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Pakistan's Capital Crisis: Implications for U.S. Policy

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Summary

Pakistan — a key U.S. ally in global efforts to combat Islamist militancy — is in urgent need of an estimated $4 billion in capital to avoid defaulting on its sovereign debt. The elected government of President Asif Ali Zardari and Prime Minister Yousaf Raza Gillani is seeking short-term financial assistance from a number of sources, including the International Monetary Fund (IMF), China, and an informal group of nations (including the United States) known as the "Friends of Pakistan." The Pakistani government reportedly has reservations about conditions on the assistance, expressing concerns that the conditions may create political and economic problems. The current crisis has placed some strain on U.S.-Pakistan relations. This report will be updated as circumstances warrant.

A stable, democratic, prosperous Pakistan is considered vital to U.S. interests.[1] U.S. concerns regarding Pakistan include regional and global terrorism; Afghanistan's stability; democratization and human rights protection; the ongoing Kashmir problem and Pakistan-India tensions; and economic development in the region. Progress in this latter area has been severely threatened in 2008 by a sharp decline in Pakistan's economic stability, culminating in an immediate need for capital assistance. U.S. officials and independent analysts are increasingly concerned that a failing Pakistani economy could undermine multilateral efforts to stabilize South Asia and curtail the incidence of Islamist radicalism.

After several years of strong and comparatively stable growth, Pakistan quickly slid into a severe economic crisis in 2008 (for reasons discussed later in the report). Real GDP growth has slowed from 7%-8% per year since 2004 to an estimated 3%-4% in 2008. Its

[1] For more information about U.S.-Pakistan relations, see CRS Report RL33498, *Pakistan-U.S. Relations*, by K Alan Kronstadt.

official rate of inflation rose from 8.8% in January to 23.9% in October.[2] Over the last 10 months, the Pakistani rupee depreciated by 23% against the U.S. dollar, leading to rising trade and current account deficits. Over the summer of 2008, apparent capital flight added downward pressure on the rupee, worsening Pakistan's capital account deficit and accelerating the decline in the nation's foreign exchange reserve holdings — leading to the possibility that Pakistan could default on its sovereign debt obligations.[3]

Since his ascension to the presidency in September 2008, President Zardari has attempted to address Pakistan's economic problems, with the support of his chief economic advisor, Shaukat Tarin. On September 19, 2008, acting finance minister Naveed Qamar released new economic policies designed to bring about macroeconomic stability and avoid seeking IMF assistance that included the elimination of fuel, electricity and food subsidies, and a reduction in the government deficit.[4] On November 3, 2008, Tarin announced reforms of Pakistan's tax system, including the politically sensitive taxation of large landowners, to reduce the incidence of tax evasion.[5] President Zardari has emphasized the importance of his nation's economic problems, stating, "The greatest challenge this government faces is an economic one."[6]

Despite the September announcement of new economic policies, Pakistan's foreign exchange reserves have continued their year-long decline. The State Bank of Pakistan's holdings of foreign exchange reserves fell from $14.2 billion at the end of October 2007 to $5.4 billion as of September 19, 2008 to $4.0 billion as of October 17, 2008.[7] Of immediate concern, Pakistan reportedly needs $4 billion to $5 billion in assistance by the end of November in order to avoid defaulting on maturing sovereign debt obligations. According to Tarin, Pakistan will need $10 billion to $15 billion over the next two to three years to continue to service its capital account deficits and its outstanding debt.[8]

The Immediate Task: Capital to Cover Debt

During September and October, Pakistan sought assistance from a number of sources, including the Asian Development Bank (ADB), China, the IMF, Saudi Arabia, the United States, and the World Bank. To date, Pakistan has been unable to secure a firm commitment for support from most of these sources for several reasons. First, many of the parties which Pakistan has approached for assistance have their own economic problems to address. Second, the approached parties reportedly have reservations about Pakistan's commitment to implement necessary economic reforms. Third, the Pakistani government is concerned that some of the proposed conditions on the economic assistance

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[2] Data from the State Bank of Pakistan web page, [http://www.sbp.org.pk/ecodata/pricei.pdf].

[3] "Flight of Capital to Dubai on the Rise: PEW," *The Post*, August 25, 2008.

[4] "Pakistan Unveils Package for Economic Stability," *Reuters*, September 19, 2008.

[5] Farhan Bokhari, "Pakistan Vows to Target Rich Tax Evaders as IMF Concludes Talks on Vital Loan," *Financial Times*, November 3, 2008.

[6] "Pakistan's Zardari to Give Up Powers," *AFP*, September 20, 2008.

[7] Data from the State Bank of Pakistan web page, [http://www.sbp.org.pk/ecodata/forex.pdf].

[8] Simon Cameron-Moore, "Pakistan Needs $10-15 Bln Fast, Says PM's Adviser," *Reuters*, October 21, 2008.

will worsen some of the nation's political and economic problems. Fourth, some of the potential sources of support apparently would prefer Pakistan negotiate an agreement with the IMF before providing bilateral assistance.

Plans A and B. Pakistan's initial approach, termed "Plan A," was to obtain loans from selected sources, such as the ADB, the World Bank, the United Kingdom's Department for International Development (DFID), and the Islamic Development Bank (IDB).[9] The ADB did agree to provide Pakistan with a $500 million loan "to address harm done to poor families and the country's economy by unprecedented international food and fuel price hikes."[10] In addition, the World Bank originally offered $1.4 billion in assistance.[11] However, the combined ADB and World Bank loans are insufficient to address Pakistan's current capital shortfall.

When Plan A proved unworkable, Pakistan shifted to Plan B, which was to secure commitments for support from an informal group of nations known as the "Friends of Pakistan." On September 26, 2008, a group of nations met President Zardari in New York City to discuss ways to support Pakistan with its political, economic, and security problems. Zardari reportedly sought $100 billion in aid from the group.[12] Calling themselves the "Friends of Pakistan," the informal coalition includes representatives from 11 nations (including China, Saudi Arabia, and the United States), as well as the European Union, the United Nations, and the IMF. The group did not, however, offer Pakistan any financial support following their September meeting. The next meeting of the Friends of Pakistan is scheduled to be held on November 17, 2008 in Abu Dhabi.

China. As part of the Plan B initiative, President Zardari traveled to Beijing in mid-October to strengthen ties between the two nations, as well to ask for financial assistance. Following a meeting between President Zardari and China's Premier Wen Jiabao, a spokesperson for China's foreign ministry stated, "As a long-time friend of Pakistan, China understands it is facing some financial difficulties. We are ready to support and help Pakistan within our capability."[13] China provided no further details on the form and extent of its intended support to Pakistan. There was an agreement 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.[14]

Saudi Arabia. President Zardari and Tarin left for Riyadh on November 4, 2008, to reportedly ask for Saudi support for Plan B and up to $6 billion in deferred payments

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[9] Mubarek Zeb Khan, "$4.5 Billion Needed within 30 Days to Build Up Reserves: Recourse to IMF Last Option," *Dawn*, October 23, 2008.

[10] "ADB Provides Pakistan with $500 Million to Accelerate Economic Transformation," ADB press release, September 30, 2008.

[11] "WB to Give Pakistan $1.4 Billion This Year," *Daily Times*, October 13, 2008.

[12] Nissar Hoath, "UAE to Host Pakistan Bailout Talks Next Month," *Emirates Business 24/7*, October 27, 2008.

[13] "President Zardari, Chinese Premier Hold Formal Talks; China Vows to Bail Out Pakistan," *Daily Times*, October 17, 2008.

[14] Ibid.

for petroleum imports.[15] The deferred oil payments would free up capital that Pakistan could then use to pay its other international obligations. In an interview prior to his departure, Tarin stated, "We will not require IMF support in case we succeed in getting money from Saudi Arabia."[16] Saudi relations with Pakistan, however, have been cool lately for several reasons, including Pakistan's quest for an oil facility in Iran.

Plan C: IMF Assistance. With the apparent failure of both Plans A and B, Pakistan moved on to Plan C — formally requesting IMF assistance. On October 22, 2008, the IMF released a statement announcing that "The Pakistani authorities have requested discussions with the IMF on an economic program supported by financial assistance from the Fund to meet the balance of payments difficulties the country is experiencing...."[17] The Pakistani government, however, has denied making a formal request to the IMF.[18] According to various reports, informal talks between Pakistan and the IMF have been going on for some time in Dubai.[19]

The exact amount of assistance offered by the IMF has not been disclosed, but a source at the State Bank of Pakistan (SBP) reportedly said it could be worth up to $15 billion.[20] A prior report stated the IMF was offering $9.6 billion over three years.[21] According to China's *Xinhua News Service*, the IMF proposed 16 conditions on providing assistance.[22] Various news accounts have divulged some of those conditions: a devaluation of the rupee; a reduction of the federal deficit from the current 7.4% of GDP to 4.3% of GDP by June 30, 2009; an increase in the base interest rate (currently 13%) by 350-400 basis points; a 30% cut in defense spending between 2009 and 2020; the elimination of nearly two-thirds of pensionable government jobs; tax reform designed to broaden the tax base, including new taxes of certain agricultural crops; direct IMF and World Bank monitoring of the preparation of Pakistan's federal budget; and prior notification of any funding agreement with any other lender.[23]

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[15] Baqir Sajjad Syed, "Zardari's Saudi Visit Part of Attempt to Avoid IMF Loan," *Dawn*, November 4, 2008.

[16] Sahar Ahmed, "Pakistan's Zardari to Seek Help in Saudi Arabia," *Reuters*, November 4, 2008.

[17] "Statement by IFM Managing Director Strauss-Kahn on Pakistan," IMF press release No. 08/254, October 22, 2008.

[18] "IMF Bailout: The Coming Medicine for Pakistan?" *Reuters*, October 27, 2008, and Sahar Ahmed, "Pakistan's Zardari to Seek Help in Saudi Arabia," *Reuters*, November 4, 2008.

[19] The meetings were held in Dubai, and not Islamabad, because of an IMF ban on travel to Pakistan. An IMF mission was in Islamabad on September 20, 2008 — the day of the suicide bombing of the Marriott Hotel. The IMF mission was unable to complete its project.

[20] Farhan Bokhari and Chris Bryant, "World 'Has Six Days to Save Pakistan,'" *Financial Times*, October 28, 2008.

[21] "Bitter Fruits of IMF Bailout," *The International News*, October 24, 2008.

[22] "Pakistan Accepts IMF Conditions For Financial Aid," *Xinhua*, November 3, 2008.

[23] "IMF Bailout: The Coming Medicine for Pakistan?" *Reuters*, October 27, 2008; and "Bitter Fruits of IMF Bailout," *The International News*, October 24, 2008; "Pakistan, IMF Agree to Cut Down Expenditures," *The International News*, November 1, 2008; "Pakistan Accepts IMF Conditions For Financial Aid," *Xinhua*, November 3, 2008; and Sahar Ahmed, "Pakistan's

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Pakistan has repeatedly stated that it sees formally asking for IMF assistance as a last resort. The Pakistani government is reluctant to accept formal IMF assistance for several reasons. First, there is a history of poor relations between Pakistan and the IMF. Second, the reduction in defense spending will be unpopular with the military and may make it more difficult for the government to combat Islamist militancy. Third, the proposed tax reforms, especially on agricultural crops, might lead to higher food prices and more inflation. Similarly, the elimination of government jobs would exacerbate Pakistan's already serious unemployment problem. Fourth, the higher interest rates might drive some companies out of business. In the words of one Pakistani economist, "Given our current political scenario, the standard IMF program would be disastrous."[24] Some analysts have cautioned that the potential negative effects of the IMF conditions could eventually lead to the collapse of the Pakistan government.

In addition, relations between the Pakistani government and the IMF may have been strained by recent reports that the IMF applied pressure on the World Bank to cancel $300 million in aid to Pakistan. According to one account, the IMF objected to the loan because it thinks the World Bank has no authority to issue such loans. However, other sources indicate that the IMF objection was designed to undermine Pakistan's Plan B.[25]

It has been reported that the IMF will formally consider Pakistan's rescue package on November 7, 2008.[26] Other sources state any formal agreement with the IMF would be approved by November 15, 2008.[27]

Pakistan's Long-Term Economic Problems

Assuming Pakistan is able to secure the short-term capital assistance it needs, it will not end the nation's economic problems. Pakistan's recent period of economic growth was based on a combination of export expansion and inward foreign direct investments (FDI). Pakistan was able to finance its modest trade and capital account deficits in part due to the inward FDI and in part due to remittances from overseas Pakistanis.

In 2007 and 2008, a rise in fuel and food prices, combined with political instability, led to a rapid rise in inflation, a spike in the trade and current account deficits, a devaluation of the Pakistani rupee, and a sharp decline in inward FDI. Foreign investment in Pakistan during its fiscal year 2007-2008 (July-June) was down by 38.4% from the previous year. Although global fuel and food prices are on the decline, the global financial crisis is expected to precipitate a possibly extended global recession. For Pakistan, a global recession will reduce demand for its exports and inward FDI flows.

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[23] (...continued)
Zardari to Seek Help in Saudi Arabia," *Reuters*, November 4, 2008

[24] S. M. Naseem, "For Economic Recovery in Pakistan," *Overseas Pakistani Friends [http://www.opfblog.com]*, September 25, 2008.

[25] "Another Blow to Pak Bailout Plan," *The Nation*, October 28, 2008.

[26] "IMF Bailout Decision on November 7," *The Post*, October 28, 2008.

[27] "IMF Might Approve Rescue Package for Pakistan by November 15," *Press Trust of India*, October 31, 2008.

The combination of high rates of inflation and high unemployment apparently contributed to a rise in poverty and hunger in Pakistan. According to one estimate, Pakistan's unemployment rate in urban areas is nearly 40% and in rural areas over 60%.[28] A recent United Nations study reportedly determined 10 million Pakistanis are undernourished and over half of Pakistan's population can be considered "food insecure."[29] Some observers speculate that the growth in poverty and hunger is exacerbating Pakistan's political problems.

When he announced the previously mentioned economic policies in September 2008, Finance Minister Qamar said that the economic stabilization package would create jobs and promote agriculture and manufacturing, and reduce poverty. There is concern in Pakistan that it would be difficult to achieve these goals if Pakistan were to accept the IMF proposed rescue package. In particular, the budget for Pakistan's Public Sector Development Program — including the proposed Reconstruction Opportunity Zones (ROZs) along Pakistan's border with Afghanistan — may face significant cuts.

Implications for U.S. Relations

As previously mentioned, the U.S. government considers a stable Pakistani government important for several reasons. In addition, because Pakistan possesses nuclear weapons, an unstable government poses a threat throughout South Asia. As a result, Pakistan's current capital crisis and its underlying economic problems may pose a serious threat to U.S. regional and global interests.

Several recent events and trends, however, may have harmed U.S. relations with Pakistan. Although the United States provides both military and humanitarian assistance ($968 million in FY2008), Pakistan is increasingly turning to other friendly nations — such as China and Saudi Arabia — for support. Over the last few years, China has become major sources of FDI for Pakistan. Similarly, Pakistan's trade relations have shifted so that China is its largest trading partner, followed by Saudi Arabia. In addition, U.S. military incursions into Pakistani territory and the signing of nuclear cooperation agreement with India[30] have harmed U.S.-Pakistan relations. Also, some Pakistani analysts think the United States is orchestrating the negotiations with the IMF and the Friends of Pakistan to force Pakistan to accept the tougher IMF conditions.

Some analysts maintain that there is a need for the United States to demonstrate its commitment to a stable and democratic Pakistan with an increase in non-military assistance.[31] Others think that the United States should condition additional aid on Pakistan increasing its commitment to combat Islamist militancy along its border with Afghanistan.

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[28] Hashim Abro, "Inflation, Unemployment and Recruitment," *Pakistan News*, October 27, 2008.

[29] Nick Schifrin, "Pakistan Headed for Economic Meltdown?," *ABC News*, October 21, 2008.

[30] For more information on the agreement, see CRS Report RL33016, *U.S. Nuclear Cooperation with India: Issues for Congress*, by Paul K. Kerr.

[31] Craig Cohen and Derek Chollet, "When $10 Billion Is Not Enough: Rethinking U.S. Strategy toward Pakistan," *Washington Quarterly*, Spring 2007, 30:2, pp. 7-19.