

The Imminent Foreign Exchange Crisis

(Mahbub ul Haq)

We face today the prospect of a very disruptive foreign exchange crisis in the next few months. Unless the government takes immediate steps to avoid such a crisis, it would become extremely difficult to pick up the pieces later on. It is certainly not in the interest of any one in the country -- whether the general public or the government or the opposition political parties -- that Pakistan should be declared bankrupt by the international community.

The facts leading to such a crisis are painfully clear. There are outstanding short-term foreign exchange deposits of nearly \$ 9 billion today. These have been parked temporarily in Pakistan's banks, mostly by expatriates, to earn a somewhat higher return at a time when interest rates are quite low in the western world. This is private money, not public resources, which should have been kept separate -- as is the practice in other countries -- and not mixed up with our foreign exchange reserves. Unfortunately, most of this private money has already been spent by the government. There are only a little over \$ 1 billion left in foreign exchange reserves. If the depositors wish to take out their money tomorrow -- as they legally can do any time -- the government has no foreign exchange to pay them. It will have no option but to freeze all the foreign exchange deposits in such an eventuality or, in other words, to declare a default. The international implications of such an action will be simply horrendous. No nation will any longer honour Pakistan's letters of credit. No borrowing will be available from any source. Every import will have

to be paid for in cash foreign exchange -- which Pakistan simply cannot print. Rupee will depreciate wildly and could easily go down to Rs.50 to 100 to a U.S. dollar within a short time. Galloping inflation, unemployment and an economic collapse will be the inevitable result.

These are not very pleasant prospects, nor are they far-fetched predictions. They are a natural and inevitable outcome of treating privately-owned foreign exchange deposits as publicly-usable reserves, which is simply a disastrous mistake. Mexico made exactly the same mistake in treating its short term borrowings (testabones) as its public reserves. When there was a botched devaluation in November 1994, and massive capital flight took place as public confidence weakened in the viability of the Mexican economy, around \$ 40 billion of such short-term reserves flew out of the country within a few weeks and Mexico faced a state of bankruptcy. Despite a hurried rescue package of \$ 50 billion that President Clinton and IMF put together, Mexico has been reeling for the last two years. Mexican peso is now 7.6 to a dollar instead of 3.5 in 1994. Unemployment rate is over 30%. Mexican economy has contracted by nearly a quarter. And this despite the fact that Mexico was in far better financial shape in 1994 than Pakistan is today. [Check all the facts on Mexico].

The crisis of confidence that led to the mass exodus of foreign exchange from Mexico and many other countries can strike Pakistan any time with unpredictable force. It can arise from a number of events -- for example, if there is a spate of industrial strikes and disruptions of normal production in the country, or if many people die in political violence, or if the current imprudent imbalance between public income and spending escalates, or if there is a serious banking crisis because of the stuck-up loans of Rs.130

billion, or if mass exodus of illegal gains through corruption continues, or if there is a sharp rise in interest rates abroad, or if IMF insists on an "open float" of the rupee leading to a major depreciation of its value, or if IMF cancels its standby arrangements, or if external community concludes that Pakistan has been cooking its books and lying with vital financial statistics and comes to distrust Pakistan's economic management. The precise trigger points for such a crisis of confidence are always uncertain. But once confidence is shaken in Pakistan's currency, the crisis can hit with almost hurricane force. Pakistan is only a hair-breadth away from such a trigger point.

It is possible that such a crisis of confidence may not occur immediately and some fortunate external developments may save us. But it would be irresponsible to count on good luck as a substitute for good policy. In November 1995, Pakistan came quite close to such a point of external bankruptcy. Next time, the crisis is likely to be worse. Political confrontation between the government and the opposition is reaching its peak. Capital flight is beginning to escalate. Corruption, or at least the perception of rampant corruption, is fairly wide-spread, leading to a weakening of confidence in the Pakistan's economy. In addition, many foreign exchange deposit accounts are now becoming unencumbered -- with the gradual retirement of rupee loans taken against them -- and will become more easily mobile next time a crisis strikes. In a globalized economy, where \$ 1200 billion move around the globe every 24 hours at the mere push of computer keys, Pakistan's current reserves will not last for even five minutes if the foreign depositors decide to move them. This will happen particularly if rupee is freely floated, instead of the present "managed float", and if investors take a flight to dollars or other strong currencies

in the expectation of a major depreciation of the rupee. Such a capital flight often becomes a self-fulfilling prophecy, as the recent experience of many countries demonstrates.

It is often argued that such fears are exaggerated. Pakistan managed in the past with foreign exchange reserves as low as \$ 100 million. But the analogy is totally false. It is false because, in the past, we lived with a regulated foreign exchange regime and we could always choke off excess foreign exchange demand through government controls. It is false because we never had short-term foreign exchange deposits of \$ 9 billion in the past which can be moved in and out of the country at will since rupee is now convertible on current account and since Pakistanis can openly maintain foreign exchange accounts abroad whereas they were punished in the past for this practice. It is false because we have now fallen into a global financial ocean from a locally-managed pond and we either have to learn to swim by global rules or we shall drown.

I have been hesitant to talk about this issue because it is not wise to create panic through an open discussion of such sensitive financial matters. But I have now come to the conclusion that international markets already know all the facts and that our foreign exchange depositors have already placed their nervous fingers on the computer keys, so that it would be irresponsible not to warn the system about the impending foreign exchange crisis. After the Mexican crisis in 1994, many analysts concluded that the crisis may have been averted if there had been an open discussion of the underlying trends, including by the IMF.

What can be done? Of course, the long-term remedy is clear. The government must balance its budget - which it is trying to do though through means which are putting the burden of adjustment on the backs of the poor, rather than the rich, and which are

being resisted throughout the country. More important is the popular confidence in a government's ability to handle tough economic decisions in a fair and objective manner. The world has not discovered so far a viable substitute for a clean, honest government. In the last analysis, there is no mystery about good economic management. It consists of many simple steps, honestly taken. For example, collect due taxes without fear or favour. No loan write-off to influential people. Control of excessive public spending. An enlightened action programme for expansion of exports. A very prudent monetary policy. Economic decisions guided by national interests, not personal greed. Rule of law. Supremacy of powerful institutions, not powerful individuals. One can go on. But any such listing makes it clear that our economic policies and administration for the last few decades are headed in only one direction : an inevitable economic disaster. Economic laws are generally unforgiving. Nations can defy these laws with impunity for some time. But there is eventually a day of reckoning.

More than any quick fix, we need to realize that we are proceeding headlong into an economic crisis and that we need to pause and re-examine our basic national strategy. There is no point in blaming any particular government. The financial crisis has been building up for some time. This is an issue which is above party politics and above any narrow parochial interests. No one gains if the country faces a financial collapse.

The writer is President of the Human Development Centre and a former Finance and Planning Minister of Pakistan.