Economic turnaround & 9/11

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DESPITE a series of domestic and external shocks such as unprecedented drought, the events of September 11, and the military build-up of India, Pakistan's economy has made commendable progress during the last three years.

The economy is now more stable, economic policies are transparent and predictable; confidence of the private sector has been restored; expatriate Pakistanis are bringing their capital back; stock market is buoyant; external balance of payments is in comfortable position; foreign exchange reserves have crossed $9 billion and are sufficient to finance ten and a half months of imports; exchange rate is stable; inflation is low and interest rates are declining.

Likewise domestic and external debt have declined; fiscal deficit has been lowered and the current account balance is in surplus; tax collection is growing; exports have picked up, governance has improved and corruption at the top levels in the government has been eliminated; and lastly, Pakistan's credit rating in international capital markets has improved.

These economic achievements owe heavily to sound economic policies, good governance and deft economic management. This fact is, by and large, accepted by stakeholders within and outside Pakistan. There are, however, some commentators who are unwilling to give credit to government's economic policies for the above listed improvements. They argue that Pakistan's economic turnaround owes principally to the events of September 11, 2001,

nessed an annual net in flow of capital from outside after accounting for debt reprofiling, grants, new soft loans, etc., to the extent of $ 100 million-significantly lower than the average of $2.1 billion during the preceding nine years of the 1990s.

Is it then accurate to attribute the reserve build-up from $1.2 billion in October 1999 to $3.2 billion in July 2001 (much before September 11) and nine billion dollars in November 2002 to the events of September 11? The fact of the matter is that this level was achieved mainly due to (a) an increase in exports of goods from $ 7.6 billion in 1998-99 to nine billion dollars in 2000-01 and 2001-02 and narrowing of the trade gap; (b) a rise in workers' remittances from $ 1.0 billion to $ 2.4 billion; and (c) reprofiling of debt stock under the Paris Club and saving debt servicing of one billion dollars annually. None of these has anything to do with September 11.

As it is well known, Pakistani exports would have reached $10 billion in 2001-02 if international markets were not closed to Pakistani exporters for six months following September 11. Foreign direct investment

> Pakistani exports would have reached $10 billion in 2001-02 if international markets were not closed to our exporters for six months following September 11. Foreign direct investment and privatization proceeds would have been much higher had there been no 'travel advice' from the western governments. In this period the country was able to reduce the external debt stock from $38 billion to $36 billion.

through the banking channel were shown as separate entries in the balance of payments under "private transfers". The total amount under private transfers was three billion dollars and $ 3.8 billion for 1999-00 and 2000-01 respectively.

Since September 11, 2001, the curbs on the hundi market in the US and UAE particularly, have led to a diversion of these remittances from the open market to banking channels. Thus the official remittances increased to $ 2.4 billion in 2001-02 but at the same time the purchases from the open market declined from $ 2.4 billion in the previous year to $ 1.3 billion only. It can thus be seen that the private transfers in the balance of payments accounts for 2001-02 of $ 3.7 billion are not significantly different from those recorded in the fiscal year prior to September 11, 2001.

Thus, those who argue about the future sustainability of remittances should remember that we have been receiving around three billion to 3.5 billion dollars annually from our overseas workers for a long period of time in one form or the other. The form of remittance does not matter as it is included fully in the balance of payments, although under different heads. These remittances are the legitimate and productive earnings from the export of manpower services which will continue to flow unless some unanticipated exogenous shock takes place. The sustainability of these remittances, whatever their form, is not in doubt but it is the component of these flows representing the reversal of capital flight which is clearly one-off and not sustainable.

Any additional flows beyond the level of $3.5 billion resulting in windfall gains from large foreign capital inflows. In particular, a substantial increase in donor assistance, debt rescheduling and an increased flow of workers' remittances, as a result of September 11, are primarily responsible for the economic turnaround in Pakistan.

In this article, an attempt is made to set the record straight and show that economic turnaround owed principally to sound economic policies, good governance, and deft economic management. In fact, as will be shown later, the events of September 11 have had adverse effects on the economy of Pakistan. While explaining my points, I shall concentrate on two important areas, namely, net foreign capital inflows and workers' remittances.

Prior to May 1998, Pakistan used to receive, on average, net foreign capital flows of around $ 2.1 billion from bilateral and multilateral sources. This amount supplemented the country's foreign exchange earnings in meeting its debt servicing obligations. The main donors and creditors were Japan, the US, UK, World Bank and Asian Development Bank. The country used to borrow new loans to repay the old ones and contracted additional loans to finance the persistent current account deficit and also to build up the foreign exchange reserves. This situation continued throughout the 1990s and resulted in almost a doubling of external debt from $ 20 billion to $ 38 billion.

The imposition of economic sanctions in the post May 1998 resulting in suspension of all foreign capital inflows changed the above picture. The withdrawal of foreign donors and creditors created a gap between the debt-servicing obligations and the debt servicing the country could afford to pay. This gap could be filled only through debt rescheduling and new money flows from the international financial institutions The then government entered into an agreement with the IMF, successfully negotiated debt rescheduling under the Paris Club and obtained additional new money from the IMF, World Bank and Asian Development Bank. On the other hand, Japan, the US and UK, the main bilateral donors, along with others, decided not to provide any new money. Japan was a substantial donor in the 1990s with an annual commitment of $ 500 million.

When General Pervez Musharraf took charge of the state of affairs, initially almost all new inflows dried up. Pakistan had to find resources from its own modest means to service its debt and for the first time had experienced negative net capital flows of $ 185 million — that is, the inflows from all foreign sources were lower than outflows from Pakistan. In the year 2000-01, after the Stand-by Arrangements were reached with the IMF and the Paris Club rescheduling was obtained, there was some relief but Pakistan still had negative net capital flows of $115 million.

It is only in 2001-02 that this trend of negative net flows reversed and Pakistan received positive net capital flows of $306 million. On average, these three years witand privatization proceeds would have been much higher had there been no 'travel advice' from the western governments. It is also remarkable that in this period the country was able to reduce the external debt stock from $38 billion to $36 billion.

The other popular misconception is about the workers' remittances. Several commentators have termed these remittances as unproductive. To them the magic word is exports, which are, beyond doubt, critical. But they are either ignorant or deliberately suppress the fact that exports of a country consist of exports of goods and exports of services. Merchandize exports represent the former while exports of services consists of manpower, capital, IT, intellectual property rights, financial, consultancy, etc.

Since the 1980s Pakistan has exported about two million workers overseas and their hard-earned money sent to their families in Pakistan is very much part of Pakistan's export earnings from services and is as productive as the earnings from merchandize exports. These remittances have fluctuated around three to 3.5 billion dollars annually as far as inflows into balance of payments is concerned.

Before liberalization of 1991 the main channel for workers' remittances was the banking sector and they were all recorded in the balance of payments of the country as private transfers. After 1991, an additional channel was opened up and the amount from overseas workers flowing into the country got divided into two parts — foreign currency accounts (FCAs) and official remittances (through banking channels). The volume remained largely unchanged and varied between three and 3.5 billion dollars annually if both the channels were counted together. In the balance of payments, official remittances were shown under private transfers as before while inflows into foreign currency account of non-residents were recorded under the capital account.

The economic impact remained unchanged as the amount of foreign exchange available to the country was the same and it was only the presentation of accounting entries in the balance of payments heads that underwent change. The period following the freezing of the FCAs in May 1998, an additional channel which was dormant become highly active and that was the open market. As the workers lost confidence in official banking channels as a result of the freezing of the FCAs, they diverted their remittances through the money changers in the open market.

In 1999-2000 and 2000-01 the State Bank of Pakistan decided to purchase these remittances from the open market to make external payments and build up reserves. An annual inflow of two billion dollars purchased from the open market and one billion dollars through the banking channel together constituted three billion dollars of workers' remittances annually in these two years. These purchases as well as remittances annually would represent the balances which Pakistanis may bring back to the country. As soon as these balances are exhausted or any other negative shock takes place, this component will dry up all of a sudden. We should therefore worry about these incremental flows as these can largely be attributed to September 11 and should rightly be discounted from any future calculations of viable balance of payments.

To sum up, Pakistan has not benefited as much from September 11 as is being pointed out by some commentators. Net capital flows have turned positive in 2001-02 after two years' of negative flows but they are still significantly short of the average flows of the last nine years. Workers' remittances of around three to 3.5 billion dollars which in fact represents exports of manpower services, have been flowing into the balance of payments of Pakistan through one channel or the other for the last two decades. To attribute them to September 11 events and to express doubts about the sustainability of this source of inflow thus appears misplaced.

The fact, however, is that the events of September 11 adversely affected Pakistan's economy during the fiscal year 2001-02. The affected areas include exports, imports, tax revenue, industrial production, foreign investment, and privatization. To the extent Pakistan was integrated with the world economy, the sharp downturn in global economy as a result of September 11, affected Pakistan's exports. Furthermore, with the shifting of the epicentre of global events to Pakistan, the country was thrust into the role of a front-line state. Thus, the events of September 11 not only disrupted the normal trading activities but also increased the cost of international trade for Pakistan.

Such disruption adversely affected both exports and imports of Pakistan. The country lost roughly $ 1.0 billion in exports earnings and imports were lower by $ 600 million. Decline in imports reduced tax collection by the CBR because roughly 40 per cent taxes are derived from imports (custom duty, sales tax at import stage, withholding tax at import stage). Decline in imports also affected industrial production because of the lesser availability of raw materials. Foreign investment, particularly in oil and gas sector and in information technology as well as privatization programme were adversely affected because of the travel advice issued by the western countries for their citizens.

On the whole, the events of September 11 cost Pakistan more than two billion dollars. Pakistan was able to withstand the negative shocks of September 11 because of the structural reform programme which it had launched some three years ago. These reforms have enhanced the shock-absorbing capacity of Pakistan's economy. To shield the economy from any future exogenous shocks Pakistan must stay on course with the reform programme launched some three years ago.

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