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STATEMENT TO THE COMMONWEALTH DELEGATION

SOCIAL POLICY AND DEVELOPMENT CENTRE

STATEMENT TO THE COMMONWEALTH DELEGATION

By
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In his first address to the Nation immediately after the military takeover General Pervez Musharraf in his indictment of the Nawaz Sharif government said

'The Economy too is in a State of Collapse'

In his second speech on the 17th of October 1999, he outlined his economic agenda including across the board accountability to recover the plundered wealth of the country from loan defaulters and tax evaders, rebuilding of investors' confidence, increasing domestic savings, carrying out pragmatic tax reforms, turning around state enterprises towards profitability, boosting agriculture and reviving industry.

Pakistan's economy has, in fact, been going through a period of economic difficulty during the last few years. In 1996-97 the growth rate was only 2 per cent. There was some recovery in 1997-98 and the growth rate rose to over 4 per cent. The imposition of sanctions following the nuclear blasts in June 98 and the suspension of the on-going ESAF/EFF program with the IMF plunged Pakistan into a financial crisis. In the face of low and depleting foreign exchange reserves, draconian measures had to be taken including the freezing of foreign currency accounts, imposition of capital controls, introduction of import restrictions, devaluation of the currency, etc. The foreign exchange reserve position improved only after the revival of the ESAF/EFF program in January this year. Many of the steps taken to counter the impact of the sanctions have inevitably had a lasting negative effect on the economy, especially on investor confidence.

The fundamental question is whether the economy was beginning to show some signs of recovery or was it in a state of collapse at the time of the military takeover. During the last nine months the government had been implementing the conditionalities embodied in the IMF program, albeit in fits and starts. Was this program beginning to yield results?

Before we can answer these questions, we need to know the financial and real indicators of an economic collapse. We can take the evidence from the recent East Asian crisis to identify these indicators. Typically a financial crisis occurs when the exchange rate becomes vulnerable and there is a steep currency depreciation alongwith a severe haemorraging of the foreign exchange reserves. Simultaneously, the banking system comes under severe strain and share prices tumble precipitiously. There is a run on deposits and some banks may even fail. Interest rates shoot up and the process of financial disintermediation becomes clearly visible. Prices of essential commodities rise exponentially and there may be shortages caused by import bottlenecks or speculative behaviour.

None of these manifestations of financial crisis was evident on the 12th of October, when the army dismissed the elected government. Pakistan had transited to a market based exchange rate regime in May 99 and an inter-bank rate had been established. This rate had remained stable with depreciation of only 1 per cent in about 4½ months. It may be argued that the exchange rate had been propped up artificially by Central Bank intervention but despite this foreign exchange reserves at the time of the military takeover stood at close to $ 1.5 billion, the highest level in the last three years and representing the equivalent of just under two months of imports.

The share market had also firmed up somewhat. At the time of imposition of sanctions in June 1998, the KSE index stood at 1000. It fell sharply to reach a low of about 750 by the end of December 98. Thereafter, there has been some recovery and on the 12th of October 1999 the index was at 1257.

The banking system did not appear to be under any exceptional stress. It had, more or less, absorbed the shock of the freezing of the FCAs. Reduction in government borrowing due to retirement of domestic debt had tended to soften interest rates and create an overall slackness in credit demand. The Governor of the Central Bank in his recent TV interview had asserted that while the stock of outstanding bad debt was high at Rs 145 billion, growth had been arrested during the last two years.

The fiscal deficit had declined in 1998-99 to 4.5 per cent of the GDP from 5.4 per cent of the GDP in 1997-98, despite the large fall in Central Bank profits and stagnation in tax revenues. This had been achieved by containment of current expenditure (including military expenditure), and a sharp cut back

in development expenditure. The government had committed itself to a tight budget deficit target of 3.3 per cent of the GDP for the current year, despite implementing steep import tariff reforms earlier in 1999. An ambitious target for CBR tax revenues of Rs 356 billion had been set, implying growth of 16 per cent. During the first quarter of the year, tax revenues have reached Rs 72 billion in relation to Rs 59 billion during the corresponding period of last year, representing growth of almost 23 per cent. While this level may have been achieved by following the usual practice of holding back refunds and rebates to meet targets, it is clear that the process of growth in revenues has resumed.

The inflation rate has moderated substantially. This is the first indication that the process of stabilisation under the IMF program is beginning to be accomplished. In the first three months, July to September, of the current fiscal year the annualised inflation rate was down to 3.3 per cent, the lowest rate for a long time. This was partly in response to the low rate of monetary expansion in the previous year, predicated on a steep reduction in the fiscal deficit and debt retirement. It has been argued, however, that inflation had merely been postponed by lack of adjustment in administered prices and that deflationary tendencies had risen in the economy due to the deep on-going recession.

This takes us to a review of the real economy. There are prospects now of a bumper cotton crop and the problem currently is one of disposing off the surplus at reasonable prices. Industrial production has been showing a steady growth rate of about 5 per cent since February 1999. Therefore, the economy was beginning to show some signs of revival.

Why then has the allegation been made that the economy is in a state of collapse? I believe that there are two reasons for this. First, as mentioned earlier, the performance of the economy has been declining on a long-term basis. During the decade of the 80s the growth rate of the economy was over 6 percent. It fell to 5 percent in the first half of the decade and to 4 percent in the second half. Last year, it fell further to 3 percent. During the last four years real per capita income has increased cumulatively by only 1 percent. There is evidence that both unemployment and poverty have risen sharply. Some estimates place the rate of unemployment at over double that prevailing at the start of the decade while poverty has increased from one fifths of the population to over one thirds.

Mr. Nawaz Sharif was elected primarily on the basis of his economic agenda. During his first tenure in the early 90's his policies of liberalisation, deregulation and privatisation had brought about a boom in the economy, although short-lived. There was widespread expectation that his return to power would trigger off a rapid process of revival of the economy. But this did not happen. A debt ridden economy gave him little fiscal space and the sanctions following the nuclear blasts, which led to a major loss of confidence and drying up of private capital inflows, more or less, put to an end any prospect for early revival of the economy. In this sense Mr. Sharif eventually paid a heavy political price for exploding the nuclear devices in May 98 in response to India.

Second, there were serious concerns about the sustainability of Pakistan's balance of payments. With external debt of almost $39 billion, equivalent to over 450 percent of export earnings, Pakistan's ability to service its external debt obligations is clearly in question. Developments in the short-run have heightened perceptions about the inherently precarious nature of Pakistan's balance of payments. The trade deficit has risen dramatically in the first quarter of this year to almost $ 500 million in comparison to about $ 255 million in the previous year. This was, of course, likely to happen because imports had been artificially depressed last year following the sanctions and also the prices of petroleum products have risen sharply meanwhile. It is not surprising, therefore, that imports have increased by almost 16 per cent. The more worrying feature was the continued stagnation of export earnings. However, there was some recovery of exports in September 99 when they registered an increase of 11 per cent, leading to a halving of the trade deficit during the month. Prospects for higher exports in coming months have improved due to the likely generation of a large cotton surplus available for export, albeit at lower international prices.

But the fact remains that the outlook for the balance of payments is not favourable. The annual trade deficit target of $ 1.2 billion is likely to be exceeded, especially due to the oil price shock. On top of this, the impact of loss of confidence in the economy following the sanctions continues to be felt on key magnitudes like home remittances and foreign private investment which fell sharply by 43 per cent and 37 per cent respectively in July and August 1999.

Altogether, there was a growing perception that Pakistan was heading towards a foreign exchange crisis due to the deterioration in the underlying fundamentals of the balance of payments. It was felt that sooner or later the Central Bank would run out of foreign exchange reserves to keep the currency afloat, especially in view of the difficulty of accessing to commercial borrowings in the face of extremely poor credit ratings internationally.

This perception of an impending crisis was heightened by the growing hiatus in the IMF program and the difficulty Pakistan was having in securing release of the $ 280 million tranche. Despite three rounds of negotiations by the former Finance Minister with the IMF between August and early October no resolution had been reached. The stumbling blocks appeared to be the failure of the Government of Pakistan to resolve the long outstanding IPP issue and to increase domestic petroleum prices in line with the rise in international prices. A breakdown of the relationship with the IFIs had the implication that the program levels of BOP financing would not materialise and the debt rescheduling by the Club of Paris would become inoperative. Coupled with the worsening current account deficit position, a foreign exchange crisis appeared imminent in the year 2000.

Overall, it would be fair to say that the economy was not in a 'state of collapse' in terms of the conventional indicators on the 12th of October 1999 when the army took over. If any thing there were visible signs of recovery both in the financial and real sectors of the economy. But the economy remained vulnerable to a future foreign exchange crisis due to the continued negative impact on private sector confidence of the sanctions imposed last year, due to the large oil price shock leading to a worsening of the trade deficit and due to the possibility of suspension of the IMF program. In addition, there was growing discontent among the people about the lack of growth in income and employment opportunities and the failure of the Nawaz Sharif government to bring about economic revival.

The latest London Economist has aptly summarised the economic developments in Pakistan prior to the military takeover as follows:

> *'The economy the General inherited from Mr. Sharif was reviving. Growth for the fiscal year, which ends on June 30th, was expected before the coup to be 3.9-*

> *4.4 per cent. Inflation is at its lowest level in 12 years. After a de facto default last year, Pakistan has built up an adequate level of foreign exchange. Before the coup, the government was close to an agreement with the IMF that would have released a vital $ 280 million loan instalment.'*

The next question which arises is will the military government be able to avert future economic collapse? In the immediate short run the impact is to the contrary. The enhanced uncertainty about the tenure and policies of the new government have actually undermined private sector confidence. Consequently, in the immediate aftermath of the takeover, punitive actions have had to be undertaken including reimposition of import margin requirements, capital controls, curbs on the operation of money changers and increased Central Bank intervention in money markets to prevent flight of capital. The stock market has fallen by 8 per cent since 12th October.

But as the policies become clearer and the economic team is put in place, markets are likely to stabilise. There is already some evidence that this is happening. However, uncertainty will continue to persist in the next few months and undermine investor confidence. First, while the process of aggressive debt and tax recovery has been welcomed by the people generally and is unambiguously supported, it is likely to affect the liquidity position adversely of major investor groups in the country and lead to distortion in investment choices with a preference for less visible investments. Second, in the absence of a time framework for transition to an elected government, risk averse investors are likely to postpone decisions due to lack of certainty about the continuity of policies beyond the present government.

The military government is likely to attach top priority to resolving the balance of payments difficulties. The newly appointed Finance Minister is an international banker of stature and his appointment is likely to inspire confidence in international markets and lead to mobilisation of substantial funds abroad. He will most probably move to resolve quickly the IPP issue and repair the strained relationship with the IMF and the World Bank. However, there will continue to be underlying structural problems with the balance of payments due to the high oil prices, low cotton and rice prices, low level of home remittances, lack of foreign direct investment, etc., coupled with uncertainty about aid inflows and future

economic policies. There will, therefore, continue to be the prospect of an impending economic crisis in Pakistan.

What is the case for sanctions to be imposed on the military government to announce a time frame for transition to democracy? Let me first say that in the presence of a fragile balance of payments position, imposition of sanctions involving suspension or reduction in aid inflows is likely to be very damaging as the recent Pakistan experience has shown. Unfortunately, the burden of the shock falls on the poor people. Research undertaken by my research center, the SPDC, reveals that in the short run the sanctions imposed after the nuclear blasts may have led to two million more people falling below the poverty line, ½ a million more children becoming malnourished and so on.

I also believe that the new government must be given enough time to accomplish two items of immediate importance in its agenda which are popular demands of the people. The first is to initiate and complete speedily the process of across-the-board accountability and the second is to recover the plundered wealth from loan defaulters and tax evaders. Beyond this the agenda of the military government relating to reforms in the judiciary, changes in the federal structure, devolution of power, etc., appear to be of a long term and structural nature and are better left to a political consensus to be evolved through the democratic process. As such sanctions may be avoided on the understanding that the military government has a tenure sufficiently long to take care of the short term agenda relating to accountability and recovery of the bad debt and tax dues, beyond which it moves towards elections and a return to democracy in Pakistan.

CONFERENCE PROCEEDING

STATEMENT
TO THE
COMMONWEALTH DELEGATION[?]

BY

HAFIZ A. PASHA[??]

October, 1999

[?] The Commonwealth delegation (fact finding mission) visited Pakistan on Wednesday, October 27, 1999 to meet the new government to press for a timetable for the restoration of democracy, to assess the human rights situation and recommend to the Commonwealth Heads of Government Meeting (CHOMG) measures needed to be taken should the regime in Pakistan persist in violating the principles of the Harare Commonwealth declaration. Leader of the delegation was Mr. Lloyd Axworthy, Foreign Minister of Canada and the members included Ms. Billie Miller, Deputy Prime Minister and Foreign Minister of Barbados, Mr. Victor Gbeho, Foreign Minister of Ghana and Tan Sri Data Musa Bin Hitam, Special Envoy of the Prime Minister of Malaysia to Commonwealth Ministerial Action Group (CMAG).

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