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Pakistan's Economic Crisis and the IMF Bailout Package

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The International Monetary Fund (IMF) has approved a US$7.6 billion bailout package to prevent Pakistan from defaulting on its external debt. The 23-month Stand-By Arrangement under the Fund's fast-track Emergency Financing Mechanism has provided an immediate US$3.1 billion funding to strengthen the country's fast deteriorating foreign exchange reserves. The programme seeks to preserve social stability and restore investor confidence in Pakistan by addressing its current macro-economic imbalances. At the same time, it sends a strong signal to the international donor community about the country's improved macroeconomic prospects.

Pakistan approached the IMF for assistance in November 2008 to avert a default on its foreign payments. The country requires roughly US$15-US$20 billion over the next two years to avoid a Balance of Payment (BoP) crisis. The Pakistani authorities were initially reluctant to turn to the IMF because of the expected stringent conditions, terming it Plan C – the last option. Plans A and B included frontload disbursements from multilateral institutions, borrowing from the international market and making an approach to friendly countries for help. Despite receiving some support from multilateral lenders and some friendly countries, Pakistan's primary request for immediate cash infusions were turned down, given weakened investor confidence in the economy. The government then turned to the IMF.

This paper seeks to examine three key issues. Firstly, how did an economy with robust macroeconomic indicators until last year reach this critical stage? Secondly, why did Pakistan's closest allies, including the United States and China, let it down? Lastly, what will be the likely economic and political implications of the IMF arrangement?

Anatomy of the Crisis

There is no doubt that an adverse external economic environment in the shape of unprecedented high levels of oil and commodity prices earlier this year and the current global financial crisis have largely contributed to the crisis in Pakistan today. Nevertheless, the genesis of the current crisis is internal. The key reasons for the current meltdown of the

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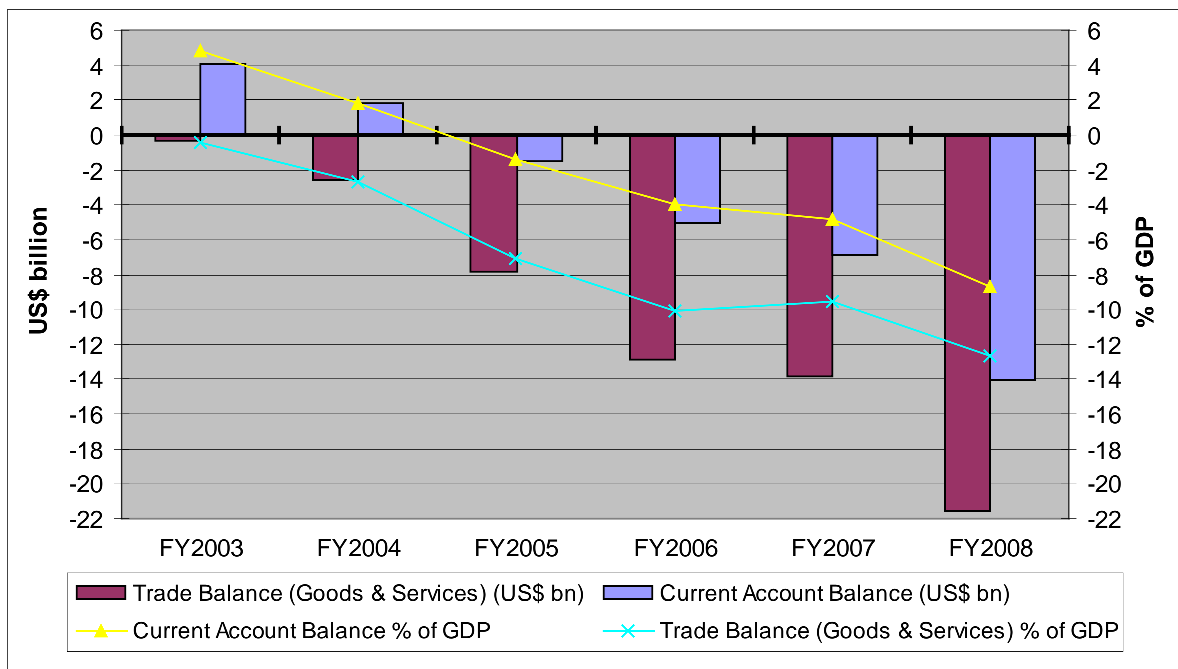
economy are continued political turmoil, deteriorating security, structural issues and the unsustainable growth policies in recent years.

Pakistan's economy has dramatically slid from high growth rates and burgeoning foreign exchange reserves to a state of crisis in less than a year. Real gross domestic product (GDP) growth has declined, foreign exchange reserves are depleted, the current account and fiscal deficits have blown up, net capital inflows have reversed significantly, inflation hovers around 25 percent and the Rupee has depreciated sharply by around 25 percent. The Karachi Stock Exchange has been in a free fall, nose-diving from the year high of 15,000 points to 9,200 in three months, forcing the government to intervene by placing a floor and proposing a bailout plan.[1]

An imminent BoP crisis loomed large when the current government assumed office in March 2008. The current account deficit (CAD) more than doubled in the fiscal year 2008 (ending at 30 June 2008). The CAD soared to US$14.04 billion (8.4 percent of GDP) from US$6.87 billion last year (see Figure 1), the highest in the history of the country. The fundamental source of such a steep increase in the CAD was a 57-percent expansion in the trade deficit over the year, in addition to an increase in net outflows from income account.

Since 2001, the fast-paced liberalisation of the economy, leading to sharp reductions in tariffs and robust demand growth, caused a steady increase in imports. On the other hand, the growth in exports could not keep pace with imports, resulting in huge trade deficits (goods and services) over the years. The trade deficit rose to US$21.6 billion in FY2008 from US$13.9 billion in FY2007 and a mere US$361 million in FY2003 (see Figure 1). Consequently, the current account balance deteriorated steadily from a surplus of US$4 billion in FY2003 to a deficit of US$14 billion in FY2008, despite a robust growth in remittances.

Figure 1: Pakistan's Trade and Current Account Balance (FY2003 – FY2008)



Data Source: State Bank of Pakistan and the IMF

[1] All data, unless otherwise stated, is from the State Bank of Pakistan and the International Monetary Fund.

Almost half of the additional merchandise import bill in FY2008 came from the food and oil sectors, which registered 46 percent and 43 percent growth respectively.[2] Nevertheless, non-oil and non-food imports grew by 21 percent, as compared to a 12 percent growth in exports.

In the first four months of the FY2009 (July-October 2008), a similar trend continues. The trade deficit reached US$7.55 billion against US$5.47 billion in the same period last year, a 37 percent increase. Furthermore, net inflows have reduced substantially, resulting in almost a doubling of the CAD to US$5.95 billion from US$2.99 billion over the same period last year.

A sustainable moderate CAD may not pose a problem as such. However, the previous government financed the deficit by unsustainable and expensive portfolio investments and borrowings. Moreover, the rise in commodity prices was not passed on to consumers, due to the political turmoil faced by the previous government, which resulted in large amount of subsidies. The resultant fiscal deficit was financed by borrowing from the central bank and this contributed in a double-digit inflation and the deterioration of country's international reserves. Furthermore, the pressure on the Rupee resulted in a 25-percent depreciation against the United States dollar in the last six months.

Pakistan's economic vulnerabilities stem from structural problems, three of which underscore the nature of the BoP crisis that the country faces time and again. First, the economy is heavily dependent on imports (including capital import, as domestic saving rate historically hovers around 13 percent of GDP), which always surpasses exports. Exports, on the other hand, are limited in commodity type and destination countries, leaving the country in the current account deficit and vulnerable to external shocks. Second, the tax-to-GDP ratio (10 percent) is far below the average 17 percent of developing countries and less than two percent of the population is covered by the tax net. The huge government expenditure on debt payments, and defence and current spending resulted in huge fiscal deficits that reached 7.4 percent of GDP in FY2008. Last but not least, public debt remains as high as 55 percent of GDP, albeit a significant improvement from 90 percent of GDP in FY2000. External debt makes up 27 percent of GDP (FY2008), down from 43 percent in FY1999.

However, much of the improvement in the country's debt position was the result of a favourable external environment. Pakistan's cooperation with the United States in the 'war on terror' resulted in relief in public debt amounting to about US$3.7 billion, coupled with a rescheduling of a US$12.5 billion Paris Club debt. These resulted in a substantially reduced debt service burden which was 12.8 percent in FY2008, as compared to 28 percent in FY1999. The military and economic assistance provided by the United States helped, to some extent, to ease the burden on fiscal resources. Moreover, the liberalisation of the capital account and international controls over informal money transfers after the September 11 attacks resulted in increased investments and remittances. Since the start of FY2008, the external and internal environments have become less favourable for borrowing. There has also been a significant decline in capital inflows. Consequently, the government failed to

[2] Oil prices surged from US$55 per barrel in January 2007 to US$140 per barrel in May 2008, a jump of more than 155 percent. Similarly international food price index increased by roughly 40 percent in 2007 and, in the first three months of 2008, prices rose by about 50 percent. The prices of rice, wheat and palm oil also increased by 78 percent, 120 percent and 102 percent respectively between April 2007 and April 2008. Islam, M. Shahid, "Of Agflation and Agriculture: Time to Fix the Structural Problems", ISAS Insight No. 30, 5 May 2008 – Quoted International Monetary Fund. http://www.isasnus.org/events/insights/31.pdf.

float planned sovereign bond and global depository receipts, due to the political turmoil at home and as a result of the global financial crisis. For all the above reasons, the foreign exchange reserves began to shrink from US$15.6 billion in October 2007 to less than US$3.5 billion in October 2008, merely enough to support four weeks of imports, in the face of maturing liabilities. As a result, external debt and liabilities, as a proportion of foreign exchange reserves, reached a staggering 900 percent at the end of September 2008, against 300 percent a year ago, making it impossible to fulfil international obligations.

Friends of Pakistan: Economics and the 'War on Terror'

After failing to mobilise capital from the international market, Pakistan turned to several friendly countries. Saudi Arabia, a longtime friend of Pakistan which helped the country out of a similar crisis in 1999 after the nuclear tests, was less than enthusiastic about Pakistan's requests for deferred payments on oil imports. Nevertheless, Pakistani government sources claim that it received a 'positive response' from the Kingdom.

China, another all-weather friend of Pakistan with huge excess foreign reserves, declined any major cash infusion and President Asif Ali Zardari's visit to China in October 2008 only yielded US$500 million, with promises of investments and trade opportunities to help Pakistan. It is likely that Beijing wants to keep a low profile. Its growing investments and cooperation with Pakistan have already raised eyebrows in Washington and New Delhi. There have been suspicions that, after the India-United States nuclear deal, China and Pakistan may attempt a similar nuclear cooperation. Furthermore, it is only wise for China to let the Americans take care of their 'front line ally' in the 'war on terror'.

The United States, wary of Islamabad's commitment (and capacity) to fight militants mounting insurgency in Afghanistan against United States-led forces, has been moving towards a multilateral approach in tackling Pakistan's crisis. The Bush administration, bogged down by the worst financial crisis since the Great Depression, has also dragged its feet on a bill promising US$1.5 billion annual economic aid over a period of 10 years for Pakistan. The aid is conditional upon Islamabad's 'performance' in the fight against militants. Washington reportedly wants Pakistan to refocus its military strategy to fighting the militants and normalising relations with India, said a Pakistani diplomat privy to the negotiations while talking to the daily *Dawn*.[3] Therefore, by involving major stakeholders in regional stability, Washington wants to share its burden on the 'war on terror'. Washington threw its weight behind the formation of the Friends of Pakistan (FoP) [4] group to help Pakistan overcome its political and economic challenges by developing a comprehensive and coordinated approach to security, development and institutional issues facing the country. The group reportedly demanded Pakistan to get an IMF loan approval which would assure careful management of the economy and provide greater investor confidence.

The IMF Arrangement and its Implications

In fact, "by providing large financial support to Pakistan, the IMF is sending a strong signal to the donor community about the country's improved macro-economic prospects," said IMF

[3] Iqbal Anwar (2008), "IMF not Pressing for defence Cuts", Dawn, 26 October, http://www.dawn.com/2008/10/26/top18.htm

[4] The FoP was formed during President Zardari's visit to America in September 2008 on the margins of the United Nations General Assembly session. The FoP includes the G7 countries, plus Australia, China, Turkey, Saudi Arabia, the United Arab Emirates, the United Nations and the European Union.

Deputy Managing Director, Takatoshi Kato. The Managing Director of the Fund, Dominique Strauss-Kahn, urged the donor community to "work together and act quickly to support Pakistan's programme in order to mitigate the impact of the current economic difficulties".

The IMF arrangement is part of a broader package which involves other multilateral institutions and donor countries. It aims to restore macro-economic stability and investor confidence through a tightening of fiscal and monetary policies, while simultaneously preserving social stability and adequate support for the poor, stated the press release issued by the IMF. The loan tranches are subject to quarterly reviews by the IMF which has set forth certain conditions. Nevertheless, most of the 'conditions' are already part of the government's economic agenda announced during the FY2009 budget in June this year.

The Fund stipulates bringing Pakistan's fiscal deficit down from 7.4 percent of GDP in FY2008 to 4.5 percent in FY2009 and 3.3 percent in 2009/10 by phasing out energy and electricity subsidies and strengthening revenue mobilisation through tax policy and administration measures.

These measures, if implemented successfully, will help to meet the target to some extent, particularly the phasing out of subsidies.[5] In the short run, reforms in tax administration and, particularly the one percent increase in the general sales tax (from 15 to 16 percent implemented in the FY2009 budget) will help raise tax-to-GDP ratio. In the medium-term, the government will have to take a number of measures such as eliminating exemptions in the general sales tax and the income tax, and introducing a commercial agriculture tax.[6] There will also be cuts on development projects through 'reprioritisation', depending on loans from elsewhere. To provide support to the poor and vulnerable, spending on the social safety net will be increased from 0.6 to 0.9 percent of GDP in FY2009 with the help of the World Bank.

The IMF arrangement also stipulates tightening the country's monetary policy, bringing down inflation to six percent in FY2010 and ensuring zero government borrowing from the central bank. These measures too are in congruence with the State Bank of Pakistan's (SBP) announced monetary policy goals. In fact, the SBP has raised interest rates three times since January 2008, reaching 15 percent in November 2008.

Nevertheless, inflation remains uncontrollable. While food and energy inflation is expected to come down with the easing of supply shortages and a fall in international oil prices, the persistent acceleration in core inflation remains a matter of concern. By October 2008, the year-on-year non-food-non-energy core inflation rose to 18.3 percent from 13 percent in June 2008.[7] If this trend continues, the FY2009 inflation could reach 21 percent, far above the target of 11 percent set for the current year, according to the IMF and the SBP estimates.

The Debate

Pakistan is in a 'Catch-22' situation. As a matter of fact, the current inflationary pressures are largely due to higher government borrowings, besides exogenous price shocks. However, the

5 The subsidies increased from a provision of Rs.114 billion (US$1.67 billion – 1.1 percent of GDP) in the FY2008 budget to Rs.407 billion (US$6 billion – 3.9 percent of GDP).

6 The government also envisages, in the budget, to increase tax to GDP ratio from 10 percent to 15 percent within the next five to seven years.

7 The 20-percent weighted trimmed measure of core inflation reflects steeper inflationary pressure as it rose to 21.7 percent in October 2008 from 17.2 percent in June 2008.

measures taken (revoking subsidies, increasing sales tax, etc.) to arrest growing fiscal deficit are fueling inflation. The large external account deficit and slowdown of capital inflows, due to domestic turmoil and international crisis, are also exerting pressure on the Rupee, which has depreciated 25 percent in six months. The net effect of depreciation in value of the Rupee, in the presence of huge inflation, has exacerbated inflation by raising input costs. Moreover, the recession in Pakistan's top export markets is also likely to hurt export growth. The IMF has already reduced Pakistan's GDP growth projections to 3.5 percent in FY2009. This vicious cycle is likely to cause a less than expected revenue generation and a more than targetted fiscal and current account deficit.

In view of such a situation, a contractionary monetary policy and austere fiscal measures are not enough. Many analysts in Pakistan and abroad have criticised the IMF and the Pakistan government. A case in point is an editorial in the *Wall Street Journal* (WSJ) saying, "Pakistan needs market-oriented reforms along the Chilean and Irish models, not the IMF's austerity prescriptions."[8] Though many in Pakistan may not agree with the alternative suggested by the WSJ, there is an increasing concern over the high interest rates, cuts on development expenditure and the increase in taxes.

The IMF and the Pakistani authorities, on the other hand, are of the view that the economic crisis in Pakistan is different from global developments where many developed and developing countries have gone for fiscal stimulus and monetary easing. In contrast, Pakistan, says the SBP report,

> "...hit by the global commodity price shock and given the delays in pass through of this price effect, witnessed a growth in its fiscal and external current account deficits that reached unsustainable levels and alarmingly high inflation. With stagnating tax to GDP ratio, this not only enhanced recourse to borrowings from the SBP but also resulted in a fall in foreign exchange reserves, triggering depreciation in the exchange rate. Since there are significant differences in 'diagnostics' among Pakistan and other countries it must be recognised that the policy solutions will also be different."[9]

The IMF pointed out in its press statement that "the program and its conditionality is based on the targets and measures that the authorities have themselves set for the next two years. The IMF is convinced that the best implemented programs are the ones that are home grown and fully owned by the country". Alongside the IMF's financial support, "there is an urgent need to mobilise additional donor support to strengthen Pakistan's resilience to potential shocks, help finance the expanded social safety net, and allow for higher spending on development programs", said the statement.[10]

To be fair, the above 'conditions' have nothing to do with the current IMF loan and were on the government's agenda earlier. Nevertheless, the Fund's oversight will restore some confidence in the economy. At the moment, Pakistan's foreign credit rating is practically at rock bottom. Standard & Poor's has lowered Pakistan's foreign credit rating three times in

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[8] "Pakistan's Plan C, Does the IMF has no Fresh Ideas?", The Wall Street Journal, 28 October 2008. http://online.wsj.com/article/SB122513397704572755.html?mod=relevancy

[9] "Interim Monetary Policy Measures", State Bank of Pakistan, November 2008. http://www.sbp.org.pk/m_policy/MPS-MAY-FY08-EN.pdf

[10] "IMF Executive Board Approves US$7.6 billion Stand-By Arrangement for Pakistan", International Monetary Fund", 24 November 2008. http://www.imf.org/external/country/PAK/index.htm

the current year to 'CCC', eight levels below investment grade and it has kept Pakistan on the watch list. Both the IMF and the Pakistani authorities are hoping that investor confidence will be restored and foreign capital will start flowing in.

There has also been an intensive debate in Pakistan in favour of and against the expected IMF 'conditions'. Two such reported 'conditions' included the cuts on defence expenditure and the imposition of an agriculture tax. However, in reality, there were no discussions whatsoever on the defence budget in the negotiations with the Fund[11] while the tax on commercial agriculture was set as a medium- to long-term agenda. In fact, tax on commercial agriculture in Pakistan is less likely to hurt the poor than the feudal landlords. There have been calls for an agriculture tax for a long time but this has always been put down by the powerful landowners who also sit on the legislative benches.

Conclusion

Apart from the Musharraf regime, no other Pakistani government has been able to meet the benchmarks of economic reforms imposed by the Fund since the first agreement between the IMF and Pakistan in the 1980s. This has resulted in the premature termination of these agreements. The Musharraf regime owed its performance to its undemocratic origins and to indirect (and direct) assistance from the United States.

It remains to be seen if Pakistan will abide by the IMF conditions this time around. How these measures would help or hurt the economy depends on several factors, including oil and food prices, the global financial crisis, and Pakistan's domestic security and its political situation. In the final analysis, much would depend on Islamabad's ability to quell militancy and keep Washington and other donors on its side by providing stable and secure business climate through good governance.

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[11] And rightly so, given the current security situation, it would be naive to think that the IMF would cut defence expenditure.