

Australia South Asia Research Centre

together with

**The Research School of Pacific & Asian Studies
&
The National Institute of Economics and Business
Australian National University**

present

**10 Years of ASARC
an International Conference**

**Recent Macroeconomic Developments and Implications
for Poverty and Employment in Pakistan:
The Cost of Foreign Exchange Reserve Holdings in South Asia**

Talat Anwar
State Bank of Pakistan, Karachi

Australia South Asia Research Centre
Australian National University
Canberra, Australia
27 & 28 April, 2004

Recent Macroeconomic Developments and Implications for Poverty and Employment in Pakistan: The Cost of Foreign Exchange Reserves Holdings in South Asia

By
Talat Anwar*

Abstracts

After a retarded economic growth over the past few years, a recovery in economic growth rate began as result of faster growth in industrial sector and respectable growth in services sectors. Although macroeconomic stability has been achieved, the reduction in fiscal deficit was also at the expense of public sector development and social sector expenditure over the past few years. While acceleration and pattern of economic growth together with stagnant investment are not pro-poor since sufficient employment is not likely to be created, the recent surge in food inflation will hurt the poor. While economic reform programmes undertaken within the framework of IMF/World Bank over past 15 years were aimed at increasing efficiency and/or reducing poverty, the trends in various dimensions of poverty indicate that absolute poverty and inequality have worsened and progress in human development dimensions remained poor in Pakistan.

Another striking development was the substantial improvement in the capital inflows in the form of worker's remittances due to the increased scrutiny of undocumented foreign currency transaction after September 11. Since the focus of exchange rate and thus the monetary policy has been on avoiding the appreciation of Pak rupee to preserve export competitiveness, State Bank of Pakistan purchased foreign currency heavily stemming from increased workers' remittances resulting in an exceptional rise in foreign exchange reserves. While foreign exchange reserve accumulation is seen as an achievement, maintaining high level of reserves involves a heavy cost. It is worth noting that the costs to poor nations are benefits in terms of low interest loans to the nations that supply reserve currencies primarily the United States. Notably, Pakistan bears the highest annual cost of foreign exchange reserves holdings at 3.3% of GDP (US\$2.5 billion) in south Asia followed by India, if compared as percent of GDP. Thus, by diverting resources from more productive uses in order to accumulate high level of foreign exchange reserves both India and Pakistan, have significantly impeded economic and social progress over the past few years. This explains why the poor are not benefiting from the recent macroeconomic gains in south Asia. It must be recognized the foreign exchange reserves are the national savings which a nation acquires through running current account surpluses. If the government utilized the foreign exchange reserves on foreign goods and services for the development of infrastructure in the country, it would not be inflationary. Thus, saving of the nations should be utilized efficiently by investing it in physical infrastructure and human capital which would generate sufficient employment and reduce poverty in south Asia.

* The author is Joint Director, Research Department, State Bank of Pakistan, Karachi. The views expressed are those of the author and do not necessarily reflect those of the State Bank of Pakistan. Email: talat.anwar@sbp.org.pk; or talatanwar@netscape.net.

1. Introduction

The performance of Pakistan's economy has been impressive over a long period of time. The economy has grown over 6 per cent per annum between 1960 and 1987. The capital inflows in terms of foreign aid and overseas worker's remittances have been substantial. The high economic growth rate combined with high capital inflow brought prosperity in the country and resulted in a substantial decline in poverty from 40 percent in the 1960s to about 17 percent in the late 1980s. However, the economic growth rate has declined to around 4 percent during the 1990s, which resulted not only in high unemployment rate but also in higher incidence of poverty and inequality in the country. It may be noted that over the last decade, the country pursued a number of IMF/World Bank structural programmes due to the financial assistance sought from these institutions. Over the last four years, country also followed two IMF programmes—a Stand-by Arrangement, 2000 and Poverty Reduction and Growth Facilities (PRGF), 2001-04. While policies pursued under these programmes are primarily aimed at reducing the fiscal deficit, enhancing exports and improving the governance, it has also been argued that these policies will reduce the poverty.

The GDP growth rates remained low during the three years of IMF programmes—2000-02. However, the economy began to recover recently as result of resumption of growth in agriculture and faster growth in industrial sector, which is reflected by a rise in exports and imports of intermediate goods. Fiscal deficit has also been reduced from 5.2 percent in FY02 to 4.4 percent FY03. Over the past two years, a substantial improvement also came from the rising capital inflows in the form of worker's remittances. As a result, accumulation of foreign exchange reserve accelerated, pushing up the reserves to an unprecedented level of over US \$12.6 billion (or 16.5% of GDP) equivalent to 51 weeks of imports in March, 2004. However, while macroeconomic fundamentals improved significantly, it remains to be seen how these macroeconomic developments have benefited the poor. What are the implications of high foreign exchange reserves holdings for poverty reduction and employment generation? What is the cost of foreign exchange reserves holdings and how is it comparable with the South Asian countries? How can these idle resources be used to change the pattern of growth in favor of the poor?

In this backdrop, the paper examines the recent macroeconomic developments in Pakistan and addresses the above questions. Section 2 discusses the recent trends in economic growth in Pakistan. Section 3 discusses the fiscal policy and the trends in revenue and expenditure. Section 4 discusses the monetary policy and the ensuing monetary and credit developments. Section 5 examines the external sector developments as well as the cost of holding foreign exchange reserves. Section 6 examines the trends in various dimensions of poverty and implications of revival of growth for poverty and employment. Finally, Section 7 draws some conclusions and gives policy recommendations from the analysis.

Table 1: Selected Macroeconomic Indicators

	FY99	FY00	FY01	FY02	FY03	FY04	
				Actual ^R	Target	Actual ^P	Targets
Real GDP (FC) ¹	4.2	3.9	2.2	3.4	4.5	5.1	5.3
Agriculture	1.9	6.1	-2.7	-0.1	2.5	4.1	4.2
Major crops	0.0	15.4	-10.6	-1.8	0.3	5.8	5.5
Manufacturing	4.1	1.5	8.2	5.0	5.8	7.7	7.8
Large scale	3.6	0.0	9.5	4.9	6.0	8.7	8.8
Services sector	5.0	4.2	4.7	4.1	5.0	5.3	5.0
Consumer price index (FY01=100)	5.7	3.6	4.4	3.5	4.0	3.1	3.9
Sensitive price indicator (FY01=100)	6.4	1.8	4.8	3.4	-	3.5	-
As % of GDP							
Budgetary deficit	6.1	6.6	5.2	5.2	4.6	4.4	4.0
Current account balance (including official)	-3.8	-0.3	0.6	4.8	-	5.9	
Domestic debt	47.4	50.2	50.6	47.3	-	46.1	-
External debt	54.9	53.5	60.2	55.3	-	48.0	-
Explicit liabilities ³	2.4	2.4	2.7	1.6	-	1.0	-
Total debt (including explicit liabilities)	104.7	106.0	113.5	104.3	-	95.1	-

P: Provisional

¹ Sectoral shares in GDP were 23.6 percent in agriculture, 25.6 percent in industry and 50.7 percent in services in FY03.

² Explicit liabilities include Special US Dollars Bonds, FEBCs, FCBCs and DBCs.

Source: Annual Report 2002 2003, SBP

2. Economic Growth and Inflation

After performing below its potential over the past few years, the performance of Pakistan's economy has been marked by acceleration in economic activity¹ in FY03. The real GDP grew by 5.1% on account of recovery in agriculture, faster growth in industry and a respectable growth in services sector (See **Table 1**). After recording negative growth over the past two successive years, the recovery in agriculture sector posted 4.1 percent growth in FY03. The recovery in agriculture which accounts for 23 percent of GDP was primarily due to a rise in the productivity of important crops, improved water availability and increased use of agriculture input. Major crops (wheat, cotton, rice and sugarcane) accounting for 40.6 percent of agriculture sector output grew by 5.78 percent and thereby were the major contributors of growth in agriculture sector. While cotton recorded a negative growth rate (3.6%), all major crops registered a significantly higher growth rate (6.9% to 15%). On the other hand, minor crops that contribute 15.9 percent to value added in agriculture recorded a marginal growth of 0.4 percent in FY03. Finally, live stock that accounts for 39 percent of overall value addition in agriculture sector recorded a modest growth of 2.9 percent.

Recovery in Agriculture sector also contributed to the faster growth in industry. The growth in industrial sector which accounts for 25.6 percent of GDP was largely contributed by a remarkable performance of large scale manufacturing (LSM) which grew by 8.7 percent during FY03. The higher sugar output, and significant increase in the

¹ Provisional estimates show that real GDP is expected to grow by 6.4 percent in FY04.

production of consumer durables (automobile and electronics), higher output of construction-related material and expansion in exports of textile products were the main factors for strong performance of large scale manufacturing sector. The services sector which accounts for about 51 percent of GDP has been growing at a faster pace than the agriculture and industry over the past few years. The growth in services sector accelerated from 4.1 percent in FY02 to 5.31 percent in FY03.

Inflation decelerated in term of CPI over the past few years. CPI remained in the range of 3.1 to 4.4 percent due to weak import prices and decline in real private consumption over the last three years (See **Table 1**). However, inflation accelerated to 5.4 percent in the first half of FY04 mainly due to a sharp increase in food prices. Food inflation rose to 10.2 percent in May, 2004. The main contributory factors for the sharp increase in food inflation were supply shortages and higher international prices.

2.1 Saving and Investment

An important recent development is the sharp rise in national saving. National savings increased substantially from 16.8 in FY02 to 18.5 as percent of GNP in FY03. The main contributory factor for the improvement in national saving was a substantial rise in net factor income abroad because of an exceptional increase in workers' remittances flows. However, despite a substantial increase in national saving, increase in overall investment was marginal. Total investment as percent of GDP increased from 14.7 percent in FY02 to 15.5 percent in FY03 (See **Table 2**). This level of investment as percent GDP is very low when compared with other developing countries. The investment to GDP ratio in most developing countries remained about 20 percent of GDP.

Although fixed investment grew by 10.5 percent in FY03 but the high growth was due to lower base in FY02. Interestingly, fixed investment as percent of GDP remained stagnant at 13.1 percent implying that the marginal increase in overall investment was due to changes in stocks. While private investment remained stagnant at 8.4 percent of GDP over the last few years and increased marginally in FY03, the public investment declined persistently during the last four years. It is

noteworthy that the persistent decline in public investment has failed to crowd in private investment over the past few years. Thus, stagnant private sector investment is mainly

Table 2: Investment as percent of GDP, FY00 to FY03

	FY00	FY01	FY02	FY03
As percent of GDP				
Total investment	16.0	15.5	14.7	15.5
Changes in stocks	1.6	1.6	1.6	2.4
Fixed investment	14.4	13.9	13.1	13.1
Private	8.4	8.4	8.4	8.6
Public	6.0	5.5	4.8	4.5
As percent of total investment				
Private	58.5	60.1	63.8	66.0
Public	41.5	39.9	36.2	34.0
Growth rates				
Total investment	10.2	5.5	0.4	16.2
Changes in stocks	7.7	8.7	3.2	63.1
Fixed investment	10.5	5.1	0.1	10.5
Private	14.3	8.0	6.2	14.4
Public	5.5	1.1	-9.0	3.8

Source; Planning Commission , Islamabad

Table 3: Summary of Public Finance- Consolidated Federal and Provincial Governments

Billion Rupees						
	FY99	FY00	FY01	FY02	FY03	YoY Change
				RE	PE	Absolute
1 Revenue Receipts (a+b)	468.6	512.5	553.0	624.1	720.7	96.6
a) Tax Revenue	390.7	405.6	441.6	478.1	555.8	77.7
b) Non-Tax Receipts	77.9	106.9	111.4	146.0	164.9	18.9
2 Total Expenditure (a+b)	647.8	709.1	717.9	826.2	898.1	71.9
a) Current	547.3	626.4	645.7	700.2	781.9	81.7
b) Development	98.3	95.6	89.8	126.2	129.2	3.0
c) Net Lending to PSEs etc.	2.2	-12.9	-17.6	-0.2	-22.7	-22.5
d) Statistical Discrepancy	n.a.	9.7	14.8	-13.0	9.8	22.8
3 Revenue Surplus/Deficit (1-2.a)	-78.7	-113.9	-92.7	-76.1	-61.2	14.9
4 Overall Deficit (1-2)	-179.2	-206.3	-179.7	-189.1	-177.4	11.7
5 Financing Through:	179.2	206.3	179.7	189.1*	177.4	-11.7
a) External Resources (Net)	97.1	69.7	120.7	82.8	88.3	5.5
b) Internal Resources (i+ii)	82.1	136.6	59.0	106.3	89.1	-17.2
i) Domestic Non-Bank	155.9	96.7	92.0	85.0	146.8	61.8
ii) Banking System	-73.8	39.9	-33.0	12.9	-69.1	-82.0
iii) Privatization Proceeds	n.a.	n.a.	n.a.	8.4	11.3	2.9
Percent of GDP (mp)						
1. Revenue Receipts (a+b)	15.9	16.3	16.2	17.2	17.7	0.5
a) Tax Revenue	13.3	12.9	12.9	13.2	13.7	0.5
b) Non-Tax Receipts	2.7	3.4	3.3	4.0	4.1	0.0
2. Total Expenditure (a+b)	22.0	22.5	21.0	22.8	22.1	-0.7
a) Current	18.6	19.9	18.9	19.3	19.2	-0.1
b) Development@	3.3	3.0	2.6	3.5	3.2	-0.3
c) Net Lending to PSEs etc.	0.1	-0.4	-0.5	0.0	-0.6	-0.6
3. Revenue Surplus/Deficit (1-2.a)	-2.7	-3.6	-2.7	-2.1	-1.5	0.6
4. Overall Deficit (1-2)	-6.1	-6.6	-5.2	-5.2	-4.4	0.8
5. Financing Through:	6.1	6.6	5.2	5.2	4.4	-0.8
a) External Resources (Net)	3.3	2.2	3.5	2.3	2.2	-0.1
b) Internal Resources (i+ii)	2.8	4.3	1.7	2.9	2.2	-0.7
i) Domestic Non-Bank	5.3	3.1	2.7	2.3	3.6	1.3
ii) Banking System	-2.5	1.3	-1.0	0.4	-1.7	-2.1
iii) Privatization Proceeds	n.a.	n.a.	n.a.	0.2	0.3	0.0

Source: Budget Wing, Finance Division, Islamabad

R.E: Revised Estimates; P.E: Provisional Estimates

© From 1998-99 onward, also include lending to PSEs

*:If one-off expenditure of Rs. 52 billion incurred on KESC recapitalization (Rs.32 billion) and CBR bonds (Rs.20 billion), is accounted for the fiscal deficit will be 6.6 percent of GDP.

attributed to a persistent reduction in public sector investment due to the reduction in budget deficit over the last four years. This explains why private investment is not responding despite a number of incentives given to the private investors.

2.2. Foreign Investment

While domestic investment remained stagnant, foreign investment did not show any significant improvement despite enormous incentives offered to foreign investors over the years.

Foreign direct investment (FDI) remained in the range of US \$ 322 to US\$ 798 million accounting for less than 1.0 percent of total FDI to Asia-Pacific region over the last four years. On the other hand, foreign portfolio investment did not exceed by US \$ 73.5 and witnessed a declining trend during the last four years. The main contributory factors for this disappointing outcome were the lack of political stability, unsatisfactory law and order conditions, the slow bureaucratic process and the inadequate infrastructure facilities.

3. Fiscal Developments

Large fiscal deficits persisted in Pakistan over the last two decades. On average, Pakistan maintained a budget deficit of 7 percent of GDP during the 1990s. Over the past few years, the Pakistan has signed two IMF programs; a) Standby Arrangements, 2000 b) Poverty Reduction and Growth Facility (PRGF), 2001-04. The reduction in fiscal deficit has been central in IMF programs. As a result fiscal deficit declined from 6.6% in FY00 to 5.2 percent of GDP in FY01, remained at this point in FY02 and finally declined to 4.4 percent of GDP in FY03 (See **Table 3**). The country's revenue also showed some modest improvement due to better tax enforcement. As a result, both total revenue-to-GDP and tax-to-GDP ratio improved to 17.2 to 17.7 percent and from 13.2 to 13.7 percent respectively. On the other hand, the current expenditure a percent of GDP declined from 19.3 percent to 19.2 percent. The decrease in current expenditure was attributed to the decline in interest payment which declined by 13.5 percent between FY02 and FY03 from Rs.261.0 billion in FY02 to Rs.241 billion. The expenditure as % of GDP on education and health remained stagnant at best and declined at worst over the past few years (See **Section 6**). However, development expenditure which was already low also declined from 3.5% of GDP in FY02 to 3.2% of GDP in FY03. Thus, the target of fiscal deficit has been achieved at the expense of public sector development and social sector expenditure which is critical for future economic growth and poverty reduction.

The country's public debt also declined over the last two years (See **Table 1**). The reduction in debt-to-GDP ratio was mainly due to the substantial primary surpluses, falling interest cost and a slight appreciation of Rupee against US dollar.

4. Monetary and Credit Developments

Over the past two years, monetary policy has been dominated by the growth in Net Foreign Assets (NFA) due to the external account surpluses. The focus of monetary policy has been on avoiding appreciation of Pak rupee so as to preserve export competitiveness. To pursue this objective, State Bank of Pakistan has been purchasing foreign currency² from the kerb and inter-bank market. As a result, growth in money supply (M2) was high due to exceptional increases in the net foreign assets of the banking sector; M2 increased by 15.4 percent and 18.0 percent in FY02 and FY03

² SBP sterilized these purchases to avoid inflationary pressure which involves a cost.

respectively (See **Table 4**). In FY03, all of the increase in NFA was attributable to a rise in the SBP NFA, whereas the NFA of scheduled bank declined by Rs.19.4 billion.

Table 4 : Monetary Survey of the Banking System (Flows)

billion Rupees			
	FY02	FY03	
	Actual	IMF	Actual
Monetary assets (M2)	235.3	281.5	317.4
<i>percent change</i>	<i>15.4</i>	<i>16.0</i>	<i>18.0</i>
I. Net foreign assets	206.2	271.0	308.9
SBP	154.3	259.9	328.3
Scheduled banks	51.9	11.1	-19.4
II. Net domestic assets	29.2	10.5	8.4
<i>percent change</i>	<i>2.0</i>	<i>0.7</i>	<i>0.6</i>
SBP	-100.7	-181.2	-228.2
Scheduled banks	129.9	191.7	236.7
A. Government sector	22.2	-43.8	-78.4
a) Net bank borrowing for budgetary support	14.3	-29.2	-56.0
SBP	-112.0	-184.9	-249.2
Scheduled banks	126.3	155.7	193.3
b) Commodity operations	5.3	-16.0	-26.6
c) Others	2.5	1.4	4.2
B. Non-government sector	19.0	70.2	148.5
a) Credit to private sector	53.0	55.3	167.7
i) Commercial banks	44.9		163.2
<i>of which EFS</i>	<i>-13.3</i>		<i>-1.6</i>
ii) Specialized banks	8.1		4.4
b) Credit to PSEs	-19.4	20.0	-11.6
i) Autonomous bodies	-15.1		-4.8
ii) Others	-1.4		-3.2
iii) PSEs special debt-repayment account with SBP	-2.9		-3.6
c) Other financial institutions	-14.4	-5.1	-7.6
C. Other items (net)	-12.0	-15.8	-61.7
SBP	26.1	39.4	28.1
Scheduled banks	-38.1	-55.2	-89.8

Source: State Bank of Pakistan (2003), Annual Report.

On the contrary, Net Domestic Assets (NDA) of the banking system declined as both government borrowings for budgetary support and commodity operation loans witnessed heavy net retirement. The government's fiscal position improved because of higher revenue, greater availability of cheap external financing and larger non-bank borrowing which helped it to retire Rs. 56 billion.

Bank credit to the private sector expanded tremendously by Rs.167 billion in FY03 compared to Rs.53 billion in FY02. Bank credits to the private sector were concentrated in manufacturing (55%), personal loans (17%), agriculture (14%) and commerce (11%)

Table 5: Balance of Payments- Summary Table

million US Dollar								
Items	FY99	FY00	FY01	FY02	FY03	Absolute change	Change FY03 over FY02 percent	
1. Trade balance	-2085	-1412	-1269	-294	-536	-242	82.3	
Exports (fob)	7528	8190	8933	9140	10889	1749	19.1	
Imports (fob)	9613	9602	10202	9434	11425	1991	21.1	
2. Services (net)	-2618	-2794	-3142	-2617	-2173	444	-17.0	
Shipment	-803	-751	-820	-740	-879	-139	18.8	
Other transportation	110	71	61	103	212	109	105.8	
Travel	-122	-142	-180	-147	-402	-255	173.5	
Investment income	-1808	-2018	-2161	-2319	-2207	112	-4.8	
<i>Interest payments</i>	-1399	-1596	-1548	-1469	-1103	366	-24.9	
<i>Profit and dividend</i>	-270	-233	-301	-457	-631	-174	38.1	
<i>Purchase of crude oil</i>	-139	-187	-312	-394	-473	-79	20.1	
Other goods, services, & income	5	46	-42	486	1103	617	127.0	
3. Current transfers (net)	2847	3989	4737	5744	6737	993	17.3	
a) Private transfers –net	2274	3063	3898	4249	5737	1488	35.0	
of which:								
i) Workers' remittances	1060	983	1087	2390	4237	1847	77.3	
ii) FCA (residents)	539	322	534	285	-12	-297	-104.2	
iii) Outright purchases	531	1634	2157	1376	0	-1376	-100.0	
iv) Export of currencies	0	0	0	0	429	429		
b) Official transfers	573	926	839	1495	1000	-495	-33.1	
of which: Saudi oil facility	390	790	683	579	637	58	10.0	
4. Current account balance (1+2+3)	-1856	-217	326	2833	4028	1195	42.2	
5. Capital account (net)	-2278	-4177	-643	-1107	113	1220	-110.2	
6. Errors & omissions	992	501	626	928	448	-480	-51.7	
7. Overall balance	-3142	-3893	309	2654	4589	1935	72.9	
8. Financing								
g	3142	3893	-309	-2654	-4589	-1935	72.9	
Changes in reserves (-								
I. Inc/+Dec)	-824	-71	-1000	-2792	-5210	-2418	86.6	
Assets	-1254	209	-1085	-3082	-5261	-2179	70.7	
SDRs	2	0	1	-4	-233	-229	5725.0	
Forex (State Bank of Pakistan)	-809	380	-727	-2713	-5678	-2965	109.3	
Forex (commercial banks)	-447	-171	-359	-365	650	1015	-278.1	
Liabilities	430	-280	85	290	51	-239	-82.4	
Use of fund credit	430	-280	85	290	51	-239	-82.4	
Repurchases	626	0	324	484	469	-15	-3.1	
Purchases/drawings	196	280	239	194	418	224	115.5	
II. Exceptional financing	3966	3965	692	138	620	482	349.3	
SBP reserves (end-period)	1740	1358	2088	4809	9997	5188	107.9	

Source: Statistics Department, SBP.

etc. The easy monetary policy stance coupled with cuts in discount rate and decline in average lending rates were the important factors in credit utilization by the private sector.

5. External Sector Developments

Despite sluggish global economic activity and rising international oil prices, Pakistan's external balance of payment improved. Pakistan's external sector started improving since FY00 mainly due to increasing workers' remittances and reduction in trade deficit owing to higher growth in exports than imports. The reduction in the rate of Export Finance Scheme and increased textile quota/greater market access in European Union because of being an ally in the war against terrorism contributed significantly toward high export growth in recent years. Over the past two years, a substantial improvement came from the rising worker's remittances, which rose from Rs 1.1 billion in FY01 to Rs 2.4 billion in FY02 and finally to Rs 4.2 billion in FY03 (See **Table 5**). Moreover, interest payments fell following the re-profiling of bilateral loans (Paris Club), retirement of expensive debt and liabilities and the partial substitution of expensive debt with soft loans from IFIs. Consequently, the current account balance turned out to be surplus in FY01 and posted surpluses of US \$ 2.8 billion and US \$ 4 billion equivalent to 4.8 percent and 5.9 percent of GDP, respectively in FY02 and FY03. The main contributory factor for the improvement in current account balance was the extraordinarily increase in workers remittances which was due to the international crackdown on undocumented currency transaction in the Middle East and other parts of the world following September 11 event.

5.1. Foreign Exchange Reserve

Over the past few years, the SBP has been pursuing the policy of avoiding appreciation of Pak rupee against US dollar to preserve export competitiveness. To achieve this objective, State Bank of Pakistan has been purchasing foreign currency from the kerb and inter-bank market stemming mainly from increased inflows³ of workers' remittances. The total SBP purchases from open market were US \$5.6 billion between 1999 and 2002, while SBP net purchases from inter-bank markets were US \$ 6.8 billion between 1999 and 2004. As a result, accumulation of foreign exchange reserve accelerated, pushing up the reserves to an unprecedented level of over US \$12.1 billion, equivalent to 51 weeks of imports in FY04.

5.2 The Cost of Foreign Exchange Reserves Holdings

While it has been emphasized that foreign exchange reserves are necessary as a measure to maintain currency stability, it should be recognized that a high cost accompanies the holding of foreign exchange reserves. When Pakistan, like other developing countries borrows from abroad, a high interest rate as a risk premium is charged. But if Pakistan invests its foreign exchange reserves in US Treasury bills, it only gains a very low return—less than 1.0 percent at present. This negative spread in interest rates implies a transfer of income from a poor country, Pakistan to a rich country, USA. It would, thus, be important to examine the cost of foreign exchange reserves holding.

³ SBP has been sterilizing these inflows which involve a cost.

Fundamentally, the cost of holding reserves is the investment that a nation must forego in order to accumulate reserves. Alternatively, the dollars that a nation must hold as reserves are dollars that cannot be spent on physical infrastructure, on health care and education, or on the promotion of private investment.

Theoretically, the opportunity cost of reserve holdings is defined⁴ as “*the difference between the highest possible marginal productivity forgone from an alternative investment in fixed assets and the yield on international reserve*”. However, the common perception is that the opportunity cost of reserve holdings is the interest rate on government debt. But, this is not a right counterfactual. If assets were not held as reserves, they would be available to nations to fund domestic investment in physical capital. Thus, the opportunity cost of reserve holdings is the marginal product of capital in the nation holding the reserves. While calculating the cost of holding reserves, one should bear in mind that reserves do provide some return. Thus, the cost of holding reserves is the difference between the opportunity cost and the return on reserves.

The return on physical capital varies across countries. In United States, before-tax return remained at averaged close to 10 percent over the post-war period (Baker 1996). The returns in developing countries are generally higher to compensate for the greater degree of risk. It is expected that the return to capital exceeds 20 percent in many of the poor countries. Evidence shows that public investment in infrastructure or education which are two other alternative uses of assets held as reserves, may give even higher rates of return than physical capital (Munnell 1994; Holtz-Eakin and Schwartz 1994). On the other hand, the reserves held as interest bearing deposits such as the short-term government debt of USA earns a very small rate of interest of about 1.0 percent. It is noteworthy that the costs to poor nations are benefits in terms of low interest loans to the nations that supply reserve currencies primarily the United States.

To calculate the cost of reserve holding two set of estimates have been computed. The low end estimate assumes 10 percent cost of holding reserves while high end estimate assumes 20 percent cost of holding reserves. The low end assumption means that return to physical or human capital in poor countries is slightly higher than the USA, while high end implies that a relatively high rate of return⁵ on human or physical capital which has been the case in many poor countries. **Table 6** shows the cost of holding reserves in Pakistan.

It is clear that cost of the increased reserves holdings has been substantial over the past three years. The cost of reserve holding increased sharply after September 11 when country witnessed heavy foreign capital inflows in the form of workers’ remittances and SBP accumulated reserves through its purchases of foreign currency. At high end which is more relevant for Pakistan being a poor country, the annual cost of reserve holding has more than tripled over the past three years—rising rapidly from US \$ 644 million or 1.1

⁴ See Ben-Basset and Gottlieb (1992), Baker (2001) and Neely (2000).

⁵ Both of these estimates are on the lower sides. Rate of Return in various infrastructure projects were estimated close to 20% or higher. See PSDP, 2003-04, Planning Commission, Islamabad.

Table 6 : Annual Cost of Foreign Exchange Reserve Holdings for Pakistan: FY01-FY04

		FY01	FY02	FY03	Dec 2003	March 2004
<u>Cost of Foreign Exchange Reserve Holdings</u>						
Foreign Exchange Reserves (FER) US \$ million		3219.5	6431.6	10719.0	12172	12600
F.E.R (As % of GDP)		5.49	10.89	15.61	15.98	16.55
(Equivalent to weeks of imports)		15	32	45	49	51
Cost of Reserve Holdings (US \$ million)	Low end	322	643	1072	1217	1260
	High end	644	1286	2144	2434	2520
Cost of Reserve Holdings (As % of GDP)	Low end	0.55	1.09	1.56	1.60	1.65
	High end	1.10	2.18	3.12	3.20	3.31
<u>Cost of Excess Reserve</u>						
Required Reserve Equivalent to 15 weeks of imports (US \$ million)		3088.94	2976.84	3508.17	3685.22	3685.2
Excess F.ER. (US \$ million)		130.6	3454.8	7210.8	8486.8	8914.8
Cost of Reserve Holdings (US \$ million)	Low end	13.06	345.48	721.08	848.68	891.48
	High end	26.11	690.96	1442.17	1697.36	1783
Cost of Reserve Holdings (As % of GDP)	Low end	0.02	0.59	1.05	1.11	1.17
	High end	0.04	1.17	2.10	2.23	2.34

Source: Authors' Calculation from Balance of Payments Data.

% of GDP in FY01 to US \$ 2.5 billion or 3.3 % of GDP in FY04. The cumulative cost of reserve holdings is US \$ 5.9 billion or about Rs.340 billion over the past three years. Thus, by diverting resources from more productive uses, the unprecedented rise in foreign exchange reserves holdings in Pakistan has imposed a substantial cost which has impeded significant economic and social progress over the past three years. This provides answer to the question that why the poor and the common man are not benefiting from the recent macroeconomic gains.

Given the fact that the cost of reserves holdings has been substantial and the main source of capital inflows are overseas workers remittances, the country does not require maintaining such high level of reserves. If we consider the adequate level of reserves equivalent to 15 weeks⁶ of imports, the country is required to maintain reserves at US \$ 3.7 billion in March 2004. By this criterion country is maintaining excess reserves

⁶ IMF requires raising the foreign exchange reserve up to 12 weeks or 3 months of imports in its various programmes. The total and short term external debt and liabilities servicing of Pakistan is about US \$ 4.0 and US \$ 1.0 billion, respectively. Thus, the country has ample reserve on this criterion as well.

Table 7: Annual Cost of Reserve Holding in South Asian countries, 2002

	Foreign Exchange Reserve (US\$ million)	Reserve as % of GNP	Reserve Equivalent of Months of imports	High cost end (US\$ million)	Cost as % of GNP
Bangladesh	1722.4	3.54	2.7	344.5	0.71
India	70377.0	14.74	13.5	14075.0	2.95
Pakistan	10719.0	15.61*	11.1	2143.8	3.12*
Sri Lanka	1705.1	10.39	3.4	341.0	2.08

*As % of GDP

Source: Authors' Calculation from Balance of Payments Data, ADB Website

equivalent to US \$ 8.9 billion which involves a heavy cost of US \$1.8 billion per annum or 2.34 percent of GDP, notably the cost of excess reserve holdings just exceeds the social sector budget of the country.

It is worth noting that foreign exchange reserves are part of national assets like domestic infrastructure, industries and human capital and their main source of funding is national saving. Thus, saving of the nations should be utilized efficiently by investing it in physical and human capital. This explains the fact why domestic investment is not responding despite having strong macroeconomic fundamentals. It is noteworthy that investment will not respond until national savings are available to the nation for investment.

5.3 The Cost of Foreign Exchange Reserves Holding in South Asia

After estimating the cost of Foreign Exchange Reserves Holding in Pakistan, it would interesting to examine how this heavy cost of reserves holdings is compared with other South Asian countries. **Table 7** presents the cost of foreign exchange reserve holdings in different south Asian countries. Since all South Asian countries are poor, a high cost end scenario is presented here. Clearly, India has the highest level foreign exchange reserves not only in absolute terms but also in terms of months of imports. Thus, India has been bearing a huge cost of foreign exchange reserves holding at US \$ 14.0 billion per annum. On the contrary, Bangladesh foreign exchange reserves holding are just close to its adequacy level i.e. equivalent to 3 months of import and thus bearing a very low cost. It is noteworthy that Pakistan bears the highest cost of foreign exchange reserves holdings as % GDP in South Asia followed by India. Thus, by maintaining high level of foreign exchange reserves both India and Pakistan have clearly obstructed significant economic and social progress in recent years.

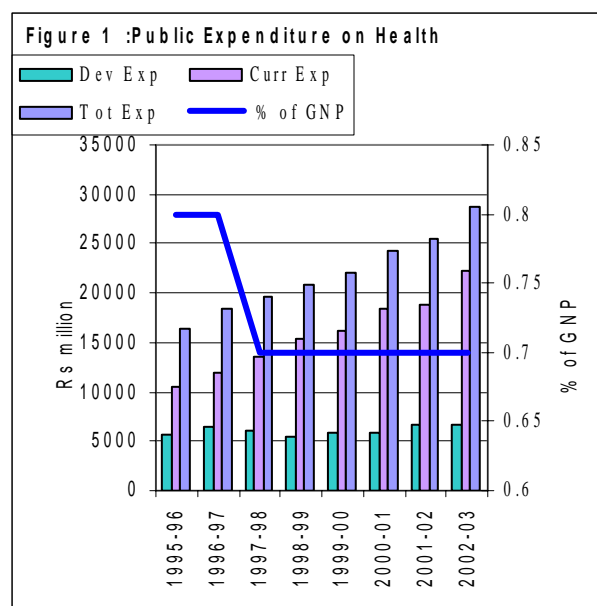
It is noteworthy that accumulation of reserve in many developing countries is a reflection of imbalance in the current account of some countries primarily the USA. The USA has a twin deficit—the current account deficit of 5% of GDP and fiscal deficit of 6% of GDP. Ridiculously, it is the developing countries including India and Pakistan that are financing the current account deficit of USA through investment of their reserve in US treasury bills at a very low rate—less than 1.0 percent and negative in real term.

6. Trends in Different Dimensions of Poverty

Poverty has various dimensions, such as income poverty, child mortality, high rate of disease, illiteracy, meager assets, inaccessible markets and scarce job opportunities and vulnerability to economic shocks. Health and education are two important dimensions of poverty. Illness pushes people into poverty through lost wages, high spending for disastrous illnesses and repeated treatment for other illnesses. Likewise, inadequate education is one of the most important determinants of poverty and unequal access to educational opportunity is a strong correlate of income inequality. It is, therefore important to examine the progress in these dimensions of human poverty.

6.1 Poverty of Health

The state of health sector in Pakistan depicts a dismal picture. The poor state of health sector is mainly due to the ineffective delivery of services as well as the low spending on the health sector in Pakistan, which remained very low at 0.8 percent of GNP relative to other developing countries. Furthermore, this low level of spending on health sector declined from 0.8% of GNP in FY90 to 0.7 percent of GNP in FY03 (See **Figure 1**). Not only the spending on health sector is low but also its allocation within the sector is directed to the areas that do not benefit the poor. Clearly, high priority was given to hospitals, medical colleges and curative services in urban areas, while primary healthcare and rural health service have been ignored which has led to a high rural-urban disparity in health care resulting in rapidly increasing poverty level in rural areas compared to urban areas during the last decade (See **section 6.3**).

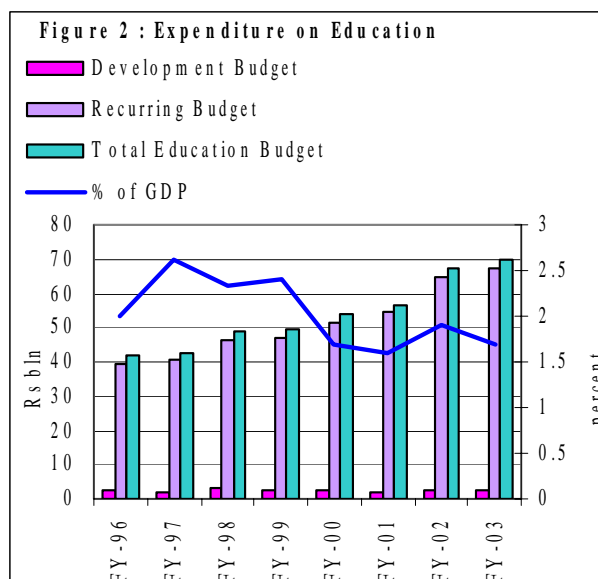


Consequently, infant mortality rate was high at 82 per thousand live births; life expectancy was low at 63 years in 2003. Although country's health indicators improved over time but its pace has been very slow. Maternal mortality rate is also high at 350-435 per hundred thousands births, largely because 78 percent of births take place at home, under the care of traditional birth attendants. Pakistan's health indicators also depict a dismal picture when compared with the countries with same level of development. The country's health indicators remained poorer than the low-income countries such as India, Bangladesh, China and Sri Lanka.

6.2 Poverty of Education.

Another important dimension of poverty is deprivation to adequate education. The state of education in Pakistan also portrays a dismal picture. The public expenditure on education as percent of GNP was the lowest at 1.8% in FY03 in Pakistan compared to other low income countries of the region such as India, Bangladesh, Sri-Lanka. It is

highly disappointingly that even this low level of spending on education has declined further to 1.7 percent of GDP in FY03 (See **Figure 2**). Moreover, this low level of spending on education sector goes largely to the recurring expenditure. Not only the overall budgetary allocation for the education sector is highly inadequate but also its allocation within the sector is directed to the areas that do not benefit the poor. Historically, priority was given to the tertiary education, whereas primary education to the bulk of population has been ignored.



As a result, the literacy rate was just 48 percent in 2001, with wide disparity between rural and urban and male and female literacy rates. The gross primary enrolment rate was 74 percent. Due to the persistent low level of primary enrolment, 5.8 million children are out of school out of 22.33 million children in 5-9 age-group, over 50 percent of them are girls. More than 50% students drop out before reaching class five resulting in a low gross secondary enrolment which was 41 percent in 2001.

6.3 Trends in Absolute Poverty and Unemployment

In contrast to the human development dimensions of poverty, absolute poverty defines poverty in terms of satisfaction of minimum physical needs of food and non-food items to enable people at the lower end of income distribution to engage in economic activity. Planning Commission, Government of Pakistan⁷ has recently notified the national official poverty line for food and non-food expenditures at Rs. 748 per month per capita in 2001 prices. This was derived from the intake requirement⁸ of 2350 calories per adult plus expenditures on non-food items. Although defining official poverty line in this way gives lower poverty line and thus lower poverty level in the country but the analysis is extended further so as to draw a policy conclusion on the basis of official poverty line notified by the government.

With average household size 6.9, the official poverty line for a household, on average, comes at Rs.5161 per month in 2001 prices. Adjusting this poverty line for inflation by CPI gives the official poverty line for an average household at Rs.5808 (or about US \$100) per month in December 2003 prices. It must be acknowledged that this is not the basic needs poverty line as is misconceived by the government officials. Rather it is a

⁷ Government of Pakistan (2003), *Economic Survey, 2002-2003*, Ministry of Finance, Islamabad

⁸ This intake requirement appears to be on the low side when compared with assumptions used in all the earlier poverty measurement studies in Pakistan. For example, Anwar & Qureshi (2003), World Bank (2002), FBS (2001), Jafri (1999) and Amjad and Kemal (1997) used intake requirement 2550 calorie per adult plus a minimum allowance for non-food requirement.

Table 8: Trends in Poverty: Headcounts Ratio (in percent)

	FY87	FY88	FY91	FY93	FY94	FY97	FY99a	FY01b	FY03c
Pakistan	29.1	29.2	26.1	26.8	28.7	29.8	30.6	32.1	31.8
Urban	29.8	30.3	26.6	28.3	26.9	22.6	20.91	22.67	22.39
Rural	28.2	29.3	25.2	24.6	25.4	33.1	34.67	38.99	38.65

Source: Economic Survey, 2003, Government of Pakistan.

a: The Head count ratio is based upon the officially notified national poverty line of Rs. 673.54 per capita per month at the prices of 1998-99 PIHS Survey.

b: The Head count ratio is based upon the officially notified national poverty line of Rs. 748.56 per capita per month at the prices of 2000-01 PIHS Survey.

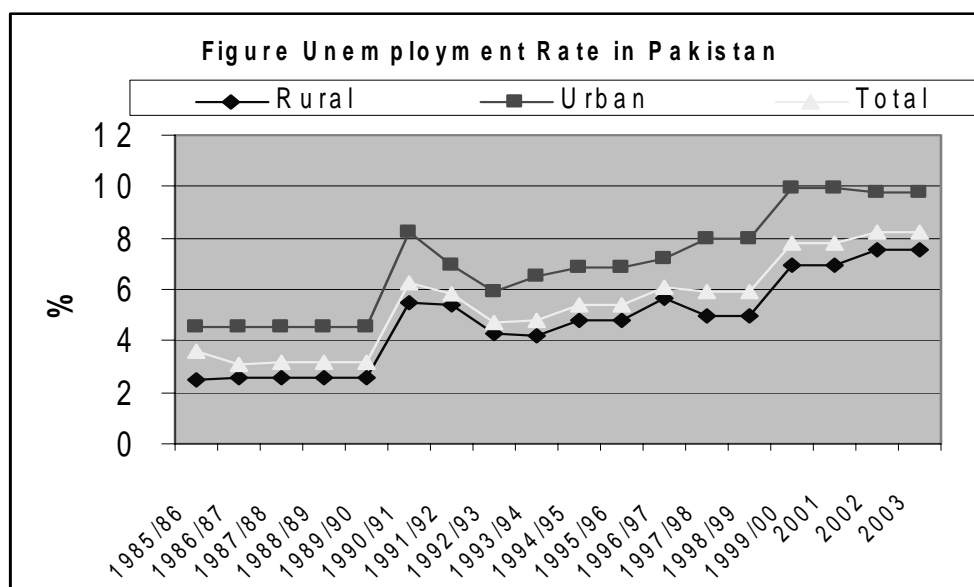
c: Head Count ratio based on the post enumeration survey of PIHS 2000-01, with 5% representative sample covering 726 households out of the original sample size of 14536 households, was conducted in February 2003.

threshold which is derived in subsistence term that gives the level of income below which survival of an average household is threatened in the society. It is noteworthy that while average salary of lower grade non-gazetted employees in the public sector is clearly below this household poverty line, the monthly wage of an unskilled worker in urban areas remained stagnant around Rs.3000 per month between 2003 and 2004 (Government of Pakistan; 2003). This suggests that income of a household headed by an average wage earner is 48% short of the official poverty line (in December 2003 prices) notified by the Government of Pakistan, Planning Commission. This trend shows that the real wages in Pakistan have fallen substantially below the subsistence level which has threatened to adversely affect the physical functioning of workers and their families which, in turn, is detrimental to the economic growth.

Poverty trends show that incidence of poverty has increased from 26.1 percent in 1990-91 to 32.1 percent in 2001(See **Table 8**). Poverty trends at the regional level show that while urban poverty declined from 26.6 percent to 22.67 percent, rural poverty increased from 25.2 percent to 38.99 percent between 1990-91 and 2001. While the result of an increase in rural poverty is consistent with a number of studies conducted during the 1990s, the decline in urban poverty is quite contrary to the finding of others. It is noteworthy that the series of poverty estimates reported by the Planning Commission is not based on a consistent poverty line. Poverty estimates relating to 1998-99 and 2001 are based on official poverty lines recently notified by the Planning Commission. On the contrary, poverty estimates relating to 1986-87, 1987-88, 1990-91, 1992-93, 1993-94 and 1996-97 are based on poverty lines estimated by Jafri (1999), which were relatively higher than others. Thus, the use of higher poverty line by Jafri (1999) and the lower poverty line by the Planning Commission give a declining trend in urban poverty as shown in **Table 8**. Since poverty lines used for estimation of poverty⁹ are not consistent, it is not logical to draw a conclusion from these estimates about the poverty trends during the 1990s. Any conclusion about poverty trends would only qualify, if a consistent poverty line were used to estimate the poverty throughout the period. Thus, there is a need to estimate poverty for 1986-87, 1987-88, 1990-91, 1992-93, 1993-94 and 1996-97 using the official poverty line adjusted for inflation for these years. This is critically important because

⁹ The only consistent series of poverty estimates are computed by Anwar and Qureshi (2003). According to this poverty increased rapidly from 17 percent in 1990s to 30 percent in 1998 and to 35 percent in 2001.

1990 is the benchmark year for the Millennium Development Goals (MDGs) as the country is required to halve the poverty between 1990 and 2015. **Table 8** also reports the headcount ratio for 2003 based on post enumeration survey of PIHS 2001, which shows a decline in poverty between 2001 and 2003. It is worth clarifying that any conclusion based on such data would be misleading as the headcount ratio for 2003 is not based on nationally representative sample survey. Furthermore, the consumption expenditure data of households is derived on recall basis after a lapse of two years. Thus, it is not appropriate to draw a conclusion from this data.



The slower economic growth together with freezing the employment in the public sector and privatization during the 1990s restrained the economy's capacity to generate employment and has resulted in high unemployment rates. The overall unemployment rate declined initially from 6.2% in 1990-91 to 4.8% in 1993-94, then rose to 6.12% in 1996-97, 7.82% in 1999-00 and finally¹⁰ to 8.2% in 2002 (See **Figure 3**). However, urban unemployment is more seriously affected than the rural unemployment over the past ten years. Urban unemployment rose rapidly from 5.88% in 1992-93 to 9.8% in 2002. The slower economic growth together with retrenchment of public sector also affected the unemployment rate of youth substantially over the past few years. In 15-19 years age group, for example, the youth unemployment rate increased from 12.0 percent in 1997-98 to 15.2 in 1999-00 and finally to 16.2 in 2002. Evidently, more educated particularly graduates in the period immediately after entering the labor force disproportionately represents among the urban unemployed.

6.4 Implications of Revival of Growth for Poverty and Employment

While economic growth has accelerated, exports have increased sharply and foreign exchange reserves are at their highest ever level, it thus remained to answer the question how these developments affect the low income and poor segments of population. Who is

¹⁰ Independent estimates put unemployment rate at a much higher level—twice as high as indicated by government data.

going to benefits from these developments? This subsection attempts to answer these questions.

Previous section shows that a recovery in real GDP growth rates on account of faster growth in manufacturing and satisfactory growth in services sector is on the way toward long term growth trajectory at 6 percent. However, it may be pointed out that growth in agriculture is partly explained by the lower base effect since agriculture witnessed negative growth rates for the past two consecutive years—FY01 and FY02. In addition, agriculture sector growth rate is likely to be lower at 2.6 percent against the target of 4.2 percent in FY04. Since agriculture sector is the main source of livelihood for a substantial proportion of the poor, poverty would thus remain unaffected by the high GDP growth rate.

Although industrial growth is reflected in higher exports, a part of the industrial growth stems primarily from a surge in aggregate demand arising due to expansion in private sector credit including personal consumption loans which rose substantially because of the easy monetary policy stance along with cuts in discount rate and decline in average lending rate. However, the growth in large scale manufacturing sector is mainly due to the utilization of excess capacity ranging from 30-40 percent created by large investment in the mid 1990s in thermal power generation through independent power projects (IPPs), cement, sugar, automobile and consumer electronics. Furthermore, employment elasticity of large scale manufacturing sector is very low relative to other sectors (See **Table 9**). Thus, this pattern of growth together with stagnant investment does not seem to be pro-poor since it is not likely to generate sufficient employment to offset the large increases in labor force over the years.

Since Karachi Stock Exchange Index (KSE-100 index) has accelerated rapidly from 1770 points in FY02 to 4606 points in December 2003, it is more likely that a big chunk of private credit expansion may have gone into speculative trading in the stock market. It may also have gone into the speculative property business as value of property has increased rapidly in the range of 30 to 50 percent over the past two years. These developments are not pro-poor as they are not likely to generate employment which is also reflected in the slower growth of construction sector at 3.4% in FY03 despite the priority given by the government to this sector.

Different socio-economic groups are likely to benefit to a greater or lesser extent from this pattern of economic growth depending upon their social and economic status. This may involve winner or loser. The small group of winners include: a) commercially engaged and export-oriented farmers producing cotton and rice (mostly large and medium scale); b) manufacturers and exporters of cotton products; c) investors involved in speculative trading in stock market and real estate; and d) rich and upper middle income groups benefiting from consumer loans. The larger group of losers encompasses: a) lower and lower-middle class formal sector's fixed salaried employees (mainly public sector employees) who will suffer sizeable losses of real income via reduced real purchasing power through higher food inflation; and b) unskilled laborers, small holder and petty

Table 9: Employment Elasticities with respect to GDP

Sector of activity	Elasticities
Overall Elasticity	0.41
Agriculture	0.37
Large Scale Manufacturing	0.02
Small Scale Manufacturing	0.85
Construction	0.87
Transport & Communication	0.45
Trade	0.57
Electricity & Gas	0.54
Others	0.68

Source: Planning Commission, Islamabad

traders in urban areas in the informal sector via reduced real wages and subsistence farmer in rural areas via reduced real income through higher food inflation.

6.5 Counterfactual Scenario

It is important to note that the above pattern of economic growth has emerged from the monetary policy which has been driven by the exchange rate policy over the past few years. The focus of both policies has been on avoiding appreciation of Pak rupee against US dollar to preserve export competitiveness. In this situation, it would be interesting to develop a possible counterfactual scenario namely, relative to what might have happened, if Pak rupee were allowed to appreciate. Had the Pak rupee allowed to appreciate, the US \$ would have devalued to Rs.52 or a bit lower. Imported intermediate inputs (constituting 75% of total imports) particularly petroleum group products, agricultural inputs and machinery groups would have become cheaper in domestic currency terms than before. This would have restored the competitiveness of exports by reducing the cost of production of exports. While prices of machinery and equipments would have declined due to an appreciation of Pak rupee, the effect on the level of investment would have been robust.

Thus, the appreciation of Rupee would have led to lower inflation rate and thus increased purchasing power of money and have had positive supply effects through a real balance effect leading to an increase in aggregate demand, expansion in investment and employment and thus high economic growth and lower poverty level in the country. The decline in petroleum products would also have resulted in a decline in utility prices like gas and electricity as well as the transport fare. In this situation, the poor including the common man would have benefited from a general decline in domestic price level together with an expansion in employment and broad-based economic activities.

7. Conclusions and Policy Recommendations

The paper examined the recent macroeconomic developments and poverty trends in Pakistan. Recent trends suggest a recovery in real GDP growth rates on account of faster growth in large-scale manufacturing and satisfactory growth in services sector. However, the pattern of growth is not likely to generate sufficient employment opportunities which

should be the foremost priority of the government, keeping in view the high prevailing unemployment rate resulting from the large increases in labor force over the years.

An analysis of various dimensions of poverty suggests a rising trends in all human dimension of poverty. Not only the poverty and inequality increased but also progress in human development remained poor over the past 15 years. It is noteworthy that the rising trends in poverty, inequality and in other human development dimensions over the past fifteen years may be attributed to the inappropriate¹¹ sequencing of policies pursued in various economic reform programmes within the framework of IMF/World Bank. Financial sector reforms were implemented before achieving macroeconomic stabilization and fiscal deficit reduction. To liberalize trade regime, tariff rates have been reduced rapidly before adopting to an alternate system of domestic taxation resulting in losses of public revenue and increased government borrowing need. A persistent devaluation of rupee against the US dollar demanded by the IMF to enhance exports raised the level of external debt and its servicing, while financial sector reforms raised the level of domestic debt and its servicing. The rising debt servicing and declining public resources resulted in reduction in development and social sector expenditure to reduce the budget deficit, which has seriously affected the physical infrastructure and human capital of the country and led to a decline in economic growth rate of GDP during the 1990s. In addition, the declining real wages, ban on employment in public sector, cut in pro-poor subsidies, increases in sales taxes and utility charges, and the declining remittances have reduced the income of the poor and middle segments of the population and led to increased poverty and income inequality¹² over the past 15 years.

Over the past 15 years, the persistent attempt to reduce the fiscal deficit to achieve stabilization within the framework of IMF and the World Bank has imposed a social cost on the economy which has adversely affected not only the physical infrastructure but also the human capital of the country. Nevertheless, a welcome development is the realization of the negative effects of IMF programs as the government has now decided to exit from the IMF program. Due to restructuring of external bilateral debt and increased capital flows from abroad, the government has now larger fiscal space for increasing the development and social sector expenditure. The government should move courageously on the provisions of physical and social capital for the vulnerable groups and escalation of social safety nets for the poor.

While economic reform programmes during past 15 years were aimed at increasing efficiency and/or reducing poverty, the trends in almost all dimensions of poverty indicate that poverty has worsened in Pakistan. While progress in human development dimensions of poverty has been poor as country's social indicators remained poorer than the south Asian countries, the income poverty has become much more of a serious problem than before in the wake of rising unemployment in Pakistan. Recent estimates show that more than 49 million people lives below the official poverty line and 3.1 million persons are unemployed. Thus, to help the million of people out of abject poverty and generate sufficient employment for the large pool of unemployed, the government

¹¹ For further detail, see Anwar (2003), Anwar (2002a), Anwar (2002c) and Kemal (2002)

¹² See Anwar (2004) and Anwar and Qureshi (2003)

should increase spending gradually on education and health sectors from the lowest in the south Asian region at 2.4 percent of GDP in FY03 to 4.0 of GDP during the next three years which would also help achieve the Millennium Development Goals.

Poverty analysis shows that over the past few years, the real wages in Pakistan have fallen substantially below the official poverty line defined in subsistence term by the Government of Pakistan which has threatened the survival of workers and their families which, in turn, is detrimental to the economic growth. Thus, there appear to be a great need to revise the minimum wage legislation in Pakistan from Rs.2500 per month to an adequate level for protecting the most vulnerable groups. Similarly, salary structure of the public sector employees needs to be revised adequately so as to bring the low and middle income public sector employees at least above the official poverty line defined in subsistence terms.

Although recent unprecedented rise in foreign exchange reserves is seen as an achievement, maintaining the high level of idle foreign exchange reserves involves a heavy cost. In this context, it may be pointed out that recently the government officials made presentations at the Pakistan Development forum to seek support of US \$ 56 billion from the donors during next 5-15 years for infrastructural development in water, power and communication sectors. The per annum financial commitment is at US\$ 4.0 billion. Given the fact that the cost of reserve holdings has been substantial and the main source of capital inflows are overseas workers remittances, the country does not require maintaining a high level of reserves. The country is maintaining excess reserves equivalent to US \$ 8.9 billion which is its idle resources. It must be recognized the foreign exchange reserves are the national saving which the nation has acquired through running current account surpluses over the past few years. Since the government intends to borrow from external sources for infrastructural development, the conventional argument that the utilization of foreign exchange reserve would be inflationary does not hold. Instead of relying on foreign loans for infrastructural improvement, a self-reliant strategy would be useful. Thus, saving of the nations should be utilized efficiently by investing it in physical infrastructure and human capital, which would not only save the country from external debt trap but also give impetus to foreign investment and generate sufficient employment for the unemployed youth of Pakistan.

While poverty is home to the south Asia as a substantial population— about 300 million in India and 49 million in Pakistan live in abject poverty, maintaining foreign exchange reserves at an unprecedented level which involves a heavy cost of about 3% of GDP is not an optimal use of meager resources. Thus, saving of people should be invested in poor physical infrastructure and human capital in these countries. Finally, the work of Nobel Laureate Amartya Sen suggests that a country's prosperity and development cannot be measured by GDP growth or the size of its economy alone. Similarly, a country's development cannot be measured by strong macroeconomic fundamentals alone. Development is freedom. It is about creating an environment where people can participate in deciding their economic and social future. It is about creating opportunities for everyone to pursue their hopes and dreams. To raise the level of welfare of people, it is essential to create these conditions in south Asian countries.

References

Amjad, R. and M. Irfan (1984): "Poverty in Rural Pakistan", in ILO-ARTEP (1984) (eds), Impact of Return Migration on Domestic Employment in Pakistan: A Preliminary Analysis.

Amjad, R and Kemal, A.R. (1997), Macroeconomic Policies and their Impact on Poverty Alleviation in Pakistan, *Pakistan Development Review*, 36:1 (Spring)

Anwar, Talat (2004), Trends in Income Inequality in Pakistan between 1998-99 and 2001, paper presented at the 18th Annual General Meeting and Conference held in January 2004, Islamabad.

Anwar, Talat and Qureshi, Sarfraz Khan (2003), Trends in Absolute Poverty in Pakistan: 1990-2001, Proceeding of the Papers at the 18th Annual General Meeting and Conference held in January 2003, Islamabad.

Anwar, Talat (2003), Market-oriented reforms and poverty in Pakistan, a chapter in reference book on "*Trade Policy Reform, Growth, Poverty and Equity in Asian Developing Countries*" edited by Kishore Sharma, Routledge and Kegan Paul, Australia.

Anwar, Talat (2002a), The Impact of Globalization and Liberalization on Growth, Employment and Poverty: A Case Study of Pakistan. *WIDER Discussion Paper No.2002/17, United Nations University/World Institute for Development Economic Research*, Helsinki, Finland. Available at <http://www.wider.unu.edu/publications/publications.htm>

Anwar, Talat (2002b), Unsustainable Debt Burden and Poverty in Pakistan: A Case for HIPC Debt Relief, *WIDER Discussion Paper No.2002/53, United Nations University/World Institute for Development Economic Research*, Helsinki. Available at <http://www.wider.unu.edu/publications/publications.htm>

Anwar, Talat (2002c), Globalization and Poverty in Pakistan, in *Human Condition Report 2002, Centre for Research on Poverty Reduction and Income Distribution (CRPRID)/ UNDP*, P Block, Pak-Sect. Islamabad.

Anwar, Talat (1999), Economic Growth, Structural Adjustment and Poverty in Pakistan; Proceedings of International Seminar on "*Human Resources Development for Sustained Economic Growth and Poverty Alleviation* as well as Progress in the Member States of the OIC." *Organized by Islamic Institute of Technology, the Organization of the Islamic Conference (OIC)* in collaboration with the Government of the People's Republic of Bangladesh and *Islamic Development Bank, Jeddah, 11-13 April 1999, 266-291*, Dhaka, Bangladesh,

Anwar, Talat (1998) Incidence of Relative Poverty in Pakistan, *The Asian Economic Review*, The Journal of the Indian Institute of Economics, Vol. XL, No.1, April 1998,P.95-107, Red Hills, Hyderabad, India.

Anwar, Talat (1997) Inequality and Social Welfare in Pakistan, *Journal of Social Sciences and Humanities*, Vol.1, No.2, 1997, Allama Iqbal Open University, Islamabad.

Anwar, Talat. (1996), Structural Adjustment and Poverty: The Case of Pakistan, *Pakistan Development Review*; Proceedings of the Papers at the 12th Annual General Meeting of Pakistan Society for Development Economist.

Arif, G.M. (2002), Measuring Poverty in Pakistan: A Critical Review of Recent Poverty Lines in *Human Condition Report 2002, Centre for Research on Poverty Reduction and Income Distribution (CRPRID)*, Islamabad.

Asian Development Bank (2002), *Poverty in Pakistan, Issues, Causes and Institutional Responses*, Pakistan Resident Mission, Islamabad.

Baker, D.(1996). "Getting More for Less: Recent Trends in Corporate Profitability," Washington, D.C.: Economic Policy Institute.

Baker, D. and Walentin, Karl (2001). "Money for Nothing: The Increasing Cost of Foreign Reserve Holdings to Developing Nations, Centre for Economic and Policy Research, " Washington.

Ben-Bassat, A. and D. Gottlieb, (1992). "On the Effect of Opportunity Cost on International Reserve Holdings." *The Review of Economics and Statistics*, V. 74, May, 29-332.

Ercelawn, Aly (1990), Absolute Poverty in Pakistan, Mimeo, Applied Economics Research Centre, Karachi.

Federal Bureau of Statistics, Household Income and Expenditure Survey (HIES), Various Surveys, Statistics Division, Islamabad.

Federal Bureau of Statistics (2001), Poverty in the 1990s, Statistics Division, Islamabad.

Frenkel, J. and B. Jovanovic, (1981). "Optimal International Reserves: A Stochastic Framework." *The Review of Economics and Statistics*, V. 91, June, 507-514.

Government of Pakistan (1985), Energy and Protein Requirements, Report of a joint FAO/WHO Ad-hoc Experts Committee, Geneva, Islamabad

Government of Pakistan (2003), *Economic Survey*, 2002-2003, Ministry of Finance Islamabad,

Holtz-Eakin, Douglas and Amy Ellen Schwartz. (1994). *Infrastructure in a Structural Model of Economic Growth*. Washington, DC: National Bureau of Economic Research, Working Paper # 4824.

Irfan and Amjad (1984), Impact of Return Migration on Domestic Employment in Pakistan: A Preliminary Analysis, ILO-ARTEP.

Jafri, S.M.Y (1999), Assessing Poverty in Pakistan in "A Poverty Profile of Poverty in Pakistan", Mahbub ul Haq Centre for Human Development, Islamabad.

Kakwani, Nanak, (1990), Testing for Significance of Poverty Differences with Application to Cote d'Ivoire, Living Standard Measurement Study Working Paper No.62, The World Bank, Washington, D.C.

Kemal, A.R. (2002), Macro-economic Policy and Poverty in Pakistan in *Human Condition Report 2002*, Centre for Research on Poverty Reduction and Income Distribution (CRPRID)/UNDP, P Block, Pak-Sect, Islamabad.

Malik, Sohail, J. (1994), "Poverty in Pakistan 1984/85, 1987/88 and 1990-91",mimeo, IFPRI, Washington D.C.

Munnell, Alicia H. (1994). "How Does Public Infrastructure Affect Regional Economic Performance?" In *The Third Deficit: The Shortfall in Public Capital Investment*. Boston, MA.: Federal Reserve Bank of Boston, Conference Series, No. 34.

Naseem, S.M. (1973): "Mass Poverty in Pakistan: Some Preliminary Findings" *Pakistan Development Review*, Vol. 12: 4, 312-360.

Naseem, S.M. (1979), Underdevelopment, Poverty and Inequality in Pakistan, Vanguard, Islamabad

Neely, C. (2000). "Are Changes in Foreign Exchange Reserves Well Correlated with Official Intervention?" *Economic Review of the Federal Reserve Bank of St. Louis*, September/October, 17-30.

State Bank of Pakistan (2003), Annual Report: 2002-2003, Review of the Economy, Karachi

World Bank (1995), Pakistan Poverty Assessment, Washington, D.C.

World Bank (2002), Poverty in Pakistan: Vulnerabilities, Social Gaps, and Rural Dynamics, Washington, D.C.