Double Demise

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The government is spending beyond its means and the State Bank is printing money to facilitate it, which is not sustainable in the short to medium run, making Pakistan’s macroeconomic stability extremely vulnerable. This is exactly what the International Monetary Fund says after consultation with the government of Pakistan, under Article IV of its Articles of Agreement, during the current fiscal year. On page two of its report on the consultation that was completed in February, 2012 it says, “The current mix of large fiscal deficits and accommodative monetary policy is increasingly unsustainable,” and “On current policies, Pakistan’s near- and medium-term prospects are not good. Growth would remain too low to absorb the large number of new entrants into the labor force, inflation would remain high, and the external position would weaken significantly.” The federal government has failed on many agreed macroeconomic benchmarks, committed in the federal budget 2011-12, and to the international creditors, including the International Monetary Fund and the World Bank. The Standby credit arrangement of the International Monetary Fund, to cushion the macroeconomic stabilization reform programme was aborted last year, and the International Monetary Fund is unlikely to commit any further reforms to Pakistan’s economy. Now, the World Bank has extended its Country Partnership Strategy, designed for the base period of three financial years from 2010-13 to 2011-14, after Pakistan failed in achieving key macroeconomic targets necessary for the provision of multibillion dollar project loans. And now, the State Bank of Pakistan has taken away any hope of being responsible for any significant growth, which could have instilled confidence in the mind of investors and the credit rating agencies, which apparently seem busy downgrading European economies for their credit worthiness.

Poor compliance on the budgetary fiscal framework is primarily responsible for that, which in turn has forced the
Federal government on monetary expansion to an extent which is larger in quantum than what the external sector including flow of remittances and export proceeds can support, by registering growth in domestic economic produce.

There is money supply in the market, for which the country's economy has not produced any financial or physical product, as real GDP growth. A spike in the international prices of commodities and petroleum products has also contributed directly to inflation. Pakistan is facing high inflation, at a time, when growth in the economy virtually summants to nothing, in per capita terms. This has increased poverty to an extent, where gains of the last decade have been reversed.

As a result, shortages, especially of energy products have resulted in social unrest and political instability. Radical ethno-religious groups taking advantage of the situation have started mobilizing masses against the federation of Pakistan. The energy shortage is an issue of federal affordability due to poor compliance on fiscal framework and not an issue of scarcity in supply. The long queue at the service stations indicates that even the general public has a monetary cushion to buy, what the federal government cannot make available for their consumption.

This energy shortage in turn is hurting industrial growth, capacity and output, which according to the Institute of Public Policy, has resulted in a loss of $7 billion, during the fiscal year 2010-11 alone. As industrial operations due to the necessity of switching to captive power become expensive and unreliable, industrial setups have started relocating operations elsewhere, triggering loss of capital. On the fiscal side, the debt repayment burden is likely to increase this year as the repayment of the IMF debt begins. According to the IMF, foreign reserves are likely to decline from $14.8 billion in financial year 2010/11 to $12.1 billion in financial year 2011/12, slightly less than three months exports. If this trend continues, which is likely, it is not sustainable. With dwindling reserves, interbank rupee dollar parity is likely to change further in favor of the dollar, which will make imports expensive and exports more uncompetitive in the international market. Thus, further widening the fiscal deficit and increasing inflation, primarily due to expensive energy imports and monetary expansion to shoulder current expense.

In a run up to the approaching general elections in the country, some of the political parties are preparing for the situation, in the hope of sharing power at the federal level. Bringing fiscal stability in short run tops their wish list. Consultants working closely with the economic reform wing of one of the emerging political parties are working on the federal fiscal outlook, aimed at another debt rescheduling with the Paris Club creditors whereas, the default amount on the IMF's loan, is being termed as arrears. The short to midterm future budgetary framework is being planned in the resultant fiscal space, which can accommodate around five percent of fiscal deficit and ensure similar average growth over that next five years. This brings the country back, to where debt rescheduling was the only option, after nuclear detonations of May 1998. The only difference is that Pakistan is much more cash supple at the moment and fear of a structural default on the external end in the short run is negligible.

The burden of external repayment during the current financial year is up to $4.1 billion, putting pressure on the rupee, which is showing a mammoth slide, against its international currency counterparts.

At the heart of this cascading economic demise, is poor compliance on the agreed and declared fiscal framework, which was to contain the quantum of all federal expenditures up to the limits, which in budgetary term is less than 4.5 percent of the fiscal
deficit. The fiscal deficit in the first two quarters of the current financial year had reached 6.3 percent of the GDP. The financial year is likely to end at above 7 percent of the fiscal deficit.

The International Financial Institutions:
The World Bank’s Country Strategy framed for the period of 2010-13, which after a completed failure during the first year of the proposed implementation, 2010 has been extended for another year. Now the base period for the country partnership strategy is 2011-2014. In short the first implementation year was a non-starter. The World Bank has placed its country partnership strategy on four pillars: (i) improving economic governance; (ii) improving human development and social protection (iii) improving infrastructure to support growth; and (iv) improving security and reducing risk of conflict. There is a slight improvement in the social protection paradigm, primarily due to the Benazir Income Support Programme, which actually provides cash to vulnerable groups.

Pakistan as a country is earning less and spending more. The difference between available finance and actual spending is the fiscal deficit. In national budgets fiscal deficit is admissible to an extent if spent on robust development. Pakistan has spent most of it on consumption. This has led to a fall in foreign direct investment during the last year, which has resulted in a downturn in economic activity. The fall in foreign direct investment is by 0.7 percent of GDP which is detrimental to the overall sustainability of development.

At the end
The net result of this situation is stalled growth and high inflation. This is spreading poverty and making the poor suffer the most. Due to stalled growth the government has introduced indirect taxation. The recent spike in petroleum prices made on March 31st is calculated to yield addition 18 billion rupees to the federal government as petroleum levy.

For the general public it is direct inflation as a hike in transportation charges and additional cost added to the manufactured goods and services provided. Obviously, service providers are dependent on the market for their profitability and consumption.

Purely speaking on numbers, some of the ‘spikes and depressions’ are historical:

- Fall in the foreign direct investment (FDI) by 0.7 percent
- Total external debt in 2011 was $56.487 billion on which, servicing liability is $3.761 billion, it was $20.589 billion in 1990 on which, servicing liability was only servicing liability was $4.902 billion.
- Subsidy to the power sector: 1.5 percent of GDP
- A gap between exports of goods and services is $12.434 billion in 2011; it was $3.135 billion.
- Pakistan paid $24 million to the World Bank in lieu of servicing of previous loans making net flow of funds negative. In 1990 the Bank’s net transfers were $238 million.
- Total imports of goods and services have risen to $43.347 billion; it was only $9.35 billion in 1990.
- Gross capital formation in 2011 fell to 13.4 percent of the GDP; it was 18.9 percent of the GDP in 1990.
- At this base line situation, instead of taking measures to improve the overall economic and fiscal situation, the government has been forced to take revenue generation measures and fiscal measures: those that can slow monetary supply and reduce consumption. Measures, which are feared to have a negative effect, on performance of the incumbent regime in the upcoming general elections, due next year.

<table>
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<th>Income Group (Quintile)*</th>
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<td>Q2 (Rs. 8001-12000)</td>
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<td>Q3 (Rs. 12001-18000)</td>
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<td>Q5 (Above Rs. 35000)</td>
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<tr>
<td>Combined</td>
<td>183.66</td>
<td>181.76</td>
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Source: FBS
Depressed Growth
Dr. Vaqar Ahmed
vaqar@sdpi.org

The Finance Minister recently gave the President a detailed presentation on the end-of-year state of the economy. The President was informed that Pakistan's economy is on sound footing. On the fiscal side measures to broaden the tax base have started to yield results and austerity measures have controlled government expenditure. On the external front, Pakistan's exports during the period July - November 2011 have grown by 11 percent over the same period last year. The remittances from abroad have also grown during this period by 18 percent. The production side of the economy has shown some buoyancy as large-scale manufacturing has registered a growth of around 2 percent and inflation has come down to around 10 percent compared to 14 percent in November last year.

Somehow the above performance is not being seen to build economic confidence across the board. Since July 2011, the Pakistani Rupee has plummeted by 5 percent. The economy has started to panic as the time for debt repayment nears. While large production units adjusted to lack of energy and rising cost of doing production, the small and medium enterprises have left the arena on account of continued losses. In the face of prolonged global recession while economies have tried to facilitate the private sector, Pakistan has come forward with Gas Infrastructure Development Cess Bill and Petroleum Products (petroleum levy) Amendment Act. Both will imply additional burden for end consumers and also impose pressures on producer margins. This in turn will also hurt the competitiveness of Pakistan's exports which until recently have fared well on the back of rising global export prices. SBP has indicated two additional threats to inflation including rising electricity tariffs and higher wheat support price. Finally there are no significant facts that may suggest that this government's performance has in fact made life easy for the common man. The protests on account of gas and electricity shortages have become a common phenomenon. Poverty figures have not been released by the government on account of fears of a serious backlash. Similarly on account of a flawed system of keeping reliable statistics no one has a clear idea regarding the rising unemployment level in the country.

When such a glaring contrast appears in the way government views the economy and a common man experiences the paralysis at the policy level, one is forced to ask a couple of (otherwise unrelated) questions:

a. Is the finance minister really comparing his performance with a decent benchmark? Showing improvement in the current account of balance of payments in comparison to the previous year (with equally depressed growth) may not be a good barometer of success.

b. How is the performance of neighboring economies vis-à-vis Pakistan? This is an important question as Pakistan's growth forecast has recently been slashed to under 3.5 percent whereas all regional partners are growing at a rate beyond 6 percent.

c. Are external account gains (exports and remittances) really influencing macroeconomic fundamentals? Many have actually questioned if the ballooning inflows being recorded under remittance from abroad are really remittances in the traditional sense.

d. Which specific reforms can deliver pro-poor growth in the short to the medium term so that the misery of the common man can be mitigated?

Now let's turn to some important developments on the international front. Recently India and Bangladesh both have revised their export forecast due to the Euro
zone crisis and fears that it will impact South Asian economies. Up till now there has been no word of apprehension or announcement of safety measures, once this crisis starts to impact Pakistan. The garment sector for one which has already lost $800 million in export orders due to energy shortages and faces a stiff competition in EU market will come under further strain. This milieu coupled with effects of a prolonged global recession will impact Pakistan through 4 key transmission channels which include trade, remittances, availability of foreign assistance and foreign investment.

On the domestic front the reforms that are long stifling the economy are not in sight any time soon. The pressures on the budget deficit in the form of operational losses of public sector enterprises, untargeted subsidies, and inefficiency of public sector development programs are all here to stay for some time. The private sector has held back its sentiments on account of weakening legal and judicial framework, lack of security for assets and profits, poor contract enforcement and an overall rent seeking regime which does not allow genuine entrepreneurs to operate.

The Planning Commission did come forward with a growth strategy which was approved by the Prime Minister. Unfortunately the implementation of this strategy was never followed up with the ministries, regulatory bodies and provincial governments. The line ministers did not even bother to read the document and see how their turf could be reformed within the overall vision given in the Planning Commission’s document. Even the Finance Minister has given a very weak endorsement of the Planning Commission’s effort. May be Mahbub ul Haq was correct after all when he said that too often it is courage rather than lack of wisdom which holds us back.

The final question to ask now is where to from here? The election years are usually marked with expansionary fiscal policies where governments do not pay any heed to the rising budget deficit in turn resulting in substantial inflation. We have already seen that while the public sector development program has been slashed in case of infrastructure and social sector projects, the expenditure is increasingly being prioritized for expenditures under the Benazir Income Support Program. Sadly in the presence of the currency depreciation, the rising value of imports and continued government borrowing such social safety expenditures will only be seen as a money illusion.

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Audit Maneuvering that Ignited the Global Financial Meltdown

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The issue regarding the role of external financial auditors in managing good governance of the corporate sector by maintaining high standard of quality of auditing, had assumed a great momentum again especially during recent years (since 2002) due to a number of audit scandals and failures of serious magnitude at the international level such as Addisco, Parmalat, Ahold, Global Crossing and ENRON. In fact, the whole process of auditing requires very careful scrutiny of the financial statements, according to the audit codes and procedures with full professional commitment and mental alertness. In certain cases, the failure in achieving the very objective of audit may prove to be of grave consequences not only for the economy of the country alone but may lead to economic distortions even at the international level.

On analyzing the factors responsible for the recent global financial crisis, it may be concluded that besides a few other factors, non observance of auditing standards and ethics was basically responsible for the worldwide melt down. Tracing the causes of the international financial crisis, some considered the collapse of Lehman Brothers in US, as a major factor exacerbating this world wide phenomenon as a result of maneuvering of its accounts books by its management to create a misleading financial position of the firm in collusion with their auditors which led to their collapse. While a few analysts based on their analysis arrived at the conclusion that this phenomenon was the factor responsible for the reason for the world wide financial crisis.

Let us look into this episode and its grave consequences. The Lehman Brothers were a global financial service firm which was engaged in multifarious financial businesses such as investment banking, investment management, equity and fixed income sales including its primary business of dealing with US Treasury security market. It was the fourth largest investment bank in USA with 25,000 employees world wide prior to its bankruptcy in 2008. The report revealed that Lehman Brothers was practicing shuffling of bad assets by loaning to other firms in exchange for short term, at quarter ending.

According to the New York Times, 'repos for short for repurchase agreements- are standard practice on Wall
Street, but Lehman was very aggressive in engineering such deals which was covered up by its auditor Ernst & Young. The temporary concealment in the accounts books gave a false impression of a far healthier balance sheet which, indeed, used to quickly reclaim the assets, usually within days. The senior management along with the firm’s auditors at Ernst & Young was aware of the maneuvering of account books which is believed to have played a major role in unfolding of the late 2000s global financial debacle.

It was also further stated in the report that Lehman, fabricated its audit books in collusion with its audit firm. Through such means the auditors shed $39 billion at the end quarter of 2007 from its balance sheet, $49 billion in the first quarter of 2008 and $50 billion in the second quarter of 2008 to make it look impressive to the stakeholders, credit rating agencies and regulators. When these facts were leaked, it ignited an exodus of its clients on a massive scale resulting in drastic losses to it in stock market and devaluation of its assets. It caused colossal financial losses to Lehman Brothers, marking the largest bankruptcy in the US history which shook not only the country’s financial system to the core but other financial institutions that had a business link with it which spread almost all over the developed world.

Its collapse was a seminal event that greatly intensified the 2008 crisis. It is widely viewed as the watershed moment in the global financial crisis contributing to the erosion of close to $10 trillion in market capitalization from global equity markets in October 2008, the biggest monthly decline on record at the time. It resulted in a rise in sub-prime mortgage delinquencies and foreclosures, and resulting decline in securities backed by the said mortgage. The factor behind the failure of Lehman Brothers was accountancy fraud by its Auditors.

There is no doubt that the major factor responsible for the world wide financial melt down originated on account of the most spectacular and shocking balance sheet manipulations by the auditors of the Lehman Brothers, causing the closure of its business seriously distorting the international financial system. It shook many sectors of a number of countries ultimately causing severe recession in US and subsequently spreading to a sizeable number of countries of the world.

This incidence of the most serious nature alerted the economic managers of the business world and the corporate sector with admonition signals. They were cautioned to look afresh at whether the stringent regulatory framework adopted by USA framed under the commonly called Sarbanes-Oxley Act and followed by many developed countries, could avert audit fraud of such a high magnitude leading to corporate disasters. The issue seems to have greater significance in case of developing countries where the audit procedures, its rules and institutional arrangements such as audit committees and accounting oversight bodies as provided under the Sarbanes-Oxley Act, are not as sound as in the case of the developed countries.

The issue of audit quality, transparency and ethics is seen to have, therefore, drawn once again fresh
consideration regarding the rotation of audit firms instead of the audit partners. The principle of mandatory rotation of audit firm signifies that its engagement with the client should be limited for a specified period of time and on completion of its engagement tenure, it should be replaced by the other firm with a view to safeguard the auditors' independence and audit transparency. The objective is to ensure the interest of the corporate sector and of the shareholders of the listed companies against any corporate debacle either on account of any financial scandal or accounting failure.

It is now being realised by a section of people concerned with audit even in the developed countries that had there been a sound mechanism and system of the provision of a second eye on the account books in the corporate sector of the USA, its most serious financial crisis forming one of the worst recessions, enveloping almost the entire world could have been averted. The same belief may be noticed in the speech delivered by Jan. F. Oygard, Deputy Governor, Central Bank of Norway, recently in a seminar arranged by the Peace Research Institute of Oslo (PRI). He was of the view that international financial crisis has revealed weaknesses in the financial system which lacked financial sector regulations to be observed by the accounting firms.

The International Chamber of Commerce (ICC) though against the principle of compulsory audit firm rotation, conceded that it had been adopted or was under consideration by a number of national governments. In a recent important move, the European Commission while considering a radical structure of the audit industry expressed their plan to introduce mandatory rotation and caps on advisory services. Their Commissioner, Michel Barnier, in his policy statement stated that “the demise of big five firm Anderson, following the 2002 Enron scandal, demonstrated that the risk of a large auditor collapsing was not academic.” He further suggested that “with audit firms, as with other sectors, the status quo is not an option; the status quo will not be an option for the European Commission”.

### TRADE IN SERVICES

**February, 2012**

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Source: FBS
TRADE IN SERVICES
February, 2012

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Source: FBS

Governance and Numbers

During the last four years, due to various external and internal factors, the current government has not been able to deliver on the economic front. International financial institutes call it a failure of economic governance. The World Bank in Para 18 of the CPS report says it is unable to extend development policy funding under the proposed series of poverty reduction support, due to the slow pace of structural adjustment, particularly in tax policy and the power sector. Both of these reforms are fiscal in nature. It was agreed with the Bank that the Government of Pakistan will reduce the fiscal deficit below 3.5 percent of the Gross Domestic Product (GDP) and bring tax to GDP ratio to 12.7 percent of the GDP. This would have to be coupled with the reduction in power sector losses which at the moment are 1.5 percent of the GDP. Accepting Pakistan's GDP at $ 210 billion the 1.5 percent of the GDP is $ 3.15 billion or 286.65 billion rupees at the current inter bank selling rate. The tax to GDP ratio on the other side has fallen to 9.3 percent of the GDP, 3.4 percent short of the agreed target. The presumed loss is $ 7.14 billion or 674.31 billion rupee.

The net budgetary impact on bad governance in lieu of these two heads is 936.39 billion rupees ($10.29 billion). A number considerably bigger than the IMF's standby facility now aborted midway, due to non compliance by the government of Pakistan. In addition to this Pakistan has lost $ 7 billion due to non availability of electricity during the financial year 2010-11 alone, which is 63.7 billion in rupee terms. Here one is not trying to argue the case that whatever is being said by the World Bank or the IMF is a panacea for every economic ill. Structural reforms through IFIs support get criticized because such reforms tend to achieve macro economic stability at the cost of micro economic stability. Trying to achieve structural reforms in the absence of an effective social safety net would be the last thing any political government can do to its citizens especially in an election year.

The dilemma that we are facing is that neither the people of Pakistan are getting any relief from existing fiscal policies, nor are the IFIs happy with these policies. So whose agenda are our planners towing up? In the run up to the next general elections, we the people of Pakistan should ask all contenders of power to share their economic agenda in their manifestos.

Abid Qaiyum Suleri
Executive Director SDPI