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469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Which Way is Pakistan Heading? - 2 [1]
Politics of an Economy on the Brink

Shahid Javed Burki[2]

'The past is not dead. In fact it is not even past': William Faulkner

Abstract

This Working Paper, the second of a three-part series, examines the performance of Pakistan's economy since 2008. In February of that year, elections were held that brought to power in Islamabad a political party -- the Pakistan People's Party (PPP) -- which was resolutely opposed to the rule by the military. Its main preoccupation in the first few months of its rule, therefore, was to force General Pervez Musharraf to give up the presidency. This goal was achieved in August when the president resigned. A month later Asif Ali Zardari, the PPP's co-chairman, was elected to the office vacated by Musharraf. Once in full political power, the party governed poorly. It allowed the country's economy to slip into a recession that has lasted for five years, the longest in history. The paper suggests that, while some external factors and natural disasters damaged the economy, bad management was the main reason for the economic downturn. Poor

[1] This paper by Mr Shahid Javed Burki is the second in a series of three Working Papers by him on the situation in Pakistan as of mid-August 2012.

[2] Mr Shahid Javed Burki is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be contacted at sjburki@yahoo.com. The views expressed in this paper are those of the author and do not necessarily reflect those of ISAS. During a professional career spanning over half a century, Mr Burki has held a number of senior positions in Pakistan and at the World Bank. He was the Director of China Operations at the World Bank from 1987 to 1994 and the Vice President of Latin America and the Caribbean Region at the World Bank from 1994 to 1999. On leave of absence from the Bank he was Pakistan's Finance Minister, 1996-97.

governance not only resulted in increased corruption but also in allowing serious electricity and natural gas shortages to take a heavy economic toll. With corruption increasing the cost of doing business and with severe shortages of some vital inputs, there was a significant decline in investment by the private sector. At the same time the country's relations with the United States deteriorated to the extent that there were calls in America for suspending all aid to Pakistan. The result was a sharp decline in the badly-needed external capital. The country failed to make the adjustments needed in its fiscal policy to compensate for the decline in external flows by increasing domestic resource mobilisation. This meant that public sector investment also declined. The two combined – declines in private and public investments – means that slowdown in the rate of economic growth is likely to persist for some time. In sum, the paper suggests that the economy has been driven to the edge of an abyss from which it needs to be pulled back. That will require concerted action on a number of fronts.

Economic Performance, 2008-12

From 2002 and until February 2008 when General Pervez Musharraf allowed people of Pakistan to vote for a new parliament, the Pakistani economy performed well.

<u>Table 1:</u> Economic Performance 2001-2012

	GDP growth %	**Incremental capital-output ratio**	**Volatility of Growth %**	**Extent of balanced growth**	**Gross Domestic Capital formation (% GDP)**	**National Savings as % of Investment**	**Private Investment as % of Total Fixed Investment**	**Manufacturing growth rate**
2000-01	2	9.05	-2.2	7.18	17.2	95.8	64	9.3
2001-02	3.1	5.59	-0.2	4.79	16.8	110.7	72.7	4.5
2002-03	4.7	3.72	1.4	4.04	16.9	123.1	73.8	6.9
2003-04	7.5	2.1	3.9	13.27	16.6	108	72.4	14
2004-05	9	1.86	4.8	9.09	19.1	91.5	74.3	15.5
2005-06	5.8	3.15	0.5	11.83	22.1	82.3	75.6	8.7
2006-07	6.8	2.88	0.8	4.85	22.5	77.7	72	8.3

2007-08	3.7	5.18	-3.1	4.07	22.1	61.5	73.2	4.8
2008-09	1.7	9.42	-4.9	4.6	18.2	68.7	74	-3.6
2009-10	3.8	3.98	-1.6	4.93	15.4	85.1	73.9	5.5
2010-11	2.4	6.9	-2	5.08	13.4	103	72.3	3
2011-12								

Source: The Institute of Public Policy, The State of the Economy, 2012: The Punjab Story, Lahore, 2012, Table A1, p. 146.

Growth in this five-year period averaged 6.8 per cent a year. In 2004-05, the economy grew by the highest rate ever in its history, nine per cent. As shown in Table 3, the rate of growth fell precipitously after the military handed over full power to a coalition government in Islamabad led by the Pakistan People's Party. The average rate of growth in 2007-12 was only three per cent a year, 76 per cent less than the average for the previous five years. As the data of Table 3 shows there were a number of changes in the way the economy performed under the new government, not just in the decline in the rate of growth. The economy became considerably more volatile with the volatility index turning negative in all the years of the democratic regime. Incremental capital output ratio also jumped, reaching a historical high of 9.42 in 2008-09, indicating that much more investment was needed to produce growth. The economy, in other words had become very inefficient. A number of factors contributed to increasing inefficiency. These included severe electricity and natural gas shortages as well as growing incidences of corruption. The latter increased the transaction costs for the investors. Gross domestic capital formation also fell to one of the lowest in history – to only 13.4 per cent in 2010-11. This was an indication of loss of confidence on the part of the investment community, both domestic and foreign, in the country's economic future. There was also decline in the proportion of investment financed out of national savings which meant that the dependence on foreign flows increased. However, largely as a result of the tension between Pakistan and the United States in 2011, external capital flows also began to decline. This trend was reversed following the 3 July 2012 statement by the US Secretary of State, saying 'sorry' for the earlier, 26 November 'friendly fire', attack that killed two Pakistani soldiers. Pakistan's relations with the United States and how they affected the availability of external finance are discussed in greater detail in a later section.

There were several reasons for the economic decline over which the government presided over by President Zardari had little or no control. In 2008-09, the world experienced the worst economic downturn since the Great Depression of the 1930s. While the emerging markets that had closer links with those of the developed world were more affected, Pakistan also suffered.

The demand for many of its products declined, hurting export earnings. This period also saw a large increase in the price of oil, an important import commodity for Pakistan. This increased the country's import bill putting further pressure on the external account. The country also had to deal with two natural disasters – floods in 2010 and 2011. The 2010 flood had few precedents in history and did enormous damage to the economy. 'Pakistan experienced extraordinary rainfall in mid-July 2010, which continued until September 2010. The result was unprecedented floods affecting the entire length of the country. The floods have been the worst since 1929,' wrote the World Bank and the Asian Development Bank, in a joint assessment of the damage caused. This was carried out at the request of the government. The loss to the economy was estimated at close to US$ 10 billion or 5.8 per cent of the GDP while 20 million people were affected directly or indirectly and 1.6 million houses were damaged or totally destroyed[3]. This disaster was followed by another flood that, while not as damaging as the one in the previous year, still took a heavy economic toll, particularly in the province of Sindh.

The way the United States fought the war in Afghanistan also had negative consequences for Pakistan. Washington's extensive use of unmanned aircraft – the 'drones' to attack the groups that had carved out havens in Pakistan's tribal areas while targeting the American forces operating in Afghanistan – created enormous resentment in the country. Some of the militants who were attacked by the United States held the government in Pakistan responsible for the American activity in the tribal belt. They used suicide bombers to attack Pakistan's military installations and large urban centres. There were negative economic consequences of the rise of domestic terrorism. The government estimated the economic loss at US$ 60 billion since it assumed power. The Lahore-based Institute of public Policy estimated that terrorism had reduced the rate of growth in GDP by one percentage point a year[4].

Even when factoring in these negative developments, a significant part of the poor performance of the economy was the result of poor governance by the civilian government that took office in March 2008. This manifested itself in many ways, two of which were critical for the performance of the economy – increase in corruption and the failure to remedy a number of emerging supply side problems, in particular in the sector of energy.

Like most societies, Pakistan was never free from corruption, in particular by those who held high office. And, like most states, the state in Pakistan made many attempts to establish institutions that would address the problem to the satisfaction of the citizenry. There were many attempts made over the past 60 years to hold accountable those who were believed to have made personal gains using the power vested in them by the offices they occupied. Soon after Pakistan

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3 Asian Development Bank and the World Bank, Pakistan Floods 2010: Preliminary damage and the needs of assessment, Islamabad, Pakistan, November 2010.

4 Institute of Public Policy, State of the Economy, Pulling Back from the Abyss, 2010.

gained independence, public resentment of corruption among those occupying the seats in the national and provincial assemblies led to the promulgation of the Public and Representative Office Disqualification Act (PRODA) in 1949. The PRODA, however, was used mostly for political purposes, to silence the vocal opposition to the administration headed by Liaquat Ali Khan, the first Prime Minister, as he wrestled to provide the new country a constitutional order. This was followed by Elected Bodies Disqualification Order, EBDO, in August 1959 by the martial law government of Ayub Khan. The order led to the removal from the political landscape a number of active politicians who, in the jargon of the day, were 'ebdoed'. Historians have seen the EBDO as an effort by the military government to disable a number of senior politicians who could have offered some challenge to military rule. According to one count, 78 politicians were barred from holding public office, a large number from East Pakistan (today's Bangladesh)[5].

One of the more serious attempts at creating a system of accountability was made by Prime Minister Nawaz Sharif during his first term in office (1990-93). He had the National Assembly adopt the Ehetesab Ordinance, using an Arabic word, meaning accountability. Saif ur Rahman, a trusted associate of the prime minister, was appointed to manage the investigative side of the effort[6]. However, with intense rivalry between Sharif and Benazir Bhutto, the accountability administration spent a significant part of its time and the resources placed at its disposal to harass political opponents. In other words, most of the efforts were either politicised or were themselves corrupted. The most elaborate attempt in this direction was made by the administration of General Pervez Musharraf, when in 2000 the National Accountability Bureau (NAB) was established. A general in whom Musharraf had a great deal of trust was put in charge. The NAB was given investigative authority and had its own system of courts. However, in keeping with tradition, this establishment too was politicised. In 2007, Musharraf promulgated the National Reconciliation Ordinance, the NRO, withdrawing hundreds of cases involving senior political figures and members of the various administrative services. As discussed earlier, the NRO was to become the source of friction between the government headed by President Zardari and the Supreme Court.

As shown by the comparative data on governance performance (See Table 2), Pakistan scored poorly in South Asia, with the average only a little better than that of Afghanistan. Its average on a scale of -2.5 (the worst) to 2.5 (the best) was -1.3 with India scoring at -0.31. Its worst score was for political stability (-2.5) and the best for regulatory quality (-0.6).

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5 Hasan Zaheer, The Rise and Realisation of Bengali Muslim Nationalism, Karachi, Oxford University Press, 1997.

6 On 18 July, 2012 Rehman Malik, Senior Advisor to the Interior Ministry, told the press that his government had requested the extradition of Saif ur Rahman from Qatar to face many charges that had been filed against him in various courts in the country. Malik was earlier the Minister of Interior but lost his job after the decision of the courts that people with dual nationalities could not be elected members of the national and provincial assembly. Malik had British citizenship along with that of Pakistan. He was one of the closest associates of President Zardari.

<u>Table 2</u>: Governance Performance – A Regional Perspective

Country			**Governance scores (-2.5 to +2.5)**				
	Rule of Law	**Control of Corruption**	**Political Stability**	**Voice and Accountability**	**Government Effectiveness**	**Regulatory Quality**	**Average**
South Asia	-0.65	-0.65	-1.41	-0.52	-0.49	-0.78	-0.75
Afghanistan	-1.9	-1.62	-2.6	-1.45	-1.47	-1.56	-1.77
Bangladesh	-0.77	-0.99	-1.42	-0.28	-0.84	-0.86	-0.86
Bhutan	0.11	0.83	0.68	-0.46	0.57	-1.13	0.1
India	-0.06	-0.52	-1.31	0.42	-0.01	-0.39	-0.31
Nepal	-1.02	-0.69	-1.68	-0.53	-0.77	-0.74	-0.91
Pakistan	-0.79	-1.1	-2.5	-0.82	-0.77	-0.6	-1.13
Sri Lanka	-0.09	-0.43	-0.83	-0.51	-0.17	-0.21	-0.37

<u>Source</u>: World Bank Governance Database
Note: Governance performance: -2.5 (weak) and 2.5 (strong).

There is considerable amount of empirical evidence to suggest that rampant corruption weighs heavily on economic development. Much of this work was done at the World Bank. Corruption, in particular at the policymaking levels, increases transaction costs and lowers the return on capital. This was one reason why the incremental capital output ratio – a measure of economic efficiently – climbed so high in Pakistan's case. Over the 2010-2012 period, there were reports of alleged acts of corruption committed by individuals occupying very high offices, or by members of their families. One of the sons of the former Prime Minister Yusuf Raza Gilani was accused of being involved in a scheme that led to serious overcharging of Haj pilgrims. Another son was alleged to have participated in the illegal import of amphetamine, a highly regulated substance that can be used for making ecstasy pills that have a high street price. As already noted, Raja Pervez Ashraf, Gilani's successor as Prime Minister, was alleged to have received kickbacks for renting ship-based power plants. There were reports that Riaz Malik, a well-known and well-connected real estate developer, had paid for expensive overseas trips by the son of Chief Justice Iftikhar Mohammad Chaudhry. This, Malik claimed in a discussion with the press, was done by him in the hope of getting judicial favours. He was fighting dozens of cases on various charges involving land acquisition. Most of these cases, including the one involving the Chief Justice's son, were under investigation by the Supreme Court at the time of writing

(August 2012). It took action on the basis of the 'suo moto' powers granted to it by the constitution. There was some hope in the country that there may be some improvement in the situation as the judiciary got more involved in holding high officials responsible.

Corruption was not the only by-product of poor governance during the democratic era. It showed up in other ways. Two of these were the immense and economically damaging shortages of electricity and gas. That these shortages reached critical points in 2011-12 was the direct consequence of poor governance that dated back to the time of Musharraf. In 2005, the World Bank made a 'power-point' presentation to Musharraf indicating that unless the government improved the management of the electricity sector, rationalised power tariffs, increased public sector investment, and allowed greater participation of private enterprise, the country could face a serious electricity crisis[7]. None of these suggestions were taken seriously. The government's complacency was the result of its miscalculation of the elasticity of energy demand, both for electricity and natural gas. The result was what the World Bank had predicted. Half a dozen years later, the country faced shortages that led to brownouts that lasted in some cases for 12 to 14 hours a day. There were similar reductions in the supply of gas. This had predictable impact on the performance of the economy. It also made the people extraordinarily unhappy with the government. The electricity situation will be discussed first followed by an analysis of the gas supply crisis.

Of the many problems the economy faced as the Zardari-led PPP government entered the fifth year in office, none was more serious than the severe shortage of energy. It hurt the economy, reducing the GDP rate of growth by two to three percentage points a year. It also caused enormous discomfort to the population especially to those who could not afford to install generators of their own to compensate for the brownouts. In order to assess the gravity of the situation in Pakistan, the World Bank compared it with a group of what it called reference countries – Bangladesh, Brazil, Egypt, India, Indonesia, Malaysia, Turkey and Sri Lanka. It found that only India, at a demand-supply gap of 28 per cent, had a situation worse than that of Pakistan. For Pakistan the gap was estimated at 22 per cent[8].

In Pakistan's case, the gap developed over a period of half a dozen years, starting about 2005. There were crises in earlier periods but these were handled expeditiously, although not with reference to a long-term energy strategy. In the mid-1990s, for instance, the governments headed

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[7] The author, along with Moeen Qureshi, a former Senior Vice President at the World Bank and Caretaker Prime Minister in 1993, reviewed the World Bank's presentation. By coincidence, the author met with President Musharraf right after the Bank team made its presentation. He suggested that the president take the Bank's presentation seriously and act upon its conclusions.

[8] Background papers prepared by the World Bank staff in preparation for the Country Economic Memorandum exercise. These papers were discussed in a conference call on 19 July, 2012 involving participants from Islamabad, Singapore and Washington. The author participated from Singapore.

respectively by Benazir Bhutto (1988-90) and Mian Nawaz Sharif (1990-93) allowed the entry of private entrepreneurs into the power sector. Called the independent power producers or IPPs, these investors were provided with a number of state guarantees. There was an enthusiastic response by the private sector that exceeded the government's expectations. By that time a caretaker government took office which having concluded that Pakistan had more generation capacity than required, cancelled the applications that had not resulted in any investments being made. This action was taken by the author, who was in charge of finance, planning and development in the caretaker set up. In fact, during his second term in office (1997-99), Sharif contemplated the sale of power to India as a part of his policy to develop better economic relations with the neighbouring country.

<u>Table 3:</u> Existing Installed Generation Capacity

			Availability (MW)	
Type of Generation	**Installed Capacity (MW)**	**Dependable Capacity (MW)**	**Summer**	**Winter**
WAPDA Hydro	6516	6516	6516	2300
GENCOS	4764	3589	2200	3222
IPPs	9085	8295	7000	6900
Rental	393	393	200	83

<u>Source</u>: Table above, p. 69

After 2005, the power crisis became almost unmanageable. It was the consequence of a number of policy mistakes made in the past. If the supply side of the energy equation was to be determined by the availability of domestic resources for generation, Pakistan should not have been that short of meeting the growing demand. It had abundant resources. The most important of these was water, a great deal of which cascaded down the main rivers of the Indus system. There was also water flowing down dozens of smaller streams as well as in the large canals that made up the world's largest irrigation system. Hundreds of generators could have been placed to tap the streams and canals where small 'heads' – waterfalls that would run turbines – could be created. This was done successfully in Nepal with the help of the World Bank. An estimated 2,200 microhydro plants, generating 18,000 kilowatts have been built in Nepal since the 1970s, according to Nepal Micro Hydropower Development Association [9]. Various studies carried out over the years estimated the electricity generation potential of flowing water at tens of thousands

[9] Amy Yee, 'Microhydro Projects are driving changes in rural Nepal', Today (Singapore), 21 July, 2012, p. 11.

of megawatts. According to a report issued in November 2011 by the Water and Power Development Authority (WAPDA), 'the hydro power potential in Pakistan is over 100,000 MW with identified sites of 59,000 MW'[10]. Only a fraction of this was exploited. For a time natural gas was abundantly available, but as discussed below, this resource was over-exploited and reached the point of near-exhaustion in 2010-11. The country had the world's fourth largest reservoir of coal but in 2011 obtained only 0.16 per cent of the total supply from this particular source. There were corridors of wind that could be tapped, given Pakistan's location. There was plenty of sunlight available round the year for generating solar energy. And yet a significant amount of electricity – 19 per cent of the total –continued to be produced using imported fuel oil.
There were two main reasons for this failure to exploit domestic resources for generating electricity. With the possible exception of the period of Ayub Khan, when serious attention was paid to planning the use of public funds for the purpose of economic development, no administration that followed put much emphasis on formulating a viable long-term energy policy. During Khan's presidency, enormous amounts of resources were committed to developing hydro-power. It was then that the giant hydro- power stations were built at Mangla (1,000 MW) on the Jhelum River and Tarbela (3,478 MW) on the Indus. Since then the governments went from one short-term shortage-solving problem to another, relying on whatever fuel was available at that time[11]. This approach created enormous inefficiencies in the energy system.

The other reason for the electricity crisis was the lack of public sector development funds. Pakistan's failure to increase the rate of domestic savings and to improve the tax-to-GDP ratio meant a steady decline in the proportion of national product spent on development. In 2011-12 financial year, it declined to two per cent of GDP, the lowest proportion in decades. This was the main reason why in the 1990s, the government turned to the IPPs for increasing power generation but that produced a problem of its own which exacerbated the energy crisis.
According to Mohsin Syed, an electrical engineer turned businessman, 3,000 to 3,500 MW of power is wasted in production, transmission, and production of this order could be added to the national grid in 12 months by improving governance and engineering practices[12].

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[10] Pakistan Water and Power Development Authority, Hydro Potential in Pakistan, Lahore, November 2011.

[11] For a discussion of the impact of this approach on the energy situation see Shahid Javed Burki, 'Making energy policies in periods of crisis' in Robert Heathway and Michael Kugelman (Editors), Fueling the Future: Meeting Pakistan's Energy Needs in the 21st Century, Woodrow Wilson Center for International Scholars, Washington DC, 2010.

[12] Nasir Jamal, 'Electricity is about right decisions', Dawn, 22 July, 2012, p.2.

Table 4: WAPDA's Demand and Supply Forecast, 2009-2030

				Fiscal Years			
		2009	**2010**	**2015**	**2020**	**2025**	**2030**
Net Dependable Capacity	**MW**	17008	19477	33028	52909	76200	106565
	Growth per year	9%	15%	9%	10%	8%	8%
Peak Demand	**MW**	20594	24474	36217	54359	80566	113695
	Growth per year	7%	9%	8%	9%	8%	7%
Surplus/Deficit		-3586	-2876	324	4066	4031	5087

Source: Water and Power Development Authority, Lahore, 2011, p 70

The private power generation policy adopted by a succession of administrations followed a 'buy or pay' approach advocated at that time by the World Bank's International Finance Corporation that works with private entrepreneurs. According to this policy, the government invited bids from the private sector, settling for those who offered to supply a certain amount of power to WAPDA at the lowest per unit price. In some cases the government also signed agreements with the IPPs to have the state sector agencies supply the fuel they needed. If WAPDA failed to procure the agreed amount of electricity, it still had to pay the IPPs. WAPDA incorporated the IPP generated power in its transmission which was supplied to the various distribution companies at the price determined by the power regulatory agency. The distribution companies then provided electricity to their customers at the price laid down by the regulator. There were several points at which this chain stretching from the point of generation to that of final consumption could break down. Some parts of the chain at times did not have the funds to pay what it owed to another part. This led to the buildup of unsettled payments within the system which came to be called the 'problem of circular debt'. More often than not, it was some large customer who failed to clear bills with the distribution company, which in turn could not pay WAPDA, which held up payments to the IPPs, which reduced the amount of power they generated. Those who failed to settle their bills included large government departments such as the army or the governments in such sensitive areas as Azad Kashmir and the Federally Administered Tribal Areas (FATA) where many influential individuals, some with large landholdings, used electric wells for irrigation. According to some analysts, it was the circular debt that was the cause of the energy crisis; the system had enough generation capability to meet the demand but was not able to function at full capacity because of the problem of debt.

This governance system was adopted at the recommendation of the World Bank which at that time was heavily involved in assisting Pakistan with the development of the energy sector. The reason for breaking up the integrated generation, transmission, and distribution system WAPDA managed was the World Bank's belief that there would be large efficiency and social gains by the privatisation of some parts of the system. By creating a number of distribution companies, the idea was to prepare them for sale to the private sector. The break-up was carried out but privatisation was stalled.

Electricity supply situation began to get serious in 2009 and, as had happened before, the government holding the reins of power – this time the PPP-led coalition – adopted some emergency measures to deal with the deepening crisis. As discussed earlier, the governments in the 1990s had turned to independent power producers to increase generation capacity. This time the solution was to buy electricity through recourse to rental power plants, the RPPs. As a report in India Today puts it, 'RPPs, typically installed within four to six months, are ideal for meeting short-term needs'. The responsibility for the RPPs was given to the Ministry of Power which was then headed by Raja Pervez Ashraf from March 2008, when the PPP administration took office, to February 2011 when Ashraf was dropped from the cabinet because of the public anger at the way he and his ministry had handled the worsening situation. The ministry had approved the installation of 19 plants, with a combined capacity to produce 2,734 MW.

'The government taking bank loans, had paid Pakistan Rs. 21.8 billion (US$ 24 million) to RPP companies but none of these plants functioned to its full capacity'. Allegations of corruption were made against Ashraf by the members of the coalition. 'The Supreme Court took suo moto notice of the allegations. It cancelled the deal in March 2011 and initiated an inquiry against the minister. The contracts of RPPs were ordered to be rescinded forthwith and all persons responsible for the same are liable to be dealt with for civil and criminal action in accordance with law, wrote a two-member bench comprising Chief Justice Chaudhry and Justice Khilji Arif Hussain in their judgment[13].

Pakistan's power crisis, therefore, represented all that was wrong with the country's governance: Absence of long-term strategic planning, adopting solutions at the moment of the crisis that did not always work for the long-run, undertaking deep institutional restructuring at the suggestions of aid-giving agencies, and corruption by the people in policymaking positions.

Turning now to natural gas. The shortage of this particular source of energy coincided with those of the electricity sector, further hurting the government's standing with the people. Natural gas

[13] Qaswar Abbas, 'In court's cross-hairs: Pakistan's new prime minister is already hobbled by charges of corruption', India Today, 16 July, 2012, p. 48.

was a relatively new fuel for the Pakistani economy. Found at Sui in Baluchistan in 1952 with its commercial use starting in 1955, its use was developed rapidly. More discoveries followed in Sindh province. During the period of Ayub Khan, an extensive network of pipelines was laid across the country to carry natural gas first to Karachi, the country's industrial hub, and later to Lahore and other areas in the north.

Over time natural gas became a vital energy source for Pakistan. In 2009-10, the country consumed about 1.5 trillion cubic feet (tcf) of the fuel. All of this was produced from domestic fields. On the basis of the production forecasts made in 2011, the country was at or near its peak production. Proven remaining gas reserves in 2010 were estimated at 27.5 tcf which meant that at the rate of consumption in 2011, these will be exhausted in about 18 years. But shortages began to occur in 2011. The sector was facing a supply gap, of 0.5 tcf in 2015 which was set to increase to 2.0 tcf by 2025. However, additional supplies could be generated by tapping what the industry called 'tight reservoirs'. These were more costly to bring to production but if they were exploited, domestic reserves could almost double. But largely because of the rapid technological development in the United States, it had become economically feasible to exploit such rock formations as shale[14].

The pattern of gas consumption that emerged over the years was largely the consequence of government's priorities and policies. By 2010, the electricity sector with 29 per cent of the share in consumption, was the largest consumer followed by general industry at 25 per cent, preferred industries (fertiliser, cement and steel) at 18 per cent, households at 17 per cent and transport at eight per cent. But this pattern began to change as a result of the policies adopted by the democratic government. Not unexpectedly, it used extensions in the reach of the gas distribution system as a way to win political favours.

Over the six-year period to 2010, although gas consumption increased at the rate of two per cent a year, about half the rate of increase in the gross domestic product, there were significant differences among different users. Consumption by industry increased by nine per cent a year. It grew by five per cent annually for domestic users, and at more than 30 per cent for the transport sector. The last increase was the result of the government's policy to switch automobiles from the use of diesel and gasoline to compressed natural gas, or CNG.

Increasing access to gas for both business and household consumption was a political priority, particularly on the part of provincial administrations. This expansion also made commercial sense for the two gas supply companies, the Sui Southern Gas Limited that served Karachi, Sindh and Baluchistan and Sui Northern Gas Pipelines Limited that served Punjab and Khyber-

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14 The magazine, The Economist, published a 14-page report on how technologies were moving the United States towards energy self-sufficiency., See 'Natural Gas: An unconventional bonanza', 14 July, 2012.

Pakhtunkhwa provinces. The companies were comfortable with expansion since it increased the returns on their large fixed assets. Since both companies are listed on the stock markets, it was important for them to show a healthy bottom line.

In 2005, the government headed by Musharraf adopted the ‘Natural Gas Allocation and Management Policy’ which identified the priority users during periods of critical shortages. Domestic and commercial sectors were placed at the top followed by the fertiliser industry. The third priority was assigned to the independent power producers, or IPPs, which had firm gas purchase agreements. The policy did not save the country from developing severe and highly disruptive shortages. The winter of 2011-12 witnessed severe gas load-shedding, which led to the closure of several industries and CNG stations. There was also very low pressure for the household sector. As a consequence, rioting by a highly agitated citizenry broke out in several cities.

Corruption within the system as well as several built-in inefficiencies contributed to the problem of gas shortage. One measure of this is what is termed ‘Unaccounted-for Gas’ (UFG) which is defined as the difference between the total volume of the metered gas received by a gas utility during a period of time and the volume of gas metered as having been delivered to the entity’s consumers. UFG is usually one to two per cent in well managed systems. In Pakistan it was recorded at 10.6 per cent. This was equivalent to a loss of US$ 323 million in 2011.

There were a number of factors that contributed to high UFGs. These included dilapidated pipelines; meter-tampering resulting in gas theft; leakages because of the system operating at higher than required pressure; and poor quality of meters. According to a study by the World Bank carried out in preparation of a natural gas project, UFG in Pakistan remained unchanged for decades but there was an upswing by about one percentage point a year in 2010 and 2011. Taking note of this change, the Oil and Gas Regulatory Agency (OGRA) announced a regulatory regime that allowed it to impose large fines on the gas utilities for excessive UFG. OGRA planned to move back to the original trajectory and was prepared to allow about 4.5 per cent of UFG in 2012. However, the senior officials of the regulatory agency allegedly found an opportunity in this tightened regime for rent creation. This was one other indication of how corruption seeped into so many different sectors of the economy.

Severe shortages of natural gas caused almost as much damage to the Pakistani economy and as much discomfort to the citizenry as the shortage of electricity. In both cases it was the failure of public policy that caused these shortages to occur. The state failed after the assumption of power by a democratically elected government. Poor policies were in place for decades, even when the economy was relatively better managed. The governments – those in the past as well as the one

that took office in 2008 – should have adopted appropriate policies in the area of energy to ensure uninterrupted supply as well as the efficient use of available resources.
In 2012, the World Bank was invited by the government to get engaged with the Sui Southern Gas Limited to reduce the UFG. The Bank agreed to provide a loan of US$ 100 million for this purpose. According to the Bank's loan document 'the reduction in the UFG would mean that more gas is potentially available for power generation fuel and could displace expensive petroleum products being used for the same purpose'[15]. But it will take more than one World Bank project to do away with the increasing natural gas shortages. Large investments were needed and the system of management, particularly at the regulatory level needed to be reformed. As with so many other things, the overall situation depended on the improvement in the quality of governance.

The Planning Commission prepared an 'Integrated Energy Plan 2009-22' to address the issue of energy shortage. It estimated that the reliance on imported oil for meeting energy requirements would increase the import bill 'from US$ 12 billion in 2007-08 to US$ 41 billion in 2022 based on crude price of US$ 70 per barrel. It is, therefore, important that the energy mix be changed to provide a more affordable and sustainable model for the country which maximises the use of indigenous resources. The plan estimated that country's generation capacity will need to increase to 50,000 MW by 2022 based on annual economic growth rate of five per cent. At least 40 per cent of this generation could be achieved by using the country's large coal reserves. Hydel capacity could be raised to 18,000 MW'[16].

Poor governance has long-term consequences. These came to be measured by economists using a different way of assessing economic performance. For the last 70 years, economists used gross domestic product (GDP) as the measure of performance. But GDP values goods and services produced by an economy, not its wealth. It was a flow concept rather than a concept of stock. However, it was the stock that produced income and it could be depleted especially during periods of high growth. This happens when a country uses its mineral or forest wealth to produce income without replenishing the stock by developing some other component. Human resource is one component of the wealth that could be improved and thus increased in value to compensate the inevitable decline in non-renewable wealth.

The United Nations' International Human Dimensions Programme on Global Environmental Change (IHDP) began work on developing a measure of wealth which it believed will produce a better indication of what was really happening to an economy and what were the future prospects. Its findings were presented at Rio+20 Conference held in Brazil in the summer of 2012 which took stock of the global environmental situation since the first meeting was held 20

[15] The World Bank, Natural Gas Efficiency Project, Report No. 59980-PK, 2 April, 2012, p. 8.
[16] The Planning Commission, Integrated Energy Plan 2009-22, Islamabad, 2011, pp. 23-25.

years earlier, in 1982. It was at that meeting that the international community adopted the 'Kyoto Protocol' for controlling climate change.
'The report', in the words of its authors, 'presents a framework that offers a long-term perspective on human well being and sustainability, based on a comprehensive analysis of nations' productive base and their link to economic development'. The report suggested some measures of what it called 'inclusive wealth'. The measure included three kinds of assets: 'manufactured', or physical, capital, (machinery, buildings and infrastructure); human capital (the population's education and skills); and natural capital (including land, forests, fossil fuels and minerals). For instance, using this measure, America's wealth amounted to US$ 118 trillion in 2008, over 10 times its GDP that year. Its wealth per person, however, was lower than that of Japan which had the highest amount for the 20 countries included in the first round of studies carried out by the UN[17]. The initial group of the countries selected represented 72 per cent of the world GDP and 56 per cent of the global production.

While Pakistan was not included in the case studies conducted by the United Nations, it would appear that in its case there may have been an actual decline in the amount of inclusive wealth. If that had happened, the country would face a declining growth trend. Forests were one example of depleting wealth. Decline in the forest cover happened largely because of poor governance. There were reports of 'timber mafias' denuding forests in the country's northern areas, an activity they were allowed to carry on in spite of the laws that prohibited tree-felling in some of the more sensitive areas. The mafias were alleged to pay large bribes to the regulators.

Not making appropriate investments at appropriate times also reduced 'inclusive wealth'. In the case of Pakistan this happened in two areas: Neglect of the irrigation infrastructure and not keeping up with natural gas reserve development as exploitation of known reserves for consumption lowered the amount of recoverable reserves. But non-renewable assets get depleted with use which is why they were called non-renewable. However, there were examples of countries making investments in other assets that could – and did – compensate for the decline in inclusive wealth by using the renewable resources. The most interesting example of this was Japan, which was one reason why the country came out on top of the UN study list.

Most of the findings in the first report had great relevance for Pakistan. The report found that high population growth caused 25 per cent of the countries assessed to have unsustainable inclusive wealth unless there was a massive amount of investment in improving the quality of the human resource. While 19 of the 20 countries studied for the report experienced a decline in natural capital, half a dozen compensated it by increasing human capital. Applying this finding to Pakistan suggested that one way of increasing inclusive wealth in the country was to invest

[17] United Nations, Inclusive Wealth Report 2012, New York, 2012.

heavily in the development of the large human resource. Here the private sector, given the space within which it can operate, could do a good job.

This brings the discussion to the point where some thought about the future needs to be offered. The Pakistani economy was in a state of great flux. But so is the theory of economic growth whose diligent pursuit would have helped to bring stability to a country buffeted from many sides. There is a consensus among those who watch the Pakistani economy that, were the present rate of economic growth of three to 3.5 per cent to persist into the future, it would mean a great deal of political and social trouble. This, not only Pakistan, but also the rest of the world, cannot afford. For some years now Pakistan has been the epicentre of international terrorism perpetrated mostly by those who were marginalised by poor economic performance. The International Monetary Fund in its 'Title IV consultations' carried out in early 2012 suggested that the economy must grow at about seven per cent a year to absorb two million workers who enter the labour force every year. Past large increases in population meant that this level of increase in the workforce will continue for several years. A seven per cent yearly expansion in the economy, therefore, will need to be sustained for many years into the future.

Not only that, economic expansion must occur in a way that ensured that its rewards become available to all segments of the population and all parts of the country. Modern economists call this approach 'inclusive development'. How could this doubling in the rate of growth and its equitable distribution be achieved in a country like Pakistan? To achieve these two goals, do those put in charge of planning for development need a new theory of growth?

This was not the first time that these questions were asked – and answered – by the planners in Pakistan. Some decades ago, the task of economic planners was a relatively simple one. As Mahbub ul Haq, the author of Pakistan's only successful five-year development plan explained in his book, The Strategy of Economic Planning, he and his colleagues at the Planning Commission were confronted with a choice[18]. As they drafted the Second Five Year Plan (1960-65) they had to choose between growth and distribution. They chose the former, leaving the second to what came to be called the 'trickle-down effect'.

There was a belief that once growth came, its benefit would trickle down to those who were less advantaged than the owners of capital. That rewards of growth would first go to those who owned capital proved to be the correct prediction. The owners of labour – then thought to be the only other factor of production – would be rewarded later when wages increased in the modern sectors of the economy. It didn't work out that way as Haq himself admitted three years after the completion of the Second Five Year Plan period. In his famous 22-family speech, he was

[18] Mahbub ul Haq, The Strategy of Economic Planning: The Case Study of Pakistan. Karachi: Oxford University Press, 1963.

unhappy that a significant proportion of the increase in incomes as a result of the Second Five Year Plan was captured by just 22 industrial, commercial and financial houses. That conclusion was based on a narrow sample of the entities engaged in the country's modern economy. It was wrongly extrapolated to cover the entire economic system. But the speech convulsed Pakistan's political and economic systems. It contributed to the rise of the Pakistan People's Party (PPP) and to the phenomenon of Bhuttoism – an expansionary state that was to be put to use to benefit the common citizen. Once in power, Prime Minister Bhutto increased the presence of the state in the economy. This was done by putting government bureaucracy in charge of the dozens of large industrial, commercial and financial enterprises that were expropriated from the private sector.

In what it calls the 'Framework for Economic Growth', FEG, the Planning Commission came up with what amounts to a new theory of development for Pakistan. The Commission's work on growth started with a criticism of the approaches adopted in the past. 'An unintended consequence of our policies has been the stifling of internal markets, cities and communities which play a critical in fostering productivity, innovation and entrepreneurship and ultimately promote growth, and prosperity and development', wrote the authors of the report. 'The Planning Commission has been involved in the formulation of Perspective, Medium and Annual Development Plans based on a savings-driven approach when growth rates are arbitrarily set and incremental capital (investment) to output ratios are used to generate investment requirements in key sectors of the economy. Public investment across sectors is allocated according to the planners' priorities. It is assumed that public sector development programmes will crowd out private investment.' After offering this criticism of the past, the Planning Commission promised a strategy that would factor in Pakistan's situation in 2010-11 and also the development in economic thought. 'Never has there been a more pressing need in Pakistan's history to search for a new model.' It suggests that the country needs to move from 'hard' to 'soft' growth[19].

By 'hard' growth, it meant large public sector investments in brick and mortar development – building roads, bridges and dams and buildings. What was needed were a combination of efforts that would improve the quality of governance, less interference by the government in the working of the private sector, encouraging greater innovation within the economy, and greater focus on the activities that would produce higher rates of growth with low rates of development. Implicit in this strategy was the recognition that it will take a long time to increase the rate of investment, in particular by the public sector. To have that happen will require some fundamental changes in the tax system, something for which there was no or little political appetite. Nonetheless, the economy could be made to perform better by improving its efficiency. In the jargon of economics, the policymakers should work to lower the incremental capital output ratio.

[19] Government of Pakistan, Towards a New Growth Strategy, Islamabad, The Planning Commission, January 2011.

Such an approach would also add to the country's 'inclusive wealth' as defined by the United Nations.

The FEG, of course, was anchored in capitalism, a view of the economic world that came to be increasingly questioned by both academics and policy analysts. It had its heyday in the 1990s when the Washington Consensus was adopted by development and financial institutions such as the World Bank and the International Monetary Fund (IMF) as their preferred philosophy. These two institutions then had enormous influence over the developing world. With the withdrawal of private finance from some of the more developed countries in Asia and Latin America, the World Bank and IMF were the only sources of capital available to a number of countries in extreme financial stress. The policies that were forced upon these countries pushed back the state from the economy, leaving the vacated space to private enterprise. The result was economic recovery that came with increased inequality.

Can Pakistan afford an FEG type of approach to address the slowdown in growth while ensuring that if the economy does pick up, its distributive impact will be positive? The answer is no, since the current political order is skewed in favour of the well-to-do and if a strategy that was so focused on giving even more space to private initiative was imposed on it, the result would be very destabilising.

Politics of Foreign Capital Flows

A country that faces a precarious economic situation, as is the case with Pakistan in 2012, has only a limited room for manoeuvre in international affairs. This was particularly the case when it was so dependent on the flows of external funds for financing needed investment. At the rate of investment in 2010-12 and with a high capital output ratio suggesting considerable economic inefficiency, Pakistan could sustain a rate of growth of only three to 3.5 per cent a year. This was about one-half of the rate at which the country needed to grow to provide employment to the two million people it was adding every year to the workforce. Remittances that were coming at record levels – they amounted to about 7.5 per cent of the GDP in 2011-12 – added another 1.5 percentage points to the growth of the national product. To reach the desired rate of growth of seven to eight per cent of GDP, Pakistan needed an additional US$ 6 billion to US$ 8 billion a year in foreign flows. The most important likely sources for this were the United States and the multilateral finance and development institutions. Even though institutions such as the IMF and the World Bank professed to work in an apolitical world, where political pressures were resisted, this was only true up to a point. Pakistan, as discussed below, was treated softly in 2008 when it went to the IMF for assistance, in part because of the American push.

This was the reason why the politics of aid should have received due recognition by the policymakers in Islamabad. It is in this context that we should view the mending of broken relations with the United States following the issue of a statement by Secretary of State Hillary Clinton on 3 July 2012. It would be useful to recall briefly the history of Pakistan's relations with the outside world – in particular with the US – in its continuing attempts to augment its own meagre resources by obtaining foreign capital for economic development.

There were three growth spurts under the military's rule. One of the more important reasons for the economy's better performance was undoubtedly the large flows of external capital into the country during these periods. With very low domestic savings rate, Pakistan was stuck in a low growth trap unless it could access foreign capital which filled the investment-savings gap. Large amounts of foreign assistance became possible as the military rulers, unconcerned about public opinion, were able to quickly align the country with the western powers, in particular the United States. This happened during the first military presidency (1958-68) when Ayub Khan brought Pakistan into a number of defence pacts with the US[20]. It happened again under General Ziaul Haq (1977-88) when he agreed to assist Washington in the latter's effort to expel the Soviet Union from Afghanistan[21]. And it happened, for the third time, under Musharraf when, practically overnight, Pakistan did a 180 degree turnabout and gave up its support for the Taliban regime in Afghanistan and became America's partner in throwing the Islamic regime out of Kabul[22]. In each case the country was rewarded handsomely by Washington which provided copious amounts of economic and military assistance. The availability of this resource created what in finance was called the 'moral hazard problem'. This resulted whenever entities – countries and firms – and individuals came to the conclusion that they were too big to fail. Help, they believed, will arrive during periods of extreme stress. In Pakistan's case this happened with the United States, China, the UAE, and IMF coming to the country's rescue at different times in its troubled economic history.

Compared to the regimes led by the military, those in which the civilians were in charge had a difficult time securing bilateral aid. This was mostly because the civilian politicians had to be more responsive to public opinion in the conduct of foreign policy. This was the case even when the road to the West, in particular to the US, was laid down by Liaquat Ali Khan, Pakistan's first Prime Minister. He had to deal with Jawaharlal Nehru's openly expressed disdain for Pakistan

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20 The reason why Ayub Khan chose to align the country closely with the United States is spelled out in detail in his autobiography, Friends Not Masters: A Political Autobiography, London: Oxford University Press, 1967.

21 See George Crile, Charlie Wilson's War: The extraordinary story of how the wildest man in Congress and a rogue CIA agent changed the history of our times, New York, Grove Press, 2007, for an account of how President Zia ul Haq was able to secure large amounts of American economic and military assistance from President Ronald Reagan for helping Washington drive out the Soviet Union from Afghanistan. He had turned down as 'peanuts' an earlier offer made by President Jimmy Carter, Reagan's predecessor.

22 For a detailed account of the reason for the dramatic shift in Pakistan's position see Pervez Musharraf, In the Line of Fire, New York, Simon & Schuster, 2006.

and unhappiness with British India's partition into two independent states. Under Nehru, New Delhi had been a difficult partner. It had started off by blocking the release of the 'sterling balances' left by the departing British. Pakistan had a share in this largesse which it needed badly. There were other actions taken by India which the government in Pakistan interpreted as being hostile. Delhi cut off the supply of electricity to Lahore from a power station now located in the Indian state of Punjab. It began to tamper with the flow of water into the canals in Pakistan that drew their supplies from the head works that, as a result of the way the line of partition was drawn, were under the control of India. Finally, in 1949, India imposed a trade embargo on Pakistan. The embargo was India's expression of unhappiness with Pakistan that it had not followed the other countries of the British Commonwealth in devaluing its currency with respect to the American dollar. The Pakistani decision did away with the parity in the rate of exchange between its currency and that of India. The Pakistani rupee was now 44 per cent more expensive than that of India. Declaring that 'India will not pay 144 of her rupees for 100 rupees from Pakistan', Sardar Vallabhai Patel, India's powerful Home Minister, ordered a trade embargo; and all trade exchanges, commercial and financial transactions between the two countries ceased. This one decision by India was to have enormous economic consequences for Pakistan. It totally transformed the structure of the Pakistani economy. It was this development in India-Pakistan relations that persuaded Liaquat Ali Khan to make the trip to Washington in May 1950. A few months earlier, the prime minister had been invited by Joseph Stalin, the Soviet Union leader, to visit Moscow. An invitation to Washington from President Truman soon followed and Khan accepted the latter, preferring an association with the capitalist Washington than the Communist Moscow. As a result of this visit, Pakistan began to identify itself with the West explicitly rejecting the Non-Aligned Movement that was launched by Jawaharlal Nehru of India, Kwame Nkrumah of Ghana and Soekarno of Indonesia. But the path the first prime minister laid was taken more frequently by the military leaders. Khan's civilian successors had to tread with caution which troubled Washington.

The civilian leadership, drawing its power from the citizenry, was more circumspect about dealing with America. When Zulfikar Ali Bhutto served as Ayub Khan's Foreign Minister, he was not pleased with the president's readiness to acquiesce to Washington's demands. Upon leaving the cabinet, he began to openly criticise the foreign policy stance of the military leader. He countered Khan's claim in his autobiography, Friends not Masters, that Pakistan and America were friends and Washington was not Islamabad's master by writing a book of his own and titled it, The Myth of Independence[23]. Once he had come to power, he swung his country away from Washington and took it towards Beijing which then was looking for ways to break out of the isolation to which it had been subjected by Washington's 'China containment policy'[24].

[23] Zulfikar Ali Bhutto, The Myth of Independence, Karachi: Oxford University Press, 1969.

[24] America's policy towards China which changed dramatically from containment to engagement is very well covered by Henry Kissinger in On China, New York, Penguin Books, 2012.

Overtime, China was to become, in the words of the leaders of both countries, Pakistan's 'all-weather friend'. While China provided significant amounts of project assistance, it was seldom that Beijing gave non-project assistance, not even to Pakistan. In the winter of 1996-97, China provided Pakistan with US$ 500 million of support at a time the country was close to bankruptcy. The entire amount was disbursed within a couple of days following the visit by the author, who was then Finance Minister in the caretaker administration, appointed by President Farooq Leghari after his dismissal of Prime Minister Benazir Bhutto.

The best illustration of how democracy served as a constraint on the formulation of foreign policy was provided by the deterioration of Islamabad's relations with Washington in the seven-month period between the end of November 2011 and the beginning of July of the following year. Given the record of the military which governed Pakistan for a total of 33 years, it was not likely that the series of events that occurred in 2011 would have resulted in the near-collapse of relations with the US, had it stayed in politics. The civilian leaders had fewer degrees of freedom. After an attack by American fighter planes on a Pakistani position near the border with Afghanistan on 26 November that killed 24 Pakistani soldiers, Islamabad ordered the closure of its territory that was used for supplies to the American and NATO troops operating across the border. Pakistan regarded the raid to be the last straw on their already overloaded backs. Early in the year, a CIA operative had killed two young men by shooting them in broad daylight on a busy Lahore street. On 2 May, a detachment of US Navy SEALs flew by helicopter deep into the Pakistani territory and killed Osama bin Laden. And turning the unmanned aircraft – the drones – into its preferred weapon, the Obama administration intensified its campaign against the militants who had created sanctuaries in Pakistan's tribal belt. It was claimed by Pakistan that these attacks had done great collateral damage, including deaths of hundreds of civilians. In spite of the billions of dollars worth of aid provided by Washington to Islamabad, America, according to several surveys, was the most disliked country in Pakistan. According to a poll conducted by the Washington-based Pew Research Center in March-April 2012, only 26 per cent of the people surveyed had a favourable view of the Americans. While the public opinion was not in favour of accommodating the US, Pakistan's worsening economic situation persuaded Islamabad to reach an agreement.

After a flurry of diplomatic activity that involved visits to Islamabad by a number of senior American officials, Hillary Clinton issued a statement on 3 July that The Washington Post said was 'artfully worded'. It was carefully worked over by the two sides. The Americans agreed to use the dreaded word 'sorry'. It was dreaded since President Obama had been accused by his Republican opponents for not minding the American interests in dealing with the world. 'We are sorry for the losses suffered by the Pakistani military', said Secretary Hillary Clinton in her statement. 'We are committed to working closely with Pakistan and Afghanistan to prevent this from ever happening again'.

Pakistan gave up its demand that the Americans should pay US$ 5,000 for every container and truck that used its territory to supply the troops in Afghanistan. The country was receiving US$ 250 before the embargo was imposed. Given the amount of traffic that would be involved in the forthcoming pullout by the Americans in 2012-14, Pakistan could have earned as much as US$ 600 million from the demanded tariff. Washington, on its part, agreed to notify Congress to release US$ 1.1 billion in withheld funds for Pakistani counterterrorism operations. Pakistan believed it was owed three times as much, as part of the existing agreement to reimburse it for its expenses. On 24 July, three weeks after the 'we are sorry' statement by Secretary Clinton, Wajid Rana, Pakistan's Finance Secretary, informed the Economic Coordination Committee of the cabinet that US$ 1.1 billion would be paid within a matter days by the United States into the account of the State Bank of Pakistan. This would bring great relief to the country in managing its external accounts. Foreign exchange reserves would increase from US$ 14.77 billion to US$ 15.89 billion. Another US$ 85 million was expected to be disbursed from the Kerry-Lugar-Berman aid programme. 'Until May 2011, the Pakistani defence authorities had billed about US$ 12 billion to the US under the Coalition Support Fund. Most of the bills were disbursed except US$ 3.5 billion that were still outstanding'[25].

There were considerable benefits for America as well in this agreement. The United States, according to the estimate of its Defence Secretary, Leon Panetta, was paying an extra US$ 100 million a month for using the northern route through Russia and the Central Asian Republics to supply its troops in Afghanistan.

Economics and politics will determine whether America and Pakistan can return to a degree of normalcy in their relations after the agreement on the transit rights. For Islamabad, it will be mostly economics; for Washington mostly politics. There was suspicion and unhappiness on both sides. A day before the Clinton statement, The New York Times wrote an editorial that seemed to reflect how Pakistan was viewed by influential opinion-making quarters in America. The editorial was titled 'Crippled, Chaotic Pakistan'. Its analysis was based on what it saw to be the consequences of inaction by the country's leadership on an important front for the Americans: protecting their flanks while they pulled their troops from Afghanistan. 'After 2011, Pakistan had a chance to develop into a more stable country. It had strong leverage with the United States which needed help to defeat Al Qaeda and the Taliban in Afghanistan. Pakistan received billions of dollars in aid and the promise of billions more, which Washington has begun to suspend or cancel. But the army continues its double game – accepting money from the Americans while enabling the Afghan Taliban – and the politicians remain paralysed, too. Soon,

[25] Wajid Rana quoted in Khaleeq Kiani, 'US$ 1.2 billion payment expected from US this week', Dawn, 25 July, 2012, p. 1.

most Americans will be gone from Afghanistan. And Pakistan will find it harder to fend off its enemies, real and perceived'[26].

Table 5: Number of Casualties

Year	Number of attacks	Number killed	
		Minimum	**Maximum**
2004	1	4	5
2005	2	6	7
2006	2	23	23
2007	4	56	77
2008	33	274	314
2009	53	369	725
2010	118	607	993
2011	70	378	536
2012	26	144	176
Total	309	1861	2856

Source: New American Foundation

Political groups on the right of the Pakistani political spectrum were equally unhappy with the 3 July agreement. They threatened to block the US equipment as it began to journey to Afghanistan. On 10 July, a group formed by a number of right-wing leaders that included Hafiz Mohammad Saeed, the leader of the banned Lashkar-e-Taiba concluded their 'long march' from Lahore to Islamabad. The group, the Defence of Pakistan Council, included Lt. General (retired) Hamid Gul, who had once served as the head of the Inter-Services Intelligence (ISI) and Sheikh Rashid Ahmed, a former minister under Musharraf who, according to one report in the American press, 'issued a rabble rousing speech that supported the idea of overthrowing the elected government'. Saeed, although carrying a US$ 10 million American bounty on his head, did not curtail his public appearances and was a prominent presence at the Islamabad rally. Although the long march was peaceful, there was an incident on the way when some soldiers were fired upon which suggested that extremist groups may have penetrated the Defence Council. These groups had targeted the military on several occasions. But the American media reporting on the reaction of the extremist elements was not impressed by the support they had managed to mobilise. The

[26] The New York Times, editorial, 'Crippled, Chaotic Pakistan', 1 July, 2012, p. 21.

Islamabad rally, according to Delcan Walsh of The New York Times, ‘highlighted the limits of extremist influence. The crowd was small by the standards of political rallies; the organisers were forced to hold the rally close to midnight, which excluded them from prime time television coverage. The rally broke up peacefully after the speeches ended; organisers said they would resume protesting later this month, close to the border’[27].

The Clinton ‘sorry’ statement patched over some of the differences between Islamabad and Washington but a number of others remained unsettled. Perhaps the most important of these was the use of drones – a weapon the American military called the ‘unmanned aerial vehicles’ – which had decimated the al-Qaeda in Islamabad but had contributed to the growing anti-American sentiment in the country. According to one count, between 1,861 and 2,856 were killed in 309 drone attacks in the eight-year period between 2004 and 2012 (See table above). Islamabad wanted a role in determining the legitimacy of the targets attacked. The Americans, suspicious about the real motives of the ISI, was not willing to share a great deal of information. The White House had made it known, through leaks, that the targeted people were selected through a careful vetting process, which involved President Obama. But questions remained not only in Pakistan but also in the US. As The Economist wrote in an article published after the intensification of the drone attacks on targets in Pakistan, ‘America has a potent new weapon. Now it needs to adapt it to its principles’[28].

There was also debate in the United States about the use of drones as anti-terrorism weapons. This centred on both moral and strategic grounds. A feature article in Esquire by Tom Junod censured the ‘lethal Presidency of Barack Obama’ for his administration’s policy of targeted killings of suspected militants. Another by Scott Shane took the opposite view and argued for ‘the moral case for drones’. A third by John Kaag and Sarah Kreps looked at the use of the weapon from the perspective of moral hazard. ‘This issue has all the hallmarks of what economists and philosophers call a “moral hazard” – a situation in which greater risks are taken by individuals who are able to avoid shouldering the cost associated with these risks’[29]. The drone issue was taken up by Lt. Gen. Zahir ul Islam, the new head of ISI, during his first visit to Washington in the first week of August 2012, when he met with General David Petraeus, the Director General of CIA. According to a New York Times report that profiled General Islam, “he will press the CIA to stop its drone campaign in the tribal belt. Instead he will press the United States to upgrade Pakistan’s F-16 warplanes so that it can do the job – a proposal one Washington official called a non-starter. (He) will also request American help in halting cross border incursions by the Pakistani Taliban from their bases in Afghanistan – a growing Pakistani

[27] Delcan Walsh, ‘Pakistani militant leads rally against supply route reopening’, The New York Times, 11 July, 2012, pp. A1 and A6.

[28] The Economist, ‘America’s drone campaign: Drones and the law’, 8 October, 2011, p. 42.

[29] John Kaag and Sarah Kreps, ‘The moral hazard of drones’, The New York Times, 23 July, 2012, p. A23. The Kagg-Kreps article refers to those by Junod and Shane.

concern that last week caused testy exchanges between Pakistan's Ambassador in Washington, Sherry Rehman, and a senior Obama administration official in a conference in Colorado'. In the profile, the newspaper also wrote about 'General Islam's strong military pedigree and many analysts see him as a favourite to succeed the army chief, General Ashfaq Parvez Kayani, when he steps down in late 2013'[30].

Pakistan's evolving relations with India also began to reflect on how it was viewed in Washington. While the Kashmir issue was pushed to the back-burner and was no longer a part of the active discourse between India and Pakistan in 2012, another area of contention surfaced between the two states: Afghanistan. This issue was likely to impact Pakistan's relations with the United States. India and Pakistan were pursuing different objectives in that long-troubled country. This was done reflecting their view of the role Kabul could play in their long-enduring rivalry. This was one area where Islamabad and New Delhi found it difficult to unload the burden of history. India had always cultivated close relations with Afghanistan in order to squeeze Pakistan. Pakistan, on the other hand, saw Afghanistan providing it with strategic depth in case of another military conflict with India. Into this difficult triangular relationship jumped in Washington in pursuit of its own strategic interests.

The Obama administration was anxious that its withdrawal from Afghanistan should not destabilise the country in a way it could, once again, become a haven for terrorists bent upon harming America. In that context, India offered an opportunity that seemed attractive to Washington. 'India will be critical for Afghanistan's future', President Obama told an Indian journalist in an interview. India, he said, had made generous contributions to Afghanistan's progress, helping to train Afghan police, promoting development and improving the lives of ordinary Afghans. India was the first nation to forge a Strategic Partnership Agreement with Afghanistan, he noted, adding that India's civil service could be a model as Afghans strengthened their own governance and institutions. India hosted an international conference on Afghanistan in June 2012, and Obama said that by doing so 'New Delhi had shown its readiness to champion Kabul's economic development'[31].

America's slow pullout from Afghanistan, which began in 2011 and set to be completed by 2014, created new problems for Pakistan. As the American presence in some parts of Afghanistan that bordered Pakistan became light, the militants fighting the Pakistani state moved over to the Afghan side and continued their operations from the sanctuaries they developed in hard-to-reach areas. This was the reverse of what had gone on for years when the Afghans, hostile to Kabul, conducted operations from Pakistan's tribal agencies, in particular North

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[30] Declan Walsh and Mark Mazzetti, 'Pakistan's new spy chief visits Washington at a time of frayed relations', The New York Times, 1 August, 2012, p. A1.

[31] Anwar Iqbal, 'Obama welcomes Pak-India efforts to lessen tension', Dawn, 16 July, pp. 1 and 3.

Waziristan. According to a New York Times report, 'the militants now use north-eastern Afghanistan as a springboard for cross border attacks; there have been 15 in the past year resulting in more than 100 deaths…the latest came this past week (late July 2012) when militants attacked a Pakistan village militia that is fighting the Taliban, according to Pakistani officials'[32].

The Clinton statement nor the signing of the memorandum of understanding by the two sides – the MOU was signed in Rawalpindi by Lt. Gen. (retired) Asif Yasin Malik, the newly appointed Secretary of Defence and Richard Hoagland, the Deputy US Ambassador – was the end of the story about Pakistan's relations with the United States. It was awkward for the relationship that the series of events that led to its weakening occurred when both sides were exceptionally sensitive to their public opinion. In Pakistan, the Americans were viewed as enemies rather than as friends. In the United States, if there was any common ground between President Obama and Mitt Romney, his Republican challenger for the presidency, it was about 'American exceptionalism'. According to one American political analyst, 'this year, listening to the candidates and their surrogates, it often seems as if the debate is about who can offer the most vigorous affirmation of American greatness. To the extent it gets any deeper, the debate centres on who has more credibility wielding American power'[33]. In such a situation, it was hard for Pakistan to expect much softening of the American position on a number of issues that were of great concern to it. Equally it was difficult for the Americans to get flexibility from Islamabad that was always there during military rule. Nonetheless, the settling of at least one dispute – the one over apology for the November 2011 attack – brought some relief to the financially hard-pressed country. The resumption of assistance by the United States, although scaled down, helped to postpone the day of reckoning. A price was paid for the suspension for several months after Islamabad closed the supply route to Afghanistan. For instance, the ambitious development programme the Water and Power Authority had formulated relied heavily on funding from the United States. Washington's assistance was needed for carrying out preliminary work on the dozens of small and big hydro-power projects the agency was working on[34]. These were delayed. The IMF was Pakistan's other benefactor during many difficult times. The last time the country turned to it was in the first year of democratic rule. In November 2008, Islamabad approached the IMF for help to stop the rapid run down of foreign reserves that had gone on for several months. The 2008 programme was generous in several ways: It was large, with soft conditions, and disbursements from it were front loaded while the promised actions by the government were put on hold, to be taken after most of the money had been provided. The result was what should

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[32] Matthew Rosenberg and Habib Zehri, 'Rockets fired from Pakistan pound Afghan villages', The New York Times, 23 July, 2012, p. A7.

[33] Peter Baker, 'Romney and Obama strain to show gap on foreign policy', The New York Times, 29 July, 2012. Baker filed this report after listening to the debate held at the Brookings Institution in late July on foreign policy between the surrogates of the two candidates.

[34] For a list of the projects and the extent of the US involvement, see Pakistan Water and Power Development Authority, Hydro Potential in Pakistan, Lahore, November 2011

have been expected. Pakistan received the funds but made few policy moves. In 2011, Islamabad withdrew from the programme, continuing the long history of its failure with respect to the Fund's programmes. As Sakib Sherani, once an adviser to the Ministry of Finance, recalled in a newspaper article: 'Pakistan has had almost continuous programme-lending engagement with the Fund since the early 1970s, with a brief interregnum in the 1980s. Since 1988, Pakistan has had 11 programmes with the IMF, spending the 14 years out of the last 20 in the Fund's intensive care unit. "Successful" programme completion has amounted to 36 per cent (a straight 'F') with only four programmes qualifying to be dubbed as "successful" (and that too purely in terms of money drawn and not on the basis of what really matters – outcomes)…In the end, even a fairly soft programme failed – leaving Pakistan straddled with a huge repayment obligation'[35].

Most analysts of the Pakistani economy had concluded that the country will be back in the Fund's care after the elections of 2013 and the coming to power of a new administration in Islamabad. However, this will happen in a difficult political environment. The West, including the United States, will not be prepared to push for a soft programme as they did in 2008. Consequently, the IMF will require much prior action which may not be politically easy. Difficult times, therefore, lie ahead for Pakistan.

This quick overview of the politics of capital flows suggests that the country in 2011-12 ventured into unchartered territory. It could no longer count on American military aid, military and civilian. With a democratic order in place, it was not likely that Washington would be able to pursue its agenda without being challenged as it had done when the military was in power in Islamabad. Civilian policymakers had to take cognisance of public opinion that had soured to such an extent that it would be hard to change. The IMF would also be aware of the United States' doubts and suspicions about Pakistan. Washington had a strong presence in the Fund's board which could not be discounted even if other members of the institution were willing to adopt a softer approach. The Chinese were not likely to provide budgetary support for Islamabad. They were likely to continue their preference for project assistance. Pakistan, in other words, had two options. It could raise its own resources for meeting its needs. It had failed to do so in the past and would find it even more difficult to do so in a democratic order, in which a number of strong vested interests had managed to contain their tax burden. They had been able to thwart a number of attempts – albeit half-hearted – to expand the tax base. It would need the exercise of considerable political will to get these interests to forego their short-term economic objectives in return for possible long-term gains. Even those who opposed tax reform would benefit from higher rates of growth which would be its result. But it needed a strong leadership that had the people's respect to get that message across.

[35] Sakib Sherani, 'Pakistan & the Fund', Dawn, 29 June, 2012, p. 7.

The other option was to settle for low rates of economic growth for years to come. This would be even more problematic than the attempt to mobilise the citizenry to make current sacrifices in return for a better future. A low rate of economic growth would have severe political and social consequences which the weak Pakistan state will find hard to manage.

(To be continued)

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