct investment and remittances recorded high growth.

This report will begin with a narration of the state of affair of the economy in 1990's, focusing particularly towards the end of the decade when General Musharraf took over power. It will then move on to examine the reform programs introduced by the new government and the immediate impact on the economy, before analyzing the subsequent impact of the 9/11 events.

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Who wrote the Success Story of Pakistan?

In the recent years a phenomenal change has been witnessed in the state of affairs of the Pakistani economy which has been successfully transformed into a stable and resurgent economy. Being amongst the fastest growing economies of the region, Pakistan's economy had been growing at an average rate of 7% for the past four financial years, with the platform now set for economic growth to accelerate even further.

The economic growth prospects are better than ever before as foreign direct investment, remittances and thereby foreign exchange reserves have reached new records. Tax revenue collections have increased substantially as all sectors of the economy have recorded broad based growth. The agricultural performance has been strong while that of the services has also been remarkably well. Nevertheless the current picture is not unscathed as the economy continues to face severe challenges in terms of rising fiscal and current account deficits and accelerating food inflation.

Despite these challenges, most of which are inevitable of any growing economy, the success story of Pakistan is outstanding. However considerable debate exists regarding the factors responsible for the current success of the economy. While some economists argue that the growth is largely underpinned by comprehensive structural reforms, prudent macroeconomic policies and financial discipline of the Musharraf and Shaukat Aziz regime, others grant the entire credit to the 9/11 events after which foreign direct investment and remittances recorded high growth.

This report will begin with a narration of the state of affair of the economy in 1990's, focusing particularly towards the end of the decade when General Musharraf took over power. It will then move on to examine the reform programs introduced by the new government and the immediate impact on the economy, before analyzing the subsequent impact of the 9/11 events.

Traveling into the *Lost Decade*

While many emerging economies progressed substantially during the 1990s, the Pakistani economy was rather laggard as it faced severe challenges in terms of declining economic growth, accelerating inflation, increasing poverty and widening income inequality.

On the contrary over the 1980s, under Zia-ul-Haq's rule, the economy was strongly stimulated by both domestic and external factors recording a high and sustained growth rate of 6.6% per annum. Increased investment provided a boost to industrial growth while with the cold war in full swing the economy had access to abundant foreign aid which coupled with rising worker remittances had kept the growth of total debt under control. Comfortable with this growth and a controlled balance of payments situation, the Zia regime did little to deal with the serious structural problems inherited from the earlier decades. These included the poor climate for private sector investment, heavy dependence of exports on cotton based goods and the inelasticity of the tax system. Rather some of these problems were intensified towards the end of 1980s and found their way into the subsequent decade.

Over the 1990s, weak macroeconomic management under the new democratic governments of the time, lack of commitment to execute competent structural reforms and corruption in public spending resulted in poor economic outcomes. Moreover the historical structural problems of public debt, weakness in exports, poor revenue collection, inadequate investments in human capital and physical infrastructure, and low quality of public institutions and governance further added to the pressures facing the economy. Economic growth slowed to an average of 4% by the end of the 1990s from over 6% per annum in the 1980s with more and more people falling below the poverty line while investment rate decelerated from an average of over 19% of GDP to 15.6% by 1999. The economy was lurching from one crisis to another during this decade.

Inappropriate sequencing of financial reforms in the early 1990s, the introduction of foreign currency accounts and the use of short-term commercial borrowings resulted in rapidly increasing the total indebtedness of the economy while the repayment of both internal and external liabilities created excess pressure on government expenditure. The fiscal and current account deficit reached as high as 7% and 5% of GDP respectively and the associated build up of public debt and external debt was recorded at over 100% of GDP and 335% of Foreign Exchange Earnings respectively. This emerged as the major source of macroeconomic imbalances during this time. The massive cost of debt servicing which amounted to almost two-thirds of the country's revenue rendered fiscal policy instruments ineffective and the country's physical and human infrastructure began to decline under the combination of a fiscal crunch, rising poverty and poor governance. These imbalances were further exacerbated by the failure to collect revenues at levels compatible with growing expenditure requirements, poor performance of exports and overall foreign exchange reserves which fell to as low as USD 415 million in Nov 1998. This was hardly sufficient to finance even two weeks of imports. Commercial banks and other financial institutions had become the instruments of political patronage and profit for certain sub-sections of society while the mismanagement of public sector enterprises like WAPDA, KESC, Pakistan Railways, Pakistan Steel Mills, PNSC and PIA, intensified the pressures for the economy even further.

Such a state of affairs had a far reaching impact on the well-being of the common man as a weak and fragile economy became the cause as well as the effect of the poor law and order situation in the country.

The Advent of Musharraf

It was in the backdrop of this state of affairs that General Musharraf took over power in October 1999, ousting the elected Prime Minister Nawaz Sharif; thereby assuming the title of Chief Executive and later on becoming the President of Pakistan. A month later, Mr. Shaukat Aziz was invited to take charge of the Ministry of Finance.

The new government believed that it was vital to restore macroeconomic stability for creating employment opportunities and preventing people from falling below the poverty-line while extensive structural reforms in almost all the key sectors of the economy were needed to enhance economic incentives, improve resource allocation, and remove impediments to private sector development. Hence in order to address these issues and thereby place the economy on a path of sustained higher economic growth the Ministry of Finance assembled a team of highly trained personnel to launch a comprehensive set of economic stabilization and structural reform policies. It was very difficult to prioritize the factors that had adversely impacted the economic growth in preceding years in terms of their intensity as they were all strongly interconnected. For example a rising debt burden, which consumed almost two-thirds of government revenues on account of debt-servicing, forced public sector development programs to decline over the years. Subsequently private sector investment also declined and the overall decline in investment caused economic growth to decelerate with a corresponding rise in unemployment and poverty. Poor governance also contributed to the slowing of Pakistan’s economic growth and the rising levels of unemployment and poverty.

However the new government prudently acknowledged that many of these economic problems were structural in nature and therefore the objectives of high growth, low inflation, external payment viability and improving living standards of common man could not be achieved without removing these structural bottlenecks. It is with this view that a series of structural reform measures were initiated in areas of privatization and deregulation, trade liberalization, banking sector, capital markets, tax system and tax administration and the agriculture sector.

A New Beginning

The economy started to show signs of improvement and stability in early 2000 soon after the launch of comprehensive reform program and the introduction of prudent fiscal, monetary and exchange rate policies. As a result modest growth rate of 4.8% was recorded for FY 1999-00 against that of 3.1% a year earlier. This was primarily due to strong agricultural performance whereby bumper crops of cotton and wheat, coupled with an increase in the production of rice, led to agricultural growth of 7.2%, which improved self sufficiency in food. In addition to this the bumper cotton crop complemented with low domestic cotton prices and falling interest rates created very favorable conditions for the textile sector. Value added in this sector grew by 13.0% during the year compared to 2.0% a year earlier. Nevertheless a combination of domestic and external shocks coupled with structural shifts still kept the economy under stress during this year.

It was primarily in FY 2000-01 that the performance of the economy was reflective of the new government’s efforts to bring macroeconomic fundamentals back on-track. During this year the fiscal deficit was contained within its targeted level, inflation was low on the back of tight monetary policy, current account was in surplus, foreign exchange reserve accumulation was satisfactory and government borrowing from the banking system was within manageable limits. However, persisting drought conditions resulted in poor agricultural performance while private sector investment remained stagnant as investors were still anticipating the outcome of reforms in order to develop a longer-term perspective. Subsequently the desired level of economic activity and employment in the country was not achieved and the economy's aggregate growth was recorded at only 2.6% during this year against a target of 5.0%. This also did not allow the privatization drive to achieve the desired results.

Nevertheless the large-scale manufacturing sector with broad based growth of 8.4% for the year emerged as the main savior whereby petroleum refining, leather and automobiles showed strong performances. Besides this the most remarkable development was seen on the external front where for the first time in its history the economy was able to post a current account surplus of USD 331 million and thereby substantial improvement was witnessed in the economy's balance of payments. Though the rupee remained under pressure it was primarily due to change in the exchange rate regime. As part of the stabilization program, the central bank allowed a free float for its currency and dismantled the Rupee band that had been in place during FY00. This, coupled with the emphasis on accumulating foreign exchange reserves, shifted the central bank's thrust in managing the exchange rate.

During FY 2001-02, the earlier fears of investors and other several stakeholders regarding the impact of major structural changes introduced by Musharraf's government on economic growth prospects calmed considerably and thereby the economy performed reasonably well. In particular, the tremendous improvement in Pakistan's external sector post-September 2001, either directly or indirectly, contributed to positive developments for many macroeconomic indicators during the year.

The trade deficit was recorded at a much lower level than in FY 2000-01 as exports grew in the second half of this year while imports dropped; the current account was in surplus and underpinned the unprecedented 6.7% appreciation of the Rupee. An upsurge in workers' remittances, increased official transfers and savings in interest payments resulted in increasing the foreign exchange reserves to an all-time high; the Rupee liquidity injected through the foreign exchange purchases enabled the SBP to ease its monetary policy stance; inflation was down to 3.5% as the appreciating Rupee lowered the cost of imported inputs; external debt restructuring and lower interest rates on domestic debt led to a reduction in debt servicing, thereby aiding the Government's effort to contain the fiscal deficit.

However there were several negative repercussions of the 9/11 events on the domestic economy; the export target of USD 10 billion could not be achieved and foreign investors remained hesitant in making new commitments. Despite this real GDP grew by a reasonable 3.6% during the year as a result of strong performance of the manufacturing and services sector. Even though the 4.4% growth was considerably weaker than the 7.6% growth recorded a year earlier for manufacturing sector, it must be noted that the economic environment was shrouded in uncertainties through much of FY 2001-02, first due to the conflict in Afghanistan and then due to border tensions with India. Unlike the previous year it was the services sector that dominated this year's growth profile with a 5.1% growth.

Post September 11

Once the world partially digested the shock of 9/11, the picture began to change rapidly for emerging economies. The global investment environment recovered much sooner than expected as fears of foreign investors were calmed and they started to show interest in the rapidly growing economies of Asia. Pakistan was not far behind than any regional economy in attracting the attention of foreign investors as economic growth continued to gain pace on the back of prudent economic policies and reform programs. Subsequently the foreign direct investment and inflow of remittances accelerated stimulating the economy even further and opening new avenues for investments.

In the past five financial years, post September 11, Pakistan's economy has experienced the longest spell of its strongest growth in years as the economy grew at an average rate of 7%. Compared with other emerging economies in Asia, this puts Pakistan as one of the fastest growing economies in the region, along with China and India. The outcomes of the outgoing fiscal year indicate that economic momentum remains on track as economic growth accelerated to 7.0% on the back of robust growth in agriculture, manufacturing and services. Strong economic growth and investor friendly environment generated increased foreign investment which stood at over USD 6 billion while workers remittances reached a new high at over USD 5 billion and foreign exchange reserves crossed the USD 16 billion mark for the first time in history. Hence it appears that Pakistan's economy would continue to be a high-mean, low-variance economy over the medium term.

Chicken or Egg: What Comes First?

What is interesting to note is that many economists and analysts argue that whatever achievements Pakistan has made on the economic front ever since the beginning of the current decade under the Musharraf regime are due only to 9/11. While we acknowledge the salutary impact of the external account improvement, we would like to stress that the trend improvement was visible well before the seminal 9/11 events as recounted in the earlier pages. Interest rates were already on the way down; foreign currency reserves were edging up; the exchange rate was relatively stable; the inflation downtrend was well defined, and the government's continuing fiscal discipline and commitment to reforms had already set the stage for re-profiling of external debt. Most risks and challenges that did exist before 9/11 under Musharraf's government emanated primarily from uncertainties regarding the structural changes than anything else. Nonetheless, the pre-existing positive trends did gain invaluable momentum in FY 2001-02, post 9/ 11.

In fact what we would like to argue here is that the reform programs introduced by the Musharraf government and the events of 9/11 were complementary in nature, contributing to the success of the Pakistani economy. Erase away and we will not be where we are. Take the case of foreign direct investment: True that FDI started to rise substantially after 9/11 as foreign investors developed confidence in emerging economies but one must pay heed that this would have not been achieved had the government not introduced dynamic economic and investment policies which included opening the economy through privatization and deregulation and establishment of a liberal FDI regulatory regime. Similarly we cannot give the entire credit to 9/11 for additional tax collection of over PKR 200 billion in five years since the event took place when it took almost ten years from 1990 to 1999 to collect taxes worth PKR 197.5 billion. Neither can we attribute the strong industrial and services growth to 9/11.

In conclusion we would like to reiterate that the economic success of Pakistan is attributable to not only the prudent macroeconomic policies introduced by Musharraf's government but equally to the 9/11 attacks. The 9/11 attacks shifted the interest of foreign investors from the West into the regional emerging economies while the liberal economic policies of Pakistan which brought macroeconomic stability to the economy attracted this interest in its favor.

Economic Snapshot

Fiscal year 06-07														
	Units	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June
Inflation														
Headline Inflation	%	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0
Core inflation	%	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1
Food inflation	%	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7
Non-food inflation	%	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1
T-bill (Wgt Avg)														
3 month	%	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69
6 month	%	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9
12 month	%	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16
External Sector														
Export	Mln US$	1,533	1,334	1,392	1,392	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583
Import	Mln US$	2,685	2,383	2,267	2,172	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373
Trade balance	Mln US$	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)
Remittances	Mln US$	464	376	435	422	410	448	475	391	457	520	513	537	505
Forex Reserves	Mln US$	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182

Research Desk

Treasury and FX Group

MCB BANK LIMITED

20th Floor

MCB Tower

I.I Chundrigar Road

Karachi

Contact

Sana Qureshi

Research Analyst

Telephone: 92-21-2270025

0300-3915027

Email: sanaqureshi@mcb.com.pk

Usman Siddique, CFA

Head of Research and Structured Products

Telephone: 92-21-2270024

0333-2153438

Email: usman.siddique@mcb.com.pk

Fax: 92-21-2270094

92-21-2270109

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