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OPINION

Fallout of the Stand-By Arrangement on Pakistan's Economy – Balance of Payments and Exchange Rate

Riaz Riazuddin[*]

Currently Pakistan is in a macroeconomic adjustment program of the IMF. And it seems pertinent to assess its implications for the economic performance of the country. A natural starting point of this brief impact assessment would be the conditions of our economy before the Stand-By Arrangement with the IMF, and the conditions (during, or) after implementation of this program.

A simple comparison of 'before' and 'after' assessment of the IMF program gauging its impact on the economy might not lead to meaningful conclusions. This is because the comparison is likely to attribute all observed outcomes to stabilization policies embedded in the IMF program, whether or not these outcomes (either good or bad) were actually caused by it. Conway (1994) pointed out this succinctly; "a test of program effectiveness must compare the outcome with the IMF program with the outcome that would have occurred in the absence of the program".

It is, therefore, also important to discuss economic conditions that would have emerged, had we not opted for the Stand-By Arrangement. Proceeding on this line of argument, a brief description of the conditions of our economy that led to a balance of payments crisis in 2008 is given; followed by a discussion of what would have happened had we tried to adjust our economy without the assistance of the IMF. Then we shall discuss the actual outcome so far and the expected one after the arrangement.

1. Economic Conditions before Stand-By Arrangement

A year before the SBA, i.e., at end-October 2007, exchange rate stood at Rs 60.68 per US$, foreign exchange reserves of banking system were at their peak around $16.5 billion, with the SBP reserves around $14.3 billion. Four-month (July-October 2007) current account deficit was $2.9 billion (equivalent to 5.3 percent of GDP); trade deficit was $3.3 billion (5.9 percent of GDP). During this period,

[*] Chief Economic Adviser, The State Bank of Pakistan; riaz.riazuddin@sbp.org.pk

export growth (YoY) was 14.2 percent and import growth rate was 4.5 percent. Monetary growth was 18.2 percent; private credit growth was 15.2 percent; and inflation (YoY) was 9.3 percent. Government borrowing from the SBP seemed to be within safe limits – around Rs 23.3 billion during Jul-Oct 2007 compared to Rs 117.1 billion in the same period a year before. Reserve money expansion was Rs 45.7 billion compared to Rs 143.3 billion in same period of previous year. Net foreign assets of the system depleted by Rs 24.4 billion compared to a depletion of Rs 54.7 billion during the comparable period last year.

In short, there was apparently no sign of any fiscal stress visible in October 2007. Although current account deficit seemed to have already crossed 5 percent of GDP level and the depletion in net foreign assets was indicating rising external imbalances, import growth was contained at 4.5 percent. Notwithstanding the non-crisis nature of these macroeconomic conditions from November 2007 onwards, macroeconomic deterioration started and became very rapid within next few months. Fiscal stress soon became visible and the speed of deterioration continued to increase till October 2008, when the SBA was negotiated and implemented from November 2008. Reserves depletion captured the entire story of BoP deterioration that became almost a full-blown BoP crisis.

From November 2007 to February 2008, forex reserves of the banking system depleted by $2.4 billion (about $603 million per month on average). During the next four months, a further depletion of $2.6 billion (about $660 million per month) occurred. Speed of reserves depletion further accelerated in the next four months, with a further depletion of $4.6 billion ($1.16 billion per month on average). System forex reserves at end-October 2008 stood at $6.8 billion, with the SBP reserves at $3.5 billion. Pak rupee depreciated by 25.6 percent from end-October 2007 to end-October 2008.

All macroeconomic indicators deteriorated rapidly within a year from October 2007. Inflation (YoY) went up to 25 percent in October 2008, current account deficit of July-October 2008 widened to $6.3 billion (11.7 percent of GDP), fiscal deficit rose to Rs 139.5 billion in first quarter of FY09 (4 percent of GDP), system NDA grew by Rs 214.4 billion and NFA depleted by Rs 288 billion that caused monetary growth to be contained during July-October 2008 to Rs 73.6 billion compared to rise of Rs 52.9 billion in the same period of previous year.

2. What Would Have Happened in the Absence of External Assistance?

Before discussing the outcome without the SBA, it is essential to discuss what factors caused this rapid deterioration in the first place. Although the increase in international oil prices played a big role in increasing the current account deficit, domestic public policy failure to adjust the economy cope with this situation played even a bigger role. This means that fiscal authorities preferred not to pass on this increase to domestic consumers that resulted in increase in oil subsidies. Moreover, financing of subsidies was done through reckless borrowing from the SBP that increased the reserve money growth to unsafe levels causing inflation to rise rapidly.

Exchange rate policy also proved to be detrimental to keeping external position at sustainable levels. The crucial policy weakness originated in late 2004 when the government asked the SBP to provide oil support to foreign exchange market to quell a speculative pressure on Pak Rupee at that time. Although that policy succeeded and the exchange rate became not only stable, but sort of over-stabilized itself to become what is known as a 'de-facto peg'. The policy of providing oil support from the SBP reserves should have been reversed in a short period of time, but it persisted and also played a role in creating BoP crisis.

Though, it is not possible to really construct a counterfactual scenario, nevertheless the discussion of initial conditions and visible deterioration from October 2007 to October 2008 point towards worsening in the absence of macroeconomic policy adjustments. It is simple to construct an indicative counterfactual scenario, based exclusively on assessment of further reserves depletion beyond October 2008. Speed of depletion would have increased manifold, because system forex reserves were already low at $6 billion; reserves would not have lasted beyond December 2008. This means that exchange rate would have depreciated further and the extent of the BoP impact of $6 billion reserves depleting in just two months would have been very drastic in all sectors of the economy.

Crisis stemming from fiscal and external shocks would have manifested itself, in the absence of any meaningful adjustment, in a monetary contraction of unprecedented proportion in our economy. Depletion of reserves would have dried up all rupee liquidity in the system, with consequent effects on interest rates and contraction (not just deceleration) in domestic as well as private sector credit. This conclusion is simply drawn from the fact that domestic liquidity (money supply or M2) is the sum of NDA and NFA. Contraction in NFA would have been so huge that even a sizeable expansion in NDA would have resulted in decline in money supply. Other sectors of the economy would also have been affected: contraction in almost all economic activities and unprecedented increase in unemployment and poverty. Luckily, this counterfactual did not become an actuality.

It is instructive here to quote Krugman (1979) about the description of a balance of payment crisis: "A standard crisis occurs in something like the following manner. A country will have a pegged exchange rate; for simplicity, assume that pegging is done solely through direct intervention in the foreign exchange market. At that exchange rate government's reserves gradually decline. Then at some point, generally well before the gradual depletion of reserves would have exhausted them, there is a sudden speculative attack that rapidly eliminates the last of the reserves. The government then becomes unable to defend the exchange rate any longer."

Krugman's description seems to fit our case, but not completely because we opted to go for the SBA with the IMF. Had we not done that, the last part of Krugman's description would also have been materialized.

3. Economic Performance during the SBA

Before dwelling on the actual economic outcome so far, it is pertinent to describe the three core actions emphasized in any IMF-supported adjustment program: a) securing sustainable external financing; b) adopting demand restraining measures consistent with available financing; and c) proceeding with structural reforms to promote growth and adjustment in the medium and longer term (Mussa & Savastano, 1999). This means that the priority objective in an IMF-supported stabilization program is to get the country out of the BoP crisis in a short-period of time through demand restraining policies, whose absence cause BoP crisis in the first place. Promoting growth remains an objective of stabilization, but not the priority objective, simply because it is not possible to restore economic growth before correcting the unsustainable external position of a country that manifested itself in a BoP crisis.

In order to assess the 'fallout' of SBA on Pakistan's economy, we pose several questions and also attempt answering those. The first question is: has balance of payments improved after implementation of SBA? The answer is unequivocally yes. Second question is: have we succeeded in securing sustainable external financing? Probably yes, given the expected assistance from the Friends of Democratic Pakistan or the Tokyo Package announced recently. Third question is: is our country proceeding with structural reforms to promote sustainable growth in medium to long-term? Answer is that the SBA is on track and reforms committed are likely to be implemented and will eventually lead to promotion of growth and reduction in poverty in the medium term.

Fourth question is: what is the impact on growth in the short run? Answer is that growth has decelerated. Real GDP growth data was recorded at 2 percent in FY09, down from FY08 growth of 5.8 percent. It is well-known that IMF-supported programs result in declining growth in short-run. According to Haque and Khan (1998), "…. The consensus seems to be that output will be depressed in the short-run as the demand-reducing elements of the policy package dominate."

The fifth question to ask is: should we attribute this slowdown in growth entirely to the IMF conditionalities? The answer lies in visualizing a counterfactual growth rate that would have occurred in the absence of the IMF program. The discussion in second section indicates that economic activities would have contracted, i.e., we would have seen a contraction in real GDP (negative growth). What we are seeing now is low but still positive growth. Therefore, it is difficult to ascribe the low growth phenomenon to the IMF SBA. In fact, the SBA has probably helped Pakistan in avoiding an economic contraction.

Sixth question is: should we attribute the entire improvement observed so far in BoP to the SBA? Answer is that part of the improvement in lowering current account deficit is due to reversal of international commodity price shock, especially oil price shock, but at the same time, the SBA had played a crucial role in securing hard currency to finance this deficit in the midst of vanishing liquidity in international financial markets and heightened risks for IFIs for lending even to sovereigns.

The conclusion is that the SBA has helped stabilize Pakistan's balance of payments and exchange rate. It has also helped our economy from witnessing a much worse macroeconomic outcome compared to what we are actually observing, had we remained outside the SBA. Program is also likely to help our economy get back on the path of respectable medium term growth trajectory with successful completion of the SBA and onward continuation of prudent macroeconomic policies.

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