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IN FOCUS

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Pakistan's Economic Crisis

Background

Despite decades of International Monetary Fund (IMF)-supported reforms, Pakistan remains a poor country afflicted by food, water, and energy shortages. These problems, at times severe enough to curtail business operations and stunt agricultural yields, cause considerable economic anxiety and weigh heavily on leaders. Corruption is another major obstacle to Pakistan's economic development, harming both domestic and foreign investment rates and public confidence, as well as eliciting skepticism among international aid donors. Since 2001, the stated policy of the United States has been to assist in the creation of a more stable, democratic, and prosperous Pakistan that is actively combating religious militancy. Pakistan plays a central role in the Trump Administration's strategy in South Asia to stabilize neighboring Afghanistan, amid concerns that its territory continues to harbor numerous U.S.-designated terrorist groups.

Elections to seat Pakistan's 15th National Assembly (and four provincial assemblies) took place as scheduled in July 2018, successfully marking the country's second-ever and consecutive democratic transfer of power. In August, new Prime Minister Imran Khan was sworn into office, bringing an end to the decades-long domination of Pakistan's political stage by two dynastic parties. In the lead-up to the 2018 elections, it was correctly expected that the new government would face significant economic challenges, most immediately a currency crisis that has grown out of persistent budget shortfalls and loans for major infrastructure projects. In late September 2018, IMF officials visited Pakistan and discussed the possibility of a new lending program, building upon several IMF loans over the past two decades. The role of China, however, as a major creditor and the centrality of Pakistan to China's Belt and Road Initiative (BRI) complicates the U.S. and international options for responding to an impending crisis and raises economic and foreign policy issues for Congress.

Current Economic Crisis

The principal causes of Pakistan's crisis are deep-rooted and structural—namely, Pakistan's weak export base and an imbalance between public spending and income. Exports are a much smaller share of the Pakistani economy than other countries of relative economic standing—8% of GDP in 2017, compared to 20% in Turkey and 52% in Thailand. As **Figure 1** illustrates, the IMF forecasts faster growth for imports than exports through at least 2023. In recent years, security concerns and energy supply problems have prevented Pakistan from diversifying its export base from low-value added products such as cotton, rice, and leather, to higher-value products and, more crucially, services.

Figure 1. Pakistan's Trade in Goods and Services

Source: IMF.

Notes: Millions of U.S. dollars; * = forecasts.

Pakistan's economic growth has been relatively robust since 2012, reaching 5.7% in 2017. However, growth rates are below that needed to keep pace with Pakistan's rapid population growth and import needs. The IMF projects Pakistan's growing current account deficit and rising debt service will cause its external financing needs to increase sharply in the years ahead. Gross external financing needs are expected to rise from $21.5 billion (7.1% of GDP) in FY2016/FY2017 to around $45 billion by FY2022/FY2023 (9.9% of GDP).

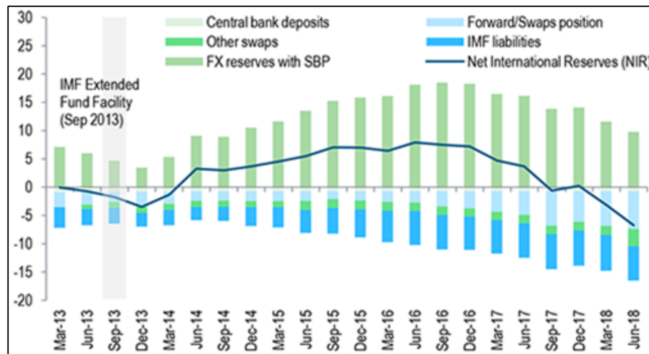
According to data from the State Bank of Pakistan, the current account deficit (imports of goods and services minus exports of goods and services) for FY2017/FY2018 (ending in June) reached $18 billion, up nearly 50% from $12.6 billion in the previous year. The current account deficit puts substantial pressure on Pakistan's foreign exchange reserves and the value of the Pakistani rupee, which declined over 11% against the dollar during 2018. This pending crisis may make Prime Minister Khan's vows to create a "Muslim welfare state" with new public services and job creation difficult to realize. It may also have negative implications for China's vast BRI, within which the China-Pakistan Economic Corridor (CPEC) is the flagship initiative. CPEC is a planned connectivity effort, valued at an estimated $62 billion, that includes major new road, rail, and energy projects for Pakistan.

Dwindling Exchange Reserves

Over the past two years, Pakistan's foreign exchange reserves have dropped by more than half, from a high of $24 billion in October 2016 to just over $10 billion in August 2018 (**Figure 2**). At the same time, its external liabilities remain formidable. These include repayments (through 2026) on Pakistan's 2013 IMF loan and various foreign exchange forward and swap arrangements. For example, in May 2018, Pakistan agreed to a $3.1 billion reserve currency swap arrangement with the Peoples Bank

of China, increasing its access to China's RMB, a more stable and convertible reserve currency.

Figure 2. Pakistan's Foreign Exchange Reserves (U.S. $ Billions)



Source: State Bank of Pakistan, IMF, Standard Chartered.

Note: SPB = State Bank of Pakistan.

U.S. Policy

While the U.S. government supported past IMF programs for Pakistan, some Members of Congress and the Administration have recently argued that the United States should not support IMF loans to countries, such as Pakistan, whose debt-burden has increased because of "predatory" lending by China. Pakistani officials have responded by asserting that it does not intend to use any funds from a possible IMF program to repay China but rather to finance much-needed imports. Further, Pakistani officials blame high oil-prices, rather than its China-related investments, for its current economic woes. While borrowing from China temporarily supported the Pakistani balance of payments and prevented an immediate crisis—and Islamabad may also consider multibillion-dollar loans from the Saudi-based Islamic Development Bank—experts consider it unlikely that Pakistan will be able to return to capital markets without a robust and stringent IMF program.

The Trump Administration has taken note of Pakistan's growing debt to China and expressed opposition to any international bailout that would provide funding to reduce such debt. Just days after Pakistan's July national elections, Secretary of State Mike Pompeo said, "There's no rationale for IMF tax dollars … to go to bail out Chinese bond holders or China itself." In August, 18 U.S. Senators signed a letter to the Administration expressing concerns about "predatory Chinese infrastructure financing." However, during a September visit to Islamabad, Pompeo reportedly assured his interlocutors that the United States would not seek to block any potential new IMF package. A staff team from the IMF visited Islamabad in September and October, 2018. According to their official statement, "[R]ecent policy measures are steps in the right direction, but not yet sufficient. Decisive policy action and significant external financing will be needed to stabilize the economy." At the same time, the IMF is working with China to improve the transparency of its foreign loans and investments.

A CPEC Reset?

Featured CPEC projects include construction within all main sectors of Pakistan's transportation infrastructure, boosting energy capacity and distribution, and developing a deep-water port at Gwadar on the Arabian Sea. The new Pakistani government appears likely to scrutinize CPEC projects more vigorously than its predecessor, especially given a singular focus on corruption amidst ongoing concerns about the pace and quality of Chinese investments to date. Khan and his party seek to move Pakistan away from the high-visibility, high-cost Chinese-financed infrastructure projects championed by the previous government; rather, they would prefer to redirect public spending toward the provision of basic services.

The Pakistani foreign minister hosted his Chinese counterpart in September, vowing to preserve CPEC as a top priority of his government. At the same time, other Pakistani officials have promised to review and renegotiate some CPEC-related agreements. A subsequent Pakistan-China meeting resulted in agreement to expand CPEC activities into the social sector, with proposed initiatives on potable water, health, and education. If pursued, these would better align CPEC with the Pakistan government's emphasis on human welfare. In an effort to move ahead on unrealized plans to establish several special economic zones (SEZs) in Pakistan, negotiators also agreed to welcome "third-country investors." Press reports suggest Pakistani officials are also pressing Chinese counterparts to establish new factories and pursue poverty-alleviation initiatives. A new nine-member Pakistani committee on CPEC, chaired by the planning minister, appears to seek more private-sector Chinese investment that would employ more Pakistani suppliers and labor. It is not clear how this "realignment" of CPEC goals will be paid for. To date, no Chinese manufacturing has relocated to Pakistan and none of the nine envisioned SEZs has been established (with only four such zones now planned). Meanwhile, the city of Gwadar reportedly has seen little or no new industry, chronic water and electricity shortages continue, construction on a planned airport and power plant has yet to begin, and virtually no commercial shipping uses the port.

Issues for Congress

Questions that Members may consider include the following:

- To what extent is Chinese lending to Pakistan a cause, or contributing factor, of Pakistan's ongoing economic crisis?
- If the IMF lends to Pakistan, what economic reforms are most essential?
- How can the United States help Pakistan boost its exports?
- What are the economic and policy implications of China's apparent growing influence in the region?
- What are the potential implications of diminished U.S. influence over Pakistan if it seeks bilateral financing instead of support from the IMF, where the United States is the largest shareholder?

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