Liberalization and Economic Crisis in Pakistan

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Executive Summary

Pakistan adopted economic stabilization and structural reform policies in 1988 in an effort to reduce domestic financial imbalances and external deficits. However, there have been problems with the implementation of these policies, in terms of consistency and sequencing. The period 1988–1996 was characterized by repeated attempts to stabilize the economy amid weak efforts at structural reforms. Since policy measures were not able to achieve their objectives, the Pakistan economy continued to be trapped in a vicious circle of poverty, low growth, low savings, and low investment, which further hampered growth and poverty alleviation.

Economic difficulties worsened as a financial crisis hit Pakistan at the end of May 1988. Reserves plummeted from $1.2 billion to about $0.6 billion, and default seemed imminent. The crisis was triggered by the country's testing of nuclear devices on 28 May 1998 amid threats of economic sanctions from the United States and other countries. Unjustifiably, fearing capital outflows, the Government froze all foreign currency accounts. As a natural response, private sector remittances also practically ceased, cutting off about $2.5 billion in inflows projected for that fiscal year. Commercial bank short-term lending to the Government and State Bank of Pakistan (SBP) dropped drastically. Two sources of foreign exchange borrowing—official sources and private transfers—which had remained seemingly insensitive to changes in economic fundamentals, now due to political reasons (in the case of official inflows) and poor decisions by the Government (in the case of foreign currency accounts) suddenly dried up and precipitated a financial crisis.

Government policy reforms initiated in the financial and monetary sectors refer back to policies in 1987/88 to support structural reforms in the areas of fiscal and trade policy. At the time, the consolidated federal and provincial fiscal deficit which was 6 percent of gross domestic product (GDP) or more in the 1980s reached 8.5 percent of GDP and became unsustainable. Thus, fiscal reforms became the main focus of reform efforts. The deterioration of Pakistan's fiscal position reflected, *inter alia*, persistent expenditure overruns, the narrow and inequitable tax base, low elasticity of the tax system, and a heavy reliance of revenues on international trade taxes. The medium-term fiscal reforms initiated at the time aimed to reduce the deficit through structural reforms of direct and indirect taxes and a forceful restraint of current spending.

Pakistan has gradually liberalized its tariffs, reducing the maximum tariff rate from 225 percent in 1986/87 to 65 percent in 1995/96. Until end-March 1997, however, the country's complex and exemption ridden tariff regime continued to give rise to high levels of effective protection, nurtured inefficient industries, generated a strong antiexport bias, put a heavy burden on consumers, diverted resources to rent-seeking activities, and encouraged corruption and smuggling.

The Government has pursued an export promotion policy in one form or another since the late 1950s. The year 1988 marked a watershed in economic policymaking in Pakistan, as the country turned decisively away from inward looking policies towards trade liberalization and export promotion. Successive governments consistently strengthened these policies in the subsequent period. While considerable progress was made in the design and implementation of these policies, as reflected in substantial growth in export earnings, there is much scope for improvement in trade liberalization and export promotion policies.

Tariff policy remains one of the most important policy instruments to influence resource allocation or investment decisions, by affecting relative prices and profitability in the country. However, its impact is eroded to a large extent by the Government's credit policy and by its investment policy administered through the Board of Investment (BOI). Furthermore, development finance institutions (DFIs) and commercial banks are formally and informally guided by the Government in selecting particular industrial sectors for venture capital investment. Apart from the export processing zones (EPZs), there is no separate institution for financing investments in export activities.

Privatization of State-owned enterprises (SOEs) has been pursued in Pakistan since 1991, following the wave of liberalization, deregulation, and minimization of the role of the state in economic activity across the world. In the first two years, the pace of privatization was rapid and 70 units were privatized. But after 1993 it slowed due to various factors such as demand for greater transparency and financial vulnerability of some of the units.

Building on the basic economic programs of previous governments, the Government in March 1997 initiated structural reforms and stabilization measures to stimulate growth, reduce inflation, improve the balance of payments, and strengthen Pakistan's competitiveness in world markets. Yet economic activity is in deep recession, inflation persists, and external reserves are not improving. Government inaction and conflicting statements and signals before implementation of structural reform policies suggest a lack of commitment and stamina. To compound matters, there are apparently some miscalculations emerging about the response of the economy, the size of the markets in Pakistan, and the combined impact of some of the structural policies being implemented. To top it all, the financial support from multilateral agencies for such an extensive reform process is too small.

Reducing the fiscal deficit is one of the most important corrections needed. Not only is the extent of fiscal adjustment a subject of debate, especially seen in a three-year context, the quality of adjustment also needs a review. Government efforts to achieve more revenues from income and sales taxes have suffered for a number of reasons. On the expenditure side, rigidities due to debt service and defense needs limit the scope of adjustment except by improving public sector productivity. Apart from a wavering commitment to downsize or rightsize, the Government has not undertaken an extensive and indepth review to improve the efficiency of its spending. As always, cuts in the development budget are most prominent. But all fiscal efforts are discredited by the pursuit of large and costly luxury projects such as motorways, airports, and rail systems that cannot be justified in terms of relative rates of return.

Reform of the banking sector is pivotal to the revival and development of the economy. Unfortunately, the process is beginning to falter. The loan recovery process is also marked by perceptions among defaulters of unequal treatment by the Government, and the banking courts have yet to prove that the new law is adequate for speedy recovery. Notwithstanding the above, the reforms overestimate the speed at which loans can be recovered. It would be better to transfer these bad assets to a separate fund for the lengthy process of recovery, and as a result lower the burden of the bad portfolio on banks so that they could reduce the spread between the deposit and lending rates.

There is consensus in the country on privatization of public corporations. However, the poor financial state of the corporations and the slowdown in markets have been major constraints.

There are other considerations that warrant a careful review of existing policy. More problems confronting the economy include the hugely indebted public corporations and the inadequate financial resources of the Water and Power Development Authority (WAPDA). There are pressures to deal with the latter issue through tariff increases, particularly in electricity. However, there are arguments against raising tariffs on a continued basis to address WAPDA's fiscal gap. First, a tariff increase will not only be unbearable to consumers but will cripple an already uncompetitive industrial sector. Currency devaluation may follow to shore up the uncompetitive industries. Since fuel prices are indexed to the exchange rate, a spiral of inflation would follow. Second, WAPDA is a monopoly and, therefore, its distribution losses of 29 percent of generated power can be largely attributed to the company's inefficiencies.

Thus, passing on the cost of these inefficiencies would be unreasonable. It is estimated that about PRs1 billion could be saved for each percentage point reduction in line losses.

A trade liberalization policy through tariff reforms has been proposed to reduce protection given to import-substituting industry and to encourage the export sector, so that existing industries would become more efficient and new resource allocation would shift toward more competitive export industries. This policy, however, has been poorly implemented. There is a need to shift the focus from further tariff reductions (except on inputs) to direct assistance to the export sector in improving marketing and technical know-how, productivity enhancement, reducing overhead costs, and increasing credit availability.

Tariff reform did not progress due to a number of mutually reinforcing reasons. First, it was undertaken simultaneously with ongoing tax reforms that aimed to broaden the tax base, promote income tax compliance, and introduce a general sales tax. Second, to complicate matters, a large fiscal imbalance existed even in 1993, and correcting this was crucial to stabilization of domestic prices and improvement of the external reserves position. With laxity in public current expenditures, and a need to reduce the fiscal deficit, there was no room left for pursuing tariff reform with rigor. Third, the pace of tariff reductions was relatively fast considering the ability of the Government to develop alternative sources of revenue and private industry to make adjustments.

The exchange rate policy of the Government that had dual objectives of restraining inflation and promoting exports has not been successful. Through periodic step devaluations following periods of relative nominal stability, the exchange rate policy has sought to recover export competitiveness that has been eroded as a result of higher domestic inflation compared with trading partner countries. In effect, the policy has accommodated persistent fiscal and monetary slippages and assured authorities that expansionary financial policies would not erode competitiveness. In fact, targeting of the real exchange rate index has failed to compensate exporters for the loss of competitiveness due to declining labor productivity and higher energy costs.

The current economic program is the sum and extension of initiatives taken by various governments during the last 10 years. The menu of reform is extensive and ambitious in its targets. It aims to rectify distortions developed during many decades. It is also cognizant of the need to provide social safety nets to the labor force directly affected by the reforms. It must equally recognize the needs of industry and agriculture to respond to the new set of relative prices, competition, and opportunities. Most structural reforms by their very nature carry short-term costs and benefits that accrue in the medium term and, more important, some of these reforms are mutually dependent for their success. Not only are there indications of wavering commitment of the Government to the total reform process, the resources committed in support of such an extensive program seem meager.

While Pakistan did not immediately suffer a financial crisis when East Asian countries were economically destabilized, there are certain underlying weaknesses that are disturbing and pose a threat to financial stability:

- Pakistan's financial sector remains weak, and despite government efforts, the recovery of bad loans is making little progress;
- the Government is continuing with low priority, long gestation infrastructure projects; and
- the East Asian crisis has increased Pakistan's vulnerability to foreign exchange liquidity problems.

There are several explanations why Pakistan did not experience the crisis that hit the East Asian economies:

- While the East Asia boom was financed by highly "sensitive" private sector capital in the form of portfolio capital and short-term debt, Pakistan's deficits have been largely financed by official flows and private sector bank deposits by residents and nonresidents that have displayed extraordinary stability during repeated balance of payments crises in the 1990s.

- The foreign currency exposure of the private sector in Pakistan was low. Despite repeated attempts, this sector had limited success in raising capital from international sources.
- While Pakistan did receive some portfolio investment in 1994 at the peak of inflows into emerging markets, its poor economic performance, political instability, and the relatively better prospects in East Asia at that time limited such flows. The Karachi stock market peaked in 1994 and lost more than one third of its value by July 1997. By then, most foreign institutional investors had already withdrawn from the market.
- Banking reforms were introduced in early 1997 and, together with better monitoring of prudential regulations, put the brakes on poor credit decision making.

At the end of May 1998, a financial crisis finally hit Pakistan and default seemed imminent. The two sources of foreign exchange borrowing—official sources and private transfers—which had remained stable and seemingly insensitive to changes in economic fundamentals, suddenly dried up and precipitated the crisis.

The Government took a number of steps to restore confidence but the market seemed unimpressed by the measures. The loss of credibility due to the mishandling of the media trial of foreign investors, which caused the stock market crash, and the freezing of foreign currency accounts will take time to recover.

Introduction

In 1988, Pakistan adopted policies geared towards economic stabilization and structural reforms, in an effort to reduce domestic financial imbalances and external deficits. The measures were also intended to promote trade liberalization, reduction in capital controls, more open investment policies, and the adoption of market-oriented monetary policy. The change in policy direction coincided with a return to democracy and free elections after nearly 12 years of military dictatorship.

The task before the Government was twofold: (i) to develop institutions and regulations in tune with openness after a period of controls and (ii) to direct the economy along more efficient lines while accommodating the cost of adjustment. Unfortunately, the period was mired by declining standards of governance from already low levels, further increases in corruption, and political instability. Seven administrations ruled the country in the 10-year span covering the period 1988–1998.

The period 1988–1996 was characterized by repeated attempts to stabilize the economy amid weak efforts at structural reforms that pushed the economy into a series of vicious cycles. In particular, increased taxation on a shrinking tax base led to its further contraction due to tax evasion and the expansion of the underground economy, and resulted in further tax hikes. Sluggish budgetary revenues led to cuts in public investment in human capital and infrastructure, undermining the profitability of private sector investment and production, thus reinforcing weakness in revenues. Low employment generation by the private sector was partly compensated by overstaffing in the public sector, which further reduced its efficiency. Double-digit inflation created the need for nominal depreciation, which fed back into inflation. Declining profitability in the banking system depressed the rate of return on bank deposits, leading to disintermediation, which in turn led to a further decline in bank profitability.

More broadly, the Pakistan economy continued to be trapped in a vicious circle of poverty, low growth, low savings, and low investment, which further hampered growth and poverty alleviation. Moreover, these structural problems eroded the institutional fabric of society, contributing to deterioration in governance and in security conditions. The attempts during recent years to correct macroeconomic imbalances have fallen victim to slippages in policy, inconsistencies and sequencing problems in adjustment policies, and sometimes policy reversals triggered by, among other factors, a slow response from the economy. The result has been a worsening fiscal and external position, reflected most conspicuously in repeated foreign exchange crises and a ballooning public debt. The country is at a point where reserves can be depleted no further, nor further borrowing sustained.

The most troubling aspect is the Government's heavy reliance on foreign currency deposits to meet external financing requirements. In the past two years, inflows into resident foreign currency deposits (FCDs) have covered one fifth to two fifths of the trade deficit. As of 28 May 1998, the total outstanding balance in foreign currency deposits stood at $11.2 billion, equivalent to one third of total external debt. About 86 percent of foreign currency deposits were either demand deposits or had a maturity of one year or less. In the shadow of the financial crisis of East Asia, this was of particular concern.

Overview of Macroeconomic Developments During 1992–1998

In 1992/93, reflecting the impact of devastating floods, viral attacks on crops, and political instability, gross domestic product (GDP) growth plummeted, and the external current account deficit widened to 7 percent of GDP creating a balance of payments crisis.

In mid-1993, Pakistan embarked on an ambitious medium-term program of macroeconomic adjustment and structural reform that sought to address deep-rooted structural problems and mounting macroeconomic imbalances that had led to a near balance of payment crisis. The program achieved, initially, remarkable stabilization, including a sharp reduction in the external current account deficit, a strong buildup of reserves, and decrease in the budget deficit to 6 percent of GDP, 2 percentage points lower than in the previous year. Significant progress was made in privatizing industrial units, deregulating economic activities, liberalizing the financial system, and opening up the economy through a relaxation of trade and exchange restrictions.

The stabilization achieved in 1993/94 was short lived and its benefits quickly eroded as the adjustment and structural reform process lost momentum and slippages in policy implementation started to surface, particularly with the proliferation of tax exemptions and concessions. As a result, inflation accelerated, the trade deficit widened, and capital inflows weakened. The announced 1995/96 budget clearly confirmed the pause in the process of adjustment and reform, eliciting an adverse market reaction. This precipitated a rapid deterioration in the external reserves position, bringing the country back to the brink of a foreign exchange crisis in October 1995.

During this period, Pakistan's economy performed below its potential. Following the sharp decline in 1992/93, the growth of real GDP recovered over the next three years, helped in part by the recovery in agriculture, investment in the energy sector in response to the new energy policy in 1994, and expansion of small-scale, export-oriented enterprises. But recovery was modest and the growth rate fell from an average of 6 percent in the 1980s to 4 percent in 1992/93–1995/96. This decline reflected, *inter alia*, poor weather conditions, a deterioration in the physical integrity of the irrigation and drainage systems, inadequate public spending on essential infrastructure and its maintenance, distortions in pricing policies, impaired international competitiveness, and stagnant productivity.

The authorities reacted by introducing, in late October 1995, a package of corrective measures, consisting of a devaluation of the rupee by 7 percent and fiscal measures in an amount equivalent to 1.7 percent of GDP on an annual basis, including a

10 percent regulatory duty on imports. Nevertheless, expenditure overruns and stagnant revenue fully reversed the fiscal adjustment achieved in 1993/94–1994/95, and the budget deficit widened again to close to 7 percent of GDP. The 7 percent devaluation—in the absence of a tightening of fiscal policy and in the context of an accommodating monetary policy—proved insufficient to halt the deficit, which expanded to a record high of close to 7 percent of GDP ($4.4 billion). This deteriorating trend continued in early 1996/97, leading to a depletion of gross reserves and bringing the economy yet again to a near foreign exchange crisis. In response, the Government introduced a second package of corrective measures in October 1996, including a devaluation of 8.5 percent and fiscal measures amounting to 1.5 percent of GDP. In 1996/97, in the context of renewed political instability that undermined private sector confidence, growth declined to 3.1 percent, barely sustaining the level of real GDP per capita. This poor performance was led by a negative growth of major crops, with repercussions on all other sectors. Growth of large-scale manufacturing has been particularly weak and became negative in 1996/97.

The fiscal year 1997/98 was marked by political and constitutional crisis and the impact of the East Asian crisis. It ended with the dramatic events of nuclear testing by India and Pakistan amid threats of sanctions from some Western countries. According to official estimates, real GDP grew by 5.4 percent supported by good crops and recovery in the manufacturing sector led by the sugar industry. Inflation came down from 11.6 percent to 8 percent in the first 10 months. On the external side the current account deficit fell sharply as imports were cut due to effective demand management policies and a general slowdown in the economy. The reserves grew slightly to about $1.2 billion, reflecting some improvement in exports, workers' remittances, and a sharp increase in the inflow of resident FCDs. The main weakness was in tax mobilization efforts, which together with lower imports belied the official estimate of robust GDP growth rate.

Gross national savings continued to fall short of the country's investment expenditure, with the gap rising from 3.6 percent of GDP in 1993/94 to 6.6 percent on average during 1996/97–1997/98. The available data suggest that the widening of the savings-investment gap was primarily caused by a sharp deterioration in national savings (about 12 percent of GDP) due to a decline in private and public savings. Domestic investment also decreased marginally (to about 18 percent of GDP), with an increase in private investment offsetting most of the decline in public investment.

Reflecting the savings-investment imbalance, Pakistan's external accounts deteriorated substantially over the three years ending 1996/97. The current account deficit, which had been contained between 4 and 5 percent of GDP since 1988/89, widened to 6.8 percent of GDP in 1995/96. This was mainly driven by import growth exceeding 16 percent in dollar terms on account of loose demand policies, and in the absence of timely exchange rate adjustments. The deterioration of the current account deficit was hardly reversed in 1996/97 as imports and exports declined. In 1997/98 the deficit was less than 5 percent of GDP mainly on account of import contraction.

The overall balance of payments turned from a surplus in 1994/95 to increasing deficits during the next three years, amounting to more than $1 billion in 1996/97. The capital account surplus rose in 1995/96, mainly through public short-term borrowing and the accumulation of FCDs by nonresidents. However, these short-term inflows could not be sustained in 1996/97, in part because of the unstable political situation. As a consequence, the deficit was largely covered by a depletion of the official reserves—from the equivalent of 12 weeks of imports as of end-1994/95 to less than three weeks in late 1996/early 1997, before partially recovering in June 1997/98. From 1995 to 1998, the total external debt (including the financial institutions' external liabilities) increased substantially, reaching $30 billion at end-June 1998.

Developments in exports and imports have displayed great variability over the last six years, reflecting Pakistan's dependence on agricultural output and highly volatile world prices, especially for cotton products. Export trends show an average growth in dollar terms of less than 5 percent compared to 8 percent in the 1980s. Persistent antiexport biases in trade and tariff policies, lagging structural reforms, and protracted commercial tensions in Pakistan's traditional markets are the main factors underlying the declining export performance. Import growth was slightly lower than 5 percent during the same period in dollar terms, slightly less than GDP growth. The country's terms of trade have deteriorated by more than 10 percent cumulatively since 1993/94, reflecting a sharp increase in the price of key imported commodities (petroleum products, wheat, edible oil) and, more recently, a decline in world prices for its major exports (cotton and rice).

Pakistan was able to increase the mobilization of capital inflows in 1995/96 to cover large current account deficits, mainly through FCDs and short-term debt. This strategy, however, rapidly gave rise to adverse market anticipations, accelerating the depletion of official reserves and precipitating the foreign exchange difficulties in the second half of 1996. Following the elections, market confidence has been increasing with the Government's package of structural reforms, and some international lenders have renewed their interest and support. Resident FCDs increased by nearly $1.7 billion during 1997/98. However, nondebt creating inflows, particularly foreign direct investments (FDIs), are still sluggish and the external situation remains fragile.

Gross official reserves (kept by the SBP) were held above 12 weeks of imports in 1994/95, but fell to five weeks of imports by end-1996/97 ($1.2 billion). During the near exchange crisis of September–October 1996, official reserves bottomed out at $600 million, equivalent to less than three weeks of imports. This was followed by a gradual recovery after the announcement of the October 1996 policy package (which included an 8.5 percent devaluation of the rupee), the reduction of political uncertainties in the first half of 1997, and the launching of the new Government's economic program. Foreign exchange reserves stood at $700 million at end-August 1998.

Pakistan's fragile external reserve position is compounded by the accumulation of short-term foreign currency liabilities by the banking system, mostly residents' and nonresidents' FCDs. About 40 percent of the $11.5 billion stock of FCDs at end-June 1998 were demand deposits, while the rest were time deposits concentrated in three-month to one-year maturities.

With a stock of public and publicly guaranteed external debt amounting to $29.6 billion at the end of 1996/97, Pakistan may be regarded as a highly indebted developing country. As a ratio of exports of goods, services, and private transfers, the public and publicly guaranteed debt was close to 220 percent at end-1997/98, and the related debt service reached 27.9 percent. Given the relatively limited openness of the country, the debt-to-GDP ratio has been contained to less striking levels—43.8 percent in 1996/97, a slight drop from 44.5 percent in 1994/95. However, the decline in the external debt to GDP ratio has not reduced Pakistan's vulnerability to exchange rate fluctuations, because of the SBP forward cover mechanism for FCDs.

The Liberalization Process, 1988–1998

Monetary Policy

To support structural reforms in the areas of fiscal and trade policies, the Government initiated reforms in the financial sector and in monetary policy in 1987/88. While continuing to exercise credit control through direct methods, it took steps to improve debt management and promote the establishment of a capital market. It also rationalized the rate structure of the National Savings Scheme (NSS) and introduced market-oriented rates of return on government debt instruments, including short-term Treasury bills (T-bills), as a prelude to eventually adopting market-oriented techniques of monetary control. The auction of government securities began in March 1991.

While foreign currency accounts for nonresidents were introduced in 1973, resident FCDs were deregulated in February 1991. Both types of accounts are protected from disclosure requirements regarding the source of funds. The interest rates payable on these accounts are capped at fractions of a percent above the LIBOR (London interbank offered rate), varying with maturity of deposit. Commercial banks are required to surrender foreign exchange to the SBP in a swap agreement, with the period of the swap corresponding to the initial maturity of these deposits. In June 1992, the SBP phased out its policy of providing free full forward-exchange cover to financial institutions with respect to these deposits and introduced a forward exchange fee of 3 percent of the deposits per year.

On 1 July 1992, the SBP adopted the credit-to-deposit ratio and the auction of T-bills to develop its ability to control monetary and credit aggregates, although direct credit controls also remained operational. It also limited the use of mandatory lending and credit to nonbanking financial institutions (NBFIs). The objectives of financial sector reform at this time were to:

- strengthen financial intermediation through the rationalization of structures of rates of return on a wide range of debt instruments,
- reduce the distortionary effects of mandatory and concessional credit allocation,
- strengthen the financial system through enhanced supervision and regulation, and
- encourage private sector participation in domestic banking.

Privatization of banking has been an important component of the authorities' financial sector reform program. It was intended to increase the competitiveness and efficiency of the banking system. Before the reform program, nationalized commercial banks (NCBs) dominated domestic banking. Since their nationalization in 1974, the NCBs had lost their commercial orientation, adversely affecting their efficiency, market responsiveness, and financial strength. Consequently, the Government sought private sector participation in domestic banking through the privatization of NCBs and the establishment of new, privately owned banks.

In January 1992, the SBP issued new prudential regulations to enhance the supervision and regulation of the banking system. The new guidelines included more stringent limits on credit concentration and on contingent liabilities, stiffer guidelines on the separation of bank ownership and management, tighter margin requirements on equity-based advances, and strengthened system of classification and provisioning for nonperforming assets (NPAs). In addition, amendments were made to the Banks' Nationalization Act of 1974 aimed at enhancing the administrative and advisory role of the Pakistan Banking Council in commercial banking.

In 1993, through an amendment to the State Bank Act of 1956, the SBP was given operational independence to conduct monetary policy and regulate and supervise the banking sector.

In 1994/95, the Government continued efforts to move toward the adoption of indirect instruments of monetary control and took measures to liberalize interest rates further.

The development of the auction market for government securities has left the financial system of Pakistan with an important role. One of the reasons for this is that the rate of return on the T-bill gives an approximate idea of the market's valuation of a low-risk asset. In this context, the Government introduced the auctioning of government securities in 1991 and rationalized the structure of national saving schemes.

MARKET-BASED MONETARY CONTROL

Considerable progress has been made in the years prior to 1997 in the use of market-based instruments for monetary control. Building on the introduction of an auction system for government securities, the SBP has been managing domestic liquidity, to a large extent, by intervening in the secondary market through open market operations. For a period following the elimination of absolute credit ceilings, the limits for credit expansion by the commercial banks were determined through a credit-to-deposit ratio mechanism (which has also been abolished). Ceilings on lending rates have been removed and the scope of mandatory and concessional credit schemes substantially curtailed.

During 1997/98, monetary reforms were carried out further with greater reliance on market-based instruments, as follows:

- the authorities initiated a reform of the primary dealer system for government securities;
- T-bills covering a range of maturities (three and six months, and one year) were introduced by steps in 1997/98; and
- the existing six-month federal bonds were eliminated as they were not well suited for trading in the secondary market.

Within this improved environment, the operational procedures for open market operations were refined with a view, among other things, to reduce short-term interest rate volatility in the interbank market. This included introducing two-way open market operations and a deposit facility at the SBP to absorb surplus overnight funds; the SBP also changed the reserve requirement from a daily to a weekly average basis. As a result, public debt management improved through the channeling of an increasing share of financial savings into marketable debt instruments both broadening the market for government securities and ensuring comparable and market-related terms on the various debt instruments.

REGULATORY AND SUPERVISORY REFORMS

The Government views the weaknesses of the financial system as a leading factor behind the slowdown in the real growth of the economy, the decline in domestic savings, and the emergence of unsustainable macroeconomic imbalances. Accordingly, it has endorsed and is fully implementing legal and regulatory/supervisory reforms in this area, specifically:

- laws have been enacted to strengthen the authority and autonomy of the SBP, to insulate the State-owned banks and DFIs from political interference, to facilitate loan recovery, and to unify the banking court system;
- banking regulations have been upgraded and the SBP's supervision capacity is being strengthened; and
- the management of the State-owned banks and DFIs has been professionalized while action plans to reduce operating losses, principally through appropriate downsizing, are being implemented under the direction of the SBP.

The continuing strategy is to insulate the banking system from political interference in order to provide proper governance and impose financial discipline. Further reforms will be based on a three-pronged approach, as follows:

- privatization of banks and DFIs. The privatization plan calls for divestiture of the Government's ownership interests in the banks and replacement of the bad assets (net of capital and reserves) of these institutions by government securities at the time of their privatization. In addition, with technical assistance from multilateral institutions, the Government is studying possible privatization of two mutual funds (Investment Corporation of Pakistan and National Investment Trust), as well as an insurance company (State Life Insurance Corporation);
- enhancement of the ability of the SBP to supervise banks and effectively enforce regulations (see Appendix 1); and

- improvement of the legal environment for loan recovery and enforcement of financial contracts.

In addition, further steps are being taken to enhance the regulatory and supervisory system, and to improve the legal environment and strengthen judicial institutions for loan recovery.

After Pakistan conducted nuclear tests on 28 May 1998 amid threats of economic sanctions from the United States and some other countries, the SBP, fearing that depositors would withdraw their FCDs, stopped all foreign exchange withdrawals from both resident and nonresident foreign currency accounts. However, depositors were allowed to encash their deposits in rupees at PRs46/$ while the official exchange rate was PRs44/$. In the ensuing days, the exchange rate in the open market fluctuated widely, rising as high as PRs70/$. By 12 September 1998 the rate was PRs58/$. On 22 July, the Government announced that exporters and importers would exchange their currencies at the average of the official exchange rate and the interbank rate, which was hovering at around PRs54/$. The Government has offered five-, seven-, and ten-year foreign currency bonds for nonresident depositors, but with little success so far.

Fiscal Policy

The consolidated federal and provincial fiscal deficit, which was 6 percent of GDP or more in the 1980s, reached 8.5 percent of GDP in 1987/88, and became unsustainable. The overall public sector borrowing requirement was even larger due to large deficits incurred by public enterprises, the main factor behind Pakistan's economic difficulties. Thus fiscal reforms have remained the main focus of the continued stabilization and structural reform efforts of successive governments since 1988. The deterioration of the country's fiscal position was reflected, among other things in persistent expenditure overruns and weak revenue generation system, including the narrow tax base, inelastic tax system, and a heavy reliance of revenues from international trade taxes. The medium-term fiscal reform initiated at the time aimed to reduce the deficit through structural reform of direct and indirect taxes and a forceful restraint of current spending (see Appendix 2).

TAX REFORM

The thrust of the tax reform program is to promote a more equitable distribution of the tax burden and greater compliance with tax documentary requirement. The salient features of the reforms are reductions in tax rates and a broadening of the tax base to include previously untaxed income and undertaxed sectors, supported by improvements in tax administration. These actions are being taken in the context of a new revenue-sharing arrangement under the 1997 National Finance Commission Award between the federal Government and the provinces, which has incorporated all federally collected taxes into the divisible pool and established a uniform sharing ratio across taxes. The new arrangement has removed the strong disincentive to tax reform that was associated with the allocation of most import taxes to the federal government and the bulk of revenues from domestic taxes to the provinces. Removal of this major structural distortion has provided an environment conducive to progress with reforms at both the federal and provincial levels. As a result, provinces will be able to reduce their dependence on nonmandatory grants and loans from the federal Government and, with a strengthened own-resource mobilization effort, will be able to better forecast and protect their priority expenditures on basic social services.

Significant progress has been made over the last two years in reforming the General Sales Tax (GST) into a modern, broadly based value-added tax. Important amendments to the 1990 General Sales Tax Act were introduced in June 1996, expanding the horizontal coverage at the manufacturing and import stages, removing excise-type features, and establishing a turnover threshold for registration. This was followed by improvements in the 1997/98 budget, including compulsory registration of importers, wholesalers, and distributors, and abolition of replacement invoices; effective extension of the GST to two major sectors of the economy, namely textiles and steel; improvements in refund procedures; and strengthening of the legal provisions to deal with delinquent taxpayers, curb tax fraud, and minimize evasion. Also, following a simplification in March 1997 in the 1997/98 budget, the GST rates were unified into a single standard rate of 12.5 percent.

Steps aimed at expanding the income tax base have already been taken, effective 1 July 1997. The concept of taxable income has been redefined to include perquisites in cash and in kind, and certain deductions have been reduced. With regard to the rate structure, personal income tax rates have been decreased to 5, 10, 15, and 20 percent (from 10, 20, 30, and 35 percent, respectively) while corporate tax rates have been lowered to 30 percent for public limited liability companies (from 33 percent), to 35 percent for private limited liability companies (from 43 percent), and to 55 percent for banks (from 58 percent). These changes took effect on 1 July 1998.

The Government committed to implement meaningful taxation on agricultural income. The recent enactment of land-based taxes by all four provinces represents a breakthrough in the tax policy area. The imposition of these taxes is expected to meet the dual objectives of promoting equitable sharing of the tax burden across different sectors as well as tapping a potentially significant additional source of revenues for the provinces. Initially, the provincial governments opted for a presumptive land-based tax, with exemption limits based on farm size, and variation in rates by irrigation status and coverage of types of farmland across the four provinces. The land revenue will continue to be collected with this new tax. Simultaneously, domestic output prices (especially wheat) in the agricultural sector will be set at border prices to reverse the deterioration of the terms of trade of agriculture that has taken place in the past, while credit availability to agriculture will be enhanced.

REFORM OF TAX ADMINISTRATION

Efforts are being initiated and will be intensified over the next three years to improve tax administration in support of the above policies regarding the GST and income tax. In this context, the Central Board of Revenue will be strengthened through incentives to assure continuity in recruitment, and will be provided with appropriate resources to acquire and maintain suitable facilities, equipment, and supplies. To promote voluntary tax compliance, an information exchange program encompassing income tax, GST, and customs is being developed. The Central Board of Revenue is being restructured under a new leadership from the private sector, into the Pakistan Revenue Service (PRS) with the aim of improving tax administration. The capacity of the PRS is being strengthened, tax collection processes reengineered, and management improved. Enhancing the tax administration will be a challenging task for the Government since the costs of adjustment will have to be borne at a time when revenues are declining (due to a shrinking economy). Moreover, tax reform is changing the emphasis from traditional sources of revenue, while taxpayers' willingness to pay is at a low point due to poor provision of public services.

EXPENDITURE REFORMS

In line with the policy to emphasize greater effectiveness and improve developmental impact, in 1996/97 the Government took measures to control the level of expenditures, rationalized its investment program, and made considerable progress in reducing spending on lower-priority activities. Expenditures on defense, civil administration, and subsidies have been contained in nominal terms, while nonpriority expenditures of the development budget have been sharply cut.

With regard to the Public Sector Development Program (PSDP), the authorities continued to better prioritize, manage, and implement the Federal PSDP and will encourage the provinces to make similar efforts. The Planning Commission has shifted its focus toward strengthening the monitoring and evaluation of the PSDP. The Government has recognized the need to restore public investment in core areas of public sector responsibility.

Exchange Rate Policy

Before 29 May 1998, the exchange rate arrangements of Pakistan consisted of a managed float under which the SBP set the daily exchange rate at which it would purchase and sell dollars (the intervention currency) in its dealings with authorized dealers. The rate was adjusted frequently, taking into account the competitiveness of the tradable sector and the need to contain inflationary pressures.

Since 1982, the Pakistan rupee has been unpegged from the dollar and operated in a floating rate system based partly on a trade-weighted basket of major currencies. Market forces played a limited role in the short-term determination of the exchange rate, since the SBP fixed daily buying and selling exchange rates in transactions with banks and other authorized dealers.[1] In recent years, the SBP has sought to manage the rupee/dollar rate in a way that strikes a balance between containing inflationary pressures and maintaining a competitive tradable sector. This policy has resulted in long phases during which the SBP implements minor “technical” adjustments vis-a-vis the dollar, interspersed with more substantial step devaluations that have allowed the real effective exchange rate to recover eroded competitiveness.[2]

FOREIGN EXCHANGE REGULATIONS

Pakistan has a highly liberalized foreign exchange system. As of July 1994, it has adopted current account convertibility of the rupee and removed all multiple currency practices. As a result, it has accepted and fulfilled its obligations under Article VlIl of the Articles of Agreement of the International Monetary Fund (IMF).

Pakistan’s foreign exchange regulations have also been liberalized for most aspects of the capital account. There are no restrictions on repatriation of profits and capital associated with FDIs. Before 29 May 1998, residents and nonresidents were allowed to maintain foreign currency accounts and were free to transfer their balances abroad.

The SBP has delegated authority to a number of banks and financial institutions to deal in foreign currency, to supervise surrender requirements, and to sell foreign exchange. Exchange receipts and payments abroad must be effected through an authorized foreign exchange dealer in any convertible currency. Letters of credit for imports must be established in foreign currency except certain settlements with specified countries. Payments for invisibles are controlled by the SBP and, in some cases, require prior approval.

Exporters are obliged to collect and surrender foreign exchange receipts with the SBP within four months of shipment, although the SBP may allow an extension to this period. Since 22 July 1998, exporters are allowed to surrender half of their earnings to the interbank foreign exchange market.

In recent years, the SBP took important steps leading to a gradual withdrawal of the SBP from its earlier central role in the foreign exchange market and the development of an interbank foreign exchange market.

After 29 May 1998, with the freezing of foreign exchange accounts, the rules and regulations were changed.

FOREIGN CURRENCY DEPOSITS

Before 29 May 1998, residents and nonresidents could open foreign currency accounts with banks and NBFIs. Since current banking regulations prohibit banks from lending in foreign currency and permit them to maintain only small uncovered positions in foreign exchange, banks surrender these deposits to the SBP against rupees for on-lending in Pakistan. The banks are then required to close the open position by purchasing a forward contract from the SBP.

On 29 May 1998, the SBP suspended withdrawal of foreign currency from all foreign currency accounts. Withdrawals could only be made in rupees at PRs46/$.

CAPITAL ACCOUNT RESTRICTIONS

Several minor additional liberalization measures regarding capital inflows have been implemented since 1994/95. Most of Pakistan's remaining restrictions on capital movements pertain to outward transactions. Residents (including firms) are not permitted to invest abroad except by purchasing foreign exchange bearer certificates.[3] Permission is subject to the condition that all proceeds should be repatriated to Pakistan through normal banking channels. Regarding inflows, foreign-owned companies can borrow any amount abroad but they need to obtain Government and SBP approval for the issuance of the debt instruments abroad.

Trade Liberalization

TARIFF REFORMS[4]

Pakistan has gradually liberalized its tariffs over the last few years, including a sequential reduction in the maximum tariff rate from 225 percent in 1986/87 to 65 percent in 1995/96. Until end-March 1997, however, the country's complicated and exemption-laden tariff regime continued to give rise to high levels of effective protection, nurtured inefficient industries, generated a strong antiexport bias, put a heavy burden on consumers, diverted resources to rent-seeking activities, and encouraged corruption and smuggling. It consisted of statutory rates modified by a comprehensive set of end-user exemptions and concessions, most of them linked to sectoral and regional policies, thus making it in effect a dual system, where about 40 percent of imports received special treatment.

Efforts to reform the tariff regime were limited and sometimes reversed during the period under review. The 1995/96 budget reduced the maximum import duty rate from 70 to 65 percent, but increased several intermediate rates for revenue purposes. Shortly after, with the stabilization program that accompanied a 7.5 percent devaluation of the rupee, the authorities reversed further the liberalization process by introducing a temporary 10 percent regulatory duty on imports.[5] The liberalization process resumed in March 1997 as the new Government reduced the maximum tariff rate to 45 percent and merged the 14 duty rates into a six-band system (10, 15, 20, 25, 35, and 45 percent). The 10 percent regulatory duty was eliminated, except on a few items, and the list of zero-rated imported goods was reduced to a minimum. As a result, a number of exemptions and concessions became redundant. An outcome of this reform is that the average rate of import duties is estimated to have fallen from 19 to 17 percent, with a significant parallel reduction in the dispersion. However, several tariff positions remain overly detailed and are characterized by the distinction between goods made in Pakistan and others.

Pakistan continues to use a system of import trade prices, rather than actual transaction values, in determining import values for customs purposes for a substantial proportion of imported items. The system, thus, spawns overstatements of import values, which leads to additional import protection. Under the General Agreement on Tariffs and Trade (GATT) Uruguay Round, Pakistan is committed to an invoice-based system by the year 2000, and to adjusting its Customs Act accordingly. The authorities have cancelled, effective March 1997, the contract of preshipment inspection with the Swiss company Société Générale de Surveillance, which had been in force since 1995.

Apart from the remaining import restrictions, mainly based on health, security, environment, and religious reasons, there are at least 28 nontrade barriers aimed at protecting local producers, and several schemes restricting imports. The negative list, which has been reduced to 68 items (from 214 in 1989) still contains several textile items that can compete with local products (cotton fabrics, carpets, and other textile floor coverings, knitwear, and bed linen). At least 17 products are subject to procedural requirements, that *de facto* restrict imports, some of which are clearly geared toward protecting local industry. These include motor cars—which can only be imported unassembled and according to a specific program of progressive replacement of the imported parts by locally manufactured parts (the "deletion program")—and tractors.[6] Imports of petroleum products, lubricants, and specific inputs for the oil industry require administrative authorization, to protect the local petroleum industry.

EXPORT PROMOTION POLICIES[7]

Pakistan has pursued an export promotion policy in one form or another since the late 1950s. One such policy was the export bonus scheme that operated from 1959 to 1972. The foundation of the existing export incentive system was laid in 1972 following a devaluation and unification of the exchange rate system. The export incentive system during the 1970s was designed in particular for manufactured exports and included the following:

- exemption of exports from sales tax and central excise duty;
- a duty drawback scheme covering sales tax, central excise duty, and customs duty on inputs used in exports;
- export tax on raw material used in exports;
- a concessionary finance and export credit guarantee scheme; and
- facilities for import of raw materials and machinery used in the manufacture of exports.

However, these export incentives were limited in comparison to incentives for domestic production. Economic policy, in general, also had a bias in favor of import substitution activities.

The year 1988 was a milestone in economic policy making in Pakistan as the country turned decisively from inward-looking policies toward trade liberalization and export promotion. These outward-looking policies were consistently strengthened by successive governments. There was significant progress in the liberalization of the exchange and trade system, reform of the financial sector, liberalization of domestic and foreign investment, and initiation of a wide-ranging privatization program that opened up areas of the economy previously reserved for the public sector.

The current system of export incentives in Pakistan is based on three elements:

- concessional tariff rates on imports for re-exports, including a duty drawback system that allows reimbursement for import duties and domestic taxes paid on imported inputs that enter production for exports;
- exemptions under EPZs and bonded warehouses; and
- export financing at concessional rates through a refinancing facility provided to commercial banks by the SBP. Duty drawback rates were substantially increased in October 1995. More recently, export incentives have been made more attractive, including accelerating duty drawback repayments, zero-rating of imports of raw materials used mainly for exports, and making a wider range of exports eligible for concessional export financing schemes.

Despite considerable progress, as reflected in the substantial growth of export earnings, there is still much scope for improvement both in the design and implementation of trade liberalization and export promotion policies. Pakistan faces a number of tariff and nontariff restrictions on its exports, some of them requiring specific export policies. On textile products, the share of restricted exports is estimated at 63 percent. The authorities have introduced some improvements in these policies as well as in the country's capacity to react promptly to growing commercial disputes with its main trading partners.

Pakistan has been managing, since 1974, a system of quotas for textile products imposed by Canada, European Union, Norway, and US under the

Multifiber Arrangement (MFA).[8] The arrangement was amended and integrated into the GATT Uruguay Round concluded in 1993, under the Agreement on Textiles and Clothing (ATC). As provided by the ATC, the MFA is to be phased out in stages by 2004, with the importing country transferring to normal World Trade Organization (WTO) rules. This is not immediately expected to make a substantial impact on Pakistan's textile exports. In addition, the liberalization process for textile products has been counteracted by the multiplication of antidumping and countervailing investigations; in 1996/97, three of Pakistan's largest export items (cotton yarn, fabrics, and bed linen) were subjected to antidumping duties.

The existence of quotas has required a complicated administrative system that has imposed hidden costs on the economy. In the past, the allocation of quotas was often viewed as discretionary and politically motivated, leading to efficiency losses and expensive trading among exporters. The authorities have taken steps to make quota allocations more efficient, progressively shifting from a quantity-based to a value-added system. However, quotas remain allocated to established exporters, which makes it difficult for new exporters to break into the export allocation system.

Exports of noncotton products have increasingly faced trade barriers, as public opinion in industrialized countries has registered growing concerns about labor, environment, and health standards in developing countries in general, and in Pakistan in particular. For instance, the US withdrew the Generalized System of Preferences for carpets and rugs, sports goods, and surgical instruments on 20 October 1996, over the issue of poor labor standards in Pakistan, including those relating to child labor. Moreover, surgical goods have been facing antidumping measures and import restrictions for health and safety reasons, including the need to meet international standards such as the ISO 9000 series.

Investment Policy[9]

Tariff policy remains one of the most important policy instruments to influence resource allocation or investment decisions, through its impact on relative prices and profitability in the country. However, this impact is eroded to a large extent by the Government's credit policy and its investment policy administered through the BOI. Furthermore, DFIs and commercial banks are formally and informally guided by the Government in selecting particular industrial sectors for venture capital investment. Apart from the export processing zones, there is no separate institution for financing investments in export activities.

The BOI was established as a "one-stop shop" to tap the opportunities for investment in Pakistan. It performs a facilitating and coordinating role for domestic and foreign investors to meet all their needs. It has launched a worldwide campaign of investment promotion and projecting Pakistan as an investor-friendly country.

Over the past few years, the Government has tried to encourage private foreign investment in various sectors of the economy. Foreign investment on a repatriatable basis in the services/infrastructure, so-

Table 1: Foreign Investment, 1992–1998 ($ million)

Item	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98 (July–March)
Direct Investment	310	360	440	1,106	703	436
Inflow	310	362	442	1,106	713	436
Outflow	0	2	2	0	10	0
Portfolio Investment	137	289	1,090	202	268	204
Inflow	137	289	1,090	205	268	204
Outflow	0	0	0	3	0	0

Source: State Bank of Pakistan. Annual Report (various issues).

cial, and agriculture sectors was also allowed, subject to certain conditions. In the past, foreign investors have been weary of kickbacks and other "gray" dealings in sanctioning various projects, but the Government has tried to mitigate their concerns through the Corrupt Business Practices Ordinance of 1998. Private foreign investment remains the primary focus of policy initiatives since the 1990s' broad-based economic reforms were initiated and the stance of economic policy was changed from inward to outward looking.

Privatization Program

Privatization of SOEs has been pursued since 1991, following the wave of liberalization, deregulation, and minimization of the role of state in economic activity across the world. In the first two years the pace of privatization was rapid and 70 units were privatized, but after 1993 it slowed due to various factors such as demand for greater transparency and financial vulnerability of some of the units. The emphasis has been changed from speed to greater level of scrutiny and transparency. The slower pace is also due to Government efforts to restructure public enterprises and institute a regulatory framework before privatization to minimize any negative impact.

The SOEs identified for privatization are divided into three categories, as follows:

- small manufacturing units and thermal power generation of WAPDA, which are for outright sales;
- large-scale manufacturing and services to be sold in suitable tranches on the national and international stock exchanges; and
- utilities and services such as electricity generation and distribution, banks, gas, and telecommunications, which will be first sold partially.

Privatization schemes and procedures have been designed to assure widespread dispersal of ownership (incorporating provisions for participation of employees and management) without excluding experienced entrepreneurs, especially in the sectors where managerial efficiency is of vital importance. These measures include transparency in the process of sale or transfer; thoroughness in the preparation of reports, information sheets, and bidding documents; and strong public awareness campaigns to build understanding and support among employees, investors, and the public.

Export Processing Zones Authority

To exploit the full export potential of Pakistan, the Export Processing Zones Authority (EPZA) was established in 1980. Its purpose was to plan, develop, and manage EPZs in economically viable areas across

Table 2: Privatization of State-owned Enterprises

Item	1991/92–1993/94	1994/95–1995/96	1996/97	1997/98	Total
Automobiles	7	0	0	0	7
Cement	9	2	0	0	11
Chemicals	7	5	0	0	12
Fertilizers	1	0	0	0	1
Engineering	5	2	0	0	7
Ghee	16	0	0	0	16
Rice	7	1	0	1	9
Roti plants	12	0	0	1	13
Banks	2	0	2	1	5
Power	0	1	0	0	1
Hotels, Resorts	0	0	0	8	8
Miscellaneous	4	2	0	0	6
Total	**70**	**13**	**2**	**11**	**96**

Source: Privatization Commission.

the country. The Karachi Export Processing Zone was its first project in 1981, with the objective of attracting foreign capital, technology, and modern management skills for export-oriented industries as well as opening new employment opportunities for the country's workforce.

Industrial Estates

Soon after Independence, given the country's low industrial base, policymakers banked upon small industrial estates to groom an entrepreneurial class that was nonexistent at the time. Pakistan's first industrial estate, the Sindh Industrial Trading Estate Ltd. Karachi, was established in 1947. The number of industrial estates increased to 72 by the end of March 1997. Industrial estates enjoy varying degrees of exemption from customs duty on imported machinery, and have other incentives and facilities available under the rural industrialization scheme, where applicable. Infrastructure facilities are also provided to these industrial estates.

Assessment of Degree of Globalization

As Pakistan has become more tightly integrated into world trade and financial markets, prospects for growth will be increasingly influenced by changes in the external environment and by policy responses to those changes. Although integration provides new opportunities for expansion, it also broadens the channels for transmission of external shocks commensurably.

Greater linkages have better positioned the country to take advantage of expected stronger growth in world trade, of markets opening to free competition in textiles and related goods covered by the MFA, of significant potential in the area of "long-distance" services trade and an accompanying reduction in pressures for migration, and of increased availability of external finance from private sources, especially FDI and portfolio equity flows. All of these factors are broadly supportive of domestic private sector activity and improved economic growth performance.

But at the same time, competition for export market share in basic manufactures is likely to be strong, and the increasing trend toward regionalism in trade (North American Free Trade Area [NAFTA], Asia-Pacific Economic Cooperation [APEC], and eventual eastward expansion of the European Union) confronts Pakistan with the risk of possible marginalization within the context of larger blocs. Moreover, despite the potential benefits of removal of MFA restrictions, long-run income elasticities for textiles and related products are low, particularly in contrast with higher-technology manufactures. Continued reliance on cotton and cotton-based products could subject the country to high degrees of uncertainty and potential instability of export revenues.

Additionally, the risk of escalation in prices of oil, food, and raw material (as occurred during 1994) could boost import bills significantly. Financial uncertainties facing Pakistan in a more integrated world economy include an expected further decline in global aid, potential volatility of private capital flows, and exposure to the risk of higher international interest rates and to swings in key currencies.

The pace of Pakistan's trade and financial integration has been largely favorable, but there remains a significant gap with the country's competitors.

As globalization accelerates in the coming decade, policies will need to be shaped not only to capture the opportunities for growth, but also to manage increasing exposure to risk in the external environment, such as financial shocks, including rapid shifts in major currency values as well as volatility in oil and commodity markets.

Macroeconomic Policy Management

Extending the basic economic programs of previous administrations, the Government has undertaken structural reforms and stabilization measures to stimulate growth, reduce inflation, improve the balance of payments, and strengthen Pakistan's competitiveness in world markets. These initiatives have been formalized in a three-year economic program (July 1997–June 2000), supported by financial assistance from the Asian Development Bank (ADB), IMF, World Bank, and bilateral donors. Six months into the program, serious concerns arose about the reform process.

The performance of key economic variables should not be judged on a monthly basis since there are conflicting indications about the direction of inflation and balance of payments. Yet it is safe to infer that economic activity is in deep recession, inflation persists, and external reserves are not improving. Inaction and conflicting statements and signals from top functionaries, even before most of the structural reform policies have been implemented, suggest a lack of commitment and stamina on the part of the Government. To worsen the problem, some miscalculations are apparently emerging about the response of the economy, the size of the markets in Pakistan, and the combined impact of some of the structural policies being implemented. To top it all, financial support from the multilateral agencies to support such an extensive reform process is too small.

Reducing the fiscal deficit is one of the most important corrections needed. Not only is the extent of fiscal adjustment a subject of debate, especially in a three-year context, but the quality of adjustment also needs review. Government efforts to achieve more revenues from income and sales taxes have suffered for several reasons. First, no attempt has been made to promote people's willingness to pay taxes by improving the public services for which people are purported to pay taxes; nor have equity concerns, both horizontal and vertical, been adequately addressed. Public perceptions about tax evasion by influential people persist. Refusal to pay taxes by groups of communities has been weakly addressed. Although the latter phenomenon partly reflects the erosion of State authority due to its bad reputation, it is also due to the Government's bowing to political considerations at the expense of the larger national interest. It can also be argued that part of the problem is due to the Government's inadequate preparation for launching a sales tax at the retail level. Second, while it was a good idea to reduce marginal income tax rates, it was naive to expect voluntary payment of taxes. There is hardly any community in the world that would do so, not to mention a society that is being taxed for the first time. Third, an equally simple-minded approach was used to improve tax administration by sacking a few officers here and there summarily without due investigation of their offenses. Many taxpayers would agree on the predatory and exploitative attitude of some tax officials, but changing that requires a reengineering process, change of management, and the introduction of checks and balances. Government action has not made tax assessment more just, revenues have not increased, nor has the morale and efficiency of the tax administration improved. Recent efforts to form a Pakistan Revenue Service will require the induction of a number of tax experts. Irrespective of how well the Government improves tax administration, it should not overestimate the speed of transformation from informal to formal economic transactions to facilitate tax collection. The Government has overestimated revenue increases from income and sales taxes, and in anticipation, decreased tariffs accordingly. Reductions in maximum tariffs have been too rapid, especially since tariffs on intermediates and raw materials have not been fully adjusted to allow domestic industry to cope with lower protection.

On the expenditure side, apart from a wavering commitment to downsize or rightsize the bureaucracy, the Government has undertaken no extensive or in-depth reviews to improve the efficiency of its spending. Cuts in the development budget are most prominent. However, efforts to continue the process of identifying a core development budget that is immune to cuts and leaves enough room for new projects in the following years is an encouraging sign. But all fiscal efforts are discredited by the pursuit of large and costly luxury projects such as freeways, airports, and rail systems that cannot be justified in terms of relative rates of return. The obsession with freeways illustrates the general approach to Pakistan's development. While many would agree that a well-developed road network in the country would contribute greatly to the development of agriculture, industry, and commerce, few would agree that this "need" translates into a single freeway between two cities. Contribution to development would be much higher if, for the same cost, a system of parallel roads (also of international standard) was built between every major city in the country. The populace at large would benefit as would the economy. The Government needs to be fiscally responsible and to spend national resources wisely and not according to its whims. The Planning Commission has time-tested methods of selecting projects for development. If these procedures are circumvented, it would not be surprising if the country were further burdened by debts and inflation as a result of projects with low economic return rate (such as freeways). The selection of grandiose projects is all the more unjustifiable if the scarcity of resources, the threat of bankruptcy, and the pitiable condition of the majority of the population are considered.

Trade liberalization policy through tariff reforms has been pursued to reduce protection to import-substituting industry and to encourage the export sector, so that existing industries would become more efficient and new resource allocation would shift toward more competitive export industries. Although the process of trade liberalization began in 1988, there are still no discernible indications of benefits. Instead, there are examples of industries closing down. The fault is not the policy itself, but its implementation. First, the pattern and schedule of tariff reductions have not been followed, resulting in a squeezing of tariff slabs to protect revenue generation on raw materials, and sending mixed signals to the market about price changes. Second, tariff cuts have been too rapid to allow industry to restructure and there is no financial and technical support available to help it do this. Third, while Pakistan has been quick to liberalize imports, export production has not been supported directly in an adequate manner. New investments and sales efforts in exports are hampered by lack of market intelligence, insurance devices to spread risks, and the reluctance of banks to lend for new projects, products or markets, or to support new exporters. This is a serious problem since expansion of exports comes from precisely these areas. The Government and external financing agencies contemplating further assistance in trade liberalization should shift their focus from programs to further reduce tariff for the time being (except on inputs) to direct assistance to the export sector in improving marketing and technical know-how, enhancing productivity, reducing overhead costs, and accessing credit.

There is a consensus in the country toward privatizing public corporations. However, the poor financial state of the corporations and the slowdown in economic activity have been major constraints to privatization. Apart from the general demand that the process should be transparent and proceeds should go to retire public debt, there are other considerations that warrant a careful review of existing policy. There is an urgent need to consider the capacity of the domestic market to absorb large public assets accumulated over many decades. This is against the backdrop of banks preparing to sell PRs120 billion-worth of collateralized assets to recover bad loans. Moreover, the capital market is underdeveloped and mobilization of equity is a serious impediment to investment in the country. Hence, the policy question is whether to divert the limited private sector investment capacity to purchase inefficient public investments (which would effectively mean a transfer of assets to the national Government, not new investments) or to encourage the private sector to invest in new, high-technology, high-value export-based industries. Lack of information about new investment opportunities has tended to bias market decision in favor of public assets. This will have significant consequences on industrial investment in the country and will undermine its ability to compete and develop further its export potentials. Another consideration in privatizing public corporations is the need to introduce professional and autonomous management in corporations before they are privatized. This will minimize further losses and prepare corporations for private ownership and management.

More problems confronting the economy include the hugely indebted public corporations and the inadequate financial resources of WAPDA. There are pressures to deal with the latter issue through tariff increases, particularly in electricity. However, there are arguments against raising tariffs on a continued basis to address WAPDA's fiscal gap. First, a tariff increase will not only be unbearable to consumers but will cripple an already uncompetitive industrial sector. Currency devaluation may follow to shore up the uncompetitive industries. Since fuel prices are indexed to the exchange rate, a spiral of inflation would result. Second, WAPDA is a monopoly and therefore, its distribution losses of 29 percent of generated power can be largely attributed to the company's inefficiencies. Thus, passing on the cost of these inefficiencies would be unreasonable. It is estimated that about PRs1 billion could be saved for each percentage point reduction in line losses.

Related to this problem is the financial obligation to buy back all private sector power when it comes on line. With economic activity in recession and consumer demand adjusting to higher prices, WAPDA's and Pakistan's financial woes will become more complicated. The issue is that electricity for immediate consumption is a nontradable good, which the nation has to produce using dollars and sell locally in rupees, causing a drain on foreign exchange. Unless users of power generate (or save) enough foreign exchange earnings from their products, the net result will be a drain on reserves. Some people have argued for a renegotiation of the buyback price with private generators. This will create a dilemma for the Government. On the one hand, reopening a deal reduces the credibility and reliability of investing in Pakistan to foreigners, while on the other, the country could face financial collapse. It would probably be best for the managers of the power industry to realize their collective gains in suggesting and agreeing to a new price for an interim period, to help WAPDA and Pakistan overcome the medium-term problem, before resuming their earlier commitments.

The current economic program is the sum and extension of initiatives taken by various governments over the last 10 years. The menu of reform is extensive and ambitious in its targets. It is aiming to rectify distortions developed during many decades. It is also cognizant of the need to provide social safety nets to the labor force directly affected by the reforms. It equally recognizes the needs of industry and agriculture to respond to the new set of relative prices, competition, and opportunities. Most structural reforms by their very nature carry short-term costs and benefits that accrue in the medium term and, importantly, some of these reforms are mutually dependent for their success. Notwithstanding the unwavering commitment expressed by the Government to the total reform process, the resources committed in support of such an extensive program seem meager. During the three-year program period, total project and nonproject aid from multilateral and bilateral creditors committed so far ($12.2 billion) barely equals the amortization and repayments of official loans that are due during the same period. The remaining financing gap is expected to be filled by private sector medium- and long-term capital and short-term capital inflows. If the financial support is inadequate, the short-term costs will seem more burdensome and the benefits will accrue much later. In the process, the will and commitment to reform might falter, thus jeopardizing the entire reform process.

With the scarcity of concessional long-term financing, Pakistan has increasingly relied on costly commercial and short-term external borrowing. Although still a small proportion of total outstanding external debt, short-term external borrowing has almost doubled in the four years ending in 1996/97. The total commercial debt as a share of total public and publicly guaranteed debt rose from 2.3 percent in 1992/93 to 7.1 percent in 1996/97. The Government has also relied heavily on FCDs to meet external financing requirements. During 1995–1997, inflows into resident FCDs have covered one fifth to two fifths of the trade deficit. As of 31 December 1997, the total outstanding balance in FCDs stood at $10.5 billion, equivalent to one third of total external debt. About 86 percent of foreign currency deposits are either demand deposits or have a maturity of one year or less. Nondebt-creating inflows have not improved in recent years, with total foreign portfolio and direct investment remaining below $1 billion in 1996/97.

TARIFF REFORM

The lack of progress in implementation of tariff reform is explained by a number of mutually reinforcing reasons. First, the tariff reform was undertaken simultaneously with an ongoing tax reform that aimed to broaden the tax base, improve people's compliance with income tax, and introduce a general sales tax. Before that, tax revenues were mainly from customs duties and, therefore, a reduction of these depended to a large extent on the success in mobilizing more revenue from income and sales taxes. Second, to complicate matters, a large fiscal imbalance existed even in 1993, and correcting it was crucial to stabilization of domestic prices and improving the external reserves position. With laxity in public current expenditures, and a need to reduce the fiscal deficit, there was no room left for pursuing tariff reform with rigor. Third, the proposed reduction in tariffs was relatively fast considering the Government's ability to develop alternative sources of revenue. Also, the three-year period for reaching the target rate of 50 percent from 92 percent in 1993 was too short for private industry to make adjustments. The plight of private industry was worsened by failures in policy implementation. For instance, the Tariff Reform Committee failed to follow its own advice and never announced a three-tariff schedule to clearly lay out the reduction in phases of tariffs. As a result, industry could neither plan accordingly, nor voice its complaints to the National Tariff Commission of impending anomalies. Furthermore, a supportive credit policy to help industry restructure in response to tariff changes was never put together. In fact, interest rates remained high throughout the period due to the large fiscal deficit. The policy of helping labor relocate in the event of industrial restructuring never arose, although the impact on employment could create additional pressures against restructuring. Most important, industrial profits were unduly squeezed when maximum tariffs on final products were reduced, but tariffs on raw materials and inputs were not reduced at the same time (as the latter were important sources of tax revenue).

The effectiveness of the tariff regime in general and of the reform process in particular was subverted and eroded in several ways by policies prior to 1993 that remained intact or resurfaced in new shapes during the reform period. First was the reintroduction of paratariffs in the form of surcharges. Second was the imposition of a regulatory duty of 10 percent on almost all imports (with a few exceptions at 5 percent). Rationalized by the Government for revenue considerations, the measure not only reversed the earlier reduction in statutory rates, but also decreased the differential in rates between raw materials, intermediates, and final products. The result was an unexpected and unjustified squeezing of domestic value-added in many industries. This led to demands for relief, which industry received through exemptions and modifications announced through self-regulatory organizations. The lesson to be learned is that across-the-board changes in tariffs of such a large magnitude (10 percent compared with a maximum of 55 percent) are bound to create anomalies in the tariff structure in a complicated real world where items cannot be uniformly classified as inputs and outputs across all industries and firms.

The third factor undermining the effectiveness of tariff reform involved the administrative difficulties in controlling smuggling. High tariff rates themselves were a major disincentive to payment of duties and therefore provided the authorities with an incentive to speed up reform. But in effect, Pakistan's geographical proximity with Afghanistan (which has no administration to control illegal movements) and obligations to provide free access to the transit trade to its landlocked neighbor complicate matters.

Last comes the valuation of imports. In principle, Pakistan moved correctly toward preshipment inspection to help customs authorities determine price and classification of imports. But the cost of the service provided by the international companies was considered too high compared with the benefits accruing to the Government in the form of better customs revenue collection. Following the revelation of some mistaken valuations in a couple of cases, and due to lingering doubts about the appropriateness of the original preshipment inspection contract, the valuation of imports reverted back to the use of a customs international trade price manual. The latter method continues to suffer from customs officers' discretionary powers, with the potential for corruption.

In essence, the tariff reform process has become unpredictable. Not only has the Government failed to follow through on its announced path, but the above factors have complicated the impact of tariffs on domestic relative prices. As a result, it is difficult to claim that reforms have had a significant impact on resource allocation in the case of new investments. Much less can be claimed for any benefit for existing industry.

Tariff policy by its nature is a collection of diverse decisions regarding taxes on thousands of commodities. Tariff reform in Pakistan has attempted to introduce a certain degree of uniformity of treatment and cultivate an environment of automaticity while discouraging discretionary treatment of issues. Yet the complexities of the microeconomic world will warrant special treatment for certain situations. In view of the need to deal effectively with the seemingly conflicting aims of introducing uniformity and addressing special problems, proper implementation of the tariff reform is crucial to its success.

The most critical aspect of the implementation strategy is an unwavering commitment by the Government to implement the reforms in full. This will be continuously tested by those segments of the economy that bear the brunt of the adjustment costs. After all, tariff reform is proposing to redirect Pakistan's industry toward exports more decisively than ever before and in the process will affect an industrial base that has operated under a different policy environment for 50 years. Moreover, the commitment to change will also be tested by the bureaucratic and institutional mindsets that have grown accustomed to regulating industry. The implementation strategy must develop a momentum that can overcome the inertia generated by vested interests, while remaining responsive to the genuine problems of the adjustment process.

In addition, to facilitate successful implementation of the reform, the following are essential:

- the reform package should be announced well in advance of changes to allow industry and the labor market to adjust. The phasing and timing of changes, once announced, should be strictly adhered to. Industry should be given at least five years to adjust before the final maximum tariff rate of 35 percent is enforced;
- a clear and unambiguous articulation of the reform package, its contents, aims, and timing are essential to assure proper transmission of the incentives; and
- to accommodate the views of industry on the classification of items in various categories enjoying different duty rates, a standing committee should be set up in the National Tariff Commission, including representatives of the Central Board of Revenue and Ministry of Industries.

To help industry and the labor market to adjust to the changes in incentives, the Government should undertake the following measures:

- ensure adequate lines of credit through DFIs and commercial banks to finance industrial restructuring;
- set up labor retraining programs to enable swift absorption of displaced labor; and
- provide technical advisory services to the industries hit hardest by the reform, to facilitate their adjustment.

Finally, these principles should result in the preparation of model tariff schedules for each of the years covering the reform package. The National Tariff Commission should take responsibility for producing these and making them available to the private and public sectors for their comments and suggestions, before including them in the budgets for future years.

EXCHANGE RATE POLICY

The current exchange rate policy of the Government, with its dual objectives of restraining inflation and promoting exports, has been unsuccessful. Through periodic step devaluations following periods of relative nominal stability, the exchange rate policy has sought to recover the competitiveness of exports that has been eroded through domestic inflation that is higher than in trading partner countries. In effect, the policy has accommodated persistent fiscal and monetary slippages and provided the authorities with the assurance that expansionary financial policies would not erode competitiveness. In fact, targeting the real exchange rate index has failed to compensate exporters for the loss of competitiveness due to declining labor productivity and higher energy costs. At the same time, the exchange rate policy has contributed to inflation since the market has recognized the policy goals and discounted all devaluations through price and wage indexation. It would be preferable to restrict exchange rate policy to maintaining competitiveness, while monetary policy is assigned the exclusive target of inflation.

Vulnerability to Crisis

The financial crisis that hit five East Asian economies during 1997/98 resulted in large devaluations of their national currencies, sharp declines in stock prices, and substantial increases in interest rates as the countries attempted to stem the outflow of capital. The erosion of confidence following the crisis led to a severe cut in gross foreign capital inflows and a reversal of net capital flows to the five countries. Economic growth in these countries, as a group, decelerated.

The economic situation prevailing in Pakistan during this period was similar to the economic and financial environment that contributed to the financial crisis in East Asia. The country's financial sector was burdened by a large portfolio of bad debts, the regulatory framework was only starting to be reformed, and the management of public sector banks had only recently been taken over by professionals. Macroeconomic mix-management led to persistent external current account and budget deficits reflected in an unsustainable debt burden that was increasingly composed of variable interest rate and short-term debt at about one month's worth of imports. Above all, short-term foreign debt, including nonresident FCDs, was nearly 10 times the gross official foreign exchange reserves of the SBP.

There are several reasons why Pakistan did not experience the crisis that hit the East Asian economies.

- The East Asia boom was financed by highly "sensitive" private sector capital in the form of portfolio capital and short-term debt. But Pakistan's deficits have been largely financed by official flows and private sector bank deposits by residents and nonresidents and have displayed extraordinary stability during repeated balance-of-payments crises in the 1990s.
- The foreign currency exposure of the private sector in Pakistan was low. Despite repeated attempts, the private sector has had limited success in raising capital from international sources.

- While Pakistan did receive some portfolio investment in 1994 at the peak of inflows into emerging markets, poor economic performance, political instability, and the relatively better prospects in East Asia at that time limited such flows. The Karachi stock market peaked in 1994 and lost more than one third of its value by July 1997. It seems that most foreign institutional investors had already withdrawn from the market.
- Banking reforms were introduced in early 1997 and, together with better monitoring of prudential regulations, limited poor credit decision making.

Although Pakistan did not immediately suffer a financial crisis when the East Asian economies were economically destabilized, there are certain underlying weaknesses that threaten the country's financial stability:

- Pakistan's financial sector remains weak, and despite Government efforts, the recovery of bad loans is making little progress while the weak economy is contributing to further business failures.
- The Government is continuing with low-priority, long gestation infrastructure projects, thus further worsening fiscal and external accounts imbalances.
- The East Asian crisis has increased Pakistan's vulnerability to foreign exchange liquidity problems.
- The worldwide market and investor confidence have weakened, resulting in reduced willingness to provide foreign capital to developing countries and harder terms. Inflows of medium- and long-term private capital to Pakistan, which were relatively small in the first place, have further declined in the aftermath of East Asia's financial crisis.
- Demand for some of Pakistan's exports to affected East Asian economies, such as cotton yarn, has fallen.
- There has been much stronger price and non-price competition from East Asia in third markets as a result of the large devaluations of their currencies. This could affect key exports such as textiles and rice.

Crisis Management

At the end of May 1998, a financial crisis, triggered by the nuclear tests, hit Pakistan. Reserves plummeted from $1.2 billion to about $600 million. Unjustifiably, fearing capital outflows, the Government froze all foreign currency accounts. As a natural response, private sector remittances also practically ceased, thus cutting off about $2.5 billion of inflows projected for the current fiscal year. Commercial bank short-term lending to the Government and the SBP fell drastically.

The two sources of foreign exchange borrowing, official sources and private transfers, suddenly dried up and precipitated a financial crisis. They had financed Pakistan's economy, and had remained stable and seemingly insensitive to changes in economic fundamentals. The change came about because of political reasons (in the case of official inflows) and poor decisions by the Pakistan Government (in the case of foreign currency accounts).

Since the fundamentals were already weak, the Government adopted the following measures after the crisis of May 1998:

- it introduced a new two-tier exchange rate mechanism (22 July 1998) comprising the official rate (on 25 July, PRs46/$) and the floating interbank rate (on 25 July, PRs52/$). With official, open-market money changers allowed to operate, there are now four exchange rates operating: the official rate, the interbank rate, the money changers' rate, and the "havala" (black-market) rate;
- it removed the SBP band (previously fixed at PRs46 for spot buying and PRs46.46 for spot selling);
- it increased gasoline prices by 25 percent;
- it introduced new dollar bonds of five-, seven- and ten-year terms available to holders of foreign

currency accounts and new dollar depositors. The bonds offer LIBOR, LIBOR plus 1 percent and LIBOR plus 2 percent for the three different terms. Exemption from taxes and identity of source of funds apply. They are redeemable in dollars upon maturity;

- it gave permission to open new foreign currency accounts with fresh foreign exchange inflows. With these accounts, the difference is that commercial banks do not have to surrender the foreign exchange to the SBP. Banks are expected, according to the new prudential regulations, to onlend foreign exchange, while covering their exchange rate risk; and
- with the introduction of the two-tier exchange rate system, it allowed exporters to retain half of their foreign exchange holdings and encash them in the interbank market. Similarly, importers must seek half of their foreign exchange requirements in the same market.

Two Government decisions were particularly harmful. First, the freezing of foreign exchange account and the second was the decision to conduct a media trial of irregularities in the award of contracts to build private power projects by foreign investors, particularly that given to a company called Hub Power Company (HUBCO).

The market seemed unimpressed by the Government's measures. The loss of credibility due to the mishandling of the media trial of foreign investors, which caused the stock market crash, and the freezing of foreign currency accounts, will take time to recover. More than $2 billion has been encashed for rupees from the $11 billion in foreign currency accounts. Fluctuations and rupee depreciation in the free market suggest that depositors have taken their funds abroad. The open market exchange rate is expected to devalue further.

Credibility is very crucial and the Government should exert greater efforts to regain it.

Notes

[1]With intermediation margins limited to 0.5 percent.

[2]Following a stable period in 1994/95 when the nominal exchange rate was only marginally adjusted downward, the rupee started appreciating against major currencies (in line with the appreciation of the dollar), putting pressure on foreign reserves and leading to an increase in the parallel market premium to more than 6 percent.

In October 1995, the rupee was devalued by 7 percent against the dollar, following which it was kept stable for a few months to check inflationary expectations. Creeping depreciation resumed in January 1996, leading to an additional depreciation by June 1996 of 2.5 percent against the dollar, but which fell short of protecting the real effective exchange rate (REER). During the summer of 1996, this policy did not prove credible and the premium on the parallel exchange market rose to 10.4 percent. In September–October 1996, two step devaluations were implemented, a total of 11.8 percent, which was followed by a period without any adjustment until April 1997. Thereafter, four modest adjustments reduced the value of the rupee by less than 1 percent.

Between 1995 and 1997, the REER (against a trade-weighted basket of currencies) was kept broadly constant, although fluctuating widely, as increases in the REER caused by the positive consumer price inflation differential with competing countries were periodically eliminated by step devaluations. Between November 1996 and June 1997, however, the substantial appreciation of the dollar and the absence of significant exchange rate adjustments increased the REER by an estimated 11.5 percent. The steep depreciation of several currencies in Southeast Asian countries had an impact on Pakistan's competitive position, reflecting the overlap of these countries' markets with those of Pakistan.

[3]These are one-year government papers, denominated in foreign currency, mostly in dollars, for which there is a secondary market.

[4]See Appendix 3.

[5]This regulatory duty was capped for the higher tariff positions, so that the consolidated maximum tariff rate was kept at 65 percent.

[6]However, specific schemes permit individuals to import cars for their own use, provided they pay import duty rates in the 100–265 percent range.

[7]See Appendix 4.

[8]In addition, a system of quotas on Turkey's imports was initiated in October 1996.

[9]For recent trends in foreign investment see Appendix 5.

Appendix 1

State Bank of Pakistan Prudential Regulations

The SBP revised prudential regulations with respect to various operations of commercial banks in July 1998 in view of the continuing changes in the financial sector. These regulations pertain to:

- limitation on a bank's exposure to a single person;
- limitation on a bank's exposure against contingent liabilities;
- limitation on a bank's exposure against unsecured advances;
- linkage between a borrower's equity and total borrowing from a bank;
- maintenance of debt-equity ratio;
- financing facility against shares;
- dealing with directors, major shareholders, and employees of banks;
- classification and provisioning for loans and other assets;
- management requirements; and
- bank charges and opening of accounts.

Appendix 2

Overall Fiscal Developments, 1989–1998

The 1989/90 budget included steps to expand the base of income taxes and improve auditing. Sales tax was extended to domestically produced and imported goods with plans to introduce a GST from 1 July 1990. Specific rates of customs and excise duties were revised, while expenditure control and monitoring procedures were strengthened.

Despite repeated efforts, the budget deficit remained high and again climbed to 8.2 percent of GDP in 1992/93, reflecting the continuing failure to generate much revenue. The tax/GDP ratio remained stagnant at about 13.5 percent, despite higher tax rates and a multiplicity of taxes.

Fiscal reforms had to address long-standing structural issues such as extending income taxation to agriculture, federal-provincial revenue sharing, improvements in tax administration, broadening the base of the GST, and reducing taxes on international trade. On the expenditure side, fiscal managers had to deal with the large share of defense spending, rising interest payments, compression of development spending, and chronic expenditure overruns.

During 1993/94 and 1994/95, there was substantial progress in reducing the fiscal deficit to 5.9 and 5.6 percent of GDP, respectively, mainly through a curtailment in both current and development expenditures by more than 3 percentage points. This was supported by a slight recovery in the tax effort, reaching 13.7 percent of GDP in 1994/95, but offset by a reduction of 1.4 percent of GDP in nontax revenues as inefficiencies in public corporations decreased transfers to the budget.

The 1995/96 budget targeted a consolidated deficit of 5 percent of GDP—a downward adjustment by 0.6 percentage points compared with the outturn for the previous fiscal year. To this end, it incorporated a host of revenue measures, including removal of tax exemptions and concessions for special industrial zones, higher withholding taxes, increased Productivity Index Unit values for the wealth tax (by 25 percent), and a doubling of the excise duty on banks' and travelers' checks. Also, there was a further expansion of the excise duty to cover more goods, services, and certain professions. Despite these measures and their reinforcement by the fiscal package of October 1995, budgetary revenue remained flat in relation to GDP and the consolidated budget deficit widened to 6.9 percent of GDP in 1995/96, reflecting an increase in current expenditure.

For 1996/97, the Government adopted a budget with a targeted deficit of 4 percent of GDP, seeking an adjustment of nearly 3 percent of GDP in the deficit. To reach this target, a further package of revenue measures was announced that included important structural measures that would yield PRs40.8 billion. Among these measures were the extension of the GST to the import and manufacturing stages, with an increase in the standard GST rate by 3 percentage points (to 18 percent), and a reduction in the number of non-zero rates to three (5, 18, and 23 percent). Most general and industry-specific exemptions from the GST were eliminated, except for basic necessities, pesticides, fertilizers, electricity, and petroleum products. The 1996/97 Finance Bill also provided for a turnover threshold below which firms pay a turnover tax of 2 percent, and for refunds within a short period of the tax credit associated with purchases of capital goods and inputs for exports. The "fixed tax" schemes were eliminated, except for those on brick kilns.

The 1996/97 budget also included measures regarding direct taxes (curtailment of tax exemptions and holidays), central excise duties (extension to certain services and imported items), customs duties (withdrawal of exemptions and upward revision of some statutory rates), and increased federal taxation of the agriculture sector through the wealth tax (the rate of wealth tax per productivity index unit was raised from PRs250 to PRs400 and the base of the tax was broadened). At the same time, for revenue considerations, the authorities decided to defer the planned reduction in the maximum tariff rate from 65 to the 50–55 percent range and maintain the 10 percent regulatory duty imposed in October 1995.

The measures introduced with the 1996/97 budget caused serious adverse reactions, including disturbances and strikes. As a result, the Government was under strong pressure to make concessions by reintroducing some exemptions in virtually all categories of taxes and by lowering some rates. Furthermore, it cleared the backlog of duty drawbacks from the previous years. The total loss from post-budgetary adjustments and concessions amounted to PRs12.8 billion and contributed significantly to a deterioration in the budgetary situation and to the broader aggravation of Pakistan's macroeconomic situation in the first quarter of 1996/97.

Subsequently, on 22 October 1996, the authorities introduced another PRs40 billion of measures deemed necessary to attain the budget deficit target. The package consisted of cuts in the noncore PSDP; reduced expenditures by provinces; lesser wheat and railway subsidies; decreased allocations for durable goods; banned fresh appointments; introduction of a land tax by provinces; imposition of a service charge for import inspection; higher petroleum surcharges, excise duty on gas distribution; and increased smaller taxes and fees such as passport fees.

As in the preceding year, implementation of the fiscal plan fell far short of the target despite the corrective measures. Difficulties stemmed partly from the fact that political turmoil and uncertainty adversely affected the budgetary performance for the first half of 1996/97 after the dismissal of the Government. Equally important, the low rate of GDP growth and the decline in imports contributed to lackluster revenue performance. On the structural side, three important improvements were initiated by the interim Government, which held office from November 1996 to January 1997. First, a new National Finance Commission Award was issued to address the existing structural distortions in the financial arrangements between the federal and the provincial governments. Second, the concessionary GST rate of 5 percent was eliminated in December with most of the goods moved to the 10 percent group. Third, all four provinces adopted ordinances introducing agricultural income taxation, which were later approved by provincial assemblies.

The new Government took steps during 1996/97 to consolidate these structural reforms initiated by the caretaker Government and, in addition, in April 1997, it implemented a lowering of tax rates concurrently with a broadening of the tax base. Work was also started on a rationalization of expenditure on the basis of the Public Expenditure Review.

The 1997/98 budget consolidated the fiscal reform efforts of the present Government. The objective was to reduce tax rates and broaden the tax base to include the untaxed and undertaxed sector. The lower tax rates aim to stimulate production and investment and help tax administration through voluntary tax compliance. Specifically, the standard rate of the Generalized System of Preferences was reduced from 18 and 23 to 12.5 percent, personal income tax rates were halved, corporate income tax rates were reduced for those spending on workers' welfare, and investment in stocks and shares of quoted industrial units was exempted from the wealth tax up to 50 percent of stocks. The sales tax was to be extended to retail activities, but was unsuccessfully enforced.

Preliminary estimates indicate that the budget deficit was reduced from 6.2 percent of GDP in 1996/97 to about 5 percent in 1997/98. Tax revenues remained sluggish due to a slump in economic activity but showed some improvement as a percentage of GDP, while expenditure cutbacks were more significant with the share of development expenditure in total expenditure declining further to less than 15 percent.

Appendix 3

Tariff Policy Objectives and Details

Before the late 1980s, Pakistan's trade policy emphasized import substitution behind high tariff and nontariff barriers. Starting in 1988, Pakistan has been engaged in a broad program of economic reform, a chief component of which has been significant trade liberalization. Although successive governments have pursued tariff reform programs with varying levels of success and zeal, in 1993, the caretaker government produced a comprehensive document identifying the objectives, targets, and strategy of tariff reform. While success in implementation and the targets have varied subsequently, the broad thrust of the objectives and strategy has remained unchanged.

Efficiency gains from trade reform are likely to be far-reaching, particularly as policy changes redress the antiexport bias that has hampered the growth of Pakistan's export base for many years. Tariff reforms represent the most sweeping and broad-based attempt to change the direction of Pakistan's industrialization policy. However, most of the benefits of this outward orientation will accrue in the medium to long term, while some of the costs of the changes will be felt immediately. Policymakers have consequently adopted a cautious and pragmatic approach to phasing in the tariff changes, which has been necessary to allow both industry and labor markets to restructure in response to changing conditions.

OBJECTIVES OF TARIFF REFORM

The prime objective of tariff reform is the rationalization of the tariff structure to enhance the efficiency of existing domestic activities, especially in the manufacturing sector, and to improve resource allocation in the years ahead. In the process, tariff reform intends to reduce the bias against export activities and minimize distortions in the domestic price structure, which would result in a more equitable incentive structure for import-competing activities. Consideration must also be given to decreasing the burden of protecting domestic industry on final consumers and users of protected goods and activities. The attainment of these objectives will improve the growth potential of the country and increase employment opportunities.

Within the framework of these broad objectives, tariff reform aims for a number of more narrowly defined objectives while remaining cognizant of inevitable tradeoffs. Restructuring of the tariff regime and sales tax has been designed to bring down high protection and incentives traditionally given to import-competing activities, especially in manufacturing, thereby reducing the disincentive against export activities. The nominal tariff rate structure has been cascading, rising with the stages of manufacture in an attempt to encourage greater value added. Tariff reform has aimed for greater uniformity across activities at the same stage of production by limiting the number of tariff rate tranches. The system of taxing imports has been simplified by merging surcharges, import license fees, and import duties into one rate. The distinction between commercial and industrial importers should eliminate windfall profits and improve the availability of inputs. The reform seeks to encourage investments by lowering the cost of machinery through a tax reduction on imported machinery that is not locally available.

While trying to achieve these objectives, the process of tariff reform has been constrained by concern over limiting the revenue impact of tariff changes. While revenue neutrality is not the aim of the tariff reform, fiscal feasibility of the new tariff structure is nevertheless essential. Some reduction in revenue from import duties as a result of the reform would not conflict with the need to reform Pakistan's overall tax system so that the current reliance on revenue from import duties is lessened, while direct tax revenues are increased. At the same time, the scope for raising income tax revenues and broad basing the sales tax is limited and involves considerable time. In view of these considerations, tariff reform aims for a tariff structure whose adverse revenue impact could be compensated by other feasible tax measures over the period of the reforms, minimizing adjustment costs arising from changes in relative prices and protection of domestic industry.

RECENT APPROACHES TO TARIFF REFORM

The interim government that took over in November 1996 quickly assessed the implementation of the 1993 reform. It suggested a two-pronged approach toward further liberalization: on one hand, trade reform policies aimed at achieving targets in across-the-board tariff reduction, simplification, and rationalization; while on the other, it was recognized that problems of specific sectors and industries should be identified and addressed at an accelerated pace but remedies should remain within the broad objectives of the overall reform.

In the first year of the reform, which coincided with the budget for 1997–1998, the Government removed the 10 percent regulatory duty, reduced the withholding income tax from 5 to 2 percent, lowered the maximum tariff rate from 65 percent to 55 percent, and decreased tariffs on raw materials by 5 percent.

The reform had both positive and negative impacts. On the positive side, the changes reduced the working capital requirements in the industry and finance sectors. Moreover, with less pressure for capital, pressure on interest rates also subsided. These measures also increased production and decreased costs, thereby encouraging exports. On the other hand, the changes resulted in a revenue loss to the Government of more than PRs18 billion.

Based on the experience of previous tariff reforms, the new Government proposed the deceleration of tariff reductions, reaching the target of 35 percent from a maximum of 65 percent in five years starting in fiscal year 1997/98. This would allow sufficient time for industry to adjust and for the Government to develop other sources of revenue while restraining expenditure. The first cut lowered the maximum tariff from 65 to 55 percent; thereafter, the maximum rate will be progressively reduced to 35 percent, at a rate of 5 percent per year, and the tariff tiers decreased to six.

Various additional issues will be discussed during the second phase of reform, including smuggling associated with Afghanistan's transit trade, the rationalization of the concessionary tariff regime, and tariff rationalization procedures. Changes in the tariff structure have been recommended for textiles, engineering products, and leather.

TEXTILE PACKAGE

Tariff changes for the textile industry introduced at end-1996 were designed to address the typical problems that this vertically integrated industry faces in Pakistan. The country produces cotton products from raw cotton to finished garments. The textile sector remains the largest industrial sector and exporter. The aim of the textile package was to revitalize this sector in addition to removing distortions and problems faced by other export groups. The underlying principle of the package is that of neutrality, i.e., no sector should receive benefits at the cost of another.

One of the major problems facing the textile spinning sector is the high price of imported raw cotton and man-made fibers, e.g., polyester, viscose, and acrylic. The textile package aimed to reduce distortions, while safeguarding the viability of investments in the man-made fiber sector, and the interest of cotton growers.

RAW COTTON

In view of the legitimate interests of the cotton growers, and the objective of providing a level playing field, the export of raw cotton was allowed without any export tax. This enabled cotton growers to receive a price for their crop that was in line with world market prices. To assure that raw material was available at world prices to the spinning sector, the import duty on raw cotton was removed. Previously, raw cotton imports were subject to customs duty, withholding tax, and an inspection fee. After including octroi duties, total levies exceeded 15 percent. Hence the 5 percent customs duty on raw cotton should be eliminated and the withholding tax imposed at the same rates as on the domestic trade in raw cotton. The inspection fee, however, will remain as it is a user charge. It is expected that irrespective of the size of the domestic crop and the extent of exports of raw cotton, the domestic spinning sector will not face shortages or an increase in domestic costs.

MAN-MADE FIBERS

Pakistan's textile products, at all stages of production, have been adversely affected by existing policies on man-made fibers. Protection given to the man-made fiber subsector has been at the cost of the rest of the textile sector. The share of man-made fibers in textile products is in the range of 10–20 percent, whereas the worldwide average is 55 percent. Changes in the import duty structure and other incentives are intended to rectify the structural deficiency in the composition of raw materials in the textile industry. This will enable the industry to diversify and encourage the production of blended fabrics, which will greatly enhance the value and marketability of Pakistan's textile products. It will also help optimize the production of polyester fiber domestically, which now has substantial idle capacity

The need for working capital was greatly reduced by allowing duty-free access to imports, since spinners will no longer have to hold stocks of domestic raw cotton for six months. The SBP was requested to insure that adequate credit is available on time for efficient inventory management by the industry.

Appendix 4

Export Promotion Policies

In addition to ensuring a competitive exchange rate and further lowering import duties to reduce antiexport biases, the authorities have adopted a targeted export promotion strategy, the main elements of which are institutional development and administrative streamlining. Specifically, the following reforms are being pursued: improving the computation of duty drawback rates, expanding the number of specific drawback rates, allowing exporters to claim drawbacks on the basis of taxes and duties actually paid, integrating the duty drawback and sales tax refunds in one window to avoid unnecessary transactions, and strictly enforcing standards on timing of repayments. Pakistan has two schemes (temporary importation and bonded manufacturing) that permit exporters to hold tax and duties on imported inputs in suspense until the associated exports have been made; a key element of the schemes is to simplify their eligibility and operating requirements to encourage their use.

Some exports remain subject to quantitative restrictions, mainly to assure the adequacy of internal supplies at reasonable prices; however, most export duties were removed in 1994. In addition, exports are strongly encouraged through a multifaceted incentive system. The Export Trade Control Order (issued in 1997) lists 26 items (live animals, grains and beans, edible oils, minerals and ores, ferrous and nonferrous metals, and sugar) as nonexportable; other items need prior authorization from line ministries (raw cotton and fertilizers), the Export Promotion Bureau (rice), or a professional association (cotton yarn). Export quotas remain in place for cement and clinker. Petroleum products are exportable only through public sector agencies. Export duties are only enforced for unfinished leather products and crushed bones. In addition, nontextile exports are subject to a 0.25 percent levy on their free on board value, the proceeds of which are earmarked for the promotion of exports through an extrabudgetary fund.

There are five schemes designed to remove the disadvantages that Pakistan's exporters face in accessing inputs at prices that are comparable to those of their foreign competitors.

TEMPORARY IMPORT SCHEME AND BONDED MANUFACTURING SCHEME

Exporters can obtain a license under these schemes to manufacture export goods under bond. They must operate a warehouse facility to store the bonded duty-free and tax-free inputs, to be released for the manufacture of exports under official customs supervision.

CUSTOMS DUTY (AND EXCISE) DRAWBACK SCHEME

This scheme rebates at fixed rates customs and excise duties on inputs used in the manufacture of specified export products, after the product has been exported. It includes fixed drawback rates for all exporters in standard and specific notifications.

Previously, import-related sales tax was refunded together with excise and customs duties under this scheme. Since 1 January 1997, refund of import-related sales tax is administered separately under a different scheme.

The drawback scheme is the most widely used export promotion measure in Pakistan. The Central Board of Revenue has made a significant effort to improve the administration of this scheme. In this context, a large number of new notifications have been issued, raising the total to more than 400 standard and individual notifications.

REFUND OF SALES TAX

Introduced on 1 January 1997, refund procedures for import-related sales tax for exporters have been merged with the refund procedures for domestic input-related sales tax for exporters.

EXPORT PROCESSING ZONES

One EPZ is in operation in Karachi and another one is under construction in Sialkot. Both are operated by the public sector.

UTILIZATION OF THE VARIOUS EXPORT PROMOTION SCHEMES

Based on 1995/96 data, few exporters use the "no duty no drawback" schemes (i.e., temporary import and bonded manufacturing schemes). Similarly there are less than 200 EPZ licenses, of which only a fraction are in operation. Most exporters use the duty drawback scheme.

Appendix 5

Recent Trends in Private Foreign Investment

In recent years, many developing countries have increasingly resorted to private foreign investment as a source of capital, technology, managerial skills, and market access needed for sustained economic growth and development. As a result, total FDI flows in the world in 1996 reached $349.2 billion against $203.8 billion in 1990. Developing countries have succeeded in attracting a greater share of global inflows of FDI from 17 percent in 1990 to 37 percent in 1996. South Asia's inherent structural and institutional rigidities made it less attractive than its East and Southeast Asian counterparts, but even then, its FDI inflows grew from $464 million in 1990 to $3.46 billion in 1996. Pakistan's FDI inflows, in spite of political upheavals and policy inconsistencies, increased from $244 million 1990 to $690 million in 1996.

The recent economic crisis in Southeast Asia has eroded the competitiveness of countries in the region. Pakistan is also a victim of this. There was a slight improvement of 1 percent in net private foreign investment in the first nine months of FY1997/98. The power sector received the largest share of private FDI. Portfolio investment rose by 10 percent while FDI declined slightly by 2.7 percent during this time.

Foreign investment has been fully protected and has enjoyed high returns in the country. Transnational companies' experience has been good in terms of their expansion and prosperity. Those listed on the stock exchanges are regarded as "blue chips."Based on their experience, Pakistan would have attracted substantial foreign investment, but for the adverse impact of political instability and the cumbersome procedures causing inconvenience to foreign investors. Attempts have been made to remove these impediments in the New Investment Policy of 1997, which includes major policy initiatives. In the past, foreign investment was restricted to the manufacturing sector, which accounted for only 18 percent of GDP. Foreign investment is now allowed in sectors such as agriculture and services, which constitute more than three quarters of GDP.

Table A5.1: Foreign Investment ($ million)

	1996–1997			1996–1997 (July–March)			1997–1998 (July–March)		
Economy	**Direct**	**Portfolio**	**Total**	**Direct**	**Portfolio**	**Total**	**Direct**	**Portfolio**	**Total**
Canada	1.7	0.8	2.5	1.4	0.8	2.2	0.3	…	0.3
France	10.2	…	10.2	2.6	…	2.6	4.7	0.4	5.1
Germany	17.6	19.7	37.3	13.7	15.5	29.2	6.6	1.0	7.6
Hong Kong, China	7.5	(20.6)	(13.1)	6.3	(22.1)	(15.8)	2.0	200.6	202.6
Italy	1.8	—	1.8	1.7	—	1.7	…	0.1	0.1
Japan	36.6	6.9	43.5	16.0	6.9	22.9	12.5	(1.2)	11.3
Korea, Republic of	7.3	—	7.3	5.4	—	5.4	4.2	—	4.2
Netherlands	0.7	3.5	4.2	6.1	1.6	7.7	24.4	0.2	24.6
Saudi Arabia	(17.0)	…	(17.0)	(17.0)	—	(17.0)	1.2	0.5	1.7
United Arab Emirates	54.9	(5.2)	49.7	10.2	(7.6)	2.6	13.4	15.5	28.9
United Kingdom	240.1	77.9	318.0	183.0	45.7	228.7	72.0	(78.2)	(6.2)
United States	246.2	111.3	357.5	166.9	69.4	236.3	199.8	69.4	269.2
Others	67.5	73.1	140.6	52.1	75.1	127.2	95.0	3.4	98.4
Total	**675.1**	**267.4**	**942.5**	**448.4**	**185.3**	**633.7**	**436.1**	**211.7**	**647.8**

( ) = Negative values are enclosed in parentheses.
— = nil; … = negligible.
Source: State Bank of Pakistan, Annual Reports (various issues).

Table A5.2: Industrial Investment (PRs million)

Item	1995–1996	1996–1997	1997–1998	Percent Change (1996–1998)
Manufacturing	62,515	72,515	83,991	15.83
Public Sector	3,840	8,584	3,871	(54.90)
Private Sector	58,675	63,931	80,120	25.32
Large Scale	50,558	58,284	68,468	17.47
Public Sector	3,840	8,584	3,871	(54.90)
Private Sector	46,718	49,700	64,597	29.97
Small Scale	11,957	14,231	15,523	9.08
Public Sector	0	0	0	0
Private Sector	11,957	14,231	15,523	9.08

( ) = negative values are enclosed in parentheses.
Source: Federal Bureau of Statistics.