MCB Bank Limited

Treasury & FX Group

Quid Pro Quo

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Veni, Vidi, Vici

On November 3rd, 2007 President General Pervez Musharraf declared State of Emergency in the country, stating the move was imperative to safeguard the national interests and counter growing terrorism. Immediately following the imposition of emergency, Moody's Investors Service and Standard and Poor downgraded Pakistan's credit rating outlook from stable to negative while the benchmark KSE 100-index plunged by 635 points to register its highest one day decline as foreign investors withdrew from equity as well as from government bonds.

This report goes back to examine the backdrop under which General Musharraf first took power in October 1999 before outlining the economic reform program his regime enacted to bring economic stability and prosperity. The report will then move forward to discuss how General Musharraf's second coup is likely to impact the economy in the short and long run.

Blast from the Past

General Musharraf took over power in October 1999, ousting the elected Prime Minister Nawaz Sharif, assuming the title of Chief Executive and later on becoming the President of Pakistan. A month later, Mr. Shaukat Aziz was invited to take charge of the Ministry of Finance.

At this point in time the economy was lurching from one crisis to another. Weak macroeconomic management under the democratic government of the time, lack of commitment to execute competent structural reforms and corruption in public spending had resulted in poor economic outcomes. In addition to this, historical structural problems of public debt, weakness in exports, poor revenue collection, inadequate investments in human capital and physical infrastructure, and low quality of public institutions and governance had been adding to the pressures facing the economy.

Inappropriate sequencing of financial reforms in the early 1990s, the introduction of foreign currency accounts and the use of short-term commercial borrowings resulted in rapidly increasing the total indebtedness of the economy while the repayment of both internal and external liabilities created excess pressure on government expenditure. The fiscal and current account deficit reached as high as 7% and 5% of GDP respectively and the associated build up of public debt and external debt was recorded at over 100% of GDP and 335% of Foreign Exchange Earnings respectively. This was rather a major source of macroeconomic imbalances prevailing in this era.

The massive cost of debt servicing which amounted to almost two-thirds of the country's revenue rendered fiscal policy instruments ineffective and the country's physical and human infrastructure began to decline under the combination of a fiscal crunch, rising poverty and poor governance. These imbalances were further exacerbated by the failure to collect revenues at levels compatible with growing expenditure requirements, poor performance of exports and overall foreign exchange reserves which fell to as low as USD 415 million in Nov 1998. This was hardly sufficient to finance even two weeks of imports.

Commercial banks and other financial institutions had become the instruments of political patronage and profit for certain sub-sections of society while the mismanagement of public sector enterprises like WAPDA, KESC, Pakistan Railways, Pakistan Steel Mills, PNSC and PIA, intensified the pressures for the economy even further. Subsequently economic growth hovered around the 4% level with more and more people falling below the poverty line while investment rate decelerated to 15.6% of GDP by 1999.

He Came, He Saw and He Made a Difference

It was in the backdrop of this state of affairs when President Musharraf usurped power from a corrupt civilian government in 1999, prompting quiet cheers from many of his countrymen. Assigning restoration of macroeconomic stability a high priority, the Ministry of Finance, under the new government, soon assembled a team of highly trained personnel to launch a comprehensive set of economic stabilization and structural reform policies.

Keeping in view that many of the economic problems that prevailed at this time were structural in nature and therefore the objectives, of high growth, low inflation, external payment viability and improving living standards of the common man, could not be achieved without removing these structural bottlenecks, the new policy-making team initiated a series of structural reform measures in areas of privatization and deregulation, trade liberalization, banking sector, capital markets, tax system and administration and the agriculture sector.

Soon after the launch of a comprehensive reform program and the introduction of prudent fiscal, monetary and exchange rate policies, the economy started to show signs of improvement and stability. Economic growth gained momentum, foreign currency reserves started to edge up as foreign direct investment and inflow of remittances accelerated and the government's continuing fiscal discipline and commitment to reforms set the stage for re-profiling of external debt. The aftermath of 9/11 attacks on the US further complemented the reform program under the Musharraf regime as the pre-existing positive trends gained invaluable momentum in FY 2001-02 (post 9/11), stimulating the economy even further and opening new avenues for investments.

Figure 1: Foreign Exchange Reserves (FY01-FY07)

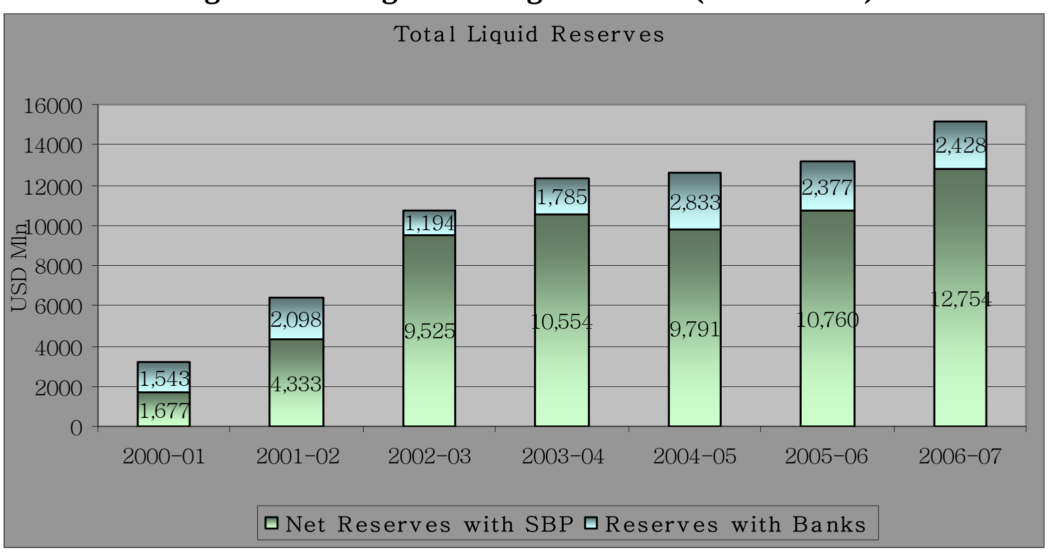
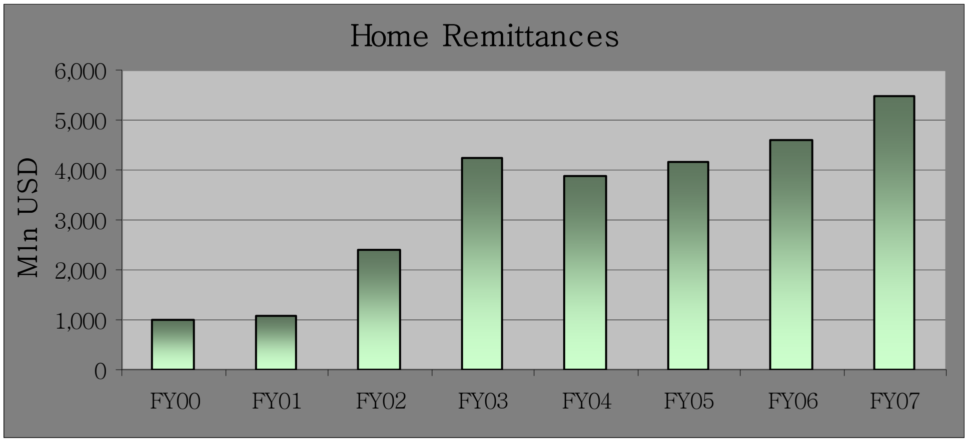


Figure 2: Home Remittances (FY00-FY07)



Source: SBP

As a result in the past five financial years, post September 11, under the Musharraf regime Pakistan's economy has experienced the longest spell of its strongest growth in years as the economy grew at an average rate of 7%. Compared with other emerging economies in Asia, this puts Pakistan as one of the fastest growing economies in the region, along with China and India. The outcomes of the outgoing fiscal year indicate that economic momentum remains on track as economic growth accelerated to 7.0% on the back of robust growth in agriculture, manufacturing and services. Strong economic growth and investor friendly environment generated increased foreign investment which stood at over USD 6 billion while the main stock index has risen more than 1,000% since the end of 2001. Workers' remittances reached a new high at over USD 5 billion and foreign exchange reserves have crossed the USD 16 billion mark for the first time in history.

The Wrong Turn

On one hand where General Musharraf has taken the economy to new heights and has enjoyed deserved rations of admiration at home and abroad, on the other he has angered many at home by his alliance with the United States in a war they saw as directed at both Islam and their ethnic Pushtun kin in Afghanistan. His persistent refusal to take off his army uniform and allow unrigged elections alienated liberal opinion.

Under these circumstances most of his support had thus evaporated even before he staged his second coup which came on November 3rd, 2007. On this day General Musharraf dismantled the constitutional facade and imposed, in effect, emergency rule for an unspecified amount of time.

The declaration of emergency did not only prompt domestic reaction but strong responses from international agencies and rest of the world. Both Moody's Investors Service and Standard and Poor downgraded Pakistan's credit rating outlook, on November 5th, from stable to negative, stating that the imposition of emergency ruling by President Musharraf *represents a further erosion in governing capacity*. The American and the British Governments as well as countries in the European Union strongly condemned the imposition of emergency, declaring that they will now have to review their aid policy towards Pakistan and that it is likely that development as well as military aid will be suspended.

Further in the absence of credible news about the market from an independent source due to the black out of private TV news channels, most investors behaved rather erratically as new rumors were sparked in the air every now and then. Subsequently the aftershocks jolted the Karachi Stock Exchange on the very first day following the imposition of emergency as the benchmark KSE 100-index plunged by 635 points to register its highest one day decline.

The decline on part of the stock market was rather anticipated as negative sentiments had earlier gripped the market just on rumors of emergency in August, 2007. This is primarily because imposition of emergency rule creates an environment of uncertainty, hurting investor sentiment. In the weeks that followed the execution of emergency, KSE continued to witness mayhem with foreign investors withdrawing around USD 180 million from equity and USD 50 million from government bonds. The KSE 100-share index recorded a decline of 341.86 points or 2.55% for the week ending November 16th while the overall market capitalization reduced by PKR 92 billion to PKR 4.004 trillion in the previous week alone.

It is not surprising that this resulted in hurting the rupee strength vis-à-vis the dollar. As foreign investors withdrew from the stock market, the rupee depreciated approximately 1%, following the emergency.

Temporary Fears?

The uncertain and fast changing political scenario, crackdown on political leaders and workers in the country under the emergency rule and worst law and order situation in Swat and other parts of the country altogether have provoked investors to minimize their portfolios on board. Nevertheless these are rather short term reactions to imposition of emergency and do not necessarily imply extension into the longer run.

It must be noted that it is long term investment which is more detrimental to economic growth and therefore any negative impact on long term investment is worrisome for future economic prospects. Fortunately, so far we have not seen any withdrawals by long term investors. Rather it is credible that amidst the current political crisis the government signed the Memorandum of Understanding worth USD 5 billion for establishment of an oil refinery at Khalifa Point in the coastal area near Hub Balochistan. According to the agreement the UAE based International Petroleum Investment Company (IPIC) and Pak Arab Refinery Limited (PARCO) would jointly set up 200,000-300,000 barrels per day refinery. This is the biggest ever Foreign Direct Investment (FDI) received by the government for the establishment of an oil refinery.

Hence one thing is clear that the current political upheaval is likely to impact short term investment more significantly than long term investment. This is reflected strongly in the FDI figures for Jul-Oct period where FDI crossed the USD 1 billion mark; up by 3.9% over the corresponding period of the previous year when political scenario was much more stable. However the uncertainty due to political instability resulted in a decline in portfolio investment which dipped by USD 141.3 million to USD 310.6 million during the first four months of the current fiscal year.

Similarly foreign aid is again a long term phenomenon. Therefore any rumors and fears regarding suspension of aid from the West are temporary and a panicked reaction to imposition of emergency. Though the American government earlier declared that it shall review its aid policy, we believe that as long as Pakistan remains a key ally to the US in the *War against Terror*, the US aid which constitutes a major portion of total foreign assistance is likely to remain intact. The economy therefore may not face any serious challenges in terms of aid suspension.

Lastly, the market does not expect the current crisis to persist for too long as General Musharraf has indicated that general elections will be held by the middle of January and thereby the political order will be restored. If smooth transition to democracy does take place in the near future then it will play positively with the sentiments of short term investors as well and we will see the local bourses recover their losses.

Nevertheless it is not possible at this point in time to analyze the economic cost of the imposition of the state of Emergency as it depends on the effectiveness of a number of factors. Long term prospects will depend upon the interaction of evolution in political and social developments, economic policies to be pursued, the quality of governance and institutions, and investment in the human capital. Sustained economic growth and poverty reduction, thus, cannot take place merely on the strength of economic policies. Political stability, social cohesion, supporting institutions, and good governance are equally important ingredients coupled with both external environments for achieving economic success.

Economic Snapshot

Fiscal year 07-08														
	Units	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	Oct
Inflation														
Headline Inflation	%	8.11	8.07	8.88	6.64	7.39	7.67	6.9	7.4	7.0	6.4	6.5	8.4	9.3
Core inflation	%	5.70	5.62	5.5	5.3	5.72	5.42	5.2	4.7	5.1	6.0	6.0	6.1	6.5
Food inflation	%	10.54	10.62	12.71	8.7	9.99	10.74	9.4	11.3	9.7	8.5	8.6	13	14.7
Non-food inflation	%	6.41	6.27	6.22	5.2	5.59	5.54	5.2	4.7	5.1	4.9	4.9	5	5.4
T-bill (Wgt Avg)														
3 month	%	8.64	8.65	8.64	8.64	8.64	8.65	8.69	8.69	8.69	8.69	9.05	9.05	9.05
6 month	%	8.81	8.81	8.81	8.81	8.81	8.82	8.9	8.9	8.9	8.9	9.12	9.12	9.12
12 month	%	9.00	9.00	9.00	9.00	9.01	9.01	9.08	9.10	9.16	9.16	9.39	9.39	9.39
External Sector														
Export	Mln US$	1,288	1,448	1,536	1,227	1,421	1,536	1,446	1,540	1,583	1,434	1,475	1,463	n.a
Import	Mln US$	2,162	2,139	2,365	2,100	2,103	2,070	2,159	2,190	2,373	2,423	2,206	2,150	n.a
Trade balance	Mln US$	(874)	(691)	(829)	(873)	(682)	(534)	(713)	(650)	(790)	(989)	(731)	(687)	n.a
Remittances	Mln US$	410	448	475	391	457	520	513	537	505	495	489	516	n.a
Forex Reserves	Mln US$	12,503	12,460	12,960	13,212	13,378	13,624	13,661	13,778	15,182	15,723	16,106	16,145	16,354

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