# ISAS Brief

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# Pakistan's Economic Troubles

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## Abstract

*There are indications that Pakistan is again headed towards a deep economic crisis. While the country's economic history was punctuated by many upheavals, the anticipated difficulties will come at a time when remedial action will be hard to adopt. There are good reasons why the world should watch the developing situation in Pakistan since its impact will be felt way beyond the country's borders. Pakistan is central to the economic and political evolution of the Muslim world. Its experience could discourage other Muslim countries to adopt democracy in order to bring inclusive economic development.*

## Introduction

In the past, whenever Pakistan was faced with a difficult external payments situation, it was helped by some country or some financial institution. The United States, China, Saudi Arabia, the United Arab Emirates and the International Monetary Fund have all played this role at different times in Pakistan's torrid economic history. In 1997, China put $500 million in Pakistan's external account to save the country from bankruptcy. Another $250 million was provided by UAE. In 2000 and again in 2008 Islamabad was able to negotiate large programmes with the Fund that injected much-needed foreign capital into the economy.

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In 2009, President Barack Obama signed into law the Kerry-Lugar-Bermen bill that promised continuous and predictable flow of American money into Pakistan. This was to happen for at least five years at the rate of $1.5 billion a year. There was an indication that this level of assistance could be extended for another five years. But that promise was not kept.

Islamabad read the help from these sources in the wrong way. It seems to have concluded that it was too large a country to fail, too large an economy to be allowed to go bankrupt, and located in too sensitive a geographic space to be ignored for too long. Financial markets have a term for this kind of behaviour. They call it “moral hazard”. This is the tendency on the part of individuals, institutions and countries to act irresponsibly in the belief that when difficult times come, they will be rescued. This is the way Islamabad has behaved not just recently but over the last several decades. Each time it received foreign assistance, it promised to mend its ways. It never did.

Most recently it walked out of the programme with the Fund, unable to meet that institution’s requirement for long-postponed reforms. The Fund was worried in particular by Islamabad’s failure to mobilise more domestic resources for financing government business. By the Fund’s reading a growing fiscal deficit was central to Pakistan’s persistent economic problems

**Genesis of the Current Crisis**

It is politics and poor governance that explains Pakistan’s failure to improve domestic resource mobilisation. The Pakistan People’s Party (PPP)-led government in Islamabad took office in March 2008 with the expectation that it will bring good quality governance to the country. But it has been reluctant to persuade a number of its diverse constituencies that they must pay their fair share as taxes. Unless those in power gather the political will to bring in most of the population into the tax net, the country will remain short of resources. It will also remain dependent on foreign sources for capital infusion. But the world may not be as accommodating this time as it was in the past. The country may not be able to get timely help as it heads once again towards a payments crisis.

That a crisis is coming was made amply clear by the Governor of the State Bank of Pakistan in his press briefing following the decision by his organisation not to change the discount rate. He has provided information on the rapid run-down in foreign exchange reserves as the trade deficit continues to be large and as the flow of foreign funds is reduced to a mere trickle. The State Bank’s report for the first quarter of the current financial year points to the difficult situation that lies ahead. ‘In the past, Pakistan has sustained larger current account deficits without losing its foreign reserves due to healthy inflows in the financial account’, wrote the Bank.

‘Unfortunately owing to both domestic weaknesses and the international financial upheaval, financial flows have almost dried up, adding to the country’s economic vulnerability. While some financial flows are expected, a part of the current account is likely to be financed through reserves…Striking a balance in managing a flexible exchange rate driven by economic fundamentals and by market speculation (within the context of sharp currency movements in the global economy) is challenging.’[2] In other words, the country seems headed towards another foreign exchange crisis of the type that has marred economic performance so many times in the past. But this time, there are some serious differences with the past.

The crisis is coming in what is an election year for Pakistan. The next general election must be held before March 2013. With so much to be done to win votes, those in power will be tempted to use the budget to finance the activities that will win them favour with the voters. The last big balance of payments crisis came in 2008, after the government headed by General Pervez Musharraf had emptied the state’s coffers to help the political party, the Pakistan Muslim League (Q), which had given it support. The party did less well than the military leader had hoped but the budgetary deficit, because of the election-related expenditures, crossed the sustainable level by a large margin.

High fiscal deficits almost always affect external payments balance. They create additional domestic demand that, in turn, increases imports and hence results in increasing trade deficit. Which is why the IMF, when called in to help with a foreign exchange crisis, almost always focuses its attention and that of the government seeking help on reducing the fiscal deficit. This is what the Fund did in 2008 when it agreed to provide Pakistan with more than $11 billion in quick-disbursing assistance.

In the 2012 election year, the pressure on the PPP-led government to spend is even greater than was the case in 2007. Then the economy was performing reasonably well, there was an increase in the rate of employment, and there was no significant pressure on domestic prices. This time the country is faced with a serious economic crisis and, as indicated by the rise of *Tehrik-e-Insaf* led by Imran Khan, there is a great deal of discontent in the country. It has reduced the electoral chances of the parties that are in the PPP-led coalition. It can be said with some certainty that the government in power will use not only public finance to build electoral support for the coalition partners, but will also seek financing from the State Bank of Pakistan.

Pakistan’s economic problems are not limited to the way fiscal and monetary policies have been formulated and implemented. There are a number of other structural problems, most of

[2] State Bank of Pakistan, *The State of Pakistan’s Economy: First Quarterly Report*, Karachi, 2012.

them caused by poor governance. There are shortages of a number of production inputs, in particular that of electricity and natural gas. The State Bank of Pakistan estimates that transmission and distribution losses vary from 11 percent to 37 percent of total supply[3]. It is estimated that electricity cuts reduce by three percentage points the rate of growth of national product. According to a special report on Pakistan published by *The Economist* in February 'at the end of November last year unpaid electricity bills reached 326 billion rupees [US$3.5 billion, or 1.85 per cent of GDP]. Among the big defaulters were the railways, the prime minister's secretariat, the army and the ISI.'[4]

## Remedial Actions

Pakistan has two options to deal with the developing situation. It could take the steps demanded of it by the IMF in which case another programme of assistance could possibly be negotiated accompanied by a fresh flow of much needed funds. This may be difficult in an election year. Or, it could persuade the countries that have come to its rescue in the past to do that once again. This would require major adjustments in public policies, in particular the approach towards the United States.

Washington is unlikely to help Islamabad unless it is reassured that it would receive Pakistan's assistance in helping it to exit Afghanistan. Given the poor opinion the Pakistani public has of the United States at this time – a fact revealed by the opinion surveys conducted by the Washington-based Pew Research Center – a swing in the policy stance will be difficult in an election year. Therefore, to factor in continuing American financial support in significant amounts would be a mistake. This was done by the Ministry of Finance in preparing the budget for 2011-12.

Would the cash-surplus countries in the Middle East help? They might as they have done in the past. But they too will need positive signals from the IMF and Washington. That, as discussed above, will not be readily forthcoming. China remains the only viable option but could not be counted upon to provide budgetary support.

In this context I should recall my visit to Beijing in December 1996 to seek its help which led to the deposit of $500 million in Pakistan's account in New York with the US Federal Reserve Bank. While Beijing stepped in with support, Prime Minister Zhu Rongji warned me that that kind of support would not be available in the future. He advised me that I should, during my brief tenure as the de facto finance minister, make a serious effort to reform Pakistan's public finance. I believe the same message was given to President Asif Ali Zardari early in his tenure. He had then approached the Chinese for help. As the history of Pakistan's

3 The State Bank of Pakistan, *Annual Report, 2010-11*, Karachi, 2011, pp. 35-43.
4 The Economist, *Perilous Journey: Special Report on Pakistan*, 11 February 2012, p. 12.

relations with China shows, Beijing is willing to provide large doses of project aid but not programme assistance in the sense of budgetary support.

With such limited options, Pakistan cannot hope to avoid a serious balance of payments crisis in the next few months. We will see a rapid run-down in the foreign exchange reserves maintained by the State Bank, a rapid drop in the value of the rupee, and continuing slow rate of economic growth. The year 2012 is likely to be one of the worst in Pakistan's economic history. Economic difficulties will affect political and social stability.

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