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Pakistan: Causes and Management of the 2008 Economic Crisis

Irfan ul Haque

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Third World Network

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CONTENTS

1 INTRODUCTION 1

2 THE GENESIS OF A CRISIS 3

3 THE YEARS OF FAT COWS 10

4 MACROECONOMIC MANAGEMENT 22

5 CONCLUDING OBSERVATIONS – BEYOND THE CRISIS 30

References 35

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Chapter 1

INTRODUCTION

2008 was arguably Pakistan's most difficult year in its short history. It had an ominous start when Benazir Bhutto was killed in a terrorist attack just days before New Year. Politically, it was a year of transition from the extra-constitutional government of President Pervez Musharraf to a democratically elected government, with its concomitant upheavals. The insurgency in the North-West of Pakistan intensified while terrorist attacks in other parts of the country gained in both severity and frequency. And then there was the unravelling of the global financial system, which started with the so-called sub-prime crisis in August 2007. Commodity prices too had shot up – the oil price leading the way – until there was a sharp turnaround in late summer. Pakistan's economy had started to show signs of stress a little earlier, but got into a full-blown economic and financial crisis in 2008. Before the year was out, Pakistan had approached the International Monetary Fund (IMF) and signed a standby agreement.

This paper aims to describe the crisis and its impact on the Pakistan economy and attempts to identity its antecedents, including the role of external factors. The paper is composed of four parts. The first part describes the crisis – its nature and magnitude in relation to the Pakistan economy. It is seen that the crisis was essentially homegrown and had its roots in the evolution of the macroeconomy in recent years. Thus, in the second part, this evolution is analysed. Obviously, the country's policies and macroeconomic management played a significant role in how the economy developed in those years, and these are examined in the third part. The last

section offers concluding observations on economic management issues in the post-crisis period.

Chapter 2

THE GENESIS OF A CRISIS

THE Pakistani crisis unfolded as domestic and external imbalances started to worsen rapidly in the early months of 2008. Inflation accelerated and soared to 25 per cent from a rate of 7 per cent in the preceding year. Before the year's end, share prices at the Karachi Stock Exchange had collapsed by some 60 per cent from the peak in April 2008. Aggregate market capitalisation shrank to less than 20 per cent of GDP at the end of 2008, compared to the peak of about 100 per cent nine months earlier.

But the Pakistani crisis differed in some respects from the financial crises that have periodically afflicted developing countries over the past two decades. One significant difference was that although fears on the value of the Pak rupee persisted throughout the year, panic selling of the currency remained limited. The rupee depreciated by one-third against the US dollar, but it occurred rather gradually between March and November 2008. However, the State Bank of Pakistan (SBP) did take a series of measures to curb speculative activity, which helped to keep the reserve situation from collapsing.[1] Since Pakistan's entry into the standby agreement with the IMF in November 2008 and the subsequent build-up of foreign exchange reserves, the rupee has remained stable against the US dollar.

Another difference was that Pakistan's domestic banking sector managed to avoid undue stress and remained generally solvent during the

[1] These included an increase in the percentage of overseas remittances surrendered to the SBP from 10 per cent to 15 per cent and imposition of restrictions on advance payment of foreign exchange for imports. For details, see State Bank of Pakistan (2008a).

crisis. The IMF's April 2009 evaluation of the Pak economy held the banking system to be well capitalised and liquid, even as bank profitability and asset quality were hurt by the adverse macroeconomic environment and the tightening of the monetary policy. There was a small increase in the ratio of non-performing loans to banking assets mainly because of the liquidity/ solvency problems in loans to private consumers and the textile sector.[2]

Table 1. Changes in the Balance of Payments (million US dollars)

	Change FY08 over FY07	Change as % of FY07 GDP
Current account balance	-7158	-5.0
Trade balance	-5584	-3.9
Exports f.o.b.	2844	2.0
Imports f.o.b.	-8428	-5.9
Services (net)	-2464	-1.7
Current transfers net	890	0.6
of which: Workers' remittances	957	0.7
Public borrowing and other capital flows (net)	-1618	-1.1
Private medium- and long-term capital flows (net)	-1408	-1.0
of which: FDI	52	0.0
Portfolio investment	-1800	-1.3
Other capital (including errors and omissions)	544	0.4
Change in foreign exchange reserves*	9640	6.7

* The (-) sign implies an *increase* in reserves and a (+) sign implies a *decrease*.
Source: Based on the data in Table 4.

[2] In general, the large (big 5) banks fared better than the medium and small banks, some of which got into severe distress because of portfolio quality problems.

However, direct exposure of the banking system to currency depreciation and indirect exposure through unhedged banking operations were found to be limited (IMF 2009b, p. 10).

The dimensions of the Pak economic crisis can be seen in the major shifts in the country's balance of payments and fiscal situation. Tables 1 and 2 summarise the changes in the key components of the balance of payments and the fiscal accounts between FY(fiscal year)07 and FY08.[3]

Table 2. Federal Government Budget (billion rupees)

	Change FY08 over FY07	**Change as % of FY07 GDP**
Federal Revenue		
Direct taxes	68	0.8
Indirect taxes	98	1.1
Other revenue	19	0.2
Total revenue	185	2.1
Federal Expenditures		
Non-development expenditures	483	5.5
Of which (i) Defence	25	0.3
(ii) Subsidies	296	3.4
(iii) Interest payments	194	2.2
Development expenditures	55	0.6
Total expenditures	537	6.2
Overall fiscal deficit	-400*	-4.6

* The overall fiscal deficit is not exactly equal to the difference between "total revenue" and "total expenditures" as the latter do not take account of some public expenditures, notably transfer payments.

Source: Ministry of Finance

[3] Pakistan's fiscal year relates to July-June and its key macroeconomic data relate to the fiscal year.

It is evident from Table 1 that the increase in imports of $8.4 billion – or 6 per cent of GDP – represented the single biggest change in the balance of payments. This component alone can substantially explain the decline in the net position on foreign exchange reserves of $9.6 billion. The more than 30 per cent increase in the import bill between the two years was composed of about a 10 per cent increase in the volume and a 20 per cent increase in the unit value of imports. Portfolio investment virtually ceased in FY08 – a net drop of $1.8 billion from the previous year – and the net inflow of public foreign borrowing declined by $1.6 billion; these two items accounted for a shift in the balance of payments of 2.3 per cent of GDP. On the other hand, worker remittances continued to rise – increasing by close to $1 billion, or some 0.7 per cent of GDP – while the magnitude of foreign direct investment (FDI) remained virtually unchanged. The economic crisis, however, continued to build in the first few months of FY09, when foreign exchange reserves declined further by $4 billion between July and October 2008, reaching a precariously low level equivalent to less than 6 weeks' supply of imports.

The change in the fiscal situation between FY07 and FY08 paralleled the balance of payments, with the size of the overall fiscal deficit changing by 4.6 per cent of GDP, virtually equivalent to the change in the external current account balance (Table 2). The principal contributor to the rise in the fiscal deficit was the increase in current expenditures (5.5 per cent of GDP), which was wholly accounted for by a sharp increase in subsidies (3.4 per cent) and an increase in interest payments (2.2 per cent). The basic reason for the increase in the subsidies was the government's slowness in passing through the sharply rising international oil and food prices to the consumer. This was also the year of political transition and serious civil unrest, and the Musharraf government was reluctant to further hurt its standing with the public through price increases and introducing economies that the situation required. On the other hand, the rise in interest payments was largely due to the tightening of monetary policy and the accompanying rise in interest rates on the domestic debt.

Before approaching the IMF in October 2008, the authorities had already prepared the so-called "homegrown stabilisation package" of macroeconomic

reform, which included steps to improve fiscal performance and further tightening of monetary policy. As a result, the standby agreement with the IMF was quickly reached. For FY09, the authorities in Pakistan (and the IMF) expected the fiscal deficit to come down to a little over 4 per cent of GDP while the current account deficit was expected to shrink by almost 25 per cent (Ministry of Finance 2009, p. xvi). Apart from a net outflow of portfolio investment of nearly $1 billion, preliminary estimates for FY09 show continuing substantial, though reduced, FDI ($4 billion) and a rise in worker remittances to an unprecedented level of over $8 billion. This is in contrast with the experience of other developing countries that have faced a sharp reduction in both worker remittances and FDI consequent to the international financial crisis.

Since entering into the standby agreement, the Pak economy seems to have stabilised though remaining fragile. Preliminary indications are that economic growth decelerated to about 2.0 per cent in FY09 compared to 4 per cent in the previous year and the growth is expected to remain modest during FY10. The main source of the decline in growth in FY09 was a fall in large-scale manufacturing, which was hit by severe power shortages on the supply side and by a fall in exports on the demand side. The sharp reduction in the public sector development programme from a planned level of Rs. 337 billion in FY09 to the actual level of Rs. 219 billion (a fall of 33 per cent) was another major dampening factor, contributing about 0.5 percentage point to the fall in the growth rate. Nevertheless, thanks to satisfactory growth in the agriculture sector, Pakistan managed to avoid the fate of some other export-dependent Asian economies which registered an output decline in 2009.[4]

The average inflation rate remained at more than 20 per cent in FY09 mainly because of the monetary overhang and the fact that the fall in the international prices of critical consumables like oil was offset by sharp reductions in domestic subsidies. However, inflation started to decelerate

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[4] The IMF's *World Economic Outlook* (April 2009) estimated a decline in GDP of about 3 per cent for Malaysia and Thailand, with no growth expected for the Philippines' economy, while India and Bangladesh were expected to grow by about 5 per cent.

towards the later months of FY09, when it fell below 15 per cent on an annualised basis.

Pakistan did not suffer unduly on account of a fall in foreign inflows during the crisis. As noted, worker remittances remained unaffected by the international financial crisis and increased substantially in both FY08 and FY09, while other private transfers, amounting to about $5 billion in the recent past, registered only a modest decline. There was a steep decline in portfolio investment during FY08, but net *disinvestment* was avoided, largely because of the floor limits placed on trading in the stock exchange that prevented investors from selling and quickly getting out of the market. The impact of the international financial crisis, however, was felt mainly in FY09, when, in addition to a fall in export earnings of about 5 per cent, there was a net outflow of portfolio investment while FDI too declined to $4 billion. On the positive side, Pakistan benefited from the easing of oil and other import prices in the second half of 2008.

In brief, the crisis of 2008 manifested itself in the emergence of serious balance-of-payments strains that resulted in the first instance from an unprecedented increase in imports, partly because of a sharp increase in oil and food prices. But the increase in volume terms was also extraordinarily high. There were reports of sizeable capital outflows on the part of Pakistani residents but they are not clearly documented in the balance-of-payments accounts. Normally, such movements show up under "errors and omissions", but this category in Pakistan's case has been relatively small in recent years and was in fact positive in FY08. Some observers speculate in private that such capital outflows were "off the books" since the Pak rupees were acquired by outsiders engaged in supporting various local activities, including insurgency. There is no indication that the insurgency in the country's North-West region has been hampered by a lack of funds or arms, but facts are hard to come by.

To conclude, it was the terms-of-trade shock, rather than a fall in foreign inflows or capital flight, that was the single most important external influence on Pakistan's deteriorating macroeconomy. However, in addition to a very tense domestic political situation, the collapse of the international financial

markets had also started to cause investors in Pakistan to fear and anticipate, early in 2008, the fall of the Karachi stock market. But these external factors were not decisive and it will be shown in the subsequent sections of the paper that the Pakistani crisis was by and large homegrown and its seeds had been sown in earlier years when the country was a beneficiary of enormous foreign resource inflows.

Chapter 3

THE YEARS OF FAT COWS

THE 1990s – Pakistan's democratic phase – were a period of mediocre economic performance. Economic growth, at just about 4 per cent a year, was slow in comparison to the country's past record. National economic management struggled between the accommodation and compromises required in a fledgling democracy at home and coping with the rising tide of globalisation and market fundamentalism abroad. But then came the nuclear explosions of May 1998, triggered by India's first move. The reaction of the world community – led by the United States and European countries – was one of utter dismay and no time was lost in the imposition of all manner of sanctions on the two countries.

It was, however, Pakistan that was hit harder. Fearing capital flight, the authorities promptly imposed restrictions on foreign currency accounts, but the process was poorly handled and considerable sums of money managed to flee the country. In addition, the exchange rate policy was made more restrictive, from a managed float to a tighter and discriminatory multiple exchange rate regime, something that did not go down well with the IMF (Janjua 2007). The economic situation, however, further deteriorated after the Musharraf takeover in October 1999, as the country's economic isolation was now exacerbated by diplomatic chill on the part of the United States and other Western countries. A view had taken hold in those countries that Pakistan was on its way to becoming a "failed state".

During the period 1998-2001, economic growth averaged 2 per cent (which implied a falling per capita income), with the level of exports and imports hovering around $10 billion. The trade balance was negative but

relatively small – about 1.5 per cent of GDP – simply because foreign capital was hard to obtain. By the middle of 2001, the country's balance-of-payments position had become dire indeed. The only significant source of foreign finance had been worker remittances, which amounted to over a billion dollars a year. New foreign borrowing had become virtually impossible as the country faced the prospect of defaulting on its external debt. In fact, Pakistan continued to pay off its past debts more or less on schedule and there was a net capital outflow of $710 million in 2001. The IMF's relations with the Musharraf government were "rocky and uneasy" and there was little support to help Pakistan to deal with its financial and economic troubles (Husain 2002). However, a standby agreement of limited duration (less than a year) and meagre amount ($465 million) was signed with the IMF in November 2000 but it came with exceptionally tough conditionality.

The situation changed 180 degrees following the 9/11 attacks. President Musharraf's decision (forced or otherwise) to let Pakistan become a frontline state in the "war on terror" was momentous and had lasting consequences for the country's security and political stability. But its economic and financial repercussions were immediate. Almost within weeks of the decision to support the American war effort in Afghanistan, the IMF, without much ado, changed its mind and quickly approved a credit of $1.3 billion under its Poverty Reduction and Growth Facility (PRGF).

The resource constraint that Pakistan had faced earlier was eased virtually overnight. Foreign aid and capital returned to Pakistan, the external debt was rescheduled (decreasing the total debt by about $10 billion), the trade sanctions were removed and, for a limited period, Pakistan gained improved market access in the United States and European Union. It was, however, worker remittances that shot up most dramatically. The proximate cause for this increase was also 9/11, which had prompted a tighter surveillance of bank accounts of nationals from Muslim countries in the United States and Europe. Remittances probably also increased because a greater number of Pakistanis came to view their overseas stay as temporary and started acquiring assets in Pakistan in preparation for their eventual return.

Between FY02 and FY07 – the year before the crisis – Pakistan received a net total of $62.2 billion in foreign exchange inflows, or close to

80 per cent of the country's exports and about 60 per cent of imports (Table 3). Worker remittances accounted for half of the current transfers and 40 per cent of the total net resource inflows.[5] Pakistan had never before witnessed foreign exchange availability of this magnitude.

The question then arises as to how Pakistan – typically a resource-constrained economy – utilised the sudden accretion of foreign exchange. In order to address this question, it is necessary to examine the actual evolution of the balance of payments over the post-9/11 period (see Table 4). In the early years (i.e., FY02-04), resource inflows consisted mostly of current transfers and miscellaneous capital inflows. During this period, there was

Table 3. Uses of Resource Flows FY02-07 (billion dollars)

Resource Inflows	
Current transfers	48.2
of which Remittances	24.8
Net public borrowing	-0.2
FDI	11.9
Portfolio investment	2.3
Total above	62.2
Exports	80.5
Total forex earnings	142.7
Resource Uses	
Imports	104.8
Services (net)	29.2
Total above	134.0
Reserve buildup	13.4
Total above	147.4

Source: Based on the data in Table 4.

[5] Current transfers include the category "other private transfers", which was also quite substantial and rose to a level of $5.5 billion in later years. The Pakistan authorities as well as the IMF staff were approached to verify the nature, source, and purpose of this inflow, but no answer was received. Considering its size, it is surprising that this source of foreign inflows has not received closer scrutiny in official analysis. One rather benign possibility is that this inflow includes transfers on account of NGO activity as well as support Pakistanis living abroad give to charities running schools, healthcare centres, and other social welfare programmes.

Table 4. Balance of Payments (million US dollars)

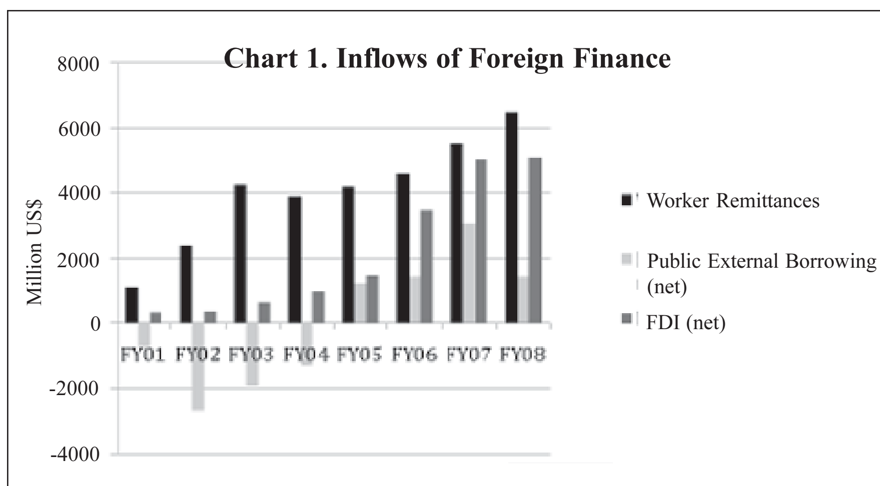
	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08
Current account balance	-1112	1589	4203	1893	-1344	-4774	-6878	-14036
Trade balance	-1269	-294	-444	-1208	-4352	-8259	-9711	-15295
Exports f.o.b.	8933	9140	10889	12396	14401	16388	17278	20122
Imports f.o.b.	-10202	-9434	-11333	-13604	-18753	-24647	-26989	-35417
Services (net)	-3142	-2617	-2128	-3594	-5841	-7304	-7752	-10216
Current transfers net	3299	4500	6775	6695	8849	10789	10585	11475
of which: Workers' remittances	1087	2390	4237	3871	4168	4600	5494	6451
Public borrowing and other capital flows (net)	-710	-2677	-1924	-1300	1226	1439	3042	1424
Private medium- and long-term capital flows (net)	345	-80	164	693	1221	4164	7336	5928
of which: FDI	323	368	612	951	1459	3451	5026	5078
Portfolio investment	..	..	..	-25	162	372	1820	20
Other capital (including errors and omissions)	2562	4250	2818	-887	-876	-154	210	754
Change in foreign exchange reserves*	-1085	-3082	-5261	-399	-227	-675	-3710	5930

* The minus sign denotes an increase

Source: State Bank of Pakistan

little public foreign borrowing; in fact, there was net repayment of the country's external debt (see Chart 1). However, towards the end of the period, private foreign investment became quite significant, as did public foreign borrowing. FDI, which was barely $400 million at the start, rose to over $5 billion, while portfolio investment soared from a negligible figure to nearly $2 billion in FY07.

Because foreign resource inflows during the period in question were largely on private account, Pakistan's fiscal situation remained by and large unaffected by the developments in the country's balance of payments. Direct



and indirect taxes as well as development expenditures in relation to GDP remained stable, though non-development expenditures showed a slight decline, mainly because of a decline in interest payments as a proportion of GDP (see Table 5). It would therefore appear that the country did not go on a spending binge in the early years, when foreign exchange reserves were built up, reaching a level of $10.7 billion in FY03 or virtually one year of imports.

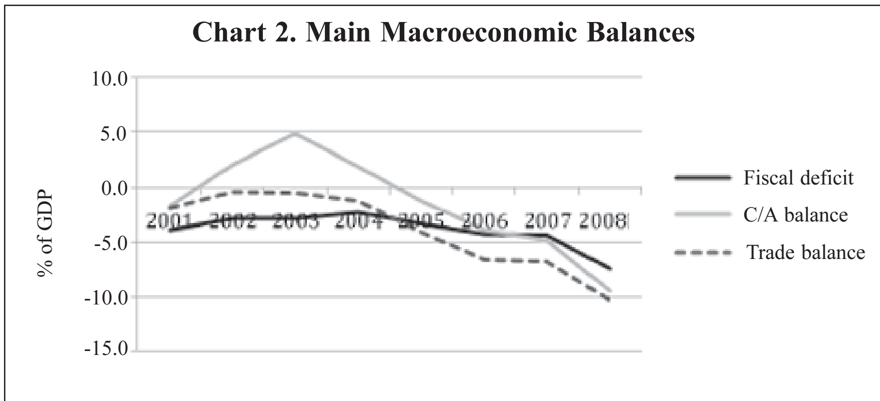
Table 5. Pakistan Fiscal Situation (% of GDP)

	2001	2002	2003	2004	2005	2006	2007	2008
Direct taxes	3.0	3.2	3.0	2.9	2.8	3.1	3.7	3.7
Indirect taxes	6.4	5.9	6.4	6.2	6.3	6.3	6.0	5.9
Non-development expenditures	14.3	14.6	13.8	12.7	12.1	12.1	11.9	14.5
Subsidies	0.5	0.7	1.2	0.8	0.8	0.8	1.0	3.7
Interest payments	8.4	7.2	5.3	5.6	4.2	4.8	3.4	4.7
Total public expenditures	14.7	15.6	14.5	13.7	13.3	14.1	14.2	16.9
Fiscal deficit	-3.9	-2.9	-2.9	-2.3	-3.3	-4.3	-4.3	-7.4

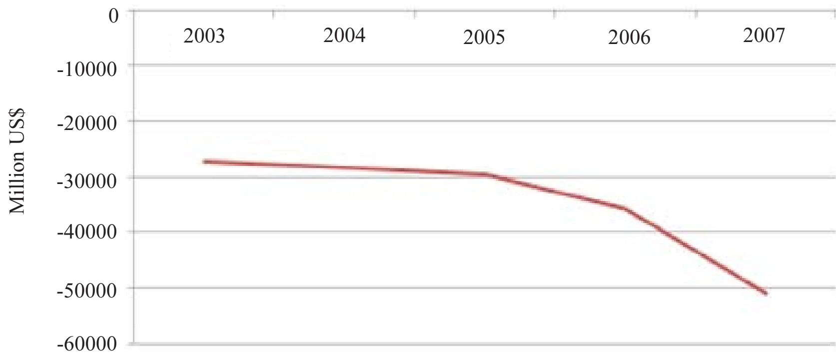
Source: Based on Ministry of Finance data

But the situation started to change around FY04. While imports and exports had risen more or less at a similar pace until that year, imports began to shoot up thereafter, reaching a rate of increase of 25 per cent a year or twice the rate of export growth during FY05-07. The result was a sharp decline in the current account balance (which had reached a peak surplus of 5 per cent of GDP in FY03) and in the trade balance (where the deficit had come down close to zero) (see Chart 2). This was reflected in an abrupt and steep deceleration in the accumulation of foreign exchange reserves (from over $5 billion in FY03 to just $400 million in FY04), though the actual reserve level (at about 6 months of imports) remained comfortable until the large drawdown during the crisis year.[6] The country's international investment position, which had hovered around a negative figure of about $30 billion, correspondingly deteriorated sharply after FY05 (see Chart 3). The overall fiscal deficit followed a pattern closely similar to the evolution in the country's trade balance: after declining to 2.3 per cent of GDP in FY04, fiscal deficits began to rise, reaching 4.3 per cent in FY07 (Chart 2).

The foreign inflows obviously had an impact on the real economy, but it did not happen in a straightforward manner. Economic growth slowly accelerated after FY01, rising to 7.5 per cent in FY04 and 9 per cent in FY05

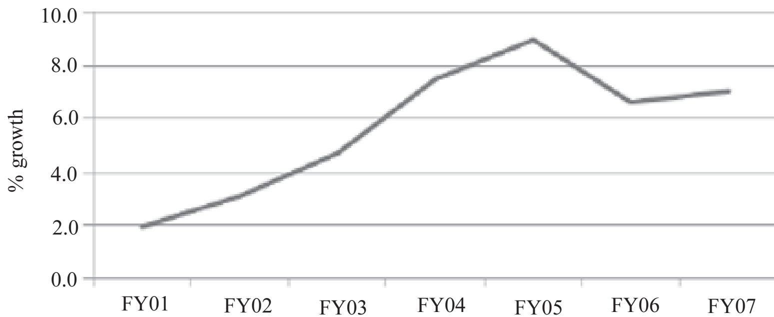


6 Reserves registered an increase of close to $4 billion in FY07, the year before the crisis. This was primarily because of a jump in both public external borrowing and foreign investment.



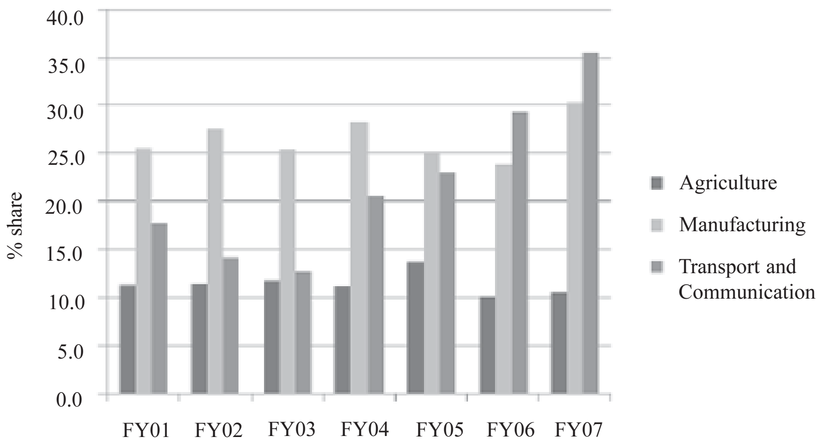
(see Chart 4). But the additional resources did not translate quickly into an increased investment rate. It was only in FY05 that investment reached 20 per cent of GDP from a level of barely 15 per cent. Even at the higher level, Pakistan's investment rate remained significantly below those of the fast-growing Asian economies, including India, where investment rates have come to exceed 30 per cent of GDP. Even Bangladesh invests about one-quarter of its GDP. Domestic investment, of course, mirrors domestic savings, which remained modest in Pakistan compared to the rates approaching or exceeding 30 per cent in some Asian countries.

The rather low investment and savings rates suggest that, at least in the early years of the resource boom, the acceleration in growth was led primarily by domestic consumption and export growth. A major portion of investment went into manufacturing during the period (Chart 5), but there was little industrial deepening or diversification in Pak exports. In two areas, however, the country did take significant strides. Following the privatisation of PTCL (the telecommunication company) in 2004 and general opening up of the telecommunication sector, there was a massive increase in investment (both domestic and foreign) in this sector. In fact, it had become the dominant sector for investment by the middle of the decade, accounting for more than 40 per cent of FDI. As a consequence, Pakistan is now one of the cheapest countries to call from and can boast among the lowest charges for cellphone use. A related development was the mushrooming of private commercial



TV channels – numbering perhaps close to 50 – which assumed a crucial role during the period of democratic transition and thereafter.

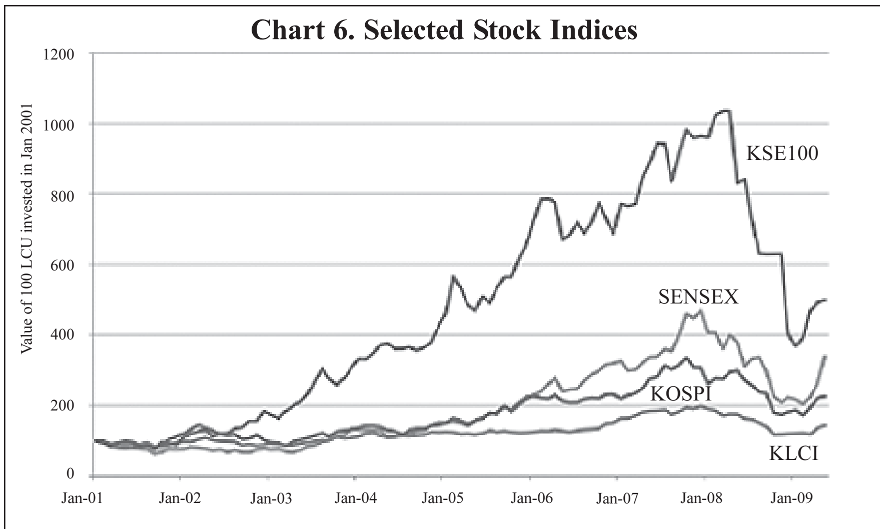
The rapid growth of the financial sector – at 17 per cent a year – was another achievement. This followed major sectoral reforms that were stretched over more than a decade and were the cornerstone of Pakistan's "structural reforms". This included granting the State Bank of Pakistan autonomy,



improving the regulatory and supervision system, privatising nationalised banks, liberalising foreign bank entry and operations, moving towards "market-determined" interest rates, and eliminating financial repression.

The results were impressive. Banking and financial services have become more efficient and highly lucrative, and attracted some $4 billion in foreign investment during 2006-08. Bank deposits rose to Rs. 4.1 trillion (about 40 per cent of GDP) and advances to Rs. 3.3 trillion (30 per cent of GDP) (State Bank of Pakistan 2008a). Closely linked to these achievements was the huge rise in the stock and real estate markets. While the performance of the commodity-producing sectors remained less than remarkable, it is these two markets that created the picture of a "booming Pakistan".

Chart 6 gives the leading indices for the stock markets in Bombay (SENSEX), Seoul (KOSPI), Kuala Lumpur (KLCI), and Karachi (KSE100), covering the period since January 2001. The indices relate to the hypothetical value of 100 local currency units (LCUs) invested on 31 January 2001. An inspection of these indices as well as the observed price-earning ratios brings out three things. One, the Karachi stock exchange was very much an outlier, compared to the other markets whose indices were rather closely clustered together. This suggests that despite the opening up of the economy to outside



investment, the Pakistani stock market remained more or less insulated from other Asian financial markets. Secondly, while the Karachi stock exchange was much more unstable, the average return on investment was far greater. An investment made at the start of the period was worth more than 10 times its original value at its peak in early 2008 in Karachi, compared to about four times the initial investment in Bombay, 2½ times in Seoul and twice the invested amount in Kuala Lumpur. Even after the sharp fall in the share prices in 2008, the overall return in the Karachi market remained much higher than in the other markets. The average annual return was 34 per cent in Karachi, 26 per cent in Bombay, 15 per cent in Seoul, and barely 9 per cent in Kuala Lumpur, indicative of, among other things, the relative riskiness of investment in the different markets.

And, finally, the other side of the high returns was the fact that the price-earning ratios (peaks as well as troughs) in the Karachi stock exchange remained consistently below the ratios observed in the other three markets (see Table 6). This, however, does not imply that shares in the Karachi stock exchange were generally underpriced; rather, it reflects the market's relative riskiness and isolation from the other markets. The Karachi market is still quite small and has been dominated by a few large firms in the three highly lucrative sectors, viz., oil and gas, electricity supply, and banking. It had earned a reputation for excessive speculation and there were frequent charges of price fixing, insider trading, and government involvement, but no formal inquiry was ever launched. Pakistan's Securities and Exchange Commission is a weak and ineffective institution.[7]

The data on the real estate market in Pakistan is fragmentary and anecdotal, but it is evident that, at least in the key urban areas, it was no less spectacular than the Karachi stock exchange. According to a BBC account: "The huge interest of investors … is typical of the unprecedented surge in real estate businesses in big cities like Lahore and Karachi following the

[7] One observer notes: "… while something can be done to maintain stability of the banking system, and to some extent stability of money and short term debt markets, hardly anything can be done to ensure that capital markets remain stable beyond creating the necessary conditions with routine monetary management, if that." (Faruqi 2007, p. 69)

Table 6. Price-Earning Ratios in Selected Markets (2005-08)

	High	Low	Current	Average	H/L ratio
Bombay	24.96	8.06	18.28	18.88	3.10
Karachi	16.61	6.31	12.11	11.54	2.63
KL	22.58	8.63	14.28	22.47	2.62
Seoul	34.62	8.33	15.8	34.39	4.16

Source: Estimates derived from Bloomberg data

attack on the World Trade Center. Since then, the value of one plot in the Defence Housing Authority [an upscale residential district] has shot up from about $65,000 before 11 September to in excess of $1.5 million after it … The boom has led to a mushrooming of Pakistan's middle class housing suburbs, often at an unprecedented speed." (Adil 2006)

Real estate in Pakistan has always been "safe investment" and there have been past property booms. However, the difference this time was that it was not just the Pakistanis but also foreigners who became keen investors and the government actively encouraged and promoted investment in this area. The introduction of mortgage lending was a new factor, but equally important was the provision of infrastructure and other facilities in new development areas. According to one newspaper report: "The property market has benefited from the present government's commitment to promote Pakistan as an investment choice. New real-estate projects in Karachi, Lahore, Islamabad and the future port city of Gwadar have built-in infrastructure to support the rapid development of housing schemes." (Fazl-e-Haider 2007)

The stock market and real estate boom was very much part of the economic order that emerged from the rising prominence of trading and financial services in the Pakistan economy.[8] Trading activities accounted for 22 per cent of the increase in domestic output between FY02 and FY07 (the

[8] Services in Pakistan account for more than 50 per cent of GDP, compared to just around 40 per cent in China or Malaysia. India too has a rather similar ratio for services, but a sizeable portion of the Indian sector consists of exportable services. (The data are from *World Economic Indicators 2008*.)

same as large-scale manufacturing) while financial services contributed 10 per cent, or just a little under the agriculture sector's contribution of 12 per cent. Considering that the share of financial services in GDP was only 3.5 per cent in FY02 (compared to agriculture's 24 per cent), that sector's performance was truly phenomenal.

The other side of the new order was a sharp increase in income inequality, reflected in boundless conspicuous consumption.[9] There was some reduction in absolute poverty during the period but that gain has probably been eroded under the economic crisis. Creature comforts in the villas of the rich came to match any in other parts of the world even as supply of publicly provided safe water or electricity became utterly unreliable. Thanks to the removal of punitive import duties, luxury cars became a common sight on Pakistani roads while the public transport system remained starved of investable funds.

The basic conclusion is that the years of relatively plentiful resources were not used by the Pak authorities or private investors to establish a robust economic foundation for future sustainable growth. The observed rapid economic growth of later years was driven by the rise of service sectors and the booming stock and real estate markets, and was ephemeral. The fragility and vulnerability of the economy to internal or external shocks increased over time and the worsening domestic and external macroeconomic imbalances could not have been sustained for long. A crisis could have been triggered by any development – a major failure of crops or a sharp fall in foreign resource inflows – but, as noted, it was the steep rise in the import bill in FY08 that broke the economy and brought its policymakers to their knees.

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[9] Hasan (2008) gives a sardonic but telling account of conspicuous consumption among the rich in Pakistan.

Chapter 4

MACROECONOMIC MANAGEMENT

BY 2001, privatisation, deregulation, and trade liberalisation had advanced considerably and, in line with the nostrums of the time, the State Bank of Pakistan had been given administrative and operational independence from the government. Nevertheless, the country's fiscal management and exchange rate remained two policy areas of deep concern. Indeed, the dominant view in Pakistan's policy circles[10] is that the country's macroeconomic problems emanate basically from its lax fiscal policy, on the one hand, and an overvalued exchange rate, on the other.[11] The policy failures in these two areas were also identified as the root cause of the 2008 crisis and underpinned the recommendations of the "Panel of Eminent Economists" that the new civilian government had set up to devise a "homegrown stabilisation programme" to rein in the deteriorating economic situation.

With respect to the fiscal situation, the Panel's report (Government of Pakistan 2008) noted:

> "The resort to strong fiscal policy to manage aggregate demand is justified on the grounds that there is significant 'policy space' currently in this area, as demonstrated by the low existing burden of taxation and extravagance hitherto in current expenditure." (p. 24)

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[10] These include official discussion forums as well as economists at research institutes and universities.

[11] A subsidiary concern has been the alleged "fiscal domination of monetary policy", i.e., the State Bank of Pakistan's lack of independence in formulating monetary policy because of the exigency of financing fiscal deficits (Sherani 2006, Zaidi 2006). This concern, as will be seen later, had a rather weak basis.

On the exchange rate, the report argued:

"There is need also for [a] major downward adjustment in the real effective exchange rate … Part of this, of course, represents a response to the virtual nominal stability of the rupee over the last five years, which probably implied significant overvaluation of the currency." (p. 25)

This diagnosis of Pakistan's macroeconomic problems raises issues that require careful consideration. That the country has always had difficulty in keeping its fiscal deficits under control is not controvertible. There is also little question that Pakistan's tax collection is close to abysmal; at 10 per cent of GDP, it compares very unfavourably with India's over 15 per cent or Malaysia's 20 per cent. The proposition that the rupee was seriously overvalued is rather more doubtful but there is little dispute that exchange rate management can be important in bringing about desired changes in the external balance. Nevertheless, the following discussion aims to show that policy failures in the two areas do not adequately explain the 2008 crisis.

For one thing, as noted earlier, there is little indication that the government pursued an unduly expansionary fiscal policy during the FY02-07 period. In the early years, the government's ability to increase expenditures was circumscribed by the conditionality under the IMF's 2001 programme and the fact that much of the foreign resource inflows were from private sources. Until the 2008 crisis, the share of current expenditures in GDP showed a slight decline and total public expenditures as a proportion of GDP remained more or less unchanged. At the same time, net claims on the public sector – at about 12 per cent of GDP – also showed no clear trend until FY06, though they rose sharply thereafter (Table 7). The government might have been cynical but it continued to profess fiscal responsibility as a key pillar of its economic policy even after ending the IMF programme in 2004 ahead of schedule, and underscored its commitment to fiscal prudence by signing into law the Fiscal Responsibility and Debt Limitation Act in 2005.

Table 7. Principal Determinants of Money Supply (% of GDP)

	2002	2003	2004	2005	2006	2007	2008
Net foreign assets	9.2	11.8	11.2	9.6	10.2	10.9	7.6
Domestic credit	36.6	37.1	41.1	44.4	43.5	46.1	43.2
Net claims on general government	13.9	11.6	11.5	12.0	10.9	12.6	14.1
Net claims on central government			13.3	13.6	12.7	14.4	15.7
Claims on private sector	21.7	24.6	26.0	28.6	29.0	29.4	26.0
Broad money (M2)	43.0	46.5	48.3	49.3	48.3	50.4	44.6
Narrow money (M1)	22.5	26.0	42.3	38.1	37.6	39.1	33.9

Source: Based on data from the State Bank of Pakistan

The concern in Pakistan's policy circles with the non-competitiveness of the rupee exchange rate also seems to be somewhat misplaced. According to the estimates of the "real effective exchange rate" in the IMF's *International Finance Statistics*, the rupee had appreciated by about 7 per cent by 2008 in comparison to its value in FY00 (IMF 2009a). The appreciation actually reached its highest level in FYs 03 and 04, when it stood at 10 per cent, but this only goes to show that there was little appreciation during the years just prior to the crisis. At any rate, the observed degree of variability in what is essentially a derived statistical measure is well within the margin of error and could not be considered significant.

Furthermore, the IMF, which is tasked with keeping exchange rate movements under careful scrutiny, chose to take a rather benign view in its recent evaluation of the competitiveness of the Pak rupee. Addressing the issue from different angles, the IMF *Country Report* for Pakistan noted:

> "The *macroeconomic balance (MB)* approach suggests that the current level of [the] real exchange rate is about 5-10 percent above the level consistent with the equilibrium current account deficit ('current account norm') of around 3.6 percent of GDP. Preliminary estimates based on the *equilibrium real exchange rate* approach suggest that the rupee is around 2 percent above equilibrium. The *external sustainability*

approach estimates that in real effective terms, the rupee is about 7 percent above the value needed for the current account deficit to decline to the level that stabilizes the ratio of Pakistan's net foreign liabilities to GDP at its 2007 level." (IMF 2009b, p. 18) [Italics in the original]

Missing from the dominant narrative of Pakistan's macroeconomic woes, however, is the role monetary policy played in the early years of resource abundance. As in other countries, the Pak authorities have had to struggle with balancing the need for price stability and maintaining the currency value competitive. The State Bank of Pakistan continued to give high priority to keeping inflation under control but it also came to see promotion of economic growth and export diversification as important policy goals (Zaidi 2006).[12] Despite the easing of the resource constraint in the early years following 9/11, private investment had remained hesitant and the economy was stuck in sluggish growth. This was at a time when globalisation was in full swing and Pakistan's main regional rival – India – was embarked on a trajectory of rapid growth.

The Pakistani policymakers were understandably anxious not to let the economy lag behind but had little room for manoeuvre in the fiscal area for reasons discussed earlier. It was at that juncture that the State Bank made a break with the past and loosened monetary policy while continuing to liberalise the exchange rate regime. A decision was made that instead of sterilising the rising foreign exchange reserves, the exchange rate would be prevented from appreciating by means of monetary policy.[13] This policy shift

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[12] The then State Bank Governor was fond of saying that he was a development economist, not a banker.

[13] The reasons for the policy shift are contained in the following somewhat rambling explanation by the SBP: "This rationalization of the discount rate was aimed at easing the money market which became tight after depreciation in the value of dollar in the wake of September 11 event and also for inducing financial institutions to reduce their lending rates to kick start the economy. Lower lending rates caused by easy monetary policy and improvements in the macroeconomic fundamentals led to increased economic activity together with escalation in the demand for private sector credit. The banks have also passed on some benefits of reduction in their intermediation costs in the form of lower lending rates, but not in the same proportion." (State Bank of Pakistan, "Monetary and Exchange Rate Policies", taken from: http://www.sbp.org.pk/publications/apr/Monetary_Exchange.pdf)

might have been initiated by the SBP but it evidently had the support of other parts of the government, notably, the Finance Ministry and the President.

There was consequently a dramatic reduction in the SBP's discount rate, slashed to 7.5 per cent in November 2002 compared to 14 per cent in June 2001. Easy and cheap credit to the private sector was seen to be helpful to Pakistani exporters as well as being a means to stimulate economic growth. Within a rather short period of time, other key interest rates were similarly slashed; notably the rate on the 6-month T-bills was reduced from 6.44 per cent in July 2002 to 1.67 per cent by end-June 2003 at a time when the inflation rate was considerably above the reduced interest rates. The easy money policy was ostensibly targeted at reducing lending and deposit rates at the commercial banks in order to "kick start the economy". According to the SBP, weighted average lending rates were brought down to 7.6 per cent in June 2003 from a level of 14.5 per cent in July 2001. Banks were pressed to lend to the private sector instead of investing in low-yield government paper, which resulted in the lowering of the spread. The gap between the lending and deposit rates narrowed from 950 basis points in July 2001 to 568 basis points in June 2003.

The result was an extraordinary increase of 300 per cent in bank credit to the private sector during FY03 compared to the preceding year. The ratio of "net claims on the private sector" to GDP rose to 25 per cent in FY03 and continued to rise until peaking at 29 per cent in FY07, just before the onset of the crisis (see Table 7). Although more than half of the credit went to industry (mostly textiles, *not* new industry), there was an unprecedented increase in consumer credit. Between FY03 and FY07, car loans rose roughly sevenfold and mortgage lending rose 14-fold, while personal loans – the biggest single category – peaked at Rs. 142 billion in FY07 (Table 8). Overall, the increase in private sector borrowing amounted to two-thirds of the total at the end of the period. By contrast, the ratio of net claims on the government to GDP remained more or less stable.

The above measures were accompanied by further liberalisation of the foreign exchange market, with the key aim of integrating the "kerb market" into the banking system. During the 1990s, Pakistan had followed a policy

Table 8. Consumer Financing (billion rupees)

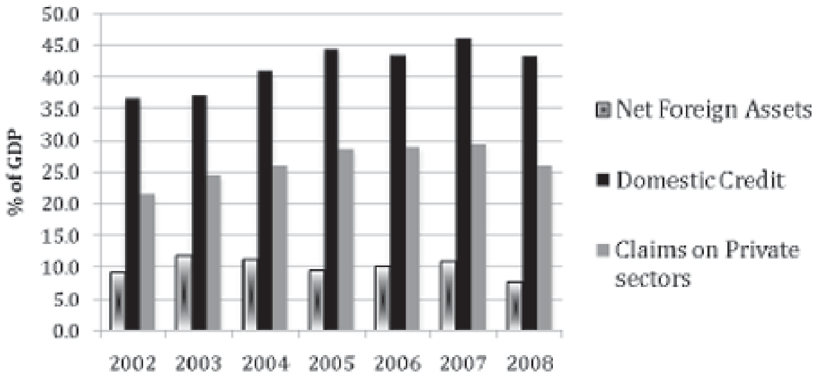
	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Total consumer finance	45.0	103.4	177.2	342.9	398.9	418.9	364.1
Of which: Housing	3.8	8.3	27.1	43.2	54.7	66.5	61.2
Car loans	15.8	33.1	66.0	97.8	105.4	105.0	78.2
Credit cards	6.7	11.2	19.3	33.5	42.8	44.4	35.5
Consumer durables	..	1.4	1.6	1.5	1.0	0.5	0.4
Personal	..	49.2	92.0	120.5	142.4	140.3	116.0

Source: State Bank of Pakistan

of "managed float", but it was turned into a free float at the start of the current decade. Some of the salient steps included relaxation of limits on overseas balances kept by foreign exchange dealers and residents, and domestic companies were permitted to make equity investments in companies and joint ventures abroad. Pak residents, however, continued to face certain restrictions on overseas portfolio investment. The authorised dealers were also allowed to buy and sell foreign exchange from each other within allowed exposure limits. They could hold on to surplus foreign exchange deposits (instead of surrendering them to the State Bank, as required under the previous rules) and were permitted to issue foreign currency travellers' cheques (up to certain limits) to foreign and Pakistani nationals. In short, there remained few restrictions on the buying and selling of foreign exchange in Pakistan and foreign exchange trading actually became highly efficient.[14]

The liberalisation of the foreign exchange market, however, was tempered by an unpublicised but de facto peg of the rupee with the US dollar.

[14] One measure of efficiency is the difference between the buying and selling rates of foreign currencies at retail level. In Pakistan, this difference is usually well below 1 per cent, compared to 5-7 per cent as typically found in the United States and Europe.



This meant that the authorities needed to intervene in the market from time to time in order to maintain the peg, though the official justification for the intervention remained avoidance of undue "gyrations" in the rupee value. This policy stance, however, did not have any significant impact on either the country's foreign exchange reserves or the rupee competitiveness because of the considerable depreciation of the US dollar against other major currencies.

The monetary policy combined with the liberalised rupee exchange rate succeeded in slowing the rise in net foreign assets (see Chart 7), but because of domestic credit creation, the ratio of broad money (M2) to GDP rose to 50 per cent. Despite this monetary expansion, inflation did not accelerate until the crisis year. The explanation probably lies in the rapid growth of the financial sector and its deepening as reflected in the rise in bank deposits. The fact is that the M2/GDP ratio in Pakistan is still low when compared to some other Asian economies, such as India, with 67 per cent, or Thailand and Malaysia, where it is about 100 per cent (Faruqi 2007).

Nevertheless, the 2003 shift in the monetary policy was remarkable as it was risky. The private sector in Pakistan had a rather poor record of loan repayments and there was little assurance that easier credit would stimulate private investment rather than private consumption. It was also the case that,

unlike mature industrial economies, Pakistan has seldom been "demand-constrained", requiring monetary stimulus to ignite economic growth. In fact, the weak performance of its industry and exports is primarily a consequence of supply-side problems, ranging from the quality of workforce and management to infrastructure bottlenecks, most notably power supply. Thus, it was hardly surprising that rising domestic consumption spilled into imports, giving rise to unsustainable trade deficits. This trend proved difficult to arrest in a country where government had virtually foresworn intervention in foreign trade. But, as observed in other countries in recent years, the loose monetary policy fed the booms in the stock market and real estate without igniting inflation as conventionally measured.

Chapter 5

CONCLUDING OBSERVATIONS – BEYOND THE CRISIS

THIS paper has attempted to show that it was primarily the shift in monetary policy in 2002-03 that set the Pak economy on an unsustainable course. But this policy shift must be seen in the broader context of general economic and financial liberalism that had taken hold the world over. And the Pakistani policymaking had been much influenced by this trend.

Pakistan's economic management has been judged, as in other developing countries, from the prism of protectionism, regulation, and state domination in the economic sphere[15], but the fact is that the country was always rather lightly regulated, loosely planned, and minimally state-controlled. There was therefore little internal dissent or fuss when the country's policymakers embraced market liberalism and the "Washington Consensus" in the 1990s. Thus, succeeding governments – whether Bhutto's left-leaning People's Party, Sharif's rightist Muslim League, or Musharraf's quasi-military government – held in practice, if not in rhetoric, a broadly similar stance on economic policy and the state's role.

The capital account and the exchange rate regime were already in the process of being liberalised in the late 1990s while nationalised banks and industries were being privatised. But this process was given a further fillip by the Musharraf government. One result of the adopted measures was that the World Bank's Doing Business index – notwithstanding its serious

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[15] See, e.g., Kugelman and Hathaway (2008), which contains a series of articles critiquing Pakistan's growth experience and economic performance from such perspectives.

weaknesses – came to place Pakistan above many other Asian emerging economies.[16] Another mark of success was the prominence the Pakistani president and prime minister came to enjoy in the leading world financial forums, notably, the annual Davos fest.

The rise of finance and easy money, however, had profound consequences for Pakistan's economy and its ethos, transcending the impact on the balance of payments. As in other countries, finance came to drive rather than support economic development; much of the observed growth in recent years resulted from income multipliers generated in the tertiary sectors. The bubbles in the stock market and real estate were a direct consequence, and monetary authorities, as elsewhere, were unable or unwilling to do anything to contain the situation. After all, the conventional measures of inflation gave no reason for alarm. But the country came to be ruled by a pursuit of quick returns, short-termism in investment decisions, and an attraction to glitter against overcoming the humdrum problems of infrastructure bottlenecks (e.g., large investment in telecommunication while failing to overcome the acute power shortage).[17] In this, Pakistan was far from unique. Similar phenomena were observed in other countries where finance came to dominate economic activity.

This criticism is not meant to question the significance of financial intermediation as a vital lubricant for economic development or to belittle the value of reforms that gave Pakistan a strong banking and finance sector that withstood well the 2008 crisis. In a 2005 ranking of countries according to their financial system health, Pakistan achieved a score of 0.5, the same as the average of industrial countries and higher than all other emerging market economies except Thailand.[18] It is also to be expected that monetary policy will remain decisive both in the management of the current economic crisis

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[16] Pakistan's business climate, according to the World Bank index, is held to be better than that of China and much better than any of the other South Asian countries, including India. It is obviously a reflection of the flawed nature of the index that private investors still find these other countries more attractive for investment.

[17] The persisting problems in the power sector arise out of not only capacity constraints but also pricing issues and delays in payments to power supplying companies.

[18] This ranking was done by the IMF and is quoted in Zaidi (2006, Table 1, p. 129).

and in the restoration of economic growth, especially if private foreign transfers continue to dominate. The only caveat is that it will have to be better targeted at helping to move finance into economically productive activities instead of allowing it to feed speculation and asset price bubbles.

In short, the economic crisis could have a silver lining. There are indications that stabilisation measures are working: the fiscal deficit is being reduced, inflation has come down (though still remaining high), and the trade balance is improving. Something positive will have come out of the crisis if these steps were to help in creating conditions for sustainable long-term economic growth. While the IMF, as is customary, has little to say on this aspect, it was the key concern in the report of the Panel of Economists that placed special stress on improving fiscal and exchange rate policies from the viewpoint not just of restoring economic stability but also improving the economy's long-term growth prospects.

Although this paper has cast doubt on the role of fiscal deficits in triggering the crisis, there can be little doubt as to the need and considerable room for improving Pakistan's fiscal performance. If the economy is to embark on a path of long-term growth and come to match the performance of other Asian economies, both domestic savings and investment rates would have to be substantially augmented from the current exceptionally low levels. Thus, any lasting improvement towards that end resulting from the stabilisation programme should be helpful and welcome.

The management of the exchange rate – the other area of policy concern – raises however a different set of issues. Although, as noted, the IMF has determined the rupee value to be within an acceptable range, the Economists' Panel took a more aggressive stance on the question. The report states:

> " … we recommend that the present crisis be seen as an opportunity to address the *chronic overvaluation of the exchange rate* for most of Pakistan's history and its implications for international competitiveness. We recommend further that the exchange rate be allowed, over the coming year, to depreciate to the level at which *the trade imbalance is eliminated*." (p. 50) [Emphasis added]

This statement is fraught with practical and conceptual problems and the authorities are urged to exercise great caution in adopting the suggested course of action. First, the report does not make clear whether a change in the current foreign exchange policy of "free float" is required. Although the rupee is free to move in the market, the State Bank is expected to intervene on the basis of a rather broad set of considerations, which include the need for foreign exchange reserve accumulation and restraining speculation (Janjua 2007). Abandoning this policy, in current circumstances, does not seem either practical or particularly useful. At any rate, a regime of active management of the exchange rate would promptly be seen as currency manipulation by Pakistan's trading partners.

A more serious issue is that the report seems to argue for a fine-tuned exchange rate policy with the specific goal of achieving a zero trade balance. It is not clear how this policy might be designed. The fact is that the exchange rate is not a policy instrument analogous to (say) tax policy that has reasonably predictable consequences. The government may adjust the nominal rate but there is no assurance that the desired change in the real rate (however measured) would materialise, especially if inflation cannot be restrained. A further complication is that there is in fact no one-to-one relationship between the real exchange rate and the trade balance; supplementary demand management policies are also usually necessary to move the trade balance in the desired direction. Finally, it is really not the exchange rate but labour productivity that is at the bottom of "international competitiveness", as Krugman pointed out years ago (Krugman 1994). Thus, the apparent undervaluation of the Japanese yen in the 1980s, the Korean won in the 1990s, or the Chinese renminbi more recently, was caused not so much by adjustments in the nominal exchange rate as by productivity improvements that occurred in these countries over time.

Specifically in Pakistan's case, therefore, overcoming the acute power shortage and other infrastructure problems, imposing rigorous standards and quality control, and generally creating a culture of innovation are more likely to make the country a successful and diversified exporter than continual adjustment in the exchange rate. The Panel of Economists has also underscored the need for dealing with some of these issues.

Pakistan is a country that continues to suffer from the consequences of 9/11 insofar as its security and political stability is concerned. But it was a beneficiary of enormous foreign resource inflows, consisting of unrequited private transfers as well as foreign investment. This happened not only on account of its geopolitical situation but also because of its general economic appeal and the size of its market. Unfortunately, the Musharraf government – notwithstanding its achievements in the communications sector and poverty alleviation – failed to utilise that opportunity to lay the foundations for sustainable long-term economic growth and left the economy in as grave a disarray as it had inherited. However, given Pakistan's "strategic" position and the interest of foreign donors in providing help, the country can be expected to continue to receive large foreign inflows. If Pakistani policymakers have learned from past experience, mistakes may be avoided and the economy might conceivably enter a period of sustained rapid growth.

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PAKISTAN: CAUSES AND MANAGEMENT OF THE 2008 ECONOMIC CRISIS

Like many other Asian emerging economies, Pakistan experienced major economic turbulence in 2008 amid the general global downturn. While the economy was plagued by serious balance-of-payments problems, the Pakistani crisis, this paper argues, was essentially homegrown.

The seeds of economic instability had been sown in the immediate post-9/11 years when Pakistan, as a frontline state in the newly launched "war on terror", became the beneficiary of massive foreign resource inflows. Instead of funding productive investment, however, the incoming capital was largely channelled towards speculative activity in the stock and real estate markets. This was the result of a domestic economic setting where the financial sector had become increasingly prominent, fuelling asset market bubbles on the back of a loose monetary policy. It was the imbalances created by this finance-driven boom which, exacerbated by the unfavourable global economic climate, would eventually set off the crisis in 2008.

Looking ahead, this paper underlines the need to chart a more sustainable course for the Pakistani economy. This would entail, among others, directing financial resources towards economically productive rather than speculative ends, and overcoming the infrastructural bottlenecks that have long impeded the country's industrial progress.

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