



## Pakistan: On the Verge of an Economic Meltdown?

*Mohsin S. Khan, who has advised the government in Islamabad, urges economic action to avert an economic crisis and offers suggestions on a path forward.*

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Steve Weisman: Pakistan is going through another bout of conflict, war, assassinations, uprisings, political turmoil, economic chaos. This is Steve Weisman at the Peterson Institute for International Economics with Mohsin Khan, senior fellow here at the Institute, to clarify the issues for us. Thank you, Mohsin.

Mohsin Khan: My pleasure, Steve.

Steve Weisman: Mohsin, you've also been advising the government of Pakistan. First bring us up to date on the economic turmoil.

Mohsin Khan: The situation for the Pakistan economy is pretty grim. It is very similar to 2007–08, almost déjà vu. Unfortunately it is—it's almost as if the government didn't learn anything from that experience.

What is happening is the following: You've got very slow growth, maybe around 2 to 3 percent for a variety of reasons, but we can go into that later. Inflation [is] rising very rapidly and the cause is exactly what was happening in 2008. You have an increase in food prices and in energy prices. The government refuses, or actually in this case, had to back down from increasing domestic gasoline prices in line with international oil prices, which meant that essentially it had to subsidize the public, which it did do.

The cost of that subsidy is rising day by day as oil prices stay high and domestic prices are kept below international prices, and the fiscal deficit rises. The expansion in the fiscal deficit is then financed primarily by the government borrowing from the central bank, which is akin to printing money. So it's pumping liquidity into the system and that's leading to higher inflation.

This is exactly what happened in 2008, which in fact led to the Pakistanis asking the IMF for a program of economic assistance alone. The ongoing IMF program has been suspended because Pakistan was not able to meet the conditions that the IMF had set for them, including on the size of the fiscal deficit and certain other actions like introducing a new or revised general sales tax, which is sort of like a VAT [value-added tax].

The government just recently, in fact this past week, said it tried to push this through but found such political opposition that it decided not to go through with it. So that's off the table.

Steve Weisman: One of the parties that makes up the governing coalition in Parliament pulled out and threatened to topple the government if they didn't withdraw the price increases.

Mohsin Khan: That's correct. That's what I'm saying. Politically it was not possible for them to go through with this tax and therefore, they have withdrawn it. But withdrawing it means that your revenue shortfall is going to be that much bigger and your fiscal deficit is going to be that

much larger. Now combine that with the oil subsidy and things are really getting out of control on the deficit. By my reckoning, the fiscal deficit in the budget was 4.7 percent of GDP. It's going to be around 8 percent if this continues. We're talking about a financial year, which runs from July 1 to June 30. For this financial year, the fiscal deficit could easily be 8 percent.

Steve Weisman: It's a terrible dilemma. If the government tried to do these reforms, would it fall? Could the reforms be done in defiance of Parliament?

Mohsin Khan: No, it couldn't be done in defiance of Parliament, given that the country is operating under a parliamentary system.

Steve Weisman: Right.

Mohsin Khan: The president of course has tremendous influence but it's not a presidential system, so it has to go through Parliament. Given the opposition in Parliament, I think government made the mistake of really not selling the tax as well as it could have by getting people to understand what this was doing. In fact, this tax was not going to be inflationary. There was going to be some increase in the taxes, but there were also going to be some reductions in taxes.

Steve Weisman: And inflation, of course, itself is a tax.

Mohsin Khan: That is exactly right. The alternative was to have higher inflation because you can't finance the fiscal deficit any other way than through borrowing from the central bank. That becomes a tax on everyone. The figures coming out right now show growth of between 2 and 2.5 percent, with inflation easily above 20 percent—it could be 25 percent. That's a serious crisis, if it's not a crisis already; it's certainly a crisis in the making.

Steve Weisman: There are so many crises in Pakistan—the war in Afghanistan and the Taliban inflicting violence in both the Frontier and increasingly in other parts of the country including Punjab. Let me come back to another aspect of the economy. Did the flooding last year have a major impact?

Mohsin Khan: It's very interesting. When the floods did occur, the papers were full of the adverse consequences this would have for the economy and particularly for growth and exports. That hasn't come to pass. It has to some extent, but not as dire as some people had thought it would be. Interestingly enough, Steve, nobody that I can see among the commentators mentions the floods as one of the factors behind the current economic crisis. In fact, there's a little bit of a bounce, strangely though it may be. But catastrophes like the floods and earthquakes, etc., do often result in a bounce up in the growth rate.

Steve Weisman: If there's investment in recovery?

Mohsin Khan: Correct. That's right. In replacing capital assets that have been lost. You get construction going, you get housing going, etc. And so there's a bounce. That bounce was very short lived in Pakistan. So you got the bounce but even with the bounce for the year as a whole, 2 to 2.5 percent growth, that's it.

I think while the floods compounded the problems in terms of resources for the government, it had to pump in some fair amount of resources, the fact of the matter is it didn't have as serious an effect as people sometimes thought it would, including myself.

There is no question that there are external factors that have created the economic problems of the country. External factors meaning political factors, security factors, etc., energy shortages; these are sort of factors that have created the problems of Pakistan. But I think it's also a case of politics playing an important role. I mean the constant concern with: How will this play out politically? I think the government is very, very nervous and I would say hasn't been strong in either communicating what it wants to do nor has it been very strong in carrying out the things that it said it was going to do.

Steve Weisman: There have been reports in the news media about a new aid package though from the United States. What do you know about that?

Mohsin Khan: Not very much actually, Steve. There is an aid package already in existence from the United States, which is the Kerry-Lugar Bill, which gives back some \$1.5 billion a year. But not much of that money has come through, but nevertheless it's there.

What we're hearing now is of course a larger both military assistance and economic assistance package for Pakistan. I understand, at least from the press, that Vice President Biden will be in Pakistan very shortly, and he is going to discuss this Expanded Aid package with the Pakistanis.

I think the aid package is, of course, essential. The external countries outside the donor countries feel they have a need to help Pakistan. But ultimately, Steve, what's going to help Pakistan has to come from what the Pakistanis can do themselves, and particularly the Pakistani government in terms of the policies it puts in place to generate economic recovery.

Steve Weisman: The United States certainly expressed disappointment and even displeasure, although perhaps some understanding, after Pakistan reversed itself and reinstated the subsidies within the last week. Are there any chances that the new package will come with conditions that Pakistan carry out some of these economic reforms?

Mohsin Khan: My feeling is that politically it could not now turn back and say, "Yes we will have a new tax bill and yes we will allow oil prices to pass through." What I think will happen is that they will think of alternatives.

Steve Weisman: What alternatives would you suggest?

Mohsin Khan: Well, there are two ways. One is a way I had suggested—pushing the tax and also oil price increases—was that the government could do this by stealth. There already was a tax, and what you had to do was play around with exemptions and play around with rates. You didn't have to tout it as a great new tax coming in. People just didn't understand it. They just thought this was an additional tax coming in. This was reforming the existing tax structure. So—

Steve Weisman: Could you do that without legislation?

Mohsin Khan: Correct. You can.

Steve Weisman: Oh, very interesting.

Mohsin Khan: You can do it as part of the finance bill in the budget.

Steve Weisman: Do you think that might happen then?

Mohsin Khan: I think something like that is going to happen.

Steve Weisman: Something has to happen.

Mohsin Khan: Something like that can happen. In oil price increases, I think the basic way is to stop financing this through the central bank. You can finance it in other ways; either finance it from abroad or finance it through selling Treasury bills, but do not finance it through central bank.

Steve Weisman: You mean by printing money.

Mohsin Khan: That's right. That's right, printing money.

Steve Weisman: How do you finance it from abroad? What about oil producers like Saudi Arabia? They have an interest in Pakistan stability. Can they help?

Mohsin Khan: Well in the past, they've helped a lot. In 2008, there was a great deal of reluctance on their part because I think the feeling was, you've got to get your own act together before we're ready to finance you. And it seemed like they had got their act together at the end of 2008 when there was an IMF program with conditions. A framework of economic policies was there. They had a good economic team. They have a very good economic team right now and they were determined to carry out what needed to be done. Now, the economic team is still, as I said, a very good team, very smart.

Steve Weisman: And you know many of them?

Mohsin Khan: I do, yes. I think the minister of finance, the governor of the central bank, the minister of planning, etc., and the secretary of finance are first-rate economists. And they know what to do and they know what needs to be done. But the political forces, I guess, are constraining them from doing what needs to be done and I think if the politicians don't get their acts together—I worry a lot that this crisis is going to turn into a real meltdown of the economy. And if that happens, Steve, the consequences one doesn't know. But one can predict that the consequences for security of the country, for that matter security for the rest of the world, if you think of Pakistan being a base from which the al Qaeda and Taliban would strike. Well from that point of view, I think that they have to get their act together and the rest of world has to help them get their act together.

Steve Weisman: It's in no one's interest, including India, to have Pakistan fall apart under economic pressure.

Mohsin Khan: That's right.

Steve Weisman: What do you think? Is Pakistan going to make it?

Mohsin Khan: Yes, I think it's going to make it. There are sensible people still in the country. There are sensible people who realize what path they're headed down. And I think that they see what the consequences are. I think the neighbors, and particularly India, should also appreciate the situation and be helpful in this regard because India doesn't need a country or a nation of 200 million odd people, a dysfunctional state on its borders—and very long borders.

When we say meltdown, we're basically saying, the state becomes dysfunctional. I'm using

an extreme analogy, but you don't want a Somalia surely with warlords and provincial leaders, etc., fighting among each other. The root of the central government disappears. I think that's the real danger, when people talk about Pakistan disintegrating, they are talking about different provinces going their own way.

Steve Weisman: All right. Mohsin, thanks.

Mohsin Khan: You're quite welcome. Thank you, Steve.

