

Ensuring a Demographic Dividend: Unleashing Human Potential in a Globalized World

Draft Summary
of the
Poverty Reduction Strategy Paper-II
April 25, 2007

Ministry of Finance
Government of Pakistan



CONTENTS

FOREWORD

PART-I

I. Introduction	1
II. Macroeconomic Management in the 1990s	4
III. Options Available	11
IV. Poverty Reduction Strategy: Phase 1	11
V. Outcomes of the First Phase of Poverty Reduction Strategy	14

PART-II

Basic Philosophy of PRSP-II.....	19
VI. Macroeconomic Framework.....	20
VII. Poverty Reduction Strategy	23
Pillar I: Drivers of Economic Growth and Macroeconomic Stability	
Demographic Dividend and Emergence of Middle Class as Drivers of Growth	23
Riding the Globalization Wave in Export Markets	26
Drivers of Growth: Manufacturing, Value Added Agriculture, Services etc.....	27
Mega Cities as Engines of Growth	29
Development of Rural Infrastructure and Markets for Growth and Poverty Alleviation	29
Pillar II: Crafting a Competitive Advantage	
Private Sector Development and Enhancing Role of the Private Sector	31
Intensifying Deregulation, Privatization and Liberalization	32
Enhancing Competitiveness and Productivity	33
Special Economic Zones, Industrial Parks, IT Parks and SME Cluster Development	34
Research and Development, Extension Services and Value- addition in Agriculture	34
Pillar III: Harnessing the Potential of the People	
Putting People at the Centre of National Development and Human Resource Development Strategy	37
Mainstreaming Gender and Empowering Women.....	38



Employment Generation and Prosperity Sharing	39
Pillar IV: Financial Sector Deepening and Economic Development	
Role of Financial and Capital Markets.....	42
Investment Projections	47
Financial Globalization in Pakistan	47
Pillar V: World Class Infrastructure	
Medium Term Development Framework 2005-2010 (MTDF), Infrastructure Development Requirements and Financing	
Public/Private Partnerships (PPP)	50
Leveraging the Water Resource for Development.....	51
Ensuring Energy Security and Energy Efficiency	51
National Trade Corridor and Modernization of Logistics Chains.....	53
Pillar VI: Effective Governance and Management	
Second Generation Reforms	56
Reinforcing Devolution	57
Effective Social Service Delivery	57
Pillar VII: Targeting the poor and the Vulnerable	
Targeting Poverty and Social Safety Nets	60
Micro Finance	61
VIII. Strategy Going Forward	63
Annexure-1	65
References.....	66

FOREWORD

The second generation Poverty Reduction Strategy Paper or PRSP – II, while essentially building upon the successes achieved in the formulation and implementation of the Interim PRSP launched in 2001 and the full PRSP launched in December 2003, is an iteration of a National Economic Strategy that takes cognizance of existing economic realities, the need to change them and set forth a framework for implementing change. Pakistan is in the midst of an economic upturn. Prudent economic policies and bold, wide ranging structural reforms over seven years have changed the complexion of Pakistan’s economy. The economy is no longer fragile. It is healthier today than ever before; a \$ 60 billion economy seven years ago, is now over \$ 140 billion; private sector is buoyant, industry, exports, imports are growing at respectable rates; domestic markets have expanded on the back of strong consumer spending; the country’s debt burden is reduced to one-half; foreign exchange reserves are at an all time high; foreign investment reaching levels never reached before, the confidence of foreign investors in future prospect is strong; credit ratings have continuously improved; and most importantly, unemployment and poverty have declined significantly and social indicators have also witnessed appreciable improvements. In short, a sea change has taken place in every aspect of the economy in a short span. The journey from low growth and macro economic stability and then onwards to recovery growth and poverty alleviation has been an arduous one but the ingenuity, skills, determination and unwavering commitment of the leadership to a home grown national vision has transformed Pakistan’s economy from fragility to a resurgent one.

In this document we have attempted to provide a strategic focus to a set of policies and strategies that would allow Pakistan to make full use of the demographic advantage it finds itself in, and to reap the “demographic dividend”. Sub-strategies under this overall theme would focus on employment generation, and Pakistan’s integration with the global economy with a view to finding solutions to the challenges that Pakistan faces today. The draft PRSP is meant to continue the process of dialogue and consultation that has been

ongoing for a while and which will now lead to a finalization of the strategy. All comments/suggestions are therefore welcome.

I would like to express my gratitude to colleagues in the government, Pakistanis from all walks of life, Donor agencies and members of civil society who have fully participated in the consultation process so far accomplished and made it possible for us to present this roadmap. Finally, I would like to commend the efforts of the PRSP Secretariat and Economic Adviser's Wing for their untiring efforts in preparing this Draft Summary.

Islamabad, April 25, 2007

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PART-I



I. Introduction

Pakistan's economic turnaround in the last seven years has been remarkable in several ways. It is a little known story, although it contains valuable lessons for students and practitioners of economic development. From crippling macroeconomic imbalances, low investment growth and increasing poverty to a virtuous cycle of reforms, macroeconomic stability, increasing investment, strong growth and reducing poverty, has not been a short or easy journey. A series of exogenous and endogenous shocks were unable to stall or derail Pakistan's economic performance. This all goes to show that given a truly national homegrown vision and unwavering commitment, there are few obstacles that can not be removed.

Yet the government is not complacent. Far from it, for the challenges are several and far from over, although their nature has also changed as Pakistan's economy continues to transform. The challenges, however, are all identified and the response formulated. This is what the PRSP II is about; facing the future with confidence and a carefully crafted roadmap, embedded in a national consensus, capable of propelling Pakistan into strong self sustaining growth and development, vastly improving the quality of life for its people.

The purpose of this document is to provide a strategic framework that can form the basis of a dialogue leading to the formulation of a detailed strategy. First, however, a brief recapitulation of the challenges that Pakistan faced at the tail end of the 90's. Persistently high fiscal and current account deficit and poor governance had resulted in rapidly deteriorating economy. The country's debt burden worsened as foreign exchange reserves dwindled to dangerously low levels, sufficient to finance a few weeks' imports. International credit rating agencies had downgraded Pakistan to a selective default level. Macro-economic instability led to a loss of confidence decelerating both investment and growth, with poverty rapidly increasing. Although Pakistan was one of the prolonged users of IMF resources and borrowed heavily from the other International Financial Institutions (IFIs), its relationship with its international development partners was characterized by lack of trust. In short, Pakistan was at the brink of economic ruin. The decade of the 90's was a lost decade for Pakistan and one of missed opportunities.

By the end of the 1990s, Pakistan, therefore, faced five key challenges: 1) improving the country's macro-economic environment; 2) bringing the debt situation under control; 3) restoring investor confidence; 4) reviving economic growth; and most importantly, 5) creating gainful employment opportunities and arresting the rising trend in poverty.

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To steer Pakistan back on to the path of strong, sustained and broad based economic growth and to create jobs and reduce poverty, Pakistan required a prolonged period of macroeconomic stability, financial discipline, consistent and transparent policies that placed poverty reduction at the centre of the country's overall economic policies. These along with improved governance and better quality infrastructure were needed to encourage private sector to play a leading role in promoting investment and growth. The government on its part needed to redefine its role in the economy.

To address these complex and multi-dimensional challenges Pakistan followed a two-pronged strategy: first, implement policies that would improve the country's macroeconomic environment and second, implement wide-ranging structural reforms to improve supply side response by removing impediments to private sector development. The country's overall economic policies were enshrined in the Poverty Reduction Strategy Paper (PRSP) launched first as Interim PRSP in 2001 and then as a comprehensive PRSP in December 2003. The PRSP since then has assumed the status of the key economic strategy document of the government for the socio-economic development of the country.

Prudent macroeconomic policies as documented in PRSP and wide-ranging structural reforms underpinned Pakistan's economic turnaround. Six/seven years of consistent and transparent economic policies along with economic reforms have transformed Pakistan into a stable and resurgent economy. Pakistan's economy has grown at an average rate of almost 7 percent per annum over the last four years and positioned as one of the fastest growing economies in the Asian region. The size of its economy has more than doubled (from \$ 58 billion to \$ 132 billion) and per capita income almost doubled (from \$ 438 to \$ 847) during the last seven years. It has succeeded in reducing unemployment and poverty. The fiscal and external account balances have improved vastly and consequently there has been a sharp reduction in public and external debt burden. Pakistan also succeeded in building foreign exchange reserves, which provided much needed stability in its exchange rate. It has now emerged as an attractive destination for foreign investment which is expected to touch the unprecedented level of \$6.0 billion this year from a tiny \$ 400 million in 1998-99 – a 5 times increase in foreign investment in just eight years. Pakistan continued to pursue its privatization program with major strategic sales taking place during the last seven years. It completed the Poverty Reduction and Growth Facility (PRGF) arrangement with the Fund ahead of time, did not draw the last tranche, and exited from a financial relationship with the Fund. Pakistan has entered international capital markets to showcase its continuously improving credit story. It has

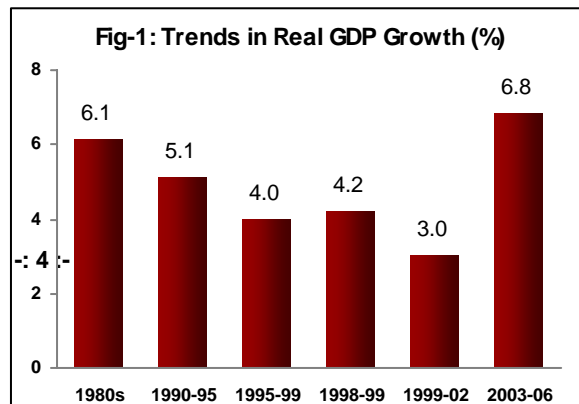
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which forms the key elements of the poverty reduction strategy. Since strong economic growth is essential for job creation and poverty alleviation, the key drivers of economic growth (Pillar-I) are examined in section VII. The central feature of this section is the discussion on demographic transition that is taking place in Pakistan; how the country can turn its large proportion of young people into a boon; how through the implementation of effective policies the demographic transition can be converted into demographic dividend; how this will generate domestic demand, expansion of domestic markets, increase in savings, investment and therefore support the growth momentum with a view to reducing poverty.

The expanding domestic markets will need enhanced supplies of goods and services, which will trigger a supply side response. Private sector development will be critical in expanding the supplies of goods and services. What needs to be done in promoting the role of private sector is the subject matter of Pillar-II. Can demographic transition be converted into demographic dividend automatically? The answer is no. It requires policies and investment for harnessing potential of the people in general and the younger population in particular. This is the subject matter of Pillar-III. What role the banking and financial sectors will play in promoting growth with a view to reducing poverty are discussed in Pillar-IV. There is a strong correlation between infrastructure spending and poverty reduction. An effective and modern infrastructure is *sine quo non* for supporting the ongoing growth momentum and poverty reduction. Pillar-V discusses the government's strategy and programs for improving the country's infrastructure. Improved governance is necessary for poverty reduction as the poor are worst hit by poor governance. Pillar-VI discusses the government's strategy for improving governance with a view to reducing poverty. In particular, this section discusses second generation reforms that include institutional strengthening, improving the delivery of social services and the role of devolution therein. While growth is necessary for poverty reduction, growth must be supported by direct intervention in improving the lives of poorer segments of society. The various initiatives that target direct interventions for the poor are discussed in Pillar-VII. The final section discusses the strategy going forward.

II. Macroeconomic Management in the 1990s

A stable macroeconomic environment is essential for sustained higher



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economic growth and therefore, should be the key element of any poverty reduction strategy. Empirical evidence suggests that macroeconomic instability has generally been associated with poor growth performance and a consequential rise in poverty¹. The persistence of large fiscal and current account deficits and the attendant rise in public and external debt have been the major source of macroeconomic instability in many developing countries, including Pakistan in the 1990s. Failures in enhancing revenues consistent with growing expenditure requirements on the one hand and stagnation in exports and decline in other foreign exchange inflows far short of payment requirements on the other, exacerbated macroeconomic imbalances. These imbalances created a macroeconomic environment which was not conducive for investment and growth. Such a state of affairs had a far reaching impact on the country's economic well-being. Indeed, Pakistan witnessed its investment rate decelerating, economic growth slowing, employment opportunities shrinking, poverty level rising, debt burden reaching alarming proportions, and foreign exchange reserves plummeting².

By the end of the 1990s, Pakistan was facing two major challenges. First, how to stem the financial hemorrhage and stabilize the country's debt situation with a view to restoring macroeconomic stability; and secondly, how to revive investment and growth to reduce unemployment and poverty. These two challenges were interconnected. A rising debt burden was consuming almost two-third of total revenues on account of annual debt servicing leaving very little to be spent on all other activities, including physical and human infrastructure. The budgetary constraints or limited fiscal space forced the government to curtail public sector investment. Being complementary in nature, private sector investment also witnessed a gradual decline³. Thus, the decline in overall investment slowed economic growth and consequently caused unemployment and poverty to rise.

Pakistan's economic growth slowed considerably during the decade of the 1990s for a variety of reasons, including worsening of macroeconomic environment, serious lapses in implementation of stabilization policies and structural reforms, the law and order situation in the major growth centers of the country, inconsistent policies and poor governance. As against an average growth rate of 6.1 percent in the 1980s, the real GDP growth slowed to an average of 4.9 percent in the first half and 4 percent in the second half of the 1990s.

¹ See Easterly (2000)

² See Khan (2003), Lorie and Kazmi (2006) and Lorie and Iqbal (2005)

³ Empirical evidence suggests a complementarity between public and private sector investment in Pakistan. See Khan (1998) for details

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The large-scale manufacturing and services sectors contributed largely to the deceleration of growth in the 1990s. The former grew by an average annual rate of 8.2 percent in the 1980s, slowed to an average of 4.7 percent in the first half and 2.4 percent in the second half of the 1990s. In other words, the large-scale manufacturing lost almost three-fourth of its growth momentum in the 1990s. The services sector also slowed from an average growth of 6.6 percent in the 1980s to 5.1 percent and 4 percent during the first and second half of the 1990s, respectively, losing one-third of its growth momentum in the decade. [see Table-1 and Fig.2].

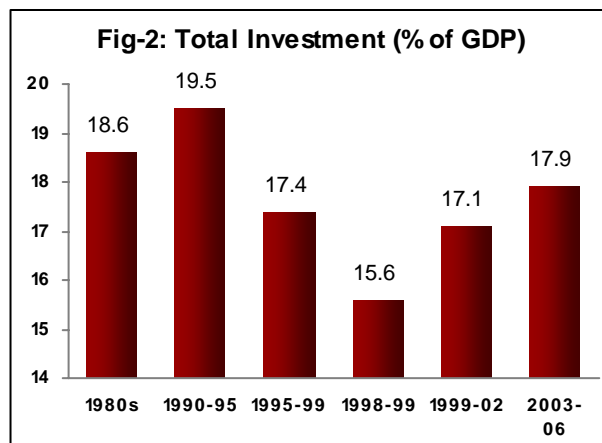
Table 1: Growth, Investment and Inflation							
Item	Unit	1980s	90-95	95-99	98-99	99-02	03-06
A. GDP GROWTH RATES	%	6.1	5.1	4.0	4.2	3.0	6.8
a. Agriculture	%	4.1	4.2	4.6	2.0	1.3	3.9
b. Manufacturing	%	8.2	5.7	3.6	3.7	5.1	10.5
c. Manufacturing (LS)	%	8.2	4.7	3.0	3.6	4.8	12.5
d. Services	%	6.6	5.1	3.8	5.0	3.8	6.9
B. TOTAL INVESTMENT	As % of GDP	18.6	19.5	17.4	15.6	17.1	17.9
a. Fixed Investment	As % of GDP	16.8	18.0	15.5	13.9	15.8	16.3
b. Public Investment	As % of GDP	9.1	8.6	6.5	6.1	5.2	4.3
c. Private Investment	As % of GDP	7.8	9.4	9.0	7.9	10.6	12.0
C. NATIONAL SAVINGS	As % of GDP	14.7	14.2	12.3	11.7	17.0	17.7
a. Domestic Saving	As % of GDP	9.3	13.9	13.3	12.9	17.7	15.4
D. INFLATION	%	7.3	11.5	9.0	5.7	3.8	6.2

Source: Various issues of Pakistan Economic Survey

Growth decelerated in the 1990s because s total and fixed investment rates also declined in the same period.

Total and fixed investment rates averaged 18.6 percent and 16.8 percent, respectively in the 1980s but declined to 17.1 percent and 15.3 percent respectively in the second half of the 1990s. The decline mainly emanated from public investment which averaged 9.1 percent of GDP in

the 1980s but decelerated to 6.4 percent in the second half of the 1990s [Table 1 and Fig 2]. The public sector investment plays a critical role as growth stimulus in developing countries. The macroeconomic environment that persisted during most of the period in



the 1990s was not conducive to investment and therefore to growth. Persistence of the large fiscal (*almost 7 percent of GDP*) and current account (*5 percent of GDP*) deficits were the major cause of macroeconomic imbalances in the 1990s.

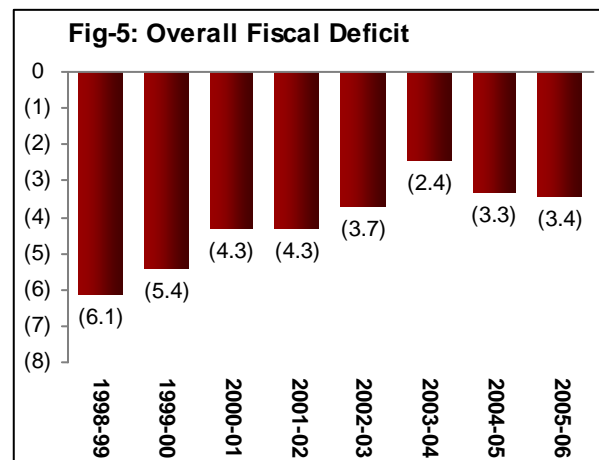
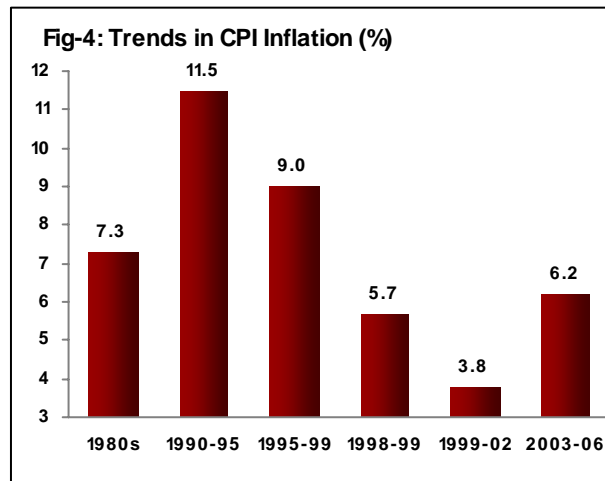
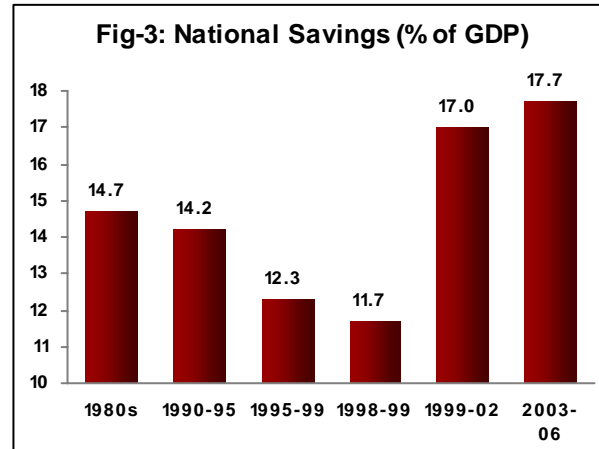
National savings rate also witnessed a significant decline during the 1990s resulting in a widening of the saving-

investment gap [see Table-1 and Fig 3]. The weakening of growth momentum in the 1990s constrained the employment generation capacity of the economy. Accordingly, the unemployment rate rose from an average of 1.3 percent in the 1980s to 5.65 percent in the 1990s.

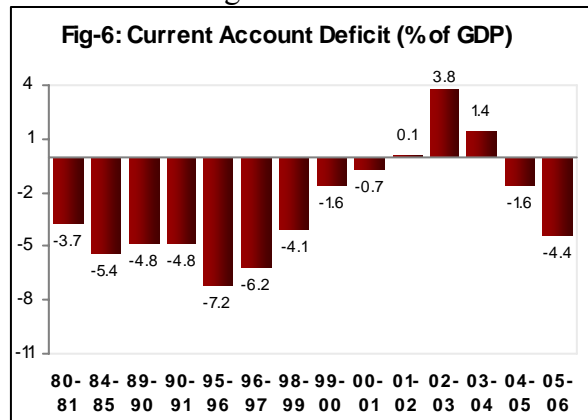
The rise in unemployment aggravated poverty which rose from 19-20 percent in the 1980s to over 30 percent by the end of the 1990s.

Inflation remained in the double-digit during most of the 1990s. Monetary policy became hostage to lax fiscal policies stance on the one hand and persistence of supply side shocks (*rising oil prices, frequent crop failures etc.*) on the other, along with frequent increases in administered prices and frequent devaluation of Pakistani rupee were the main factors responsible for double-digit-inflation in the 1990s.

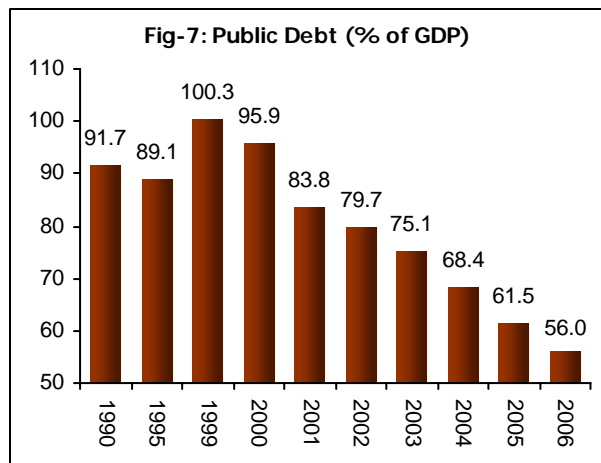
By the end of the 1990s, Pakistan's **public and external debt** had reached unsustainable levels. Pakistan's public debt grew at an average rate of 18 percent and 15 percent per



In many developing countries, including Pakistan, the twin deficits have been the prime cause of low economic growth. An important channel through which fiscal deficit damages growth performance is by reducing national savings and crowding out domestic investment. National savings rate declines because of the negative public savings (*revenue deficit*). Low national saving rate forces government to rely more on foreign savings to achieve investment and growth targets.



Greater reliance on foreign savings leads to greater accumulation of external debt. This is exactly what happened in Pakistan in the 1990s. Large fiscal and current account deficits led to the accumulation of both public and external debt, thus increasing the country's vulnerability to external shocks, reducing investment rate and consequently slowing economic growth. It was,

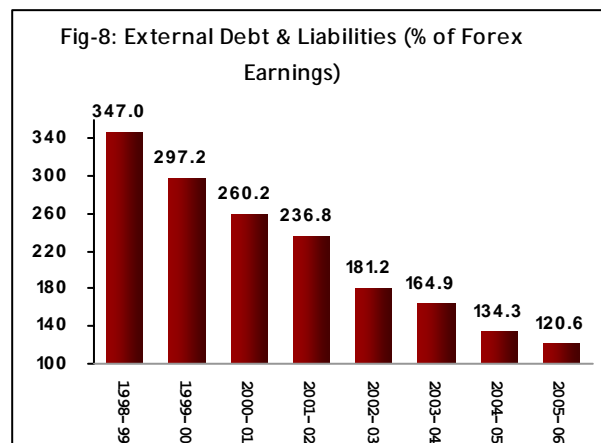


therefore, clear that Pakistan's debt situation in the 1990s was consistent with the findings of recent literature on the relationship between debt and growth. The literature has found a strong negative relationship between fiscal and current account deficits and economic growth⁵. When a country like Pakistan sustains such large fiscal and current account deficits over a prolonged period of time, there will be deceleration in investment and economic growth. Besides large fiscal and current account deficits, the imprudent use of borrowed resources, the rising real cost of borrowing, stagnant exports and a declining flow of foreign exchange have been responsible for a rapid accumulation of external debt in the 1990s.

⁵ For more on this issue see Pattillo et.al (2004)

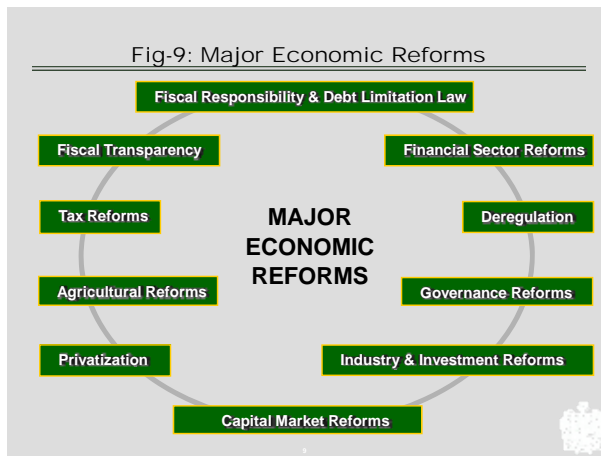
Pakistan's total stock of external debt and foreign exchange liabilities grew at an average rate of 6.6 percent per annum during 1990-99 — rising from \$ 20.5 billion in 1990 to \$ 38.9 billion by end June 1999. Foreign exchange earnings on the other hand, either remained stagnant or increased marginally.

While external debt and liabilities increased by \$ 18.4 billion in the 1990s, foreign exchange earnings rose by only \$ 4 billion. Consequently, the burden of the debt (*external debt and foreign exchange liabilities as percentage of foreign exchange earnings*) rose from 256.6 percent in 1989-90 (*at the end of the 1980s*) to 347 percent by 1998-99 (*at the end of the 1990s*). Similarly, external debt and liabilities were 54.9 percent of GDP in 1989-90 but increased to 64.6 percent by 1998-99 [See Fig 8].



The results were disastrous for the economy. By the end of the 1990s, almost two-thirds of budgetary resources were expended on debt servicing, leaving only one-third to be spent on all other activities including health, education, infrastructure etc.

The under investment on physical and human infrastructure adversely affected investment climate leading to the deceleration in investment and growth and consequent rise in poverty.



Summary: The decade of the 1990s was a decade of lost opportunities for Pakistan. Poor macroeconomic management brought the country to a point where it witnessed investment and growth decelerating, employment opportunities shrinking, poverty rising, debt burden reaching alarming proportions, foreign exchange reserves plummeting and most importantly, the vulnerability of the country to external shocks was at its highest. Pakistan had by and large lost its economic sovereignty. To reiterate, at the end of the 1990s, Pakistan faced five key challenges: (i) improving the macroeconomic

environment, (ii) bringing debt situation under control, (iii) restoring investors' confidence, (iv) reviving economic growth, and most importantly, (v) creating gainful employment and arresting the rising trend in poverty.

III. Options Available

To address the multi-dimensional challenges that the economy of Pakistan faced at the end of the 1990s, the government set out four major policy objectives. First, to stabilize the country's debt situation with a view to improving macroeconomic environment. Second, to revive economic growth in a stable macroeconomic environment. Third, to reverse the rising trend in poverty and fourth, to improve governance. These four policy objectives were interrelated. A reduction in the country's debt burden would create the fiscal space needed to allow public sector investment to rise. Being complementary in nature, a rise in public sector investment, particularly on infrastructure, would encourage private sector to increase investment. Higher investment, both from public and private sector, would help revive economic growth, enhance employment generation capacity of the economy, create more jobs and reduce poverty. Good governance on the other hand would serve as catalyst in promoting investment and growth and therefore, reducing poverty.

Given the nature of the challenges and policy objectives the Government had two options available. First, to implement all the four policy objectives simultaneously. The second option was to prioritize these objectives and address the core issue first. The Government opted for the second option. The approach required realism and the objective was not to try and address all issues simultaneously which would have created an agenda that would have been far too ambitious. A focused approach was therefore necessary, it was felt that without addressing the country's debt situation first, the foundation for achieving higher economic growth on a sustained basis within a stable macroeconomic framework could not have been laid. Therefore, stabilizing the country's debt situation was considered to be the core issue and was addressed first.

IV. Poverty Reduction Strategy: Phase 1

The above discussion clearly outlines the economic crisis that Pakistan faced at the end of 1990s. A major change in the orientation of economic policy was required. First, Pakistan needed a prolonged period of macroeconomic stability to improve its investment climate and revive economic growth. Second, it needed financial discipline, and consistent and transparent policies to encourage private sector to play its dominant role. Third, the country needed a coherent strategy to fight unemployment and arrest the rising trend in

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poverty. In other words the government needed to place the poverty reduction as its first priority.

The government accordingly followed a two pronged strategy. On the one hand, the government took measures to improve the country's macroeconomic environment, slow the pace of accumulation of public and external debt, restore investors' confidence and lay the foundation of strong growth on a sustained basis with a view to reducing poverty. The poverty reduction strategy was based on four key pillars: (a) accelerating economic growth while maintaining macroeconomic stability, (b) improving governance, (c) investing in human capital, and (d) targeting the poor and vulnerable. On the other hand, the government was of the view that macro policies needed to be complemented by wide-ranging structural reforms in almost every sector of the economy to improve supply side response by removing impediments to private sector development and improvements in the investment climate and improving the allocation of resources [See Fig.9].

A reduction in fiscal and current account deficits leading to a reduction in country's debt burden was considered to be the key elements of restoring macroeconomic stability. Bringing balance of payments to a viable position, building foreign exchange reserves to provide stability to exchange rate and regaining financial sovereignty were also considered vital for improving macroeconomic environment. The government successfully maintained consistency, continuity and transparency in economic policy.

The Poverty Reduction Strategy was supplemented by a wide-ranging structural reform in key sectors of the economy⁶. These reforms included the reforms in **tax system** and **tax administration** with a view to broadening the tax base, improving the tax compliance and minimizing the tax evasion⁷; **trade reform** with a view to removing tariff and non-tariff barriers, bringing the maximum and the average tariff at lower levels and liberalizing Pakistan's trade regime; **financial sector reforms** with a view to improving the health and soundness of the country's banking and financial sector; **fiscal transparency** to improve financial controls and budgeting as well as posting of data pertaining to public finance regularly on the website; **agricultural sector reforms** with a

⁶ Key reforms are listed in Figure 9.

⁷ For a detailed discussion on tax and tariff reform and reform in tax administration see Khan (2004) and Government of Pakistan (2006).



- Accelerating the process of privatization and private sector development. Improving the climate for domestic and foreign investment, increasing attractiveness of foreign private investment flows especially for export-oriented activities, and reducing incentives for flight of capital abroad.
- A coherent external borrowing policy that laid the framework with which the government would incur additional debt.
- Adopting a medium and long-term debt strategy with clearly defined goals of debt burden reduction. Putting in place debt management and monitoring systems to effectively review and monitor progress on debt including on contingency management in the context of a rolling medium-term macroeconomic framework.

INFLATION

Ensuring the supply of essential food items by increasing domestic production and liberalizing import regime, and keeping the price of wheat / flour stable in domestic market have been the key policy instruments to keep food inflation at lower level. Prudent monetary and fiscal policies were pursued to keep core inflation (*non-food and non-energy*) under control. These policies were implemented to keep headline inflation under control. Consistency and continuity in policies were maintained to restore investor's confidence, which were considered vital for promoting investment and reviving economic growth.

Where does Pakistan stand today after the first phase of implementation of the Poverty Reduction Strategy? This is the subject matter of the next section.

V. Outcomes of the First Phase of Poverty Reduction Strategy

Prudent macroeconomic policies and structural reforms of the last seven years have transformed Pakistan's economy. The economy is no longer fragile. Indeed, it is healthier today than ever before; economic policies are consistent, transparent, and predictable; private sector is buoyant; industry, exports and imports are also growing; both poverty and unemployment have been reduced significantly while social sector indicators have improved; debt burden has declined sharply; foreign exchange reserves are at comfortable level and providing stability to the exchange rate; foreign investment is rising sharply; Pakistan no longer needs to be in a Fund program, and it has accessed

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international capital and equity markets to showcase Pakistan's continuously improving economic performance.

Pakistan's economy continues to maintain a solid pace of expansion since the last four years (2002-03 to 2005-06). The recovery has been strong, rapid, sustained and broad-based. With economic growth at 6.6 percent in 2005-06, Pakistan's economy has grown at an average rate of almost 7 percent per annum during the last four years and over 7.5 percent in the last three years (2003-04 to 2005-06), thus positioning itself as one of the fastest growing economies of the Asian region. The growth momentum that Pakistan has sustained for the last four years is underpinned by dynamism in industry, agriculture and services, and the emergence of a new investment cycle with the investment rate reaching a new height at 20 percent of GDP. Therefore, the pre-requisite for sustained economic growth appears to have gained a firm footing during the last four years (See Annex.1 and Table 1).

Agriculture is the mainstay of Pakistan's economy. Nearly 22 percent of total output (GDP) and 44.8 percent of total employment is generated in agriculture. What ever happens to agriculture is bound to affect not only the country's growth performance but a large segment of country's population as well. Over the last six years, growth in agriculture has witnessed a mixed trend. During the first two years (2000-01 and 2001-02), the country experienced crippling drought, which badly affected its agriculture and eventually overall growth in agriculture turned negative (-1.1 percent) for these two years. In the next four years (2002-03 to 2005-06), relatively better availability of irrigation water and better policies have had a positive impact on overall agricultural growth as it registered an annual average growth of 4 percent. **The large scale manufacturing** continues to maintain its growth momentum and grew at an average rate of 11 percent per annum during the last six years, reflecting the confidence of the private sector in the economy of Pakistan.

On the **fiscal side**, Pakistan succeeded in reducing fiscal deficit from an average of 7 percent of GDP to an average of 3.5 percent in the last six years. In other words, fiscal deficit reduced by an average of one-half compared with the decade of 1990s. The wide-ranging tax and tariff reform, reforms in tax administration and rationalization of expenditure played important roles in narrowing the revenue-expenditure gap during the last 7 years. As a result of improvement in the fiscal balance, the **public debt** also declined sharply from 96 percent of GDP in June 2000 to 56 percent in June 2006 — a reduction of 40 percentage points of GDP in 6 years. Improved fiscal balance, prudent monetary policy and better supply situation of essential commodities resulted in reducing

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It was during this phase that on 8th October 2005, areas in the North Western Province and the state of Azad Jammu and Kashmir were hit by a devastating earthquake in which over 70,000 people were killed and far more were injured and maimed for life. Millions were rendered homeless and lost all of their livelihood. From Karachi to Khyber, the nation galvanized as one to respond to the needs of their unfortunate brethren. Every body contributed whatever they could and more. The international community's response was also immediate and generous, both during the early recovery and relief phase and the ensuing reconstruction phase. Pakistan gratefully acknowledges the invaluable support provided by countries, donor agencies, civil society, without which it would not have been possible to deal with a tragedy of this magnitude. The fiscal impact of the earthquake has been absorbed, without compromising Pakistan's prudent fiscal stance, despite the magnitude of the shock, which was equivalent to 1 percent of the GDP in the fiscal year 2005 alone. According to the November 2005 World Bank/ Asian Development Bank assessment of earthquake losses, the overall cost associated with the earthquake was estimated at US \$ 5.2 billion, which included the estimated costs for relief, livelihood support of victims, and reconstruction. The cost of reconstruction of lost assets and restoration of services was estimated to be Rs. 208.1 billion. It is proposed to have a separate chapter in the full PRSP II document dealing with the government's strategy for disaster mitigation and preparedness.

PART-II

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Part II: Basic Philosophy of PRSP-II

Introduction

Pakistan has witnessed an economic turnaround in a short span of 7 years. The economic landscape of Pakistan has changed and therefore its challenges are also different today. How to sustain the ongoing growth momentum within the stable macroeconomic framework is the biggest challenge. Linked with this are the challenges of job creation, poverty alleviation, improving social indicators and strengthening the country's physical infrastructure to sustain the growth in the range of 6-8 percent growth in the medium-term. To convert the ongoing demographic transition into demographic '*dividend*' is another major challenge. This will require massive investment in human capital which will, in turn, enhance productivity. The rising average per capita income and the growing middle class along with higher inflows of workers' remittances will continue to fuel domestic demand which will, in turn, sustain growth momentum. The ongoing demographic transition is increasing the share of working age population and therefore, leading to a decline in dependency ratio. A decline in dependency ratio will increase savings and therefore, investment which will be a key determinant of strong economic growth.

The supply side improvement will be critical to match growing domestic demand being fueled by demographic dividend. The supply side response can be improved through private sector development which will require strengthening of institutions, improving the competitiveness of our industry, strengthening of physical infrastructure, building a robust banking and financial system, further strengthening of tax administration, a continuing transparency in economic policy making, consistency and continuity in policies and removing irritants and impediments to private sector development. In other words, the pace of implementing second generation reforms would need to be accelerated.

It is in this background that the government has prepared the **new** Poverty Reduction Strategy which is the subject matter of rest of this paper. The new PRSP or PRSP-II will ensure that, as the country makes this inevitable demographic transition, clear cut priorities and sectoral strategies are in place that could, in effect, provide the Government the strategic framework for PRSP II. This second generation poverty reduction strategy is built around a set of seven pillars, which are:



1. Drivers of economic growth and macroeconomic stability
2. Crafting a competitive advantage
3. Harnessing potential of the people
4. Financial sector deepening and economic development
5. Provision of world class infrastructure
6. Effective governance and management
7. Targeting the poor and the vulnerable

In order to formulate an integrated policy framework, the PRSP-II has also been aligned with the Medium Term Development Framework (MTDF). While the MTDF provides a framework for translating the VISION 2030 into action during the period 2005-10 with an emphasis on “sustained long term growth”, the PRSP-II presents the strategy to ensure that the growth is broad-based and leads to effective poverty reduction. However, before we delve into the details of the new Poverty Reduction Strategy, the broad contours of which have been described above, we need to discuss, though briefly, the medium-term macroeconomic framework which sets targets for key macroeconomic aggregates. These along with MDGs targets are needed to be spelled out. This is exactly the subject matter of the next section.

VI. Macroeconomic Framework

The recent trends in global and regional poverty as well as Pakistan’s own experience from the last PRSP suggest that rapid economic growth over a prolonged period is essential for poverty reduction. At the macro level, economic growth implies greater availability of public resources to improve the quantity and quality of education, health and other services. At the micro level, economic growth creates employment opportunities, increases the incomes of the people and therefore, reduces poverty. Many developing countries have succeeded in boosting growth for short periods but only those that have achieved higher economic growth over long sustained periods have seen a lasting reduction in poverty – East Asia and China are classic examples of lasting reduction in poverty. It is also clear from the evidence of East Asia and China that growth does not come automatically. It requires policies that will promote growth.

Macroeconomic stability is therefore, key to sustained and high economic growth. The recent experience of Pakistan suggests that a strong and broad based economic growth will create employment opportunities and therefore, reduce unemployment. At the same time it increases the incomes of the people and therefore reduces poverty. During the last three years (2003-04 to 2005-06), the real GDP has grown at an average rate of over 7.5

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percent per annum and accordingly the economy generated approximately 8 million jobs. Therefore, the stronger the economic growth the higher the capacity of the economy to generate employment.

Growth is a necessary but not sufficient condition for poverty reduction. Realizing this fact the government had launched a targeted program under the title of poverty related and social sector program some 6 years ago. During this period the government has spent Rs. 1441 billion on such programs to cater to the needs of poor and vulnerable sections of the society. These targeted programs along with strong and broad based economic growth have succeeded in lifting approximately 13 million people out of poverty.

The macroeconomic framework for PRSP-II has been prepared with a view to sustaining the ongoing growth momentum in a stable macroeconomic environment. Growth, investment and inflation aspects of the macroeconomic framework are well documented in Table-1. Following the strong growth momentum of the last 4 years the framework projects a growth of 7.2 – 7.5 percent in the next four years. This growth will be supported by a strong growth in agriculture, manufacturing and services sectors. Investment is key to sustained growth momentum. In order to achieve a growth of 7.2 – 7.5 percent in the next four years the overall investment is projected to move in the range of 21 – 22.8 percent of GDP with private sector investment taking the lead and public sector investment focusing on human and infrastructural development. National savings as percentage of GDP is targeted in the range of 17 – 19.4 percent during the same period, thereby projecting a current account deficit in the range of 3.4 – 4 percent of GDP (see Table-4).

Macroeconomic stability is vital for achieving the growth target in the next four years. Fiscal developments are key elements of macroeconomic stability. Table-2 documents the trend in public finance. The overall budget deficit is targeted to be reduced from the current level of 4.2 percent of GDP to 3.3 percent of GDP by 2010 – 11. Total revenue continues to improve from 13.2 percent to 14.7 percent of GDP during the period while total expenditure remains in the neighborhood of 17 – 18 percent of GDP during the same period. The Fiscal Responsibility and Debt Limitation Act (FRDL), 2005 binds the government to achieve revenue balance (total revenue – total current expenditure) by June, 2008 (at the end of the fiscal year 2007-08) (see Table-5).

The fiscal aspect of the macroeconomic framework adheres to the limit set by the Act and accordingly revenue surplus is maintained throughout the MTMF. Public debt is the outcome of the budget deficit and the way it is financed. Public debt is projected to

Macroeconomic Framework

Table 4: **Growth and Inflation**

(Percent)

Items	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Real GDP Growth (%)	6.6	7.0	7.2	7.1	7.3	7.5
Agriculture (%)	2.5	4.5	4.4	4.5	4.3	4.4
LS Manufacturing (%)	9.0	12.5	13.5	14.0	13.8	14.2
Manufacturing (%)	8.6	10.5	11.2	11.8	11.7	12.1
Other Sectors (%)	7.6	6.8	6.9	6.5	6.7	6.9
Nominal GDP at MP (BI.Rs.)	7713	8808	9988	11266	12731	14411
Nominal GDP Growth (%)	17.2	14.2	13.4	12.8	13.0	13.2
Inflation (CPI based) (Period average)	7.9	6.5	5.5	5.0	5.0	5.0
As % of GDP						
Investment	20.0	20.5	21.0	21.7	22.2	22.8
- Fixed Investment	18.4	19.0	19.5	20.2	20.7	21.3
- Public Investment	4.8	5.0	5.2	5.4	5.5	5.6
- Private Investment	13.6	14.0	14.3	14.8	15.2	15.7
National Savings	15.6	16.1	17.0	17.9	18.6	19.4
Foreign Savings (excl. Official Transfers)	-4.4	-4.4	-4.0	-3.8	-3.6	-3.4
ICOR	2.8	2.7	2.7	2.8	2.8	2.8
Nominal Exchange Rate (Rs./\$)	59.9	61.5	62.9	64.5	66.0	67.5
Nominal GDP in Billion \$	128.8	143.2	158.8	174.7	192.9	213.5
Population in Billion	155.4	158.4	161.3	164.3	167.4	170.4
Per Capita GDP in \$	829.0	904.0	984.0	1063.0	1152.0	1253.0

Macroeconomic Framework

Table-5: Trends in Public Finance

(Billion Rs.)

Items	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Total Revenue	1073.2 (13.9)	1162.7 (13.2)	1358.4 (13.6)	1571.3 (13.9)	1826.1 (14.3)	2125.6 (14.7)
Tax Revenue	804.2 (10.4)	909.6 (10.3)	1065.0 (10.7)	1255.9 (11.1)	1469.6 (11.5)	1722.1 (11.9)
Non-Tax Revenue	269.0 (3.5)	253.1 (2.9)	293.4 (2.9)	315.4 (2.8)	356.5 (2.8)	403.5 (2.8)
Total Expenditure	1398.8 (18.1)	1536.2 (17.4)	1757.9 (17.6)	1987.6 (17.6)	2271.9 (17.8)	2601.1 (18.0)
- Current Expenditure	1118.8 (14.5)	1126.2 (12.8)	1278.4 (12.8)	1430.8 (12.7)	1616.7 (12.7)	1830.2 (12.7)
- Development Expenditure *	321.1 (4.2)	410.0 (4.7)	479.5 (4.8)	556.8 (4.9)	655.2 (5.1)	770.9 (5.3)
Fiscal Deficit w/o Earthquake	-259.8 (3.4)	-323.5 (3.7)	-359.5 (3.6)	-394.3 (3.5)	-432.8 (3.4)	-475.5 (3.3)
Fiscal Deficit with Earthquake	-325.6 (4.2)	-373.5 (4.2)	-399.5 (4.0)	-416.3 (3.7)	-445.8 (3.5)	-475.5 (3.3)
Revenue Surplus/Deficit	-45.6 (0.6)	36.5 (0.4)	80.0 (0.8)	140.5 (1.2)	209.4 (1.6)	295.4 (2.0)
Public Debt as % of GDP	56.0	50.6	46.4	43.3	40.1	37.2
GDP at Market Price	7713	8808	9988	11266	12731	14411

* Adjusted for Net Lending

Note: Figures in parentheses are as % of GDP



decline from 56 percent of GDP in 2005-06 to 37.2 percent by the end of the MTMF. The declining path of the country's debt burden is fully consistent with the FRDL Act, 2005. The key to the creation of fiscal space during the PRSP II period will be a paradigm shift in the Tax/GDP ratio. The Government is working towards this end.

On the external side the macroeconomic framework projects a trade gap in the region of \$ 9 – 11 billion and current account deficit in the range of \$ 6 – 7 billion (see Table-3). As percentage of GDP the current account deficit is projected to decline from 4.4 to 3.4 percent of GDP during the period. External debt is the outcome of the current account deficit and the way it is financed. With the declining current account deficit, the external debt as percentage of GDP continues to decline from 28.9 percent in 2005-06 to 21.9 percent by the end of the macroeconomic framework period (see Table-6).

Finally pro-poor budgetary expenditures on the 17 pro-poor sectors identified in the PRSP are projected to grow from the current Rs. 434.6 billion or 5.63 percent of GDP to 6.2 percent of GDP by 2008-09 (Figure-10)⁸. Pro-poor expenditures will be prioritized through a Medium Term Expenditure Framework (MTEF) that will be consistent with the FRDL Act, 2005 which stipulates that expenditures on social sectors would be 4.5 percent of GDP in any given year and that allocations for health and education would double as a percentage of GDP over the next 10 years.

The targets for key macroeconomic aggregates presented in the Framework are the broad direction over the medium term and are indicative and are not meant to preempt any future adjustments required to achieve the desired targets.

⁸ The 17 pro-poor sectors identified in PRSP are: **Market access and community services:** (i) roads, highways and buildings, (ii) water supply and sanitation, **Human development:** (iii) education, (iv) health, (v) population planning, (vi) social security and welfare, (vii) natural calamities, **Rural development:** (viii) irrigation, (ix) land reclamation, (x) rural development, (xi) rural electrification, **Safety nets:** (xii) food subsidies, (xiii) food support program, (xiv) Tawana Pakistan (xv) low cost housing, and **Governance:** (xvi) administration of justice and (xvii) law and order.

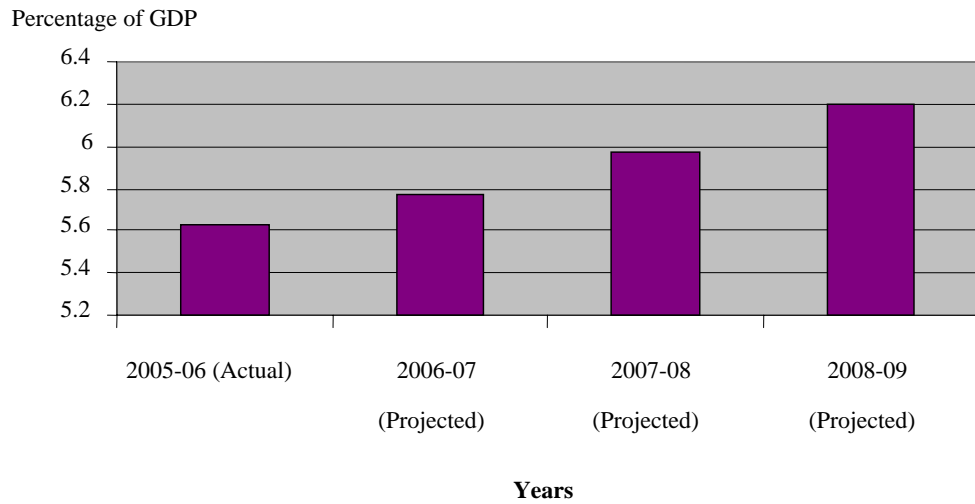
Macroeconomic Framework

Table-6: Trends in Balance of Payments

(Million \$)

Items	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
<u>Trade Balance</u>	<u>-8259</u>	<u>-9331</u>	<u>-9904</u>	<u>-10439</u>	<u>-10902</u>	<u>-11061</u>
- Exports	16388	18027	20190	22815	26009	29910
- Imports	-24647	-27358	-30094	-33254	-36912	-40972
<u>Services Balance</u>	<u>-7304</u>	<u>-8043</u>	<u>-8843</u>	<u>-9162</u>	<u>-9744</u>	<u>-10320</u>
<u>Private Transfers</u> of which	<u>9914</u>	<u>11034</u>	<u>12350</u>	<u>12900</u>	<u>13650</u>	<u>14200</u>
- Workers' Remittances	4600	5500	6200	6400	6700	6950
Current Account Balance (excluding official transfers)	-5649	-6340	-6397	-6700	-6997	-7181
- as % of GDP	-4.4	-4.4	-4.0	-3.8	-3.6	-3.4
Overall Balance	1200	3397	2585	2094	2458	2745
Foreign Exchange Reserves (Including FE-25 deposits)	11471	14196	16075	17642	19558	21746
- Months of Import Cover	5.6	6.2	6.4	6.4	6.4	6.4
<u>External Debt as % of GDP</u>	<u>28.9</u>	<u>27.0</u>	<u>25.5</u>	<u>24.3</u>	<u>23.1</u>	<u>21.9</u>
Memo. Items						
- GDP in Billion \$	128.8	143.2	158.8	174.7	192.9	213.5
- Exports Growth (%)	13.8	10.0	12.0	13.0	14.0	15.0
- Import Growth (%)	31.4	11.0	10.0	10.5	11.0	11.0

Figure 10: Projected PRSP Pro-Poor Expenditure (Budgetary) as a Percentage of GDP





VII. Poverty Reduction Strategy

Pillar 1: Drivers of Economic Growth and Macroeconomic Stability

Demographic Dividend and Emergence of Middle Class as Drivers of Growth

At the time of independence in 1947, Pakistan’s population was 32.5 million. By 2005-06, the population is estimated to have reached 155.4 million. Thus in roughly two generations, Pakistan’s population has increased by 122.9 million or has grown at an average rate of 2.7 percent per annum. While Pakistan has more mouths to feed, more families to house, more children to educate, and more people looking for gainful employment with millions migrating from the countryside to major cities in search of jobs and raising pressure on urban infrastructure, this large population on the other hand also represents a big opportunity for Pakistan to benefit from demographic dividend which can fuel Pakistan’s economic growth for the next fifty years. Pakistan is witnessing changes in the age structure of the population with proportion of working age population increasing and offering a window of opportunity to turn this demographic transition into a demographic dividend.

What is demographic transition and demographic dividend? The demographic dividend is defined as “transition from a largely rural agrarian society with high fertility and mortality rates to a predominantly urban industrial society with low fertility and mortality rates”.⁹ Demographic transition consists of three phases resulting from the lag between changes in fertility and mortality. At an early stage of this transition (phase one) the fertility and mortality rates are high, resulting in the decline of the share of working age population and creating bulge in the young age groups. In other words, the share of dependent population is higher, freeing less resource for investment and growth. During the second phase, fertility rates decline, leading to fewer younger mouths to feed. On the other hand, the population bulge enters and stays in the working age. The working age population grows more rapidly than the population dependent on it, freeing up resources for investment and economic growth. Other things being equal, per capita income grows

⁹ See Lee and Mason (2006)

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more rapidly, making more income available for dependents. Accordingly, the welfare of the family improves. This dividend period is quite long and lasts five decades or more.¹⁰

During the third phase, low fertility rates reduce the growth of young age population while the working age population moves out of the workforce gradually. In other words, the inflows of young age population moving into working age slows, the current working age population moves out of work force gradually and continuing improvement in old age mortality increases the share of elderly population . Other things being equal, per capita income grows more slowly and the first dividend begins to evaporate. But a second dividend is also possible. The working age population reaching retirement level has a powerful incentive to accumulate assets unless it is confident that its needs will be provided for by families or governments. Whether these additional assets are invested domestically or abroad, national income will rise. Therefore, the first dividend yields a transitory bonus lasting for over five decades and the second dividend transforms that bonus into greater assets and sustainable development. These outcomes are not automatic but depend on the implementation of effective policies. Thus, the dividend period is a window of opportunity rather than a guarantee of improved standards of living.

Where exactly is Pakistan in this demographic transition? As shown in Table 7, the Population Census data depicts two phases of demographic transition. During the first phase when fertility rates were higher (see Fig-10) the share of young age (0-14 years) population continued to rise thereby creating a bulge in the young age population while the share of working age (15-59) continued to decline until 1972. Pakistan appears to have entered the second phase of demographic transition from 1981 onward.

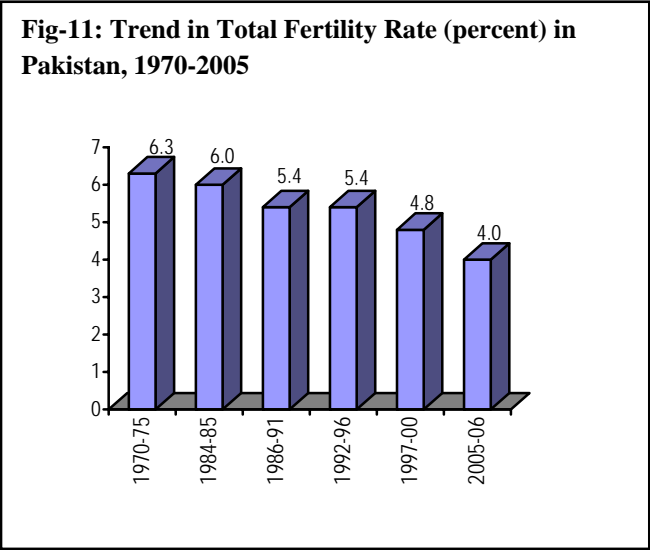
¹⁰ ibid

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Table 7: Demographic Transition in Pakistan (%)			
Census	Young (0-14 age)	Prime (15-59 age)	Old (60 + age)
1961	42.4	50.6	6.9
1972	43.8	49.2	7.0
1981	44.5	48.5	7.0
1998	43.4	51.1	5.5
2006 (E)	36.8	57.2	6.0

Source: Various Economic Surveys & Planning and Development Division

As a result of decline in fertility rate from 6 percent to 4 percent during 1981 and until 2006 (see Fig.-11) the share of working age (15-59 years) population continued to rise from 48.5 percent to 57.2 percent and accordingly the share of young age (0-14) continued to exhibit declining trend (from 44.5 percent to 36.8 percent). Thus, Pakistan is currently passing through the demographic transition phase during which this transition can be converted into a demographic dividend. Empirical evidence supports the fact that Pakistan is in the second phase of demographic transition as more resources are available for investment, economic growth is accelerating and per capita income is rising at a faster pace. In other words, Pakistan has already started reaping its first dividend on the back of a large scale spending on social sector (education, health vocational training, etc.) over the last several years.



The demographic dividend currently being offered to Pakistan is through these mechanisms : labor supply , saving and human capital in conjunction with rising per capita income , growing middle class, availability of consumer credit , inflows of workers remittance and rising exports (foreign demand) are fueling consumption demand leading to the expansion of domestic market . For example, the consumer items such as automobiles, motor cycles, refrigerators, air conditioners, television, cellular mobile, packaged milk etc. have been registering a high double digit growth for the last four/five years. The growing domestic demand is being met through various booming sectors of the economy such as agriculture, manufacturing and services. As such, strong domestic demand leading to the expansion of domestic market, has

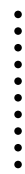


emerged as a key driver of economic growth and is supporting the ongoing growth momentum. Realizing the significance of the phenomena of demographic dividend for an emerging economy like Pakistan, the government has already initiated a large number of employment generation programs to reap the benefits of the demographic transition. These programs include the recently launched National Internship Program, establishment of the National Vocational and Technical Education Commission (NAVTEC), increased budgetary allocation for social sectors, especially education (including higher education through the Higher Education Commission (HEC)), health, population etc. In addition, the Government has launched Rozgar Scheme (self employment scheme), Khushal Pakistan Program and many other initiatives. In this context, the impact of the development of mega cities as well as of rural infrastructure as sources of growth will be significant.

Riding the Globalization Wave in Export Markets

Integration with Global markets through international trade and investment has been an engine of growth in many of the world's economies. China's value added in most of its export industries is around 25 percent. It has been China's ability to link with other nations in international production chains that has facilitated its dramatic increase in exports. Pakistan has achieved considerable success in global markets in recent years as measured by the growth rate in exports. Pakistan like many other countries, including China, has adapted to globalization and has created healthy, growing and competitive industries. Pakistan has engaged in a number of Free Trade Agreements (FTAs) on both a regional and bi-lateral basis. The agreements include the South Asian Free Trade Agreement (SAFTA) and FTAs with Sri Lanka, China and Malaysia. The US Government is considering an arrangement for preferential market access to the goods produced in the Reconstruction Opportunity Zones (ROZs), to be located in the tribal and other backward areas of Pakistan, through legislation in the US Congress. The creation of ROZ's would encourage investment by granting duty free entry into United States for certain goods produced in designated territories.

Pakistan's manufacturing exports have grown at an average of just over 7 percent per annum during the last couple of years while global manufacturing exports have grown at 8 percent per annum. The growth in international export markets represents an opportunity to harness these powerful global market forces in ways that can create jobs for Pakistan's workforce. A domestic market expands in response to growing consumption demand, the production of manufacturing items will increase thereby



creating economies of scale. This scale will provide competitive edge to our industries which will help them to move from basic textile exports to more value added textile items. The economies of scale will help Pakistan's industries becoming competitive and move toward higher value added export items such as automobiles, engineering goods etc. Therefore, the expansion of domestic market will be a stepping stone into global market which will help create jobs and reduce poverty.

The Government is implementing a comprehensive program to further boost exports in a sustainable way based on improving long-term competitiveness. These efforts include: 1) Expanding market access on favorable terms to key world markets such as the EU, USA and key Asian markets, 2) Expand and modernizing Special Economic Zones, Export Processing Zones, Industrial Parks and IT-Parks, 3) Encouraging linkages between export-oriented industries and their respective education and training providers.

Drivers of Growth: Manufacturing, Value Added Agriculture, Services etc

Pakistan is witnessing the emergence of a strong middle class with growing purchasing power, supporting domestic demand expanding domestic markets, and ultimately emerging as a critical driver of economic growth. Historically Pakistan's drivers of growth are very instructive. Pakistan's GDP grew at 6 percent over the 80s, and only at 4 percent over 1990-04, with very high growth kicking in only over the last three years. Consumption accounts for 3.7 percent of GDP growth of 6 percent over the 80s. Over 1990-04, consumption drops, accounting for only 2.9 percent of GDP growth of 4 percent. So the primary weakness in growth is accounted for by a large drop in consumption over the 90s compared to the 80s. A second weakness in growth is accounted for by government expenditure, which dropped from 1.2 percent of GDP growth of 6 percent to a negative contribution of -0.1 percent of GDP growth of 4 percent. While government expenditure is ostensibly meant to shrink to crowd in the private sector, this does not happen in the case of Pakistan over the 90s. Private investment drops from accounting for 1.2 percent of GDP growth of 6 percent in the 80s, to accounting for 0.6 percent of GDP growth of 4 percent in the 90s. Finally, net exports actually help prop up the weak growth in the last decade, turning from -0.1 percent in the 80s, to 0.5 percent in the 90s.

Private consumption has contributed, on average, 7.5 percentage points of real GDP growth of 7 percent over the last three years with investment contributing to 0.7 percentage points. The net exports contribution has been negative to the extent of 1.5 percentage points during the same period.

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So structurally, the main drivers of long run growth in Pakistan have been consumption and to some extent government expenditure. Their contribution declined over the 90s compared to the 80s, private investment did not substitute for them, nor have exports substituted sufficiently, so growth decelerated. Recent surge in GDP growth is primarily driven by strong consumption growth.

Besides the drivers given above, **consumer finance** is a driver of growth as well. Increase in consumer finance has been recorded at 38.8 percent for FY 06. The growth in consumer loans in 2005-06 remained robust and their scale expanded by 27 percent. Increased demand for a product elicits a supply response, which generates employment, tightens the labour market, and improves the conditions of employment, principally the wages, as observed. A consumption and export led growth policy will therefore serve to generate employment and decent work quite well.

The intense economic activity in the country due in turn to increased domestic demand has increased per capita income of the people thus raising their standards of living and bringing them prosperity. Some of the important sectors providing the bulk of the supply have been: agriculture, manufacturing and services.

Agriculture Sector: The rural sector also comprises a large and expanding non-farm sector where employment generation is crucial. New jobs can be created by accelerating growth in agriculture and by increasing the area under cultivation, raising crop yields, diversification of cropping patterns, production of high value crops such as fruits, vegetables, flowers, etc. Livestock and dairy sector have high potential for job creation and income generation as well.

Manufacturing Sector: The overall manufacturing sector has continued its positive trend during the last few years. Overall manufacturing recorded an impressive and broad based growth of 9 percent, against a target of 11 percent and last year's growth of 12.5 percent during 2005-06. Large-scale manufacturing, accounting for 69.5 percent of overall manufacturing registered an impressive growth of 9 percent in the current fiscal year 2005-06 against a target of 13 percent and last year's achievement of 15.4 percent, thereby, registering a remarkable 10.7 percent average growth rate from 2000-06.

Auto industry is one of the integral parts of the manufacturing sector. The auto industry in Pakistan is fast growing and may soon begin to achieve economies of scale. This sub-sector of large scale manufacturing indicate comprehensively that supply to meet the ever

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increasing domestic demand is being catered to effectively in the manufacturing sector as well as the services and value added agricultural sectors.

Services Sector: Coming towards *services*, telecom sector takes the lead. Increase in fixed line teledensity was subdued initially. Up to 2002, Pakistan lagged behind in cellular penetration as compared to other Asian countries. However, exponential growth started in cellular segment and the subscribers totaled 53 million in 2006 against 0.7 million subscribers in 2001. Currently this number has been increasing at the rate of about 2 million new customers per month for the cellular companies.

Pakistan plans to have 90 percent teledensity by 2015, as compared to the current 37 percent, and it would be about 185 million users as the population is likely to swell to 206 million by then. This shows the tremendous growth potential in all the three categories i.e., fixed line, wireless and cellular.

Mega Cities as Engines of Growth

Urban centers provide massive opportunities for overall economic development. Development of mega cities has multi faceted impact on the economy. Pakistan will see the rise of large urban centers and mega cities which will propel the growth of national economy. For Pakistan this growth is already happening in a period of major economic and technological change and an increasing emphasis on market based decisions.

Development of Rural Infrastructure and Markets for Growth and Poverty Alleviation

There are 48,363 rural localities in Pakistan the population of which is around 99 million. About 67 percent of total population lives in rural areas. The principal aim of rural development in Pakistan remains to improve the quality of life of the rural people by improving the rural economy and living conditions in the villages by enhancing agricultural productivity, water resources availability, improving rural infrastructure, providing social amenities, undertaking productive projects to meet local community needs, besides creating gainful employment opportunities.

Since the inception of Pakistan many rural development programmes have been formulated. Besides, Schemes for Infrastructure Development and provision of basic services contribute to the well being of the rural people.

The recently approved *Rural Development Strategy*, formulated by the Government of

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Pakistan, in a broader sense draws on various initiatives, policy measures and programmes relating to agriculture development, availability of water resources, sustainable environment, rural housing and sanitation etc. This will augment both growth and employment opportunities in the rural economy.



PILLAR II: Crafting a Competitive Advantage

Private Sector Development and Enhancing Role of the Private Sector

The private sector will play an increasing role in driving growth and creating job opportunities. A strong Private Sector Development (PSD) strategy will therefore be a key element in enhancing the competitiveness of the private sector. The features of the strategy are 1) lowering the barriers to development of small and medium enterprises; 2) developing a modern financial sector with a view to providing a wide range of financial services; 3) removing irritants and impediments to private sector growth; 4) strengthening the country's physical and social infrastructure 5) consistency and continuity of economic policies. All these measures are expected to significantly improve Pakistan's investment climate, reduce the cost of doing business for the private sector, thus contributing to enhancing the competitiveness of the private sector.

An Economic Reforms Unit (ERU) has been set up in the Ministry of Finance which will perform two basic functions. Firstly to prepare a comprehensive PSD and secondly, to streamline and simplify processes, procedures and regulations at all levels of government. Both functions will be carried out in close partnership with the private sector and all stakeholders at the federal, provincial and local levels of government. To this end a better Business Advisory Council (BAC) will be set up to identify issues and then to formulated and implement remedial measures. In addition, the government is in the process of revamping the existing Monopoly Control Authority (MCA) into a Competition Commission, the draft law of which has already been finalized. At the heart of the Commission's work will be a Competition Policy that lays down a framework for enhancing competition in the economy.

A forward looking PSD strategy, supported by a vastly improved regulatory environment, processes and procedures will go a long way in freeing the private sector from constraints that impede its growth. This will create an enabling environment that will allow the private sector to focus on productivity, innovation and growth, responding to opportunities in the national and global markets.

Private sector competitiveness is also being enhanced by taking into account the recent findings on the State of Pakistan's Competitiveness Report by the Competitiveness

Support Fund¹¹ and released by the Prime Minister. These are being used to implement an initiative to improve corporate governance, enhance transparency, protect minority shareholders rights, assist companies in being able to list shares on the stock market, raise capital and improve the use of Boards of Directors. An initiative to help companies invest in human resources and improve the motivation of employees and apply modern management will also be undertaken. Finally, companies will be assisted to register patents, acquire and license technology and improve their access to the latest technology.

Intensifying Deregulation, Privatization and Liberalization

The Government is following a policy of intensifying deregulation, privatization and liberalization with a view to transforming Pakistan's economy into a truly private sector market economy which is highly competitive, fuelling growth, creating gainful employment, generating wealth and most importantly, reducing poverty. As part of overall liberalization policy the government is also pursuing trade liberalization policy to encourage exports and provide consumers with access to imports from the global market at reasonable prices. Sustained export performance is a key priority. The Government will also continue to liberalize its import regime while continuing its efforts on enhancing market access for its exports for both traditional and non traditional items.

The Government seeks to promote a globally competitive economy by reducing public and private barriers that hinder development. The present Government's reforms implemented in Pakistan are based on liberalization, deregulation, privatization, and good governance. Policies adopted include opening markets for imports and foreign investment, encouraging exports and linkages with multi-national enterprises, lowering administrative controls and reducing government ownership. The Government understands that improved competitiveness derives from the introduction of best practices, a focus on human development, making up the value added chain and improved logistics.

¹¹ The Competitiveness Support Fund is a joint initiative of the Ministry of Finance, Government of Pakistan and the United State Agency for International Development. It has been established to support repositioning of Pakistan's economy on a more competitive global footing. The government is already providing support from the fund to gems and jewellery sector, pharmaceutical and agro-based industries to improve their competitiveness with a view to preparing them as export items of Pakistan

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With regard to trade, Pakistan's access to global agricultural commodity markets is often restricted. Given the country's position as a major agricultural exporter and importer, the Government will strengthen every aspect of rules governing agricultural trade, eliminating distorting subsidies and significantly improving market access.

The focus on improved competitiveness has made it essential to improve the functioning of factor markets. The privatization of large parts of the financial sector has strengthened Pakistan's banking and financial sector. The attention given to this area will be matched by reforms in the labour and land markets. Additional reforms will be undertaken to reform laws governing labour welfare and to rationalize the labour levies system. Health and safety at work regulations also need to be tackled. Another challenge is to ensure clear title for land transactions.

Enhancing Competitiveness and Productivity

Competitiveness relies on ensuring that the population is healthy, secure (in both civil and criminal aspects of society) and capable of sustaining the basic requirements of life through improved education, infrastructure and a stable macro-economic climate. It is further enhanced by the provision of world-class tertiary education and vocational skills training and the development of a knowledge economy based on a fully developed Information and Communications Technology (ICT) infrastructure.

Improved competitiveness leads to sustained economic growth which has proven to be effective in generating employment and reducing poverty. Therefore, the Government recognizes improving competitiveness as a cornerstone of its economic growth strategy. The economy has responded well to the structural reforms carried out in the last 7 years and has emerged as one of the stronger growing economies of Asia.

Although, as a result, Pakistan has significantly improved its position in the Global Competitiveness rankings of the World Economic Forum, much more needs to be done. The Government will therefore continue to implement its second generation reforms in addition to the private sector specific reforms listed above.

Poverty and in particular the nutrition of a large proportion of the population will continue to be focused upon by the government. It is a key element of government attention because it believes that poor nutrition adds to costs of healthcare and reduces labour productivity. Fundamental improvements in the access to education, nutrition and health are key elements in the Government's approach to enhancing competitiveness.



Special Economic Zones, Industrial Parks, IT Parks and SME Cluster Development

Pakistan's location already provides it with a competitive advantage that is unique. Situated strategically at the cross roads of Central Asia, Middle East and the Far East and its membership of growing organizations such as SAARC and ECO. Pakistan has access to all growing markets of the world. The Government intends to enhance the role of Special Economic Zones (SEZs), etc in attracting investment to achieve its goal of generating employment and further augmenting industrialization, modernization within a cohesive strategic plan. The SEZs and associated industrial parks and clusters will play an important role in increasing competitiveness. The SEZs are to be benchmarked with those of other countries to ensure that they are developed on the lines of best international practices.

There are already some excellent examples of industrial parks such as "Marble City", "Textile City", Pak-China Economic Zones near Lahore and the Lasbela Industrial Estate in Balochistan. The Government has also declared that the area around Gwadar Port city will be an SEZ. Cluster development in Punjab, e.g., around Sargoda has been extremely successful. Furthermore, the National Industrial Parks Development and Management Company (NIPDMC) has been established as a public-private partnership to foster this approach.

These projects are aimed at fast pace industrialization that will generate employment in the country. The hallmarks of successful SEZs include high quality infrastructure, access to a productive labour pool, a critical mass of support industries, streamlined bureaucratic processes, and a suitable regulatory framework.

The industry mix of these zones will be based upon both Pakistan's current competitive advantages and the competitive advantages the country can develop.

Research and Development, Extension Services and Value-addition in Agriculture

The Government is focusing on the critical challenges that impact the competitiveness of the agricultural sector by 1) strengthening science-based organizations and technology resources in order to enhance basic agronomic research into new varieties of crops and to reduce the high level of post-harvest losses; 2) continuing to consolidate land holdings in

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order to take advantage of economies of scales and marketing: 3) improving process efficiency and minimizing waste (and managing biological effluent disposal); 4) promoting the integration of food factories with backward and forward linkages; 5) improving the standards of safety both within the workplace and most particularly of the food products themselves with regard to ingredients and overall hygiene, 6) increasing public awareness of the advantages of quality/healthy foods; 7) encouraging access to export markets via improved infrastructure facilities (e.g., reduced waiting periods at major ports) and improved packaging and labeling able to meet international standards of health and hygiene.

Pakistan has diversified ecological and climatic zones and a wide variety of crops are grown. Agriculture accounts for about 22 percent of GDP. The Government has ensured that the sector effectively keeps pace with the growth of population. The Government remains focused on expanding agriculture-based export earnings via increases in crop productivity and value-added in down-stream intermediate processing and food manufacturing.

Water supply, distribution and management are the single most important aspect of agriculture in Pakistan. The Government is building on successful projects to improve irrigation and drainage infrastructure and to further introduce innovative social and management options including the encouragement of water users groups.

The Government will encourage public-private linkages between research institutions, extension agencies and agribusiness companies that will allow agricultural support enterprises to flourish. Agricultural (farm) costs of production are an essential factor in determining the overall competitiveness of the final food product and the Government's target is to reduce these costs compared with Pakistan's overseas competitors.

As a result of strong efforts by Government via both federal and provincial extension services the total number of livestock has increased. The quality of the animal herd has also improved. Government is also working with the processing industry to overcome bottlenecks in the production of dairy/agri products (e.g., by promoting cooling tanks at the farm level). For meat production, the Government will continue to strengthen health and nutrition awareness programs for cattle farmers, removing distortions and improving hygiene in meat marketing and by encouraging the production of *halal* meat products for export to Muslim communities overseas.

Post harvest losses will be reduced by an emphasis via extension services on removing distortions and so allowing investment in innovation and improved technology, logistics

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and storage chains. New enterprises will be encouraged to locate near the source of raw materials. Close relationships between farmers, intermediate processors and final manufacturers will be encouraged through associations and strategic working groups. At the tertiary or final stage of the value chain, the Government will emphasize presentation of the food product to the consumer on the supermarket shelf.



Pillar III: Harnessing the Potential of the People

Putting People at the Centre of National Development and Human Resource Development Strategy

Pakistan Human Development Indicators have not kept pace with the countries economic performance while these indicators have improved much more needs to be done. The preliminary step for any human resource development strategy has to start with education. Educational attainment has a positive impact not only on economic growth and poverty reduction but is also directly linked with technological adaptation, innovation, and increased productivity, generating positive spin-offs and growth effects for the economy.

In Pakistan, Education for All (EFA) Plan of Action (2001-2015) is under implementation for 1) achievement of universal primary education and quality education for all; 2) increase adult literacy rate to 86 percent for both males and females by 2015; 3) reducing illiteracy by 50 percent with a focus on reducing the gender gap; and 4) provision of quality education and technical and skill development. Concurrently, an Ordinance for compulsory primary education has been promulgated in all the provinces except in Balochistan which underscores the mutual social responsibility of state and society. An incentive package has been developed to meet the educational needs of poor students which include free textbooks, uniforms, stipends, fee waivers and nutrition. Stipends for students are being provided through Zakat as well as formal budgetary allocations.

As a step to improve the governance aspects of the education system, a National Education Assessment System (NEAS) has been put in place to evaluate and assess learning achievements of students at primary and elementary levels. The Fast Track Initiative (FTI), a global partnership initiated by G-8 countries through multi-lateral and bi-lateral arrangements to accelerate attainment of the goal of Universal Primary Completion (UPC), is underway. The Ministry of Education and the provincial governments have formally entered the FTI process with the support of development partners linking it to PRSP, Sector Reforms and the National Plan of Action for EFA. For higher education, a number of interventions are being undertaken by the Higher Education Commission to improve the quality of higher education thereby laying foundations of a strong knowledge-based economy. Faculty development is being carried out through increasing the number of PhDs both through in-country and foreign training programmes. The establishment of technology parks, business incubators and funding of



joint programmes with industry are expected to transform the universities into creative and vibrant institutions where new ideas are born and transformed into commercial products and processes. Simultaneously, the National Commission on Human Development (NCHD) is working in over forty-two districts in supplementing the social service delivery at the grass roots level.

The endeavor to move towards a ‘knowledge based economy’ encompasses progress in all areas including high value-added agricultural produce, information technology, biotechnology, engineering sciences, pharmaceuticals, material sciences, basic sciences, social sciences, economics, finance and other disciplines.

Skilled work force is instrumental in enhancing both the efficiency of the labour market and reducing skills bottlenecks. To address skills development, the Government of Pakistan has established the NAVTEC. The Commission is mandated to facilitate, regulate, and provide policy direction for technical education and vocational training to meet national and international demand for skilled manpower. A National Internship programme has been launched in order to provide real life work experience for the fresh graduates before they enter the market as professionals. Adequate funds commensurate with the needs are being earmarked for human development and it is planned to increase the budgetary allocation for education, health and population welfare to 5.5 percent of GDP by the year 2015. Out of this the share of the education sector is projected at 4 percent of GDP.

Mainstreaming Gender and Empowering Women

Gender mainstreaming, which is increasingly recognized as a key policy tool, is not only a question of social justice, but is necessary for ensuring equitable and sustainable human development. It is one of the key ingredients for a comprehensive poverty reduction strategy that allows harnessing the potential of the segment of a society which hitherto has not been adequately involved in the development of the country. Gender issues are highly relevant to achieving all the MDGs, be it protecting the environment, achieving sustainable development or enabling universal access to health care. MDGs being mutually reinforcing, progress in achieving one goal affects progress in the others. Success in many of the goals will have positive impacts on gender equality, just as progress toward gender equality will help achieving other goals. The PRSP endorses this mainstreaming approach by aiming to create an environment that is more welcoming to women, focusing on policies that initiate improvements in female human development to

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achieve the desired results. The national and the provincial Gender Reform Action Plans (GRAPs) which are being implemented across the country are manifestation of this paradigm. GRAPs propose policy, institutional and budgetary reforms at all levels across all sectors. They translate national and international commitments into concrete policy actions for emancipation of women in Pakistan.

Under the overall ambit of the National Policy for Development and Empowerment of Women, the government has initiated a number of steps for political, economic and social empowerment of women. Women are playing an increasing role in the decision making process as a result of the opportunity provided by reservation of quota in local government elections and national parliament. The capacity of women councilors is being enhanced through various trainings at the local level. A ten percent quota for women across the board in all government departments has been approved by the government. A number of schemes including National Fund for Advancement of Rural Women and First Women Bank are facilitating the process of economic empowerment. Micro-credit schemes under the aegis of Ministry of Women Development (MoWD) through First Women Bank, Khushhali Bank and Zarai Taraqiyati Bank have started creating a new entrepreneur class among poor women on local basis. Legislative measures have been taken to prevent violence against women and the passage of Women Protection Bill is a milestone step in this direction. Women are being provided justice through gender sensitized alternate dispute resolution mechanism (Musaliyat Anjuman) at the grass root levels. Gender responsive budgeting has been initiated on pilot basis and gender responsive amendments have been introduced in the government's 'Budget Call Circular' at the Federal and Punjab level. Gender responsive budgeting is now planned to be expanded to all the provinces. In tandem, statutory bodies such as the National Commission on the Status of Women (NCSW) are providing a platform to examine the policies, laws, rules and regulations affecting the status and rights of women and gender equality as guaranteed in the Constitution. These measures form the basis for attaining the goal of gender equality and empowering women.

Employment Generation and Prosperity Sharing

The role of employment as the principal link through which economic growth is transmitted to the poor to enable them to overcome poverty has been increasingly emphasized in the analysis of development policy in recent years. The magnitude of benefit to the poor derived from economic growth largely depends on the nature and extent of employment that growth generates. The draft National Employment and Skills Development Policy cognizant of this fact focuses on the sectors of agriculture,

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manufacturing, public works programme and housing. In addition, on-going targeted programmes are also supporting the process of employment generation. The President's Rozgar Scheme, implemented through National Bank of Pakistan, is providing employment opportunities to the matriculate unemployed in the age bracket of 18-40 years. Aik Hunar Aik Nagar (AHAN) being undertaken by Small and Medium Enterprise Development Authority (SMEDA), synonymous to the successful international 'One Village, One Product' model aims at providing the much-needed non-traditional work opportunities in the rural areas by enabling the rural businesses to access a range of appropriate technologies and financial capital. In addition, Pakistan Poverty Alleviation Fund (PPAF) and Khushali Bank have been entrusted to promote micro financing and micro credit schemes while the Small and Medium Enterprise (SME) Bank is financing small-scale activities under 'Hunarmand Pakistani Scheme'. Khushal Pakistan Programs and Khushal Pakistan Fund (KPF) will continue to provide employment opportunities, through labor intensive public works program, during the PRSP II period. The scope of the KPF, for which an amount of Rs. 10 billion has been allocated in the Public Sector Development Programme (PSDP) 2006-07, includes funding various development schemes for the whole of Pakistan, for the provision of clean drinking water, sanitation, district link roads and capacity building for improvement in service delivery of health and education sectors.

The unemployment rate peaked during 2001-02 and has been declining since then. This downward trend is being sustained and unemployment in 2005-06 was 6.2 percent. The decline in unemployment is more pronounced amongst females, which has almost halved over the last six years. With specific focus on the sectors of dairy, public transport, livestock and tourism, there is a huge potential to generate large-scale employment which could be to the tune of 11.2 million during PRSP-II period.

One of the manifestations of poverty is child labour and Pakistan has been grappling with this problem for some time. A number of programmes pertaining to education, literacy and pre-vocational skills are carried out to fight against child labour. Pakistan Bait-ul-Mal is running 124 centres to provide free education to child laborers across the country. Further, Ministry of Education, under Education Sector Reform Programme focuses on combating child labour through non-formal education and literacy programmes.



Pillar IV: Financial Deepening and Economic Development

The development of financial markets and institutions is a critical and inextricable part of the economic growth process. *Financial sector deepening* (financial development that includes not only an expansion in the financial sector, but also an improvement in institutions so that the financial system can allocate capital to its more productive uses more efficiently), and economic growth are empirically linked. In countries with better financial development, an efficient financial system ameliorates market distortions, reduces information and transaction costs. It, thus identifies and funds good business opportunities, mobilizes domestic savings, monitors the performance of businesses, enables the trading, hedging and diversification of risk and facilitates the exchange of goods and services. Empirical evidence suggests that financial development increases the growth of the income of the poorest of the population.

The banking sector of Pakistan was nationalized and public sector financial institutions were expanded during the early 1970s, based on the objectives of directing banking activities towards national socio-economic objectives and ensuring complete security of depositors' funds. The dominance of the public sector in banking sector and non bank financial institutions, coupled with centralized policies marked with administered interest rates, domestic credit controls, high reserve requirements, use of captive banking system to finance large budgetary requirements of the government and controls on international capital flows were responsible for deterioration of financial institutions and their inability to play a vital role in economic growth of the country.

There has been a remarkable improvement in Pakistan's financial sector and this must be viewed against the backdrop of developments that took place over the last two decades. Pakistan initiated a broad-based program of reforms in the financial sector in the early 1990s. The pace of reforms, however, has increased manifold since 2000. Some of the key reforms included privatization of a number of financial institutions, rightsizing of banks and Development Finance Institutions (DFIs) through restructuring and improvement in corporate governance by promoting transparency and disclosure. Other reforms included strengthening of the legal framework to expedite recovery of stuck-up loans by promulgating a new recovery law, revision of Prudential Regulations (PRs) for Corporate/ Commercial banking to accommodate four separate categories viz. Risk management, Corporate Governance, Know Your Customer (KYC), Anti Money laundering and Operations as well as issuance of separate Prudential Regulations for SMEs, consumer and agriculture financing. In order to ensure that the depositors' money is protected, State Bank of Pakistan (SBP) is working to improve the banking system

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monitoring and risk management framework as well as strengthening the capital base of the banking system.

A brief overview of the sub-sectors of the financial system is given below.

Role of Financial and Capital Markets in Pakistan

Banking Sector

The banking sector of Pakistan is regarded as one of the best performing sectors in the region. The banking industry's assets have risen to over US \$ 60 billion, its profitability is exceptional and at an all-time high, non-performing loans are at an all-time low, credit is fairly diversified and bank wide system risks are well contained¹². Almost 78 percent of banking assets are in private hands (see Table-8). Unprecedented growth of financial sector has led to growing foreign direct investment in this sector: the present foreign investment comes to 47 percent of total paid up capital of all the financial institutions.

Table-8: Public, Private and Foreign Assets of Banking Sector (in %)

	2000	2001	2002	2003	2004	2005	2006
Public sector Banks	56.1	54.2	43.9	41.7	24.9	22.9	22.4
Private Sector Banks	28.4	29.1	43.5	47.7	65.1	67.9	72.4
Foreign banks	15.5	16.7	12.6	10.7	10.0	9.3	5.2
Total Private Sector	43.9	45.8	56.1	58.4	75.1	77.2	77.6

Source: State Bank of Pakistan

The financial sector of Pakistan is full of opportunities and presents an investment friendly atmosphere and a huge market. The ongoing financial sector development and transformation has helped in meeting the growing financing requirements of the productive sectors, while generating consumption demand that turned out to be the main driver of economic growth. Banking sector credit witnessed record growth reaching close to Rs. 402 billion (\$ 6.7 billion) in FY 06. Additionally, access to finance has increased in pro-poor sectors such as agriculture, SME finance, consumer finance, microfinance and

¹² Speech by Dr. Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Graduate Institute of International Studies, Geneva, February 1, 2007.

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Islamic banking (see Table-9). The expansion in these sectors will further strengthen the growth of the middle class as an engine of growth.

Table-9: Sector-wise Number of Borrowers					
	2002	2003	2004	2005	Sep 2006
Corporate Sector	14,256	17,743	19,333	19,881	20,499
SME Sector	67,520	91,663	106,248	161,316	163,691
Agriculture	1,339,961	1,411,508	1,503,827	1,534,502	1,449,319
Consumer Finance	252,156	721,201	1,619,207	2,407,806	2,587,938
Commodity Operations	1,458	2,069	3,207	6,730	5,509
Staff Loans	72,570	69,796	72,633	72,927	76,840
Others	56,683	63,696	73,735	44,144	42,056
Total	1,804,604	2,377,676	3,398,190	4,247,306	4,345,852

Source: State Bank of Pakistan

SME Finance: SME financing is one of the priority sub-sectors. This is not only on account of the fact that this is an under serviced segment but also since the sector has tremendous employment generation and poverty alleviation potential. SMEs contribute over 30 percent to GDP, 25 percent to export earnings besides sharing 35 percent in manufacturing value addition¹³. According to the latest available statistics, SME financing constitutes 17.7 percent of the total loan portfolio of the banking sector. Banking institutions, running on Islamic principles, are also experimenting with interest free financial instruments (e.g. Mudarabah, Murabaha, Ijarah etc.) for this sector. In order to facilitate the sector, State Bank of Pakistan established a separate SME department in 2005 to focus on SME financing issues and has restructured the key support institutions such as SMEDA and SME Bank. Keeping in view the contribution of SMEs in Pakistan's economic growth via increased employment generation, there is a need to improve the dispersion of the branches in the country through a branch rationalization exercise.

It may be reiterated that in line with other developing countries, the SME sector in Pakistan also does not have adequate access to financing from the formal sector and has been primarily relying on the credit facilities from the informal sector at a high cost. One basic reason for reduced access to financing from banks by SME borrowers has been inadequate enabling regulatory environment, due to which banks are forced to evaluate the financing requests from prospective borrowers under the existing prudential

¹³ Government of Pakistan, SME Policy 2007



regulations which are basically driven by their requirements for lending to corporate sector. The State Bank has thus drafted separate Prudential Regulations for the SMEs. The scheduled banks have been directed by SBP to establish dedicated departments for handling SME financing. A full-fledged SME Bank was also set-up as a leader in developing the SME lending model. The SME Bank is currently undergoing restructuring where after the bank is expected to become a major lender to the SME sector. For the purpose of facilitating credit decision, the SBP is also contemplating the setting up of Credit Information Bureau in the private sector for collection/compilation of data on the credit history of SMEs, which will ultimately improve the credit risk appraisal capacity of the banks and reduce the non performing loans.

Microfinance: Microfinance has been globally recognized as an important poverty alleviation tool and Pakistan has taken a lead to mainstream microfinance in the country. Since the last decade a number of microfinance institutions have emerged which are serving remote areas. Estimates show that currently there are about 1 million borrowers out of which 60 percent are from rural areas¹⁴. Average interest rates for microfinance lending come to around 18 percent, which is well below regional levels (Bangladesh 25 percent, India 30 percent). Pakistan is amongst the few countries in the world that has a separate legal and regulatory framework for microfinance institutions/banks and a transparent reporting system. The SBP has developed a comprehensive strategy for increasing the outreach of microfinance to 3 million people by the year 2010. This strategy is based on four pillars: commercialization of microfinance industry, infusing competition by allowing multiple and international players, encouraging all-encompassing financial service delivery and launching innovative solutions to product delivery. It is further proposed to establish a micro finance bank in each district of the country.

Islamic Banking: Islamic banking continued to show impressive growth since the last few years. Growing at a rate of 59.1 percent, total number of branches increased to 70 in 2005 from 44 in 2004. Two foreign banks having 5 Islamic Banking Branches are also part of this overall position. It is envisioned that Islamic banking and finance industry landscape would evolve in parallel with conventional banking. Although the performance of Islamic banking has been encouraging, it is still relatively insignificant compared with

¹⁴ Expanding Microfinance Outreach in Pakistan, February 14, 2007, SBP



conventional banking. It is therefore timely to formulate specific strategies to develop further Islamic banking industry in line with principles of Shariah and play their important role in generating pro poor growth. There is a need to enhance capitalization and efficiency of Islamic Financial Institutions to ensure that they are adequately capitalized, well performing and resilient and at par with international standards and best practices. A detailed strategy focusing on enhanced access to Islamic financial services along with improved corporate governance and is in the process of formulation by the SBP.

Non-Banking Sector

Capital Markets: Pakistan's Stock market has been the best performing market in the region. The Karachi Stock Exchange (KSE) share index that stood at 1,507 points at the end of the year 2000 had reached 11,271 points by 30th March, 2007 with market capitalization being close to US\$ 50.5 billion, or equivalent to 37.5 percent of GDP¹⁵. Portfolio investment during July-Feb FY 07 stood at US\$ 981.2 million compared to US\$ 470.9 million during the same period last year.

Securities and Exchange Commission of Pakistan (SECP) has undertaken various capital market reforms to bring stability and protect the investors. Some of these reforms include developments of laws and regulations (such as amendments in Proprietary Trading Regulations 2004, amendments in National Clearing and Settlement System regulations and Central Depository Company of Pakistan Limited regulations etc.), development of new products, market transparency and governance regulations.

The Government is planning to launch a second generation of capital market reforms to facilitate the mobilization of financial resources for productive investment and employment generation. These reforms also aim to ensure balanced development of the Pakistani financial sector, which will reduce systemic vulnerabilities in a bank-dominated financial system. The Government plans to put special emphasis on strengthening the enabling environment for pension funds and other nonbank financial institutions, given the strong causal relationship between the level of development of institutional investors and the deepening of capital markets. The ADB will lend support to the Government's renewed capital market development initiatives.

¹⁵ Based on estimated GDP for FY07.



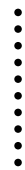
Non Bank Financial Institutions (NBFIs): In order to bring efficiency to the financial sector and consolidate the fragmented business of NBFIs, Non Bank Finance Corporations (NBFC) rules were promulgated on 1st April 2003. These were followed up by the introduction of the Universal NBFC concept in 2005 with the objective to consolidating the non-bank financial services sector by allowing multiple business lines under one umbrella.

Over the past few years, mutual funds industry has been the star performer amongst NBFIs and the industry is expected to grow further due to a booming stock market and rising demand for funds among retail investors. Emergence of the mutual funds in the financial sector will allow small investors to take on diversified risks in the capital markets.

Future plans for the sector include promulgation of the regulatory framework for Real Estate Investment Trusts, promulgation of a regulatory framework for private equity and venture capital funds, amendments in NBFC Rules in light of international best practices, strengthening of on-site and off-site monitoring of entities along with computerized quarterly analysis of information to assess the financial health of NBFIs.

Insurance Sector: As of 30th June 2006, there are five life insurance companies, fifty-one non-life insurance companies, one *Takaful* operator and one reinsurance company operating in Pakistan. Various reforms have been initiated in the insurance sector of Pakistan with the view to accelerate the growth of this sector. Since 2000, various laws have been administered in order to reform insurance regulation. These include the Insurance Ordinance 2000, SEC (Insurance) Rules 2002, Ministry of Commerce Rules 2002 and *Takaful* Rules 2005. Other regulatory changes include the abolition of the office of controller of insurance and conversion of Corporate Law Authority in to SECP within which a separate department was formed to look after the affairs of the insurance industry.

Going forward, further reforms are envisaged for the insurance sector, which include bringing Postal Life Insurance under the ambit of the Insurance Ordinance 2000, removal of anomalies in the tax laws and changes in governance structure of public sector insurance companies. In order to ensure that the insurance industry penetrates the rural areas and the marginalized groups, steps will be taken to make group insurance compulsory and a framework will be developed under which all insurers would be



required to underwrite a certain proportion of their business in rural areas as well as among the socially deprived by introducing micro-insurance schemes.

Investment Projections

Financial sector reforms have transformed the financial sector into a privately owned and markedly competitive sector (see Table 8).

Financial sector is currently attracting heavy foreign investment and is among the top three sectors with respect to foreign inflows¹⁶. Existing foreign banks have by and large enhanced their presence and stake in Pakistan along with new foreign banks that have entered the domestic market for the first time. For example, Standard Chartered Bank has acquired Union bank, ABN-Amro has acquired Prime Bank, Tamasek of Singapore has established NIB bank. There are other transactions which are in the pipeline reflect the robustness and profitability of banking sector in Pakistan. The increasing investment and build up of foreign stake in financial sector is also a manifestation of the investors' confidence in Government of Pakistan's determination to build a sound financial system as an engine of growth for the economy.

Foreign portfolio investment in the local bourses has also shown an upward trend signifying an increasing foreign interest in the country's capital markets¹⁷. Foreign Portfolio Investment, as represented by the Special Convertible Rupee Account (SCRA) shows a net inflow of US\$ 104 million in January 2007 alone; an inflow of US\$ 23 million was recorded on just one day i.e. 31st January 2007. Interest exhibited by foreign companies in buying stakes in local companies has also been very well received by the market through the country's privatisation programme. The government completed eight privatisations worth Rs. 196.2 billion during fiscal year 2005-06. The privatization program for the current fiscal year is also on track.

Financial Globalization in Pakistan

One way of achieving better financial institutions is by means of availing the opportunities offered by globalization. Liberalization of the financial sector of Pakistan has enabled the domestic sector to take advantage of global opportunities.

¹⁶ FDI in the top three sectors for Jul-Feb FY07 is as follows: Telecommunications—US\$ 1.2 billion, Financial Business—US\$ 572.8 million, Oil & Gas Explorations—US\$ 352.7 million.

¹⁷ Securities and Exchange Commission of Pakistan



Financial globalization in Pakistan has led to increased liquidity and lowered the cost of capital, thus leading to better allocation of financial resources and more productive investments. It has also spurred competition and led to a new age of financial sector development by improving screening of credit risks, monitoring of borrower activities, diversification of the financial portfolio and substantially increasing the outreach to the customers. Foreign financial institutions have also brought about improvements in the system by bringing in highly diversified financial tools and best practices from the developed economies.

This enhanced financial development as a result of financial globalization is going to play a key role in meeting the growing demand of a nation blessed with unparalleled demographic dividend. The increase in available funding will realize huge investments in infrastructure, corporate sectors, household financing and SME and Micro financing. This, in turn will lead to huge employment generation that is a prerequisite for realizing the unparalleled demographic dividend.

Going Forward

Despite these positive results, Pakistan can not afford to be complacent. Second generation reforms need to be built on past accomplishments in order to utilize the financial sector's resources to achieve a healthy level of economic growth and alleviate poverty. With an average credit growth of 30 percent over the last three years, and the rapid diversification of banks' loan portfolios, there is need for vigilance in the future. The government intends to play the role of a regulator and facilitator in the financial sector. It is intended to sustain the momentum of reforms so far achieved through maintenance of the growth enabling environment.

Keeping in view the importance of financial deepening for economic development, Pakistan's medium term financial sector strategy will focus on the following areas:

- Broadening access to middle and lower income groups
- Development of new liability products to utilize savings of small savers
- Corporate restructuring to support financial sector reforms
- Infrastructure financing
- E-banking



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- Private equity, Pension and Provident funds
 - Investment banking
 - Human resource development and capacity building
 - Promotion of Islamic banking
 - Further consolidation and restructuring of the banking sector
 - Focus on Development Finance to serve the underserved markets
 - Further strengthening of supervisory regime & strengthening Risk Management



Pillar V: World Class Infrastructure

The government's vision for economic growth and poverty reduction sets ambitious targets, which will require massive investment in quality and affordable infrastructure, to sustain high rates of private sector led growth, enhance the competitiveness of its economy and to optimize its locational advantage. This will be a primary objective during the PRSP II period and beyond. The magnitude of the investment is such that this will be only partially funded from the Budget. The large part of financing will be leveraged through public private partnerships.

Medium Term Development Framework 2005-2010, Infrastructure Development Requirements and Financing Public/ Private Partnerships

The government's infrastructure development initiatives are an essential part of its Poverty Reduction Strategy. Keeping this in mind, the MTFDF 2005-2010 was prepared by GoP in 2005. The strategy of MTFDF focuses on expansion of social and physical infrastructure, in addition to development of crops, livestock and fisheries in agriculture; enhancement of the manufacturing production base; and provision of an enabling environment to foster local and foreign investment and enhance both public and private savings.¹⁸ The MTFDF envisages an investment of Rs. 2042 billion during 2005-2010 under the PSDP, out of which the infrastructure sector shall obtain the highest share of almost 49 percent.

The pivotal step from strategy formulation to implementation of infrastructure projects is to create an environment conducive to private investment. The government is adopting investor-friendly policies, but operational, legal, and procedural constraints still have to be identified and removed to achieve the MTFDF's private investment targets. The government has also set up an Infrastructure Project Development Facility (IPDF) under the auspices of the Ministry of Finance (MOF), to generate Public Private Partnership (PPP) projects with Implementing Agencies (line ministries, provincial governments, local bodies, state owned enterprises etc.). IPDF will act as the principal *facilitator and coordinator* of PPPs in Pakistan, with primary sectors of focus including transport and

¹⁸ GoP, 'MTDF 2005-2010', (May 2005).

logistics, municipal services (water supply and sanitation, solid waste management, etc.) and small scale energy projects. The government is in the process of setting up an Infrastructure Project Financing Facility (IPFF) that will provide the residual long-term, fixed rate local currency *financing* to financially viable and bankable PPP projects.

Leveraging the Water Resource for Development

The implementation of a comprehensive set of measures for the development and management of water resources will include the creation of additional medium and large-size reservoirs, integrated resource use, the introduction of water efficient techniques including measures to enhance the water table, containment of environmental degradation, institutional strengthening, capacity building and human resource development. Future goals would also include catering to the increasing demands for drinking water supplies and for industrial and commercial activities in a cost effective manner. Inextricably linked to irrigation, water resource management and development, are vital for economic growth and poverty reduction in Pakistan. An allocation of Rs. 276 billion during 2005-2010 has been proposed for the water sector under the MTF, including a federal allocation of Rs. 218 billion and provincial allocations of Rs. 58.2 billion. An enabling environment shall be created for active stakeholders' consultation and participation at all levels and in all aspects of water resources including irrigation, drainage, domestic water supply, flood protection, drought mitigation, waste water treatment and pollution control. A draft National Water Policy, prepared by the Ministry of Water and Power with inputs from highly professional experts in water resource management from across the country, is currently under process¹⁹.

Ensuring Energy Security and Energy Efficiency

Considering the critical importance of maintaining energy efficiency and security for ensuring sustainable growth, the Government of Pakistan approved the Energy Security Plan (ESP), 2005-30 in February 2005. Salient features of the ESP include: increasing exploratory efforts to significantly enhance the annual production levels of gas and oil; diversifying the energy mix, by expanding the share of coal, nuclear and renewable energy from its current combined share of 20 percent to 36 percent by 2030; increasing

¹⁹ GoP, 'MTDF 2005-2010', (May 2005)



storage capacity, so that strategic reserves which currently stand at 29 days of demand or less are brought closer to the United States' 60-day supply by 2015 and Europe's 90 days by 2030; developing hydropower resources as they are cheap and eco-friendly; promoting efficient use of energy through energy conservation and demand management measures; building up the local power engineering industry with power plant equipment, steam turbines, and generators; and initiating research in emerging thrust areas such as fusion, fuel cells, and hydrogen for energy generation and storage.

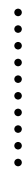
Whereas the estimated hydel potential in the country is 46,000 MW, the present installed capacity of hydel power is only 6,459 MW. The total investment for the power sector during 2005-2010 is estimated at Rs. 1102 billion, including Rs. 445 billion expected to be generated by the private sector.²⁰ There are plans to develop the hydro power resources on a large scale through construction of massive storage dams such as Bhasha-Diamer, Kalabagh, Kurram Tangi, Munda and Akhori. Total investment on these major dams over the period 2006-2017 will amount to Rs. 1088.6 billion²¹. Estimated power generation of these dams will be equivalent to 35,092 Mkw – Kalabagh (14,400 Mkw), Bhasha-Diamer (18,220 Mkw), Akhori (2,155 Mkw) and Kurram Tangi (317 Mkw). The Petroleum Exploration and Production Policy 2007, initiated by the Ministry of Petroleum, is to establish policies, procedures, and the tax and pricing regime related to the petroleum exploration and production (E&P) sector.

The Iran-Pakistan-India (IPI) gas pipeline project, currently under approval by GoP, is an arrangement under which Iran would provide 2.1 billion cubic feet of gas per day in the first phase, and 3.2 billion cubic feet during the second phase, to Pakistan. The construction work of the pipeline, worth approximately US\$ 3 billion, will begin next year, while the first gas delivery is expected in 2012. Regional linkages will be established and possibilities explored for importing power from Central Asian Countries. Current linkages with Iran will be expanded for importing power particularly in remote areas of Balochistan.

A considerable amount of empirical evidence confirms the fact that environmental conservation spurs economic development. Development based on utilization of natural

²⁰ GoP, 'MTDF 2005-2010', (May 2005)

²¹ GoP, Planning Commission, (2007)



resources, pressures of population growth and a subsequent increase in demand and poverty can all take a heavy toll of environmental assets. Conversely, the degradation of natural resources can have a devastating impact on the poor, given that they tend to be strongly dependent on the exploitation of such resources. In this regard, the National Environment Policy, approved by the Pakistan Environmental Protection Council (PEPC) in 2004, aims to protect, conserve and restore Pakistan's environment through sustainable development. An energy conservation programme will be undertaken including enactment of necessary laws by Ministry of Science and Technology and ENERCON (National Energy Conservation Centre, Ministry of Environment), for energy efficient building designs, use and manufacturing of energy efficient appliances. Co-generation technologies to conserve energy would be promoted. ENERCON would develop a mechanism to monitor strict compliance of energy conservation laws. The Alternate Energy Development Board (AEDB) was established in 2003 as a central national body which will facilitate development of renewable energy (such as wind and solar energy) projects.

National Trade Corridor and Modernization of Logistics Chains

To support sustained growth and increase competitiveness the GoP - with the assistance of mainly, the World Bank and the Asian Development Bank (ADB) - has launched a major strategic initiative to improve the trade and transport logistics chain along the north-south 'National Trade Corridor' (NTC) linking Pakistan's major ports with its main industrial centres and neighbouring countries. With the concept of the programme approved by the government in August 2005, the GoP intends to achieve the objectives of the NTCIP with an investment programme of around US\$ 6 billion over the MTRDF period (2005-2010). NTC is essential for supporting 7-8 percent of the sustained economic growth annually. The ports, roads and railways along this corridor handle 95 percent of external trade and 65 percent of our total land freight.

The main rationale of the NTCIP is for Pakistan to gain a competitive advantage in the fast globalizing world and enhance efficiencies through, 1) provision of world class infrastructure 2) efficient logistics chain, and 3) smooth interface between the public and private sectors. NTCIP holds a holistic and integrated approach to reduce the cost of doing business by improving trade logistics to international standards. The main focus will be overhauling the complete logistics system including:

- Procedures - legislation, regulation, administration and documentation

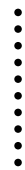


- Services – shipping and port services, trucking, railways, handling, warehousing, customs, insurance, banking, freight forwarding etc.
- Infrastructure – ports, roads, rail, aviation/air transport, warehouses, dry ports and pipelines

NTCIP hinges on a consensus building process with all stakeholders through informed consultation that focuses on: 1) quick results through policy interventions, systematic and procedural improvements, and cutting administrative red-tape involving small investments; 2) longer term higher cost investments (with pragmatic investment assessment from the private sector); and 3) deep rooted institutional reforms to ensure sustainability. The Highways Rehabilitation Project is supporting the government’s efforts to improve the efficiency of the national highway network with the assistance of the World Bank. In the port sector, the Asian Development Bank (ADB) is funding the Port Management Unit in the Ministry of Ports and Shipping. The objective of the unit is to establish and monitor benchmarks, prepare and help implement plans to corporatize the ports and assist the ports in achieving the status of landlord ports. ADB is also presently funding: (a) technical assistance to prepare a framework for Public Private Partnerships (PPP) in infrastructure, and (b) technical assistance to prepare a trucking strategy which will become integral part of the overall strategy for NTCIP.

Table-10: Transport Targets during 2005-2010						
Year	Railways		Roads		Air Transport	
	Passengers (Passengers/km)	Freight (Ton/km)	Passengers (Passengers/km)	Freight (Ton/km)	Passengers (Passengers/km)	Freight (Ton/km)
2004-05	23.57	5.28	215.09	138.14	24.5	0.601
2005-06	24.16	5.81	223.06	146.28	25.7	0.627
2006-07	24.77	6.38	232.54	155.06	27.0	0.654
2007-08	24.38	7.03	241.85	164.36	28.03	0.682
2008-09	26.00	7.73	251.52	174.22	29.7	0.711
2009-10	26.70	8.50	261.58	184.68	31.1	0.742
Growth Rate	2.5%	10.0	10%	6%	4.9	4.3

Source: GoP, ‘MTDF 2005-2010’, (May 2005).



Pakistan globally ranks 98th on the ease of trading across borders, up from 117th position last year.²² Time to import has dropped from 39 to 19 days in Pakistan, which is a direct result of a new customs clearance process that allows traders to file cargo declarations before shipments arrive and to pay tariffs and port fees electronically. Modernization of harbours, internal transportation corridors and the air transportation system being initiated under the National Trade Corridor Project complements ongoing efforts at the border. Risk management techniques are now used for choosing which cargo containers to inspect. Training of staff and main traders were conducted during 2005-06. The Karachi container terminal has fully incorporated the new system. Time needed to export goods from Pakistan has dropped from 33 days in 2004 to 24 days in 2005-06.²³

Pakistan's infrastructure development plans and the related policy / institutions and regulatory framework will be a major initiative targeting the improvement in the competitiveness of the private sector, removing infrastructural bottlenecks to sustain and strengthen private sector led growth. The plan is ambitious but the government is firmly committed to its implementation. The government's success in providing the basic necessity of electricity to the poor through the village electrification programme is already well known. Pakistan has a remarkable history of successfully confronting major challenges. It has enormous human capacity to confront the next round of related challenges.

²² World Bank, 'Doing Business in South Asia 2007: How to Reform' (2007).

²³ World Bank, 'Doing Business in South Asia 2007: How to Reform' (2007)



Pillar VI: Effective Governance and Management

Second Generation Reforms

Pakistan has been implementing wide-ranging structural reforms in almost every sector of the economy to improve supply-side response by removing impediments to private sector development, improving the investment climate with the ultimate objective of strengthening the growth impetus and poverty reduction. The first generation reforms implemented so far include: financial sector reforms, capital markets reforms, tax and tariff reforms, reforms in tax administration, fiscal transparency, reforms in privatization programme, governance reforms, particularly with respect to devolution and capacity building, agricultural reform, and most importantly, the passage of the Fiscal Responsibility and Debt Limitation Act 2005. The second generation of these reforms, which will be implemented over the next five years, would focus on strengthening institutions, improving the competitiveness of domestic industry, building a robust financial sector in an environment of global financial restructuring, further strengthening of tax administration, promoting transparency in economic policymaking, further reform of capital markets and strengthening the country's physical and human infrastructure.

As part of institutional strengthening, major ongoing and planned government initiatives include reforms in judiciary, police, civil service, pension, the restructuring of the Central Directorate of National Savings (CDNS), restructuring of Federal Bureau of Statistics (FBS) into an autonomous institution, transforming the existing MCA into a Competition Authority Organization, and introduction and adoption of E-Government Strategy. Reforms aimed at improving competitiveness will work towards strengthening of the country's physical infrastructure, that is, the supply of gas, power, well functioning ports, roads, rail linkages, telecommunication network, and water availability. Second generation banking and financial sector reforms will include; voluntary mergers and consolidation of smaller banks into bigger more effective and stronger banks; further strengthening of the legal framework; formulation of new Banking Laws to deal with current and future challenges; a deposit insurance scheme to protect the small depositors; further liberalization of financial services in the context of the Agreement on Trade Related Investment Measures (TRIMs); promoting transparency and accountability in banking system; and observance of international standards, particularly legal and administrative measures to combat money laundering.



Reinforcing Devolution

Governance reforms and devolution of power to the grass roots level were initiated to address poverty reduction through elected and accountable local governments by strengthening the political, administrative and financial structures at the local level. Devolution and the strategy adopted for implementation has been effective as the service delivery indicators for the first term of local governments have shown positive trends, whereas the social sector indicators were declining or stagnant in the pre-devolution period. The devolution process initiated in August, 2001 requires concerted efforts and intelligent use of available resources to reap the benefits of new governance paradigm in Pakistan. The Federal and Provincial Governments are pursuing medium and long-term strategies to consolidate devolution and governance reforms.

In the coming years, government's efforts towards consolidating fiscal decentralization will focus on strengthening the provincial finance commission, developing MIS to monitor releases to the local governments, revision of delegation of financial power rules, beefing up the procurement and contracting systems and strengthening internal control systems within line departments. The successful implementation of devolution is dependent to a large extent on the capacity of local government institutions and the quality of officials working in the local governments. Budgeting, planning, monitoring, financial management, accounting and auditing are some of the key areas where capacity building efforts will continue in the future. Due to shifting of executive functions from the Province to the District and Tehsil, the Provincial Departments will have to redefine their roles to enable local government institutions to play their due role.

Effective Social Service Delivery

The delivery of basic social services like education and health is a central theme of poverty reduction. Expanding inclusive service delivery is critical to achieving the Millennium Development Goals and maximizing the gains from the upcoming demographic dividend. The main responsibility and role of improving delivery of social services like education and health now lies with the provincial and district governments. Government's effort in the next 3-5 years will focus on better aligning accountabilities and expenditures, resources, and administrative and policy functions across the different tiers of governance, in order to improve social service delivery.

The increased spending on the education sector during the last five years combined with better service delivery at the grassroots level, as a result of devolution, has resulted in

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improved outcomes in the education sector (see Table-11). Future governance reforms in the education sector will focus on: 1) transparent criteria for teachers recruitment; 2) decentralizing the management of local schools management committees (SMCs) or parents teachers associations (PTAs) and reaffirmation of their role in school management and in monitoring and curbing teachers' absenteeism; and 3) developing transparent approach to targeting districts and students for scholarships for girls or boys; and formal contract between the provincial and district governments for transfer of additional resources for education.

Table-11: Adult Literacy and the Gross Enrolment Rate				
	Adult Literacy Rate 10+		GER (Excluding Katchi)	
	PIHS 2001-02	PSLM 2004-05	PIHS 2001-02	PSLM 2004-05
Pakistan	45	53	72	86
Male	58	65	83	94
Female	32	40	61	77
Regional breakup				
Urban	64	71	91	104
Rural	36	44	66	79
Provincial breakup				
Punjab	47	55	76	95
Sindh	46	56	63	75
NWFP	38	45	77	80
Balochistan	36	37	62	67

Source: PRSP Progress Reports

In the health sector, the medium term strategy of the government aims at raising public sector health expenditures through focus on preventive programmes. This approach provides a clear shift from curative to preventive health care especially for disadvantaged and weaker sections of society, living in the rural areas. It aims at promoting gender equity through targeted interventions like deployment of Lady Health Workers (LHWs) and improvements in maternal and pre-natal health care. Other programmes include adoption of DOTs strategy against TB; Roll-back Malaria approach in combating malaria; measures for preventing the spread of HIV/AIDS, immunization against communicable diseases including Polio, Tetanus, Hepatitis-B, public health education campaigns; setting up a viable disease surveillance system; and institutionalizing federal-provincial-district partnership in the war against disease. The increased spending on

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health sector along with better service delivery at the grassroots level has improved outcomes in the health sector (see Table-12).

Table-12: Percent of Children Aged 12-23 Months Immunized						
	PIHS 2001-02			PSLM 2004-05		
	Male	Female	Both	Male	Female	Both
Pakistan	53	52	53	78	77	77
Regional breakup						
Urban	70	71	70	86	87	87
Rural	48	45	46	73	71	72
Provincial breakup						
Punjab	57	58	57	85	84	84
Sindh	49	40	45	74	72	73
NWFP	56	57	57	77	76	76
Balochistan	24	24	24	64	60	62

Source: PRSP Progress Reports



Pillar VII: Targeting the Poor and the Vulnerable

Targeting Poverty and Social Safety Nets

Assisting the poor and vulnerable is a key objective of the second generation PRSP-II. The Social Protection Strategy consisting of a range of programmes and policies, has been formulated with the objective in mind to achieve certain redistributive, risk-pooling, and social cohesion goals, and act as an enabling mechanism that allows the poor and vulnerable to participate more productively in the economy. The incidence of poverty in Pakistan shows a decline from 34.5 percent in 2000-01 to 23.9 percent in 2004-05. The incidence, manifestation and causes of poverty and vulnerability vary across Pakistan, with the highest rates of poverty and vulnerability being observed in the rural areas.

There are a number of programmes in Pakistan which tackle poverty and vulnerability directly or indirectly, but they need to be integrated into a holistic framework, in order to maximize impact. Currently, Zakat and Pakistan Bait-ul-Mal (PBM) are the main institutions for addressing social protection needs of the poor and vulnerable. The Ministry of Social Welfare and Special Education is responsible for shaping, directing, and coordinating government policies on social protection at the national level.

The National Social Protection Strategy under approval of the Government aims to fill this gap by developing an integrated and comprehensive social protection system, covering all the population, especially the poorest and the most vulnerable. The Goals of the Strategy are: 1) to support chronically poor households and protect them against destitution, food insecurity, exploitation, and social exclusion; 2) to protect poor and vulnerable households from the impacts of adverse shocks to their consumption and wellbeing that, if not mitigated, would push non-poor households into poverty, and poor households into deeper poverty; and 3) to promote investment in human and physical assets, including health, nutrition, and education, by poor households capable of ensuring their resilience in the medium run and of interrupting the intergenerational cycle of poverty.

The Core Instruments proposed by the Strategy include: 1) expanding the coverage of cash transfers using conditional cash transfers (CCTs) supplemented with unconditional transfers, through the Food Support Programme (FSP) and Zakat; 2) a new public works programme based on low-wage employment; 3) child labour programmes, and various new pilots such as (a) combination of cash transfers and basic skills development aimed

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at 'graduating' the poor into microfinance clients and (b) programmes for bonded labour; and 4) scaling up school feeding and social care services.

The main short term objective of reaching the poorest can be achieved by: 1) keeping the current benefits working and effecting a transition to better and more comprehensive systems; 2) introducing new means of testing and development of databases through some pilots across chosen rural and urban areas; 3) scaling up successful pilots across the country following assessment of lessons learnt; 4) extension of the current level of benefits to the target population of the poorest of the poor; 5) introduction of pilot CCT programmes; and 6) scaling up successful pilots to the whole target population. After these have been accomplished (which could take 3-5 years to complete), and with the basic systems in place and more resources available, it will be possible to contemplate: (a) adjustment of benefit levels to higher levels; and (b) the addition of new programmes.

Micro Finance

In Pakistan, microfinance (MF) has been recognized as an important instrument for poverty reduction in the first generation PRSP-I. Realizing the need and importance of MF, as a tool of poverty reduction and social mobilization, the government has accelerated its efforts to establish strong foundations of MF in formal sector and extended considerable support to the informal sector (NGOs) as well. In order to promote the MF in formal sector, the most significant step taken by the government was the launching of Microfinance Sector Development Programme (MSDP) in 2000. The main objective of this programme was to broaden and increase the pace for the development of the sector to provide the financial services to poor on sustainable basis. Khushali Bank (KB), the first specialized microfinance bank, was established in 2000 under a special ordinance. Then Microfinance Institutions (MFI) Ordinance 2001 was put in place to provide a separate regulatory framework for MF sector.

Currently, microfinance services in Pakistan are being provided by microfinance banks (MFBs); commercial banks; rural support programmes (RSPs) and nongovernmental organizations (NGOs) with the Pakistan Poverty Alleviation Fund (PPAF) being wholesale provider of credit to NGOs. It is estimated that around 40 Microfinance Institutions (MFIs) are operating in all of the above mentioned categories, offering over 400 outlets countrywide. Cumulatively, the outstanding loans of these institutions in 2005-06 amounted to Rs. 6.6 billion. The Microfinance institutional framework currently supports one million active borrowers, which are planned to be increased to 3 million by 2010.

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Future challenges include adapting policies to provide the conditions for expansion of the microfinance sector and to maximize its social and poverty impact. The broad conditions required for this expansion, at the highest level are macroeconomic stability and continued development of the banking sector. The key role of MF policies at this stage of the development of the sector is to provide an enabling environment in which the sector can grow. First, there is a need to move away from subsidization of microfinance services to commercialization of such financial services, which invariably involves looking beyond the government or donor subsidized credit delivery systems to self sufficient institutions providing commercial finance. Secondly, the microfinance industry has to move from single to multiple products in order to ensure its financial and social sustainability. The microfinance providers would be encouraged to mobilize savings through deposits and provide insurance. Thirdly, financial sustainability of microfinance is contingent on recognizing that the credit has to be priced effectively. The administrative cost of delivery, disbursing and collecting a micro or tiny loan portfolio is much higher in comparison with conventional loan portfolios. The key to reducing costs is to introduce market competition, innovation and efficiency. Fourth, options to enhance the access to credit for the lower income group can be augmented by the combination of credit bureaus and statistical risk-scoring techniques. Fifth, the MF Banks/MFIs need to know their customers, know their market and design products to fit the financial requirements of the people they serve. The design of products has to be based on the financial requirements of the household and the economic activities the household supports.

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VIII. The Strategy Going Forward

1. As stated in the beginning, while Pakistan has made remarkable progress in its economic performance, undertaken wide ranging structural reforms, achieved both macroeconomic stability and strong growth sharply reduced poverty, yet there is no room for complacency. Indeed the Government is far from complacent for the challenges are several, but then so are the opportunities. The important thing is that both challenges and opportunities have been identified. The PRSP II attempts to bring these challenges and opportunities together within an integrated and holistic strategy. This strategy will be implemented jointly by all stakeholders, with the Government providing an enabling environment through both its policies and actions, all within a stable macroeconomic framework.
2. The purpose of this draft, as also stated earlier is to continue the discussion and consultative process with all stakeholders. It is in a sense an outline, meant to serve as a basis for this dialogue. It is not cast in stone and will evolve, enriched by the dialogue it has initiated.
3. Given the significant resources required to fund the Poverty Reduction Strategy, the Government will prioritize the Poverty Reduction Strategy through the MTEF, which is being used for budget making. The budgetary and non-budgetary medium term expenditures for PRSP-II are being estimated as part of an exercise to cost the MDGs that has recently been completed. This exercise costs the financial resources required to achieve the MDGs related to the health, education, and water and sanitation sectors. This costing /expenditure framework will adhere to the stipulations of the Fiscal Responsibility and Debt Limitation Act under which expenditure on social sectors would be at least 4.5 percent of GDP in any given year and allocations on health and education would double as a percentage of GDP over the next ten years.
4. The PRSP framework will also provide an assessment of our performance in achieving the Millennium Development Goals. While the triggers and targets may be specific to funding programmes, they are essentially monitoring tools for assessing the PRSP implementation process. Monitoring progress against the MDGs is as important to the Government as it is to the relevant Development Partners.
5. The 2005 earthquake was the most debilitating natural disaster in Pakistan's history. The PRSP-II will present a detailed description and review of the relief, rehabilitation and reconstruction efforts. There are lessons from this experience that have to be built



into our poverty reduction strategies to ensure that we can take a pro-active position to minimize our losses in case of future natural disasters.

6. The PRSP Secretariat has been able to develop a system of tracking budgetary and non-budgetary expenditures (input indicators) on various aspects of poverty, based on the civil accounts provided by the office of the Controller General of Accounts and the Provincial Accountant Generals on a quarterly basis. Both budgetary and non-budgetary expenditure have been reported regularly for each quarter in the PRSP progress reports. The Secretariat has so far produced five annual (FY 02, FY 03, FY 04, FY 05 and FY 06) and 16 quarterly reports.
7. Although progress has been made in the PRSP Monitoring and Evaluation (M&E) system, several challenges still need to be addressed. In particular, there is a need to ensure that the large scale household surveys conducted by the Federal Bureau of Statistics that provide the data for the outcome indicators are consistent and comprehensive and cover the entire range of PRSP indicators.
8. During the PRSP-II period (2006-09) the Monitoring and Evaluation system will be consolidated with the following specific objectives:
 - The production of high quality statistical information;
 - Steady operation of the institutional mechanism;
 - Extending the M&E system at the province and district levels;
 - Impact evaluation of policy inputs; and the regular production of quarterly and annual progress reports.
9. The dissemination activities of the PRSP to the public have improved through the development of a PRSP communication strategy, which is being implemented. The poverty monitoring groups have helped to deepen the involvement of Multilateral Development Agencies in the PRSP M&E process.

Annexure-I: Performance of Key Economic Indicators

	Unit	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 (P)
I. Real Sector								
Real GDP Growth	%	3.9	2.0	3.1	4.7	7.5	8.6	6.6
Agriculture	%	6.1	-2.2	0.1	4.3	2.3	6.7	2.5
Large Scale Manuf.	%	1.5	11.0	3.5	7.2	18.1	15.6	10.7
Investment	% of GDP	17.4	17.2	16.8	16.9	16.6	18.1	20.0
National Savings	% of GDP	15.8	16.5	18.6	20.8	17.9	16.5	16.4
Inflation		3.6	4.4	3.5	3.1	4.6	9.3	7.9
Food Inflation	%	2.2	3.6	2.5	2.9	6.0	12.5	6.9
Non-Food Inflation		4.7	5.1	4.3	3.2	3.6	7.1	8.6
Core Inflation		3.5	4.2	3.5	2.5	3.7	7.0	7.1
II. Fiscal Sector								
Revenue Collection (CBR)	Billion Rs.	346.6	392.3	403.9	460.6	518.8	588.4	712.0
Fiscal Deficit	% of GDP	5.4	4.3	4.3	3.7	2.4	3.3	3.4
Public Debt	% of GDP	94.8	82.8	77.7	72.7	67.7	61.7	56.0
- of which foreign currency Denominated	% of GDP	45.8	42.3	40.8	36.7	32.0	29.1	26.2
Debt Servicing	% of Total Revenue	63.8	57.0	51.1	35.7	31.3	30.2	28.0
III. External Sector								
Exports (f.o.b)	Billion \$	8.2	8.9	9.1	10.9	12.4	14.4	16.31
Imports (f.o.b)	Billion \$	9.6	10.2	9.4	11.3	13.6	18.8	24.6
Trade Deficit	Billion \$	-1.4	-1.3	-0.3	-0.4	-1.2	-4.4	- 8.2
Remittances	Billion \$	1.0	1.1	2.4	4.2	3.9	4.2	4.6
Current Account Balance	% of GDP	-1.6	-0.7	1.9	3.8	1.3	-1.6	-4.4
Foreign Direct Investment	Million \$	470.0	322.4	484.7	798.0	949.6	1524	3521
External Debt and Forex Liabilities	Billion \$	37.9	37.1	36.5	35.5	35.3	36.6	37.2
External Debt and Liabilities	% of Forex Earnings	297.2	259.5	236.8	181.2	164.7	134.3	120.6
Foreign Exchange Reserves	Billion \$	1.3	3.2	6.3	10.7	12.3	12.6	13.1
IV. Monetary & Capital Market								
Weighted Avg. Lending Rate	%	14.0	13.7	13.1	7.58	5.05	8.2	9.9
Credit to Private Sector	Rs. Billion	18.0	48.6	53.0	168.0	325.0	437.8	352.3
Stock Market (KSE Index)	1991=1000	1521	1366	1770	3403	5279	7450.1	9989.4
Market Capitalization	Rs. Billion \$ Billion	392 6.7	339 5.8	408 6.8	746 12.8	1357.5 23.4	2013.2 33.7	2766.4 45.9

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