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Reviving an Ailing Economy

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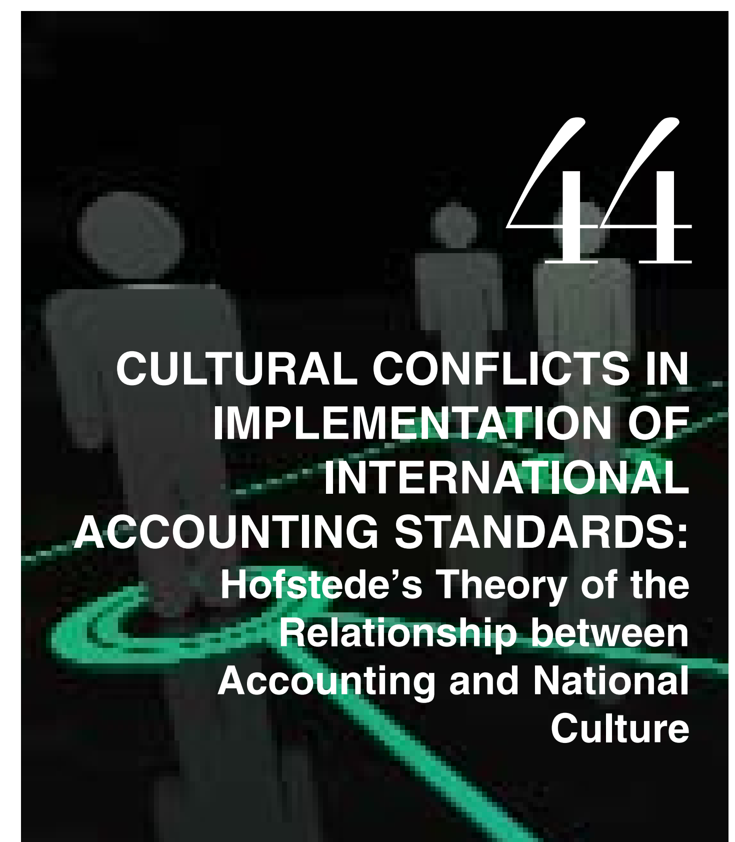


The current state of Pakistan's economy is at best confusing. Political turmoil, compounded by the Mumbai saga, is having a negative effect on investor confidence. In recent years foreign investors have increasingly begun to concentrate on Country Risk Assessment (CRA) and are deterred by prospects of terrorism, inflation, current account and trade deficits, default in repayment of loans, and capital flight. Fiscal irregularities also distort the image of public finance.

Public debt remains a serious problem for Pakistan. High domestic public debt pushes up interest rates and hinders social and economic growth. Pakistan also has a burgeoning budget deficit which can only be lessened by stimulating revenue growth through broadening and strengthening the country's tax base.

Brazil provides a comparable case study in achieving sustained economic growth in developing countries. With a little over 20 years of democracy and as checkered a political history as Pakistan's, Brazil's economy has remained on the brink of disaster. Years of fiscal profligacy finally led to an acute economic crisis in 1999. In 2002, Lula da Silva won the presidency and encouraged market reforms; by 2004 growth was returning. In 2005, Brazil announced that it would repay its IMF loans early. So did Pakistan when we famously "broke our nation's beggar's bowl". However, Brazil paid its debts and lowered interest rates. It kept a lid on spending. As foreign investment increased, the stock index went up. Improved investor perception of the country became evident from increased foreign direct investment (FDI) in to local companies. Brazil received an investment grade rating from S&P 500 for its debt. A ratings upgrade helped drive demand and raised stock prices further.

The good news for Pakistan is that the international community is keen on helping it get out of its economic quagmire. US$ 3 billion assistance package from China and the IMF's credit line of US$ 7.6 billion will help in bridging the country's fiscal needs, estimated at US$ 13.4 billion by IMF. However, evidence suggests that poor countries that receive lots of external aid grow no faster, on average, than those that receive very little. A report by the World Bank sorted 56 aid-receiving countries by the quality of their economic management. Those with good policies like low inflation, a budget surplus and openness to trade and good institutions with little corruption, strong rule of law, and an effective bureaucracy benefited from the aid they received. Those with poor policies and institutions did not. Recent evidence also suggests that the best way to encourage private sector investment is by putting in place stable macroeconomic policies, with low inflation, low interest rates and low rates of taxation.

Another policy priority should be to revitalize agriculture through equitable distribution of agricultural land to rural poor, improving availability and management of water, and providing better access to agricultural credit and extension. This will help reduce poverty in rural areas.

We need to reinforce our faith in the country's credit system. Attracting foreign investors may still be possible. In addition to policy coordination, political introspection is also necessary for Pakistan to attract productive capital. Our economy needs strategic intervention and inspiration from the government which should be committing all its energies to doing just that.

Abdul Rahim Suriya

In November 2004, the Government of Pakistan decided to quit the then IMF program called Poverty Reduction and Growth Facility (PRGF) Arrangement and refused to draw the seventh tranche under this program. After exactly four years of economic autonomy, once again, Pakistan is back in time and finds itself under the IMF Stand-By Arrangement.

With a trade and current account deficit of USD20 billion and USD14 billion respectively, foreign currency reserves plunging to less than USD3.5 billion, depreciation of rupee by over 30 percent, the economy was teetering on the brink of default. Together with a nearly insolvent situation in the external account, the fiscal situation had also deteriorated to an alarming level. As the fiscal deficit deteriorated to 7.8 percent of GDP in 2007-08, the government had to resort to an all time high borrowing of Rs.700 billion from the State Bank. The ballooning fiscal deficit, together with steep rise in food and fuel prices in the international market, had pushed consumer prices to hit the roof as inflation reached nearly 22 percent in June 2008. Subsequent to June 2008, the government had to increase the rates of petroleum products and utilities to eliminate the subsidy given by the caretaker government by keeping such prices low, without passing them to the consumer. Thus, the effect of steep rise in inflation during the election period has caused even more pain for the common man. These conditions, coupled with the global financial meltdown of unimaginable proportions, had left no choice to the government but to approach the IMF for its emergency funding to preclude possible default on its external financial obligations.

Consequently, at the request of Pakistan, on November 24, 2008 IMF Executive Board approved the Stand-By Arrangement of USD7.6 billion mainly aimed at supporting Pakistan to stabilize its economy, especially focusing on addressing its perennial twin deficits - balance of payments and fiscal deficit. Since then, Pakistan has already received the first tranche of USD 3.1 billion, providing some respite and breathing time.

As per the economic review contained in the annual report for 2007-08 that has just been released on November 7, 2008, the State Bank of Pakistan has also portrayed a gloomy picture of the economy, highlighting the worsening key economic indicators, including slowdown of the economy besides the fiscal and current account deficits. Clearly, Pakistan's economy is in bad shape and needs urgent and effective policy actions, not only for its stabilization, but also to revive economic growth that helps in reducing poverty and inflation.

While the Advisor on Finance has outlined an ambitious, but impressive, nine point agenda to stabilize and revive the economy that entails achieving macroeconomic stability by containing twin deficits of balance of payments, current account and fiscal deficits, stabilizing the rupee, reducing inflation, building foreign exchange reserves, enhancing tax to GDP ratio to 15 percent of GDP, enhancing savings by 3 to 4 percent and lowering public debt to GDP to 45 percent of the GDP, building social safety nets through targeted subsidies to provide protection to the vulnerable segments of population living below poverty line, enhancing agricultural and industrial productivity, accelerating human resource development, improving energy mix, implementing administrative reforms to improve service delivery by the government and developing capital markets to their full potential. The real challenge, however, will be in developing the details of this agenda and its implementation.

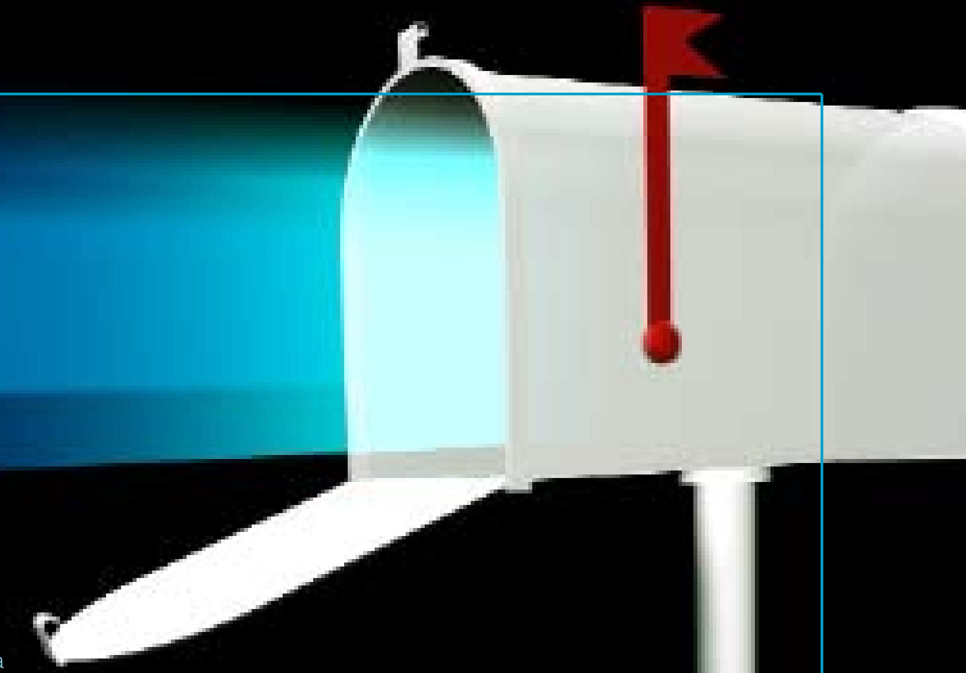
At present, the plan comprises of broad ambitious targets, and a detailed operational plan that describes how these targets will be achieved, is still to be worked out. The Advisor has also rightly emphasized the need for revitalizing the Planning Commission, which should be responsible for stewardship of the economy including preparing pragmatic medium and long-term plans in coordination with the Ministry of Finance. Therefore, I set out below, some urgent steps required from the economic managers of the country for preparing the roadmap for stabilization and economic recovery as a pre-requisite for restoring investor confidence:

- Urgent steps should be taken to restructure and strengthen the Planning Commission
- Developing more detailed short and medium-term plans by the Planning Commission in consultation with the Ministry of Finance, and with the involvement of other Ministries and Provincial Governments to stabilize and revitalize the economy.
- Establishing effective monitoring mechanisms to ensure rigorous implementation of plans through monthly and quarterly reporting on key performance indicators (KPIs) included in the plans.
- Taking effective and timely corrective actions, when exceptions and deviations are identified.
- Obviously, the real challenge will be not in preparing the plans- this being the easier part- but in their implementation. This can only happen if there is full commitment from the top leadership on the objectives, strategies and actions envisaged in the plans.

Under the current circumstances, there could not have been a more appropriate theme for *The Pakistan Accountant*, the official magazine of our Institute, and I congratulate our Editorial Group on selecting this theme and for including papers that not only discuss various issues and problems affecting our economy but more importantly, the suggestions to address them. I also take this opportunity to extend our best wishes, on behalf of our Institute, to the national economic managers under the leadership of the Advisor on Finance, and all the success in steering the economy away from its perennial economic ailments.

Syed Asad Ali Shah

Join the Discourse



This month's Topic is based on motivational theorist Abraham Maslow's famous quote:

"The difference between the great and good societies and the regressing, deteriorating societies is largely in terms of the entrepreneurial opportunity and the number of such people in the society. I think everyone would agree that the most valuable 100 people to bring into a deteriorating society would be not 100 chemists, or politicians, or professors, or engineers, but rather 100 entrepreneurs."

Abraham Maslow.

Do you agree with Maslow's statement that:

"…the most valuable 100 people to bring into a deteriorating society would be not 100 chemists, or politicians, or professors, or engineers, but rather 100 entrepreneurs."

Comments

The universal law is given in the Eternal Code of Life, the Qura'n. All myths of present day society are shattered by a simple statement that "Allah has declared entrepreneurial activity as *halal* and speculative/interest based activities as *haram*."
(Surah Baqara: 275)

Mohammad Naeem Khan
Karachi

I completely agree with Mr. Maslow's statement. In order to save a sinking economy, 100 entrepreneurs would do the trick. Entrepreneurs are leaders, they own and they control. They have the desired authority, and the related responsibility. They have the vision and ability to execute strategies in order to achieve the desired goals.

This topic is extremely relevant to the prevailing situation in Pakistan. In order to analyze a situation, one would use a benchmark. In our case, the most relevant benchmark is that of Dubai, a stone's throw from Pakistan and similar in terms of geography, yet extremely advanced by all other means of comparison.

HRH Shaikh Mohammed is the 'Entrepreneur' of Dubai. He owns Dubai, and is also informally referred to as the Chief Executive of Dubai. He has a vision for placing Dubai amongst the top three cities in the world. His strategies have made Dubai the cynosure of the globe.

Applying Maslow's theory to Pakistan, if the country is divided into 100 or so administrative areas, and the same are assigned to entrepreneurs whose responsibility is to utilize the resources from within their areas towards the development of their own area, the excessive and redundant layers in the existing system would be shed away, utilizing the true potential of the area (something similar to the 7 emirates of the UAE, or the 50 states of the USA).

Mansoor Anwar
Dubai, UAE

The only reason behind any regressing, deteriorating society is the loss of confidence of a citizenry in the institutions of the state, ultimately leading to deterioration in all spheres of society, irrespective of the fact whether that society is governed under oligarchy or democratic order.

The most important factor to restore the confidence of the people in the state and its mechanics is the provision of justice to the common man. The Great Roman and Greek civilizations collapsed despite being democratic in order. The British Empire survived the onslaught of the military might of the Germans only because a common man was able to get justice.

The most valuable 100 people are those who can ensure that justice is provided to the common man. These 100 people could be jurists, or trustworthy lawyers, or common policemen. Once they are able to restore the confidence of the common man, the level of trust is developed at all levels of human and capital investment.

Murtaza Ahmed Ali
Karachi

I would disagree with Maslow on two accounts. Firstly if 100 most valuable people are to be added to any society, it would always be a combination of brilliant people in different areas rather than all 100 belonging to a single area of expertise. Secondly, Maslow differentiates good societies from deteriorating ones on the basis of the entrepreneurial opportunity that they carry, which itself is a flawed hypothesis. Entrepreneurs may provide the foundations for creation of wealth but do not emphasize upon its just distribution. Entrepreneurial opportunity can only serve as a threshold for distinguishing a good "economy" from a deteriorating one where as great societies are founded on the health of their value system and justice.

Syed Shahid Abbas Rizvi
Islamabad

I fully agree with Maslow's statement.

We can see in our neighborhood that countries that provide and implement basic ingredients of investment where one can risk capital, produce people we call entrepreneurs. A single entrepreneur makes a difference to the life of many others by providing jobs, increasing productivity and stimulating economic development.

Entrepreneurial activity transforms societies from regressive to progressive, helps in overcoming backwardness and opens doors to endless opportunities.

Naveed Aslam
Karachi

Maslow was wrong. If you look at history most people who have had influence on societies were not entrepreneurs but politicians, rulers, warriors, scientists, chemists, engineers, educationists and economists. Be it Muhammad (pbuh), Jesus Christ, Albert Einstein, Karl Marx, Franklin D. Roosevelt, Mohammad Ali Jinnah, or Gandhi, all of them affected societies through their non-entrepreneurial expertise and efforts.

Some influential people have been entrepreneurs, like Bill Gates, but it is not so much Gates' entrepreneurial capabilities that have changed the world, but his philanthropic activities in the form of the Bill and Melinda Gates Foundation that is influencing under-privileged societies and changing them for the better.

Saleemullah
Karachi

For Good Measure:
Recouping the Economy in the Long Term

Adnan Afridi

The year 2008 will be remembered as one of the most turbulent years in global economic history. The impact of a number of global events, ranging from the global subprime crisis to the collapse of leading financial institutions, to the surge in global commodity prices has impacted regions differently and unevenly.

In economies like Pakistan, which are dependent upon exports and imports, inflation often leads to balance of payments difficulties. If other countries are not inflating to the same extent, home produced goods will become less competitive in foreign markets and foreign goods will become more competitive in the home market. Exports will be depressed and imports will rise. If this process continues, it must lead to a balance of payments deficit in the current account. The problem will be a particularly difficult one when inflation is of the demand pull type, because in addition to the price effects the excess demand at home will draw in more imports. Every country endeavors to maintain the value of its currency at par with other strong currencies so that its economic growth, price stability, investment and international trade remain on the targeted path. A strong currency is an important contributor to political stability and prosperity of the people. Economic history indicates that the disintegration of a former superpower came about mainly due to its shattered economy and an unprecedented decline in the value of its currency.

Being an open and highly import dependent economy, Pakistan has been hit hard by the rise in global commodity prices. As a result, the origin of its economic ailments lies in the sharp growth in the domestic fiscal deficit and the external current account deficit. A principal factor for growth in macroeconomic imbalance is the continuous rise in global oil prices. On the domestic front, subsidies on petroleum products rose to Rs. 175 billion and on the external account side, the oil import bill was equivalent to 6.9 percent of GDP or almost 80 percent of external current account deficit, as the price per barrel of oil reached all time highs. During 2008, the average price per barrel was USD 94.4 and the pressure intensified in the first quarter of 2009 with the average price per barrel reaching close to USD115.5.

Another factor that led to an increased import bill was that the Government had to import food products as

local food production fell short of demand. Additionally, distribution problems added to the food shortage. Concurrent with high global commodity prices, both public and private sector imports in value terms were much higher. The country's import bill, during the current financial year 2008-09, is USD40 billion reflecting a growth of 30.9 percent, whereas exports are slightly above USD19 billion. The unprecedented trade deficit of about USD21 billion has caused a decline in Pakistan's foreign exchange reserves from $11.4 billion to $6.6 billion and increased the country's external debt to $46 billion. If Pakistan fails to pay immediate attention to this problem, the country's foreign exchange reserves will continue to dwindle, and we will find ourselves in the deadly debt trap, i.e. borrowing to make debt payments.

Although the global financial crisis has had a limited effect on Pakistan, Pakistan's capital markets have been under severe strain due to the current political uncertainty and macroeconomic imbalances. As a result of high inflation, the State Bank was forced to raise interest rates and reduce liquidity in the economy. Additionally, the Government and State Bank have been forced to ask donor countries and multilateral agencies such as the International Monetary Fund for help in order to resolve the balance of payments crisis. All of these events have caused erosion in equity values and deterioration of investor sentiment in the country.

A strong macroeconomic policy response could limit the damage. The four major economic challenges that Pakistan is currently facing are deceleration in economic growth, rising inflation, growing fiscal deficit, and widening of trade and current account deficits. The key to meeting these challenges lies in boosting the country's agricultural and industrial production by finding more efficient ways to produce.

For quick results we have to recognize that the global economy is increasingly driven by knowledge rather than the traditional factors of production. According to the Global Competitiveness Report, Pakistan's position on the technology index was far below Korea, Malaysia, Thailand, China and India. Pakistan's economic sovereignty faces a threat from these problems at present. A campaign to boost agricultural and industrial production will have to be launched on a priority basis.

Pakistan is blessed with abundant agricultural potential and efforts to exploit this potential and raise yields are critical in bringing the country back to being self sufficient given the size of its population. The government needs to initiate necessary measures that will boost production of major crops and livestock. Pakistan is the fifth largest livestock producing country in the world. A few measures were introduced in the federal budget 2008-09 but additional measures are needed in the light of future experience. The performance of the agricultural and livestock sector may be kept under regular monitoring to enable the government to take immediate remedial steps. A significant increase in the agricultural and livestock sector would raise the country's GDP growth and the revenue collection would also increase.

Besides, sufficient growth in the agriculture and live stock sector will reduce food shortages and will help in bringing down food inflation provided that the government is able to check hoarding, profiteering and smuggling. Additionally, agricultural products such as cotton and sugarcane are also used by our industrial sector. Thus, good performance of the agriculture sector should lead to good performance of the industrial sector as well.

Agricultural products contribute only 21 percent to GDP, but 44 per cent of the population is employed by this sector. Growth in this sector can bring immense benefits to the country. It would, therefore, be necessary for the Government to focus simultaneously on boosting industrial production, in particular the production of high-value industrial items.

The question is what should be done to bridge the massive export-import gap of nearly $21 billion? Even the best performance of the country's agriculture sector could make a difference of not more than $4-5 billion through a reduction in imports and increase in exports of the agricultural products. Therefore, what should be done to meet the deficit of the remaining $16-17 billion?

The remedy lies in boosting the country's industrial production and exports. In the first instance, efforts must be made to boost textiles and small-scale manufacturing sectors. Pakistan has vast experience in the manufacture of engineering goods ranging from electric fans, sewing machines and bicycles to tractors, defense products etc. However, high rates of export-led growth of the local engineering goods industry has so far not been possible as the cost of production is higher compared to foreign countries, thus making Pakistani goods less competitive. Increasing the production of tractors and various types of machinery and other engineering goods for domestic use will provide Pakistan with an opportunity to save billions of dollars that are presently being spent on the import of mechanical and electrical goods and machinery. Once the engineering goods industry starts to develop there will be reduction of costs and improvement of quality, and in due course of time Pakistan may become an exporter of machinery and other engineering products rather than a being a net importer of these products.

In addition to developing our engineering goods industry, an effort may also be made to boost the exports of IT products. India has excelled in this field and its exports of IT products alone are greater than our total exports. There is reportedly great potential in Pakistan to develop this sector. All possible efforts should, therefore, be made to increase the exports of IT products.

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

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

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

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

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

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

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

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

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

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

Adnan Afridi is Managing Director of Karachi Stock Exchange.

On the Road to Recovery

Muhammad Farid Alam

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

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

What went wrong and why

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

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

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

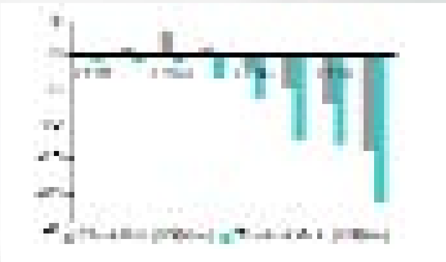
Fixing of essential commodity support prices at a higher level disregarding international prices was also an extreme measure which will continue to have an impact on inflation, for e.g. wheat support price was fixed at PKR 950 per maund. The international market has come down almost 40 percent since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

The Capital Inflow cover has declined

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

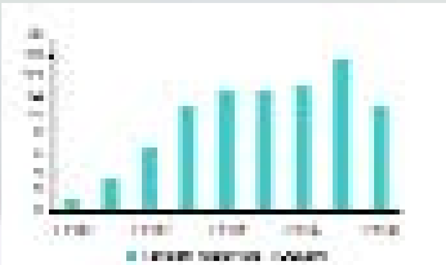
Source: SBP

The Twin Deficits have risen sharply



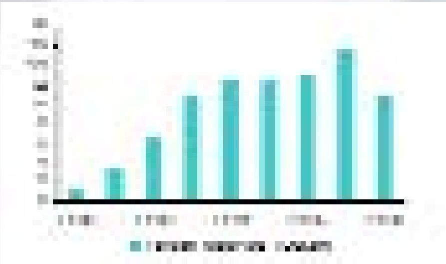
Source: SBP

Forex reserve cover has fallen



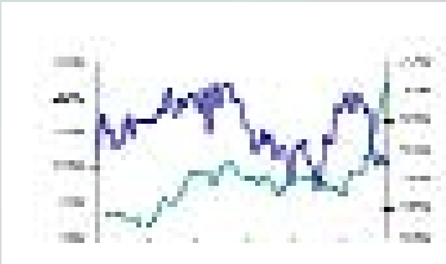
Source: SBP

Fiscal slippages have increased



Source: Federal Bureau of Statistics

Both CPI and M2 growth has spiked



Source: SBP

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

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

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

Current economic indicators are better than those in FY98

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

Source: SBP

Is Pakistan on the road to recovery?

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

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

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

Subsidy burden expected to decline substantially

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

Source: Ministry of Finance

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

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

Pakistan's external debt profile is extremely healthy

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

Source: Ministry of Finance

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

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

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

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

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

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

Secondly, Pakistan carries an inherent weakness in the trade account and since 2003 the country has been running persistent and expanding trade deficits. However, in 2008 a decline in the capital inflow cover to 59 percent of the trade deficit, led to a US$4.4 billion reduction in Pakistan's Forex reserves. This was caused by a 38 percent year on year reduction in foreign investment inflows with FDI remaining stagnant at US$5.1billion in 2008. Considering that G-8 countries are currently in recession while construction activity in the Middle East has slowed down, there is high likelihood that home remittances and investment inflows into Pakistan will also slowdown further in the current fiscal year as cash flows of the Pakistani expatriates are affected. Therefore, high dependence on capital inflows in the shape of remittances or foreign investment to finance the trade account deficit is no more a sustainable option. Therefore, the only viable solution to alleviate the prevailing balance of payment distress is to equilibrate the trade account. This would include serious structural reforms to spur exports through quality improvement, product and market diversification.

Thirdly, Pakistan needs to develop a proactive and integrated energy policy. This would involve utilizing all local energy resources like coal, wind power, solar and hydel power on a fast track basis. This would cushion the country from external oil price shocks in the long term. The policy should target power generation of approximately 5,000 mega watt from these sources over the next five years under a crash program. In addition, the government should also consider fixing the estimated 100k barrels of oil per day (bopd) oil import from Saudi Arabia at current price for a period of five years. This would provide the basis for reducing inflationary pressures while the real economy should benefit from a much needed boost in the form of lower input costs while domestic demand would continue channeling towards the formal sector. This would provide Pakistan relief in an already distressed balance of payments position while simultaneously preventing exposure to further commodity price shocks as seen in the past.

Furthermore, although the government has implemented an austere fiscal regime the need to resolve the circular debt issue as soon as possible becomes very important. With Pakistan's internal debt at around US$40 billion i.e. 25 percent of GDP, the government can effectively resolve the circular debt issue by structuring five year bonds against them. This strategy was effectively followed by the government of India in the past to meet its financing needs.

In line with other commodity prices, international DAP prices have come off by 56 percent since reaching their peak of US$1,250 per ton in September 2008 and currently stand at US$550 per ton. This translates into a landed price of PKR2,450-2,550 per bag, vindicating the case for elimination of subsidies on DAP which should further contribute in reestablishing fiscal discipline.

Lastly, there is a need to not only pass on the entire benefit of the rapid decline in the international commodity prices onto the domestic consumers in the shape of reduced domestic prices but also to watch that the sale price is actually reduced and middleman does not take undue advantage because of his monopolistic position for e.g., as we have seen recently that the rice crop was not picked up by PASSCO at the harvesting time and middleman exploited the situation. The government has not yet completely passed on the recent rapid decline in global commodity prices. This has caused the differential between domestic and international prices to rise in the country which can have harmful consequences for the economy. This is because this differential presents a clear arbitrage opportunity to smuggle cheap commodities through the Iran/Afghanistan route. An influx of cheap smuggled commodities will be highly detrimental to the domestic manufacturing sector which is already facing high distress caused by power shortages and high financial and production costs. There is a clear need to pass on the benefit of the downturn in commodity prices which will not only lower inflationary pressures but also close an unhealthy arbitrage opportunity.

In a nutshell, the economic situation is improving. However, there are many medium to long term structural weaknesses in the economy that continue to pose risk to recovery. I have highlighted key policy challenges, which if handled carefully should accelerate the pace of recovery and growth. In every challenge lies an opportunity and while the recent measures undertaken by the Government of Pakistan lend credence to an expected gradual recovery, I believe further proactive policy response in implementing the aforementioned steps would underpin a resurgence in confidence accelerating Pakistan's overall macroeconomic well-being.

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Ten Recommendations for Economic Prosperity

Dr. Khawaja Amjad Saeed

Prelude

Pakistan's potential for growth and development is tremendous. We need to comprehend the nature of the economic problems facing our country and develop strategies for way forward. This piece addresses three aspects namely:

- Ten Prerequisites to Economic Stability
- Ten Symptoms of Economic Instability
- Ten Suggested Strategies for Way Forward

Ten Prerequisites to Economic Stability

1. Global economies of developing and developed countries are interconnected. The world has become a global village. Any major event which occurs in respect of investment flows, import and export of goods and services, movement of people across borders, perceptions developed due to terrorism and other destabilizing factors have great impact. Therefore, leadership of any country must ensure that prerequisites to economic development and stability are ensured.

2. We must establish various committees of the Parliament and support these to function impartially. Some belated work has been done and other aspects appear to be on the upcoming agenda. Therefore, whatever legal framework exists, it does not instill confidence in stakeholders.

3. A clear cut guideline for implementation must exist within an economic system. The Quaide-e-Azam had promoted an economic system based on Quran and Sunnah. In the last 62 years of our existence, we have not yet succeeded in evolving and implementing an Islamic Economic System in our country. In fact we have no clear cut economic system.

4. The 1973 Constitution of Pakistan requires the Parliament to eliminate social evils, ensure socio-economic development and guarantee the wellbeing of the people. Several articles of the Constitution have hardly been addressed.

5. A clear cut economic strategy with well defined goals and well formulated polices to serve all segments of society must be evolved and implemented.

6. Standard of living and purchasing power of the common man must be elevated to keep the economic wheel of the country moving.

7. GDP must increase with sustainability and the gap between haves and have-nots must be bridged to ensure social stability.

8. Social sectors must receive substantial budgetary allocations to ensure reserves of duly trained, well qualified human resource for socio-economic development.

9. Gini Index, highlighting declining economic disparity, must be available.

10. Unemployment levels must go down.

Ten Symptoms of Economic Instability

While empirical research can reveal causes of socio-economic instability, some of the symptoms which need to be properly addressed, are:

1. Common man is dissatisfied as their basic needs remain unmet.
2. Foreign Exchange Reserves which stood at US$16 billion declined to US$6 billion. With financial assistance of US$4 billion from the IMF, the situation has marginally improved to US$9 billion now.
3. Rupee-Dollar parity which was Rs.61 to US dollar is now hovering around Rs.80.
4. Due to economic mismanagement, surplus wheat was earlier exported and later imported at double price.
5. Agriculture, which is the backbone of Pakistan's economy, has been ignored. Only recently, some interest has been aroused. The real issues of low yield, new varieties, innovative pre and post harvest practices, taxing the agricultural net income, tenancy relationships, and several related issues have yet to be addressed.
6. Lip service needs to be replaced by tangible microcredit allocations for the small and medium size (SME) sector.
7. Hardly any industrial policy exists for quantum jump in industrial production and harmonizing the relationship of vendor industry to large scale industry.
8. Growing unrest in search of a just and fair legal system.
9. A long-term vision for 2025 for Pakistan is not available.
10. These gaps need to be addressed namely:
    - ❑ Savings-Investment
    - ❑ Budget Deficit to GDP
    - ❑ Balance of Payments (BOP)
    - ❑ Very low Tax GDP ratio resulting in high reliance on domestic and foreign assistance

Ten Strategies for Way Forward

Pakistan is a land of great potential which needs to be exploited to our advantage. Some strategic suggestions are offered to improve the current situation.

1. For attracting DFI and even investments from Pakistani expatriates abroad, steps should be taken to inspire confidence in our political set up with minimal impact of terrorism which needs to be eliminated by whatever approach which works successfully.
2. Potential investors' fears need to be alleviated through constitutional guarantees and/or in such ways as may be acceptable to them.
3. Leaders having wealth abroad are urged to bring back the money to the country's coffers.
4. Political stability is the first prerequisite. One leading brokerage house predicted KSE 18,000, without political uncertainty at the onset of the democratic setup in Pakistan. Today it is artificially maintained at around 9000. The current setup must study this decline.
5. Institutional arrangements must stay in place for the vital functioning of Parliament, and all parliamentary committees must be appointed immediately and must function in consonance with the principles of good governance.
6. Accountability must be ensured from the highest to the lowest level and any departures be brought to task.
7. Economic strategy must be formulated on the following lines:

(a) All three constituents of economic development namely, agriculture, industry and infrastructure must receive immediate attention with an integrated approach.

(b) All four components of agriculture namely, crop, livestock, forestry and fishery be given due importance. Provinces should be motivated to develop a result oriented strategy.

(c) An enlightened industrial policy within the scope of hi-tech, large scale, small and medium scale industries should be developed. Vendor industries should be encouraged to promote employment and ensure translating advantages flowing from forward linkages.

(d) A comprehensive infrastructure policy package covering all four components be developed and implemented. These include:

i. Intellectual infrastructure
ii. Physical infrastructure
iii. Financial infrastructure
iv. Social infrastructure

One theory of economic development is that if the government develops infrastructure, economic development will follow as private sector initiative is unleashed.

8. Annual Employment Budget should be announced along with annual budgets of federal and provincial governments. Self employment must be encouraged. Entrepreneurial courses should be taught in all educational institutions throughout Pakistan.
9. Innovation should be encouraged and initiative taken to increase production in agriculture, industry and services sectors with strong linkages to export orientation. Stakeholders must be approached to help develop a comprehensive plan in this respect.
10. Human Resource Development and an accelerated domestic resource mobilization effort is the call of the day.

COVER STORY

The Forex Crisis in Pakistan

Abdul Wahid

The main reasons of foreign exchange crisis may be one or more of the following:

- Deficit in trade
- Capital outflow
- Lesser foreign investment
- Free foreign exchange transactions
- Purchasing power of the currency.

If the economic and industrial policy of the country is suitable, there shall be more production, more exports and so more foreign exchange. When the euro was introduced, it was equal to the dollar. Today, euro is higher to dollar by about one-third. All these factors are interrelated and so a country's foreign currency may go up or down due to its economic condition.

Foreign exchange crises are of two types. One is the value of Pak Rupee and the other is shortage of foreign currency reserves in the country as generally announced by State Bank of Pakistan. To an extent both these aspects are interlinked, but both aspects are also separate.

Exchange Rate

The history of value of Pak Rupee in terms of other important foreign currencies, in use in Pakistan, are as under:

	Nov-08	Jan-08	Jan-07	Jan-03	Jan-98	Jan-82
U.S. Dollar	78.50	61.95	60.89	58.18	44.16	9.88
Australian Dollar	51.46	55.90	48.15	33.94	28.78	11.15
Canadian Dollar	63.52	61.80	51.95	37.74	30.99	8.32
Chinese Yuan	11.50	8.52	7.78	7.02	5.33	5.67
Euro	99.65	91.30	80.21	61.82	-	-
Hong Kong Dollar	10.13	7.94	7.81	7.46	5.70	1.74
Japanese Yen	0.82	0.57	0.51	0.49	0.33	0.04
Kuwaiti Dinar	287.48	226.84	210.45	194.52	144.86	35.08
Malaysian Ringgit	21.66	18.87	17.30	15.33	11.15	4.40
Qatar Riyal	21.56	17.02	16.69	15.33	12.13	2.70
Saudi Riyal	20.92	16.52	16.23	15.51	11.77	2.89
Singapore Dollar	51.88	43.21	39.72	33.54	26.04	4.84
Swiss Franc	64.68	55.90	49.67	42.31	25.46	5.44
UAE Dirham	21.37	16.86	16.58	15.85	12.02	2.69
UK Pound Sterling	120.77	122.29	118.90	94.05	72.65	18.95

US $ in 1947 was for Rs. 3.30

From the above it is clear that value of our rupee in terms of other foreign currencies is has been decelerating. It is not one, but both aspects, that are lowering the value of Pak Rupee in comparison to other currencies. Let us evaluate the reasons for the devaluation of Pak rupee. These may be one or more of the following:

- Economic growth
- Balance of trade
- Outflow of capital
- Demand and supply of the currency

From the above chart it is also clear that some currencies were improving slowly while others very sharply. It is not possible for any country to improve or reduce the value of its own currency. In our history, we have seen devaluation of rupee in terms of $ few times. Value of our currency is calculated in terms of USD to which we are linked.

Let us consider the following:

a. The value of money is not the quantity of money that is available. It is the purchasing power that is behind the money. Indonesia has revalued its currency downwards twice. Recently, Turkey has converted old 1 million liras to new 1 lira. Italian lira was also very little fraction of money which now has euro. Pakistani coins were 64 paisas in a Rupee and 3 *pies* in a paisa. In pre-partition days, apart from this *pie*, there was half-paisa (dhela), one-fourth of a paisa (damri), and in the 1930s even seashells were used as a small fraction of money. Six shells would make one ghunta or a damri and four ghuntas were in a paisa. It is not that the prices were so low that such fractions of coins were in low usage, but the purchasing power behind this money was very high.

b. There was a law under which no citizen could hold foreign currency account or foreign currency in other countries except with the knowledge and permission of the State Bank. This law continued in practice till 1992 when the foreign currency accounts were allowed to Pakistani citizens in the country and abroad. International travelers and Umrah /Haj performers were issued foreign exchange in the shape of travelers cheques as foreign currency notes. Students were allowed to make remittances on Form E for their exam fees, education course, correspondence course and books.

c. All the foreign currencies were available in the market through private brokers and the rates could be ascertained from the Bolton Market footpaths in Karachi. Afghanis, no doubt a soft currency, was dealt in Chowk Yadgar, Peshawar and on Allama Iqbal Road in Quetta. Indian currency was generally available in Karachi and Lahore. The hard currencies mainly US dollar and UK pound were available in all the main cities of the country. Saudi riyal was much in demand during last five months of Islamic calendar.

d. Hundi has been in practice for ever. People working abroad have to remit their earnings to families back home. Since the rate of hundis was, and is, better than bank conversion rate poor workers prefer these, taking the risk of non reliability based on the past experience of others and themselves. It was in practice since inception, is still going on,and shall continue based on human logic of making more and more wealth and getting more purchasing power for their earnings.

e. In 1990s there was a government campaign, “pay off loans and save the country”. Public was asked to donate and also give loan on profit / interest. No one knows its present status. Few years ago, we had paid back all the IMF loans which were considered to carry harsh conditions for the economy of the country, mainly no subsidy, more taxes and higher prices. Recently, again the doors of IMF were knocked on because the World Bank and circle of friendly countries were not willing to help. The term help or aid is not clarified, whether it is a donation or a loan. If it is a loan then the terms and rate of interest are not made public. Donation and loan are two extremely different things. No doubt, sometimes a little remaining balance of the loan, considered to be remaining part of interest, not realized, is written off. After defense, cost of borrowing i.e. interest and charges on international and local loans, is the second heaviest load on the national budget. In a developing country the conversion rate can be improved only through more exports, creating demand for PKR and reducing demand for foreign currencies.

Foreign Exchange Reserves:

1. To study the Foreign Exchange crisis, its Balance Sheet , especially its Receipts and Payments must be considered. Apart from the import export (balance of trade) our receipts also include foreign investment aid, particularly on account of the war on terror. NATO forces are provided logistic facilities. We were also receiving cash help and aid to meet our damages and cost. Receipts may be more or less but the payments give the net result.

2. Pakistan's foreign exchange balance was quite high just more than a year ago. Wheat, sugar, oil, petrol were quite low. Balance of trade, which is the main source of foreign exchange, has generally been negative in the history of Pakistan. Remittances by Pakistan abroad had a big favorable effect and sometimes could even meet the trade deficit. We may call it export of labor, but in totality this export is quite harmful for the economy of the country. It is just like exporting all of the cotton grown in the country and not manufacturing yarn, clothes, finished, dyed and printed cloth. When Venezuela could not pay back the IMF, they refused to refund saying they would pay when they were able to. Despite international denigration the Venezuelan government was unfazed.

3. It is natural business and commerce to go up or down. Rumors play a big role and it is always quick and more effective than announcement of real news. Everyone believes that this information has been confidentially provided to me by a friend and well wisher. About a few months ago, where wheat price in the world went up, oil, gold and rice also shot up. Before the Olympics in 2008 in China, the whole world and experts were blaming China for forward purchasing of petrol at higher and higher rates for the requirement during the Olympics. Wheat was blamed for change of crop to maize in USA, Russia and Australia which could produce oil that could be used in vehicles and that was more economical and profitable.

4. In UAE, state ruler of Dubai has a good planning for developing its area of land, law and order, communications and infrastructure. A new eighty storey revolving building is under construction. Since Iraq and Iran have been involved in the war on terror, capitalists from both these countries have moved their capital to Dubai where real estate prices rose sharply. It also affected Pakistani investors. There were many advertisement campaigns to get residential visas with the booking of an apartment in Dubai. Free movement of capital in Dubai also attracted investors from several Arab and Muslim countries. As demand went up so did prices and capital from Pakistan moved to Dubai. Most of it was illegally done.

5. After price rise in Dubai, some builders and developers in Jeddah, Makkah and Malaysia advertised their proposed projects. Advertisement is a source of attracting a target market. It is badly affecting our foreign exchange position. Foreign currency bank accounts can be freely shifted out. Money changers and money dealers are also available to send any amount, big or small, to any part of the world. From Pakistan capital is shifting to countries where good rate of profit, prospective investment and safe profit is shared.

6. Capital outflow due to law and order situation, lesser chances of investment, attractive investment opportunities in Dubai and UAE have increased the demand of foreign currency in private sector. The rate of dollar increased it and to control it the State Bank of Pakistan had to put its stock on the market. This way the balance foreign exchange position was badly effected. Foreign investors also took back their investment even at a loss.

7. Stock Exchange crisis has been ongoing for the last few months as locals and foreigners want to dispose off their holdings at lower rates available.

8. The late Khalid Ishaque, scholar of law, religion and languages, maintained that in Pakistan there were seven to eight persons who could individually pay off the entire debt of the country. Looking to entrepreneurs in Hong Kong, Singapore, Dubai, UK, USA, Middle East and many other countries, we can see large number of departmental stores, chains of supplies and factories owned by Pakistanis, some with dual nationality. Question arises whether they have earned all these investments in those countries or the capital has been shifted from Pakistan one way or the other. Most countries do not question the source of overseas investments. Only recently have money laundering and drug money become taboo.

9. It has also been noted that figures of trade with UAE, particularly Dubai, do not tally with local statistics. It is a matter of serious concern and demands a detailed inquiry on our part to ascertain and find out who has taken how much foreign exchange without record. Over invoicing on exports and under invoicing on imports has been a malaise in our foreign trade. Over invoicing in trade cannot be ruled out, particularly incase of items without customs duty. Every anti Pakistan wants his foreign currency stock abroad. Most of the big exporters have got their children, cousins, in laws, relatives and friends in the importing country who have established commercial houses with regular imports from Pakistan.

10. In the 1960s, a big lot of gold in jackets deep in the sea was found by a navy diver. The news appeared in the press. Later on in a press conference in USA, in reply to a question in this regard, the then Finance Minister, Mohammad Shoaib replied, "On laboratory test, it was found not to be gold." When the question was raised in the National Assembly, the reply was that the "gold is in State Bank." Auditor General of Pakistan Mushtaq Ahmed on retirement was made a Chartered Accountant whereafter this provision in the Chartered Accountants Ordinance was deleted. No subsequent Auditor General could claim to be a Chartered Accountant on retirement.

11. The recent case of Khanani & Kalia has brought to the forefront the issue of whether the State Bank has got the rights, powers and duties to supervise these foreign exchange houses. There are many other political, criminal, economical, cultural issues that have been subjected to investigation by high power Commissions to no avail. In developed countries, there is the practice of making public, all confidential files after lapse of certain number of years. The case of Liaquat Ali Khan's assassination was covered in an Indian magazine that same year of assassination, and recently the confidential file was made public in the US. Similarly, the details of bank advances, loans, overdrafts, write-offs and foreign aid loans, may never come to light.

Suggestions

1. Holding foreign currency in cash or bank, locally or abroad, should be prohibited as in 1947 to 1992.
2. All declared Foreign Exchange be routed back to Pakistan.
3. Imports should be restricted, only necessary items imports should be allowed.
4. Foreign governments should be approached to provide lists of investments and holdings by Pakistanis, even those with dual nationality who have been issued a Certificate of Pakistani Origin.
5. Learning from the experience of the euro, ASEAN countries, the Arab bloc and Muslim countries, Africa and South America could introduce a common currency, and benefit like the European countries. Thereafter the currencies of these blocks shall remain available for conversion and revaluation

Walking Through the Crisis

Romessa Mirza

Once again, we find ourselves on the threshold of collapse. Time and again, the phrase 'history repeats itself' comes alive for Pakistan by putting us in a situation where we seem to be at the verge of a breakdown. The previous economic crisis of 1999 had also painted the gloomiest of pictures. There had seemed no point of return, while experts had felt that the only way thereon was downhill. However, light dawned upon the gloominess as fresh policies and determined plans turned the tables and brought about an economic revival.

Current economic scenario
However, today we are once again looking at a disheveled macro-economic scenario and it is yet to be seen whether we can resist the pressure to cave in this time or not. Casting a look upon the current scenario, we see some appalling facts such as the depletion of foreign exchange reserves at an alarming rate, the burgeoning inflation, widening external deficits and depreciating Pak Rupee. Foreign exchange reserves have tumbled down to USD 6.6bn, from which the State Bank of Pakistan accounts for a meager USD 3.5bn, down 74 percent from USD14.1bn in November 2007. This, accompanied by the widening balance of payments deficits, poses intimidating challenges for the government. The deteriorating trade balance (trade deficit up by 53 percent YoY for fiscal year 2008), and widening current account deficit (100 percent YoY rise to USD 14bn in fiscal year 2008) have further fueled the PKR depreciation (15 percent fiscal year 2009 TD), leading to the prevailing macro-economic scenario of the country. The global commodity price hike also had a significant impact on inflation, as domestic commodity prices are linked to international prices, taking inflation up to a 30-year high of 25.33 percent YoY in August 2008.

Route to the solution: Centralized planning
Pinning down each one of the problems highlighted above should be the chief priority of the leadership to bring the economy back on track. Though there is a plethora of policies that have been chalked out for economic stabilization, what we need is a central planning authority with coordinated efforts channeled towards well correlated plans. Scattered plans, with narrow scopes, would lack the potential for proper implementation, primarily because they would be a small part of the bigger whole. On the flipside, well-coordinated, centralized planning would afford better foresight, helping to work towards a predetermined, widely accepted and well-understood goal.

Immunity from international meltdown
Looking at the global crisis, we can safely say that Pakistan's financial system is relatively isolated from that of the international financial markets. This non-linkage is a blessing in disguise for Pakistan. Moreover, Pakistan's relatively less exposure to derivate instruments has also prevented further unpleasantness. Our local companies are also not very dependant for credit inflows on foreign institutions, thus further isolating us from adverse consequences ensuing from such external dependencies. Exports from Pakistan are only 9.4 percent of the GDP, thus placating the affects that we might otherwise have been prone to. As opposed to consequences faced by countries running enormous exportable surpluses, Pakistan could in fact benefit from the plummeting commodity prices such as that of oil, steel and fertilizer. This scenario presents a clean slate to Pakistan, where it has an opportunity to make its mark in the local and global financial arena.

Consistency in policies: a prerequisite to success
At a local level, myriad issues need to be addressed. However, the most noteworthy is the fact that there is always a sudden shift in policies with the advent of each subsequent government, which renders all previous plans inadequate. The abandonment of theprojects kicked off by the previous regime causes large amount of losses, while the ensuing chaos reduces credibility for further investments. A prerequisite for the revival of the economy is chalking out plans with a solid footing which bear a high potential for implementation. The latter is another instrumental issue which deserves more attention. Despite the availability of detailed, well made plans, we do not see positive developments coming to light. A primary reason for this is the inadequate implementation and lack of proper checks and balances. Time well spent in drawing out a plan might as well be considered squandered away when the plan is limited to paper.

Fighting through the monetary crisis
On the monetary front, a major problem is that of excessive government borrowing (Rs.688bn for fiscal year 2008) which has also been a dampener on the economic growth experiences in the past. Stricter controls are mandatory for curtailing the money supply growth, another contributor to the burgeoning inflation.

Inflation is yet another facet which demands utmost and urgent attention. Primarily driven by the food and energy components, this indicator is likely to get a breather in future. Following the dip in international crude oil prices (61 percent in fiscal year 2009 TD) the government has reduced the retail price of petrol as well. The nose-diving crude oil prices will have a two pronged effect: firstly, they would help curtail the persistent trade account deficit as oil, which constituted approximately 28 percent of the total imports in 2008, devoured a major portion of the import bill; secondly, inflation is also expected to slow down as energy prices go down.

Inflation is expected to be curtailed further as a result of the hike in commodity prices screeching to a halt. BDI (Baltic Dry Index) has plummeted by 91 percent in fiscal year 2009 TD. This is expected to filter down to a fall in local prices as well. This will also be given support by the bumper crops such as wheat, rice and cotton expected this year. The deficiency of these crops earlier had put the country in a difficult situation as we had no choice but to import the required food items at prices soaring sky high then. Now the surplus is expected to bode well for the trade balance. The rupee depreciation against greenback will give further incentive to importers in other countries.

With the approval of the IMF loan, the foreign reserves of Pakistan shall climb back up, thus putting many fears to rest for now. Boosting investor confidence, this is expected to stabilize the rupee dollar parity as well. Standard & Poors has further downgraded Pakistan's credit rating to CCC. However, post IMF, we expect the credit worthiness of the country to improve significantly. This will also bode well for the banking system, and would ease the procedures for importers who are otherwise having difficulty in obtaining LCs.

Effectively dealing with the fiscal imbalances
The need of the day is to mobilize resources to formalize all sectors, thus broadening the tax net and improving the overall fiscal situation of the country as well. The tax to GDP ratio, continuously on the fall for the last three years, declined to 10.1 percent in 2008. The average level of tax to GDP ratio from 1995 to 2000 stood at 13.6 percent. Now the IMF has also reportedly set the target for this ratio at 15 percent in the coming five to seven years.

To further improve the worsened budgetary position of the country, fiscal balances need to be restored with headstrong measures. The defense expenditure alone stood at an approximate level of Rs.277bn in 2008, amounting to 20 percent of the current expenditures of the government. Subsidies have also been on the rise, standing at approximately 26.3 percent of the current expenditure in 2008 (FY 2007: 7.6 percent), while they are 3.6 percent of GDP as well.

However, infrastructure development is still instrumental to pave the way for future development. This can be seen in the form of deployment of additional terminals, port facilities, road development and highways, railways, and dams. Nevertheless, it is an undertaking that can only be efficiently implemented with full cooperation of both the private and public sector. PPP (public private partnership) presents innumerable, unexplored avenues.

External imbalances: a lasting menace
Exports also need to be increased by introduction of the correct set of policies to give incentives to the most deserving exporters. Even with a trade surplus, China still provides attractive export incentives. For example, the tax rebate rate has been raised three times this year in China. The most recent increase came in November 2008, covering a list of 3,770 items which account for 27.9 percent of the country's total exports. Such measures are necessary to narrow down the trade deficit as Pakistan would find it increasingly difficult to contain the existing deficit over a prolonged period.

Additionally, the remittances, a bright star in the current account, need to be encouraged further. This could be done through various measures including development in banking products. Innovative ideas would best optimize local capabilities. For example, an improvement in the financial products arena in the form of innovative products for non-resident Pakistanis (NRPs) could be well received. This would not only boost business for the banks and widen their customer base, but would also further encourage remittances. It could also expedite development of the local commodities market, Real Estate Investment Trusts (REITs), private equity etc. by allowing NRPs a wider base for investments.

Inducing investment for sustainability
Presence of the necessary infrastructure will be conducive to the much needed specialized industrial estates, which require basic utilities, ancillary facilities and technology. Social sector development should also be streamlined with particular emphasis on the development of human capital in order to breed a more refined generation for future development of the nation. This is also required to build a value system which lies at the core of the prosperity of a country. It will also help foster technocrats needed for each specialized area of leadership.

The main deterrent for private sector investment is shattered confidence which needs to be restored through effective policy measure and incentives. However, any incentives provided, whether they are in the form of subsidies or otherwise, need to be introduced with proper checks and balances. Moreover, any such assistance should be extended with the primary objective of making the company or sector self sufficient. Continuous support, regardless of output, defies the very purpose of giving initial support to an infant industry. Such everlasting support, as has been given in the case of several state owned enterprises, only serves to desecrate the much needed government funds, which could have otherwise been used very effectively in high performing areas.

The financial sector has great potential for innovative banking products. Islamic banking is also growing with its distinctive ideology and adaptability to the needs of end users. The huge population of the country also presents opportunities in the form of availability of inexpensive labor, as well as a vast, under-served consumer market. Corporate farming, including food processing, development and utilization of new collection and distribution channels, as well as development of storage facilities present myriad possibilities for high return investments. On the agricultural front there are vast tracts of arable and fertile, yet under-utilized land, in Pakistan. Measures at the grassroots level are required to enhance the crop yields and increase efficiency of the farmers, especially through increased training.

The energy projects coming on the way need to be implemented as soon as possible to satiate the rising energy needs of the economy and to support further industrial growth. The prevailing power crisis is a major deterrent in productive industrial undertakings. Moreover, the hike of 31 percent in gas prices, for captive power plants, also aroused much hue and cry from the effected parties. A recommended step is to identify the sectors contributing most to GDP growth rate and exports, such as agriculture and large scale manufacturing, and devise effective measures for the promotion of each. Both local and foreign investment needs to be encouraged.

A considerably large demand supply gap of about 5,000 mega watts in the power sector exists at peak levels. Foreign investment could be encouraged in the sector, where guaranteed returns further reinforce its attractiveness. The current scenario of depreciating PKR also bodes well for it as the returns are indexed against the dollar and the US inflation. Moreover, fuel costs are a pass-through item for the sector. It is also noteworthy that the power sector would generally find gas to be the least expensive option but it is forced to use furnace oil or diesel due to availability issues of the former. Moreover, industrial units are prone to load shedding, particularly after the onset of winter season. This stresses the need for investment in both refining as well as exploration and production sectors. Besides gas, exploration in Thar coal reserves is also expected to bear high returns. It is ironic that Pakistan has the fourth largest coal reserves in the world but it is importing millions of tons of coal per annum for the cement industry.

A similar trend is seen in petroleum and oil products where refineries have been unable to meet the local demand; 52 percent and 60 percent of the demand for HSD and FO respectively was being met through imports as of September 2008. Furthermore, on an equivalent basis, 380k bbl/day of oil is consumed per day in Pakistan, while only 70k bbl/day is being supplied locally. Hence, Pakistan itself is deficient in provision of many resources, in spite of having the relevant reserves. Once these demands are met, the door is also wide open for exports. Thus, priority should be given to the maximum usage of natural indigenous material by enforcing the appropriate energy mix in industries and also devising future plans bearing our natural endowments in mind. Measures like these would make Pakistan a production driven economy.

Looking ahead
There needs to be a political will and the required foresight to revive the ailing economy of Pakistan, thus implementing Vision 2030 which envisages "a developed, industrialized, just and prosperous Pakistan through rapid and sustainable development in a resource constrained economy by deploying knowledge inputs." Over the longer term the government should reduce its stake in the field of economic production and business, and should strengthen the enabling environment, encompassing the legal and regulatory framework, for rapid development of the economy.

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The Real Economic Woes

Mohammad Ashraf

The worldwide economic crisis is encompassing the globe more rapidly than the effect of short term solutions of inducting billions of dollars in to recession bound economies. According to a latest report the economic crisis is expected to linger on in developed countries for at least another eighteen months. Hence, the effects of this recession in developing countries like Pakistan may be felt for longer than eighteen months.

Meanwhile, the Gulf region is readying itself for a new wave of capital repatriation from the US and Europe following the global crisis, as had happened after September 11, 2001. Those present at the recent World Bank meetings in Washington were told that developing and poor countries must be protected from the global financial crisis as inflationary pressures and the risk of lower export growth threaten their hard-won social and economic gains.

Australian Prime Minister Kevin Rudd has said that the global economic crisis is a result of the "comprehensive failure of extreme capitalism". He named greed and fear as the "twin evils" at the root of the financial sector collapse. Obscene failures in corporate governance which rewarded greed without any regard to the integrity of the financial system were one of the factors behind the collapse, Rudd said.

Governments around the industrialized world have pumped billions of dollars into their financial sectors to bail out institutions, leading to charges that 'capitalism privatizes profits but socializes losses'. While senior banking executives seem to be getting away with corporate murder, the depositor and taxpayer have borne the brunt of it once again.

It is interesting to note that our past economic/financial managers have very tactfully avoided this situation for a very long time with the simple concept of working capital management in a corporate entity. Let's say, for example, that our imports are US$100 and our exports are US$25. Then out of the deficiency of US$75, US$30 is payable immediately compelling us to sell our nationalized assets to foreign investors to avoid default and generate excess for the time being, as well.

Anyway, *Economic Bailout* for Pakistan is on the cards whereby International Development Bank (IDB), Asian Development Bank (ADB), various other countries

including, above all, China have made firm commitments while Iran has showed its intention to provide electricity and deferred payment oil. International Monetary Fund (IMF) and World Bank are also providing aid on strict terms and conditions.

The State Bank of Pakistan (SBP) has provided liquidity of billions of rupees in the money market by relaxing various statutory reserve requirements while the Federal Board of Revenue (FBR) has slapped increased customs duties over various imported items post-budget.

Currently, the timing of some of these measures is uncertain; consequently, the trickle down effect of these measures might or might not be apparent during this recession period. However, these short term solutions are merely a shot in the arm of a terminally ill patient.

The real problems of generating economic activities, reducing unemployment, reducing unnecessary imports, increasing export and foreign exchange reserves have not even been touched upon, belying the fact that banks are withholding wealth which could generate economic activity and strong companies' shares would attract investors instead of creditors.

Infrastructure

At the outset, China has offered a solution to our power generation problem through two nuclear power plants while Iran has offered immediate supply of electricity. It is important to understand that it is easy to give soft term loans and insist on internal correction like broadening of tax base, more privatization etc. which may or may not be the real cause of our economic woes.

Our former financial managers concentrated on balance of payments only through privatization which has not only severely affected our existing industry but also badly affected our future expansion plans. A new section in relation to depreciation has been inserted in the Income Tax Ordinance, 2001 for the purposes of promotion of investments in selected zones. The Prime Minister has also recently announced some more investment incentives but one wonders if these measures are backed by any infrastructure capability in those areas.

Imports

We are still unable to grasp the concept of commercial importer. The World Trade Organization (WTO) regime is taking on the challenge of reducing regulatory duties and countries are increasingly trying to engage with this idea to improve their balance of payments. The main reason for this is that every country gives first preference to its local industry to generate employment and avoid unnecessary import bills.

However, Pakistan has done just the opposite. We have reduced our rate of advance income tax from 6 percent to 2 percent, we have introduced a very lucrative sales tax regime for importers, and we have put a next to none regulatory and compliance burden on importers.

Surprisingly, FBR has imposed a regulatory duty by increasing the tariff over hundreds of items but the devastating impact of reduced income tax at import stage, special sales tax regime, less regulatory burden, less compliance cost etc. are still the most convenient mode for any of the businesses, that is, tradable imports.

The devastating impact of such an import mechanism is not confined to imports of luxurious and consumable items, only, but this has also resulted in high import cost of raw material and capital goods. A sole agent importer may sell the raw material to any manufacturer, at any selling price, after being absolved from the payment of 2 percent advance tax at import stage.

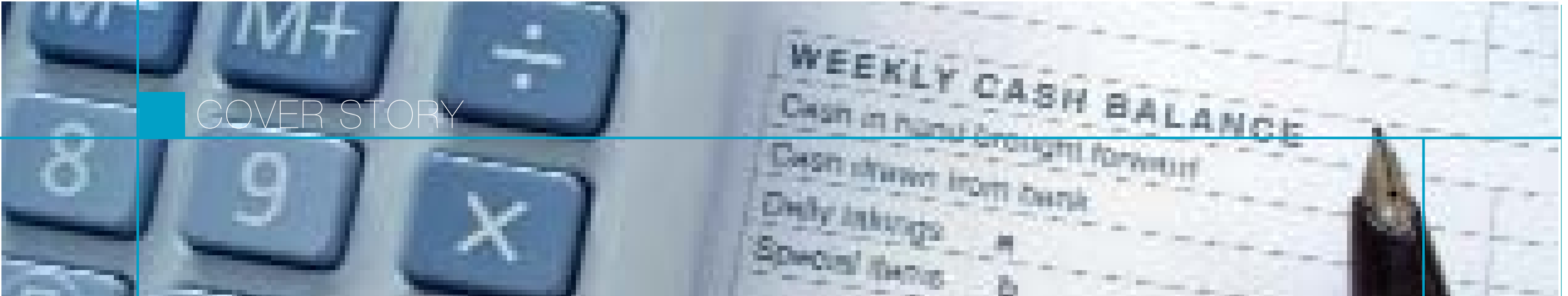
It is high time we reviewed our HS Code in depth and incorporated Income Tax rates based on such review of HS Code, instead of a mere 2 percent in the Income Tax Ordinance, 2001, and Sales Tax Rates on the same basis as in Sales Tax Act, 1990.

Such exercise should be based on market representation and comprehensive study whereby HS codes must be segregated into raw material, necessities, medical, capital goods and luxuries. In the absence of such policy, our widening difference in balance of payments, almost at 75 percent now, can be expected to cross 100 percent.

Export cum Import

It is also argued that apart from privatization of our nationalized assets, our former managers myopically exported wheat, rice and cotton to avoid the negative balance of payments default. This resulted in subsequent import of these items in much higher quantities and at much higher prices resulting in unnecessary increase of import bills.

One fails to understand the economic reasons behind such export cum import and government intervention. One also fails to understand the basis for such exports which are immediately imported on another basis. Such decisions when coupled with lowest quality issues at higher prices have severely affected our balance of payments.



Capital Gains

Exemption of Capital Gains on Shares to residents and non-residents has also depleted our foreign exchange reserves. Shares purchased at different prices and sold at different prices, not for the purpose of investment, but for the purposes of reaping the benefits of speculation, have hit us very hard.

This directly affects our foreign exchange when coupled with the gap in foreign investment and divestment in shares at our stock exchanges. It is usual for investors to invest when prices are low and play the speculation game when prices are skyrocketing. Consequently, divesting from the market involves outflow of foreign exchange.

Our non-aligned fiscal and monetary polices are unable to identify the differences between primary and secondary markets and between speculation and real investment. Consequently, such trading coupled with capital gains exemption will continue to deplete our foreign exchange reserves unless due correction is made.

Generating Economic Activity

We have become increasingly dependent upon imported tradable or consumable items. While our import bills are imploding, we seem to be more concerned with under-invoicing imported items instead of curbing the import of unnecessary items.

The core reason of this problem is the non alignment of our monetary and fiscal policy. This contradiction is evident from the fact that SBP was seeking government intervention on the widening difference in balance of payments, while FBR reduced taxes and duties on imported items in the current Finance Bill.

It is a pity that in 61 years, we have been unable to exploit our reserves in the Northwest and Baluchistan. While Afghanistan is negotiating with the Taliban, we are still inclined to use force in the North. We are paying the cost of this policy by not being able to exploit our natural reserves and by relying on reimbursable foreign aid. The present government must not only announce investment incentives for various industrial zones but should also concentrate on improving infrastructure development necessary for setting up industry, creating employment, increasing exports of value added products and the necessary exploitation of our resources.

Conclusion

Perhaps going back to the basics would work. For any business, it's all about people, not money per se. It is people who make business happen; money is just the corollary. Money is a measure of value through which there can be an exchange of goods and payment of debts. It is inevitable, therefore, that the current crisis is prompting a willingness to change views. The IMF, an institution charged with the promotion of free markets overseas, whose mantra during the economic crises in Asia and Latin America in the 1990s was 'less government is good government' is now talking about the need for regulation and oversight.

IMF Managing Director Dominique Strauss-Kahn notes that countries in Africa, including many of those with some of the lowest levels of market and financial integration and openness, are now set to weather the crisis with the least amount of turbulence.

The new investment incentives must be backed by infrastructure. We need to curb our shortsighted approach of export cum import. We need to understand the difference between speculation and real investment for the purposes of Capital Gains exemption. We need to exploit our natural reserves which would be subsequently used for the betterment of that particular area instead of relying on reimbursable foreign aid, and alienating our own people.

Mohammad Ashraf is an International Tax Advisor.

Remembrance

Ghulam Haider (R-1511) died in Karachi on May 22, 2008

Ghulam Haider passed accountancy exam of London Chamber of Commerce and Industry in 1975. He was awarded the Kasbati Memorial Gold Medal by the Institute on his outstanding performance in CA examination. He started his professional career with M/s Rahim Jan & Co., Chartered Accountants in 1983. He later entered into professional practice under the name and style of M/s Haider Shamsi & Co., Chartered Accountants in 1986 and continued until death. In March 2007, he was diagnosed with middle stage throat cancer. During treatment he lost his natural voice. This disability, however did not deter him and he continued practice till his last day with great courage and spirit.

Ghulam Haider leaves behind his wife, son and daughter.

In the backdrop of world financial earthquake

Moin M. Fuda

The year is 2004. Michael is a 28 year old man from Atlanta, Georgia. He wants to buy a $450,000 mansion in the brand new suburban development on the outskirts of Atlanta, but he doesn't have enough money to do so. Michael is earning $45,000 per year at an IT company where he has worked for the past six months and his decision making abilities have always been questionable. At 22, he leased a BMW on his credit card even though he worked as a pizza delivery boy. Within three months Michael wasn't able to pay his credit card bill and the BMW was repossessed. He is jealous that a number of his friends have bought houses and apartments and, therefore, he believes that he is entitled to live in a big fancy mansion with his wife.

So he meets Jimmy at a local one stop mortgage shop and shows him $4700 in his bank account. Jimmy, the mortgage broker, advises Michael that while he can't get him a 30 year fixed rate mortgage due to his poor credit score there is the "loan product that's perfect" for him called an Adjustable Rate Mortgage (ARM) because the interest rate is currently only 3%, and a 30 year fixed rate is at 5.7%. "Fixed rate mortgages," says Jimmy "are for old people carrying high rates because when they die the loan has to be paid by the insurance company, whereas ARM rates are for young people, offering attractive rates and if the interest rates go up, you can just call me and I will get it refinanced, and best thing is it's a piece of cake since I can get it for you at a down payment of $4500."

"Awesome!" says Michael "Where do I sign?" Being impulsive and fiscally irresponsible by nature, he never really stops to think about what would happen if the interest rates go up and he suddenly has to pay 6% or 7% interest. Jimmy, on the other hand, couldn't care less. He is not lending out his own money, he's only a mortgage broker. Besides, he gets a hefty commission each time he gets another ARM signed up. After Michael has left the office, Jimmy calls his pal Bill, the banker, at the mortgage department of the First Regional Bank of Georgia. "Bill," Jimmy says, "I've got another one for you. The loan is for $450,000- adjustable rate. Our guy has six months work history, but his credit is terrible, and he has no major assets except a $4500 down payment. Is that ok?" "Another subprime!" "Sure!" exclaims Bill. You see, a 'subprime mortgage' is a mortgage given out to people who are a high credit risk, like Michael. "Sign him right up, Jimmy; I'll have the money to you by closing." So is Bill totally nuts or just plain stupid? Actually, he's neither. He is not worried about non-payment of installments by Michael. In fact, as soon as the deal is closed, his mortgage is placed into a vast pool along with thousands of other subprime mortgages given out by the First Regional Bank of Georgia. This vast pool is then divided up into shares, each one is called a 'mortgage backed security' that can be bought and sold like stocks or bonds.

> So who's to blame? The blame is so large that it encompasses everyone, not just greedy Wall Street 'fat cats'. The Federal Reserve, the public, Wall Street itself, investors, auditors, credit agencies, and even the mortgage industry.

Now that Bill has thrown Michael's mortgage into a pool, he has to find buyers for these shares, but he doesn't have to wait long. The phone rings. It's Linda, the investment banker, from Lehman Brothers in New York City. "Do you have any mortgage shares for me to buy? We just can't get enough of them. We love mortgage shares because real estate is such a safe investment. I mean, even if the home buyers default on their mortgages, the home itself is great collateral. Real estate never goes down in value, so how can we lose? It's a win - win." "Well Linda," says Bill. "I do happen to have mortgage shares for you, but they're subprime shares. They're riskier than other types of shares. But don't fear- we called our friends over at AIG this morning and for a token fee they've agreed to insure the shares against default. Isn't that great?" "That's awesome! I'll buy all of the mortgage shares you have, since I have investors waiting around the world desperate to earn high yield," says Linda. You see, Alan Green Span had brought misery to these investors who could only earn 1.5%. After three years, in 2007 in suburban Atlanta, a number of new developments had sprung up, chock full of mansions that there weren't enough people to buy all of them.

Things for Michael aren't so wonderful. His ARM rates have risen placing him in danger of running out of money. In a pinch, Michael calls Jimmy the mortgage broker. "I would like to re-finance to the fixed rate mortgage." "You see, the thing is you are a bad credit risk, so I can't arrange refinance for you," says Jimmy. "But what about my house?" asks Michael. "Can't you use that as collateral?" "Yeah, about that house," responds Jimmy. "It's not worth what you paid for it, because they've built so many other mansions around here. We can't even sell the ones we have on the market now. I just can't get a bank to refinance someone like you with depreciating assets and bad credit. I'm sorry, buddy. I just can't help you. Have a good day."

Michael is now stuck. He doesn't have enough money to pay his mortgage and no one will refinance him because his credit is bad, and his house is worth nearly $300,000. He is not alone, either. In 2006 and 2007, a large number of subprime loans begin to default. All of a sudden, Linda and her buddies in New York are holding millions of mortgage shares since in the process they either could not sell or got greedy for higher yields and kept these in Lehman's books, and now these are worth a whole lot less than what was paid for them. Some, in fact, are worthless. And on top of this, the collateral behind the shares has decreased greatly in value.

Linda gets a phone call from Harry, who is a big-time investor in the Lehman Brother's hedge fund. "I got my statement today and I have lost $135 million in this quarter." "Well, you see, we invested money in mortgage shares and they're not doing so well right now, the market goes up and down and they'll come back. I'm sure," says Linda.

"But you told me that they were safe investment with the best rating and were also insured." Ok Harry don't you worry,' says Linda. "I will lodge a claim on AIG." "You do that, and in the meantime I am pulling out my money from Lehman." As people like Harry pull their money from Lehman, investor confidence crashes and small investors begin to sell their shares of Lehman Brothers. The further down the stock goes, the more people sell in a panic. All of a sudden everyone's selling and Lehman is running out of cash.

Desperate, Linda calls AIG where Hank tells her that they have a little issue there. She was the millionth person that had called that day asking for an insurance payout. Someone from Goldman Sachs had just asked him for $1 billion in cash two minutes ago over this subprime stuff. They just didn't know if they could pay them all, because they never anticipated all of them asking for insurance payouts at the same time.

Despondent, Linda calls Citibank and asks for a loan. "We need some cash because everyone is bailing on us. Loan us a couple of billion, please." "Hi Linda!" says George from Citibank. "You know, we pioneered this subprime business; we lost all that money on mortgage shares not to mention the money we lent to other investment banks. But we got out first. I mean FIFO, first in first out. Our Arab brothers have rescued us, and my bosses have told me not to lend money to anyone. Besides, your credit rating has been downgraded to junk bond status. I'm afraid we can't give you a loan. You're just too much of a risk. Sorry, Linda!"

The next day, Lehman Brothers goes bankrupt. Linda is fired. Bill and Jimmy are enjoying their new life styles in Hawaii since they made millions in commissions. Michael, after foreclosure of his mansion, is at his mom's house eating pizza. After Lehman's bankruptcy, panicked investors began to shell shares in all the other financial companies. As the selling gathered momentum, it became indiscriminate. Suddenly, the federal government realized that if it didn't step in to calm the markets, the entire banking system would face total collapse. With no more loans, no more credit and AIG's inability to pay claims, the entire U.S. and world economy would face not just recession but full-blown depression, hence, nationalization of AIG and a $700 billion bailout package.

So who's to blame? The blame is so large that it encompasses everyone, not just greedy Wall Street 'fat cats'. The Federal Reserve (Greenspan) for keeping interest rates unnaturally low, thus enticing people who could not afford to buy houses as well as not providing reasonable yield to investors. The public (Michael) for buying above their means, planning poorly for the future and spending money wastefully. The mortgage industry (Jimmy and Bill) for lending money irresponsibly to people they knew were terrible credit risks. Wall Street (such as Linda) for buying mortgage backed securities under the idiotic premise that they would never lose value, thus enticing the mortgage industry to lend without standards. Investors (like Harry) who in greed of higher yields did not care to read in between the wording of these bonds. Insurers (like AIG) for blind underwriting of mortgage backed securities that they knew they couldn't pay for, and auditors for certifying the accounts of Banks and Insurers without going deep into the quality of credit risks and the claim reserves, thereby avoiding qualifying their accounts. Credit agencies for not investigating the viability of the mortgage backed securities before issuing them high credit ratings and finally, regulators for failing to properly monitor lending and insurance underwriting standards.

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IPSAS - The Long Road Ahead

Ian Sanderson

The challenges of embracing change in public sector accounting

In November 2007 the World Bank issued a report entitled "Pakistan: Public sector Accounting and Auditing". The aim of the report was to support "more effective public financial management through better quality accounting and public audit processes in Pakistan and to provide greater stimulus for more cost-effective outcomes of government spending". One of the main recommendations of the report was the adoption of IPSAS (International Public Sector Accounting Standards); firstly the cash-basis IPSAS and then the accruals basis IPSAS.

Over 60 countries have plans in place to adopt IPSAS or have already done so, and these include Pakistan and its regional neighbours India, Sri Lanka, Bangladesh and Afghanistan. While the main reason for adopting IPSAS is to support better resource allocation decisions (knowing what you have, what you need, and the funding implications) the adoption of an international accounting framework in the public sector also sends out a positive signal to potential investors in a country. On a domestic level the adoption of high quality financial reporting standards will lead to a higher level of accountability for taxpayers' money and this should raise public confidence in government.

Obstacles to implementation - the need for political will and influence

There are many obstacles to be overcome in implementing IPSAS, and perhaps the greatest is achieving the buy-in of key stakeholders. One of the major problems in implementing a new accounting framework in the public sector is the ability of governments to combine the political will to change, with the political power to make change happen; these two attributes do not always go hand in hand.

While many leaders in developing countries are committed to openness and transparency they are often challenged by others within government whose commitment to change is not necessarily as strong. Words must be associated with deeds to prove a government's accountability; this is why strong political will must be aligned to the political power to break down ingrained vested interests.

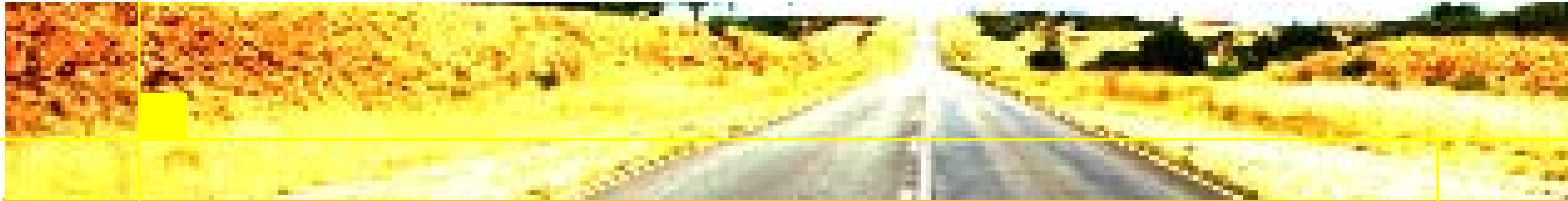
Centralised versus decentralised corruption

Where vested interests exist a new accounting system has the best chance of being successfully implemented in countries where corruption is "centralised". Centralised corruption is usually focused at the top echelons of a federal government, whereas "decentralised" corruption occurs at all levels of government. Where centralised corruption exists governments actually have the incentive to have a strong accounting system in place at provincial and district levels because it will allow those with vested interests to know what is happening at all levels of government and spot potential opportunities to spread their influence. In a decentralised system few people have the incentive to have an open and transparent accounting system because it will make them more accountable.

Where is most value added: reform in the public or private sector?

If one accepts that the aim of improving public sector accounting is to improve resource allocation and attract inward investment, but also accepts that those with vested interests will be resistant to change, is there an alternative way of investing in accounting which will improve resource allocation and economic growth?

The engine of financial growth and development is the private sector. To achieve sustained growth there is a point where private sector businesses need to have strong financial statements which will allow potential investors and lenders to make informed investment and



lending decisions. While this is not an issue for major publicly quoted companies (if a major company was to relocate to Pakistan, accountants would arrive on the next plane), accounting capacity issues are often significant in smaller companies.

If resistance to improve the quality of accounting in the public sector exists, an alternative approach is to focus more efforts on improving the accounting of small and medium sized enterprises which is something that Pakistan has done by developing two standards for small and medium sized entities. Such an approach can be supported by both government and companies; governments better know companies' profitability and how they should be taxed, while companies can prepare financial statements to the quality required by investors and lenders.

Embracing IPSAS

IPSAS are a set of general purpose accounting standards for the public sector. There are currently 26 accruals based standards and one-cash based standard. Most of the accruals based standards are based upon IFRS, and this supports the aims of both the IPSAS Board and the International Accounting Standards Board (IASB) to see convergence of accounting standards throughout the world. The IPSAS Board is the only international body which issues a cash-basis accounting standard.

In many developing countries there has historically been no public sector accounting framework; and this has contributed to wastage in public sector spending and increased opportunities for corruption; if you don't know what you've got its clearly harder to miss it when its gone. The cash-basis IPSAS is therefore an important step on the road to creating a transparent accounting framework for many developing countries. The implementation of the cash-basis IPSAS is often sponsored by a major donor agency such as the World Bank because it is seen as a tool to improve governance and accountability in the public sector.

What is the cash-basis IPSAS?

There is a lot more than meets the eyes to the cash-basis IPSAS. The cash-basis IPSAS has two parts. Part 1 describes the mandatory elements of the standard while Part 2 is not mandatory but provides a number of “Encouraged Additional Disclosures” which represent a transition basis for moving fully to accruals based IPSAS. One example of these encouraged disclosures is to provide details of a public sector organisation's property, plant and equipment at cost or at valuation; gradually as the organisation becomes more aware of what it owns and the respective value of its assets the progression towards accruals accounts becomes greater. It is interesting to note that governments often do not know the full range of assets that they own.

Some of the encouraged additional disclosures aim at increasing the transparency of public sector organisations through encouraging disclosure of government borrowings (e.g. their source and schedule of repayments), the entities that the public sector controls (e.g. the percentage of ownership, public sector voting power). Whether a public sector organisation will want to disclose such information will be a litmus test of public sector transparency.

Another interesting encouraged disclosure is that which considers related party transactions and should include “information about aggregate remuneration of key management personnel” (2.1.32). This type of disclosure often runs into difficulty because of the sensitive and personal nature of the disclosures. It is however, important to note that the IPSAS Board must reflect best practice when it issues a standard, even if it has no control in ensuring adherence.

Another recommended practice is that where an entity produces budgets it should include these in the financial statements alongside the actual financial outturn. There is no comparable international private sector accounting standard because such information would be considered too sensitive for private sector companies to disclose to their competition. The financial statements must disclose reasons for material variances and this will ultimately be a test for the Auditor General of Pakistan to ensure that such variance analysis reporting is true and fair.

Those governments which hope to migrate towards accruals based accounts will also be expected to adopt a cash flow statement as provided in IPSAS 2 *Cash Flow Statements.*

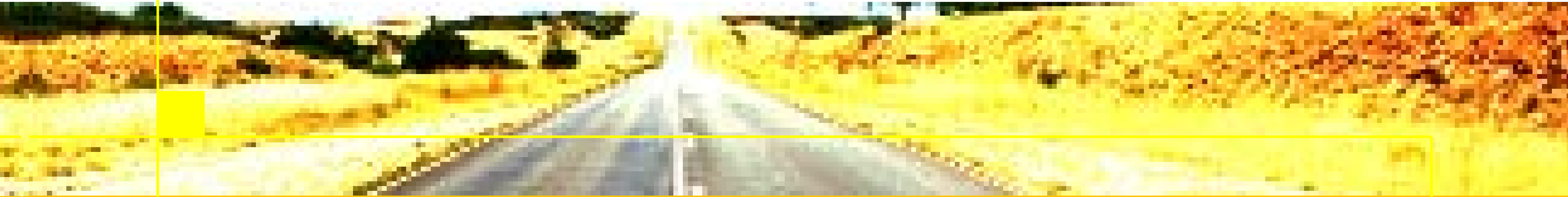
Issues raised by the World Bank

The World Bank report noted three specific gaps between the current public sector financial statements in Pakistan and IPSAS:

- ❑ Accounting policies and notes to the accounts are absent
- ❑ Controlled entities' financial statements are not consolidated
- ❑ Third party transactions are currently not included

How to address these issues

It will be a major challenge for the public sector accounting profession in Pakistan to close these gaps. The IPSAS Board frequently acknowledges the difficulty of making the transition to IPSAS by allowing generous transition periods when IPSAS are adopted. For example, the accruals based IPSAS 17 *Property, Plant and Equipment* allows 5 years to ensure that a complete and accurately valued set of assets appears in the financial statements, while the IFRS equivalent (IAS 16) allows no transition period.



Accounting policies and notes

Of the three issues highlighted by the World Bank the disclosure of accounting policies and notes is probably the easiest to address. However, while many of the required disclosures are not technically difficult, many of the encouraged additional disclosures may prove politically difficult for some governments to make.

Control and consolidation

The issue of control frequently proves difficult for public sectors adopting IPSAS. IPSAS requires that all entities which are controlled by another entity are consolidated into the financial statements of the controlling entity. Control is defined as *“the power to govern the financial and operating policies of an organisation so as to benefit from its activities”*. This definition is a lot more subtle than at first may seem the case. Control is not about the actual exercise of power but the *potential* to exercise power. This means that theoretically a company may exist with 100 per cent of shares in private hands, but if a government has the power through legislation to appoint the majority of the board of directors of the company, and thus govern the financial and operational policies of a company, the government has control of the company.

In practice this means that a public sector organisation will have to review its relationships with all its related businesses; this takes time and judgement, especially when a government may have created businesses to perform functions outside government. An example of this can be taken from Canada. In 2005 the Canadian Auditor General raised concerns about the accounting treatment of a number of foundations (charities) created by the government to distribute grants more effectively, but which in practice did not adhere to accepted accounting rules or definitions of control. Control boundaries from a financial reporting point of view are not necessarily the same as can appear in legislation.

The issue of how to consolidate controlled state owned enterprise (referred to as Government Business Enterprises under IPSAS) also becomes an issue under IPSAS. Often state owned enterprises produce accruals based financial statements. Interestingly consolidation of such state owned enterprises is easier under cash-basis IPSAS because the cash flow statements of the government and state owned enterprises are likely to be similar. The issue becomes more significant when the government moves towards accruals based IPSAS. It will then be necessary for state owned enterprises to have financial statements and accounting polices that can be consolidated. It is an interesting issue because it demonstrates the amount of effort that will be required to one day produce fully compliant IPSAS financial statements in the public sector.

Accountability is best served by timeliness

The cash-basis IPSAS states that “The usefulness of the financial statements is impaired if they are not made available to users within a reasonable period after the reporting date. An entity should be in a position to issue its financial statements within six months of the reporting date, although a timeframe of no more than three months is strongly encouraged” (1.4.4). The reason is to ensure that timely and accurate information is made available. This is not easy, and the standard states that “ongoing reasons such as the complexity of an entity's operations are not sufficient reason for failing to report on a timely basis.”

While transparency and accountability are clearly best served through the timely preparation and audit of financial statements, the level of technical capacity required to do this is significant. Auditing IPSAS compliant public sector financial statements in a timely way will be a challenge for the Auditor General.

Third party transactions

Accounts which do not include all revenue and expenditure streams are incomplete. Pakistan receives a notable amount of its funding from national and international donor agencies but these funding streams are not currently included in its public sector accounts. The cash-basis IPSAS requires that the cash flow statement shows in separate columns cash flows that the public sector organisation itself controls and any third party cash flows relating to cash paid for goods or services by the third party or obligations settled. Third parties can be of two types, they can be entities related to the organisation but where the organisation does not control the cash of the entity, or they could be donor agencies. Disclosure is only required when the organisation is formally informed by the third party or recipient that a payment has been made or received, or, when it has otherwise been verified. This may prove more difficult in practice than theory because of the timing of cash flows and the subsequent timing of notifications by donor agencies; elaborate tracking and recording systems may be required. The standard also requires the purpose of the third party assistance be disclosed which may be a politically sensitive issue.

The challenge ahead

The Pakistan public sector and its accounting profession will be challenged by the adoption and implementation of IPSAS. At present, financial reporting by the public sector, (especially by the central, provincial and local governments), is not based on any recognized accounting standards. Consequently, the adoption of IPSAS at these levels of government will significantly enhance the reliability of financial reports produced by such governments. It will not be easy, but the rewards of successfully rising to the challenge will be improved resource allocation and improved confidence in public sector accountability in Pakistan.

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Addressing Problems That Tear Families Apart: Why Good Governance Matters for Family Firms

A. Razzak Dawood

Introduction

Corporate governance is conventionally regarded as applicable in the domain of public corporations and family firms have long been excluded from the good governance debate; however, the fact that only15 percent of family-owned businesses survive until the third generation indicates that governance is also a crucial issue for family businesses. What causes family firms to fail the test of time?

In case of the Pakistani family businesses, the fall of Dacca and the subsequent massive nationalization of industries during the early 1970s was a time of great change. Events of that period placed a great deal of pressure on the weak fabric

While corporate governance is conventionally regarded as applicable to public corporations, family-owned companies are equally in need of sound governance mechanisms.

of business families, many of which fell apart immediately or weakened to the point that they were torn apart in subsequent years. While some may blame the events of those years for the failure of family firms, others say that "the fault, dear Brutus, lies not in our stars but in ourselves." If 1971 never happened, many business families would still have broken apart, perhaps a few years later. The reasons lie within those family firms.

Families are no different than any other institutions, even countries. They require values, codes of justice, fair play, and support for the weaker members of the family. They require a mechanism for redressing grievances and for having open and candid discussions.

Problems Faced by Family Firms

The Dawood Family Industries were unique in the sense that it broke up while the first generation was still at the helm of affairs and the second generation had just entered the business. Ahmad Dawood, who founded the Dawood family business, was an individual of many faces. To some he was a colossus and a captain of industry, but to others he was a tyrant. Some faced his wrath, others faced his affection. He was just the same with his family as with the family business.

He had a vision, he was ambitious, and, at the same time, he was ruthless. He could smell opportunity miles away and pursue his goals with tenacity. I am personally grateful to him for he sent me to England and USA for studies which allowed me to add to my intellectual capacity and my grooming. He placed Dawood Group of Industries on the map as a leading business house with a reputation for running profitable enterprises and paying dividends. Ahmad Dawood was a smart man, but not a wise one. He had little appreciation for the collective human capital and intellect in the Dawood family. He could not understand the importance of having guiding principles or checks and balances, and he gave little attention to elements required for institution building.

The Dawood family did have a family council; however, the objectives and governance procedures of the council were not clear, even to its members. It met at the whim of the chairman. From time to time, discussions were recorded but were later changed or not implemented. The family soon started to perceive the council to be ineffective and unjust. The members never discussed the most contentious issues, as it was too embarrassing to talk about them. Conversations avoided key issues such as the security of family members, ownership structure (as divided within the family), and the mechanism for an individual to leave the family business. There was no succession planning. All those and other issues led to internal pressures, disillusionment, and exasperation.

This experience led to the realization that the Dawood family could benefit greatly from managing the relationship between family members like a family business. These lessons apply in other countries and in other family businesses as well. For a family-owned business to have good governance within its enterprises, it must have good governance between the family members. Poor governance in the family leads to tensions that will inevitably spill over to the boards of various companies and then into the management.

The opposite of this scenario is also true - good governance in the family will lead to good governance in the company.

Family-owned businesses face unique problems with continuing their operations successfully over several generations due to governance issues.

Briefly, problems within a business family are summarized below:

- Very few families understand that their assets comprise three forms of capital: human, intellectual, and financial. Even fewer families understand that without preservation of their human and intellectual capital, they cannot preserve their financial capital; unfortunately, families often concentrate solely on financial capital.
- Many families fail to understand that preserving wealth is a dynamic process. Each generation of the family must maintain the wealth-generating spirit of the first, founding generation.
- Families often fail to measure properly the timeframe for successful wealth creation. Planning for the use of family's human and intellectual capital is too focused on the short term and on individuals rather than wealth creation mechanisms. The lifespan for a family business should instead be measured by generations, and long-term planning is essential.
- Families must also understand that fundamental issues of wealth preservation and good governance are qualitative, not quantitative. Most families measure success based on the size of their financial balance sheets. But without a qualitative assessment of human and intellectual capital, the family balance sheet is incomplete and ineffective in measuring whether a family is achieving its wealth preservation goals. Family wealth includes human behavior, teamwork, and understanding.

Creating and applying a system of good governance is crucial for the preservation of not just financial wealth, but also human and intellectual capital of family firms.

Qualitative issues crucial to a family business

- Is each family member succeeding and satisfied with the family business?
- Does the family provide incentives for leaders of each generation to stay in the family business and to listen to each member's concerns? Do family members know how to leave the family business amicably for retirement or other reasons?
- Are family stories being shared with younger generations? These stories are the glue that binds the family members together. Do all family members understand and accept that although good governance within the family over a long period of time is difficult, it is indispensable?

What Is To Be Done?

If a family is to function as a business, then it follows that a well-managed family business should have a statement of its purpose, values, and goals. The creation of such a statement is the starting point for the process of organizing a family to preserve wealth through good governance. There are several points to keep in mind:

- The objective of a system of family governance must be to align the aspirations of each individual family member with the goals of the family as a whole. Enhancing synergies between individual and family objectives encourages the long-term preservation of the family's wealth: its human, intellectual, and financial capital.
- A family's wealth consists primarily of human and intellectual capital; financial capital is secondary. Financial capital alone cannot provide long-term wealth preservation. What a family's financial capital can provide is a means to promote the growth of its human and intellectual capital. Without intellectual capital, even with all the money in the world, under-educated family members will not make optimal decisions. Therefore, the development of human and intellectual capital contributes to growth of financial capital.
- An explicit and voluntary statement of the family's values and goals is necessary to create a system of governance through which those family principles can be practiced. It ultimately allows for more effective wealth preservation. Each successive generation must reaffirm its commitment to this system of governance, including a process for settling family disputes and grievances. Any such governance system must recognize that family members will be willing to give up some freedom if they realize the greater benefit for doing so, and it also allows each member to play a role in the evolution of that system.

Conclusion

Each family has to decide what its objectives are. If the objective is purely to enhance financial capital, by any means and as fast as possible, then corporate governance is not for those families. If family leaders want a long-term strategy for wealth preservation, then corporate governance is a good beginning.

I am now a first generation family business owner. While waiting for my two sons to join the business, I concentrated on building professionalism in our companies. We have made some progress on good governance, but have much ground to cover to make our boards truly effective, to make various board committees operational, and build strong systems of checks and balances in all functional areas. My sons are now part of our family's firm. Once they have more experience and knowledge of the business, we will collectively begin the long journey towards good governance by setting out our purpose, objectives, values, and the form of governance that best suits us.

We will certainly address issues such as the role of women members of the family (in particular, daughters-in-law), retirement age, succession planning, education trust, security of members, and options for leaving the family business. The mere enhancement of financial capital is not the objective; rather, it is the long-term preservation of all assets through good governance, creating a lasting, multi-generational institution. If, 20years from now, one of my sons states that he is now a first generation family business owner, then I will have miserably failed. If my grandson says this, I will be very disappointed. If subsequent generations say this, then perhaps I didn't work hard enough.

Families that choose to enter the process of long-term wealth preservation face the daunting fact that, if they are successful, this process may never end. They have to commit to good governance practices for all generations to come. The result of good governance within the family and its companies is a family-based, professionally-run, continually growing institution. Many family leaders have such dreams. We will know in 100 years whose dream has come true.

This paper was published by the Center for International Private Enterprise (CIPE) Economic Reform Feature Service. A. Razak Dawood is the former Federal Commerce Minister and currently chairs the Pakistan Business Council. He is chairperson of the first family-owned Pakistani multinational company.

A True Islamic Financial System

Dr. Ahmad Kaleem

The Quran prohibits interest and offers trade and charity as alternatives. Being an Islamic state, Pakistan has twice attempted to introduce Islamic banking. Firstly, we tried to *Islamize* the entire financial system. After an unsuccessful attempt and loss of twenty years we allowed Islamic banks to operate parallel to conventional banks. Unfortunately no serious work has been done to understand whether mere *Islamization* of existing banks is the only viable solution, or is the existing Islamic banking setup moving towards another failure in future. Is there a need to review the whole idea of developing a true Islamic financial system?

Islamic banking in Pakistan was first introduced in 1979 when the government of General Zia-ul Haq decided to Islamize the whole financial system. With the conversion of all interest based depository accounts into profit and loss sharing basis, the process was announced to have been completed in June 1985. All banks showed a keen interest in the new system until the issuance of BCD circular No.13 of June 1984 which allowed banks to provide finance on mark-up and on buy-back agreement basis; buy-back agreements being nothing more than disguised forms of interest. This procedure was, however, declared un-Islamic by the Federal Shariat Court in November 1991.

Appeals were made against the judgment to the Supreme Court of Pakistan which gave its final judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. The Court also directed the government to set up, within a specified time frame, a commission and task forces for the transformation of the financial system, to achieve the objective.

> "Those who devour interest do not rise except as rises one whom Satan has smitten with insanity. That is because they say, 'Trade is also like interest;' whereas Allah has made trade lawful and has made interest unlawful....
>
> "(Ch 2:275).

In a meeting held on September 4, 2001 under the Chairmanship of the President of Pakistan, attended by officials of the Ministries of Finance and Law, Governor State Bank, Chairman and some members of the Council of Islamic Ideology, the State Bank of Pakistan decided to shift towards interest free economy in a gradual and phased manner without causing any further disruptions. Separate Islamic banks were allowed to operate parallel to conventional banks. In addition, conventional banks were also allowed to offer Islamic banking products through separate Islamic branches and Islamic windows.

Confusion starts to set in when trade is ideally translated as partnership (musharika) and joint venture (mudaraba) which are only the modes of doing trade not its kind. The concept is taken from the Holy Quran:

"Those who devour interest do not rise except as rises one whom Satan has smitten with insanity. That is because they say, 'Trade is also like interest;' whereas Allah has made trade lawful and has made interest unlawful..........."(Ch 2:275).

Usually this verse is not interpreted along with the successive verse *"Allah will blot out interest and will cause charity to increase"* (Ch 2: 276).

The quoted verses clearly direct human beings to replace interest with trade and charity. The concept of trade allows Islamic banks to earn profit while charity does not. This article explains in detail the concept of trade and charity and why they are offered as alternatives.

Trade can be divided into three broad categories i.e. deferred payment (murabaha), instant cash and advance payment (bai salam). A trader accepts deferred payment when either he has excess supply of commodities or when the customer cannot purchase on cash. Similarly, a trader demands advance payments when there is either shortage of commodities or the customer has excess cash and is looking for discounted prices. In all of the mentioned types of trade cash or money is used as a medium for exchange of goods or to store value, while it is the market forces which determine the profit margins.

Now I shall attempt to explain what types of transactions are declared 'forbidden'. Islam categorically explains that commodities and money should be exchanged in equal quantity and quality. Otherwise it is nothing but interest. For example, a person says 'if you give me Rs. 100 today I will give you a new note of Rs. 100 after three months'. This transaction cannot be declared as interest based because the quantity and quality of Rs. 100 note remains the same since the old and new Rs. 100 notes carry the same value. But if a person demands Rs. 110 against the actual lending of Rs. 100, this becomes interest and is prohibited.

The same rule of 'similar quantity and quality' applies in case of commodities to declare the transaction Islamic or un-Islamic. For instance, a person says 'if you give me one mound of wheat today I will return you the same one mound of wheat from the new harvest'. Although the quantity may be the same, but there are chances of differences in quality which can be inferior or superior. Even instant exchange of two different types of wheat without pricing them first can raise the issue of uncertainty (gharar) and is, thus, discouraged.

Charity is the second alternative to interest mentioned in the Quran. It is the transfer of funds from people having excess money towards people who are short of money. Islam declares charity among the five pillars of belief (iman). Its main aim is to discourage the unequal distribution of wealth and to promote the concept of brotherhood in society.

Here one should understand the characteristics of charity money which are different from interest based loans. Charity means transfer of ownership, possession and right of use of money to the recipient while a loan only transfesr possession and right of use of money from the lender to the borrower. It is the ownership of money against which the lender demands interest. That is why the Quran always refers to returns against Qard-i-Hasana towards Allah:

"If you lend to Allah a goodly loan, He will multiply it for you and will forgive you; and Allah is Most Appreciating, Forbearing" (Ch 64:17).

Loans are broadly divided into productive loans and consumption loans. Similarly human beings are categorized as zakat payers (the affluent) and zakat recipients (the poor). For loans for consumption purposes, Zakat and Sadaqat are the available alternatives mentioned in the Quran. Qard-i-Hasana has been signalled as the best available alternative for loans for productive purposes. On the flip side, the concept of trade is applied if rich people seek money for productive purposes as they are in a better position to absorb risk. But what if the rich seek loan for consumption purposes? Interestingly, the Quran advises believers to adopt a moderate life style (Ch 17:26…29) and earn through effort and hard work (Ch 53:39).

Thus, a truly Islamic financial system looks after the needs of all segments of society. It even defines the basic consumption needs (food, clothing, water and shelter) in Chapter 20, verses 118 and 119. At the end, I would like to promote the idea of Islamic charity banks running parallel to other Islamic banks, whereby interest free loans are available to the less privileged on flexible terms and conditions.

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IFAC News

The Global Financial Crisis

IFAC Addresses Credit Crisis Issues

As the consequences of the credit crisis continue to unfold, the International Federation of Accountants has considered what role it can play in rebuilding investor confidence in capital markets. IFAC's focus has been threefold:

1. To increase awareness among preparers and auditors of existing and newly developed guidance that can assist them in providing assurance in relation to reporting on financial instruments;
2. To support convergence in the reporting of financial instruments, while at the same time strongly supporting (the continuation of) fair value accounting since reducing transparency is not in the interests of investors; and
3. To participate in and promote discussions of best practice with respect to the audits of financial institutions and other organizations that are affected by the current crisis.

Relevant Guidance

New Audit Practice Alert

In October, the staff of the International Auditing and Assurance Standards Board (IAASB), issued a practice alert entitled *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*. The alert was developed following consultation with the IAASB's Task Force on Fair Value Auditing Guidance, which is considering the need for new or modified guidance in light of current marketplace issues. The purpose of the alert is to highlight areas within the International Standards on Auditing (ISAs) that are particularly relevant in the audit of fair value accounting estimates in times of market uncertainty.

The alert directs auditors to the recently revised ISA 540 (Revised and Redrafted), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which was influenced by the changes in the credit markets during 2007. While not effective until audits of financial periods commencing on or after December 15, 2009, it includes guidance that is likely to be useful to auditors planning their 2008 engagements.

Convergence in Fair Value Standards

IFAC has monitored the initiatives of the International Accounting Standards Board (IASB) and in response to their initiatives to remove differences in the application of fair value accounting in different jurisdictions, IFAC has issued a press release expressing support for convergence in reporting on financial instruments. The release also indicated IFAC's opposition to attempts within Europe and the United States to change more radically the use of fair value accounting without adequate due process. In particular, IFAC considers that making changes at a national or regional level that exacerbate reporting differences would serve to further confuse financial markets and would result in a reduction of confidence in financial reporting - exactly the opposite of what is required in current circumstances.

IFAC believes that the additional guidance given to those applying both accounting and auditing standards relating to fair values has been very valuable and will contribute to the public interest through more consistent application of the standards.

IAASB Nears Finalization of the Clarity Project with the Issuance of Eight Standards

The International Auditing and Assurance Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC), moves closer to completion of its Clarity Project* with the release of seven clarified International Standards on Auditing (ISAs) and one clarified International Standard on Quality Control (ISQC), following the consideration and approval by the Public Interest Oversight Board (PIOB) of the due process. To date, the IAASB has released 29 final redrafted ISAs and one final redrafted ISQC in the new clarity style.

Titles of the newly issued standards are as follows:

➡ International Standard on Quality Control (ISQC) 1 (Redrafted), *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*
➡ ISA 220 (Redrafted), *Quality Control for an Audit of Financial Statements*
➡ ISA 500 (Redrafted), *Audit Evidence*
➡ ISA 501 (Redrafted), *Audit Evidence-Specific Considerations for Selected Items*
➡ ISA 505 (Revised and Redrafted), *External Confirmations*
➡ ISA 520 (Redrafted), *Analytical Procedures*
➡ ISA 620 (Redrafted), *Using the Work of an Auditor's Expert*
➡ ISA 710 (Redrafted), *Comparative Information-Corresponding Figures and Comparative Financial Statements*

The PIOB has also considered and approved the due process of four additional ISAs that were approved by the IAASB at its September 2008 meeting. However, in finalizing ISA 210 (Redrafted), *Agreeing the Terms of Audit Engagements*, the IAASB approved conforming amendments to the following four reporting standards:

➡ ISA 700 (Redrafted), *Forming an Opinion and Reporting on Financial Statements;*
➡ ISA 800 (Revised and Redrafted), *Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks;*
➡ ISA 805 (Revised and Redrafted), *Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement;* and
➡ ISA 810 (Revised and Redrafted), *Engagements to Report on Summary Financial Statements.*

The IAASB agreed that these four ISAs will be issued only after the PIOB has considered and approved the due process applied to ISA 210 (Redrafted), which is expected in February 2009. The IAASB recognizes that the four reporting standards present fewer implementation challenges than other ISAs, and so the interest in issuing a final text including conforming changes outweighs the desire to make them immediately available.

IAASB Chair John Kellas commented on the IAASB's progress: "The approval of the twelve standards now cleared by the PIOB made the IAASB's September meeting one of its most productive. It also kept us firmly on our timetable for completion of the Clarity Project by the end of 2008. By issuing eight of these standards today we are fulfilling our commitment to make the standards available as soon as practicable. As noted in the Clarity Project Update, early attention given to implementation of the clarified ISAs is of the utmost importance."

In addition to ISA 210 (Redrafted), at its meeting last week the IAASB approved new ISA 265, *Communicating Deficiencies to Those Charged with Governance and Management*, and ISA 402 (Revised and Redrafted), *Audit Considerations Relating to an Entity Using a Service Organization*. Subject to PIOB approval, these ISAs will be released in March 2009. The IAASB has also agreed to changes in the approved clarified ISAs as a result of a review for consistency and other matters of clarity; they will be made available on the IAASB's website in early 2009.

The IAASB considers that, with its approval of the final three ISAs (subject to PIOB approval) and its review of consistency, its work in redrafting its international standards under the Clarity Project is now complete.

The complete set of clarified ISAs will be effective for audits of financial statements for periods beginning on or after December 15, 2009. The ISAs can be downloaded free-of-charge from the IFAC online bookstore at http://www.ifac.org/store. The IAASB also plans to publish the set of clarified ISAs in a handbook, expected to be released in April 2009.

* Key elements of the Clarity Project drafting conventions include: establishing an objective for the auditor with respect to the subject matter of each standard; clearly distinguishing requirements from guidance on their application; avoiding ambiguity through eliminating the present tense to describe actions by the auditor and using more imperative language where a requirement was intended; and other structural and drafting improvements to enhance the overall readability and understandability of the standards.

CULTURAL CONFLICTS IN IMPLEMENTATION OF INTERNATIONAL ACCOUNTING STANDARDS:
Hofstede's Theory of the Relationship between Accounting and National Culture

Over the years several empirical studies have examined the effect of national culture on accounting. One of the most important of those is Geert Hofstede's seminal (1980) work, which represents the most extensive work on cross-cultural differences. From attitude surveys collected from approximately 116,000 IBM employees across 39 countries, Hofstede identified four underlying value dimensions along which each country can be positioned. Hofstede defines *culture* as 'the collective programming of the mind which distinguishes the members of one human group from another', and *values* as 'a broad tendency to prefer certain states of affairs over others.'

These societal values determine the parameters within which certain professions, including accountancy, function:

- ❑ individualism versus collectivism defines the degree of interdependence among individuals in a society. Auditors in collectivist cultures may be less likely to report control weaknesses or illegal activities of their clients.
- ❑ 'large or high power' distance versus 'small power' distance refers to power inequality versus equalization of power. It has been suggested that in large power distance cultures, auditors may be more willing to give into pressure from powerful clients, or to obey superiors' requests for unethical behavior.
- ❑ strong versus weak uncertainty avoidance(*uncertainty avoidance* refers to employees' desire to avoid ambiguous or uncertain outcomes). This refers to societies that maintain rigid codes of behavior and are intolerant towards non-conforming people versus societies that maintain a relaxed and casual atmosphere and are more tolerant towards deviance. For example, in high uncertainty avoidance cultures, any action which is not specifically prohibited by professional standards will be more likely to be judged as acceptable.; and
- ❑ masculinity versus femininity, that is the way a society allocates social roles to the sexes. In more masculine cultures there is a greater emphasis on gaining power, money and status. Employees in more masculine cultures are more likely to engage in behavior such as under reporting of time, or omission of auditing procedures to meet budget goals.*

In 1988, Gray extended Hofstede's model by overlaying accounting values and systems and their links to societal values and institutional norms. Gray posits that accountants' value systems are related to and derived from the unique societal values in each country. Essentially, accounting values, in turn, affect accounting systems, therefore, cultural factors directly influence the development of accounting and financial reporting systems at a national level.

Gray identifies four accounting value dimensions that can be used to define a country's accounting sub-culture:

- ❑ professionalism versus statutory control;
- ❑ uniformity versus conformity;
- ❑ conservatism versus optimism, and
- ❑ secrecy versus transparency.

In the backdrop of cross culture trading and global stock markets, the issue of corporate disclosure has gained immense significance. In a study titled *Accounting Disclosure in Companies listed on the Egyptian Stock Exchange* (Dahawy & Conover 2007) * the authors conclude that though disclosures in actively traded Egyptian companies are detailed and comprehensive, what is noteworthy is that these requirements are based on the International Accounting Standards (IAS) requirements and not on the

A	Denmark, Sweden, Ireland, Britian	Small power distance, weak uncertainty avoidance (village market)
B	New Zealand, Norway, Canada, US, Australia, Netherlands, S. Africa	
F	Denmark, Sweden, Ireland, Britian	Large power distance, weak uncertainty avoidance (family)
G	Singapore, Hong Kong	
D	Italy, France, Belgium, Spain, Portugal, Greece, Korea, Japan, Brazil, Mexico	Large power distance, strong uncertainty avoidance (pyramid of people)
E	Iran, Pakistan, Taiwan, Thailand, Ecuador, Arab region	
C	Switzerland, Finland, Germany, Austria, Israel	Small power distance, uncertainty avoidance (well-oiled machine)

information needs of the users. The research paper concludes that international accounting standards are partly inconsistent with Egyptian culture and socio-economic environment where insider trading, corruption and exchange of information between related parties do not, generally, raise many eyebrows.

The study lists examples of accounting policy disclosures and major items that companies fail to comply with. Accounting policy disclosures include:

a. Policies related to consolidated financial statements (44 percent). Since the Egyptian tax code prohibits consolidated reporting, Egyptian companies must contemplate reporting one set of unconsolidated financial statements to local tax authorities, and another set of consolidated financial statements to satisfy the requirements of international accounting standards. The best way for Egyptian companies to deal with this dichotomy is to ignore the IAS requirements and present unconsolidated financial statements.

b Leasing (45 percent). IAS leasing standard contradicts local leasing law; and

c . Treatment of intangible assets (25 percent). The standard for acceptable treatment of intangible assets was introduced in to the Egyptian market as recently as 2003.

According to Nobes and Parker (2004) in addition to environmental factors --- legal systems, sources of external finance, taxation systems, representation by professional accounting bodies, historical inflation, economic and political events --- culture is another factor that is seen as an influencer on international accounting practice and financial reporting. Differences in culture can be used to explain international differences in accounting practices.

Conclusion

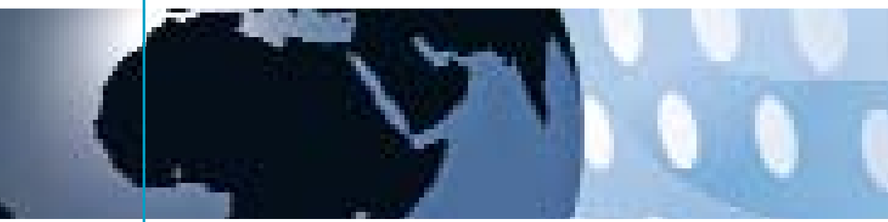
As countries move towards harmonization of international accounting standards, the Hofstede-Gray model provides important clues to understanding how local cultural values may seep in to the accounting treatment and ultimately impact financial disclosure.

The International Accounting Standards Board (IASB) is actively pursuing the formulation of an international set of standards that would conform to the cultural and environmental needs of all member countries, and at the same time fulfill the goals of the IASB to develop and harmonize accounting practices all over the world.

Hofstede's proposition that culture is the ultimate form of control, since human beings do as they are socially programmed to do, has implications for accounting professionals as they operate in an environment where market forces increasingly determine the manner in which organizations are controlled

* William E. Shafer, L. Jane Park, *An Investigation Of Cultural Differences In Accounting Students' Ethical Decisions* (California State University, Los Angeles)

* Khaled Dahawy, Teresa Conover, *Accounting Disclosure in Companies listed on the Egyptian Stock Exchange* (The American University in Cairo and The University of North Texas); Middle Eastern Finance & Economics ISSN:1450-2889 Issue 1 2007 EuroJournals Publishing Inc. 2007



World in Focus

GOP Reveals Plans for Taskforce on Investor Protection

Federal Minister for Investment, Senator Waqar Ahmad Khan has said that a special taskforce comprising officials from the ministries of investment, finance, interior and defense has been set up to safeguard investor interests. The Ministry has an ambitious plan to generate US$20 billion in foreign investment by end of 2009. Government of Pakistan is offering incentives in the form of tax breaks, 100 percent repatriation of capital and security. Ten year tax exemption will be guaranteed to investors who help set up a special commercial zone. Investors from the UAE and GCC countries are being targeted for investment in agricultural farming projects, and leasing and transfer of land will be facilitated by the Ministry.

Pakistan's CPI Rises 26.48% in a Year

Pakistan's Consumer Price Index (CPI), a key indicator of inflation, rose 24.68 percent in November from last year, according to the Federal Bureau of Statistics. Average inflation in the first five months of fiscal year 2008-09 (July-June) is 24.65 percent, compared to 7.85 percent in the corresponding period last year. The International Monetary Fund, which has approved a $7.6 billion bailout package for Pakistan, has projected inflation at an average of 23 percent. State Bank of Pakistan has projected inflation at 20 to 22 percent in fiscal year to June 30. Pakistan's inflation rate for fiscal year 2007-08 was 12 percent.

Iranian Banks Issue CDs with Total Ceiling of 1bn euros

With a 70 percent fall in oil prices since July, the Iranian central bank has decided to allow all banks, most of which are state owned, to issue certificates of deposit (CDs) with a total ceiling of 1 billion euros (US$1.33 bn) with maturities ranging from one to five years and denomination in euros, yen or dirhams. This is being seen as a rare move by the world's fourth largest producer of crude to tap investment for loans in non-Iranian currencies. The central bank estimates Iran's foreign reserves at around US $80 billion. Analysts say international credit conditions may make it difficult for Iran to raise funds, and US and UN sanctions may deter investors. The government maintains the existence of what it calls 'wandering capital' in search of opportunities such as non-resident Iranians and investors from Middle East and Asia who might be interested buyers of the CDs.

EU Accepts US Accounting Standards

The European Union has taken the final steps this December to accept US accounting rules, but was unable to resolve US concerns over chicken trade and new EU rules on credit rating agencies. The United States already recognizes International Financial Reporting Standards as adopted by the EU. Now that the EU will recognize US rules, companies will most likely be able to cut costs by not having to convert to international accounting standards.

A recent US Securities & Exchange Commission proposal to simplify the filing of financial statements in the U.S. for non-American companies by eliminating the need for "reconciliation" (quantitative comparison and explanation of differences) between European and U.S. accounting standards was welcomed by the European Commission. The Commission also noted the need to remove this reconciliation requirement for European issuers using International Financial Reporting Standards as adopted by the EU.

Egypt Short Listed as Top Three Property Investment Destinations

Egypt's real estate market is catching global attention as house prices rise and new developments spring up in key areas of Cairo (such as New Cairo), Hurghada and Sharm

Al Shaikh. Tourism in Egypt has doubled between 2001 and 2006 and 13 million visitors are expected in 2008. Investment was boosted by the free float of the Egyptian pound in 2003, and tourism has boosted short term property rentals. A mortgage law passed in 2001 allows banks to repossess properties and evict defaulting owners. Egypt benefits from investment from the Gulf region. The government of Prime Minister Ahmad Naseef has slashed tariffs and modified investment regulations. Registered property can not be sold or rented for the first five years. For unregistered property, there is no limit on sale or lease but the property is subjected to a minimal capital gains tax. To avoid formal registration, a 'signature validity court verdict' allows immediate resale. All properties can be bought freehold, except in Sharm Al Shaikh where 99-year leases are available.

Books

Financial Risk Management:

A Practitioner's Guide to Managing Market and Credit Risk

Steve L. Allen

Steve Allen's book is being recommended as an excellent read for both seasoned risk professionals and for any professional seeking to understand modern risk management. He has made a complex topic understandable and has provided the necessary tools to help people sharpen their own intuition about risk exposure and how to manage it.

The book begins with basic concepts and builds carefully to the practical and theoretical ideas necessary for dealing with the complexities of the most sophisticated and relevant financial instruments today.

Available@amazon.com

Price: US$80.00

The Granularity of Growth:

How to Identify the Sources of Growth and Drive Enduring Company Performance

Patrick Viguerie,
Sven Smit and Mehrdad Baghai

While growth is a top priority for companies of all sizes, it can be extremely difficult to create and maintain- especially in today's competitive business environment. In order to achieve this goal you need to think through the growth challenges your organization faces and follow a detailed approach that will allow you to uncover, understand, and capture potential growth opportunities. Based on an extensive quantitative study of corporate growth, this book offers powerful new insights on how companies can excel in this essential endeavor. It skillfully demonstrates the problem with the broad-brush way that many modern companies describe their business opportunities - "China is where the action is" or "Aging will generate increased demand for healthcare" - and discusses how real growth can be found at a much more granular level, in 'pockets of opportunity' within all industries. Written in an engaging and informative style, *The Granularity of Growth* reveals why growth is so important, what enables certain companies to grow so spectacularly, and how to ensure that growth comes from multiple sources as you take both a broad and a granular view of your markets.

Available @amazon.com

Price US$29.70

Built to Last: Successful Habits of Visionary Companies

Jim Collins and Jerry I. Porras

What makes a visionary company? This book, written by a team from Stanford's Graduate School of Business, compares what the authors have identified as 'visionary' companies with selected companies in the same industry. The authors juxtapose Disney and Columbia Pictures, Ford and General Motors, Motorola and Zenith, and Hewlett-Packard and Texas Instruments, to name a few. The visionary companies, the authors found out, had a number of common characteristics; for instance, almost all had some type of core ideology that guided the company in times of upheaval and served as a constant benchmark. Not all the visionary companies were founded by visionary leaders, however. On the whole, this is an intriguing book that occasionally provides rare and interesting glimpses into the inner workings and philosophical foundations of successful businesses.

Available@amazon.com

Price US$18.00

Management Lessons from the Obama Campaign: Preparation, Persistence, Execution

Barack Obama's sudden surge in the polls in early October before the US Presidential elections reflected two years of preparation that preceded it, his persistence in staying on his policy course of Change, and his flawless execution. As a result, he emerged as the winner

In contrast John McCain's presidential campaign changed tactics ever so often without any long-term direction. It kicked off with an overemphasis on McCain's military service and years in the US Senate, to highlight Obama's lack of experience, then a shift to McCain as an agent of change in American politics, and back again to McCain's seniority and service. The final nail was Sarah Palin's nomination as Vice President despite her apparent lack of exposure to international policy. Reports of infighting between John McCain's and Sarah Palin's campaigns showed lack of discipline and panic under pressure. As a result John McCain lost an election that he was poised to win.

Many good strategies fail due to poor execution when companies are unable to get the right message across. They jump from one strategy to another without taking the opportunity to realize what works and what doesn't. Good ideas are rejected because they sound “strange”. The key to success is really to understand what makes a company different, then formulate a strategy that celebrates that difference. And stick to that strategy till it delivers.

Barack Obama not only devised a brilliant strategy, he also made sure he got the right message across directly to those whom he needed to mobilize. In the end, it was his flawless execution that helped him realize his goal.