

GLOBAL FINANCIAL CRISIS: ITS IMPACT ON DEVELOPING COUNTRIES AND LESSONS FOR PAKISTAN

Muhammad Usman*

Abstract

The global financial crisis of 2008 was the worst of its kind since the Great Depression of the 1930s. It surfaced to notice in September 2008 with the failure of several large United States based financial firms. Its underlying causes had been reported following the subprime mortgage crisis. The failures of large financial institutions in the United States rapidly evolved into a global crisis resulting in European bank failures, declines in various stock indexes, and significant reductions in the market-value of equities and commodities worldwide. The crisis led to liquidity problems and the de-leveraging of financial institutions especially in the United States and Europe, which further accelerated the liquidity crisis. World political leaders and central bank directors coordinated their efforts to reduce fears but the crisis progressed into a currency crisis with investors transferring vast capital resources into stronger currencies leading many emergent economies to seek aid from the International Monetary Fund. International Monetary Fund's and World Bank's Structural Adjustment Programmes have returned to countries, including Pakistan, which were doing well before the ongoing financial crisis.¹ Therefore, the financial crisis carries many pertinent lessons for the economies of countries like Pakistan. The paper aims at highlighting the salient aspects of the global financial crisis, its impact on developing countries and drawing lessons for Pakistan.

Towards a Global Financial Crisis

Historical Perspective

Worldwide, the Great Depression started in 1929 and ended between the late 1930s or early 1940s for different countries. As the largest and most important economic depression in

* Defence Analyst.

¹ Huzaima Bukhari and Dr Ikram ul Haq, "Is Capitalism 'at bay'?" *The News* (Islamabad), November 9, 2008.

modern history, it is now a benchmark for how far the world's economy can fall. The Great Depression originated in the United States starting with the stock market crash on October 29, 1929, known as Black Tuesday. The end of the depression in the U.S. is associated with the onset of the war economy of World War II, beginning around 1939. The depression had devastating effects in the developed and developing countries. International trade was deeply affected, as were personal incomes, tax revenues, prices, and profits. Cities all around the world were hit hard, especially those dependent on heavy industry. Construction virtually halted in many countries. Farming and rural areas suffered as crop prices fell by 40 to 60 per cent. Facing plummeting demand with few alternative sources of jobs, areas dependent on primary industries, such as farming, mining and logging, suffered the most. However, even shortly after the Wall Street Crash of 1929, optimism persisted; John D. Rockefeller said that "these are days when many are discouraged. In the 93 years of my life, depressions have come and gone. Prosperity has always returned and will again." Most countries set up relief programmes, and suffered political upheavals, pushing them to the left or right.

The present financial crisis began in the developed countries and spread to the rest of the world, touching the emerging economies like Russia, China, India, Brazil and East Europe.² It is not the first time that the global financial system has suffered a crisis. The 1997 crash caused devastation in countries like Indonesia and Thailand. The bursting of the IT bubble in 2000 led to a recession in the US in 2001. The lowering of interest rates in the US to overcome the recession led to liberal lending for mortgages and building. The housing bubble finally burst in 2007 inspiring the sub-prime crisis. The innovative financial engineering concealed and dispersed the risk attached to bad lending practices of the lending institutions.

Global Financial System

The global financial system comprises institutions and regulations. The main players are the institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government departments, e.g. central banks and finance ministries, and private

² Arvind Gupta, "Global Financial Crisis: Is There a Way Out?," *Institute of Defence Studies and Analyses*, New Delhi, (November 5, 2008).

institutions acting on the global scale, e.g., banks and hedge funds or private investment funds.

Forecast of the Crisis

Besides many other studies by international financial institutions (IFIs), a Deloitte Research Study titled *Global Economic Outlook 2007 (Is a crisis imminent or are things better than we thought?)* predicted the crisis in these words, “The US invests far more than it saves (its current account deficit) and the rest of the world saves far more than it invests (a current account surplus). This is the big imbalance in the global economy. It involves a massive flow of capital to the US from the rest of the world. The magnitude of this transfer is unprecedented in recent history and probably cannot be sustained indefinitely. Therefore, when it ends, it could have a destabilizing effect on the global economy, if only because of the shifting of gears.”³ The international financial system has failed to deliver on two accounts, (i) preventing instability and crises and (ii) transferring resources from richer to poorer economies.⁴

Global Trends

Global trends leading to the crisis were:

- a. **High Commodity Prices:** In 2008, the prices of many commodities, notably oil and food, rose so high as to cause genuine economic damage. In January 2008, oil prices surpassed \$100 a barrel for the first time, the first of many price milestones passed that year. By July the price of oil reached as high as \$147 a barrel although prices fell soon after.
- b. **Trade:** In mid-October 2008, the Baltic Dry Index, a measure of shipping volume, fell by 50 per cent in one week, as the credit crunch made it difficult for exporters to obtain letters of credit.

³ “Global Economic Outlook 2007: Is A Crisis Imminent, or Are Things Better Than we Thought?”, *A Deloitte Research Study*, http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/dtt_GlobEcon07_091506.pdf.

⁴ Jayati Ghosh, “Global Inequity Must End,” *Daily Times* (Islamabad), October 26, 2008.

- c. **Inflation:** In February 2008, Reuters reported that global inflation was at historic levels, and that domestic inflation was at 10 to 20 year highs for many nations. "Excess money supply around the globe, a surge in growth supported by easy monetary policy in Asia, speculation in commodities, agricultural failure, the rising cost of imports from China and rising demand of food and commodities in the fast growing emerging markets," have been named as possible reasons for the inflation. In mid-2008, IMF data indicated that inflation was highest in the oil-exporting countries and developing Asia on account of the rise in oil and food prices.
- d. **Unemployment:** The International Labour Organization predicts that at least 20 million jobs are likely to be lost by the end of 2009 due to the crisis - mostly in "construction, real estate, financial services, and the auto sector" - bringing world unemployment above 200 million for the first time.

Impact of Global Financial Crisis

Following a period of economic boom, the financial bubble has burst. The collapse of the US sub-prime mortgage market and the reversal of the housing boom in other industrialized economies had ripple effects around the world. Other weaknesses in the global financial system have also surfaced. Some financial products and instruments have become so complex and twisted, that as things started to unravel, trust in the whole system started to fail. The problem was so severe that some of the world's largest financial institutions collapsed. Others were bought out by their competition at low prices and in other cases, the governments of the wealthiest nations in the world had to resort to extensive bailout and rescue packages for the remaining large banks and financial institutions. Towards the end of October 2008, the Bank of England said the world's financial firms had now lost £1.8 trillion (\$2.8 trillion) as a result of the continuing credit crisis. As a result, says the United Nation's Conference on Trade and Development in its Trade and Development Report 2008 as summarized by the Third World Network: The global economy is teetering on the brink of recession. The downturn after four years of fast growth is due to the global fallout from the financial crisis in the United States, the bursting of the housing bubbles in the US and in other large economies, soaring commodity prices, increasingly restrictive monetary

policies in a number of countries, and stock market volatility. “Fallout from the collapse of the US mortgage market and the reversal of the housing boom in various important countries has turned out to be more profound and persistent than expected in 2007 and beginning of 2008. As more and more evidence is gathered and as the lag effects are showing up, we are seeing more and more countries around the world being affected by these rather profound and persistent negative effects from the reversal of housing booms in various countries”.⁵ The IMF foresaw the global economy's growth slowing to 3.7 per cent in 2008 and 2.2 per cent in 2009, i.e., well below the 3 per cent level the fund traditionally considers the threshold for a world recession.⁶

US Bailout Plan – 2008

The US has implemented a \$700 billion bailout package. Other countries are not far behind. The combined European Union bailout packages ran about \$2.3 trillion. UK’s bailout package amounts to about \$692 billion; Germany has offered about \$670 billion; France \$490 billion; Ireland \$545 billion and Spain \$140 billion. Japan has announced \$275 billion worth of bailout package. Several countries have coordinated their interest rate cuts to overcome liquidity problems. Despite these massive, unprecedented bailouts, the financial system remains risk prone and volatile.⁷ The Emergency Economic Stabilization Act of 2008, commonly referred to as a bailout of the U.S. financial system, is a law authorizing the United States Secretary of the Treasury to spend up to \$700 billion to purchase distressed assets, especially mortgage-backed securities, from the nation's banks. Opinions about the plan clashed:

- a. **Proponents’ View:** Proponents of the bailout plan argued that the market intervention called for by the plan was vital to prevent further erosion of confidence in the U.S. credit markets and that failure to act could lead to an economic depression.

⁵ Kanaga Raja, “Economic Outlook Gloomy, Risks to South: Say UNCTAD,” *Third World Network*, September 4, 2008, <http://www.twinside.org.sg/title2/finance/twninfofinance20080804.htm>.

⁶ Tom Barkley, “IMF Slashes World Growth Forecasts Again,” *Silicon Investor*, <http://siliconinvestor.advfn.com/readmsg.aspx?msgid=25152632>

⁷ Op. cit., 2.

- b. **Opponents' View:** Opponents of the rescue plan argued that since the problems of the American economy were created by excess credit and debt, a massive infusion of credit and debt into the economy would only exacerbate the problems with the economy. They asked for better alternatives to resolve the crisis.⁸

Global Financial Crisis- A Timeline

A *timeline*⁹ of salient events of the global financial crisis from 2007 to 2009 is attached as Annex A.

Impact on Developing Countries

Impact on Developing Countries

Of historically unprecedented magnitude and scope, this crisis has serious implications for people, particularly for poor people in poor countries¹⁰. In fact, when crisis strikes, whether it is an economic meltdown like what South Korea experienced in 1998 or a natural disaster in rich countries such as Katrina in the United States in 2005 or the Kobe earthquake in 1998 in Japan, it is the poor and the disempowered whose lives are most thrown off balance and are the slowest to recover. Not only is it occurring in a world of unprecedented financial globalization, where the

⁸ "Emergency Economic Stabilisation Act of 2008", http://en.wikipedia.org/wiki/Emergency_Economic_Stabilization_Act_of_2008.

⁹ Mauro F. Guillen, "The Global Economic & Financial Crisis: A Timeline", *The Lauder Institute*, University of Pennsylvania, May 15, 2009, <http://lauder.wharton.upenn.edu/pdf/Chronology%20Economic%20%20Financial%20Crisis.pdf>.

¹⁰ Sakiko Fukuda-Parr, "The Human Impact of the Financial Crisis on Poor and Disempowered People and Countries," *The New School*, New York, October 30, 2008, [http://docs.google.com/viewer?a=v&q=cache:eH5-Xq7H1mcJ:www.un.org/ga/president/63/interactive/gfc/sakiko_p.pdf+Sakiko+Fukuda-Parr,+"The+Human+Impact+of+the+Financial+Crisis+on+Poor+and+Disempowered+People+and+Countries,"+The+New+School,+New+York+\(October+2008\).&hl=en&gl=pk&pid=bl&srcid=ADGEESi0JFapewuzdt_IKsqP39dhEdXiSt7qHDvo7g1nLPFLu0SnfxTNApRQQRWmgxzyYgUO2EP5qhnCJrwENhbi8w9LU8j2YC7inBDqLfnbXaoO-K-5GK0Q9qTtTtMsrl6gyirCOUg&sig=AHIEtbSuCOdC00xm-qwHk8sEuwwmoFPC1w](http://docs.google.com/viewer?a=v&q=cache:eH5-Xq7H1mcJ:www.un.org/ga/president/63/interactive/gfc/sakiko_p.pdf+Sakiko+Fukuda-Parr,+"The+Human+Impact+of+the+Financial+Crisis+on+Poor+and+Disempowered+People+and+Countries,"+The+New+School,+New+York+(October+2008).&hl=en&gl=pk&pid=bl&srcid=ADGEESi0JFapewuzdt_IKsqP39dhEdXiSt7qHDvo7g1nLPFLu0SnfxTNApRQQRWmgxzyYgUO2EP5qhnCJrwENhbi8w9LU8j2YC7inBDqLfnbXaoO-K-5GK0Q9qTtTtMsrl6gyirCOUg&sig=AHIEtbSuCOdC00xm-qwHk8sEuwwmoFPC1w).

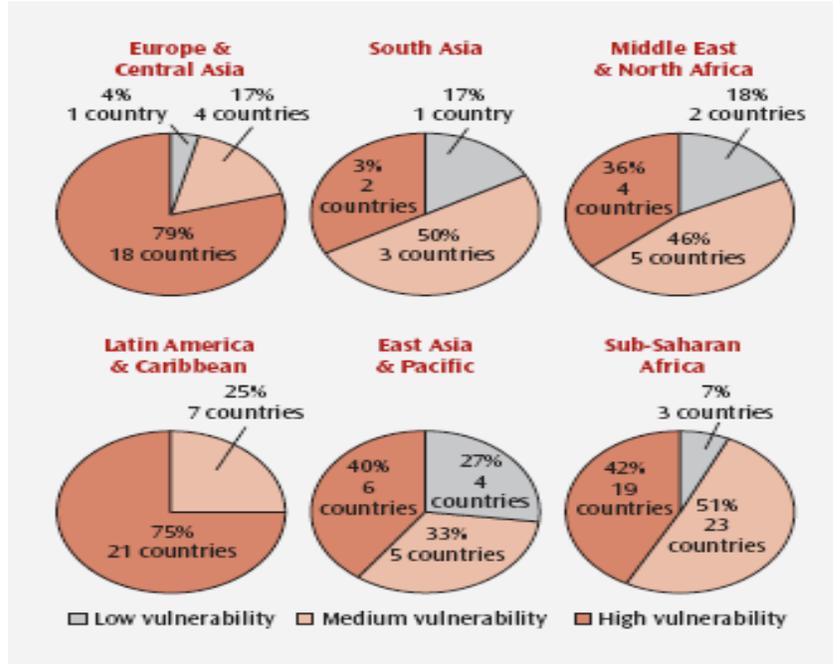
financial sector plays a historically large role in economic activity, but it is also an imported crisis, with origins outside the developing world. The crisis also comes on the heels of a major global shock from high food and fuel prices. The World Bank Report on “Global Financial Crisis and Implications for Developing Countries” described the impact of financial crisis in following broad terms:¹¹

- a. Virtually no country, developing or industrial, has escaped the impact of the widening crisis, although those countries with stronger fundamentals and less integration into the global economy going into the crisis have generally been less affected.
- b. Consensus growth projections for developed countries in 2009 are being slashed and world trade volumes may fall for the first time since the 1982 recession.
- c. Earlier concerns about rapid credit growth in some developing countries have been proven valid.
- d. Investment is expected to suffer as it bears much of the direct impact of the financial crisis.
- e. Should the freeze in credit markets not thaw quickly enough, the consequences for developing countries could be severe.
- f. Remittances from host countries are expected to decline in response to the global slowdown but the impact on flows to recipient countries will depend significantly on exchange rates.
- g. Low-income countries will be significantly affected by the crisis even though the channels of transmission are likely to be quite different from those operating in emerging markets.
- h. As a result of the food and fuel crises, the number of extremely poor was estimated to have increased by at least 100 million.
- i. Recent declines in food and fuel prices do not imply that pressures and problems have disappeared.

¹¹ World Bank, “Global Financial Crisis and Implications for Developing Countries”, *G-20 Finance Ministers’ Meeting*, Sao Paulo, Brazil, November 8, 2008, <http://www.worldbank.org/financialcrisis/pdf/G20FinBackgroundpaper.pdf>.

- j. The challenges faced by developing countries earlier are now compounded by the pressures emanating from the global financial crisis. For vulnerabilities in emerging and developing countries, see fig below.

FIGURE 1.5 Vulnerabilities in emerging and developing countries



Source: IMF.

Note: Vulnerabilities are measured on the basis of developments in exports, foreign direct investment, remittances flows, external debt ratios (emerging markets), and aid flows (low-income countries). For a detailed explanation of the methodology, see IMF 2009.

- k. While the effects will vary from country to country, the economic impacts could also include:¹²
- (1) Weaker export revenues;
 - (2) Further pressures on current accounts and balance of payment;
 - (3) Lower investment and growth rates;
 - (4) Lost employment.
- l. There could also be social effects:
- (1) Lower growth translating into higher poverty;

¹² Dirk Willem te Velde, "The Global Financial Crisis and Developing Countries," *Overseas Development Institute (ODI)*, UK, (October 2008).

- (2) More crime, weaker health systems and even more difficulties meeting the Millennium Development Goals.

The Way Forward

Developing countries especially South Asian countries can do a number of things to reduce the adverse effects of the financial crisis and prepare the way for a resumption of rapid growth in 2010:

- a. Policy attention needs to focus on creating as much additional fiscal space as possible to prop up the domestic economy while preserving macro economic stability. As noted, the decline in global fuel and food prices has provided a welcome opportunity to regain the loss in fiscal space owing to previous higher prices. This gain should not be wasted in reversing the policy changes made in aligning domestic prices better to the global prices, especially domestic fuel prices. Additionally, efforts must intensify to raise public revenues. All South Asian countries have scope for raising revenues through strengthening tax compliance and aligning better public utility prices to their production costs.
- b. A careful look at expenditure priorities is in order. Public spending that creates jobs, especially for the poor, will be essential. Important examples include rural and other infrastructure (rural roads, irrigation facilities, rural power); basic urban services; and well-designed safety net programmes.
- c. The ongoing efforts to increase the efficiency and effectiveness of the banking sector must continue. These measures should aim at lowering intermediation cost, reducing non-performing loans, improving banking services, and strengthening prudential regulations.
- d. In the face of sliding world demand, efforts to raise domestic productivity and competitiveness become critical factors for protecting export market shares. The scope for increasing the competitiveness of the South Asian economies is large and includes policies to improve the availability of infrastructure, lower the transaction cost of private investment through

better governance, and reduce restrictions on trade and investment.

- e. In an environment of constrained resources, greater attention to improving implementation capacity and corruption prevention in public spending becomes even more important.

Global Economic Summit

Global economic summit of G-20 comprising Argentina, Australia, Brazil, Britain, Canada, China, European Union, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, South Africa, Saudi Arabia, South Korea, Turkey and United States was held at Washington on November 15, 2008. The 3,600-word declaration mentioned the following actions to be taken:¹³

- a. Continue vigorous efforts and take whatever further actions are necessary to stabilize the financial system.
- b. Recognize the importance of monetary policy support, as deemed appropriate to domestic conditions.
- c. Use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability.
- d. Help emerging and developing economies gain access to finance in current difficult financial conditions, including through liquidity facilities and programme support. We stress the International Monetary Fund's (IMF) important role in crisis response, welcome its new short-term liquidity facility, and urge the ongoing review of its instruments and facilities to ensure flexibility.
- e. Encourage the World Bank and other multilateral development banks to use their full capacity in support of their development agenda, and we welcome the recent introduction of new facilities by the World Bank in the areas of infrastructure and trade finance.

¹³ "G-20 Declaration on Financial Crisis", *CNN-Money* (Online), November 15, 2008, http://money.cnn.com/2008/11/15/news/international/g20_declaration/index.htm.

- f. Ensure that the IMF, World Bank and others have sufficient resources to continue playing their role in overcoming the crisis.¹⁴

World Bank's Global Monitoring Report-2009

The prospects for an economic recovery, essential for alleviating poverty, are highly dependent on effective policy actions to restore confidence in the financial system and to counter falling international demand. While much of the responsibility for restoring global growth lies with policy makers in advanced economies, emerging and developing countries have a key role to play in improving the growth outlook, maintaining macroeconomic stability, and strengthening the international financial system. In World Bank's view:¹⁵

- a. The world faces the severest credit crunch and recession since the Great Depression. Developing countries' growth prospects and access to external financing are subject to unusually large downside risks.
- b. Though originating in advanced countries, the crisis is hitting developing countries hard.
- c. While transmission channels may differ, both emerging market and low-income countries will be severely impacted.
- d. Economic policy responses should be adapted to country circumstances: countries with strong fundamentals may have room for monetary and fiscal stimulus, while those in weaker macroeconomic positions and with limited access to external financing will have less room for policy maneuver; some may need to undertake fiscal consolidation.
- e. Advanced, emerging, and developing countries should take comprehensive action to resolve liquidity and solvency problems in the banking system and strengthen prudential supervision.
- f. Development aid must be increased to help countries cope with the crisis.
- g. It is crucial to maintain an open trade and exchange system.

¹⁴ www.independent.co.uk, (accessed November 16, 2008).

¹⁵ "Global Financial Crisis and its Impact on Developing Countries: Global Monitoring Report – 2009," *World Bank*, 23.

Possible Policy Responses

The current macro economic and social challenges posed by the global financial crisis require a much better understanding of appropriate policy responses:

- a. There needs to be a better understanding of what can provide financial stability, how cross-border cooperation can help to provide the public good of international financial rules and systems, and what the most appropriate rules are with respect to development;
- b. There needs to be an understanding of whether and how developing countries can minimize the financial contagion;
- c. Developing countries also need to manage the implications of the current economic slowdown – after a period of strong and continued growth in developing countries, which has promoted interest in structural factors of growth;
- d. Developing countries need to understand the social outcomes and provide appropriate social protection schemes.

Islamic Banking - The Silver Lining

A number of financial crises that gripped the world over the last three to four decades have put the international financial system in question. The weaknesses of the prevailing interest-based financial system create a strong rationale for introducing a new system of the international finance. The principles of Islamic banking deter interest and introduce in its place the principle of risk/reward-sharing. Financing through the Islamic modes expands in tandem with the real economy and helps to curb excessive credit expansion, which leads to lavishness and contributes to the instability in the international financial markets. There is a need to find out solutions of current crisis through the principles of Islamic financial system. This alternative system does not allow short selling because one may only sell something one owns. Islamic banking is currently one of the fastest growing types of finance in some Muslim countries. There are advantages in considering or even applying some of the basic Islamic principles involved to come out of the current crisis. To be sure, while the world's first Islamic bank was founded back in 1975, it is only in the last five years or so that Islamic finance has surged. Salient aspects of Islamic banking are:

- a. Size of Islamic financial industry reached US\$ 250 billion and is growing annually at the rate of 15 per cent per annum;¹⁶
- b. 42 countries had Islamic banking institutions out of which 27 are Muslim countries including Bahrain, UAE, Saudi Arabia, Malaysia, Brunei and Pakistan and 15 are non-Muslim countries including USA, UK, Canada, Switzerland, South Africa and Australia;
- c. Leading foreign banks, Standard Chartered Bank, Citibank, HSBC and ABN AMRO, had opened Islamic banking windows or subsidiaries.

Pakistan's Perspective

Impact on Pakistan

In South Asia, the second largest economy, Pakistan, faces serious vulnerability in the region. High fiscal and current account deficits, rapid inflation, low reserves, a weak currency, and a fragile economy put Pakistan in a very difficult situation to face the global financial crisis. China and India adopted stimulation packages and have recovered sooner than other countries. These countries had sufficient foreign exchange reserves and could afford stimulation package. Pakistan could not do so due to weak foreign exchange position at the time of onset of the crisis. Pakistan was also faced with political upheaval at that time. Therefore, Pakistan was forced to cut back on its expenditure and could not afford stimulation packages like those of China and India. Efforts are now underway to arrest the decline of the macro economy through demand management including tightening of monetary and fiscal policies. Pakistan's ability to borrow externally is already heavily constrained and bond spreads are very high. The global financial crisis means that non-official foreign capital flows will be even more expensive. The contagion effects on domestic financial sector could be substantial, but stress tests suggest that the banking sector as a whole is likely to withstand the shocks.¹⁷ This is mainly due to the improved health of the financial sector

¹⁶ Muhammad Imran, "Islamic Banking Current Scenario and Way Ahead," *Standard Chartered Bank*, November 17, 2005.

¹⁷ "Global Financial Crisis: Implications for South Asia," <http://docs.google.com/viewer?a=v&q=cache:AK3NB-PJoLAJ:siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1171488994713/3455847-1212859608658/5080465->

based on past reforms. In November 2008, to avoid a default on foreign debt payments, Pakistan developed a stabilization programme, which was supported by the International Monetary Fund (IMF)¹⁸. In 2007-08, the sharp rise in international oil and food (specifically wheat) prices had led to rapidly expanding macroeconomic imbalances in Pakistan. The effects of the global slowdown have also been transmitted through the trade balance, with a slowdown in global demand and fall in commodity prices having varying effects. These effects are enunciated as under:

- a. **Financial Sector:** The operating environment of the financial sector experienced significant deterioration in 2007 and 2008, due to a confluence of factors emanating from both the domestic and international economic and financial developments. While the domestic environment was characterized by weakening macroeconomic indicators and the uncertainty caused by the prolonged period of political transition, the global financial crisis and the commodity price hike had a feedback impact on the financial sector through the real sector of the economy.
- b. **Capital Flows and Workers' Remittances:** A beleaguered international economic environment has held back Foreign Investment as it posted a decline of 47.5 per cent during the first ten months of 2008-09 compared to the corresponding period of the previous year.¹⁹ Some Asian economies have witnessed an anticipated fall in workers' remittances as unemployment grew in advanced host economies. However, workers' remittances to Pakistan remained vigorous and unaffected by the crisis, totaling US\$ 6.36 billion in July-April

1224618094138/SARGlobalFinancialCrisis.pdf+ "Global+ Financial+ Crisis: +I mplications+ for+ South+ Asia," + www.worldbank.org&chl=en&gl=pk&sig= AHIEtbSRIsJaFpx_N7tNjCjXBoTT9IzvMQ (accessed October 21, 2008).

¹⁸ "Pakistan Country Overview 2009: Bank's Assistance to Pakistan", *World Bank*, <http://www.worldbank.org.pk/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/PAKISTANEXTN/0,,contentMDK:20131431~menuPK:293057~pagePK:1497618~piPK:217854~theSitePK:293052,00.html>.

¹⁹ Mohammed Mansoor Ali, "Global Financial Crisis: Impact on Pakistan and Policy Response" (paper presented at Regional High-Level Workshop on Strengthening the Response to the Global Financial Crisis in Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies, Dhaka, Bangladesh, July 27-30, 2009).

2008-09 as against US\$ 5.32 billion in the corresponding period last year, a rise of 19.5 per cent.

- c. **Commodity Prices and Trade:** An unprecedented hike in international commodity prices wreaked havoc on Pakistan's external sector during 2007-08, with the current account widening significantly.²⁰ However, in the wake of a reduction in global demand and the resultant decrease in commodity prices, the import bill has reduced significantly, decreasing the current account deficit
- d. **External Financing:** The global crisis has restricted Pakistan's ability to tap international debt capital markets to raise funds. Pakistan's presence in the international capital markets in 2008-09 was limited to the repayment of Eurobond amounting to US\$ 500 million²¹ made in February 2009 with no new issuance at the backdrop of financial crisis engulfing the global markets.

Macro-Economic Stabilization Plan 2008-10

A panel of Planning Commission of Pakistan comprising economists have unveiled a proposed macro-economic stabilization plan for 2008-10 seeking a Rs 115 billion cut in the country's expenditures. However, the macroeconomic situation remains fragile and the medium-term outlook is uncertain. Progress with the implementation of reforms has been uneven, with inadequate measures taken to boost revenue and control public spending.²² However, the scope for counter cyclical fiscal policy is limited at this time, but Pakistan is taking measures to protect social spending to help reduce the adverse effects of the crisis on the poor.

Fiscal Year 2008-09

Economic activity significantly slowed down in 2008-09. The current account deficit narrowed to 5.1 per cent of GDP. Overseas remittances have increased but financial inflows (such as FDI and portfolio investment) dropped sharply—by over 37 per cent—due to macroeconomic instability, deteriorating security situation and global

²⁰ "2009 Pakistan Economic Update", *World Bank*, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:22369850~pagePK:2865106~piPK:2865128~theSitePK:223547,00.html>.

²¹ Ibid.

²² Ibid.

recession. But with the assistance of IMF disbursements, SBP foreign exchange reserves rebounded to about \$9.1 billion (2.9 months of imports) by end-June 2009.²³ However, fiscal problems continued during 2008-09 and the fiscal deficit target was 5.2 per cent of GDP. Overall revenues fell substantially short of the target primarily due to a drop in tax revenues as the economic slowdown reduced Pakistan's two main tax bases-manufacturing and imports.

Economic Growth and Investment 2008-2009

While the economic environment in Pakistan remained inhospitable for growth and investment during the first half of 2008-09, firm policy action to restore macroeconomic stability paid off dividends by December. The Rupee stabilized, after losing 19.3 per cent in value against the US Dollar.²⁴ This occurred on a build-up of foreign exchange reserves from November onwards, when Pakistan entered an IMF programme, after the country's international liquidity had declined to an import cover of only several weeks. Confidence in the banking system and financial markets was largely restored from December, with the second half of 2008-09 exhibiting greater stability and positive trends in virtually all macroeconomic indicators barring inflation.

Fiscal Year 2009-10

The first two months of FY 2009-10 suggest that fiscal instability will continue, and the first quarter fiscal deficit target will likely exceed the estimates. Revenues have continued to under perform.²⁵

Vulnerability

Pakistan's vulnerability has been summarized by World Bank as under:²⁶

²³ Ibid.

²⁴ "Economic Survey 2008-2009," *Ministry of Finance, Government of Pakistan*, Islamabad.

²⁵ "2009 Pakistan Economic Update", *World Bank*, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:22369850~pagePK:2865106~piPK:2865128~theSitePK:223547,00.html>.

²⁶ "2009 Pakistan Economic Update", *World Bank*, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:22369850~pagePK:2865106~piPK:2865128~theSitePK:223547,00.html>.

- a. Failure to raise revenues in future would further intensify Pakistan's vulnerability to external shocks, and jeopardize development efforts by limiting resources available for planned investments in human and physical infrastructure.
- b. Pakistan's high economic growth in the earlier part of this decade was in part by heavy reliance on external financing and on expansionary fiscal stance, while revenues and savings remained stagnant.
- c. Reliance on external financing left the economy vulnerable to external shocks, which came in 2007-08 and led to a balance of payments crisis. To reduce the economy's vulnerability, expanding domestic revenue mobilization would be critical.

Friends of Pakistan Forum

Friends of Pakistan (now called Friends of Democratic Pakistan) forum comprising Saudi Arabia, UAE, China, France, England, US, Canada, Turkey, Australia, Italy, UN and European Union was launched on September 26, 2008. On November 17, 2008, the Friends of Pakistan met at Abu Dhabi acknowledging that Pakistan is facing "formidable challenges and needs a well-coordinated international cooperation". The forum agreed on a broad framework for cooperation with Pakistan in four major sectors including cooperation in the fields of development, security, energy and institution-building.²⁷ The Friends of Democratic Pakistan forum held its first Summit in New York on September 24, 2009, under the co-chairmanship of President Barack Obama, President Asif Ali Zardari, and Prime Minister Gordon Brown. Also attending were twelve heads of government and senior representatives of nine countries and five multilateral institutions. The pledges made so far have yet to materialize.

Lessons Learnt

The ongoing global financial crisis has a negative impact on the economies of developed countries in general and developing economies in particular. Nevertheless, a few lessons can be drawn to minimize the negative fallout of global financial crisis:

²⁷ *Dawn* (Online Edition), November 18, 2008.

-
- a. **Policy Measures:** Following policy measures may be adopted to address the challenges of financial crisis:
- (1) Significant cuts be made in the expenditures to curtail aggregate demand;
 - (2) Tight monetary policy should be followed by the State Bank of Pakistan to contain inflationary spiral;
 - (3) Prioritize the scarce government expenditures available for development-related programmes;
 - (4) Implement improved and transparent targeting of income support and other programmes aimed at the poor and the vulnerable groups;
 - (5) Intensify public-private partnerships with the objective of making private investments, including foreign investors, the most important funding source for economic development;
 - (6) Reinforce the importance of sound governance, managerial and systemic mechanisms to ensure that investments in the social sector are cost-effective and aimed at output-oriented service delivery.
- b. **Agrarian Solutions:** Pakistan is an agrarian economy. The input industry for agriculture and livestock including dairy sector be domestically developed and cost of production be reduced to encourage farmers. If we become self-sufficient in food, half of our problems will be addressed.
- c. **Contingency Planning:** Government and other institutions including the defence ministry should evolve a comprehensive system of contingency planning to meet the unexpected financial/economic crisis.
- d. **Checks and Balances:** A system of checks and balances should be enforced in the national economic system to effectively monitor the irregularities like illegal flight of capital etc and eliminate corruption. This measure will curtail depletion of foreign exchange in the country and ensure availability of funds for social development.
- e. **Banking Sector Reforms:** Pakistan's banking sector is made up of 53 banks, which include 30 commercial banks, four specialized banks, six Islamic banks, seven development financial institutions and six micro-finance banks. Reforms should be introduced in the banking sector to channel savings

for productivity rather than for non-productive loans to customers. The banks should transfer benefits and profits to the customers and help in poverty alleviation in the country.

- f. **International Finance Institutions (IFIs):** The bailout packages offered by IFIs are very hazardous and may be adopted as a last resort because conditions like the withdrawal of subsidies badly affects the poor. Moreover, these IFIs ask for imposing agricultural tax etcetera, which can impede that sector's growth.
- g. **Friends of Democratic Pakistan:** Forums like the Friends of Democratic Pakistan should be asked to provide meaningful support beyond mere rhetoric and promises. Regular interaction with these forums is likely to bring positive response from them.
- h. **Forex Remittances:** Some countries are much smaller than Pakistan but receive more forex remittances from their expatriates. Our overseas community needs to support the country by increasing forex remittances. Government should provide more incentives to the overseas community in this regard.
- i. **Economic and Financial Intelligence:** "The Economist" Intelligence Unit compiles the economic and financial forecast of all countries. Similarly, we need to have economic and financial intelligence outfits to give feedback and early warning to national finance institutions regarding emerging trends in these fields for timely steps to counter the crisis.
- j. **Economic Activity Bureau (EAB):** There is a need to establish an Economic Activity Bureau to accelerate economic activity in the country.
- k. **Islamic Banking:** State Bank of Pakistan has already taken a quantum jump and concrete steps in this direction. We need to capitalize on this base for betterment of our economy.

Conclusion

The newspapers in the last quarter of 2008 were stirring emotions with headlines such as "meltdown", "economic crisis", "global recession" and "billions written-off". For the developing world, the rise in food prices as well as the knock-on effects from the financial instability and uncertainty

in industrialized nations are having a compounding effect. High fuel costs, soaring commodity prices together with fears of global recession are worrying many developing countries, including Pakistan. There is a need to accept the challenges emerging out of this crisis, learn the lessons from other nations like China, explore opportunities in adversity and equip ourselves to pre-empt such challenges in future. A Chinese proverb will suffice to say, "A crisis is an opportunity riding the dangerous wind." The global financial crisis is an ongoing issue which put a number of countries into a recession and the major stock indexes into a downward spiral. The events described above started a plethora of problems in the economic and political world and continued through the end of 2008 into the beginning of 2009. Its effects are not likely to end soon. ■

Annex-A

GLOBAL FINANCIAL CRISIS - A TIMELINE (2007-2009)

Date	Event
7 February 2007	HSBC announces losses linked to U.S. sub prime mortgages.
17 May 2007	Federal Reserve Chairman Ben Bernanke said growing number of mortgage defaults will not seriously harm the U.S. economy.
17 August 2007	The Fed cuts the rate at which it lends to banks by half of a percentage point to 5.75%, warning the credit crunch could be a risk to economic growth.
3 September 2007	German corporate lender IKB announces a \$1bn loss on investments linked to the US sub-prime market.
4 September 2007	The rate at which banks lend to each other rises to its highest level since December 1998. The so-called Libor rate is 6.7975%, way above the Bank of England's 5.75% base rate; banks either worry whether other banks will survive, or urgently need the money themselves.
18 September 2007	The US Federal Reserve cuts its main interest rate by half a percentage point to 4.75%.
1 October 2007	Swiss bank UBS is the world's first top-flight bank to announce losses \$3.4bn - from sub-prime related investments. The chairman and chief executive of the bank step down. Later, banking giant Citigroup unveils a sub-prime related loss of \$3.1bn. A fortnight on Citigroup is forced to write down a further \$5.9bn. Within six months, its stated losses amount to \$40bn.
30 October 2007	Merrill Lynch's chief resigns after the investment bank unveils a \$7.9bn exposure to bad debt.
9 January 2008	The World Bank predicts that global economic growth will slow in 2008, as the credit crunch

	hits the richest nations.
21 January 2008	Global stock markets, including London's FTSE 100 index, suffer their biggest falls since 11 September 2001.
31 January 2008	A major bond insurer MBIA, announces a loss of \$2.3bn – its biggest to date for a three-month period -blaming its exposure to the US sub-prime mortgage crisis.
10 February 2008	Leaders from the G7 group of industrialized nations say worldwide losses stemming from the collapse of the US sub-prime mortgage market could reach \$400bn.
7 March 2008	In its biggest intervention yet, the Federal Reserve makes \$200bn of funds available to banks and other institutions to try to improve liquidity in the markets.
8 April 2008	International Monetary Fund (IMF), which oversees the global economy, warns that potential losses from the credit crunch could reach \$1 trillion and may be even higher. It says the effects are spreading from sub-prime mortgage assets to other sectors, such as commercial property, consumer credit, and company debt.
4 August 2008	Global banking giant HSBC warned that conditions in financial markets are at their toughest "for several decades" after suffering a 28% fall in half-year profits. Of Europe's top banks, HSBC has among the heaviest exposure to the troubled US housing and credit markets.
15 September 2008	Bank of America agrees to a \$50 billion rescue package for Merrill Lynch. Lehman files for bankruptcy and thousands of its employees are told it's all over. This is the largest bankruptcy filing in the history of the United States at \$ 639 billion.
19 September 2008	Asia starts to recover with the Nikkei closing up 431 points at 11,920. Russian stock markets bounce back after the government pledges 500

	<p>billion roubles to fight the crisis. The British government increases its guarantee for British banks deposits to £50,000 and the Bank of England announced it will auction £ 10 billion. On Wall Street, the Dow Jones Industrial closes at 11,388.44 points, up 368.75, despite employment data being worse than expected. Bush Administration announces Bailout Plan to Confront Crisis. Congress is asked to give the administration new powers to execute a plan that could cost taxpayers billions to buy toxic debt and bad mortgages.</p>
2 October 2008	<p>The U.S. Senate approves the bailout. Congress passes the \$700 billion asset relief bailout. European leaders, lead by French president Nicolas Sarkozy, consider their own bailout, which would cost € 300 billion.</p>
9 October 2008:	<p>The IMF announces emergency plans to bailout governments affected by the financial crisis, after warning that no country would be immune from the ripple effects of the credit crunch. The Dow falls to a five-year low, ending the day at 8,579 points. The FTSE ends at 4,313.8 its lowest level since August 13, 2004.</p>
9 November 2008	<p>China announces a two-year \$ 586 billion stimulus package to help boost the economy by investing in infrastructure and social projects and by cutting corporate taxes. Economic growth has slowed in China with sharp drops in property and stock values. The money from the stimulus package will be spent on upgrading infrastructure, particularly roads, railways, airports and the power grids throughout the country and raise rural incomes via land reform. Also spending will be made on social welfare projects such as affordable housing and environmental protection. Some Chinese factories engaged in low-end export</p>

	manufacturing have gone out of business.
15 November 2008	International Summit in Washington to reinvent the international financial system. Leaders agreed to cooperate with respect to the global financial crisis and issued a statement regarding immediate and medium term goals and actions considered necessary to support and reform the international economy.
25 November 2008	The International Monetary Fund (IMF) approves a \$7.6bn (£5.1bn) loan for Pakistan to shore up the country's economy. Pakistan needs the money in order to avoid defaulting on international debt.
12 December 2008	A \$14bn (£9.4bn) bail-out deal for the US car industry has failed to get Senate support, raising fears of job cuts and a possible industry collapse.
15 January 2009	Asian Markets Fall Sharply: The Nikkei 225 index in Tokyo shed 4.9 per cent. By midafternoon the Hang Seng in Hong Kong was down 5 per cent the benchmark Kospi in South Korea 6 per cent. The key indexes in Singapore and Taiwan were 3.2 and 4.4 per cent lower.
22 January 2009	Microsoft has said it will cut up to 5,000 jobs over the next 18 months, including 1,400 immediately.
27 January 2009	Chancellor Angela Merkel's cabinet approved a €50bn (£46.7bn) stimulus package today, the biggest programme in Europe, to tackle overcome the country's deepest economic crisis since the second world war.
29 January 2009	President Barack Obama took the troubled Wall Street banks to task yesterday for paying out billions of dollars in bonuses to staff, accusing them of displaying "the height of irresponsibility" and of letting down the American people.
9 March 2009	The financial crisis wiped \$50 trillion (£35tn) off the value of financial assets last year, the Asian

	Development Bank (ADB) said.
11 March 2009	Chinese exports plunged by more than a quarter in February from a year ago as the world's third-largest economy was hit by a drop in demand for its goods.
13 March 2009	The White House has sought to assure China that its \$1 trillion (£0.7tn) in investments in the United States is safe despite the economic downturn.
14 March 2009	Finance ministers from the G20 group of rich and emerging nations have pledged to make a "sustained effort" to pull the world economy out of recession.
18 March 2009	World Bank has cut its prediction for China's economic growth in 2009 from 7.5% to 6.5%, saying it could not "escape the impact of global weakness".
25 March 2009	Barack Obama has told Americans he sees signs of economic recovery, but urged them to be patient and look beyond their "short-term interests".
31 March 2009	Germany's unemployment rate rose to 8.6% in March as the global economic downturn continued to tighten its grip on Europe's largest economy.
30 April 2009	Unemployment across the 27 EU member states reached 20 million in March 2009.
7 May 2009	President Barack Obama has said he aims to cut \$17bn (£11bn) from next year's US government budget, saying he had found examples of "stunning" waste.
24 Sep 2009	Friends of Democratic Pakistan forum held its first Summit in New York under the co-chairmanship of President Barack Obama, President Asif Ali Zardari, and Prime Minister Gordon Brown. Also attending were twelve Heads of Government and senior representatives of nine countries and five multilateral institutions.

17 December 2009	American weekly news magazine, <i>Time</i> , has named Chairman of the U.S. Federal Reserve, Ben Bernanke as man of the year 2009. <i>Time</i> magazine's rationale for picking Bernanke: "The main reason Ben Shalom Bernanke is <i>Time</i> 's Person of the Year for 2009 is that he is the most important player guiding the world's most important economy. His creative leadership helped ensure that 2009 was a period of weak recovery rather than catastrophic depression, and he still wields unrivalled power over our money, our jobs, our savings and our national future. The decisions he has made, and those he has yet to make, will shape the path of our prosperity, the direction of our politics and our relationship to the world."
-------------------------	---