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Pakistan

and the

Global Financial Crisis

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Introduction

Capitalism, an economic system whereby land, labor, production, pricing and distribution are all determined by the market, has a history of moving from extended periods of rapid growth to relatively shorter periods of contraction. The ongoing Global Financial Crisis 2008-09 actually has its roots in the closing years of the 20th century when U.S. housing prices, after an uninterrupted, multi-year escalation, began declining. By mid-2008, there was an almost striking increase in mortgage delinquencies. This increase in delinquencies was followed by an alarming loss in value of securities backed with housing mortgages. And, this alarming loss in value meant an equally alarming decline in the capital of America's largest banks and trillion-dollar government-backed mortgage lenders (like Freddie Mac and Fannie Mae; the government-backed mortgage lenders hold some $5 trillion in mortgage-backed securities).

The $10 trillion mortgage market went into a state of severe turmoil. Outside of the U.S., the Bank of China and France's BNP Paribas were the first international institutions to declare substantial looses from subprime-related securities. Just underneath the U.S. subprime debacle was the European subprime catastrophe. Ireland, Portugal, Spain and Italy were the worst hit. The U.S. Federal Reserve, the European Central Bank, the Bank of Japan, the Reserve Bank of Australia and the Bank of Canada all began injecting huge chunks of liquidity into the banking system. France, Germany and the United Kingdom announced more than €163 billion ($222 billion) of new bank liquidity and €700 billion (nearly $1 trillion) in interbank loan guarantees.

Towards the end of 2007, it had become quite clear that the subprime mortgage problems were truly global in nature. Of the $10 trillion around 50 percent belonged to Freddie Mac and Fannie Mae. By September 2008, the U.S. Department of Treasury was forced to place both Freddie and Fannie into federal conservatorship. On 15 September 2008, Lehman Brothers, one of America's largest financial services entity, filed for bankruptcy. On September 16, American International Group (AIG), one of

America's largest insurer, saw its market value dwindle by 95 percent (AIG's share fell to $1.25 from a 52-week high of $70).

Germany, the fourth largest economy on the face of the planet, is economically, technologically and politically integrated with the world around it. With financial institutions going belly-up all around, credit institutions in Germany, investment firms, insurance companies and pension funds also came under severe financial stress. With bailout packages all around, *Bundesministerium der Finanzen* also managed to get its €480 billion bailout package approved through the *Bundestag* in record time. Germany's answer to the Global Financial Crisis has been the Financial Market Stabilization Act. The Act creates a bailout package to *"stabilize financial markets, provide needed liquidity, restore the confidence of financial market players and prevent a further aggravation of the financial crisis* (the Act has been enacted through federal legislation in less than a week's time)."

On 11 October 2008, finance ministers from the Group of Seven, G-7, Canada, France, Germany, Italy, Japan, the U.K. and the U.S. met in Washington but "failed to agree on a concrete plan to address the crisis." On October 13, several European countries nationalized their banks in an attempt to increase liquidity. On November 14, leaders from twenty major economies gathered in Washington to design a joint effort towards regulating the global financial sector.

Pakistan's Twin Deficits

Pakistan's financial crisis predates the Global Financial Crisis. For the past several years, Pakistan has been running an unsustainable budgetary as well as trade deficits. The Government of Pakistan, with expected revenues of around $20 billion, routinely spends some $26 billion a year thus incurring a budget deficit of over 7 percent of GDP. On the trade front, accumulated exports hardly ever cross the $20 billion a 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.

In 2007-08, Pakistan's balance of payment (BOP) crisis, as a consequence of $147 a barrel oil and a spike in commodity prices, meant a frightful depletion of foreign exchange reserves down to a less than 3-months import-cover. Inflation, in the meanwhile, shot up to over 24 percent and Pakistan stood caught in a vicious cycle of stagflation--economic stagnation plus high inflation.

Pakistan's BOP crisis had come at a time when the entire donor community including the U.S. and the Europeans were both engrossed in their own subprime disasters. Pakistan, desperate for a bailout package, pleaded the U.S., begged Saudi Arabia and urged China for a billion-dollar donation. The pleading, the begging and the urging was to no avail. Finally, on 24 November 2008, the International Monetary Fund (IMF), reportedly allured by the United States Department of Defense, announced a 23-month, $7.6 billion, Stand-by Arrangement (SBA) of which the first tranche of $3.1 billion was released. As a consequence, foreign exchange reserves jumped from a low of $6 billion to over $9 billion.

Pakistan's Banking Sector

Pakistan's banking sector is made up of 53 banks of which there are 30 commercial banks, four specialized banks, six Islamic banks, seven development financial institutions and six micro-finance banks.
According to the State Bank of Pakistan's (SBP) Financial Stability Review 2007-08, *"Pakistan's banking sector has remained remarkably strong and resilient, despite facing pressures emanating from weakening macroeconomic environment since late 2007."*

According to Fitch Ratings, the international credit rating agency dual-headquartered in New York and London, *"the Pakistani banking system has, over the last decade, gradually evolved from a weak state-owned system to a slightly healthier and active private sector driven system."*

As of end-2008, data from the banking sector confirms a slowdown (after a multi-year growth pattern). As of 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 in October. In the meanwhile, the SBP has jacked up economy-wide rates of interest (the 3-month treasury bill auction has seen a jump from 9.09 percent in January 2008 to 14 percent as of January 2009 and bank lending rates are as high as 20 percent).

Overall, Pakistan's banking sector hasn't been as prone to external shocks as have been banks in Europe. To be certain, liquidity is tight but that has little to do with the Global Financial Crisis and more to do with heavy government borrowing from the banking sector and thus tight liquidity and the 'crowding out' of the private sector.

Circular Debt

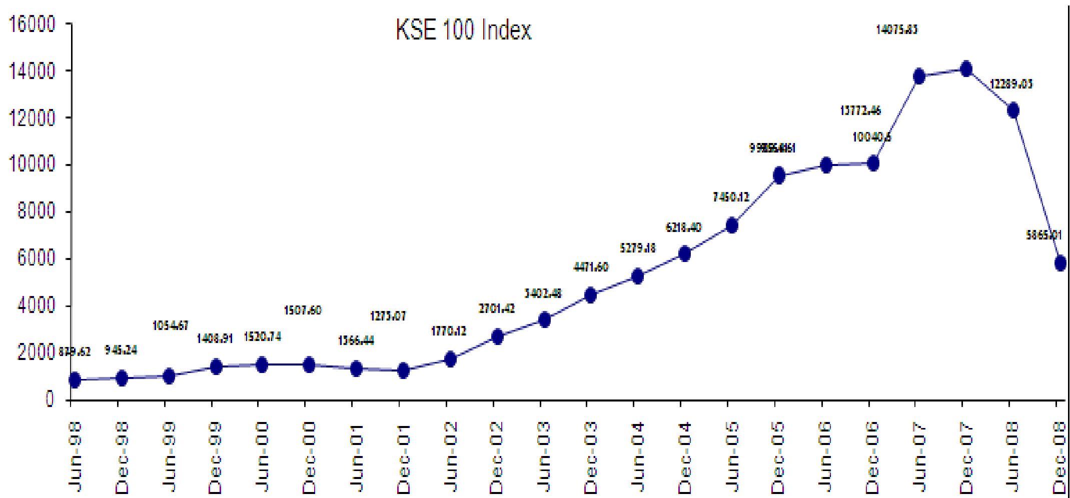
On 26 January 2009, Raja Pervaiz Ashraf, Minister for Water and Power, told the Senate that the *"federal government will settle half of the Rs400 billion circular debt by the end of January."* Circular debt arises when the

Government of Pakistan owes—and is unable to pay--billions of rupees to Oil Marketing Companies (OMC) and to Independent Power Producers (IPPs). As a consequence, OMCs are unable to either import oil or supply oil to IPPs. In return, IPPs are unable to generate electricity and refineries are unable to open LC's to import crude oil.

According to BMA, a leading financial services entity, *"The circular debt problem is seriously impacting the operations of the entire energy value chain. Due to low cash balances and liquidity as a result of the debt problem, the companies have to resort to short term financing at high interest rates. Refineries are having problems opening LC's to import crude oil due to mounting payables and receivables. The same can be said about the OMC sector including the fact that financing costs in the entire energy sector have skyrocketed. IPP's like HUBCO and KAPCO are also having difficulty purchasing oil and continuing operations."*

The Karachi Stock Exchange

The Karachi Stock Exchange (KSE) is Pakistan's largest and the most liquid exchange. It was the "Best Performing Stock Market of the World for the year 2002."



As of the last trading day of December 2008, KSE had a total of 653 companies listed with an accumulated market capitalization of Rs1.85 trillion ($23 billion). On 26 December 2007, KSE, as represented by the KSE-100 Index, closed at 14,814 points, its highest close ever, with a market capitalization of Rs4.57 trillion ($58 billion). As of 23 January 2009, KSE-100 Index stood at 4,929 points with a market capitalization of Rs1.58 trillion ($20 billion), a loss of over 65 percent from its highest point ever.

According to estimates of the State Bank of Pakistan (SBP), foreign investment into the KSE stands at around $500 million. Other estimates put foreign investment at around 20 percent of the total free float. During calendar 2006 as well as 2007 foreign investors were quite actively investing into KSE-listed securities. In September 2007, Standard & Poor's cut its outlook for Pakistan's credit rating to "stable" from "positive" on concern that "security was deteriorating." On 5 November 2007, Moody's Investors Service announced that Pakistan's credit rating had been placed "under review."

Towards the end of 2007, the uncertainties of the upcoming general election, a troubling macroeconomic scenario, an active insurgency in the Federally Administered Tribal Areas (FATA), double-digit inflation, a ballooning trade deficit, an unsustainable budgetary deficit and a worrying depletion in foreign currency reserves had all brought dark, threatening clouds over the KSE.

IMF: Panacea or More Pain?

On 24 November 2008, the Executive Board of the IMF agreed to bail Pakistan out by agreeing to a Stand-by Arrangement (SBA) valued at $7.6 billion. The two conditions are: a cut in the budgetary deficit from around 7 percent of GDP to 4.2 percent of GDP and an increase in taxation from 10 percent of GDP to 10.5 percent of GDP.

The fact of the matter is that 2 out of 3 Pakistanis are already at or below $2 a day. An increase in taxation would mean a further slowdown in the economy. A further slowdown would mean increased unemployment. Same thing with the rate of interest; this high cost of capital is bound to shut down a lot of our industrial units—and that means even more unemployment.

All this slowdown and all this additional unemployment could very well bring Pakistanis out on to the streets—and that means a full blown political crisis. There is no denying that we are in a terrible financial mess. With the IMF in the equation the question now is if a serious, full blown political crisis can somehow be averted (according to IMF's own estimates the IMF package will slowdown real GDP growth to 3 percent in 2008-09 and add an additional 2 to 3 million to bottom-line unemployment).

Coalition Support Fund

Coalition Support Fund (CSF) was created by the U.S. Congress after 9/11 to reimburse key allied countries, particularly Pakistan and Jordan, for providing assistance to the U.S. in the global war on terror. According to the Defense Security Cooperation Agency (DSCA*), "The Department of Defense programs for supporting our coalition partners and building partner military capacity enable coalition partners to participate in U.S. operations and conduct counterterrorist operations when they otherwise lack the financial means to do so."* Under CSF, direct overt U.S. aid and military reimbursements to Pakistan over FY2002-FY2009 (U.S. fiscal years) totaled $11,998 million of which economic-related aid amounted to $3,129 million and security-related aid amounted to $8,869 million.

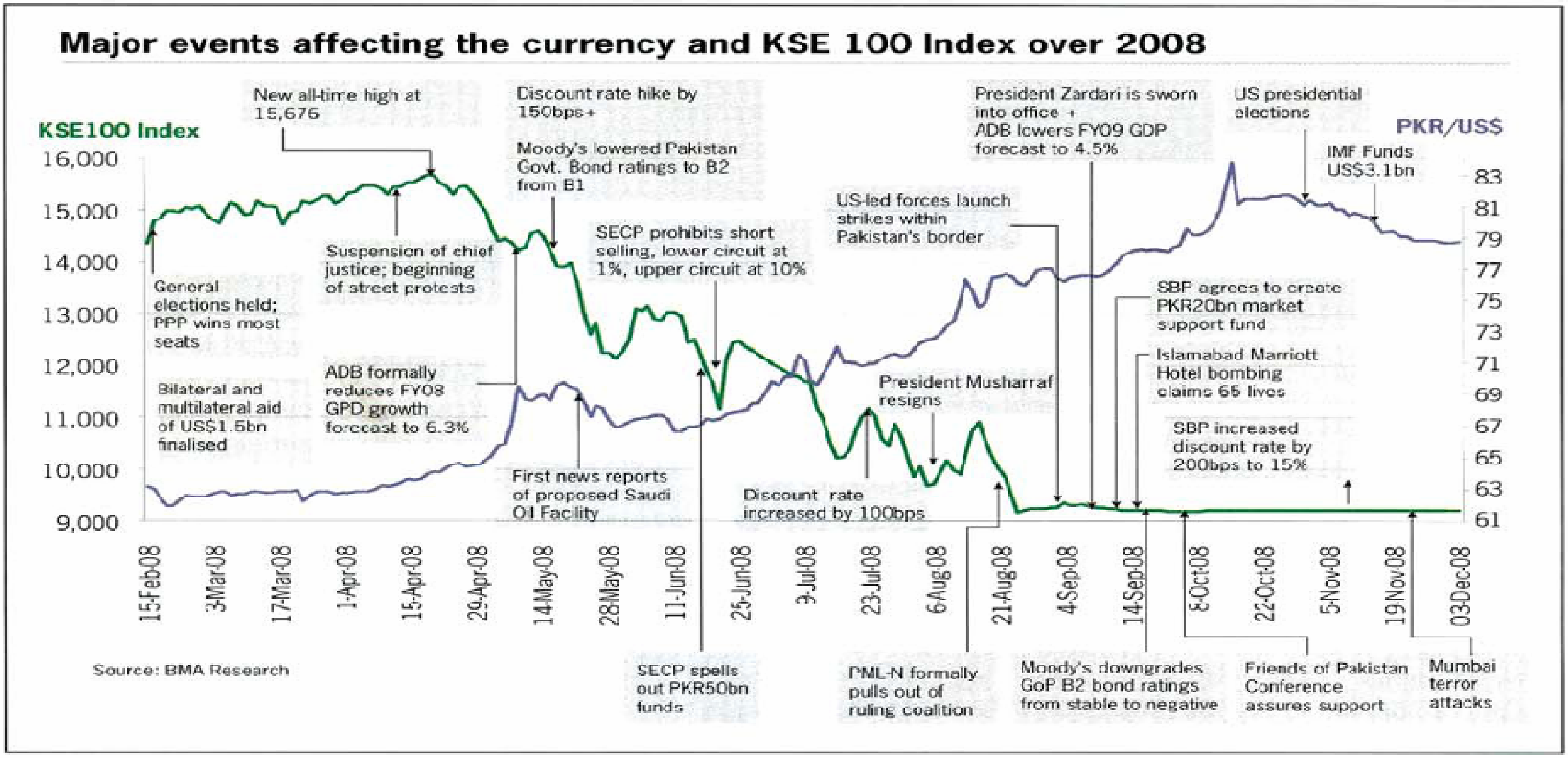
CSF has indeed been a source that filled Pakistan's ever-widening current account deficit. Under the new Obama Administration, Pakistan had requested a reimbursement of $156 million but the United States unilaterally deducted $54 million and reimbursed a total of $101 million.

Conclusion

A sharp spike in the international price of crude along with an unprecedented jump in commodity prices were the two major external culprits behind Pakistan's macroeconomic imbalance. Oil has since come down from a high of $147 a barrel to under $40 a barrel while commodity prices have experienced a drastic trimming. The two put together shall provide long-needed relief to Pakistan's trade account (and inflation).

The other side of the coin is that the world economy is slowing down like never before. Consider this: America buys nearly 30 percent of Pakistan's exports. America is our only major trading partner with which we have a trade surplus. American investors account for nearly 30 percent of Foreign Direct Investment (FDI) into Pakistan. And, America is slowing down like never before.

The Global Financial Crisis and the accompanying global credit crunch had a minor direct impact on Pakistan. But, Pakistan's economy remains in the thickest of woods. For FY 2008-09, Pakistan needs a colossal $13.4 billion foreign inflow of capital. Of the $13.4 billion, IMF's contribution is expected to be $4.7 billon and Pakistan still needs to find other multilateral and bilateral donors to bridge the whopping gap.


Major events affecting the currency and KSE 100 Index over 2008
KSE100 Index
PKR/US$
16,000
15,000
14,000
13,000
12,000
11,000
10,000
9,000
83
81
79
77
75
73
71
69
67
65
63
61
New all-time high at 15,676
Discount rate hike by 150bps+
Moody's lowered Pakistan Govt. Bond ratings to B2 from B1
President Zardari is sworn into office + ADB lowers FY09 GDP forecast to 4.5%
US presidential elections
IMF Funds US$3.1bn
US-led forces launch strikes within Pakistan's border
SECP prohibits short selling, lower circuit at 1%, upper circuit at 10%
Suspension of chief justice; beginning of street protests
General elections held; PPP wins most seats
SBP agrees to create PKR20bn market support fund
Islamabad Marriott Hotel bombing claims 65 lives
ADB formally reduces FY08 GPD growth forecast to 6.3%
Bilateral and multilateral aid of US$1.5bn finalised
President Musharraf resigns
SBP increased discount rate by 200bps to 15%
First news reports of proposed Saudi Oil Facility
Discount rate increased by 100bps
15-Feb-08
3-Mar-08
17-Mar-08
1-Apr-08
15-Apr-08
29-Apr-08
14-May-08
28-May-08
11-Jun-08
25-Jun-08
9-Jul-08
23-Jul-08
6-Aug-08
21-Aug-08
4-Sep-08
14-Sep-08
8-Oct-08
22-Oct-08
5-Nov-08
19-Nov-08
03-Dec-08
Source: BMA Research
SECP spells out PKR50bn funds
PML-N formally pulls out of ruling coalition
Moody's downgrades GoP B2 bond ratings from stable to negative
Friends of Pakistan Conference assures support
Mumbai terror attacks