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Foreign Liquidity Crisis and the Economy – *Pakistan A Long Term Comparative View*

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Foreign Liquidity Crisis and the Economy – *Pakistan*

A Long Term Comparative View - Abstract

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During the waning days of the year 2013, the people of Pakistan were enlightened by the President of the country as a parting thought of the year,…."the begging bowl can't be broken..…people should be patient… the debt of Pakistan has increased from Rs 6700 billion in 2008 to Rs 14800 billion in 2013….only through democracy Pakistan can develop….all institutions, media, political parties should…do more…." With such exhortations from President, the year ended.

Taking ***exception,*** *the rejoinder is that "begging bowl" can be broken as comparative experiences have shown us. It has been broken by a number of countries including India next door and many other countries. What a succor such exhortations are for ordinary Pakistanis, facing intensified burden of poverty, back breaking prices of basic food items essential for survival, a debilitating energy crisis, trundling through for a few scraps of fuel (see exhibit), and living under constant fear of terrorism.*

This is too wide a canvass; hence we shall limit ourselves to explore implications of the above. The central proposition of this paper is that breaking the 'begging bowl' would need a firm resolve at ***structural transformation*** *as outlined in this paper and it would be doubly difficult in current times than it was before. This would, require more than tinkering around with trade and exchange regime or chasing stabilization programs, papering over periodic liquidity crisis and near-insolvencies with expensive bridge financing, while squeezing the belt ever more tightly. For more than half a century we have been doing just that. Pakistani rupee has been steadily depreciating all along as we have gone through many standby programs but we are back to square one. Standby programs have failed to deliver from recurrence of crises. Look where we stand today.*

Instead, breaking the bowl would require ***structural transformation which*** *Pakistan embarked upon rather half heartedly two decades ago, while experimenting with autarchy, socialism - Fabian or Islamic, nationalization, back to market system, bad governance and all, but never pursuing it through its fruition as other countries did. This transformation will be more difficult in current times than it would have been in previous decades. Let us see how far we succeed in outlining how this* ***structural change*** *can be accomplished…. or is there any other way out?*

Foreign Liquidity Crisis and the Economy – *Pakistan*

A Long Term Comparative View

Shakil Faruqi

1. The *'begging bowl'* analogy is all too familiar, referring to Pakistan's recourse to IMF, World Bank, ADB and a few reluctant bilaterals to seek foreign financing on emergency basis to stem default on foreign obligations. This situation arose from current account deficits that have persisted except for a few years in between, though foreign trade balance has always been negative. In some years, the counterpart financing inflows were strong enough to enable Pakistan to tide over adversities; in other years, Pakistan had to seek foreign exchange ***(forex)*** liquidity on emergency basis to avert imminent technical insolvencies. It did; but eventually Pakistan returned back to square one where it started from.

2. In this sense, the string of periodic liquidity crises are not once for all short term phenomenon. Instead, these crises are rooted into ***structural imbalances*** in foreign trade and capital flows, which can be traced back to its manufactured export base, weak and confined to a few sectors like textiles, and incapable of making inroads into global markets. This failure in large part, occurred due to upheavals in the Pakistan's industrial sector that occurred during nationalization, followed by reforms and privatization, back to current corporate sector which is facing a debilitating energy crisis and a business environment sliding into near anarchy.

3. True, Pakistan pursued ***structural adjustment programs,*** including opening up of foreign trade, liberalization of exchange regime and capital flows; together with reforms of financial system ushering in a market-based economy in place of controlled economy. Those were ***necessary conditions*** of structural adjustment of the economy, just not its external sector. But the ***sufficient condition*** was ***structural transformation*** of the type discussed here in this paper, based on ***acquiring*** comparative advantage where none existed before, thus complementing reforms of policy and incentive regime. This transformation in emerging economies involved ***restructuring*** of their light manufacturing export industries, ensuring that they are cost effective,

efficient and competitive in global markets. This was followed by efforts to attract ***foot-loose*** industries of advanced countries looking for relocation, together with foreign direct investment, technology transfer, investment in infrastructure facilities and allied sectors to bolster their supportive role in transformation of industrial sector. Once they succeeded at exporting, they developed their heavy industries along the same lines, which was initially set-up for import substitution.

4. Pakistan did not succeed at ***structural transformation*** of its foreign trade the way emerging economies did. Its manufacturing industries lagged behind, and mostly catered to import substitution rather than exports. That is, ***structural transformation*** of this type has eluded Pakistan to the point that its one time frontline exporter, textile industry, is having a hard time to maintain its toehold in foreign markets in spite of all the support it has enjoyed as priority sector for six decades. This failure resulted in foreign trade deficits which could not be overcome by depreciating its currency or through other short term gap-fill measures in response to recurrent liquidity crises over the previous decades.

5. This transformation is different than those discussed under adjustment programs of international financial institutions, the ***IFIs.*** Their focus is on fiscal deficits, current account deficits, public revenues and expenditures and budget deficits and public debt, all expressed as ratios of GDP, as though these ratios will improve by magic while structure of the economy remains mired into its own inadequacies and conflicting goal posts. Likewise, no amount of econometric modeling can cope with this transformation.

Current Account Deficits *and Currency Depreciation*

6. Let us now have a look at foreign trade and current account deficits over the past decade, followed by a review of foreign exchange regime as it evolved over the reform period of early 1990s to mid-2000s; and trends of exchange rates over FY00-FY13. In between, we need discussion of currency market that took long contours to arrive at its present configuration which is rarely done; though currency markets play a conspicuous role in capital outflows in Pakistan both through formal and informal channels, shelving Pakistan into periodic foreign liquidity crises.

7. Much of currency depreciation owes to persistent current account deficits that occurred over the past eight years. During early years of 2000s, current account (***C/A)*** was in surplus, but starting 2005 through 2013 it was negative except in FY11 when a small surplus occurred (*Data Set 6.1).* The cumulative ***C/A*** deficit during these nine years amounted to US$ 47.2 billion, while cumulative foreign trade deficit amounted to US$103.5 billion. The largest ***C/A*** deficit occurred during FY08 amounting to US$14 billion, followed by another deficit next year of US$9.0 billion plus. These deficits could not be overcome by remittances, substantial though they were; hence foreign liquidity crises. A detailed analysis of deficits will take us far away from the theme of this paper; besides, it is well documented and analyzed by SBP, IMF, and many others.

8. Steady depreciation of currency was not the cause of these deficits as commonly perceived; rather it was the outcome of weaknesses of foreign trade structure of Pakistan, aggravated by swiftly rising burden of foreign debt. These deficits had to be financed from foreign borrowings and reserves, since net foreign private investment inflows were small except for FY06-08 years owing to exceptional size of privatization proceeds. Besides, boom in stock market abruptly turned into a crash in the middle of 2008. Since then, net private foreign investment did not recover the lost ground.

9. As a consequence, Pak rupee depreciated at a fast clip and this trend accelerated in recent years. The BoP is in crisis and is reminiscent of crises that occurred during 1990s. This is historical, but fundamentals of BoP crises are the same underlying forex liquidity crises of today. Government had to requested IMF's assistance under standby or extended fund facility, ***EFF***, furnishing forex liquidity; a familiar outcome. The question remains why value of rupee is sliding and why inflation is rampant; in short, why time and again Pakistan ends up in such crises.

10. That debate goes on, but there is a great deal of dismay as Pakistan is forced to undergo again a regimen of belt tightening, increase in utility rates, energy price hikes; increase in price of imported oil and petroleum products, significant increases in price of consumer essentials and basic food items. In addition, the government has to undergo privatization of failing ***PSEs*** as happened during reform years to stem public sector deficits and mounting debt burden. Meanwhile, SBP has to strive to maintain price and exchange

rate stability via monetary management, which means controlling inflation and keeping real effective exchange rate, ***REER,*** stable. The fiscal deficits have remained out of line, hence SBP's efforts were unsuccessful.

11. This is familiar to all. People of Pakistan are a veteran of IMF's standby agreements which are deemed a success, heralded once again in recent times with the release of second tranche of US$ 550 million under ***EFF,*** though a repayment of $170 million to IMF is looming large ahead. This is typical of bridge financing arrangements. Part of the success was mutation of circular debt funded through huge government borrowings from banking system, large increases in utility rates and hikes in income tax rates of captive tax payers, mainly the salaried income group. Meanwhile, circular debt has resurfaced and has already begun its climb; forex reserves have dwindled and would have been worse except for remittances of ***Pakistani diaspora*** whose numbers have swelled by 2.5 million new migrants over the past five years. It is currently estimated at about 6 million. Their remittances are around $15 billion and rising fast.

12. What a saga this has been if one looks at it in a long term perspective, away from up-down of current economic and financial trends. To wit, Pakistani rupee has been depreciating for ***more than half a century*** with no end in sight; yet current trade deficits never ended; nor did current account deficits. They kept appearing. To cope with their financing, Pakistan signed on nearly a dozen IMF programs during late 1980s through late 1990s, but most ended up in non-performance and were truncated after first tranche release; representing a revolving short term credit.

13. Therein lies the challenge for technocrats and policy makers alike, namely should their preoccupation be with exchange rate, inflation and public debt as short run phenomenon and deal with it tranche by tranche conditionalities of IMF; or look at it in longer term perspective to figure out why forex rate stability has been so elusive. Invariably, preference of policy makers has been to muddle through during their political tenure, make as much hay as possible, while structural factors that underlie these crises and their long term prognosis better be relegated to next government in the line; turn by turn- a *fiat accompli* of this process.

14. Structural factors are far more powerful in shaping current events than is commonly perceived. This is central to efforts at 'breaking the bowl' as outlined in the last section of this paper. We have been glued to mitigate short term forex needs, treating them as periodic liquidity crisis that will go away. But it is about time we realize that this fixation has not delivered. We have to focus on long term structural causes of BoP crises, persistent depreciation of the rupee, and all. True, reforms of foreign trade regime were undertaken with long term perspective involving reduction of tariff barriers, quantitative restrictions on imports, export promotion schemes with inducements such as subsidized credit, preferential access to infrastructure and energy supplies. In spite of all these, current account rarely returned to positive levels and devaluations continued.

15. With reforms of foreign trade regime and capital flows undertaken alongwith economic and financial reforms, Pakistan did not achieve ***transformation*** of its foreign trade sector. The paradigm shift towards export industries may have mitigated adverse outcome, but it did not deliver. Besides, this paradigm shift was undertaken out of sequence, undermining its efficacy as subsequent events proved.

16. That is, capital accounts were opened before trade account had adjusted. Some would suggest that it is the same old argument of export-led growth that has occurred in US favored countries as a special case; Korea being on the front line. So, what is new? Look beyond Korea and see what other countries have done, including neighboring giants, China and India. Were they special case like Korea? They did not enjoy preferential access to US markets. Instead, they focused on ***structural transformation*** that has no parallel in their history.

17. This transformation was not limited to export industries; it also involved import substitution industries like steel, automobiles and some light machinery industries. In this endeavor, Korea, Malaysia, Brazil succeeded early on. China and India ventured belatedly and they also succeeded. Early on, export prospects of steel and automobiles from these countries were not even on the horizon, while IT industries were new entrants, but they made significant inroads in global markets. Indian conglomerates like Tata, Mitthal, Ambani, Reliance and a few others now have significant presence overseas.

18. Thus, ***structural transformation*** is not synonymous to export based manufacturing alone. The dynamics of comparative advantages are such that import substitution industries of earlier days could become winners in future, provided their growth is solidly based on efficiency and costs.

19. Most lament the twin gap, namely current account deficit and budget deficit for the predicament Pakistan faces today, but do not have much new to offer other than parleying deficit financing of one type or the other, coupled with financing of forex liquidity shortages via prime cost based foreign borrowings at LIBOR+5.0, plus IMF assistance, thus perpetuating BoP crises and hoping for a reversal. Pakistan has been unable to reverse these trends over the past. Such reversal cannot be achieved through short term bridge financing.

20. Pakistan is about to embark on bond based Euro-borrowing for longer term, this time with the help of IFC, but will that deliver the economy from its structural deficits? We have been through this route before in the late 1990s. We made a mess of euro-dollar bond issues for years to come! We are ready to do the same again. The current predicament is only one more episode of the same variety; same problems, same prescription. As usual, visit of IMF team and release of next tranche is anxiously awaited and reported in the media as national event, heralding achievements like demise of circular debt by borrowing more from banking system or from SBP, or borrowing through Islamic instruments like ***sukuk,*** pledging Karachi Airport as guarantee, a meaningless pledge, nonetheless fully *sharia* compliant, tendered with all solemnity to behold.

21. For those not familiar with nuances of IMF's ***standby*** or ***EFF*** facilities, centered on furnishing limited short maturity forex liquidity, it is difficult to comprehend the implications of non-performance of IMF programs. The position advanced in this paper is that standby programs are unlikely to succeed in their avowed goals. The reason is that this crisis like others in the past is not a forex ***liquidity crisis*** as usually alluded to.

22. The roots of the crisis lie much deeper in the ***structure*** of foreign trade and trends of capital flows, foreign direct investments, ***FDIs,*** or foreign portfolio investments, ***FPIs***; while bilateral commitments bear no relation to needs of stabilization. We are reluctant to accept that pursuit of ***stabilization***

has been elusive. Even if achieved, time and again it has turned out to be ephemeral and Pakistan landed into the same type of balance of payments crisis as before.

23. As a footnote, how IMF is able to prevail on its conditionalities in return for just a few hundred million dollars of bridge financing remains largely unknown. The reason is the combined leverage of all ***IFIs***, bilaterals and commercial lenders who will not open the taps until certification of "good financial and economic health" is garnered from IMF. They would not provide fresh financing or join the rescue operation until then. Time and again, I observed in the field concern of senior IMF officials whether this leverage is intact, before reopening negotiations with client government on standby facilities, knowing that IMF financing alone would not suffice.

Transition to Floating Rate Regime

Evolution of Currency Market

1. A review of exchange rate movements over a long period is needed within the context of foreign exchange and trade regime that has prevailed over the past. Moreover, discussion of foreign trade and exchange rate remain confined to balance of payments trends without any reference to currency markets. This is rather odd, because we cannot have a meaningful discussion of price of any item without reference to their markets; but such is the routine regarding exchange rate discussions.

2. Foreign currency market of Pakistan has transformed over the past two decades and bears hardly any resemblance to what it was in pre-reform era as discussed in the Annex attached. Pakistan's currency market evolved during reform years on the heels of liberalized foreign trade regime and financial system reforms undertaken during early 1990s through mid-2000s. A complex change has unfolded over these years unlike any Pakistan's economy underwent before. We need to look at evolution of currency markets, its structure, size and trends given in the Annex, then try to figure out how they operate in current environment to understand how exchange rate gets determined in the ***applied*** context of Pakistan.

3. In brief, foreign currency market is diverse. Currently, it is dominated by ***interbank market*** which is a part of combined ***formal*** market for Pakistani rupee including ***kerb market***. In addition, there are ***informal markets*** and ***off-shore*** markets which are undocumented and unknown, but they exist. These markets are not insular; they are interlinked. Exchange rate is not determined exclusively in ***formal*** markets; it is a combined outcome of both formal and informal markets operating in tandem. The days of ***managed*** exchange rates are long gone. Market intervention by SBP is not a feasible alternative as it was in the days of ***managed*** regime or ***dirty float*** regime.

4. Before reforms, there was ***fixed exchange rate*** regime administered by SBP which was not even remotely close to a ***currency market*** as such. It was a system of acquisition and allocation of foreign exchange ***by fiat*** at official exchange rates, much lower than market rates which conferred economic rent upon those favored with import licenses. Owing to this rate differential, there developed an extensive parallel market or ***havala*** market with its own exchange rates for transactions via its underground network, trusted by public, though no records were kept and there were no traces of transactions. It operated for decades on ***trust*** and still does; thriving on transfers, though origination, sources and destination are unknown. Trading is brisk at forex rates with a small premium above formal exchange rate.

5. During mid-1990s, Pakistan gradually moved towards ***managed float,*** thereafter to ***dirty float***; while SBP kept tinkering around with a slew of controls on foreign exchange, while capital accounts remained open. During the transition from fixed rate to dirty float, a ***multiple exchange rate system*** came into being, whereby ***authorized dealers*** namely banks were permitted to determine their own rates for foreign currencies except US dollar, the reserve currency. Thus emerged ***interbank currency market***, though US dollar to rupee parity remained a prerogative of SBP to determine. Since this rate determined cross rates in the currency market, so indirectly SBP controlled currency rates.

6. The authorization extended to banks to determine their own foreign currency rates was a crack in fixed rate regime. Later on, SBP abandoned two tier system of exchange rate, abolished official rate and replaced it with ***interbank rate***. This was accompanied by overhauling the system of trading; such as allowing banks to engage in public trading of foreign currency and interbank trading thereby providing a foundation for interbank market.

7. In early 2000s, SBP made a move towards a ***unified exchange rate*** with ***clean float***. Foremost, SBP authorized commercial banks to hold on to their forex balances arising from export proceeds, foreign currency deposits, and transfers like remittances instead of surrendering them to SBP. Eventually SBP shifted from dual exchange rates to ***unified*** exchange rate based on a ***clean float*** of rupee, allowing open trading in currency market after ensuring that market liquidity levels are just enough for routine needs and market participant will not be able to launch a speculative attack against rupee *vis-à-vis* US dollar. This practice has sustained to this day.

8. In current times, foreign currency rates are an outcome of all three markets; the ***interbank market***, the ***kerb market*** and the ***informal market***. But no causation can be established beyond an imbalance in the supply and demand for foreign currency, regardless where they are originating from. Often there have been speculative attacks on Pakistani rupee, but in the open market regime with relatively clean float, there was no sustained raiding by speculators over the past decade to push down exchange rate. Depreciations did occur, but most were rooted in the known imbalances of supply and demand of foreign currencies in the formal market.

9. There is a feeling that currency market in Pakistan has not performed well as it should; or else why depreciations occur? We are disappointed each time rupee slides to a new low and interpret it as failure of markets and regulators alike. We wish for a gleaming currency market; but we need some realism in what we think markets are, and what they can accomplish. We should realize that it has taken advanced countries much longer to develop their currency markets with all resources at their disposal, a sophisticated institutional structure of a depth and reach that never existed in Pakistan, together with checks and balances with effective accountability. Comparative experiences of East Asian and Latin American countries show that evolution of their currency markets was compressed, though often times derailed by financial crises that occurred during the 1990s when paradigm shift to liberalized markets was thought to have taken root.

10. We are on initial segment of a rising learning curve. We have come to accept that liberalized currency markets with floating exchange rates are here to stay; that the era of managed exchange rate is over for good, after decades of *ad-hocism* and interventions, mutilating market operations, be it market for

sugar, cement, currency or any other item. Reverting back to interventionist regime is not going to resolve enigma of sliding exchange rate, if it is still an enigma after decades of experience. The idea has taken hold that exchange rate is now driven by market based currency flows; SBP is no longer fixing up exchange rate as it used to, incredulous though it is for many. Most believe that SBP will have to intervene if depreciation gets worse.. If it did intervene, it will do so through market operations, and not by ***fiat.***

11. Besides, intervention in global currency markets by any central bank to arrive at a desirable exchange rate have not succeeded in the past. Instead, the central bank, be it in ***emerging countries*** or developed countries retreated after suffering massive losses with hardly any 'improvement' in exchange rate. The reason is that global currency market is massive, and it cannot be swayed by intervention of a single central bank to affect exchange rates of local currency *vis-a-vis* major reserve currencies. Movements of exchange rates have a dynamics of their own, independent of what some central bank is trying to accomplish in the global currency market.

Exchange Rate Movements

12. In this background, let us now focus on the post-reform era and outline what transpired during 2001-2013 concerning ***nominal exchange rate*** within a ***free float*** regime and open capital accounts. Such a long period, is not meaningful for currency market operations, because forex transactions occur on spot rates at the time of trading rather than on what they were in distant past. For the same reason, monthly averages of exchange rates are indicator of what transpired during the month, but such averages do not provide a meaningful guide to those engaged in day to day trading.

13. Three distinct phases of interbank nominal exchange rate movements can be discerned from monthly averages during FY01-13 period, reflecting forex demand pressures in currency markets *(Data Set 6.11)*. In the ***first phase*** that lasted from FY01 to FY07, exchange rate remained stable around Rs 60 to one US dollar for most years. In 2001, exchange rate was Rs 63 to a US dollar, and appreciated to Rs 59 to a US dollar in 2005, though in-between there were numerous variations. By June 2007, exchange rate stood at Rs 61 to a US dollar. In the ***second phase***, during FY07-10, rupee depreciated from 61 to 83 to the dollar, or by 36 percent over three year period. This trend continued.

14. In the ***third phase,*** June 2010-December 2013, rupee depreciated to Rs 108 to a US dollar, or by 30 percent. Thus, during past 8 years, 2005-13, nominal exchange rate of rupee versus US dollar depreciated by 83 percent. This kind of depreciation has implications for its participants, namely banks, importers and exporters, ***Pakistani diaspora*** and currency traders in formal markets. It is equally significant to those engaged in currency trading in informal markets, though they are not burdened with niceties like real exchange rate.

15. For history buffs, if we go back, official exchange rate was Rs 24 to US dollar in June 1991. By mid-2001, Pakistani rupee had devalued to Rs 63 to US dollar, or by 162 percent in nominal terms. If we go back even further at truncation of Pakistan in 1971, ***official exchange rate*** was about Rs 10 to a dollar, though there were different exchange rates for export bonus scheme, SBP and interbank rates. Thus, rupee has been devaluing all the time during ***managed regime,*** and depreciating during ***market-based regime***. Overall, since 1971 till 2014, rupee has depreciated about ***eleven times*** and it is not over yet. What has this long term depreciation spread over half a century has accomplished for the country, together with reforms and stabilization packages of all sorts? That is a rather sobering thought.

16. Next, let us look at trends of ***real exchange rates*** obtained by adjusting nominal exchange rate with ***relative price index, RPI,*** of Pakistan and US, reflecting inflation differential as per consumer price indices, ***CPI,*** of the two countries, re-aligned for a common base period, the year 2005. This is done to correct for purchasing power parity, though one could raise issues with regard to comparability of consumer baskets; or point out incompatibility of purchasing power rooted in income differentials. If we do this adjustment, we find that real exchange rate thus arrived, has shadowed nominal exchange rates during 2005-2013, more or less. This is what an open currency market is supposed to do, given free floating forex regime, liberalised trade and open capital accounts. Hence exchange rate depreciation is no longer an issue. It is not a part of conditionalities of IMF in recent years.

17. For dealing with tradables, we need to contend with their proportion in both exports and imports, reflecting appropriateness of relative exchange rate movements in real terms. First, we have ***nominal effective exchange rate, NEER,*** which is a weighted index of exchange rates, where weights are respective shares in tradables of partner countries. But ***NEER*** does not reflect

competitiveness unless adjusted for differential between domestic price level and partner country price levels. This adjustment is needed for estimation of ***real effective exchange rate*, *REER*,** index which captures value of rupee versus value of foreign currencies for similar basket of tradables. In the base year ***NEER*** and ***REER*** are the same, but if inflation were to rise faster in Pakistan, nominal exchange rate will have to depreciate to maintain stable ***REER*,** otherwise competitiveness of Pakistan's exports will suffer. This happened during 2005-2013; rupee depreciated to offset impact of inflation.

18. SBP routinely publishes estimates of ***NEER*** and ***REER*** shown in the *Data Set 6.11*. In the base period both ***NEER*** and ***REER*** are the same; but since inflation in Pakistan has been higher than in the partner countries during 2005-2013, ***REER*** appreciated during FY07-08, then depreciated in FY09-10 by significant margin. Subsequently ***REER*** rose and has been hovering around 103 over the past three years. True, stability of ***REER*** has been elusive for most years with no clear trend over the long haul, but for the past three years, ***REER*** has appreciated.

19. If we look at the patterns of ***NEER*** and ***REER*** of India and China over the same period, we find that in both countries ***NEER*** depreciated by almost the same margin, about 28 percent during 2005-2012. This is the same pattern as in Pakistan, though depreciation of ***NEER*** in Pakistan was steep, about 63 over this period. ***REER*** of India and China appreciated during four out of seven years, while ***REER*** kept fluctuating. India suffered trade imbalances and significant depreciation of its currency over the past couple of years. Since then, India recovered, while China has continued on its course. The US applied pressures on China to let Yuan appreciate, but China did not oblige. Why such patterns emerged in a few leading economies and why not in Pakistan? That is the issue, and it takes us back to structural factors that underlie foreign trade and exchange regime and capital flows.

20. Sustained depreciations of past years cannot be explained in terms of formal market operations alone. It is a result of foreign trade imbalances rooted in imports; unremitting capital outflows, both formal and informal, a massive gold market, and currency trading in parallel markets. Nonetheless, currency market of Pakistan is remarkably open; undocumented trading is palpably brisk and its turnover is immense, often being conducted off-shore, mostly in gulf markets. Hence, currency market has been under severe pressure over the past.

21. Whenever exchange rate begins sliding fast, the news excites everyone, just not exporters, importers and currency traders, because people perceive devaluation as harbinger of bad news; which it is. Often this is punctuated by IMF's refusal to release its tranches and the call to *do more* is repeated. It means yet another round of inflation led by imports, especially oil and petroleum imports. The rising costs of imports are prominently displayed, but imports of high value items like luxury cars are not; nor how luxury imports are being financed; or why debt servicing is so high.

22. In a country saddled with recurring foreign currency shortages over long periods, it is difficult to talk of stable exchange rates. In a society where attitudes towards 'imported' are routine; where consumer items are bought if labeled as 'imported', together with imports like crude oil and petroleum products, edible oils, medicines and other essentials; pressures on exchange rate will sustain. Meanwhile planeloads of officials frequently travel abroad to arrange financial assistance, typically as foreign loans thus adding to short term obligations. The larger the commitment tendered to borrow overseas and accepted by lenders, the more 'successful' is the foreign trip, displayed in headlines as though it is a salutary achievement.

23. Such is the folklore; without much awareness that soon calls for belt tightening will follow to repay these debts. The conditions that give rise to currency depreciation and their implications are not discussed, except among a close circuit of those concerned. The media portrays conditionalities of ***IFIs*** that force Pakistan to undertake measures which are against interest of vast segments of public at large. That currency markets determine exchange rate is not emphasized, though this realization is slowly creeping in among beneficiaries of remittances, frequent interface on the bank counter, travels abroad and emigrant experiences.

Open Capital Accounts - ***and their Aftermath***
Comparative Experiences

1. In addition to current account ***(C/A)*** deficits, a good deal of pressures on exchange rate emanated from ***capital outflows*** owing to open capital accounts. Formal flows ar are captured in BoP below the line of current account and are lodged as foreign investment inflows of ***FDI*** or ***FPI***; disbursements on foreign borrowings, and a few other items; but ***informal***

flows remain unknown except for anecdotal events reported often. Pakistan is one of the countries in among developing or emerging economies where foreign currency rules are more liberal and allow massive transfer of funds overseas through banking system and foreign exchange companies, ***FECs.***

2. There are indications of transactions in parallel market. For example, in the wake of stock market collapse in 2008, a few transactions amounting to several billion dollars were apprehended in blatant violations of rules, but nothing happened beyond cancellation of license of ***FECs*** involved. Besides a good deal of outflows are not known. As anecdotal evidence, overseas real estate purchases of Pakistanis are often cited. To wit, Pakistanis were named third largest investor in Dubai real estate when the real estate bubble burst a few years ago. Currently, Pakistanis are reported to be fourth largest investor in Ajman export zone; besides, advertisements for properties in the UAE frequently appear which shows interest of Pakistani investors.

3. The source of inflows to parallel market have not dried up in spite of all out efforts in post 9/11 period to eliminate ***havala*** transactions, suspected of money laundering. The main source still remains under-invoicing of exports or over-invoicing of imports; or kick-backs on foreign contracts; or currency balances of Pakistani businesses overseas to avoid tax net; or black money balances held abroad. But Pakistan kept capital accounts open, while underground flows and money laundering continued.

Trends of Foreign Investment
FDIs and FPIs

4. Foreign capital inflows, both ***FDIs*** and ***FPIs***, have remained anemic. The annual inflows of net ***FDIs*** were fairly small in the past decade and were concentrated during FY07-08 amounting to $10.5 billion, or 42 percent of total net ***FDIs*** during FY05-13 *(Data Set 6.1)*. But net ***FDIs*** in FY07-08 were exceptional, because these were mostly privatization proceeds of two largest commercial banks, namely HBL and UBL. Routine ***FDIs*** for FY05-13 were only $2.8 billion per year, far lower than those during these two years.

5. Preliminary data shows that net ***FDIs*** during July-December of 2013, the first half of FY14, stood at $416 million as against $568 during the first half of FY13 last year, representing a drop of about 26 percent. The exception is ***FDIs*** destined to energy sector which rose to about $192 million; but at the same time ***FDIs*** in telecommunication sector declined which has been on the vanguard in earlier years. Future prospects for FDI or ***FPI*** inflows remain poor owing to current situation. We cannot pin down these upheavals solely on macroeconomic conditions; it has a great deal to do with deterioration of enabling environment or business friendliness discussed below. This is amply demonstrated in a recent editorial of Business Recorder attached here on page 30 of this paper, though attaching media editorials is frowned upon in serious academic research.

6. In Pakistan, capital inflows were way behind the levels that occurred in East Asian or Latin American countries in spite of open capital account. Net ***FDIs*** to Pakistan were a tiny part of net ***FDI*** flows to Asian comparator countries over the past decade. During 2001, total net ***FDI*** inflows of Asian comparator countries were $53.2 *billion*, while in Pakistan it was $79.0 *million* (*Data Set 6.2)*. Subsequently, in 2009, net ***FDIs*** to comparator countries were $129 *billion*, while in Pakistan these were $2.8 *billion*. Likewise, total net ***FDIs*** to comparator countries in 2012 were $323.0 *billion*, whereas in Pakistan these were $853 *million* only. True, net FDIs to all comparator countries were only 6 percent of ***global net FDI*** flows in 2001, which rose to 11 percent in 2009, and then nearly doubled to 21.5 percent in 2012. That is, flows of net ***FDIs*** to countries like China and India were overwhelming, while Pakistan struggled to attract just a few hundred million dollars during this period.

7. If we do a similar comparison with 10 ***emerging economies*** of Asia and Latin America, with some overlapping countries like China, India, Thailand and Malaysia, but include Brazil, Chile and Mexico, the position of Pakistan concerning net ***FDIs*** becomes nearly negligible. The total net ***FDIs*** to ***emerging economies*** in 2001 were $118 billion, amounting to 13.3 percent of global net ***FDIs*** flow, rising to $178 billion in 2009, or 15.3 percent of global net ***FDIs*** *Data Set 6.21***.** Thereafter, net ***FDIs*** to ***emerging economies*** more than doubled to $437 billion in 2012 amounting to 29 percent of global level, net ***FDIs***. Clearly, the favourite destination of ***FDIs*** has been ***emerging economies*** over the past decade in spite of global financial crises of 2008 and all. Unfortunately, Pakistan is no longer classified as emerging economy, therefore this analysis is not relevant.

8. We hear often that globalization has benefited advanced countries relatively much more than it has developing countries. If flows of net ***FDIs*** are any indicator this does not bear out. Total net ***FDIs*** to 11 advanced countries were indeed a large part of global net FDIs flow in 2001, amounting to about half, or 47.5 percent *(Data Set 6.22)*. Thereafter, their share declined to about 31 percent in 2009 and has remained the same over next three years. One could argue this happened because of financial crisis of 2008 as their capital markets went into a tailspin, but that does not bear out. If include all advanced countries, this share will rise further. But it does not diminish the observation that ***emerging economies*** have made major inroads into global net ***FDI*** flows over the past decade.

9. The situation regarding ***FPIs*** is more tenuous since ***FPIs*** are more sensitive to short term interest rates and exchange rates. The financial crises of mid-1990s in Mexico and similar crises in late 1990s in East Asian countries confirm this trend (*Data Set 6.1)*. ***FPIs*** to Pakistan never amounted to much even in stock market boom of 2004-08. The total net ***FPI*** inflows during FY05-13 were $1.5 billion with volatility in between. ***FPIs*** turned back with stock market crash, and were negative for most years. In the current boom of Pakistan's stock market which started a few years ago, ***FPIs*** have not been a factor; instead undocumented inflows are rumored to be major source of funding in current boom; but this is conjectural.

10. Total amount of ***net FPIs inflows*** in comparator countries was $4.5 billion; then it declined to $50 billion in 2009; followed by another decline of 116 billion in 2012 for all 9 Asian comparator countries. But their share in global ***net FPIs*** flows increased from one percent in 2001 to about 22 percent. Similar trends for ***emerging economies*** have prevailed over these turbulent years. This is a major development for most countries outside the orbit of advanced countries.

11. Advanced countries have fared worse as inflows of ***net FPIs*** are positive only for 2001. But after that, especially after financial crisis of 2008, ***net*** F***PI*** flows show a bleak picture. That is, during 2009-2012, ***net FPI*** flows to advanced countries substantially declined *(Data Set 6.22)*, representing a retreat of substantial magnitudes, though this needs to be reconfirmed. Apparently, ***FPIs*** have reversed; their flows; actually investments in capital markets have nosedived and market crash of 2008 has persisted long among capital markets of advanced countries.

12. Pakistan is perhaps one of a few countries where liberalization and opening up of foreign trade and capital flows did not materialize into capital flows at anticipated levels; sporadic inflows aside. Pakistan was not able to enhance its presence in foreign markets, though a few Pakistanis succeeded in overseas business. During reforms, the ***inverted sequence*** of opening up of capital accounts worsened capital flow trends (see pp23, para 7). One could even argue that the premature opening up of capital accounts, before trade account had matured, helped capital outflows, except for a brief interlude during middle of the past decade.

Capital Flows, Amnesty and Business Friendliness

13. Capital flight from Pakistan continues for a myriad of reasons. To reverse this tide, government declared a ***general amnesty,*** first time way back in early 1990s, whereby foreign currency balances could be brought in Pakistan as deposits, *no questions asked*. It was a realistic approach, because formal currency regime had no writ on underground flows. Under amnesty protocol, these deposits were lodged in foreign currency accounts, ***FCAs,*** by residents and non-residents alike with banking system. From early 1990s through mid-1998, ***FCAs*** substantially increased to $9.7 billion.

14. Of this, residents ***FCAs*** were $6.0 billion, and non-resident ***FCAs*** were $3.65 billion. In the aftermath of nuclear explosions and impositions of sanctions in 1998, government panicked and slapped a freeze on ***FCAs***. It was a very bad move. The government relented later on, but damage was done. It allowed redemption of old ***FCAs*** in rupees, but at exchange rates much lower than those prevailing at the time of freeze. This was a violation of guarantee of exchange rate tendered. In the aftermath, $11.0 billion fled from the country, though this is unconfirmed.

15. This historical recount is needed to understand why Pakistan has been unable to attract foreign investment since then through current times. These deposits were slowly redeemed in rupee over several years at a substantial loss to depositors, and by early 2000s, these ***FCAs*** deposits had dwindled to $2.2 billion dollars. Meanwhile, new ***FCAs*** began to inflow under FE-25

scheme starting in FY99 replacing old ones. By FY05 those were $3.3 billion, and by end of the decade were 4.5 billion, rising to $5.8 billion by FY13. Looks like amnesty schemes do work wonders in Pakistan.

16. Recently, government declared another ***amnesty*** similar to those announced by European countries, like Italy, Spain, Poland, Greece and Cyprus, who invited their ethnic diaspora and newly rich to bring in their funds, *no questions asked*, no taxes levied, and no restrictions on transfer out. Same is the case in US and UK as long as inflows are properly declared; *no questions asked* as to their *bona fides.* Switzerland has long been heaven to inflows of such funds. They have amassed massive wealth from overseas depositors and investors, including those from India and Pakistan. In most countries, keeping stolen property is a crime; but stolen wealth is welcome. There is no way to restrict outflows of capital, much less stamp them out.

17. Apart from these amnesty loaded inflows, Pakistan has been unable to attract business based foreign investment, though it has revamped its incentive package time and again. Currently, Pakistan is not a destination for such investment because of security concerns, foremost. Besides, Pakistan is not perceived business-friendly country; its ***business friendly index*** is 110 (*Data Set 6.2, 6.21, 6.22).* This is reinforced by data on components of index which is not shown here, such as investor protection, availability of energy infrastructure, trained, disciplined and motivated labor force; recource to conflict resolution in treatment of taxes, duties and other levies.

18. In contrast, business friendly index of comparator countries is superior; for example, in Malaysia it is 6; in Thailand it is 18. But Pakistan's index of 110 is not far behind China's index of 96, and it is surprisingly superior to India's 134, Brazil's 116 and Indonesia's 120. Among ***emerging economies***, business friendly index for most countries is superior; in Korea it is 7; in Chile, it is 34; in Turkey it is 69. Among advanced countries, highest business friendly rating is of the US at 4, UK at 10, Australia at 11, and Canada at 19, while index of some European countries like Belgium is at 36 and in France at 38; while Russia is way behind at 92. This index is only an indicator, but the message is clear that Pakistan has to improve its business enabling environment. Tinkering with incentive package is not going to achieve to enhance inflows of foreign investment.

Foreign Exchange Reserves - Trends
The First Line of Defense

1. The shortfall of supply of foreign liquidity has to be financed by draw down of foreign currency reserves lodged in financial accounts as outflows, *after* all other sources of financing have been exhausted. These draw downs should not be confused with ***stocks*** of cash reserves of SBP and the banking system shown in *Data Set 6.1*, excluding gold because this treasure trove is non-operational. Nearly 80 percent of total forex reserves were held by SBP and remainder was held by banks *(Data Set 6.1).* A smaller amount of foreign currencies are held by foreign exchange companies for their turnover, but their balances are not included in reserves.

2. For banks, there are two major sources of foreign currency; first and the largest one are balances of their clients engaged in foreign trade and services; the second source consists of ***FCAs*** held as deposits both by residents and non-residents. In late 1990s, SBP allowed banks to keep their foreign currency balances instead of ***surrendering*** them to SBP at the going rate of exchange in a bid to develop interbank foreign currency market. Initially, banks were enthused by the idea of owning their own portfolio of foreign currencies, but they quickly learned that maintaining a portfolio of foreign currency reserves is risky because of risk exposure to fickle-minded global currency market. Comparative experiences also confirm that most banks, except large money center banks, generally shy away from maintaining foreign currency portfolio. It is true that holding forex reserves provides banks opportunities for exchange rate arbitrage, but playing for this arbitrage demands expertise in management of forex portfolio which is too expensive for smaller banks.

3. There was a steep growth in foreign exchange reserves from $6.4 billion in FY02 to $17.5 billion in FY07 at average annual rate of 22 percent; never achieved before nor thereafter*(Data Set 6.1)*. Instead of growth total reserves declined to US$11.5 billion in FY08, reaching back to US$ 18 billion in FY11. Thereafter reserves began to decline and were down to $8.5 billion by end of 2013, barely enough for a few weeks of imports. These long terms trends indicate a broad picture, but do not reveal how reserves were tuned to short term needs; or what actions were taken to deal with them.

4. Dramatic changes in reserves aside, *adequacy* of reserves relative to outflows matters most, expressed in terms of reserves available for number of weeks of imports. In FY02, reserves were enough for 35 weeks of imports, the highest ever. Thereafter, this cushion began to shrink and by FY12 it was at 17 weeks and further down to 11 weeks by June 2013. By end of the year, it was even lower; good enough only for half a dozen weeks, or so. That is far from a comfortable level because a slight adversity could push the country to technical insolvency.

5. Forex reserve levels of past decade is in dire contrast with massive reserve build up by comparator countries like India, China, the front line ***emerging economies*** during FY01-12, the period for which data is available (*Data Set 6.2, 6.21)*. For example, forex reserves of India increased from US$ 49 billion in FY01 to US$ 300 billion by FY12; while forex reserves of Brazil increased from US$33 billion to US$ 373 billion, more than ten times the level of 2001. Similar patterns show for Thailand and Sri Lanka. The most dramatic increase was in forex reserves of China which increased from US$ 220 billion in 2001 to US$ 3388 billion in 2012, more than 15 times its level in 2001, an astounding achievement ever witnessed.

6. In this comparative picture Pakistan is nowhere to be seen. Increase in forex reserves of China, Brazil, Russia and India, the BRIC countries, or those of emerging economies occurred due to build up of foreign trade surpluses over a long period, pursuant to transformation of their industrial base, fueled by relocation of foot-loose industries of advanced countries, financed by massive foreign investment inflows and technology transfer. This happened with adoption of liberalized foreign trade and investment regime, accompanied by investment in infrastructure, retraining of their labor force, and adoption of modernized, business friendly outlook. In short, it is a societal transformation, never witnessed before.

7. This reserve accumulation has altered global balance of international finance. With persistent large foreign trade surpluses of ***BRIC*** countries, together with phenomenal rise of their forex reserves, their currencies have strengthened *vis-a-vis* US dollar. This is harbinger of realignment of international financial position of these countries and reconfiguration of their shares in IMF. In part this has already occurred; the G-7 group was enlarged to include Russia, then it became G-8. There is talk of including BRIC countries and other to make it G-15; but it is unlikely that G-8 would

relinquish their position. This realignment is being stalled by over-represented European countries; but when it occurs, it will drastically alter international financial system with major implications for all, especially developing countries.

Structural Transformation
Foreign Trade under a new Paradigm

1. Let us go back to the opening lines of this paper and reassert that the ***begging bowl*** can be broken as other countries have done. This would need a deep seated change in the ***mindset,*** instead of rushing around bridge financing, because current account deficits will not melt away unless structure of foreign trade rooted in indigenous manufacturing base is revamped. The current muddle will continue until we figure out how to sustain growth of a modernized and outward oriented corporate sector in Pakistan. It is a wishful thinking that exports can revive from ***existing*** manufacturing base. Swiftly rising remittances may provide a reprieve of sorts from liquidity crunch, but that is not going to resolve the imbalances emerging from foreign trade. Instead, the implications is that if Pakistan cannot increase exports of goods, perhaps it can export its people, tragic though it is for the country.

2. In the past, forex liquidity crises usually ended up with a clarion call for exchange rate depreciation, controlling trade deficits without specifics of what is to be controlled in the era of liberalized trade; followed by a scramble for foreign financing and rescheduling of foreign liabilities, but rarely redressing their underlying structural causes since it was beyond the time horizon of ruling governments. The same is happening now. Let us return to those in a comparative setting to better understand why Pakistan found itself in an unending cycle of periodic liquidity crises including the current one, while the comparators or emerging economies succeeded in a spectacular manner. What were the differences?

3. Foremost, in the early 1990s, opening up and liberalization of trade and exchange regime, reforms of financial system, closure or privatization of insolvent financial institutions and public sector enterprises, the ***PSEs***; all of this was not a homegrown initiative. The government had no choice then but

to embark upon reforms. The process was full of ironies; it was led by the same regime that had fostered nationalization and state control nearly two decade ago. Neither they nor their successors had ideas of how to do away with nationalized regime, state ownership and control, privileges and priorities embedded in interlocking governance. Instead, they fostered *strategies* to garner ever-enlarging share of state assets sold at a pittance in the name of privatization, financed by loans from state owned banking system, followed by willful default and endemic loan write-offs; at the same time conveniently blaming conditionalities of ***IFIs*** who funded costs of structural adjustment via concessional forex loans.

4. The same is the case in current times. The government is embarking on privatization of major PSEs like PIA and railways, whose past performance was exemplary, but deteriorated over the past decades because these PSEs were stuffed with mostly corrupt and incompetent cronies, who did not have any interest in promoting business of the PSE they had parachuted in. Thus, government contributed to insolvencies of PSEs, led to the emergence of circular debt, and contributed to foreign liquidity needs, since procurement of new equipment provided yet another opportunity to siphon away funds for overseas transfer thus aggravating forex liquidity crisis. Under privatization, they are cornering assets of PSEs which are up for grabs, leaving hulk of insolvent PSEs for eventual dilution.

5. This is ***inverse transformation***, in contrast to successful economies who achieved a strong balance of payments position based on modernized industrial sector. We have been unable to foster a ***societal resolution*** in Pakistan of what the role of public sector will be; or how far private sector will be allowed to expand in group-linked ownership which spawn cartels, powerful enough to shut down regulatory agencies. Private sector cannot replace public sector in key areas of national interest; but we never seem to learn from comparative experiences nor our own, about limits of private sector; or role of public sector in promoting economic growth.

6. ***Emerging economies*** embarked upon ***structural transformation*** of their industrial base towards light manufacturing where ***none existed*** before, behind a carefully crafted shield of protective structure that were tolerable during 1980s and 1990s; elaborate and sophisticated competitive investment incentives; large investment in supportive infrastructure; all geared to

enhance competitiveness of their nascent light manufacturing industries established with implicit subsidization – in short, the typical infant industry formula that was in vogue in early rounds. In Pakistan, we adopted same formula of infant industry promotion, but infants grew up into dwarfs. Amidst all this dawned the era of reforms, structural adjustment to move towards market-based liberalized system from a nationalized system.

7. Pakistan is one of the few countries where liberalization and opening-up did not materialize into a structural change of the type being discussed because Pakistan followed an ***inverted sequence,*** i.e., instead of opening up of foreign trade as a first step, followed by open capital accounts as next step, Pakistan opened up both trade and capital accounts before foreign trade structure could support such a move or foreign reserves position warranted. The government simply got carried away with designation of ***emerging economy*** in Morgan Stanley rating way back, though its industrial structure or exports could not sustain onslaught of foreign competition.

8. In contrast, India started reforms in 1991, opened up and liberalized its foreign trade, rather gingerly opened up for selected foreign investment not easily yielding on ownership composition. Now India is further liberalizing foreign ownership and ***FDIs,*** having resolved first outstanding foreign private liabilities from its own reserves. Most ***emerging economies*** first opened up foreign trade, but not across the board. Instead, they selected segments of foreign trade for opening up, together with a mix of protection for potentially significant industries; then opened up when they were ready to face competition in global market.

9. They focused first on their industrial incentive regime; nurtured domestic export industries which could withstand competition in foreign markets; then opened up foreign trade regime and capital flows. Their objective was modernization of industrial base and technological growth to make inroads in international trade and finance. If it were to be achieved through globalization, then so be it. They never wavered from this trajectory; they harbored no ambivalence about what they wanted to achieve.

10. As part of liberalization of foreign trade regime, these countries went after ***foot-loose*** US and European light industries, looking to relocate their manufacturing overseas to reduce their costs of production. The emerging economies of East Asia learned this strategic approach from post-war Japan

and successfully emulated this model. It was not a blind pursuit of export-led strategy, discussed in the literature which cannot traverse beyond an arcane debate of effective protection, as though all a country needed to do was to rationalize its protective structure and *presto*, a golden era of export led growth would dawn upon the country.

11. The aspirants like Korea, Taiwan, Thailand and Malaysia first revamped their incentive and foreign investment regime after they had done detailed studies of ***comparative structure*** of their foreign investment incentives to ensure that they could offer a package superior to competing countries, industry by industry, item by item. I saw it very closely as I supervised these studies for Thailand and Malaysia in the early 1980s and persuaded the World Bank to initiate a similar study for the Philippines. In parallel, they kept capital account pretty much under wraps until their current account was strengthened and stabilized. Growth of export industries and liberalization of foreign trade was stage managed, starting in late 1970s through mid 2000s, with the overarching goal of enhancing their share in global trade.

11. These countries opted for a trade and exchange regime co-existing with rules of foreign investment in a crafted sequence, being mindful of what industries they could profitably nurture; instead of the haphazard route that Pakistan adopted. In the initial stages, they kept protective structure for strategic industries blanketed in wraps under an elaborate umbrella that avoided infant industry syndrome or countervailing measures abroad. Once, this incentive mechanism was installed, these countries went all out to welcome foreign companies, conferring upon them ownership rights that were anathema in earlier times owing to scars of colonial era, with guaranteed repatriation of profits and capital in measured doses, together with liberal tax incentives and free of cost facilitation of business.

12. To facilitate relocation of ***foot-loose*** industries of advanced countries, these countries invested in modern infrastructure around industrial centers, and installed supportive facilities at massive costs. They also adopted a layered mechanism of protection; provided subsidized credit, initially for assembly operations and eventually for manufacturing under an elaborate investment incentive package designed to confer a competitive edge over other countries including their regional competitors. They established export

processing zones which were virtual enclaves of exports, starting with assembly line operation which eventually shifted to local manufacturing, while keeping away mandarins and meddlers in their place.

13. A visit to export processing zones was revealing to me because Pakistan did the same way back in late 1950s, like SITE of Karachi but after initial success, this undertaking tapered off and careened downhill after nationalization in early 1970s. The misguided installation of dry ports in the hinterlands are mostly rotting hulk; an utter waste of public investment outlays. Undaunted, the government would like to spend more to revive them. Even more misguided was installation of heavy machinery complex in the cornfields of Taxila, without realizing that it is easy to stick-in a sophisticated heavy machinery complex at stupendous costs, but to create an ***industrial society*** is a different proposition altogether. Eventually this complex closed down and was disposed off unceremoniously.

14. Attracting foreign investment with embedded technology transfer by European, US or Japanese industries was their major target, not in a ***supportive role*** but in a dominant role. This elemental difference is not as well publicized as the push for liberalized trade regime. For them, the battle was to attract complete package of modern factories and their installations, all foreign owned and financed, with technology transfer in the relocated ventures. That is, technology transfer was seen as part and parcel of relocating foot-loose foreign industries rather than something apart. The dogged pursuit of ***foreign investment*** by emerging economies was not only a means of foreign financing but also for technology transfer.

15. This transfer was not accomplished by sending their engineers and technicians overseas for higher studies, because they recognized that such an approach would be self defeating; a process that Pakistan inadvertently followed with results for all to see. Instead, they revamped their basic educational system towards producing an army of technical personnel and engineers. That was the start. Currently, China is producing 60,000 engineers a year, while US is producing about 6000 engineers, something that worries a great deal policy both makers and corporate sector of the US. Besides, their emphasis was to use off-the shelf-technology rather than rediscovering the wheel, to leap frog the process of acquiring skills and techniques by their industries so as to be able to compete in overseas markets.

16. Once they began piling up trade surpluses and forex reserves and felt confident that capital inflows are here to stay, they slowly opened up capital accounts. With liberalized rules for inflows of FDIs, these countries also furnished guarantees for repatriation of profits or capital invested at market exchange rates. Thus began gigantic inflows of ***FDIs*** in ***emerging economies***. They opened up their financial markets after these markets had grown, and were capable of handling ***FPIs***. The response of overseas portfolio investors in securities of ***emerging economies*** was overwhelming; but free-for-all type of capital outflows, since financial crises had shown dangers of runaway outflows which no country could sustain.

17. This lesson was learned in mid-1990s in Mexican Peso crisis, and was further reinforced in late 1990s during financial crisis of East Asian countries. Pakistan could not match sophistication of ***structural transformation*** of ***emerging economies*** because it was not a system of investment and export promotion; rather it was a mode of ad-hoc favoritism to chosen recipients of the government assistance, instead of a promotional effort based on potential and performance. So it is in current times.

18. Investment in industries and supportive infrastructure of sites and services in ***emerging economies*** was initially funded by borrowings from the World Bank and also from regional banks like Asian Development Bank, and Latin American Bank, the group of ***IFIs.*** Subsequently, ***OECF*** of Japan jumped in with heavily subsidized costs of yen-based lending, with the stipulation that contracts for heavy industries will be awarded to Japanese powerhouses, like Mitsubishi and others; the same formula as adopted by Exim Banks of advanced countries.

19. During early industrialization period, the World Bank and other ***IFIs*** were lending heavily for industries as well as for infrastructure like railways, shipyards and power projects at concessionary loan financing for long term. The key factor was their in-house capability to manage implementation of these projects; a capacity that no longer exists. At that time, the World Bank, also helped many countries to establish development finance institutions, the ***DFIs,*** to undertake a mix of foreign and local financing for industrial development and provided massive amounts of industrial finance through ***DFIs*** in China, Korea, Philippines, Indonesia, not in Malaysia or in African countries, but in India, Pakistan, Turkey, and also in Latin American countries. Other ***IFIs*** also joined in this effort later on.

20. In early phases, these ***DFIs*** were very successful at promoting industrial growth. This led to establishment of local industries and helped to improve their international competitiveness in selected lines of consumer goods greatly in demand in markets of advanced countries. Once this stage was arrived, those industries who could gain a toehold in foreign trading were placed in export processing zones to test the waters, but only if they could swim in the tide of international competitiveness. This was acquisition of comparative advantage where none existed before.

21. When these newly established industries began export of consumer goods, such as high value electronic goods, textile garments and shoes, light machinery, power tools, lathe machines and so forth stamped with brand names of world class manufacturers, this impacted hard on industries in advanced countries. Besides, relocation of their industries overseas, shift of capital and technology, amounted to exporting jobs overseas which led to a massive reaction from those adversely affected, and extraordinary pressures were applied upon the government to stem tide of cheap imports. It was done through quantitative restrictions, revision of import standards, labeling requirements, imposition of quota system and all. But these measures could not halt, much less reverse, the trends of industrial relocation.

22. This is all well known; but what may not be so well known that US and European countries brought pressures on the ***IFIs*** to stop financing for industrial development, energy and infrastructure in which endeavour they succeeded. The World Bank stopped lending for industrial projects and industrial finance by mid-1980s, and shut down the departments concerned. Meanwhile, the financial failure of a number of ***DFIs*** provided a powerful; argument to cease lending for industry indirectly through local ***DFIs.***

23. The World Bank also scaled back lending for complex multi-purpose power and energy projects in response to Big Oil and money center bank pressures and shut down Energy Department and ceased project lending for petroleum industries. The priorities shifted to ***poverty reduction*** via long term cash loans that suited client countries like Pakistan admirably; and it also suited to ***IFIs,*** owing to much softer rules for disbursements, procurement and accountability as compared with project cycle based lending. It was end of an era not to return back.

24. Since this paradigm of protective umbrella, material incentives and foreign financing cannot be replicated, does that mean that Pakistan need not go through such a structural transformation and yet prevail over periodic crises in its external sector? If exports have to grow, as they must, Pakistan will have to find ways of promoting light manufacturing on similar patterns as outlined above. The most challenging part is improvement of enabling environment, not financing as widely believed.

25. If Pakistanis could invest overseas in Ajman and Dubai, they would do the same at home if they feel it is safe and profitable. In between is the saga of projects like gas pipeline which should be a national priority, instead of pushing for pie-in-the-sky variety of proposals like bullet trains and super highways while industries have shut down for lack of energy. Meanwhile, gas companies, PIA, railways and other ***PSEs*** are being stripped of their viable assets in preparation for privatization. The stakes are too high for those who stand to benefit from this process the same way they did during the 1990s.

@@@ The End @@@

Exhibit

*... **energy crisis**....... and the burden of the poor.....*

A woman carries firewood. —Photo by Tariq Saeed

Annex: Currency Market of Pakistan

1. This Annex provides an overview of currency market of Pakistan, its ***structure*** and ***size*** for meaningful discussion of exchange rate determination. There was no currency market in pre-reform days of officially determined exchange rates. The present structure of currency market is the outcome of reforms of foreign trade and exchange regime. As exchange rate got liberalized, a currency market began to emerge, and by late 1990s, there were several tiers of the market owing to multiple exchange rates. As the evolution reached a ***unified exchange rate*** regime with open trading in foreign currency by SBP, the banking system and the ***FECs,*** the market base solidified as outlined below. There is an informal market of Pakistan rupee; its existence is palpable and casts a long shadow on exchange rate, but no attempt is made here to contend with it.

The Structure

Interbank Currency Market

2. The formal currency market mainly consists of ***interbank market*** whose participants are SBP and banks. This market emerged with establishment of a network of trading in foreign exchange in late 1990s as SBP began transferring chunks of market to interbank operations, like oil import payments, keeping an unofficial ceiling on exchange rate within a band. This was ***dirty float***. In early 2000s, SBP moved towards a unified exchange rate regime with ***clean float***. As part of this move, SBP authorized commercial banks to hold balances of foreign currency deposits, export proceeds, and remittances instead of surrendering them to SBP. Besides, SBP overhauled system of trading, allowing banks to do public and interbank trading of foreign currency, thus furnishing a foundation for interbank market.

3. SBP eventually moved to a ***clean float*** of rupee, converting currency market to open but supervised trading. Slowly the idea took hold that SBP is no longer fixing up exchange rate as it used to do before. This was the start of ***floating exchange rate*** regime which has endured through current times. The banks handle foreign trade financing and transfers of their clients, be they importers or exporters. They are also engaged in lending foreign currency based loans to the extent feasible, given additional risks of exchange rate movements.

Kerb Market

4. Next, there is currency market operated by foreign exchange companies, ***FECs,*** called ***Kerb Market*** which evolved from money changers who for decades were regarded part of ***black market*** in Pakistan until their documentation and registration in mid-1990s. In those days, since they did their business in shadows or on street corners, they were dubbed ***kerb*** traders and this name has stuck to this day. After registration as licensed currency dealers, they operate under rules, regulations and directives of SBP governing their trading. In early 2000s they were upgraded into foreign exchange companies, ***FECs,*** doing their business on almost the same footing as commercial banks. The ***FECs*** are not a footnote to currency market of Pakistan; they are not kerb operators either; rather they are part of mainstream of formal market.

5. Thus, a new segment of ***formal market*** has emerged; its outreach and branch network is fairly extensive, operating under rules and regulations specific to ***kerb market,*** but not much different from those governing ***inter-bank market,*** though details of their market operations are not publicly known. Their currency rates are slightly above interbank rates, representing a premium for retail transactions. These companies also tap informal sources of foreign liquidity that would otherwise have found its way through ***havala or hundi*** system. Whatever the source of foreign liquidity ***of FECs***, there is a market now out in the open which has provided a significant boost to currency market.

6. It was a good move to bring ***FECs*** in the mainstream and it represented a break from control mentality that prevailed for so long. The same people who were considered shady and were vilified as black marketeers, they were given a seat across the table as trading partners in currencies by banks and SBP, apart from simply being a mechanism or a tool for currency purchase operations. This was a milestone in liberalization and reforms. As trading partners of banks and SBP, these companies gained respectability they never had before.

Informal Market

7. In spite of these developments, there still exists an ***informal market,*** or ***parallel market*** in foreign currencies, undocumented and unknown in its size and reach and it is believed to be very large. Its market size is not a footnote and its impact on currency market shows up whenever exchange rate is under pressure, imparting some clue to its size and presence in Pakistan. There are

indications of transactions in parallel market but those are not publicly known. Their flows occur through same age old ***havala, hundi***, or cash and carry methods of informal transfer of currencies, in spite of all out efforts in post 9/11 period to eliminate them suspected of money laundering. The main source of funds for informal market remain under-invoicing of exports or over-invoicing of imports; or foreign currency balances of Pakistani businesses held to avoid tax net; or black money balances held abroad.

Off-Shore Markets

8. There are ***off-shore markets*** of Pakistani rupee in money centers of gulf countries, mainly Dubai and Bahrain with open trading and not so open trading in advanced countries. Gulf markets are significant for size of operations and impact, but there are not even notional estimates of these off-shore markets. For example, Pakistan is believed to be the third largest investor in Dubai real estate, and fourth largest investor in Ajman export zone, amidst oil rich countries all around. This is rather ironic. A third world country raked with crisis, with severe balance of payments problems and pressures on its currency being touted one of largest investor in the Gulf. It defies common sense, but this market exists.

9. The implications of such a structure of currency market for exchange rate are far reaching. Clearly, market exchange rate is not determined in the formal markets alone; it is a combined outcome of two formal markets, parallel market and off-shore markets, all operating in tandem. The days of fixed exchange rates are long gone and market interventions by any party including SBP is not a feasible alternative that it used to be. It is now an open market.

Size of Currency Market

10. Currency market of Pakistan has grown significantly over the past decade, regardless of how such estimates are done. We have presented here estimates of ***formal*** currency market in *Data Set 6.1* based on current account entries, where payments, the debit entries, are ***outflows*** representing ***demand*** of foreign currency; while receipts are ***inflows***, representing ***supply*** of currency in ex-post manner, but not both, even though the two sides of transactions, their ***turnover,*** is done at different times at different market exchange rates by different parties. The ***turnover*** of any item, currency included, may occur several times at various layers of a market, before reaching retail level for final transaction. If we add up

the turnover, it would exaggerates ***size*** of the market. Any item could have turnover several times before final sale to the client; hence market size mostly refers to estimated value of final sales, not turnover.

11. ***Financial account*** entries of inflows are financing items of deficit on current account, primarily trade deficit plus deficits lodged with services, income and transfers; representing their ***outflows***. This deficit on current account has to be covered by inflows, such as disbursements on foreign loans, trade financing credit, ***FDI*** and ***FPI*** inflows, and uses of foreign exchange reserves by SBP. Transactions of these ***financial account*** inflows occur separately from transactions of outflows to discharge liabilities due lodged in current account; hence inflows are not included in estimation of size of currency market.

12. At the macrofinancial level, total ***outflows*** were $20.3 billion in FY01 and have grown to $57.0 billion in FY13 as shown in *Data Set 6.1* attached. These ***outflows*** were close to total ***inflows*** recorded separately in ex-post manner. They have to be as per accounting identities, except for differences owing to translation of currencies at cross rates prevailing in the currency market which are nearly impossible to reconcile at ***aggregate level***, not at retail transaction level. These are formal market flows through banking system; the remainder occur through ***FECs*** and other markets and those are not counted here; hence outflows are underestimated by a considerable margin.

13. The growth of demand of currency market, the outflows, was volatile during the past decade. Total outflows during FY08 were $54 billion, but they declined to $49.7 billion in FY10, suggesting that formal currency market in Pakistan shrank over these years. Subsequently, it rose fast and was $57.2 billion in FY12, but declined again in FY13. This violates the intuitive sense that size of currency markets always increases. Such gyrations from year to year cannot be explained in routine factors and entail serious implications for exchange rate and monetary stability. But fundamentals of economic or financial causality do not run in reverse directions over short periods, presenting contrasts to established conceptual framework of observation in applied realm.

14. The operations of currency market are beholden to fluctuations in exchange rates, underground flows, capital flight and investments of Pakistanis in the US, UK and Gulf countries. Remittances are by now flowing through banks, but some remain informal. Overseas investments by Pakistanis are fairly large, but there is no way of confirming those. For payments, importers buy foreign currencies from their own banks. They may supply it from their own currency portfolio, or buy from other authorized dealers or from ***FECs.*** A good

part of imports are bought on short term trade credit from overseas suppliers, but when these payments fall due, local banks have to furnish foreign currency needed from their own sources, or from purchases in open currency market. Therefore, to analyze trends of currency market we have to focus on debit entries for payments for imports, services, factor incomes and transfers on current account, while keeping tabs on net inflows of ***FDIs, FPIs***, short term foreign trade credits, both public and private, and disbursements on medium to long term loans in financial accounts.

@@@ End of Annex @@@@