Pakistan and the Global Financial Crisis

Center for Research & Security Studies

Pakistan-Focused, Independent Questions
Independent Answers

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Introduction

Capitalism, an economic system in which land, labour, 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 actually has its roots at the end of the twentieth century, when U.S. housing prices began declining after an uninterrupted, multi-year escalation. By mid-2008, there had been an increase in mortgage delinquencies that was striking. This increase in delinquencies was followed by an alarming loss in value of securities backed by housing mortgages, and this loss meant an equally alarming decline in the capital of America’s largest banks and government-backed mortgage lenders, such as Freddie Mac and Fannie Mae, who held some $5 trillion in mortgage-backed securities.

The $10 trillion mortgage market went into a state of severe turmoil. The Bank of China and France’s BNP Paribas were the first institutions outside of the United States to declare substantial losses from subprime-related securities. The European subprime catastrophe was a close second to the U.S. subprime debacle, with Ireland, Portugal, Spain and Italy 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.

It became quite clear in the final quarter of 2008 that the subprime mortgage problems were global in nature. Of the $10 trillion in the mortgage market, around 50% belonged to Freddie Mac and Fannie Mae. In September 2008, the U.S. Department of the Treasury was forced to place both Freddie and Fannie into federal conservatorship. Then on 15 September 2008, Lehman Brothers, one of the largest financial services entities in America, filed for bankruptcy. On September 16, the large U.S. insurer American International Group (AIG), saw its market value drop by 95% (AIG shares fell to $1.25 from a 52-week high of $70).

Germany, the fourth largest economy on the planet, is economically, technologically and politically integrated with the world around it. When financial institutions went belly-up across the globe, the credit institutions, investment firms, insurance companies and pension funds in Germany also came under severe financial stress. Amid other countries' domestic bailouts, the German finance ministry managed to get its €480 billion package through the Bundestag in less than a week: the Financial Market Stabilization Act was Germany’s answer to the global financial crisis, creating a bailout package that would 'stabilize financial markets, provide needed liquidity, restore the confidence of financial market players and prevent a further aggravation of the financial crisis'.

On 11 October 2008, finance ministers from the Group of Seven (G7) of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States 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 unsustainable budgetary and trade deficits. 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% 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.

Pakistan's balance of payment (BOP) crisis in 2007-08, which occurred as a consequence of $147-a-barrel oil and a spike in commodity prices, meant a frightful depletion of foreign exchange reserves, down to an import cover of less than three months. Inflation, meanwhile, shot up to over 24%, and Pakistan was caught in a vicious cycle of stagflation—economic stagnation coupled with high inflation.

Pakistan's BOP crisis came at a time when the entire donor community, including the U.S. and Europe, were engrossed in their own subprime disasters. Desperate for a bailout package, Pakistan pleaded with the U.S., begged Saudi Arabia and urged China for a billion-dollar donation, all to no avail. Finally, on 24 November 2008, the International Monetary Fund (IMF), reportedly lured by the United States Department of Defense, announced a 23-month Stand-By Arrangement (SBA) of $7.6 billion and released the first tranche of $3.1 billion. 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, which include thirty commercial banks, four specialized banks, six Islamic banks, seven development financial institutions and six micro-finance banks.

According to the 2007-08 Financial Stability Review from the State Bank of Pakistan (SBP), 'Pakistan's banking sector has remained remarkably strong and resilient, despite facing pressures emanating from weakening macroeconomic environment [sic] since late 2007'.

According to Fitch Ratings, the international credit rating agency with head offices 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'.

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 in October. At the same time, the SBP has jacked up interest rates: the 3-month treasury bill auction saw a jump from 9.09% in January 2008 to 14% in January 2009, and bank lending rates are now as high as 20%.

Overall, Pakistan's banking sector has not been as prone to external shocks as have been 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, and thus tight liquidity and the 'crowding out' of the private sector.

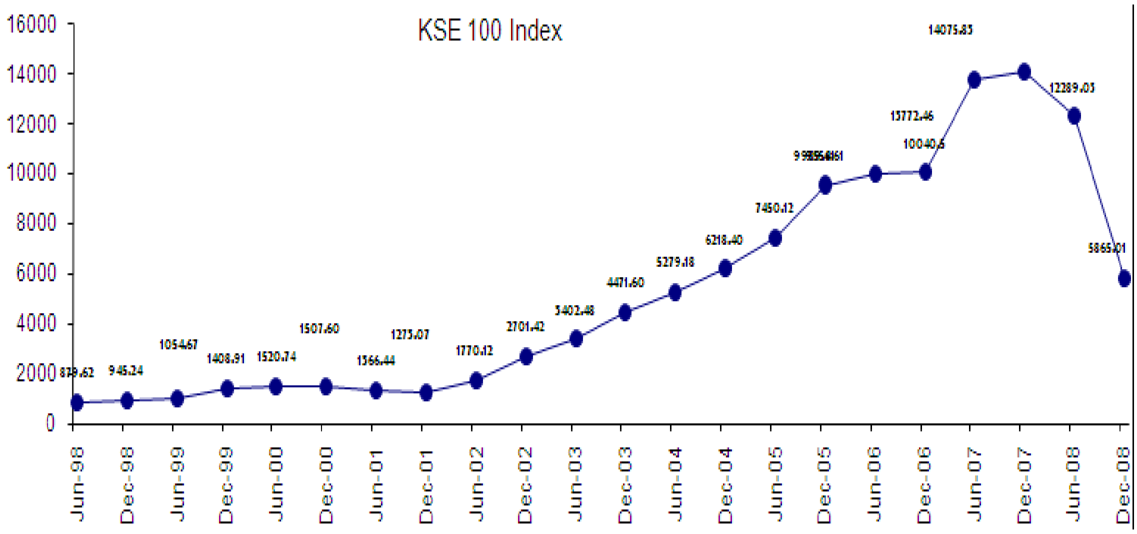
Circular debt

On 26 January 2009, Raja Pervaiz Ashraf, Minister for Water and Power, told the Senate that the 'federal government [would] settle half of the Rs400 billion circular debt by the end of January'. The circular debt in Pakistan has arisen because the government of Pakistan owes—and is unable to pay—billions of rupees to oil marketing companies (OMCs) and independent power producers (IPPs). As a consequence, OMCs are unable to import oil or supply oil to IPPs, and IPPs in turn are unable to generate electricity. Neither can refineries open letters of credit (LCs) 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 LCs 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. IPPs like HUBCO and KAPCO are also having difficulty purchasing oil and continuing operations'.

The Karachi Stock Exchange (KSE)

The Karachi Stock Exchange (KSE) is Pakistan's largest and most liquid exchange. BusinessWeek cited it as the 'best-performing stock market in the world' for the year 2002.



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

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

The end of 2007 was a bleak one for the KSE. Uncertainties over the upcoming Pakistani 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 drop in foreign currency reserves created a dark, threatening cloud over the market.

IMF: Panacea or more pain?

On 24 November 2008, the Executive Board of the IMF agreed to bail out Pakistan through a Stand-By Arrangement (SBA) valued at $7.6 billion. There were two conditions: Karachi must cut its budgetary deficit from around 7% of GDP to 4.2% of GDP, and increase taxation from 10% of GDP to 10.5% of GDP.

The fact of the matter is that 2 out of 3 Pakistanis are already earning $2 a day or less. An increase in taxation would mean a further slowdown in the economy. A further slowdown would mean increased unemployment. A rise in the interest rate would lead to the same thing: this high cost of capital would shut down a lot of Pakistan's industrial units—and this would mean even more unemployment.

This heavy slowdown and additional unemployment could very well bring Pakistanis out into the streets—and that would signal a full-blown political crisis. There is no denying that the country is in a terrible financial mess. With the IMF in the equation, the question now is whether a serious, full-blown political crisis can somehow be averted. According to the IMF’s own estimates, the SBA package will slow real GDP growth to 3% in 2008-09 and add an additional 2 to 3 million to bottom-line unemployment.

The role of the Coalition Support Fund (CSF)

The Coalition Support Fund (CSF) was created by the United States Congress after 9/11 to reimburse key U.S. allies, particularly Pakistan and Jordan, for their assistance to the U.S. in the Global War on Terror. The Defense Security Cooperation Agency (DSCA*)* maintains that 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 U.S. fiscal years 2002 through 2009 totalled almost $12 billion, of which $3.1 billion was economic aid and almost $9 billion was for security.

The CSF has helped to narrow Pakistan’s ever-widening current account deficit. Under the new Obama Administration, Pakistan requested a reimbursement of $156 million, but the United States unilaterally deducted $55 million and reimbursed a total of $101 million.

Conclusion

The two major external culprits behind Pakistan’s macroeconomic imbalance were a sharp spike in the international price of crude and an unprecedented jump in commodity prices. 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. Taken together, the two should provide welcome relief to Pakistan’s trade account and inflation woes.

At the same time, the world economy is slowing down as never before. Consider this: the United States buys nearly 30% of Pakistan's exports. America is the only major trading partner with which Pakistan enjoys a trade surplus. American investors account for nearly 30% of foreign direct investment (FDI) into Pakistan. Now America is facing an unprecedented economic slowdown.

The global financial crisis and the accompanying global credit crunch have so far had only a minor direct impact on Pakistan, but the Pakistani economy remains in dire straits. For the 2008-09 fiscal year, Pakistan needs a colossal $13.4 billion foreign inflow of capital. Of that $13.4 billion, the IMF contribution is expected to be $4.7 billon. Pakistan must find other multilateral and bilateral donors to bridge the whopping gap.