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UNSUSTAINABILITY OF THE BALANCE OF PAYMENTS

SOCIAL POLICY AND DEVELOPMENT CENTRE

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The inherent unsustainability of Pakistan's balance of payments has been amply demonstrated by the need to seek debt rescheduling from the Club of Paris earlier this year and more recently from international commercial banks. The country's balance of payments position was fragile even prior to the nuclear blasts in May 1998, with foreign exchange reserves of just above $ 1 billion. The freezing of foreign currency accounts following the blasts and the imposition of capital controls fundamentally undermined private sector confidence and led to the drying up of a number of critical capital inflows and severely impaired access to the international capital market. At one stage, despite the accumulation of arrears on debt repayment, foreign exchange reserves fell to below $ 500 million in November 98 and recovered only after the revival of the ESAF/EFF program with the IMF in January 99.

Since then there has been a degree of complacency about the external payments position with reserves rising to the peak level of $ 1.8 billion earlier this year and currently hovering at $ 1.5 billion. But it must be remembered that this has not happened because of any major improvement in the underlying fundamentals of the balance of payments like a reduction of the current account deficit but due to the debt relief and additional borrowings, especially from various IMF facilities. By now the official debt relief exceeds $ 2 billion and if such relief had not been obtained, the foreign exchange reserves would already have been completely depleted.

The period of debt consolidation comes to an end in December 2000, beyond which Pakistan is expected to resume normal debt repayments. Will the country be able to maintain its normal imports and honor its external payments at that time? This is probably the most important medium-term issue of national economic policy.

The objective of this note is to highlight the trend in the country's balance of payments during the decade of the 90s and thereby demonstrate why the external payments position has become unsustainable. This is followed by an analysis of the various policy options which are available to the country to address this problem.

BALANCE OF PAYMENTS

There are two components of the balance of payments, the current account and the capital account. The current account gives the balance of trade in goods and services and current transfers. The capital account gives the net position with respect to borrowings and non-debt creating inflows like foreign private investment.

Pakistan has traditionally carried a deficit on the current account. This has had to be financed by a surplus on the capital account, achieved primarily by resort to incremental borrowings. In the event that the capital account surplus is not large enough to fully finance the current account deficit the residual gap has to be met by depletion of foreign exchange reserves. Alternatively, there is accumulation of reserves when the current account deficit is less than the net inflows on the capital account.

The overall balance of payments position of Pakistan during the decade of the 90s is given in Table 1. The volatility in the balance of payments is clearly visible. There have been years like 1992-93, 1995-96 and 1996-97 when the current account deficit exceeded $ 3 billion. As opposed to this, in the last two years, for example, the deficit has fallen below $ 2 billion.

TABLE 1
CURRENT AND CAPITAL ACCOUNTS IN THE BALANCE OF PAYMENTS IN THE 90s

($ Million)

	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-2000 *(Projected)*
Current Account Deficit (-)/ Surplus (+)	-1377	-1058	-3331	-1651	-2163	-4348	-3557	-1701	-1580	-2500
Capital Account Deficit (-)/ Surplus (+)	1263	1410	2819	3533	2496	3953	2358	1553	-1267	-3050
Exceptional Financing	)	)	)	)	)	)	)	)	4101	5100
Change in Foreign Exchange Reserves (Decrease (-)/Increase (+)	-114	352	-512	1882	333	-395	-1199	-148	1254	-450

Source: SBP Annual Report

Usually, in years when the current account deficit has worsened the country has been compelled to go in for larger short-term and medium-term commercial borrowings to finance the deficit and avoid the occurance of a financial crisis caused by rapid depletion of foreign exchange reserves. Therefore, the surplus on the capital account was relatively large in 1992-93 and 1995-96. In some years such financing has proved difficult, as in 1996-97, when there was a severe haemorraging of foreign exchange reserves and the country plunged into a crisis. As opposed to this, the current account deficit was relatively small in 1993-94 while net inflows on the capital account were substantial. Consequently, there was a large build-up of foreign exchange reserves.

CURRENT ACCOUNT

There are three major components of the current account, viz, the trade balance, net receipts or

TABLE 2
CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS IN THE 90S

($ Million)

	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-2000 *(Projected)*
Trade Balance	-2483	-2236	-3267	-2000	-2537	-3704	-3145	-1867	-1774	-2150
Exports (f.o.b)	5902	6762	6782	6685	7759	8311	8096	8434	7571	8200
Imports (f.o.b)	-8395	-8998	-10049	-8685	-10296	-12015	-11241	-10301	-9345	-10350
Services (Net)	-1790	-2224	-2748	-2355	-2384	-3249	-3659	-3264	-2497	-2700
Receipts	1630	1581	1628	1720	2150	2100	1840	1708	1399	1600
Payments	-3420	-3805	-4376	-4075	-4534	-5349	-5499	-4972	-3896	-4300
Current Transfers (Net)	2896	3402	2684	2704	2758	2605	3247	3430	2691	2350
of which:										
Home Remittances	1848	1468	1562	1446	1866	1461	1409	1490	1055	1000
Resident FCAs	190	1165	543	752	381	763	1347	1476	539	350
Current Account Deficit (-)/ Surplus (+)	-1377	-1058	-3331	-1651	-2163	-4348	-3557	-1701	-1580	-2500

payments for services and current transfers including home remittances and inflows into resident foreign currency accounts. During the 90s both the trade balance and net transfers have been variable while there has been a steady deterioration in the services account (see Table 2).

Exports showed some buoyancy upto 195-96 and have stagnated since then. In fact, in 1998-99 the value of exports was even less than the level four years ago in 1994-95. Imports have been marked by larger fluctuations due to changes in international prices and special factors like the large imports of vehicles for the yellow cab scheme in 1992-93 and machinery imports for private power plants in 1995-96 and 1996-97. Much of the decline in the level of imports during the last two years is due to a fall in international prices, especially of petroleum products. From the peak level of $ 2.3 billion in 1996-97 oil imports fell to about $ 1.5 billion in 1997-98 and 1998-99.

The net balance on the services account deteriorated sharply from about $ 1.8 billion in 1990-91 to $ 3.3 billion in 1997-98. This is due, first, to rising interest payments on official debt and foreign currency accounts and, second, due to repatriation of higher profits and dividends. The visible improvement of about $ 800 million in the services account in 1998-99 is attributable to the conversion of foreign currency deposits into rupees leading to a reduction in interest payments and lower payments for travel abroad which for sometime were not catered for by the Central bank and had to be made through purchases in the Kerb market.

Current transfers reached a peak of $ 3.4 billion in 1997-98, due primarily to a large inflow of $ 1.5 billion into resident foreign currency accounts. Home remittances have shown a variable through declining trend. The deterioration in current transfers in 1998-99 of over $ 700 million is due primarily to the shock caused by the freezing of foreign currency accounts. Both home remittances and inflows into new FCAs registered sharp declines.

What is the outlook for the current account in 1999-2000? By now it is clear that the current account deficit will be significantly larger than last year. The trade balance is likely to deteriorate despite some recent buoyancy in exports due primarily to the oil price shock which will raise the overall import bill sharply. The cost of petroleum imports is likely to cross the peak level attained in 1996-97. Simultaneously, the net liability of services is likely to be larger while current transfers will continue to fall due primarily to smaller inflows into FCAs. Altogether, the current account deficit may approach $ 2.6 billion, over $ 1 billion higher than last year. This will begin to exert pressure on the reserve position and the exchange rate later on in the year.

CAPITAL ACCOUNT

The capital account consists of net inflows of long-term public and private capital, medium and short term capital, foreign private investment (both direct and portfolio) and inflow into non-resident foreign currency accounts. The variability in the capital account is due primarily to fluctuation in the level of medium and short-term borrowings, net inflows into non-resident FCAs and other inflows.

The net inflow of long term official capital has shown a declining trend because the rate of disbursement of loans has not kept pace with the rise in debt repayment. Between 1990-91 and 1997-98, the disbursement of loans increased from $ 1.5 billion to $ 2.5 billion while debt repayment rose from $ 800 million to almost $ 1.9 billion (see Table 3).

Foreign private investment peaked in 1994-95 at over $ 1.5 billion, due largely to the buoyancy of the stock market which attracted large inflows of portfolio money. This was replaced by substantial direct investment into IPPs in 1995-96 and 1996-97. Since then foreign private investment has become increasingly shy. Following the imposition of sanctions in May 98 there was a substantial withdrawal of portfolio funds and in 1998-99 there was a fall of almost 55 per cent in foreign private investment.

TABLE 3
CAPITAL ACCOUNT OF THE BALANCE OF PAYMENTS IN THE 90S

($ Million)

	90-91	91-92	92-93	93-94	94-95	95-96	96-97	97-98	98-99	99-2000 *(Projected)*
Long Term Official Capital (Net)	736	1015	857	783	753	687	693	602	1114	150
Disbursement of Loans	1542	1956	2156	2240	2425	2370	2490	2493	3189	2050
Repayments	-806	-941	-1299	-1457	-1672	-1683	-1797	-1891	-2075	-1900
Foreign Private Investment	230	562	447	649	1529	1311	698	793	360	500
Long Term Private Capital (Net)	66	470	787	789	260	389	525	-98	-69	
Medium and Short Term Official Capital (Net)	)	)	697	498	-161	434	-266	572	-1408	-1000
Non-Resident FCAs	)	)	239	693	270	967	196	-699	-2294	-2700
Others[?]	231	-637	-208	121	-155	165	242	383	1030	)
Capital Account Deficit (-) Surplus (+)	1263	1410	2819	3533	2496	3953	2358	1553	-1267	-3050

[?] including outstanding export bills, fund credits and errors and omissions.

There was a significant net positive inflow of private long term capital (supplier's credits, etc.) Upto 1996-97. Since then it has turned negative reflecting the fall in domestic private investment, especially in manufacturing. Inflows of medium and short term capital have generally been large in years like

1992-93 and 1995-96 when the current account deficit was large and could only be financed at the margin through higher short and medium term commercial borrowings. In 1998-99, as expected, the inflow was substantially negative. Inflows into non-resident FCAs were positive upto 1996-97 and have since turned negative with withdrawal of almost $ 2.3 billion due to the changed policy on FCAs after May 1998. Altogether there has been a marked deterioration in the capital account during the last two years. The balance of payments has only been sustained in 1998-99 through exceptional financing arrangements of over $ 4 billion involving official debt relief, roll-over of deposits, etc.

What is the prospect for capital inflows in 1999-2000? The impact of loss of confidence of foreign investors and lenders will continue to be felt in the absence of any fundamental improvement (in fact, deterioration) in the balance of payments position and in the domestic policy stance (with continued uncertainty about resumption of flows under the IMF program). As such, inclusive of exceptional financing of over $ 5 billion, the overall surplus on the capital account is unlikely to exceed $ 2 billion. Therefore, with a projected current account deficit of almost $ 2.6 billion, depletion of reserves during the year could approach $ 600 million implying that the end-of-year level of foreign exchange reserves is likely to be about $ 1.2 billion.

POLICY OPTIONS

The above analysis has highlighted the role of a number of factors which have contributed to the growing unsustainability in Pakistan's balance of payments. These include <u>slow growth in export earnings, higher import bill due particularly to the sharp rise in oil prices, rising interest payments, higher repatriation of profits/dividends (especially by IPPs), continuing fall in home remittances, lower inflows</u>

into FCAs following the freezing of accounts in 1998, lower foreign private investment due to confidence factors, smaller net inflows of long term official capital because of rising debt repayment and lack of access to commercial short and medium term borrowings. All negative factors have come together at essentially the same time and the balance of payments was only sustained in 1998-99 by exceptional financing of over $ 4 billion and will be supported in 1999-2000 by another round of exceptional financing of over $ 5 billion.

But what happens after 31st of December 1999 when the exceptional financing arrangements come to an end? The prospect of default in our international payments becomes a real possibility once again because most of the negative factors listed above are likely to persist. The two and half year breathing space given by the debt relief was to be used to enhance the debt repayment capacity of the economy. Uptil now there is no evidence that this has happened. On the contrary, the current account deficit is likely to deteriorate sharply in 1999-2000 by almost $ 1 billion while initial estimates of net BOP financing gap in 2000-01 are as much as $ 2 billion. Of course, a big part of this is due to the exogenous negative shock of rising oil prices but there is also no convincing evidence that the government is seized with the problem of restoring viability in our external transactions. The export drive remains weak, efforts at import substitution will necessarily be slow and deep structural reforms remain to be adopted to restore confidence of foreign investors.

In his Economic Revival Plan the Chief Executive has already indicated that Pakistan may seek another round of debt relief beyond December 2000. In this a product of the realisation that efforts in the short run to improve the balance of payments will require aggregate demand management of a magnitude which could fundamentally jeopardise prospects of economic revival and relief to the common man?

Therefore, is the government essentially postponing the day of reckoning by talking of further debt relief? It needs to be realised that while this strategy may permit some temporary pump-priming of the economy in the year 2000 it is unlikely to be sustainable. The international donors gave us debt relief the first time on the presumption that Pakistan would take strong enough reform measures to enhance our debt repayment capacity beyond December 2000. In stead, what we have seen is a policy of fits and starts with partial and defective implementation of conditionalities embodied in the ESAF/EFF program.

Next time we go for debt relief the donors are likely to be much tougher. They will put even greater emphasis on strong measures for macroeconomic stabilisation involving sharp and rapid reduction in the fiscal and current account deficits including major cut backs in public expenditure (especially military expenditure), fundamental broad-basing of the tax system, major hikes in tariffs of power, gas, etc. quantum depreciation of the exchange rate, severe restrictions on public sector imports (including defence imports) and higher interest rates. In the presence of such a strong stabilisation program (as the condition for any further debt relief) the objectives of growth and poverty alleviation may have to be largely sacrificed.

What then is the alternative strategy (to seeking further debt relief) that the government ought to adopt? The first pre-requisite is that there will have to be a radical shift in government thinking about the short-run objectives of economic policy. Instead of focusing on economic revival which is likely to be unsustainable anyway in the absence of a viable balance of payments position, the emphasis initially will have to be on reducing the current account deficit during the next year which can then be followed by a strategy for more sustained revival of the economy. In other words the sequencing of policies will initially have to be on aggregate demand management to indirectly contain the current account deficit and directly via export promotion and import substitution.

The Chief Executive's Economic Revival Plan does focus on the need to compress imports, especially of wheat, edible oil and petroleum products. While the strategy for increasing domestic wheat production has been articulated, policy measures for substituting imports of edible oil and petroleum products have not yet been specified. Perhaps the most glaring ommission in the Chief Executive's speech is emphasis on exports and the contours of an export promotion strategy. A vigorous export drive has to be launched on a top priority basis, backed by an appropriate exchange rate policy.

In summary, unsustainability of the balance of payments is clearly the prime challenge to Pakistan's economy and the limiting factor to future revival and growth possibilities. Efforts will have to be made to reduce the current account deficit by December 2000 when the period of debt relief expires. Otherwise, the country will have no other option but to go in for severe import compression and jeopardise all prospects of economic revival. This will be necessary even if we obtain a second round of debt relief as donors will probably lay primary emphasis on current deficit reduction, in the context of any future IMF program, to enhance the debt repayment capacity of Pakistan's economy.

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