The impact of financial crisis on Pakistani economy

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Introduction

Background

The term financial crisis refers broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. The present financial crisis in the West is characterised by contracted liquidity in global credit markets and banking systems. For example, a downward drift in the housing market of the United States, risky practices regarding lending and borrowing, and excessive individual and corporate debt levels have caused multiple adverse effects on the global economy.

The current financial crisis dates back to the end of the twentieth century, and became more pronounced throughout 2007-2008. All these years, it has passed through various stages exposing persistent weaknesses in the world financial system and regulatory framework. It started to emerge with the bursting of the U.S. housing mortgage bubble in 2005. The major reason behind the crisis was an increase in loan incentives such as easy initial terms, along with the trend of rising housing prices that encouraged borrowers. As a result, people could easily enter into difficult mortgages in the belief that they would be able to quickly refinance at more favourable terms in future. In 2006-2007, however, the rising interest rates and declining housing prices in many parts of the U.S. made refinancing more difficult.

The global financial crisis has also affected the developing countries depending on the structure of regional economies and their integration into world markets. According to a World Bank analysis, throughout the developing world, growth is forecast to slow down in 2009, as a result of falling exports and remittances, and stock market declines caused by capital flight and depreciating local currencies, though recession is not expected[1]. However, the reversal of the rise in fuel and food prices is shifting terms of trade and helping to ease inflationary pressures.

Far away from the U.S. and Europe, Pakistan has suffered from high fiscal and current account deficits, rapid inflation, low reserves, a weak currency and a declining economy that have put the country in a very difficult situation. There

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have also been worries about issues surrounding political instability and poor law and order situation. These factors created a perilous environment for economic growth. Furthermore, a weak institutional base and the inability of successive governments to undertake long-term and broad-based reforms and policies have made sustained economic growth difficult. Therefore, Pakistan's economy was already in a dire situation well before the current financial crisis hit the developed countries.[2]

It is believed that in the short run Pakistan can survive the current global crisis as its financial sector is weak in nature and is not strongly embedded to the global financial sector. But, in the long run, the country will have to bear the impact of the crisis on a number of counts such as falling of foreign direct investment, development aid, remittances and exports. Moreover, the twin deficit, budgetary and trade, phenomenon, the plunge in stock markets, energy shortages and rising food inflation were least linked with the global financial crisis.[3]

According to the World Bank's "Global Economic Prospects 2009", political instability and poor law and order situation have taken a toll on Pakistan's economy, while the global financial crisis added substantial downward pressures on its financial markets. Pakistan and the IMF agreed to lower the target for the gross domestic growth this fiscal year to 2.5 per cent from 3.5 per cent[4]. But, many analysts have said that even achieving this target would be very ambitious. While the national conference on the 'Impact of Global Financial Crisis' in Pakistan concluded that the country could not avert the current global financial crisis, it could exercise restraint and prudence in facing the difficult times ahead.

Objective:

The purpose of this study is to analyse the impact of the global financial crisis on Pakistan's economy. It begins with the impact of the financial crisis on the external sector of economy along with financial institutions and socio-economic situation. The study will also highlight the root causes of Pakistan's financial crisis. It will also evaluate how the government is managing the problem through different policies, and what the best solution would be to get rid of this economic situation.

External and Financial Developments

A strong economy requires a cutting-edge financial system that inspires confidence and efficiently provides a wide range of financial services to households and businesses alike; and capital markets are an essential component of a strong financial system. A diversified financial system is conducive to both financial stability and to efficient resource allocation in support of medium-term economic growth.

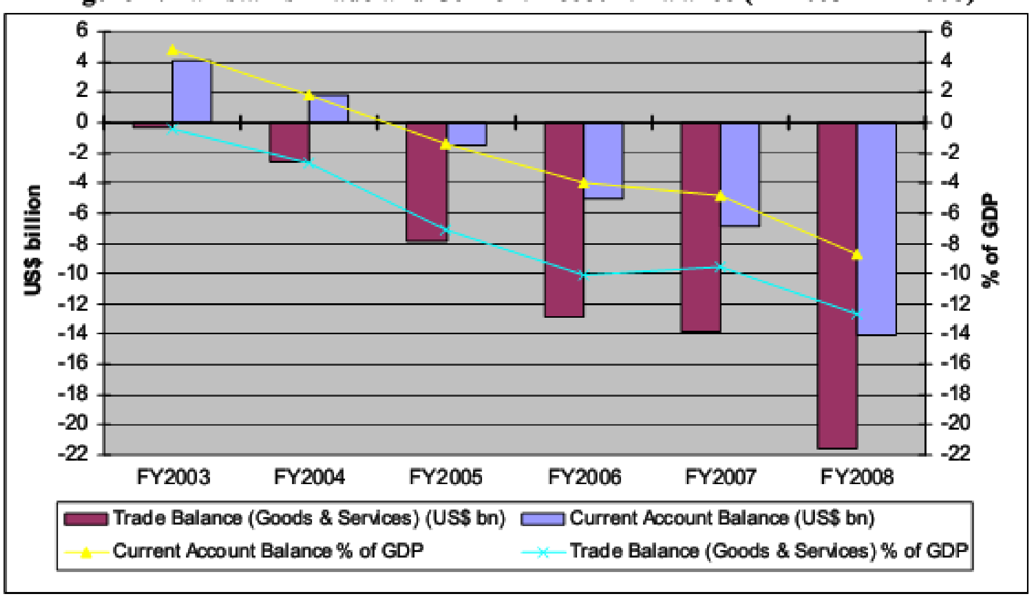
Twin Deficits

The World Bank reported that large net losses from food and oil prices have led to a sharp decline in current account and fiscal balances, allowing little scope for countercyclical policies. Pakistan is particularly vulnerable, with large fiscal and current account deficits, high inflation, low reserves, weak currency, and deep political instability.[5]

It is also apprehended that Pakistani exports may be hit severely due to recession in the Western world. The United State and the European Union are the major destinations of Pakistani exports. Both are badly hit by the current financial crisis. The huge unemployment will result in diminished purchasing power of the people in these countries, which will surely affect exports from all the countries including Pakistan. Pakistan may, therefore, face problems in the exports sector as about 54 per cent of the country's exports go to U.S. and European countries.

The government of Pakistan routinely spends some $26 billion a year based on expected revenues of around $20 billion, incurring a budget deficit of over 7 per cent of GDP. On the trade front, accumulated exports hardly ever cross the $20-billion year mark, but imports end up exceeding $35 billion; a trade deficit in excess of $15 billion a year and a current account deficit of over $1 billion a month.[6] The broader picture can be seen in the figure 1 below:

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



Sources: State Bank of Pakistan and the IMF

Approximately half of the additional goods import bill in financial year 2008 came from high fuel prices in the international market that peaked in July 2008.

That led to an increase in both inflation and current account deficit. Oil imports increased by 43 per cent in the year 2007-08, and reached $10.5 billion. That was the major cause of the worsening trade deficit, which soared by 57.4 per cent to $15.3 billion, even though the annual export target of $19.2 billion was exceeded.[7] Furthermore, in the first four months of the financial year 2009 (July-October 2008), a similar trend continued. The trade deficit reached US$7.55 billion against US$5.47 billion in the same period the previous year, a 37 per cent increase. Moreover, net inflows reduced substantially, resulting in almost a doubling of the current account deficit to $5.95 billion from $2.99 billion over the same period the previous year.[8]

Thus, international oil prices was the major cause of the worsening fiscal and trade imbalances and Pakistan was caught in a vicious cycle of stagflation, i.e., economic stagnation coupled with high inflation. However, the subsequent fall in oil prices has brought some relief. It is hoped that the same trend would extend to other imported raw materials such as fertilizers, reducing the cost of production and increasing food production.

Pakistan's balance of payment crisis came at a time when the entire donor community, including the U.S. and Europe, was beset with its own financial crisis. Desperate for a bailout package, Pakistan pleaded with the U.S., asked Saudi Arab and urged China for a billion-dollar financial support, all to no avail. Finally, in November 2008, the International Monetary Fund agreed to a stand-by arrangement of $7.6 billion and released the first instalment of $3.1 billion. As a consequence, foreign exchange reserves jumped from a low of $6 billion to over $9 billion.[9]

Given this background, the government should have reviewed its strategy instead of searching for financial assistance in the form of aid and should have worked out a favourable regional strategy. Pakistan has not yet cashed in on its geo-strategic importance on a broad perspective as the country is the gateway to Central Asia and surrounding major emerging economies like China, India and Iran. Moreover, Pakistan can get maximum profit in the shape of transit fee as the oil-rich Central Asian countries can easily utilise the Gwadar port for their two-way trade. That would not only bridge Pakistan's fiscal deficit but will also help in establishing industry in the country.

Foreign Direct Investment

There are strong apprehensions that foreign direct investment (FDI) may further decline due to recession in the economies of the developed countries. It must be pointed out that Pakistan is in dire need of FDI and has taken a number of policy measures to attract it in the past few years. Despite enormous potential and attractive business opportunities that exist in Pakistan, the potential investors have not invested capital at the desired level due to various reasons, especially political instability and security concerns.

The figures for the period July 2008 to January 2009 in this regard are even more disturbing in the perspective of portfolio investment. A total of $321.4 million left the country under this head which may partly be explained by the global financial crisis and partly by the loss of confidence in the Pakistan economy that appears to persist to this day[10]. It is unfortunate that the elected government has failed to establish its economic bona fides one-year after it won the elections in February 2008.

The economic growth experience in the Musharraf era was highly dependent on foreign capital inflows. It therefore is one of the main factors in the economic growth of Pakistan. Official figures put Pakistan's FDI target for this year at $3.5 billion compared to $5.2 billion last year. This downward trend in FDI is very disturbing, but needs to be watched very carefully. Obviously, there is nothing that Pakistan can do about the present global financial crisis which is already reducing the level of foreign investment drastically. However, efforts must be made to remove bottlenecks at the domestic level to facilitate and, if possible, to accelerate the flow of FDI as soon as possible.

The recent stand by arrangement with the IMF and subsequent improvement in some of the macroeconomic indicators of the country may encourage foreign investors to take a favourable view of the country. But, most of the analysts are of the view that Pakistan could become a more attractive destination for investors due to its geo-strategic location. That is, China, India and Iran, the fast growing economies, surrounding the country. Pakistan could take maximum benefit from it in future.

In addition, continuity and consistency in policies, coupled with an investment-friendly and hassle-free environment, could make Pakistan a destination of choice for foreign investors. However, there remains the need for more diversification and reforms as foreign investment is concentrated in only three sectors of IT/telecom, banking and finance, and tobacco. Thus, the government has to restore the confidence of foreign investors through establishing political stability and security. Moreover, the government should try to attract foreign investment in agriculture and power sectors, along with other developmental projects. But, much more needs to be done by the government.

Banking Sector

In response to the growing demands of financial globalisation, Pakistan's banking system is starting to integrate with the international financial markets. According to the 2007-2008 Financial Stability Review by the State Bank of Pakistan, Pakistan's banking sector has remained remarkably strong and resilient, despite facing pressures emanating from weakening macroeconomic environment since late 2007.

It is hard to exactly identify the likely impact of the present global financial crisis on Pakistan's banking system. In the staring weeks of this crisis, Pakistan's financial market experienced a mild shock as rumours about freezing of foreign currency accounts and seizure of bank lockers by the government spread over the country. That shook the trust of the account holders as people of Pakistan remember the cooperative and financial company's fiasco of 1980s and 1990s. They have not forgotten how the government broke their trust by freezing their foreign currency accounts in 1998. That led to noticeable withdrawals of money from the banking system already experiencing liquidity crunch. As the currency market turned unstable, the State Bank of Pakistan intervened to ease liquidity and injected about $20-100 million in the currency market. It also lowered the cash reserve requirement for banks from nine to seven per cent.

The data from the banking sector for the final quarter of 2008 confirms a slowdown after a multi-year growth pattern. In October 2008, total deposits fell from Rs3.77 trillion in September to Rs3.67 trillion. Provisions for losses over the same period went up from Rs173 billion in September to Rs178.9 billion. The three-month treasury bill auction saw a jump from 9.09 per cent in January 2008 to 14 per cent in January 2009, and bank lending rates are now as high as 20 per cent.[11]

Additionally, the presence of foreign banks in Pakistan expands access to credit as well as financial services, which can encourage efficiency and innovation in domestic banks. Pakistan has a concentration of foreign banks. They accounted for one-tenth of deposits in the country in 2007-2008. Thus, the ripple effect of shocks from the credit squeeze in the West would have an impact on local financial markets through these banks.[12]

Overall, Pakistan's banking sector has not been as prone to external shocks as have been the banks in Europe. Liquidity is tight, certainly, but that has little to do with the global financial crisis and more to do with heavy government borrowing from the banking sector, leading also to the 'crowding out' of the private sector. Therefore, there should be a strong central financial institution which basically deals with all economic dealings such as economic stability and expansion and collection of taxes. Moreover, it should be the sole responsibility of this institution to check inflation, hoarding, monopolies and concentration of wealth. Otherwise, the government would not be able to restore the confidence of the account holders and ensure financial stability in the country.

Karachi Stock Exchange

The Karachi Stock Exchange (KSE) has been in a free fall 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[13]. That was due to the global economic meltdown and insecurity in the country which increased investor's anxiety, during the period July-December 2008. These gloomy events have had an adverse impact on the performance of Pakistan's equity market.

According to estimates of the State Bank of Pakistan, foreign investment in the Karachi Stock Exchange stands at around $500 million. Other estimates put foreign investment at around 20 per cent of the total free float. During 2006-2007, foreign investors were actively investing in KSE-listed securities. However, the year 2008 was a miserable one for the KSE. The benchmark KSE has undergone a sharp reversal in the rising trend of its leading KSE-100 index. The index underwent a huge loss of 58.3 per cent to close at 5,865 points on December 2008 as against December 2007.[14]

Political instability, the financial crisis, a troubling macroeconomic scenario, an active insurgency in the Federally Administered Tribal Areas (FATA) and NWFP, hyper inflation, a ballooning trade deficit, an unsustainable budgetary deficit and a worrying drop in foreign currency reserves created a dark, threatening cloud over the market. Moreover, the KSE growth was based on speculation. Therefore, it has shown a falling trend after the bursting of the speculative bubble.

Working Remittances

The country's economy heavily relies on remittances sent by the more than three million overseas Pakistanis in Europe, the Middle East and the U.S. It is like a goldmine for Pakistan, playing a key role for stability in the balance of payments and mitigating unemployment problems. These overseas Pakistani send $7 billion a year, more than the loans the country received from foreign countries[15]. According to the ministry of finance, the flow of remittances has remained robust during the last seven months of the fiscal year 2009 despite the global economic meltdown. The oil-rich countries along with the United States accounted for more than three-fourth of the remittances during the first seven months of the current fiscal year 2008-2009[16]. The remittances sent by these communities are not only helpful in poverty reduction in Pakistan but also in decreasing budgetary deficits.

There is a strong likely hood that this single largest source of foreign exchange may come under stress. The financial crisis will have a significant impact on the size of remittances which Pakistan receives from the West. It would not only affect the businesses of this community but their job prospects. Throughout Pakistan, at least one family in every village is dependent on regular remittances to survive. The country would, therefore, be in deep crisis if remittances are seriously affected due to the financial crisis in the West.[17]

Socio-economic Situation

Pakistan would also face problems related to poverty alleviation programmes which are funded by the U.S. and European countries. These countries are supporting many developmental projects, particularly in the education and health sectors. According to an Asian Development Bank report, a 10 per cent increase in food prices could drive an additional seven million people into poverty in Pakistan; a 20 per cent increase, 14.7 million; and a 30 per cent increase, 22 million. After food, the second major household expenditure is energy, the price of which increased by about 30 per cent in the first quarter of 2008.[18]

Pakistan's rating by Standards and Poor (S&P) has been revised to ccc+, a few notches above the default level. The impact will be differential in the sense that the poor segments of society will be badly hit as government may have to cut the public sector development programme, reflecting its inability to complete the social and development projects for poverty reduction. In that case, the achievement of the millennium development goals will also become difficult.

In November 2008, the IMF agreed to bail out Pakistan through a SBA (details discussed below) valued at $7.6 billion with the condition of an increase in taxation and interest rates which means an increase in the cost of doing business which would further increase inflation. That would also lead to the closure of many industrial units in Pakistan, creating more unemployment. According to the IMF's own estimates, the SBA package will slow real GDP growth to three per cent in 2008-09 and add an additional 2 to 3 million to bottom-line unemployment.

Thus, the present global financial crisis would further widen the gap between the rich and the poor, and people with lower incomes would bear the brunt of economic slowdown.[19] The present global financial crisis is bound to make matters worse unless long-term structural reforms are adopted such as relying on the industrial and agricultural sectors for economic development.

Plan to Avert Financial Crisis

Pakistan has been facing a severe economic crisis since 2007. Thus, the crisis in Pakistan came at the same time as the global financial crisis. The problem arises from the policies the successive governments have followed. The ruling coalition government obviously has no plan based on indigenous resources and capability by exploiting its natural and human resources on the base of its national interest. They tend to look outward for assistance in the form of aid instead of investment in development projects. Hence, the government hopes a recently formed group of countries called "Friends of Pakistan", including the U.S., the U.K., Canada, France, Germany, China and the Gulf states, can help financially.

Friends of Pakistan

The Friends of Pakistan (FoP) membership consists of countries that are also members of the aid-to-Pakistan consortium, which was constituted in 1960 by the World Bank in an effort to facilitate coordination among the major assistance providers to Pakistan. However, the global economic crisis could limit assistance.[20]

The new regime's initial response was to take financial assistance from multilateral donors as well as from FoP for immediate relief. Pakistan appealed to the U.S., Saudi Arabia and China for donations. Perhaps, it was thought that Pakistan's deep-rooted relationship with China and Saudi Arab and its role as a front line state in the U.S.-led 'war on terror' could induce the 'friends' to immediately give at least $10-15 billion.

China declined any major cash infusion and President Asif Ali Zardari's visit to China in October 2008 yielded only US$500 million, with promises of investment and trade opportunities to help Pakistan. China provided no further details on the form and extent of its intended support to Pakistan. The two sides did agree to foster closer economic relations between China and Pakistan, setting the goal of increasing bilateral trade from $7 billion in 2007 to $15 billion in 2011.[21] This shows Beijing wants to keep a high profile in term of trade instead of aid.

Saudi Arab, a long-time friend of Pakistan which helped the country in a similar crisis in 1999 after the nuclear tests, was less than enthusiastic about Pakistan's request for deferred payments on oil imports. However, Pakistani government officials claim to have received a positive response from the Saudi government.

The United States, bogged down by the current financial crisis, has also dragged its feet on a bill promising $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. Obviously, the coalition government thought that Pakistan's role as a front line state in the 'war on terror' could would the U.S. to immediately give at least $5-10 billion to bail it out and overcome the worsening financial mess. However, these hopes were soon dashed when Richard Boucher made clear in a news conference in Islamabad that "the 'friends' would not throw money on the table." In other words, any assistance will follow a thorough assessment of Pakistan's plans.[22]

IMF Bailout Package

As 'friends' did not come forward, the government moved on to other plans. As a result, Pakistan asked IMF to provide funds to overcome the crisis. And, on November 24, 2008, the executive board of the IMF agreed to give financial assistance to Pakistan through a SBA valued at $7.6 billion. There were two conditions, i.e., Islamabad must cut its budgetary deficit from around 7 per cent of GDP to 4.2 per cent, and increase taxation from 10 per cent of GDP to 10.5 per cent.[23]

Any increase in taxation would mean a further slowdown in the economy and that will result in further unemployment. A rise in the interest rate would lead to an increase in the cost of input. As a result many, industrial units will be closed.

Recent Developments

Later on, the government came up with a more realistic approach; Pakistan has sought assistance from Friends of Pakistan (FoP) for 54 mega development projects, including the $8.4 billion Diamer Bhasha dam, and the Neelum Jhelum hydropower project.[24] But, the government needs to do more by drawing up plans on the regional basis, particularly with China and Iran. In addition, Gwadar port has a geo-strategic importance and can attract about 50 per cent of oil supply of Central Asian countries. Pakistan can get maximum benefits should they utilise this port. Hence, the ruling elite must review further its strategy and come up with a more feasible solution by exploiting the country's geo-strategic importance.

But, it is important to highlight that these arrangements must be investment-oriented instead of focusing on aid and assistance, as in the subsequent visit of President Zardari to China, the two sides have signed various investment, energy and trade MoUs. The Chinese leadership has much concern about the crisis, but wants Pakistan to overcome the financial and crisis by investing in developmental projects. This is essential for the health of Pakistan's economy.

Conclusion

The impact of global financial crisis has not been felt in Pakistan as a separate crisis as the country is already facing the same since 2007. The country may escape the immediate negative implications of the global financial crisis. But, there will be long-term direct and indirect consequences. Its direct implications would on FDI, bilateral assistance and the size of remittances, in future. The indirect consequence would be that Pakistan's exports will suffer as imports of the developed economies in financial meltdown will fall, and the possibility of slashing of funds from ongoing foreign-funded projects can also not be ruled out.

Therefore, at present, the Pakistan economy is under threat. Old problems are combining with emerging new ones. There is a real danger that if the government does not respond to the emerging financial and economic difficulties in a timely and resolute manner, the macroeconomic situation could worsen significantly. There is no doubt that an adverse external economic environment in the shape of the current global financial crisis has contributed to some extent to the crisis in Pakistan today. Nevertheless, the genesis of the current crisis is internal. The key reasons for the current meltdown of the economy are continued political turmoil, deteriorating security, structural issues and the unsustainable growth policies caused by much reliance on financial aid.

Many analysts in Pakistan and abroad have criticised the IM, and the government needs to develop the economic base through encouraging sectors like industry and agriculture, along with a sound regional policy to get finances in terms of investment-oriented projects, not the IMF's austerity prescriptions.

In addition, this is the right time to divert Pakistan's trade and investment from the West to the region, particularly China. As both the U.S. and Europe have been severely hit by the global financial crisis, China's reserves have increased and it is searching for investment across the globe. The country is fortunate to have a friend like China in the neighbourhood.

Notes

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