BALKANISATION AND POLITICAL ECONOMY OF PAKISTAN

YOUSUF NAZAR

FOREWORD

DR MUBASHIR HASAN

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Tel: 021-3568828, 35681520
Fax: 021-35682391
web: www.nnagency.com
Email: mail@nnagency.com

Official Correspondence
4-C, 14th Commercial Street, D.H.A., Phase II Ext., Karachi, Pakistan.
Tel: 021-35805391-3
Email: riazmansuri@hotmail.com

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This book is dedicated to those 60%-70% Pakistanis who live in poverty and survive on less than 2 Dollars a day

About the author

Yousuf Nazar is an international finance professional with specialisation in emerging economies. As the head of Citigroup's emerging markets public equity investments unit based in London from 2001 to 2005, he helped Citigroup manage its over US $2 billion proprietary equity portfolio in the emerging markets of Asia, Latin America, Central/Eastern Europe, Middle East and Africa. Before this assignment, he also served as a Director of Citibank's strategic planning group during the 1990s.

Since 2006, he has written many articles on Pakistan's political and economic issues with a particular focus on the developments in an international context. His interest in politics dates back to his student days as a political activist when he worked against General Zia-ul Haq's martial law in 1977.

His experience in the developing countries spanned across several areas of international finance. He did his Bachelor's degree in administrative studies and an MBA in international finance and economics from York University in Toronto. He currently spends his time on advising his clients on their international investments and strategy.

Contents

Foreword	i
Preface to the revised edition	iii
Introduction to the first edition	xxiii
The gathering storm and its implications	1
Balkans of the next world war?	5
An illicit affair turns sour	9
Arms and foreign debt	15
Hillary Clinton – wake up!	18
Is global economy headed for recession?	21
A nation in denial	24
Limits of military power	26
The establishment strikes back	28
War of terror: America’s quest for hegemony	32
Obama must remove Pakistan’s fears	38
Pakistan must avoid debt trap	41
Leadership not IMF is the issue	44
Time to cut interest rates	48
Need for a new era of strategic partnership with China	52
Global financial meltdown	55
The price of being a security state	58
Drone attacks and charade of protests	61
Zardari, his own nemesis?	63
State within a State	65
Crisis, political will and competence	70
The government surrenders to the brokers	73
The monetary policy: behind the curve	77
Huge challenges, puny response	80
Faltering economy	83
Economic policy: continuity or change?	88
The fiscal imperative of tax reforms	92

The economy can destabilise democracy	96
Challenges for the new government	100
Balkanisation, not Talibanisation is the real threat facing Pakistan	103
The long term trend of rising oil price	108
How subprime lending in the US led to a global credit crunch?	112
Pakistan is the largest buyer of arms in the developing world	115
Budget largely irrelevant for common person	117
Real incomes' growth stymied	119
Real income growth lags behind Asia	123
Economy: illusion of progress	127
Political economy model of a security state	130
Political economy model and instability	133
External debt: false sense of achievement	136
Global stock markets turmoil: more to come?	139
The myth of energy routes through Central Asia	142
Untaxed billions while 74 per cent live on less than $2 a day	146
Monetary policy: rising inflation and difficult choices	150
Development strategy and the myth of liberalisation	154
Pakistan economic outlook	157
Rupee depreciation: The wrong debate?	161
The drug threat from Afghanistan	165
The stock market crash	167
Selling Pakistan's energy assets	170
In the line of fire: setting the record straight	173
US Quest for global energy control	176
Are we ready for $100 a barrel oil price?	180
Conclusion: Pakistan's Way Forward	182

Foreword

Early in 2008 just after the new government had taken over I saw an insightful article in DAWN worth reading again and again to grasp its full economic and political implications. In a very coherent and lucid manner, citing eye-opening facts and figures, Yousuf Nazar was warning all those who cared to ponder about the economic debacle that stared Pakistan in the face. I immediately phoned Zubeida Mustafa of DAWN to ask 'Who is Yousuf Nazar, how can I speak to him'? Very kindly she found out and gave me his telephone number.

At that moment, I was keen to know from Yousuf Sahib what had triggered the sudden and steep down turn of the economy soon after the induction of the new Government. He said that he had been elaborating in his articles in DAWN since 2006 that the economy of Pakistan was extremely vulnerable. The current precipitous fall had been in the making for some time and that the new government and the one preceding it failed to take even rudimentary steps to lessen its ferocity.

The government economists believed and elaborated ad nauseam that there is nothing seriously wrong with the economic policies pursued by them. The fundamentals of Pakistan's economy are sound. The crisis like the present one arise due to international factors such as rise in oil prices, changes in interest rates, paucity of loans etc.

Many among of our present day economists subscribe to the Donald Reagan's mantra of privatisation, deregulation and globalisation. They allege that Pakistan's economic woes are the result of wrong policies of Islamabad: high budget deficits, faulty taxation system, and deficient infrastructure development, low rates of savings, rampant corruption and failure to develop export-led growth patterns and more… They argue that had Pakistan fully and honestly adhered to the policies of the 'market economy' it had promised with International Financial Institutions it would have fared better.

Yousuf Nazar, on the other hand, believes that the fundamental reasons for economic plight of Pakistan go far beyond what appears in the current literature on economy. The strategic relationship of the ruling elites with foreign political and economic powers, the absence of the rule of law, frequent unconstitutional interventions by the military, compliant judiciary and political leadership are responsible not only for the severe economic problems but also strike at the stability of the state itself. Inflationary trends, high unemployment rates, rising debt, high poverty levels are the symptoms and not the cause of the present economic scene.

Who are our ruling elites? Who amongst the ruling elites exercises the supreme authority? Why they are so inextricably linked with foreign powers and their interests? Finally what needs to be done to break this 'vicious cycle' as the author puts it and transfer sovereign authority from the elites to a democratic polity are some of the basic questions facing the country.

The ruling elites are found in two categories: those exercise legal power to rule and those who are beneficiaries, extra-ordinaire, of assisting and supporting those elites who directly exercise political power. In this second category fall industrialists, bankers, members of higher judiciary, landlords, sardars, pirs, big traders, media and real estate barons, top notch lawyers, doctors, managers, accountants, members of parliament when in office, big political leaders in office or opposition and retired senior civil and military officers. The first category comprises the combine of civil and military officers. It is the civil authority at the district level and below which principally governs the country through a huge apparatus of police, magistrate, jails, revenue collector and intelligence network. The civil is the principal repository of the coercive power of the state. The military is the protector of the last resort of the civil authority. The intelligence and assessment of the state of 'law and order' plays a crucial role for the military to come into action.

The compact between the elites of Pakistan and the United States and its allies is wholly one sided. Despite all the assurances for national security, the US has never helped Pakistan in any war. Indeed, it has stopped the supply of military and economic aid at most crucial times for Pakistan. It is absolutely essential for the elites as well as the people to scrap the compact that has been in operation for more than half a century. The country's economic woes must be assessed merely not in terms of the knowledge of the science of economy but as the author advises in the light of political economy

Mubashir Hasan

Publisher's note: *Dr Mubashir Hasan was Pakistan's Finance Minister during 1971-74. He is a founding member and former Secretary General of the Pakistan Peoples Party. He was a close associate of Zulfikar Ali Bhutto.*

Preface to the revised edition

The first edition, published in March 2008, was titled The Gathering Storm. This related to an article I wrote in 2006. It is with a heavy heart that I have changed the title for this revised edition as my worst fears have become more than just that. Pakistanis are suffering from an experience that has been the most traumatic since the breakup of Pakistan in 1971. While the so-called "War on Terror" has taken its toll, the response of the ruling classes bears more responsibility for the nation's despondent mood and low morale. Pakistanis have never been so unsure about their identity and the future. The Pakistani army has 147,000 troops fighting militants in the tribal areas. More than 35,000 Pakistanis have died in the War on Terror since 2001. The Pakistani army has suffered 12,829 casualties and 3,097 deaths including an estimated 194 officers. More than 3,600 police and paramilitary personnel have been killed.

In this context, it is tempting to believe the narrative in the global media and of those Pakistanis who believe that the country faces an existential threat from extremists and its political landscape is polarised between the liberals and extremists. A former Indian ambassador M. K. Bhadrakumar believes that all sorts of free-wheeling forces are at work under the cover of the "Pakistani Taliban" and the thesis of 'blowback' is based on simplistic assumptions regarding the processes going on within Pakistan. However this is just one piece of the puzzle. Pakistan's current situation cannot be analysed in isolation and without an understanding of the history of Pakistan, the so-called Islamic fundamentalism and that of American foreign policy in what the US statesman Zbigniew Brzezinski called the 'arc of crisis' in 1979. This arc stretches across the southern flank of the former Soviet Union from the Indian subcontinent to Turkey, and southward through the Arabian Peninsula to the Horn of Africa.

If we start from 9/11, it is impossible to discuss the US invasion of Afghanistan in 2001 without mentioning what some of the leading neoconservatives were thinking at the time. Robert Kagan and William Krystal co-founded the Project for New American Century (PNAC) which exerted great influence on the Bush Administration's development of military and foreign policies, especially involving national security and the War on Terror. They are the editors of the Weekly Standard, an opinion magazine, founded by Rupert Murdoch's News Corp., which has been called as "the neo-con bible". Kagan and Kystal published an article titled 'The Gathering Storm" in the *Weekly Standard* on October 29, 2001, declaring:

"This war will not end in Afghanistan. It is going to spread and engulf a number of countries in conflicts of varying intensity. It could well require the use of American military power in multiple places simultaneously. It is going to resemble the clash of civilizations that everyone has hoped to avoid. And it is going to put enormous and perhaps unbearable strain on parts of an international coalition that today basks in contented consensus."

It was not just an opinion piece. It echoed the views of the US establishment. President George W. Bush told Prime Minister. Bush on January 30, 2003 that he "wanted to go beyond Iraq in dealing with Weapons of Mass Destruction (WMD) proliferation, mentioning in particular Saudi Arabia, Iran, North Korea, and Pakistan," according to a secret note of their telephone conversation. This was revealed by Philippe Sands (Professor of International Law at University College London) in his book 'Lawless World' in 2005.

This was completely in line with the grand designs of a "new American century" in which America will continue to be the dominant military power. This agenda had the complete support of the US establishment led by the Pentagon and the CIA and represented a radical shift from the policies of the Clinton era. Pakistan's military leaders failed to comprehend this shift and continued the policy which is now commonly described as their "double game". They behaved as if they were living in the 1990s when the US mostly ignored their support of the Talibans and other militants, partly because it suited her interests, or in the 1980s when the Reagan administration turned a blind eye towards Pakistan's secret nuclear programme in exchange for its support in the Afghan war against the Soviet Union.

But the US establishment had a much more bigger and ambitious agenda in which "terrorism" was to become an excuse for military interventions and promoting American security interests in the 'arc of crisis.' Unwittingly, Pakistani establishment was to provide that excuse in abundance till it had a rude awakening during 2006-2008 that the US establishment had plans that went far beyond the pursuit of Al-Qaeda's leadership and remained unaffected by the election of Barack Obama as president in 2008. The Pakistani military establishment was also outwitted and outclassed in a global propaganda war when it tried to resist America's push to expand the Afghan War into Pakistan beginning in 2009. The whole might of the US establishment with its formidable array of network of think-tanks, analysts, journalists and commentators was deployed to demonise Pakistan's military establishment. They had plenty of ammunition. As the American billionaire George Soros wrote in his book, *"The New Paradigm for Financial Markets"*, in contemporary America there is freedom of thought, yet the Bush administration "managed to mislead the people by using Orwellian Newspeak."

Pakistani establishment did use militancy as a policy tool but the history of the use of Islamic fundamentalists pre-dates the Talibans and Afghan jihad. The fact is that the Pakistani military establishment has been part of the much wider and global US policy of using Islamic fundamentalists and militants to further its security interests; a policy that has been described as "Devil's Game" by an American journalist Robert Dreyfuss of *Rolling Stone* magazine in his book with the same title.

For those who may be unaware of history and America's clandestine relationship with the Muslim Brotherhood, this may be a revelation but it is not. Ian Johnson, Pulitzer Prize-winning author of "*A Mosque in Munich*", recently wrote in the New York Review of Books that since the 1950s, the United States has secretly struck up alliances with the Brotherhood or its offshoots on issues as diverse as fighting communism and calming tensions among European Muslims.

Former Egyptian President Husni Mubarak had criticised the United States repeatedly for its failure to take action against the Islamic radicals in London and Germany, Said Ramadan's (the son-in-law of Hassan al-Banna, founder of the Muslim Brotherhood) Islamic Centre in Geneva, New Jersey-New York cells such as the one affiliated with an Egyptian blind sheikh Omar Abdul Rahman, the ringleader of the 1993 attack on the World Trade Centre, and other US-based cells.

Mohammed Atta, the alleged ringleader of 9/11 hijackers, was also an Egyptian and member of an "engineering syndicate" in Cairo that fronted for the Muslim Brotherhood.

Between 1994 and 1996, the US supported the Talibans essentially because it viewed them as anti-Iranian, anti-Shia, and supportive of American commercial interests. "The Taliban," said a State Department official in the Clinton administration, "will probably develop like the Saudis. There will be Aramco, pipelines, an emir, no parliament, and lots of sharia law. We can live with that."

Gary Bernsten, the CIA's bin Laden head in 2001, has maintained in his book "*JAWBREAKER*" that it was the US top army officials who were responsible for letting bin Laden escape from Tora Bora in early December 2001. Former Colin Powell's Chief of Staff Colonel Lawrence Wilkerson told MSNBC's Ed on May 11, 2011 that President George W. Bush wasn't interested in bringing Osama bin Laden to justice. *"I don't think they really wanted to get bin Laden, You could be very cynical and say he didn't want to get him because once they got him the war was over and that left all the political advantage gone,"* Wilkerson added.

A US Senate Foreign Relations Committee report, "TORA BORA REVISITED" dated Nov. 30, 2009 stopped short of charging Dick Cheney and Donald Rumsfeld of deliberately letting Osama escape or of criminal negligence but nevertheless concluded:

"After bin Laden's escape, some military and intelligence analysts and the press criticized the Pentagon's failure to mount a full-scale attack despite the tough rhetoric by President Bush. Franks, Vice President Dick Cheney and others defended the decision, arguing that the intelligence was inconclusive about the Al Qaeda leader's location. But the review of existing literature, unclassified government records and interviews with central participants underlying this report removes any lingering doubts and makes it clear that Osama bin Laden was within our grasp at Tora Bora."

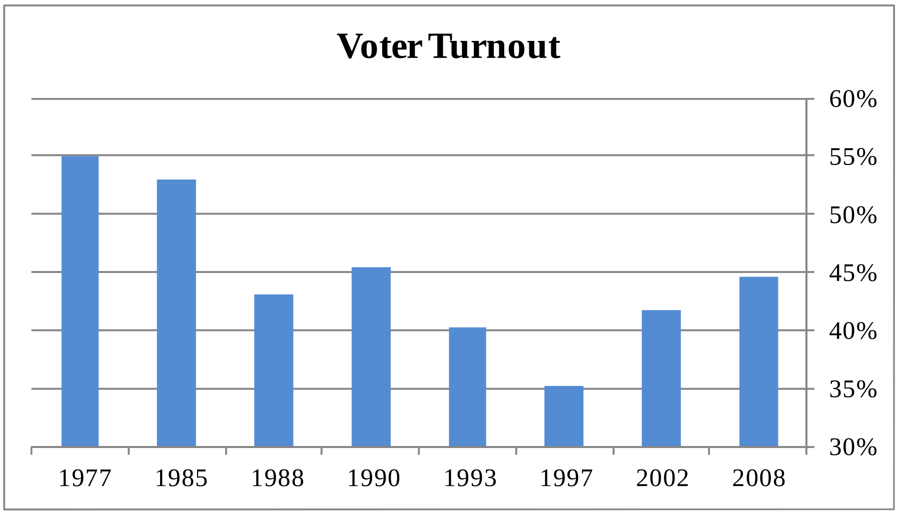
The American agenda in Afghanistan and Pakistan continues to be heavily influenced by the Pentagon and the CIA. The state department and sometimes even Obama's White House have mostly followed the foreign policy priorities of the US establishment. The following extract from what are quite literally the minutes of Obama's National Security Team meeting does not leave much room for doubt about the near term US objectives in Pakistan. The meeting was held on November 29, 2009 in the Oval Office. They appear on page 328 of Bob Woodward book "Obama's Wars:

Extract:

Vice President Joe Biden: *The context for this is that this is necessary to defeat al Qaeda and support the effort (attacks) in Pakistan. We can't lose sight of Pakistan and stability there. The way I understand this, Afghanistan is a means to accomplish our top mission, which is to kill al Qaeda and secure Pakistan's nukes."* Yes, the President agreed. *"The main pillar of this would be top secret and not be made public."*

However, the NATO supported al-Qaeda's militants including some former associates of the Taliban leader Mullah Omar such as the Libyan rebel commander Abdel-Hakim Belhaj in the armed uprising against Libya's Colonel Gaddafi. According to the daily Guardian (September 5, 2011), British intelligence and security service interest in Libya has focused for 20 years on the Libyan Islamic Fighting Group (LIFG), whether "it was opposing Muammar Gaddafi and working with al-Qaida, or taking part in the armed uprising that has now overthrown the regime." It is little wonder then some former ISI operatives like late Khalid Khawaja were close to both the Talibans and controversial characters like Pakistani-American businessman Mansoor Ijaz with well known connections to the CIA and the US establishment.

Now let's focus on Pakistan. The activities of a few thousand militants are just one aspect of what is going on in a country of 180 million. There is a much bigger reality which does not make the headlines. It has become fashionable to describe Pakistan as a land of jihadis and seething mass of hate against America, India, Israel, etc. However neither the results of elections held in the past fifty years nor do public opinion polls support this characterisation. Polls after polls list inflation, joblessness, power shortages, crime, etc, as the issues that concern an average Pakistani the most. This does not leave much room for fretting about the so-called enemies of the State. There is another interesting static notwithstanding the allegations of widespread fraud in the voter lists and actual voting. The voter turnout in Pakistan declined from 55% in 1977 to 40% in 1993 and 35% in 1997. It recovered subsequently in the 2002 and 2008 elections but never to the levels witnessed in the 1970s.



It does not make a sensational story but Pakistan is actually polarised between corrupt and decadent elites and a disillusioned, apathetic, under-employed and poor population that seems to treat bad rulers and pathetic governance as her fate. There is vertical polarisation between the social classes and horizontal polarisation between the regions and ethnic groups. Most of those who belong to Pakistan's opportunist ruling elites are "lifestyle liberals" or "moderate Muslims". They have ruled Pakistan for all of its history and are responsible for the mess Pakistan is in now but they have found a convenient scapegoat: extremism.

The roots of Pakistan's current crisis go back to its birth and early years when its westernised and elitist rulers struck an alliance with the west even at the cost of subverting democracy and alienating the majority of the population of what was then Pakistan. It was common in the 1950s-1960s for a Punjabi general or a Muhajir bureaucrat to describe Bengalis (who were the majority) as treacherous, extremist, seditious, violent or plainly inferior. Some West Pakistanis even argued that East Bengal (now Bangladesh) was an economic and political liability and Pakistan would be better off without it. The dismemberment of Pakistan forced the uniformed elites and its allies to make a retreat and hand over power to Pakistan's first ever elected leader in 1971. But they struck back five years later in 1977 (after a coup-attempt during the intervening period) to reclaim the power they had lost due to their blunders. Still, they somehow considered it their natural right to rule Pakistan because it was "not fit" for democracy. Ironically, these elites have presided over the gradual slide of an elitist state into a criminal enterprise with an inner cancer that has little to do with extremism which is merely one of the symptoms of what ails Pakistan.

Pakistani generals fought as America's proxies in the "great game" in the decade of the 1980s on false and deliberately distorted assumptions built on the massively exaggerated threat of the former Soviet Union when it was in fact imploding from within due to the failure of the communist experiment and a weak economy wrecked by the depressed price of oil. The "Afghan jihad" turned Pakistan into a brutalised and criminalised society. Pakistan lost the decade of the 1990s to political squabbles of short-sighted politicians and behind-the-scenes manipulation of its security establishment. The economy stagnated and Pakistanis got disillusioned with democracy and politicians. The past ten years' events have shaken the belief of millions of Pakistanis in the very future of their country.

Pakistan continues to pay the price of President Bush's folly in 2001 and that of the policies and actions of its greedy, incompetent and myopic elites while the world has moved on to face more important and bigger challenges. The United States and Europe remain mired in the worst economic slump in the last 80 years as a consequence of the bursting of the history's biggest credit bubble. Europe, struggling under the weight of huge debts, is looking towards China and other countries like Brazil and Russia to save her economy and banking system. The head of the International Monetary Fund IMF Christine Lagarde warned recently that the global economy faced the risk of a "lost decade" of little or no growth.

The worst global financial crisis since the 1930s is more than just an economic phenomenon. As I wrote in the DAWN of October 11, 2008: ***"It may turn out to be the most important event since the collapse of the Soviet Union and the fall of the Berlin Wall in 1989. A unipolar world emerged following the disintegration of the Soviet Union. The year 2008 may go down in history as the year of the beginning of the fall of the Anglo-Saxon financial capitalism and when global economic power began its shift from the West to the East."***

On the other hand, the US failure in Afghanistan could result in a civil war in Afghanistan. Such an outcome is borne out of its apparent unwillingness to accept her failure or defeat and inability, for whatever reason, to arrive at a political settlement and prepare for an orderly transition according to a plan acceptable to all the major parties. This may even lead to Afghanistan's disintegration with a reconstituted Northern Alliance controlling the North and the Talibans capturing the South. Let me emphasize that this is far from an outlandish scenario. If this happens, the repercussions would spill over to Pakistan and threaten regional and global peace.

These developments have far-reaching and grim implications for Pakistan's future, but its ruling elites seem to be paralysed by the traumatic experiences of the past decade. They hope to muddle through this period with the help of friends like China and Saudi Arabia. Historically, they treated Washington as the centre of the world, India as their main rival and accumulating wealth as the main goal. In the future, the US may not bail out Pakistan like it did during the Afghan war and the War on Terror. India sees China as a rival and merely considers Pakistan an irritant that has the potential to destabilise the whole area. The country has an acute leadership crisis and its fragile democracy - or, more accurately, a plutocracy - governs only in theory. The army still calls the shots but the state has never been so weak although the reports of its impending collapse, imminent takeover by the Islamic militants and economic meltdown are simply exaggerated.

Pakistan's army chief and his senior commanders sit atop the real power structure. Decades of army or quasi-army rule, the 'jihad against the Soviets', and the War of Terror, have seen an unchecked and extraordinary rise in the influence and power of the intelligence agencies who practically control Pakistan's broken and predatory institutions while reporting to the army high command. A serving intelligence officer says the Inter-Services Intelligence (ISI) "spent" $600 million on high-tech systems and equipment alone in recent years.

Besides a rise in militancy, sectarian and ethnic extremism and proliferation of arms, the use of militant and non-militant groups by the intelligence agencies has a less obvious and ominous dark side: the rapid growth of the 'black economy" fuelled by growing criminalisation of the society. The rule of law, governance and civilian institutions are the major casualties of this phenomenon. Pakistan's police force is understaffed, underequipped, ill-trained, highly politicised, and extremely corrupt. The condition of the courts throughout the country is not much different which is not surprising because there is little respect for the rule of law. Getting a law degree is a cheap and short course in Pakistan and can be attained by studying part-time and, if one desires, with the help of unfair means including cheating. The good students usually pursue medicine, engineering, technology or business studies.

Money laundering, a useful indicator of illicit trade activity, is estimated to occurring on the order of billions of dollars. A study by Pakistan's central bank put the size of Pakistan's black economy at around 30% of GDP (compared to 25% in Greece and 20% in Italy), or around $60 billion a year. It is probably bigger. In 1999, a United Nations report had put the estimate of the amount of money stolen from official coffers and held abroad at a staggering $50 billion. The estimates of the wealth of Pakistanis stashed away in foreign bank accounts are as high as $300-$400 billion according to some Switzerland-based private bankers with whom I have spoken, but no firm estimate is available in the public domain.

The law, in letter or practice, does not offer sufficient checks against money laundering. It is quite likely that billions of dollars a year, reported as "workers' remittances," actually represent money laundered through banking channels. During 2006-2011, total remittances into Pakistan grew from $4.6 billion to $11.2 billion while the world went through major financial crises and the Great Recession. Intriguingly, more than two-thirds of this increase, or $4.5 billion, according to the State Bank of Pakistan's data, came from the neighbouring Gulf, principally Dubai, Abu Dhabi and Saudi Arabia.

However, few in the government seem to care because the top priority of Pakistan's powerful elites continues to simply be financial gain. The government is squeezed between external compulsions and domestic pressures and handicapped by its own vulnerabilities, weaknesses and limitations. Perhaps never before has such a level of malfeasance and mediocrity manifested itself in Pakistan's highest offices. Time is running out as Pakistan struggles through what could be the worst political and economic period of its history whilst its leadership is bogged down by the weight of entangled foreign policy and domestic political issues. It has a single point agenda: survival.

The present ruling coalition overcame its initial difficulties by forcing Musharraf out with the tacit approval of the US and the army. But the coalition soon fell apart and the traditional political rivals reverted back to the power politics of the 1990s, allowing the military to reclaim the space it had lost during 2007-2008.

The question of the legitimacy and calibre of the institutions and individuals who rule and have ruled Pakistan has reached tragic and grotesque proportions. The army and its frequent interventions must share the ultimate responsibility for this. It is their actions, and not extremism, that lies at the core of Pakistan's crises. President Asif Ali Zardari became the leader of the ruling party solely as a result of his wife's assassination; he had no experience of either running a political party or of governance and had a highly controversial past.

Nawaz Sharif, leader of the country's second largest party, chose to cut a deal with a military dictator to get out of the country and enjoy the hospitality of Saudi autocrats rather than stay in the jail. Sharif is a mediocre and corrupt businessman who was a propped up by the intelligence agencies. During 1999-2008, a military general (Musharraf) with no democratic legitimacy whatsoever ruled Pakistan. He had a reputation for recklessness as an army commander. Musharraf's rule was given legal cover by a Supreme Court chief justice and many other judges, who, perversely, owed their positions to extra-constitutional acts.

Pakistan's civil society is small and dominated by well-to-do urbanites. Unfortunately, this class has little or no interest in reforming the system, its political economy or in the issues related to economic injustice or lack of opportunities. Pakistan's best known and largest NGO, the Edhi Foundation, was founded by a poor and an illiterate man with the help of small donations. A section of the civil society has made a business out of NGOs by tapping foreign funding sources such as the USAID. These civil society activists famously glorified the judges that were removed by Musharraf. Although their dismissal was illegal, many of the judges represented some of the most pliable legal talent in the country, barring few exceptions. The rest served as long-standing rubber stamps of past autocratic rulers. They rose against the establishment only when their own jobs were threatened. What choice did they have when pushed against the wall?

Moreover, the subsequent restoration of the judges and their resulting performance confirmed the views of the sceptics who maintained that achieving judicial independence without fundamental reforms was simply wishful thinking. The rot is too old, too dirty and too complicated for such simplistic hopes to have materialised, notwithstanding the accusations that the lawyers' movement was supported and manipulated by 'hidden hands'.

While many lawyers have sincerely fought for the rule of law and human rights, a large number of lawyers have been allied with anti-democratic forces and intelligence agencies for a long time. It was also alleged that hawkish and "India-centric" elements in the ISI conspired against Musharraf because he went too far in offering India a deal on Kashmir. While it is difficult to prove such speculation, the circumstantial evidence suggests that many of the senior judges were close to both the intelligence agencies and the religious extremist groups supported by these agencies. The latter have been violently opposed to peace initiatives between India and Pakistan.

Benazir Bhutto, the country's most popular leader, was murdered in its most heavily protected city. Within hours of the horrible crime, fire engine hoses washed away critical evidence on the murder scene. Not a single television station was carrying a live transmission when Benazir (a tender soul who I first met in 1978) was attacked; seeming impossibility given cameras chased her everywhere she went. There are no signs that her real killers will ever be caught and brought to trial. It is a common practice in Pakistan to arrest some petty criminals and release them after a lengthy trial for "lack of sufficient evidence." No one, including her husband and senior party leaders, seems keen about the case. A United Nations investigation reported in 2010 that the failure of Pakistani authorities to effectively investigate the killing was "deliberate" and that the investigation had been "severely hampered" by the country's powerful intelligence agencies.

Bhutto had her share of failures and flaws, most notably her dogged pursuit of the politics of power to the extent that it sometimes became hard to distinguish between the policies of PPP and other pro-establishment parties. Bhutto's compromises and stories of corruption of her husband weakened her political and moral authority and despite her heroic struggle against General Muhammad Zia-ul-Haq, her subsequent track record seriously damaged her stature. The corruption cases made her vulnerable to blackmail by establishment and the US and forced her to cooperate with them. She was wrong to believe that the path to democratic governance goes through Washington. However, after her return to Pakistan and during her last days, Benazir's tone became stridently anti-establishment. She declared in Peshawar on December 2, 2007 that she was against using the military in the tribal areas, and favoured negotiations as the only viable instrument for restoring peace. Picking on the theme of an article I had published just a few days before, Benazir declared that Pakistan faced a grave threat of 'Balkanisation' because of the government's domestic policies. She was acting like the person I knew in 1978-1981 and emailed me to express her agreement with my analysis. She defied both the establishment and the US. In the process, she gave her life to redeem herself, despite the warnings of close friends and associates that she was on a suicidal mission. Benazir Bhutto's murder created a leadership vacuum in the country because there was no other leader of her national and international standing.

In Pakistan's vaudeville politics, most politicians and groups owe their creation or sustenance to the intelligence agencies and/or foreign interests and are unable to protect Pakistan's interests on many issues because of their compromised positions. Zardari has relied heavily on Americans for both coming into and staying in power. Nawaz Sharif will forever be indebted to the Saudis for providing him a home during exile. The leader of the third largest party was granted British citizenship despite an operating style reminiscent of organised crime and has lived in London for the past 19 years.

It remains to be seen if someone like Imran Khan, who is not a traditional politician, can turn his party into a major national political force given his growing popularity. In the short-term and given Imran's unwillingness to oppose the establishment, it is seriously doubtful that Pakistan will find a leader who could establish the dominance of democratic institutions over the military establishment and the entrenched elites, introduce reforms and pursue a foreign policy which is free from the army's interference.

The promise of change has great appeal but it is impossible for any political force to bring change in Pakistan without challenging the forces of status quo: namely oligarchs and the defence establishment. Pakistan's economy cannot be set right so long as the state's security needs, as defined by the beneficiaries of outmoded defence theories and myths, are considered immutable and used to justify the denial of the people's basic needs and rights and delay the much needed structural reforms. No major change is possible or sustainable without transforming the fundamental character of the national security state that Pakistan is and without breaking the axis of the defence establishment and the elites that has governed Pakistan since 1950.

Until and unless those who seek real change address this core issue, Pakistan may have to wait for many years for a leader like Luiz Inácio Lula da Silva or Recep Tayyip Erdogan. Both Lula of Brazil and Erdogan of Turkey won elections following years of struggle at the grassroots level in countries with a history of military interventions and economic mismanagement. Both of them are credited with strengthening democracy and transforming the economies of their countries through reforms and competent management.

A real change is not possible by just winning elections and forming a 'clean' government without confronting the forces of status quo. Barak Obama promised change but has been unwilling to challenge the establishment. This has caused widespread disappointment and a plunge in his approval ranking. Z.A. Bhutto, even with his great intellect, experience and a rare grasp of history, tried to co-opt these forces but that only hastened his fall from the lofty peaks of his popularity during 1970-1974. Mr. Bhutto realised this later and when I met him in September 1977 after Zia's coup; he seemed to have been humbled by the enormity of challenge of bringing change. "Pakistan is a very difficult country to govern," he conceded rather pensively. He was arrested the next day and never got a chance to correct his mistakes.

Pakistan's media is very much an institutional participant of a corrupt and decadent status quo. Certainly, many individual journalists do an outstanding job and have helped create a vibrant media that has played an important role in creating political awareness. At the same time, there are elements in the media who are or have been on the payroll of secret state funds or otherwise benefit from the state. Obvious and critical questions like how terrorists can freely operate radio stations and issue bomb threats in live interviews to TV channels are rarely asked. Meanwhile, myriad superficial and senseless TV talk shows – the staple of Pakistani primetime entertainment – continue. The appointments of mid-level bureaucrats and even deaths of their relatives are delivered as ‘breaking news’ but the coverage of institutional corruption and organised crime or discussion of reforms is scant. Army leadership, by and large, remains a holy cow.

The media, though dynamic, is nevertheless a microcosm of the power politics of elites and is obsessed with political leaders and army generals in a rat race for revenues that has left little room for serious or investigative reporting, substance or meaningful debate on national issues. The owners are happy to mint money and have shown little inclination to invest in investigative reporting and serious journalism. Indeed, the situation bears a striking resemblance to the workings of Rupert Murdoch in the West.

However, Pakistan has produced journalists who have fought for media’s freedom in difficult conditions, faced imprisonment, police brutality and even death while performing their duties. In 2011, Pakistan continued to witness an exceedingly deadly trend of fatal violence against journalists (allegedly from both terrorists and state agencies), according to a report of World Association of Newspapers and News Publishers. Of the 44 journalists killed thus far in 2011, eight of them died in Pakistan, a figure eclipsed only by Iraq. In 2010, Pakistan lost 10 of the 99 journalists killed worldwide, sharing the top spot with Mexico.

Pakistan is facing its gravest crisis since 1971. The so-called War on Terror and economic stagnation since 2008 has brought Pakistan to the brink again. The state is weaker, the government is dysfunctional, the people are despondent and the rich have moved billions out of the country. Pakistan risks failure as a state because its institutions and leaders seem to be incapable of facing grave external and internal threats to its survival as a consequence of the selfishness, short-sightedness, and incompetence of the military and civil elites that have governed Pakistan during the last three decades.

If truly empowered, only its people can save Pakistan, but apathy seems to be the pervasive reaction in the face of the country’s pathetic governance. Pakistanis tolerate military dictators for long periods or elect corrupt and incompetent people but paradoxically complain about bad leaders. Yet, Pakistanis are a resilient people; this resilience is the driver of Pakistan’s historically healthy economic growth over the last three decades despite political upheavals, natural disasters, energy shortages and failed leadership.

With a population of 180 million, Pakistan is the sixth largest country in the world. The country has a large irrigated-agriculture sector that has remained the backbone of its economy despite slow improvements in productivity and a critically low level of investment in agriculture technology, new seeds and the water infrastructure. Statistically, agriculture is the second largest sector, accounting for over 21 per cent of GDP but remains by far the largest employer, employing 45 per cent of the country’s total labour force.

Pakistan has the 8th largest army in the world with around 620,000 active personnel and the 7th largest number of nuclear warheads. In relative terms, however, its economy is small, standing at 47th in the world. Israel, the Czech Republic and Egypt, nations of 6.8 million, 10.5 million and 81.1 million, respectively, have bigger economies than Pakistan. Pakistan is ranked 125th out of 169 countries (and below India, Egypt, Vietnam, Cambodia, Tajikistan, and Sri Lanka) in the Human Development Index.

At least 61% of the nation is living on less than $2 a day, according to World Bank development indicators. While this apparently represents a marked improvement from a figure of 73.9% in 2002 the upward shift is dubious and reportedly a result of data doctoring on the part of the Pakistani government than an economic miracle because there wasn't any. In either case, the fact remains that 60-70% of Pakistanis live in poverty and the middle class in Pakistan is small in stature, totalling roughly 20 million people or just 11% of the nation's population.

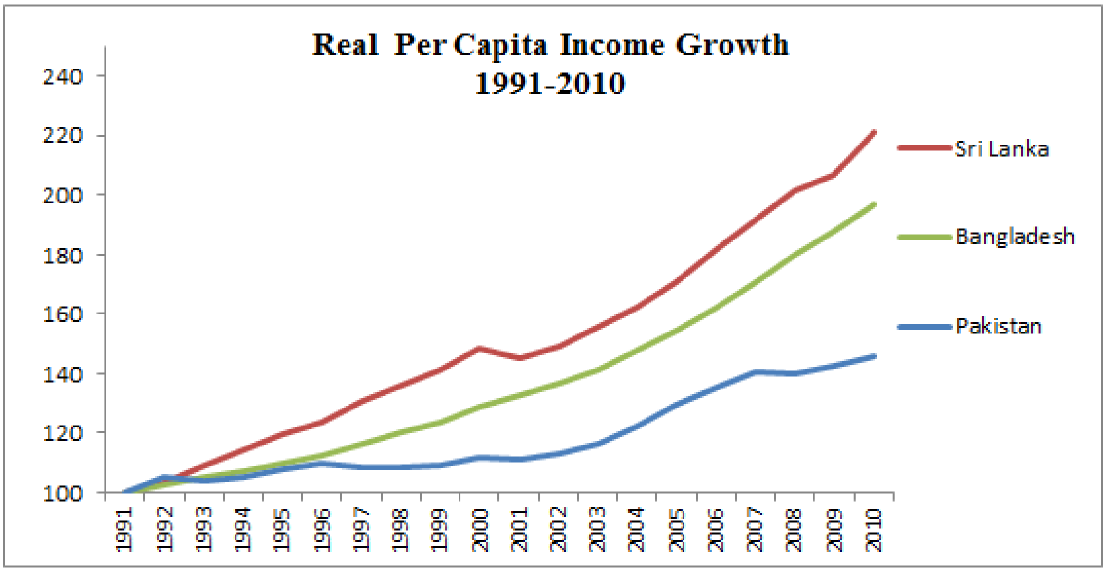
Nearly 62 per cent of the country's population resides in rural areas, and is directly or indirectly linked with agriculture for their livelihood. A secular international boom in agriculture products during the 2000s and increase in remittances by overseas workers to their families in rural areas and small cities have been the principal drivers of the agriculture sector growth in the recent decade. Consequently, a new class of traders, small shopkeepers, semi-skilled workers and office workers has emerged, transforming some of the rural areas into small towns and cities.

However, the rate of agriculture sector growth declined from 5.4% in the 1980s to 4.4% in the 1990s to 3.2% in the 2000s. While it did contribute to development of trade and small-scale industries, demand for consumer goods and urbanisation, the benefits appear to have been largely limited to areas in central and northern Punjab.

Regional disparities have grown as many parts of southern Punjab and rural Sindh along the Indus River (the main source of irrigation) as well as Balochistan have not kept up with the national growth rates. According to a report produced jointly by the World Bank Asian Development Bank and the Government of Pakistan, from 1972-73 to 2004-05, the economy grew on an order of 2.7 times (the slowest among provinces) in Balochistan, 3.6 times in the Northwest Frontier Province (NWFP) and Sindh and 4.0 times in Punjab. Rural Sindh has over 50% of the province's population but just 30% of the economy. The growth divergence has widened historic income differences and per capita income levels in the Khyber Pukhtoonkhwa, rural Sindh, and Balochistan, all of which are significantly (20% or more) below the national average. The incidence of poverty in rural Sindh (mostly Sindhi speaking) is twice that of urban Sindh - dominated by non-Sindhi speaking population groups - according to the Asian Development Bank. Sharp income disparities and ethnic divisions exacerbated by narrow political interests represent a combustible combination.

Still, in overall terms, Pakistan's economy did not perform poorly in the last decade (average GDP growth: 4.8%) or even during the 1990s when the average GDP growth rate was 4.6%. But it could have done a lot better given that during 2003-2010, the country received generous financial assistance (both on account of War on Terror as well as in the form of earthquake and flood aid and debt relief) from international sources. Moreover, the international economic environment (pre-2007) was also conducive for growth in the emerging economies underpinned, in part, by the demographics a boom in commodity prices, low interest rates and record investment flows into the emerging markets.

The performance looks even less impressive when we see that Pakistan's economic growth rate lagged behind not just that of the developing countries in Asia but even those of Sub-Saharan Africa during this period. Another key indicator, Pakistan's GDP per capita in real terms, which is adjusted for inflation, grew by only 2% a year during the past two decades. The rise in real incomes in Pakistan during this period was less than half the growth rate of 4.7% in Sri Lanka and 45% less than 3.6% real income growth in Bangladesh as illustrated in the graph. It is important to note that Pakistan's real per capita income growth rate was just 1.1% during 1991-2001. The growth accelerated only after 2002 when the aid started to flow after 9/11 as sanctions were lifted, and external debt was rescheduled. This is well known but more significant is the fact that Sri Lanka and Bangladesh have grown much faster with significantly less aid. This should receive more attention from Pakistani leaders and planners.



A consumption driven GDP growth, concentrated in certain parts of the country, is not the most meaningful indicator when other long term trends such as security conditions, youth unemployment, income inequality, capital formation, quality of education, continuous brain drain of skilled professionals, female literacy, regional disparities, energy security and water availability point to a gradual decline when compared with most developing countries. After all, regional disparity and income inequality were some of the root causes behind the dismemberment of Pakistan in 1971 although Pakistan's economy did very well by traditional measures, including a GDP growth rate of 6.8% during the 1960s.

Pakistan's economic outlook in the next few years is not promising. Both foreign aid and investment are likely to drop in the current international environment when developed economies themselves face financial crises of unprecedented magnitude. It is unlikely that the US would continue to write large checks as it did during the War on Terror. International financial institutions may not be as generous as they were after the oil shock of 2007-2008 – given their diminished capacity to extend loans in the wake of the European sovereign debt crisis and, in no less measure, due to Pakistan's poor track record in implementing IMF programmes. In fact, Pakistan has rarely been serious about any targets set under the IMF programmes. Pakistan's rulers use the IMF, helped by the media, as a convenient scapegoat to cover their ineptitude while the fact is that the countries like Brazil and Turkey have benefited from the IMF assistance in the recent years.

Given Pakistan's volatile economic performance and abuse of aid, could a fall in the aid flows prove to be a blessing in disguise? Some would go further and argue that real change (a change that would make a substantial difference to the lives of ordinary Pakistanis) is not possible without dismantling the current status quo and power structure that continues to favour upper Punjab and Pakistan's army. The elites have governed Pakistan through the military and civil bureaucracy or through a plutocracy where some privileged groups and their parasites control the government machinery. Hence both military dictatorships and civilian governments have failed to provide effective governance.

The centrally governed security state's structures are now crumbling. Some people believe Pakistan is actually stronger than widely perceived and point to its large "black economy". But if the examples of Greece and Italy offer any lesson, combination of corruption, crime and large black economy can lead to systematic collapse if not complete state failure. Pakistan's case is worse because in addition to the above three factors, its security establishment has been obsessed with 'security' in a medieval sense of the term that was largely limited to the protection of international borders from external aggression by keeping the armies strong and happy. In the process, it has become a Leviathan that sees its survival as an end itself even at the cost of devouring her children.

Spending on Pakistan's high profile nuclear programme remains shrouded in secrecy and is not subject to any parliamentary or judicial oversight. Some reports indicate that Pakistan has nearly doubled its nuclear arsenal to more than 100 weapons in a few years. Since the security establishment does not derive its power and legitimacy from the people, it has shown callous disregard for even the minimal needs of Pakistan's citizens, the fundamental resource and strength of a country. This is evident from years of autocratic governance, breakdown of basic police and judicial services, economic plunder and criminal neglect in maintaining or building infrastructure. For example, little investment has gone into the maintenance of its only railway network since 1947. It is now bankrupt.

The ruling elites have dispensed with even the pretence of observing laws. Regardless of the rationale or effectiveness of the CIA's drone attacks in the tribal areas of Pakistan, it is a fact that an army chief secretly agreed to these attacks and to let the US drones use air bases in Pakistan. Of course the granting of such permission has dubious legitimacy under either existing law or authority. Few have dared to pursue this question seriously, including the Supreme Court of Pakistan, because Pakistani rulers are used to treating US ambassadors as viceroys. The US did not want Benazir Bhutto to oppose General Musharraf's emergency rule imposed on November 3, 2007. American Ambassador Anne Patterson travelled to Karachi and met with Benazir Bhutto on November 19, 2007 and asked her not to oppose the emergency measures and cooperate with Musharraf. The Ambassador pressed Bhutto so hard that she reportedly lost her cool and shot back: "You want me to cooperate with someone who wants to kill me?"

The establishment claims that it joined the so-called War on Terror to save Pakistan from security threats and economic collapse but it is ironic that Pakistan has not been in so much mess since 1971. There is a powerful pro-US lobby within Pakistan's establishment and the media. Accounts of secret intelligence briefings (see Obama's Wars by Bob Woodward) given to President Obama on November 6, 2008 revealed that the CIA had bribed elements even within the ISI. This lobby's ultimate apology for serving as a client state of the US (especially since 2001) is what it calls Pakistan's 'economic dependence' on foreign aid - that is, on external debt flows from the US dominated multilateral institutions.

The facts tell a different story. Ninety per cent of the US 'aid' since 2001 till 2008-09 was for military purposes. Even if Pakistan takes loans from multilateral institutions and other Western governments into account, Pakistan's dependence on foreign aid looks more like a 'debt trap.' During the four-year period prior to June 30, 2008; about 55 per cent of new foreign loans, on average, were used to repay old debts. The net debt flows averaged just $1.4 billion a year (or about 0.9% of GDP) during this period compared to an average of $4.8 billion in foreign investments, $5 billion in workers' remittances and $15 billion in tax revenues. Pakistan needs $2 billion a year (or 1.25% of the GDP) in additional tax revenues, foreign investments, and other private capital flows to eliminate this so-called 'dependence on foreign aid.'

During 2001-2008, the priorities of the Bush administration, the patron saint of Musharraf regime, remained firmly focused on the militants in Pakistan and Afghanistan while four Pakistanis committed suicide every day because they could not afford to feed themselves and/or their families. The alleged threat to the US from Islamic militants is a myth. According to a former US Intelligence Chief Dennis Blair, in the past decade terrorists have killed fewer than 20 Americans inside US borders, most of them in a single attack at Fort Hood Texas in late 2009. Blair, speaking at the Aspen Security Forum in July 2010, contrasted the terror body count with deaths from car accidents and street crime, which killed more than one million Americans in the same time frame. Admiral Dennis Blair who served Barack Obama as the head of National Intelligence warned, "We're alienating the countries concerned because we are treating the countries just as places where we go attack groups that threaten us. We are threatening the prospects of long-term reform." The Admiral could have added that the Talibans, though a retrograde and violent group, never posed a threat to the United States. That claim is patently false, even ridiculous.

Some former CIA officials believe the real reason behind Bush's policies was to perpetuate a theatre of conflict as a continuing justification for the expansion of the US military campaign into Central Asia. Whatever the motive, the military campaign was based on a dangerous premise that 40 per cent of the Pushtun population of Afghanistan were Talibans or its sympathisers. A military solution to bring peace and stability with the help of crime syndicates controlled by the warlords and presided over by a puppet wheeler-dealer like Karzai was a non-starter. An American campaign to control the war-torn narco-state of Afghanistan, in the backdrop of strong religious sentiments combined with nationalist Pushtun feelings, with the additional complications of a multi-billion dollars drugs and arms trade, was doomed to fail.

The US failure in Afghanistan and Pakistan's own policy of using militants as a policy tool helped fuel an insurgency that destabilised Musharraf's regime and could lead to a bigger catastrophe in the future. Regional, political and economic polarisation combined with debilitated state structures has reached a point where Balkanisation - and not Talibanisation - is the real threat facing Pakistan. Why Balkanisation? The term usually refers to division of a place or country into several small political units, often unfriendly to one another. The term balkanisation comes from the name of the Balkan Peninsula in Europe, which was divided into several small nations in the early twentieth century.

While the hold of the state of Pakistan is tenuous at best in the north-western tribal areas, it faces a nationalist insurgency in Balochistan. The political government has no role in foreign or defence affairs and little control over Balochistan policy. A US Army study (*Baloch Nationalism and the Geopolitics of Energy Resources, April 2008*) noted that the context of today's insurgency differed in certain important respects from that of its 1970s predecessor. Most fundamental of these differences are those stemming from energy resource developments in what some are calling the "Asian Middle East" (embracing parts of South, Central, and Southwest Asia). Given the magnified economic and strategic importance of Balochistan, the security establishment has adopted a policy of zero tolerance of dissent and ruthlessness instead of reconciliation with the dissidents. But since it does not shy away from conducting covert operations in either India or Afghanistan, it is not surprising that their intelligence agencies might be using the Baloch insurgency to put pressure on Pakistan.

One major fallout of the prolonged periods of military rule (1977-1988 and 1999-to 2008) since the break-up of Pakistan in 1971 has been that the country no longer thinks nationally. For example, there is no real national party. The PPP, which once played that role, was squeezed out of that role by army generals and their minions, like Nawaz Sharif, with the slogan "Jag Punjabi Jag" (wake up Punjabis) and mindless repression and persecution of its followers, leaving aside its own mistakes for a moment.

The current PPP government in Islamabad does not really govern the largest province, Punjab. The ruling party in Punjab has a history of alliances with religious extremists and does not have much support outside Punjab. In its own power base of Sindh, President Zardari's PPP is a virtual hostage to a neo-fascist party - the Muttahida Qaumi Movement (MQM) which dominates Karachi - Pakistan's biggest city, port and commercial hub. The MQM has a large following among Urdu speaking muhajirs, who are the fifth largest ethnic group in Pakistan after Punjabis, Pushtuns, Seraikis, and Sindhis. The PPP has traditionally enjoyed strong support among the Sindhis, who form the majority in the rest of the Sindh province outside Karachi. After the Talibans and other religious extremists groups, the MQM has probably the largest number of armed supporters and is capable of paralysing Pakistan's largest city at a short notice and often does.

Americans accuse Pakistani establishment of supporting the Talibans as a hedge against the anticipated withdrawal of the US troops from Afghanistan, but the Americans themselves seem to be supporting the secular MQM and Baloch nationalists as hedges against a future military takeover in Pakistan by a right-wing general or as instruments of leverage to be used against the central government in Pakistan. And this represents just one aspect of the complex US-Pakistan relationship.

There is an extreme degree of distrust that goes beyond intelligence agencies or army generals. Many Pakistanis believe the US wants to denuclearize Pakistan through the United Nations by creating internal chaos and conditions that would justify such intervention. American fears, concerns and reservations about Pakistan's nuclear programme are well known and go back to the 1970s and 1980s when extremism or Talibans did not even exist. On Aug. 1, 2007, then-Senator Obama made a major policy statement on national security at the Woodrow Wilson Centre. In it, he declared: "We will wage the war that has to be won, with a comprehensive strategy with five elements: getting out of Iraq and on to the right battlefield in Afghanistan and Pakistan; developing the capabilities and partnerships we need to take out the terrorists [and] the **world's most deadly weapons**" (emphasis added).

It is therefore not surprising that even President Karzai (who was handpicked by former CIA chief George Tenet to lead Afghanistan after 9/11) and pro-US President Zardari have privately expressed their suspicions that the Americans have been behind the Tehreek-e-Taliban Pakistan (TTP) attacks in Pakistan. On May 7, 2009, President Zardari shared this view with Zalmay Khalizad, the former US ambassador to Afghanistan, Iraq and the United Nations when they met in Washington.

More than two years later, Pakistan military spokesman Major General Athar Abbas echoed the same theme and told media on October 17, 2011: "When they ran away from Swat, Fazlullah's group was in tatters and was scattered. They got time and support in Afghanistan." General Abbas stopped short of directly accusing the Americans of supporting the TTP but complained: "We have given locations and information about these groups to the Afghanistan government and Isaf (International Security Assistance Force), but apparently there has been no action." Key leaders of the (TTP) including the deputy chief Faqir Mohammed and Maulana Fazlullah continue to operate from their hideouts in Afghanistan.

In separate meetings with former US Chairman of the Joint Chiefs of Staff Admiral Mike Mullen and CIA Deputy Director Stephen R Kappes on July 12, 2008 in Rawalpindi, President Musharraf, General Kayani and DG (ISI) Nadeem Taj asked why the CIA-run predator and the US military did not swing into action when they were provided the exact location of TTP' leader Baitullah Mehsud on May 24, 2008. Baitullah Mehsud was killed one year later in a drone attack but that apparently did little damage to the TTP's capacity to stage terror attacks inside Pakistan. Its leadership found refuge in Afghanistan. Recently, Pakistan blamed NATO for supporting the TTP in launching the Aug 27. 2011 attack in Chitral in which 31 of its troops were killed. An op-ed in DAWN (Oct. 24, 2011) commented that it was hard to believe that one ally would provide succour to a deadly militant organisation against another. The op-ed writer (a university teacher) visited the scene of the attack and found hardly anyone in the area disputed the report about NATO air cover for the TTP incursion.

Both the CIA and the ISI have been playing games with each other through proxies but Afghanis and Pakistanis have paid a heavy price. Afghanistan could disintegrate between the north and the south. Pakistan does not face such a threat in the next few years but the medium and long-term outlook is bleak. Large armed groups (beyond religious extremists) and organised crime enjoy significant influence and power in all the four provinces of Pakistan and in its tribal areas. The authority of the government has eroded over the years and the army's capacity to control violent and armed groups has suffered due to its involvement in politics as well as commercial ventures. This capacity has particularly diminished since July 2007 when it stormed a stronghold of religious fanatics at a mosque in the heart of Islamabad and provoked a backlash from some of its former allies in the religious groups.

With the army heavily engaged in wars and conflicts – both of its making and imposed upon it – and the political leadership fighting for survival, the economy and its management have suffered. Pakistan's economic prospects are diminishing while its nuclear stockpile is growing. Pakistan had one of the highest inflation rates among the major developing world countries during 2007-2011 and borrowed heavily from the IMF. Pakistan received record external aid during Musharraf's era but its economic managers squandered away a historic opportunity to undertake structural reforms, leaving the economy vulnerable to internal and external shocks.

Pakistan's economy is one of the weakest and most vulnerable among the major developing countries to external shocks like high oil prices due to limited fiscal space, narrow exports base and systemic, structural and fundamental imbalances. Pakistan was the first country outside Europe to seek IMF assistance during the global financial crisis of 2008, in part because of its dependence on imported oil and years of neglecting to develop its energy resources. These problems have been compounded by endemic incompetence and corruption. Pakistan can no longer afford the polity of patronage, personalised and arbitrary governance, and incompetence.

A modern and competitive economy has little room for criminal groups that thrive on state patronage and dominate different industries and markets. Pakistan should learn from the Southeast Asian experience, which has enjoyed a significant head start in economic development over much of the rest of Asia. In a recent issue, the Economist raised the question: "So why does (the rest of Asia) still have no global consumer brands of the stature of South Korea's Samsung or rising technology leaders, like Taiwan's AU Optronics or China's market-leaders Huawei and Lenovo?" In a recent book, "Asian Godfathers", Joe Studwell examined this failure in stark terms. The region's business scene, he says, remains dominated by old-fashioned, mediocre, sprawling conglomerates, run at the whims of patriarchal owners. These firms' core competence, such as it is, is exploiting their cosy connections with governing elites. Their profits come from rent-seeking; that is, being handed generous state contracts and concessions, or using their sway with officialdom to keep potential competitors out. If they need technology, they buy it from abroad. As a result, Mr Studwell says, the region has "no indigenous, large-scale companies producing world-class products and services."

Pakistan can learn from East Asian experience, particularly from China's policy to focus on economic development and put conflicts in the cold storage. Pakistan must put its house in order now. This must start with a gradual disengagement from the conflicts in Afghanistan and Kashmir. Peace is the most essential pre-requisite for economic development.

Pakistan needs to redefine 'security' to include energy, water and food security as being more important and reallocate resources through a restructuring of the armed forces with more emphasis on brains than brawn. All the army divisions combined could not have accomplished what a brilliant prime minister and a few scientists achieved for Pakistan's nuclear programme.

Pakistan needs to spend 8-10 per cent of its GDP on education and infrastructure including energy, water and transportation. This is not possible without drastic cuts in defence and establishment expenditure, much of which is simply a criminal waste hidden behind mindless and self-serving rhetoric by some generals, politicians and bureaucrats. Pakistan cannot achieve a sustainable growth rate of seven-eight per cent a year and reduce poverty without huge investment in human resources and basic infrastructure, a task too large for the private sector.

The state must take the lead especially because Pakistan is so far behind her competitors, it must invest much more than it ordinarily might simply to catch up. Pakistan needs effective governance and fiscal space to make these investments. Even within the existing system, improvements are possible through rightsizing of government ministries and bureaucracy, decentralising governance, strengthening the capacity of provincial and local governments, and by upgrading the judiciary and police at provincial and city levels.

To finance these investments, Pakistan must reform the financial sector to mobilise domestic savings, rationalise returns on deposits, improve access to credit for small farmers and businesses, and introduce special schemes to attract capital from overseas Pakistanis, who represent a great source of financial as well as intellectual capital. Pakistan has a critical shortage of intellectual capital. Beyond a few notable exceptions, it does not have any educational institutions of international standard. Its best and the brightest prefer to stay abroad and it is largely the mediocre who stay behind and rise to senior positions in both the government and the private sector. But only a stable government committed to serious reforms can attract the capital of overseas Pakistanis, financial or intellectual. The country must introduce reforms to improve tax collection, remove disincentives and hurdles, deregulate prices and trade in the agriculture sector, liberalise trade for raw materials and capital goods and impose taxes on agriculture income and property gains.

All this would require foresight and tremendous political will backed by competent management. Do Pakistani leaders have the will and capacity to face the consequences of a suicidal pursuit of the ‘strategic depth’, an oxymoron called the War on Terror and of a serious and prolonged economic stagnation? Time will be the ultimate judge but establishment dunces - which include uniformed and civilian bureaucrats, politicians, feudal lords, businessmen, judges, some media barons, and a motley array of parasites - do not appear to be qualified, prepared, or willing to face the gathering storm.

The western financial meltdown provides Pakistan with a historic opportunity to reduce its dependence on foreign aid, disengage from playing the ‘new great game’ on behalf of the West, and make a bold and decisive shift in its foreign policy that is driven by its own long-term economic and strategic interests and not by so-called security interests and self-created crises. China has a long-term strategic interest in a strong, stable and economically independent Pakistan. It is the only major power that has both the will and the capacity to exploit Pakistan’s natural resources and help build its infrastructure that is in dire need of huge investments. In contrast to the US, China sees itself, and not India, as the leader of the future Asian century and has a natural interest in a Pakistan that is more than a client state of the West. But the full potential of Pakistan’s relations with China cannot and will not materialise without a major shift in Pakistan’s foreign policy.

This shift must include a radical change in its relations with India that have recently shown signs of improvement. Pakistan should build friendly diplomatic, economic, cultural and people-to-people relations with all the neighbouring countries, especially India, and follow the principles of non-interference in each other's internal affairs and peaceful co-existence. China cannot and will not jeopardise its global interests just to help Pakistan although it has a great stake in a stable and strong Pakistan. India too wants to see a stable Pakistan because its collapse would destabilise the whole region and hurt Indian economy. However, Indian leadership does remain seriously concerned because of past experiences like the 1965 war and Kargil because it was Pakistan's army generals and not India that started armed aggression.

Pakistan needs to feed a hugely young, under-educated, under-employed and resentful population. To do that, it needs to maintain a GDP growth rate of 7-8 per cent a year to make a real difference to the lives of eighty per cent of the population. This growth rate is necessary due to highly skewed income distribution and nearly two per cent population growth rate. This growth rate cannot be achieved without large foreign and domestic investments that are unlikely to materialise if Pakistan continues the policies that perpetuate domestic and external conflicts.

Therefore, Pakistan's most fundamental and crucial challenge is to transform itself from a dysfunctional client national security state into a modern democracy. Pakistani leadership needs to move into 20^{th} century if not the 21^{st} century. Pakistan is too big, too fractured and too complex to be governed by an army dictator or a cabal. But democracy or political will alone will not be sufficient unless Pakistan can come up with a sustainable economic development model which is free of both neo-liberal and Islamist dogmas. While liberalisation and deregulation can be given credit for much of India's progress since 1990, it would not be entirely correct to say of China's progress. A new study prepared for the US government (US-China Economic and Security Review Commission) says it's not capitalism that's powering China, but state capitalism — China's massive, centrally directed industrial policy, where the government positions huge amounts of capital and labour in economic sectors it intends to nurture.

Hence, Pakistan needs to follow a pragmatic course. Its model of development should be uniquely appropriate for a country that has one of the world's largest, fastest growing and youngest populations and which suffers from serious institutional weaknesses and is critically short of energy, water and skilled human resources.

Pakistan cannot stop the drift towards self-annihilation and hope to move forward unless it:

- disengages from its overt and covert conflicts,
- realigns its foreign and economic policy focus from the West to the East, and
- empowers its people.

Disengagement, realignment and empowerment are the essential pre-conditions for the process of institution building and economic development to start and take root. Failing to do so will result in a higher and growing risk of failure as a state and Balkanisation a real possibility. Peace, independent foreign policy and a plural democracy have to be the pillars of a modern Pakistan.

This edition includes analyses of Pakistan's current economic problems, the key issues that led to Musharraf's downfall, the role of the intelligence agencies in Pakistan and many more papers that I have written since the publication of the first edition of this book. Almost all the articles have been arranged in chronological order, i.e. date of publication with the exception of the first;

“The gathering storm and its implications.” This was the first article I published when I started writing in 2006. I would like to thank everyone, especially former op-ed editor of DAWN Zubeida Mustafa and editor of the Business Recorder Mr. Arshad Zuberi, who has provided me invaluable support and encouragement with their comments, criticism and suggestions. That being said, all errors and omissions are mine.

Yousuf Nazar
November 2011

Introduction to the first edition

It was the spring of 2006 and I had arrived in Karachi from London for a short visit to plan our family's move to Pakistan after having spent a long time abroad and a career in international finance. As I met with family, friends, businessmen, bankers, stock brokers and government officials, I was struck by a general sense of optimism about Pakistan's economy. It was after a long time that the educated intelligentsia seemed to be upbeat about Pakistan's prospects. People talked about the foreign money pouring in, rising property values, booming stock market and cheap mobile phones. The restaurants were full and it was difficult to find a room in good hotels.

The chatter in Karachi's Sind Club – a favourite haunt of Karachi's business elite for power lunches – was full of stories of which foreign bank was coming to buy what. A CEO of one of the banks told me, "the economy is booming and Musharraf-Shaukat team is the best we have had in a long time." I listened quietly as he told me about his contacts with the president and the prime minister, who had turned the economy around.

It was during the summer of 2006 that I got a phone call from the economic and business editor of DAWN, Mr. Jawaid Bokhari, to write something for the newspaper. It was on August 19, 2006 that I published my first article (which is the last in this compilation), "*the gathering storm and its implications*." The article argued that the military or quasi-military governments – even with the help of the United States- could not bring either political or economic stability to Pakistan.

In the autumn of 2006, the bomb blasts and suicide killings were limited to certain areas and most Pakistanis had not experienced the fear and terror they were to face in the following year and thereafter. The discussions about the War on Terror were mostly - and understandably - in the context of the clash of civilisations, injustice to Muslims in Palestine, Kashmir, and Bosnia, the fallout from the 'jihad' in Afghanistan, terrorism and 9/11. However, there was an almost complete absence of the word 'OIL' from these discussions. Oil provides nearly 96% of the world's transportation energy and has been and is the most important natural resource in the world. In the context of Middle East politics, oil has been one of the fundamental pillars of the US foreign policy for well over five decades and any discussion of its foreign policy remains incomplete without an understanding of the role of oil. These thoughts led to another article, "*US quest for global energy control*", published on November 4, 2006.

I was invited to some television talk shows and tried to focus on oil as an important factor in the War on Terror and due to its increasingly critical importance in the global political economy and the geo politics of our region. This did not get much encouragement from other participants and media persons, whose views had been shaped largely by the most recent history - 9/11, the rise of militancy and extremists, events in Afghanistan, etc. Those were important issues without any doubt but I felt that the role of oil and the critical issue of energy security in the context of our national and foreign affairs did not receive due attention.

Barack Obama told a Washington gathering in February 2006: "if there's a single example out there that encapsulates the ability of unstable, undemocratic governments to wield undue influence over America's national security just because of our dependence on oil, this is it.

America's dependence on oil is a major threat to our national security, and the American people deserve a bold commitment that has the full force of their government behind it.” However, in Pakistan, the rulers were implementing the privatisation programme to sell oil companies in bits and pieces without any strategic plan or vision for the energy security of the country. In a broader context, the political economy was not given the importance it deserved.

The pursuit of natural resources has been a key element in the political economy of the modern times. It was the riches of India that attracted the East India Company and led to the colonisation that was to last for nearly a century. Cotton was one of the main reasons behind the US annexation of Texas in 1845. It was oil that occupied US President Franklin Roosevelt’s thoughts, when after leaving the summit of the Allied leaders in Yalta in February 1945; he secretly flew to Egypt and sailed on a navy vessel, the USS *Quincy,* to Great Bitter Lake to meet King Abdul Aziz ibn Saud of Saudi Arabia.

It was the failure of the centrally planned economic system of the nuclear-armed Soviet Union that was the principal cause of its disintegration. The collapse of the oil prices in the late 1980s – after reaching peak levels in 1980-81 – eliminated Soviets’ only remaining source of growth and precipitated the collapse of an inefficient and corrupt economy as Russian soldiers lined up at the food ration stores. More recently, the Iraq war is ‘largely about oil’, as former Federal Reserve Chairman Alan Greenspan put it and it is in the pursuit of oil and other natural resources that China has poured tens of billions of dollars in Africa.

I was therefore inclined to look at my country, its successes, its failures, its geo-strategic importance, and its role in the post 9/11 world as a student of political economy. After writing the piece on oil and energy, I published dozens of articles on Pakistan’s economy.

The fundamental theme was that without a major change in the structure of the political economy of Pakistan, not only there was little hope of a meaningful transformation in the lives of ordinary Pakistanis but also the danger that it could face serious economic crisis in the coming months and years. On December 18, 2006, I wrote, “when a credit or a liquidity driven boom is used to finance an ever-increasing level of consumption and does not result in higher capital formation and investment spending, it causes higher inflation. The problem is exacerbated when higher consumption also involves finished goods imports that put additional pressure on the current account.”

Musharraf’s economic policies were probably the most elitist in Pakistan’s history. His tenure saw an unprecedented liquidity-driven boom in the financial sector. His biggest failure was that a historic opportunity to capitalise on the money inflows for economic development was thrown away and sacrificed at the altar of special interests and political expediency.

After eight years of rule by the military and its hired technocrats, with the full support of the United States, Pakistan’s critical economic and social indicators slipped below those of the developing world. For example, in contrast to 1999 when it was 5 per cent higher, the country’s per capita income was 6.5 per cent below the average of all low income countries in 2006 when measured on purchasing power parity basis.

In 2007, most of the economic and social indicators of the world's sixth largest country by population were worse than those of rest of the world except African countries and a handful of others like Nepal, Bangladesh, Laos, Tajikistan, and Mongolia. The economy remained largely un-documented, exports base failed to broaden, external debt-to-GDP ratio remained worse than even that of Sub-Saharan African countries, and the tax-to-GDP ratio fell to a level below what it was in 1988. The underground economy flourished with tax and money laundering havens in real estate and stock trading.

The claims of economic miracle and growth were belied by a cold fact. Pakistan's per capita GDP (or income per person) growth had been one of the lowest in Asia and below the average of all low-income countries in the world during 1999-2006, when measured in purchasing power parity terms. What it meant in simple terms that the so-called economic boom had not touched more than 80 per cent of the people who lived in a country with one of the highest inflation rates in Asia. It was ironic that not only they were no better off economically than they were seven years ago; they felt much less secure going out of their homes than they did ever before.

On the contrary, General (now retired) Pervez Musharraf, his ministers, and his economic managers were telling the world at forums like Davos, businessmen, and the bankers that Pakistan never had it so good. Most of them appeared to believe so. But the myth of the 'economic miracle' was soon to explode as Pakistan was to face double digit inflation, record levels of trade deficit and domestic debt, a balance of payments crisis, and a depreciating currency in less than twelve months. What went wrong? The common culprits are oil prices, incompetence and corruption but the fundamental reasons go far beyond and deeper.

It might be interesting to narrate a small incident here. Commenting on the budget of 2007-08, I wrote on June 10, 2007: "It appears that in its last budget, the current administration has chosen not to take difficult decisions regarding increasing the tax base and cuts in non-development expenditure because it would rather leave it for the next government to make tough policy choices when the crunch comes."

The comments carried on the front page of a leading daily, greatly upset Prime Minister Shaukat Aziz. He twice telephoned a mutual acquaintance – CEO of an international bank in Pakistan – to communicate his displeasure to me and asked him about my 'motives'. I was quite amused.

Few weeks after Pervez Musharraf 'suspended' Chief Justice Iftikhar Chaudhry, I wrote two papers on the political economy of the national security state. Commenting on the judiciary's crisis, I wrote on April 9, 2007: "the military rule, by systematically damaging the rule of law has imperilled Pakistan's development prospects and the current crisis needs to be debated in that broader and fuller context. It is old news that the Pakistan's military rulers have always operated above the law and have never been accountable to the courts despite pretensions to the contrary. The conquest of the judiciary will remove even that pretence and will destroy whatever is left of that institution. [But] the business community seems to be watching from the sidelines hoping that this crisis will somehow get resolved and it will be business as usual."

In the second paper published on April 16, 2007, I expressed doubts about whether a transition to democracy would be enough to face the challenges ahead: "the threat of Talibanisation and the alleged 'deal' between General Musharraf and Benazir Bhutto have dominated the news recently. The two subjects are perceived to be interlinked in that some analysts see the need for an understanding between these parties as something that would benefit both at a time of a seemingly growing threat from the extremist forces and tensions between Islamabad and Washington. However, some of the fundamental questions must be addressed before one jumps to welcome the possibility of a rapprochement between the government and the People's Party as need of the hour or condemn it as a sell-out. Both the viewpoints may turn out to be redundant if the establishment, the politicians and the media do not address basic and crucial questions about the future direction of Pakistan's political economy. Power sharing adjustments between military leaders and civilian politicians have taken place before but failed to bring either stability or prosperity to the country. This time, the stakes are even higher. Pakistan cannot afford to live in a state of continuous external or internal conflict because it is receiving aid to do so."

Almost a year later, I was to write in March 2008, "Pakistan's inflation rate in the first seven months of the fiscal year of 2007-08 has hit nearly 17 per cent – the highest in Asia, its exports growth has stalled and the budget and current account deficits are reaching one of the highest levels among the major developing economies. The fundamental and structural imbalances and weaknesses – and not the just the high oil price – have contributed to the gradual but predictable deterioration in the country's macroeconomic fundamentals over the last two years. Do we need continuity or a change in our economic policies?"

This is one of the basic questions which motivated me to write a series of articles during the period from August 2006 to March 2008. The question has assumed critical importance. I have not been fond of the economic prescriptions of the World Bank (or for that matter of the IMF) in the past but an observation from its February 2008 report on Pakistan's infrastructure is worth quoting: "without adequate irrigation resources, power, and transport infrastructure, the very sustainability of Pakistan as an independent nation may be at stake as shortages could lead to increased social discontent and disharmony amongst the federation and the provinces." These huge problems cannot be addressed through quick fixes. Pakistan's elites can no longer afford to avoid the basic and most pressing questions about the very nature and sustainability of the political economy of the national security state that Pakistan is.

Some interest groups feel we need continuity of economic policy. Do we need continuity of failures? Pakistan's elites will be the biggest losers if the country fails to rise up to the challenges of the 21st century. They cannot even dream to afford the lifestyles they have in Pakistan, anywhere else in the world. They have the most to lose. The country was fortunate to get a new economic life in the aftermath of 9/11 through massive capital flows in the form of transfers from overseas Pakistanis, sale of government entities, aid, etc. But the liquidity-driven boom is over and the country does not have a sustainable growth or development model. Far from it.

While a lot is written about and much made of around $11 billion in the US aid to Pakistan during Musharraf's rule, it is rarely mentioned that during the period from 1999 to 2007, the US arms sales to Pakistan totalled almost $10 billion. Also forgotten is the fact that 77% of all new foreign loans obtained during the much maligned period of 'civilian' rule during 1990-99 were used to repay the loans obtained during General Zia-ul-Haq's tenure. General Musharraf and his team, addicted to aid, seemed to have little appreciation of the fact that a period of record global economic growth and liquidity boom since 2000 – and not just external aid - was the principal reason behind Pakistan’s economic performance through the years from 2001 onwards.

Pakistan cannot afford to continue the policies of a national security state that failed to address important national priorities even during a period of benign global economic environment of record growth, high liquidity, low inflation and interest rates - that lasted from 2000 to 2007. These policies were instrumental in promoting the robber baron culture under a patronage-driven protectionist economy that is incapable of standing on its feet in a global economy where skilled and educated workforce and not the size of its army has become a measure of a country’s strength and potential. Faced with worldwide energy and food crises, highly competitive global markets for goods and services, global economic slowdown and a financial crisis, Pakistani leadership must be prepared to make tough policy choices and to take bold and imaginative decisions. Pakistan needs a change and not continuity in its policies.

If Pakistan is to break the debilitating and vicious cycle of military intervention, promise of reform, failure, demoralisation, retreat by the military and quasi-civilian rule, its political parties will need to get down to the serious business of introducing structural reforms that would give a greater stake to the masses in protecting and fighting for democracy. The independence of judiciary is essential for establishing the rule of law but it is not enough. Economic justice cannot be provided without a fair and equitable tax system for which comprehensive reforms must be introduced.

There is an urgent need to redefine the national economic priorities and formulate development strategy. While Agriculture, Energy, and Exports must be the top economic priorities, we must take cognizance of the following:

1. Despite all the rhetoric about free trade, major producers of agricultural commodities continue to follow protectionist policies that include the use of subsidies. The European Union’s subsidies on agriculture alone exceed an amount that is twice the agriculture GDP of Pakistan.
2. The governments and not private sector companies control 80% of world’s oil resources. India and China are not selling their oil companies but buying oil assets abroad.
3. Only those manufacturing industries that have the scale and expertise to compete on a global scale can succeed in a world of low trade barriers.

The starting point of change should be a comprehensive reorientation of fiscal and trade policies: (a) from protectionism and big government to fair competition and less government in areas where it is least effective or non-productive; and (b) from consumer-led growth to exports-led growth.

The government should remove disincentives to savings and investments. It should drastically cut the size of the government under whose weight small farmers, traders, entrepreneurs and small businesses cannot grow. It must remove fiscal, trade, and monetary policy distortions that are designed to give favourable and unjustified benefits to special interest groups.

The cost has been high: low agricultural productivity, fragmented and uncompetitive textile industry – its largest, incompetent and inefficient security forces, an apathetic populace and a weak and vulnerable economy without sustainable growth prospects. So far the casualties have been the democratic process and economic development. Any further delay in addressing the core issues may hurt more than just democracy and development. It may imperil the future of the state of Pakistan.

I hope that the publication of these articles will contribute to the debate on political economy of what has been called an army with a country and not a country with an army. I would like to express my sincere and deep gratitude to Mr. Abbas Nasir, the former editor of DAWN, and Mr. Jawaid Bokhari, for their constant encouragement. I owe a loving thanks to my wonderful wife Tehmina who put up with my uncivilised hours when I wrote, and to my young sons, Raza and Saahir, who thought I had turned into a ‘nerd’ when they saw me engrossed into materials and busy writing.

Yousuf Nazar
March 2008

The gathering storm and its implications

(This was the first article I wrote and published in DAWN of August 19, 2006)

A New York Times article (August 9, 2006) comments that "moderate reformers across the Arab world say American support for Israel's battle with Hezbollah has put them on the defensive, tarring them by association and boosting Islamist parties. The very people whom the United States wanted to encourage to promote democracy from Bahrain to Casablanca instead feel trapped by a policy that they now ridicule more or less as "destroying the region in order to save it."

The issue is not just limited to the Middle East. Here at home, the government and the "mainstream" political parties, notably those belonging to the Alliance for the Restoration of Democracy (ARD), have to do a lot of serious thinking and soul-searching about the growing radicalisation of political thinking from Indonesia to Morocco, spurred by an unashamedly and almost blind support of the United States to the recent Israeli aggression against Lebanon.

The issue of military's role in Pakistan's politics has been the subject of ARD's charter of democracy and the military has been blamed for not allowing the growth of democratic institutions and practices, but military's dominance of our history is closely linked with our foreign policy under which the army has always sought aid from the US in exchange for the support and help in achieving the latter's strategic objectives in the region.

The US-Pakistan defence relationship has served the US foreign policy interests while enabling the US to keep a strong grip over Pakistan's domestic polity. Obviously, Pakistan is not an isolated case where the US policy makers supported corrupt, autocratic and incompetent regimes to further their strategic interests. The democracy and development in the US-allied states (e.g. Pakistan, Egypt, Saudi Arabia and Indonesia) took a back seat as the US sought reliable partners to pursue its global and regional foreign policy goals. It is in this context that the present debate about army's role in our political history needs deeper examination.

While the ARD's charter and a letter to President Musharraf written by "distinguished citizens", that included former heads of ISI, have received a lot of media attention, it is quite interesting that almost none of the opposition parties or for that matter, the "distinguished citizens" have commented on the US-Pakistan Army nexus that has been a critical factor in sustaining prolonged periods of army rule in Pakistan.

Now another group of prominent citizens has written a similar letter to the president. If we are going to have a truly representative government and an independent legislature and judiciary, are we going to have an independent foreign policy? Or can we have a democracy and an independent foreign policy?

The Israeli actions juxtaposed with Dr Condoleezza Rice's declaration of a "new Middle East" may prove to be the beginning of a new era in the Muslim and Arab countries where for any government or political party to support US foreign policy in the region would become a political liability. Sensing this mood, even the otherwise moderate and pro-US King Abdullah has spoken. In an interview with the BBC (August 8, 2006), he criticised the international community for only offering a piecemeal way of dealing with the crises in the Middle East.

He spoke of a region that was being radicalised by the growing support for Hezbollah as it fought back Israeli onslaught in the just-ended war. The moderates, he said, were being marginalized. The BBC correspondent, who interviewed the king, said it was clear that countries like Jordan and Egypt, who have close ties with the United States and peace deals with Israel, feel deeply worried, if not threatened, by this crisis.

Here in Pakistan, unless the “moderate” political forces can provide a model of democracy and development that does not depend on US military and economic assistance, their ability to provide a viable alternative to the military or autocratic rulers, is likely to be seriously tested in the coming years. The challenge seems greater now than compared to any other point in post-cold war period. It would be naive to assume that the US (under neo-conservatives or democrats) would actively support the “moderate” political parties in their demand to hold free and fair elections to establish a truly representative government.

The Bush administration’s brief honeymoon with a vision for democracy in the region is already over for all practical purposes with the election of Hamas in Palestine. More importantly, the prospect of a Hezbollah-dominated government in Lebanon is a thought scary enough for any US government to entertain any ideas about representative rule in the region’s countries.

Let’s now come to what is really wrong with the premise that the mainstream parties appear to operate upon: the route to power goes via Washington. The trouble is that Pakistani’s elites tend to attribute all happenings to America, which is not as powerful and as omnipotent as they think it is. No doubt it is the sole superpower but let us look at the facts. Its Middle East policy, if there is one, is in tatters. It has failed to impose democracy on Iraq, which is closer to an all out civil war. Syria and Iran are openly defiant and hostile and old allies like Saudi Arabia and Turkey are visibly cool.

It is remarkable that leftist leaders are back in command in many South American countries (in America’s backyard) and have won elections despite their anti-US stance on a range of policy issues. President Lula in Brazil [the largest economic power in the Western Hemisphere], Chavez in Venezuela [the fifth largest producer of oil from whom the US imports 12% of its crude oil requirements] and Evo Morles in Bolivia [one of the world's largest producers of coca, the raw material for cocaine] have won elections in the recent years despite their leftist policies. Chavez even thwarted a coup attempt, which had American support.

And in Mexico, Lopez Obrador of the leftist Democratic Revolution Party came close to winning the last month’s presidential election which he lost by 244,000 votes; a result which has triggered civil disobedience by his supporters since last two weeks.

But wasn’t Latin America the first to the embrace the New World Order and undertake large-scale privatization starting in the 1980s? Weren’t the US - supported economic reforms supposed to transform the Latin economies into prosperous democracies? Then why are we witnessing the revival of the populist leaders right under the nose of Uncle Sam?

One of the leading and most respected US economists, Paul Krugman, who teaches at Princeton University and has been called ‘the most celebrated economist of his generation’ by the Economist, writes about the Latin American experience with economic reforms and privatization in his latest book, The Great Unravelling: “the actual results have been mixed. On the economic side, where hopes were initially highest, things have not gone too well. There are no economic miracles in Latin America, and there have been some notable disasters, Argentina’s crisis being the latest. The best you can say is that some of the disaster victims, notably Mexico [a close US friend], seem to have recovered their balance (with a lot of help, one must say, from the Clinton Administration) and moved onto a path of steady, but modest, economic growth……so while the US may have hoped for a new Latin stability based on vibrant prosperity, what it actually got was stability despite economic woes, thanks to democracy. Things could be lot worse.”

There are a few lessons to be learned from the Latin American experience. Economic reforms alone (read privatization and deregulation) without a massive investment in infrastructure and human development cannot alleviate poverty nor do they provide a foundation for a sustainable high economic (or GDP) growth, contrary to the “wisdom” that currently prevails among the mandarins in Islamabad. They talk about the endorsement of their policies by the World Bank and investors. But economic policy is a more complex business than some commercial bankers and bureaucrats in Islamabad would like to believe. They would be well advised to recall that when the IMF and the World Bank held their annual meeting in September 1997 in Hong Kong; everyone congratulated the hosts on their economic policies, which had insulated them from the turmoil in the South East Asia. A month later Hong Kong had not only crashed but had briefly brought Brazil and rest of the emerging markets down with it.

Another example is Japan in the 1980s when its property and stock markets reached frenzied heights and foreign investors flocked to Japan. This was followed by a spectacular collapse and a recession that lasted well over a decade. Both Hong Kong and Japan practiced the so-called “crony capitalism”, a euphemism used to describe corrupt and incestuous politico-economic systems. The Asian economies had to go through a painful period of structural reforms before they could resume normal economic growth.

Second lesson is that military dictatorships brought neither political nor economic stability to Latin America but democracy did bring some stability. Third, it is possible for political parties to win popular support and win elections despite US opposition provided their leadership has conviction in its policies and an ability to inspire confidence among the masses.

In Pakistan’s case, however, the traditional political parties face the challenge of convincing the people that they can bring some progress to a country ravaged by poverty and corruption. Their track record while they governed caused widespread disenchantment and disappointment, charges [often true] about the establishment obstructing the democratic process notwithstanding.

It would take more than a charter or a declaration to mobilise the ordinary people out of their antipathetic and stoic attitude towards the way Pakistan is misgoverned. If the masses continue to suffer and perceive the mainstream parties as ineffective and followers of the US policy, Pakistan’s drift into the politics of religious extremism and xenophobic ethnicity is likely to continue with the under-privileged and the illiterate finding the alternative of “jihad” growingly more appealing. After all, they don’t have much to lose! It is a different matter though that most “religious parties” in Pakistan, with a long history of collaboration with the corrupt military dictatorships, have little in common with the philosophy and character of Hezbollah’s leadership.

Balkans of the next world war?

While the 9/11 was a big tragedy and caused the loss of around 3000 human lives, it is an undeniable fact that hundreds of thousands of innocent Iraqis, Afghans, and Pakistanis have died in the last decade as a direct consequence of the hubris and irresponsible and reckless actions of America. The 9/11 pales in comparison to the sufferings of Pakistanis as a nation which has paid the highest price both in human and economic terms for fighting this war. Yet they are demonised as a country- with the help of a loyal corporate US media -to hide the blunders of the US establishment. And their brown sahib apologists – devoid of any original thought – parrot what they read in the New York Times whose reports have recently read more like press releases from the Pentagon and the CIA.

The unfortunate reality is that US establishment always needs a whipping post especially for its domestic audience. Once the Russian 'evil empire' was the biggest threat to the World. Then the bogey of the clash of the civilizations was raised. Saddam Husain was portrayed as modern day Hitler, never mind that the US armed him to fight Iran. Before Osama's death it was Al-Qaeda and now it is the ISI. An idiot tried to explode fire crackers in New York… blame it on the ISI. Your wife is sleeping with your neighbour….blame it on ISI, you slip in the bathroom …….blame it on ISI, your daughter is a lesbian ….BINGO …ISI. About time American officials get real and think hard before they sink deeper into the mess called Afghanistan, a mess they created in the first place.

The US media – dominated by a handful of corporations including the thoroughly discredited News Corp. of Rupert Murdoch – must ask the US establishment what its wars have achieved? After 1.3 trillion dollars (probably more if one takes into account the indirect costs), and 10 years later, it seems certain that American response to 9/11 will go down as one of the most catastrophic blunders of the US foreign policy in modern history.

The US establishment and its mouth pieces in the poodle corporate media (e.g. CNN, New York Times, et, al.) continue to be in denial. They talk about the US forces in Afghanistan as if it is their birth right to be there. A plain and inconvenient truth is that the US forces in Afghanistan are occupation forces and Afghans are within their legitimate and moral rights to resist occupation. Afghans have a right to determine their own future without any outside interference including that of Pakistan or India. It is irrelevant whether those Afghans are ethnic Pushtuns or Tajiks or Uzbeks, modern or conservative, liberals or right-wing Islamists.

Sir Sherard Cowper-Coles who was Britain's ambassador to Afghanistan from 2007 to 2009 recently wrote in the New Statesman:

" The point is that it has always been beyond the power of even the mightiest nation on earth to win the wars on which, with British support, America has embarked in both Iraq and Afghanistan. It is a profound delusion to think that, in five or ten or 15 years, any external power could stabilize a country in the condition Iraq and Afghanistan were in when our troops entered. Britain might do everything right in Helmand, and America might do everything it can across other parts of southern Afghanistan, yet we would still be some way from stabilizing the country in any enduring way."

In realpolitik terms, an escalation of conflict is incompatible with the declared intention of the Americans that they want to unwind the war and reach a political settlement. It is a folly to think that the Americans can beat the Talibans and negotiate from a position of strength. It is too late for that. They cannot bomb Afghanistan into peace nor would a 'white men's burden' mindset work. The history is not on their side. While the White House, the Pentagon, the state department, and their blind followers in the US media and the so-called think-tanks have carried out synchronised attacks on Pakistani Army generals (for whom I do not have much sympathy either) for either supporting the Afghan Talibans or not doing enough to fight them, the Americans themselves have been secretly meeting the leaders of the Haqqani group to draw them into talks to end the war, according to the US media reports. Yet they want Pakistan to launch an operation in North Waziristan. We might even see an escalation in the drone attacks. This time, North Waziristan and even parts of Balochistan could be the target of such attacks.

This is not the first time the US officials have approached the Haqqanis since this war began in 2001. In fact, the US made several attempts to seek reconciliation with the Haqqani group but failed. According to a Wall Street Journal (WSJ) report of November 8, 2007; back in autumn 2002, Jalaluddin Haqqani – a one time partner of the Central Intelligence Agency – secretly sent word that he could ally with the new US-friendly Afghan government. CIA officers held talks with his brother, Ibrahim, and made plans to meet with Mr. Haqqani, who was leading some of the Taliban's troops. But, according to the WSJ, the US military forces operating separately from the CIA arrested Ibrahim — cutting off the talks and entrenching his brother as a nemesis. So it was basically a case of blowing away an opportunity to reconcile due to the fact that the US misadventure in Afghanistan has been an unmitigated policy and operational disaster since November 2001, forget what happened in the "Afghan jihad" of the 1980s and thereafter.

Those Pakistanis who have maintained and continue to say, 'this is our war', do not seem to understand that extremism cannot be countered with more violence because violence begets more violence and hatred. It is a vicious cycle. Worse, the supposedly democratic forces fighting this war have no credibility. Even a conservative paper like the Wall Street Journal (re: *Pakistan's Next President Is a Category 5 Disaster, WSJ of Sep. 2, 2008*) had to concede: "Mr. Zardari is a caricature of everything that's morally bankrupt with the country's Westernized elite, and thus an inviting propaganda target for al Qaeda and the Taliban."

These 'socially liberal' Pakistanis are in denial of the realities of international politics and Western policies. They dismiss everything as conspiracy theory whereas the fact is they demonstrate little understanding of the frustrations, motives and selfish interests of the western powers that have shown unmistakable signs of financial, moral, and intellectual bankruptcy in the past decade. Misguided polices and irresponsible actions of big powers have serious widespread repercussions around the globe.

The US and its NATO allies, in their desperation to salvage their declining global power and save face (e.g. blatant lies about everything including the WMDs and double-dealings with militant groups like the Haqqanis), have resorted to taking help of even some Al-Qaeda linked so-called Islamic militants in Libya and Syria.

A French newspaper La Temps recently reported that Abdel Hakim Belhadj, who leads the rebel forces in Tripoli, was a founder of the Libyan Islamic Fighting Group, and is believed to have been close to head of Al Qaeda in Iraq, Abu Musab al-Zarqawi. The Huffington Post – an American online publication – noted that for US intelligence services, the man who led the rebel assault on Tripoli, and is now the de facto military governor of the capital, is an old acquaintance. The CIA had tracked down the accused jihadist, and eventually captured him in Malaysia in 2003. The agency is believed to have then transferred him, in total silence, to a "top secret" prison in Bangkok. Other Western papers, such the Guardian, have also reported on these links.

Both Libya and Syria have had autocratic governments, but democracy is hardly the issue. The US and its European 'poodles' cannot fool the world any longer by talking about human rights to justify their military campaigns to topple anti-Western governments in those parts of the world that are rich in natural resources and have more than 70% of the World's oil reserves. Given the neo-colonial agenda of the US and its allies like the UK and France, it is not surprising that China and Russia recently vetoed the European Union-sponsored UN Security Council resolution that threatened sanctions against Syria. Noticeable abstentions were Brazil, India, South Africa, and Lebanon. Talk about the East-West divide. This wide gulf of views between those of the US/NATO and the rest of the world was also observed in the recent UN general assembly session when US/NATO countries were the only ones to walk out when Iranian President questioned the incidents of 9/11.

Here in Pakistan whose military and civil elites have fought America's war for money are wrong to assert that only emotional Muslims oppose these wars. For example, two-thirds of Britons want NATO to withdraw troops from Afghanistan.

Even in the United States, there is little support for the war. The CBS News / New York Times poll of June 24-28, 2011 reported that the majority, that is, 58% of Americans oppose the US military involvement in Afghanistan – the highest level of opposition yet recorded by the poll – while only 35% thought the US was doing the "right thing" in fighting its war in Afghanistan. Last Thursday, protesters in Boston erected tents that bore the rallying cries "Fight the rich, not their wars" and "Human need, not corporate greed."

The cost of the war may turn out to be more than human lives and economic stagnation. It could result in the balkanisation of Pakistan. Sadly, Pakistan's elites and its corrupt and intellectually deficient generals who sided with President Bush's mad and reckless 'crusade' failed to anticipate its longer term consequences. Bush's policies stand discredited within America and the world over. Pakistan's political leadership and its civil society ought to ask themselves why they continue to follow this policy, never mind their mostly justified and legitimate grievances against the military establishment.

Pursuit of peace with respect for the basic principles of non-violence, non-interference in the affairs of other countries, and observance of fundamental human rights, in summary, a principled stand can help us get out of the quagmire we are in. We should stay firm and tell Americans that a negotiated peace settlement is the only option, and that they might have to swallow the bitter pill of talking to the Haqqanis if that is what it takes. Why Peace is the only option? I would end with a long quote (my apologies) from an interview of Dr. Henry Kissinger published in the Financial Times of May 20, 2011:

"Kissinger laughs even as he sketches a scenario for an Afghanistan even grimmer than anything anyone has yet imagined, where the presence or absence of al-Qaeda will be the

least of its problems. What might happen, he says, is a de facto partition, with India and Russia reconstituting the Northern Alliance, and Pakistan hooked to the Taliban as a backstop against their own encirclement.

Suddenly, spring goes chilly. The prospect looms of a centennial commemoration of the first world war through a half-awake re-enactment. Not Belgium but Sarajevo. Think proxy half-states; the paranoia of encirclement; the bristling arsenals, in this case nuclear; the nervous, beleaguered Pakistanis lashing out in passive-aggressive insecurity. "An India-Pakistan war becomes more probable. Eventually," says the Doctor, his voice a deep pond of calm. "Therefore some kind of international process in which these issues are discussed might generate enough restraints so that Pakistan does not feel itself encircled by India and doesn't see a strategic reserve in the Taliban." He looks directly at me. "Is it possible to do this? I don't know. But I know if we let matters drift this could become the Balkans of the next world war."

October 6, 2011

An illicit affair turns sour

Time is running out fast. Pakistani Generals' latest love affair with the United States that started after 9/11 seems to be heading for an acrimonious break up after exchanges of charges of betrayal. The US tolerated Pakistan's duplicity (we cannot point to America's because it is a super power and nor can we try Bush for war crimes) from day one and even supported it at times as long as it served its objective of a prolonged conflict and full-scale presence in Afghanistan and securing intelligence to eliminate Al Qaida's Arab command.

Truth is the first casualty in a war and history is written by the victor. We may never find out the whole truth but we know for sure as Gary Bernsten, the CIA's TORA BORA unit head in 2001, has maintained in his book "JAWBREAKER" and told media, it was the US top army officials who were responsible for letting bin Laden escape from Tora Bora in early December 2001. Osama's will (confirmed by the US Senate investigative report) is dated December 14, 2001. The US could get hold of the will but not the man?

Few are asking this question and those who dare to ask are dismissed as conspiracy theorists by the very people who claim to champion virtues such as rationality and objectivity. As a writer and a student of politics; I am more concerned with the pursuit of truth because in the real world, interests drive politics and media is part of it.

If we put Gary Bernsten's story together with what Seymour Hersh wrote in the New Yorker in January 2002 (expanded upon by Ahmed Rashid in his book *Descent into Chaos*), the circumstantial evidence and findings of 2009 US Senate Report, taken together, suggest that the decision to let bin Laden and Al Qaeda fighters escape was that of George Bush and US Vice President Dick Cheney. Gary Bernsten's account has been more or less corroborated in a US Senate Foreign Relations Committee (under John Kerry) report, "TORA BORA REVISITED" dated Nov. 30, 2009.

I have written about the collusion of Pak-US establishments and Tora Bora on many occasions during the past three years in this space in addition to maintaining this position in TV appearances. But given the murky nature of US-Pakistan intelligence relations, Pakistani media is shy of highlighting specific and important incidents that involved the ISI and militants.

The US Senate Report stopped short of charging Dick Cheney and Donald Rumsfeld of deliberately letting Osama escape or of criminal negligence but nevertheless concluded:

"After bin Laden's escape, some military and intelligence analysts and the press criticized the Pentagon's failure to mount a full-scale attack despite the tough rhetoric by President Bush. Franks, Vice President Dick Cheney and others defended the decision, arguing that the intelligence was inconclusive about the Al Qaeda leader's location. But the review of existing literature, unclassified government records and interviews with central participants underlying this report removes any lingering doubts and makes it clear that Osama bin Laden was within our grasp at Tora Bora."

I wonder if the unclassified records led to the above findings, what the classified (i.e. secret) information would have revealed?

Former Colin Powell Chief of Staff Colonel Lawrence Wilkerson told MSNBC's Ed Schultz on May 11, 2011 that President George W. Bush wasn't interested in bringing Osama bin Laden to justice.

"I don't think they really wanted to get bin Laden," Wilkerson said. Then Col. Wilkerson using words carefully as if wanting to hedge in legal terms, said what millions of "uneducated Pakistanis" have suspected for a long time:

"You could be very cynical and say he didn't want to get him because once they got him the war was over and that left all the political advantage gone."

But all that is behind us. The US is now looking for an exit strategy from Afghanistan and wants to leave behind a friendly government that would continue to play host to a reduced number of troops and a string of military bases both in the south and north of Afghanistan, including in areas closer to Iranian and Russian borders.

This cannot be achieved so easily because the US does not control half of Afghanistan. It has to break the back of Taliban resistance before it can withdraw to achieve its objectives. Pakistan is unwilling to be used for this purpose because it will have to live with the Talibans for better or worse. The strategic and military objectives of Pakistan and America are diametrically opposite and nearly irreconcilable.

While the US has stumped the ISI with the "death" of Osama, this does not change the ground situation much. While it does enable Obama to tell American public "mission accomplished" and proceed with withdrawal but he would still need Pakistan to implement his Afghan-exit strategy. He first tried to buy Pakistan's support and failed.

He is now on the offensive and man in a hurry who has had low popularity rankings, while dealing with a troubled economy and 9% unemployment. He also needs money as he prepares to campaign for the next presidential elections in 2012.

Obama will now behave more like George Bush and may use threat of sanctions, exert pressure through more drone strikes and might even slow down the flow of US dollars to Pakistan if not go for outright suspension of aid. The US is not in a position to make large scale ground incursions into Pakistan's territory but some in the US establishment would consider even going to the extent of encouraging India to launch military strikes on selected Pakistani targets.

A US-based intelligence monitoring service STRATFOR believes,

"The American option might be to support a major crisis between Pakistan and India to compel Pakistan to cooperate with the United States. However, it is not clear that India is prepared to play another round in the US game with Pakistan."

But encouraging India to do that would be highly risky and Indians are no fools either to play America's game. But an India-Pakistan conflict cannot be ruled out.

Meanwhile, Pakistani press continues to debate the fiasco and the military and the civilians leaders seem to be in a cold war and playing behind the scene partisan politics as always.

The opinions are polarised between the pro-Army right wing media and a tiny group of pro-America liberal politicians and a section of press. Both miss the point that it is neither incompetence nor complicity. Both the US and Pakistani establishment played the game as long it served their mutual interests. The time for break has arrived and Pakistan must now choose whether it wants to continue the affair under the new terms and to serve the US interests that go far beyond the elimination of Al Qaeda.

Pakistan's current crisis or rather the present chapter of its never-ending series of crises started with the invasion of Afghanistan and escalated because since 2004, we were told, Al Qaida had safe heavens. The story began with a farce and continued with a lot of lies and deceptive double games but it had to come to an end at some point.

If you believe that Pakistan harboured Osama, then why would Al Qaeda and its affiliates target Pakistan including military targets? Something needs to be explained. Both can't be true.

We need to go back to 9/11.

When the former head of the Star Wars program (Dr. and Colonel Robert Bowman) says 9/11 official story is a lie, what am I to do but to say…a very murky and confusing picture.

Dr. Paul Craig Roberts, father of Reaganomics and a former assistant secretary of the US treasury, asks a difficult question:

"How many of us have the wits to wonder why the "terror mastermind"–who defeated not merely the CIA and the FBI on 9/11, but all 16 US intelligence agencies along with the intelligence services of NATO, who defeated NORAD, the National Security Council, the Pentagon and Joint Chiefs of Staff, the US Air Force, and Air Traffic Control, who caused security procedures to fail four times in US airports in one hour on the same day, who caused the state-of-the-art Pentagon air defenses to fail, and who managed to fly three airliners into three buildings with pilots who did not know how to fly–did not pull off any other attack in almost ten years and died in a shabbily maintained house? "

Besides the 'no attack in 10 years' question, there is the question of astounding level of technological sophistication required to beat NORAD.

I myself have spoken with Dr Robert Bowman who was the Director of the Star Wars program under Ford and Carter and is an authority on aviation with a Ph.D. in Aeronautics and Nuclear Engineering. He has publicly spoken and written trashing the official 9/11 version.

While most in our mainstream media blame uneducated Pakistanis, none of these writers have demonstrated knowledge of the fact (or have been honest enough to point out) that very serious defense experts such as Dr. Bowman dismiss official 9/11 version and accuse the US intelligence of engineering the attack.

I myself obviously cannot give a definitive answer but I would pay more attention to Dr. Bowman, who as a US Airforce Colonel once commanded NORAD (North American

Defense Command), than to some editor, reporter, or columnist of a Pakistani or US newspaper or a TV Anchor.

These serious charges by some important and knowledgeable Americans have added to the confusion and make it difficult to draw black and white conclusions specially given that one third of Americans themselves do not believe the official 9/11 story.

But one obvious impact on Pakistan and Afghanistan is the war that ensued and has caused so much pain and suffering. First because we were told Osama was there and he was responsible for 9/11, and then because Al Qaeda has safe heavens. It is not me but the Newsweek magazine which said last October, that the threat of Al Qaeda was massively exaggerated by US defense and intelligence establishment. If so, we have paid a heavy price for the war. Haven't we?

And shouldn't we be concerned how it all started, on what grounds, and how it escalated and what were the reasons given? And when people like former Malaysian Prime Minister Mahathir call 9/11 an inside job, one needs to think and pay attention.

And it is not just them. Some of the finest non-American journalists like Robert Fisk have acknowledged doubts about 9/11. Cabinet members of Reagan and Bush Sr. have challenged the official version. The logical thing for the US government to do is to prove 9/11 charges in a court of law and convict criminals in great American tradition of justice. This is a legitimate and logical demand and not a conspiracy theory.

If after trillions of dollars spent on intelligence and defense budgets in the last decade, the US has not been able to convict even one individual for 9/11, it is either complicit or incompetent. If Pakistani Generals have been its partners… it applies to them as well.

Celebrated economist and Director of the UN Millennium Project Jeff Sachs and former FED Chairman Alan Greenspan are on record saying that the real reason behind these wars was oil. So did Richard Clarke who served as G.W. Bush's anti-terrorism chief. And so also wrote George Soros, that billionaire and one of the biggest hedge fund managers in the world, who cornered the Bank of England and broke sterling's link from the European Monetary Union.

Many of the eminent Americans cited above served the US government in senior positions with access to top decision makers and were privy to a lot of confidential info. Are all of them conspiracy theorists?

The fact is that oil and oil routes was one of the factors. The wars in Iraq and Afghanistan were part of a bigger global agenda articulated in one of the founding documents of "The Project for the New American Century" (PNAC), an organisation formed by the neo-cons in 1997. The PNAC wrote a letter to President Clinton on January 26, 1998. The letter urged Clinton to *"enunciate a new strategy that would secure the interests of the US and our friends and allies around the world."* The letter urged Clinton to attack Iraq saying:

"if Saddam does acquire the capability to deliver weapons of mass destruction, as he is almost certain to do if we continue along the present course, the safety of American troops in the region, of our friends and allies like Israel and the moderate Arab states, and a significant portion of the world's supply of oil will all be put at hazard. As you have rightly declared, Mr. President, the security of the world in the first part of the 21st century will be determined largely by how we handle this threat."

This letter was signed by Donald Rumsfeld, Paul Wofowitz, Richard Armitage, and Richard Pearle among others. President Bill Clinton did not agree with the strategy advocated by these powerful and influential neo-cons. But they were to get the opportunity to implement their grand global strategy with the election of G.W. Bush Jr. in 2000.

Deputy Defense Secretary Paul Wolfowitz, Defense Secretary Donald Rumsfeld and Vice President Dick Cheney had commissioned the PNAC blueprint prior to the presidential elections of Bush Jr. The PNAC prepared and in September 2000 released a detailed paper titled:" Rebuilding America's Defenses".

The PNAC outlined a roadmap of conquest. It called for "the direct imposition of US "forward bases" throughout Central Asia and the Middle East "with a view to ensuring economic domination of the world, while strangling any potential "rival" or any viable alternative to America's vision of a 'free market' economy" (See Chris Floyd, Bush's Crusade for empire, Global Outlook, No. 6, 2003).

The PNAC document called for America to build and project its military might globally and argued for the transformation of America as tomorrow's global force. Almost prophetically, it declared:

"A transformation strategy that solely pursued capabilities for projecting force from the United States, for example, and sacrificed forward basing and presence, would be at odds with larger American policy goals and would trouble American allies. **Further, the process of transformation, even if it brings revolutionary change, is likely to be a long one, absent some catastrophic and catalyzing event – like a new Pearl Harbor**."

Given this background and history, it is therefore not surprising that in the past week, two top former US officials who worked as Asst. Secretaries of State under different presidents including Ford, Carter, Reagan, and Bush Sr. (Dr. Paul Craig Roberts and Dr. Steve Pieczenik) have trashed the US claims about Osama's death. Dr. Steve (who knew Osama and worked for Reagan) has even offered to testify before a grand jury that 9/11 was an inside job. Both are members of the influential think-tanks, such as the Council on Foreign Relations. Some serious people do not have any trust in the US government!

If you believe the US is so foolish that it would spend 2 trillion dollars just to nab Osama and about 100-200 members of Al Qaeda central (as per the account of US officials themselves) then of course you are entitled to it.

And if you believe that they are so stupid as to give Pak Army over 20 billion since 2001 and train them as well so that it can send insurgents across the border to hit US forces and do not know what they are really doing, then it is your right to interpret and see the events as you like. I can only draw attention to the glaring inconsistencies in the case that is made by people who have regressed into the state of intellectual lethargy of dismissing all doubts and even legitimate questions as conspiracy theories.

Kerry Lugar Bill earmarked 50 million dollars just for buying media influence in Pakistan. Many Pakistani analysts have been given “grants” to study in the US and do “fellowships” in US think-tanks including govt. funded institutions like the US -Institute for Peace. The public discourse is polarised between Jihadi-ISI version and an All-American narrative while the reality is much more complex.

I cannot cover the entire history of the US policies in this space. Pakistan Army (with its own share of blunders and fools and liars like Musharraf) has used Americans when it could and vice versa. In the current spy war, the US through its CIA stumped the ISI to gain an upper hand and dictate Afghan policy and implement its regional agenda.

It was a huge intelligence and foreign policy failure of Pakistan’s military high command; intelligence because it was caught by surprise and foreign policy because the neither the President nor the Army chief were trusted by the US president or the US Joints Chief of Staff. It was less of a military failure because no radar in the world could have detected the never-before-seen stealth-modified bluehawk helicopters, which only the US has and because Pakistan would not have shot down US helicopters even while they were leaving. The Army chief should share the greatest responsibility for both intelligence and foreign policy failure.

The United States President deliberately chose a course of action that he must have known would cause huge embarrassment to Pakistan and its army generals. Ultimately, it was a major political and not an operational security decision and marked a break down of trust between the security establishments of two countries unless we are to believe some reports that say even the denials were pre-agreed upon. But this seems unlikely in so far this particular operation is concerned.

However whipping up anti-America sentiments would be counterproductive from Pakistan’s domestic policy view. Pakistan needs peace and to eliminate all reasons that could provide America and/or India with justification to strike on Pakistan targets. Jamaat-e-Islami and Pakistan Tehreek-e-Insaf should not pursue the kind of politics that Jamaat played during 1971, launching Crush India movement at the behest of General Yahya Khan. What followed was a catastrophe.

The only way out of this deadly cycle is to disengage from conflicts, stop protecting terrorists, pursue peace with India, and break this unholy alliance of the US and Pakistan Generals. Both are villains. US has played the great game and did everything to protect its oil and regional interests and Pak rulers have prostituted themselves because of arms, cash, and because of their fear of India. In the process, they have imperilled the future of Pakistan because the price of continuing to play the double game any longer may be prohibitive with grave consequences for Pakistan.

May 13, 2011

Arms and foreign debt

The Army establishment may have won this round of the turf battle with the CIA by continuing to use Raymond Davis as a bargaining chip but this should not and cannot obscure Pakistan's life and death issue. Which is: historically its Army has not shown enough realisation that the cessation of all external and domestic conflicts is the most critical and essential pre-condition for Pakistan to survive as a viable nation-state. The security state of Pakistan's number one problem is not extremism. It is its security establishment and its addiction to arms and debt justified in the name of "India-centricity", non-strategy of "strategic depth" and the support for militant groups justified on flimsy grounds of a "need for strategic assets." You don't need F-16s and nuclear weapons to fight extremism or terrorism. During 2002-2009, Pakistan was the sixth largest buyer of conventional weapons in the world with total purchases of $12.5 billion according to the US Congress documents. This excludes spending on its nuclear program.

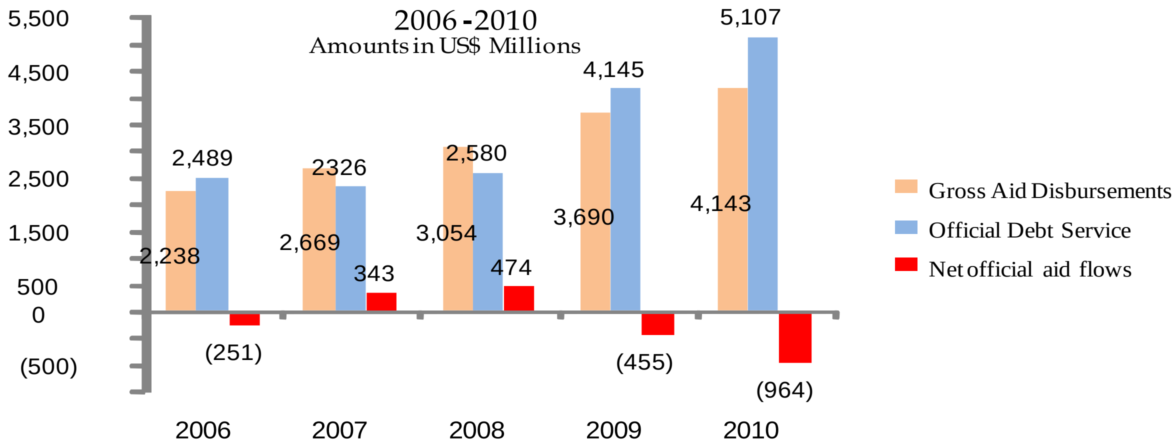
Is it just a coincidence that during this period, Pakistan total external debt increased by $13.7 billion to $45.8 billion in the beginning of 2009? While the spending on the nuclear program remains shrouded in secrecy and is not subject to any parliamentary or judicial oversight, the recent reports indicate that Pakistan has nearly doubled its nuclear arsenal to more than 100 weapons in a few years and appears on track to soon surpass Britain as the world's fifth largest nuclear power. That may or may not be an exaggeration but Pakistan's possession of a large number of nuclear warheads is not a secret.

We are borrowing to buy and build arms and sinking into debt while maintaining the myth that we need to borrow for our economic survival and development. It is important to point that in the recent years the net official aid flows (that is aid disbursements from multilateral institutions like the IMF and the World Bank, and other governments) have turned negative because the government of Pakistan has been paying more in debt servicing (principal and interest) than it has been receiving in new loans or aid as shown in the graph.

For example, total aid received by the government (that is excluding borrowings by the private sector) was $4,143 million during the financial year ended June 30, 2010 but during the same paid, the government had to pay $5,107 million in debt (principal and interest) repayments. What it means that the net impact of the aid is actually negative on Pakistan's economy because the government had to pay a net amount of $964 million to the external donors.

This shows that while Pakistan has been piling on debt, it has not used the borrowings properly as is reflected by its growing incapacity to service the debt. Latin America faced a similar debt trap in the 1980s and like some of the Latin countries, Pakistan's only practical way out may be to seek cancelation of part if not whole of the debt.

Net Aid Flows to Pakistan Turn Negative



Note: The above figures exclude commercial borrowings and private sector debt

Another major reason for the rise of external debt has been mismanagement and incompetence. According to the Debt Policy Statement 2010-2011 published (November 2010) by the ministry of finance, "the currency exposure of foreign debt originates from two sources: USD/other foreign currencies and PKR/USD. This two-pronged exchange rate risk has been a major source of increase in the stock of external debt over a period of time in contrast to actual inflows."

For example, foreign exchange losses contributed to about $3.1 billion increase in Pakistan's external debt during 2007-2008 alone. Many economists, journalists, politicians, analysts, leading columnists, TV anchors, and some former generals do not seem to be aware that:

(a) actual quantum of net aid flows is small (less than one per cent) compared to the size of Pakistan's economy,

(b) almost all the "visible aid" is used to repay the past loans,

(c) **the biggest foreign exchange utilization in the past decade seems to have been for the purchase of arms, and**

(d) one reason for the rapid rise in Pakistan's external debt in 2008-2010 was the currency losses (and not 'new aid') which could have been avoided if the ministry of finance and/or the State Bank of Pakistan had the necessary expertise to do so.

The above figures do not include Coalition Support Fund (CSF) payments made by the United States government as reimbursements for the expenses incurred by the government of Pakistan. The CSF payments cannot be termed as aid not only because they were reimbursements of actual expenses but also because they mask the more important fact that the CSF monies have been insignificant when compared with the actual economic (not to mention the human losses) costs of the "War of Terror" suffered by Pakistan. These are as follows:

CSF Payments $millions

2006	2007	2008	2009	2010
1260	1127	1536	1674	2726

Consequently, Pakistan now spends more on debt servicing than on defence, and seven times more on arms than on primary schools. In October the government projected that it would increase its defence budget by 25%, or 110 billion rupees, to 552 billion rupees for the current fiscal year while slashing spending on education, healthcare, and infrastructure.

Pakistan has been lucky that that overseas Pakistanis have sent billions home and have been and are the largest source of external financing and foreign exchange. Remittances from overseas Pakistanis increased from $4.6 billion in 2006 to nearly $9 billion in 2010. It is this source (although some of it may be laundered money), more than any other source of 'aid' that has helped Pakistan to face difficult times. But the establishment should not rely on this bonanza. It should reappraise its priorities and take the lead in steering Pakistan away from conflicts and refocus the political economy on generating growth and employment than on arms spending and borrowing. The army leadership can and must take the lead and put India, Afghanistan, Kashmir, and nuclear issues on the back burner and focus on nation rebuilding. It can begin this process setting an example through making deep and voluntary cuts in military expenditure and then by asking the "civilians" to do the same. Pakistan needs to make investments to repair and rebuild its administrative and physical infrastructure. Pakistan cannot achieve a sustainable growth rate necessary to support its around 2% population growth rate and reduce poverty without huge investment in basic infrastructure and human resources.

A February 2008 report by the World Bank warned, "Without adequate irrigation resources, power, and transport infrastructure, the very sustainability of Pakistan as an independent nation may be at stake as shortages could lead to increased social discontent and disharmony amongst the federation and the provinces." Since Pakistan is so significantly behind other Asian countries with whom it competes in international trade and for investment capital, it should invest much more than the averages to catch up. Pakistan needs to spend 8-10% of its GDP on education and infrastructure. This is not possible without drastic cuts in defence and establishment expenditure, reducing corruption, and more and better tax collection.

The army has to stop its arms spending spree and find a way to transform Pakistan from a dysfunctional debt and arms-addicted national-security state – which has been and continues to be in a state of constant tension and sometimes war with its neighbouring countries and with itself. Army holds the country together. If it does not take the lead and makes the right initiatives in the right direction, there may not be any rational reason or room for hope for Pakistan. It may be too much to expect power-broking and scheming mortals with limited intellect and vision to become saviours and nation builders overnight. But the choice is quickly becoming stark. Act to save the state of Pakistan or let it wither away under the weight of its own history and blunders of the self-serving and short-sighted ruling elites.

March 21, 2011

Hillary Clinton – wake up!

Secretary of State Hillary Rodham Clinton has blasted the leadership in both Afghanistan and Pakistan for the poor economic growth, corruption, energy shortages and political instability that are plaguing their people. "Last month in Doha — actually, now two months ago, in December — just before the protests began in Tunisia and Egypt, I warned that the region's foundations were sinking into the sand," Clinton told an audience at the Asia Society during a lengthy review of US policy on the two countries."

In Afghanistan and Pakistan, conflict is blasting the foundations apart, brick by brick. Reconciliation and reform offer another way," she said. Clinton also pointed out that "anti-Americanism" in Pakistan was not helping resolve domestic problems within the country. "Shocking, unjustified anti-Americanism will not resolve these problems," she said. Clinton was speaking in the backdrop of an impasse between Islamabad and Washington involving a Raymond Davis, an American Embassy employee, who was arrested for killing two Pakistanis on Jan 27.

While I agree with the first part of Clinton's statement holding the Pakistan leadership responsible for the country's political and economic woes, her apparent lack of understanding of anti-Americanism in Pakistan is more shocking. Is she kidding us?

The US supported dictators like Zia and Musharraf, armed tyrants like the Shah of Iran and Husni Mubarak, both of whom looted and plundered their country, and suppressed their people.

Pakistan used to be called the "most allied" of US allies yet the US watched the dismemberment of Pakistan with "its teeth in her mouth" as late Z.A. Bhutto put it in his address to the UN Security Council on 15 December 1971.

The US actively supported the 1977 movement against the most popular leader (Z.A. Bhutto) of Pakistan's history. Pakistanis do not like American policies because they have always supported the power hungry generals in exchange for fighting their wars whilst the Pakistani generals conquered their own country and people again and again and killed two popular Pakistani leaders; Bhutto and his daughter. Pakistan never recovered from the trauma of the hanging of Bhutto and its aftermath.

The US policies made Pakistan a breeding ground of the destructive forces erroneously called "jihadis". They are not "jihadi" but Saudi forces. They have been sponsored and financed by the corrupt Saudi tyrants so that they can protect their interests and stooges like Nawaz Sharif and proxies like the Jamaat-e-Islami. Saudis have remained and are the biggest American allies in the Middle East and the Muslim world.

Mrs. Clinton should know Pakistanis do not like American policies because after the Afghanistan war of the 1980s and what was till then, the biggest covert CIA operation since the Vietnam War, Pakistan was turned into a chess board of the "great game" and a battle field of the forces whose birth was facilitated by an unholy marriage of convenience between the Saudi tyrants and America's neo-imperialists.

The so-called "liberals" in Pakistan who seem to dominate the English press should know that these are historic realities. Many of these liberals have been co-opted in many think-tanks and NGOs and I bet most of them do not even know that to stand for "liberalism" implies a belief in capitalism. And that is why I am not a liberal and can never support American neo-imperialism. I believe in the politics which is of the people, by the people, and for the people.

Pakistan's major political parties (Pakistan Army, PPP-Z, PML, MQM, ANP, JUI, etc.) have also been co-opted by the Americans. The people are fed up with all of them. They keep the people distracted and divided over non-issues. I do not care about the 17th or 18th amendment nor are the blasphemy or the blasphemy laws real issues. What are the real issues? I want to know how much of the peasants' land is forcibly occupied by the military? I want to know where did $5 billion of the earth-quake aid money go. I would like to know how much each of the big generals and political leaders has in foreign bank accounts? I am not for subsidies but before one does away with food and kerosene oil subsidies for the people, I want to know how much each of these Musharrafs, Sharifs, Zardaris, Makhdooms, Pirs, Sardars, and Maulana Diesels pay in taxes every year? Mrs. Clinton should tell them to pay taxes. They might if she really means business. Would the US should refuse them visas and ask its banks to initiate money laundering cases against them, if they don't comply?

But American hypocrisy is nothing new. They talk about the high ideals of freedom and justice but are quick to label a genuine freedom movement as a sectarian strife like in Bahrain. They are more concerned about the 5th fleet there than the rights, miseries, and now the blood of the 70% poor and oppressed of Bahrainis. Sometimes, the US missions and their agents foment ethnic divisions. May I ask Mrs. Clinton, why the biggest US ally in Europe – Britain and its secret services have protected and supported a wanted man like Altaf Hussain for almost twenty years? Why did the Americans conspire to install an idiot and buffoon like Zardari through this corrupt political system; something for which Zardari expressed his deep gratitude to the US officials [we are here because of you]. Why were they so keen for a "pro-western" Kayani to replace Musharraf as COAS?

If Mrs. Clinton cares so much about Pakistani people, why did she not stop the sale of F16s to Pakistan and divert that money for nation building? Mrs. Clinton should not insult our intelligence. The grand bargain of the Americans with Pakistan's decadent and corrupt military and political elites is the same as was with Husni Mubarak and the same bargain it has had with despots in the oil kingdoms. We will give you money and military toys as long as you keep your end of the bargain. It is this unprincipled bargain between the US and corrupt Muslim leaders that has made America deeply unpopular among the masses in the last few decades. Some right-wing extremists might exploit this but that is not the real issue. It is time for Americans to realise that the 19th century was Britain's, the 20th century was American, and the 21st century is going to be the Asian century. America's influence is waning and its power is on the decline. The only course is to retreat honorably.

Pakistanis are accused of apathy (as were the Egyptians for decades) but the people are not fools. Yes, they have been exploited, divided, deceived, suppressed, and kept poor and deprived for decades but one can fool people for long but not forever. Some people who have little knowledge and understanding of how the nations develop and build, talk of Pakistan's dependency on the US. These under-graduates of political economy should know all American-supported dictatorships piled up huge amounts of foreign debt not because a country needed them or used the debt for real development but it was a pay-off to the corrupt elites so that they could continue to support America's political and security agendas. The latest example is that of Husni Mubarak. Egypt has $30-40 billion in foreign debts and Mubarak has amassed a fortune of more than $70 billion. Did American politicians wake up in the last few months and realised; Oh my God, Egyptians need freedom, social and economic justice and Mubarak must “do more?”

Our problem is not economic but political. It always was and which is why the people of Pakistan must understand this “great and dirty” bargain between Pakistan’s elites and the US government. They will have to rid themselves free of this unholy alliance if Pakistan is to be saved. They will have to understand that there are people on both sides of the so-called ideological divide – liberals and extremists. Both are serving American interests; nothing new! Husni Mubarak was secular and liberal. King Fahd is a “devout” Muslim and a fundamentalist. Both served the US interests in the Middle East.

Pakistan’s way forward – if there is one – is for the people to recognize this game and oppose all leaders, parties, and institutions who are not pro-people. The masses will have to rise for their own interests. Till they do not, there is little hope that this circus of Pakistan’s politics will stop. A circus which has clowns like Zardari and Sharif, artificial anti-American fundamentalists like Fazalur Rehman, neo-fascists like Altaf Hussain, pretenders to being “defenders of national interests” like the Generals, and sidekicks of the establishment like many judges and corrupt media barons. So Mrs. Clinton, it is not “anti-Americanism” in Pakistan which is not helping resolve domestic problems within the country. It is America’s strategic partners in Pakistan – the Army and corrupt elites – that represent the biggest obstacles to resolving critical issues in Pakistan.

February 19, 2011

Is global economy headed for recession?

The most recent economic data from the United States points to a marked slowdown and has disappointed most economists who had been predicting better results. Major indicators such as Corporate Purchasing Index, Home Sales, Unemployment, Consumer Sentiment, and widely cited Weekly Leading Index (WLI) from the Economic Cycle Research Institute (ECRI) have led some analysts to conclude that another recession may be imminent. Not everyone agrees. In fact, the market participants seem to be divided over whether we are headed for a deflation or high inflation in the medium term.

Those who worry about inflation have piled on real assets like metals, particularly gold, and those who believe deflation is unavoidable and low interest rates are here to stay for quite a while, have favoured government bonds, especially US treasuries, helping the dollar to appreciate against most major currencies in the last three months.

On July 7 the IMF came out with a revised and slightly better forecast for the global economic growth for 2010 but kept its forecast for 2011 unchanged. IMF warned that the risk of a slowdown in the global economic recovery has risen sharply, but advised the governments to continue planning to tighten fiscal policy. The IMF’s advice could be counter-productive.

After all, most mainstream economists and august bodies like the US Federal Reserve, the World Bank, and the IMF failed to anticipate not only the financial crisis of 2008 but also the severity of the recession. Sharp reductions in government budgets in a sluggish economic environment can precipitate recession.

Few disagree that the world’s economic outlook is clouded by a weaker than expected economic recovery in the United States, the sovereign debt crisis in Europe, and the threat of a collapse of the property market in China.

Nobel Laureate Paul Krugman fears we are in the early stages of a third depression; the previous ones were in 1873 and 1929-31. Depression generally means a prolonged period of contraction in economic activity characterised by falling prices, high unemployment, and weak demand and reduced availability of credit.

Hence some believe that governments are making a major policy error by obsessing about inflation when the real threat is deflation, preaching the need for belt-tightening when the real problem is inadequate spending. That may be right but Krugman feared a depression in 1999 as well following which the world economy experienced seven years of record economic expansion. He could be wrong again but on balance the probability of a recession has increased. Why is that so?

Three Ds – Debt, De-leveraging, and Demographics – hold the key to understanding why the US and Europe are quite unlikely to experience the growth rates of the 1990s and up to 2007 but could also be in for a prolonged period of sluggish growth and high unemployment.

The first and most central to the current crisis is Debt. According to the IMF, the US public debt has almost doubled in three years to a current level of 64 per cent of GDP, the highest since 1950. An IMF report (July 7) warned that under the current policies, the US public debt could reach 95 per cent of GDP by 2020, considering the impact of ageing population and health care costs.

The biggest reason and risk would be the policy failures and the collective unwillingness and inability of the Americans to go through a long period of painful adjustment in their life style and standard of living. The IMF and noted economists such as Kenneth Rogoff and Nouriel Roubini have warned about the debilitating and pernicious effects of such high and unsustainable levels of debt.

It may be instructive to recall that in 1991 Japan had a budget surplus of 2.9 per cent of GDP but in five years it turned into a deficit of 4.3 per cent of GDP and by 1998 hit a staggering level of 10 per cent of GDP. During 1991-2001, Japan's economy struggled with an average yearly real GDP growth of 0.9 per cent while the prices fell by an average of minus 0.3 per cent.

Record low interest rates failed to revive economic growth in Japan and lift it out of the deflationary cycle. This has been called a liquidity trap implying that despite cutting interest rates to near zero level and injecting massive amounts of liquidity, economic growth could not be revived as the demand for goods and services had suffered long- term damage due to the destructive effects of high levels of debt and a financial shock that saw a long-term and severe fall in the stock market.

During 1991-2001, Japan's stock market fell by 54 per cent and its stock index (NIKKEI-225) currently trades in 9000-10000 range compared to a level of 37,000 in the beginning of the 1990s.

Some argue that the US is not Japan. Wall Street banks generally believe that the recent data is typical of a slowdown at this stage of the recovery in the economic cycle. They contend that double dips are extremely rare and have been caused by very adverse change in fiscal and/or monetary policy, the chances of which are slim now. However, it should be noted that a combination of over 9 per cent unemployment rate and budget deficit is also rare.

While it is not improbable that the US economy may continue to grow in the second half of 2010, albeit at slower pace than the first half, and through the first half of 2011, the risk that the economic recovery will be disrupted by a violent shock in the financial markets has increased in the second quarter of this year.

European sovereign debt crisis continues to cause jitters and euro has lost more than 12 per cent of value against the dollar. A major bank failure or an event – like Greece announcing a restructuring of debt which would tantamount to default – cannot be ruled out.

The most heavily indebted countries in Europe including Britain, Greece, Spain, and Portugal have all pledged to reduce their budget deficits but deficit reduction at a time of sluggish economic activity could be a double edged sword. As the UK government deals with $230 billion deficit and prepares to make spending cuts, the Financial Times recently cautioned that there was a serious risk that if the cuts are too brutal the country could return to recession.

This is a dilemma the UK shares with the US and other highly indebted European countries. After having cut interest rates to record low levels and spending trillions of dollars to stimulate the economies and thereby pushing debt levels to dangerous and unsustainable levels, the governments may have just run out of policy options and tools.

Should a financial shock – such as a European country default or a major bank failure or /and a property market collapse in China – hit the global markets, it is seriously doubtful and questionable whether the US and European governments would have the ability to prevent another recession.

They may well muddle through the current phase but in addition to the financial market risk, the risk of policy errors remains significant and could see the world plunge into a another recession which will probably be longer and more painful than what we experienced during the last couple of years.

July 19, 2010

A nation in denial

It is common to blame the rulers and elites for Pakistan's failure to evolve as a stable and civilized society with a viable political system. Few Pakistanis blame themselves. I have thought many times about putting this in writing but somehow could not. But more I think about this, the more I get convinced that we need to resolve some very fundamental contradictions that have roots in our history. We need to come to terms with what may be unpleasant facts for many or most Pakistanis. The collective failure to recognize them and appreciate their implications has contributed to self-doubts about Pakistan's national identity, pervasive hypocrisy, misconceptions about the role of Islam in the affairs of the state, and failure to generate a climate for open and frank public discourse that is perversely dominated by a section of the media patronised by the intelligence agencies.

Not everything Quaid-e-Azam or Muslim League said or believed in should be treated as gospel. These may appear to be rather minor points for some but grown-ups with troubled childhoods sometimes need to face tough questions and realise that the childhood was not perfect but whose ever is. Those issues are as follows.

Number One: Pakistan was founded by a great leader who drank scotch and wore modern English suits. Quaid-e-Azam was a unique statesman who has the rare historic distinction of a creating a new country. He was an exceptionally principled and honest man driven by a desire to secure the interests of Muslims in the post-British India. But he was not a religious person at all. He drank alcohol, married a non-Muslim modern woman, and dressed like an English man. Incidentally, Quaid-e-Azam selected a distinguished lawyer and a Qaidiani, Sir Zafarullah Khan, as Pakistan's foreign minister. Jinnah felt very strongly about the political and economic rights of the Muslim minority in the united India but never envisioned Pakistan to be a theocracy or a religious society. He could not have; having had the lifestyle he led.

Number Two: After independence, Muslim league came to be dominated by a feudal aristocracy that contributed little to Pakistan movement or was opposed to it. Most of them were local politicians and opportunists who merely jumped on the Muslim League bandwagon. In 1945, Sindh was the only Muslim majority province where Muslim League formed the provincial government. The Muslim League leaders did not have any clear vision for the future of Pakistan beyond empty rhetoric.

Number Three: The new born Pakistan's leadership was responsible for sowing the seeds of a client state relationship with the United States. As head of a newly-born 'moth-eaten Pakistan' to use Jinnah's own words, and with little or financial resources, it was foolish to seek a military solution to Kashmir with Pakistan completely dependent on Britain for its survival. It was desperate and according to the memorandum (NO. 845F.51/10-3047 of 30 October 1947) of conversation between Mir Laik Ali, Mr. Jinnah's special emissary to Washington, and the US State Department officials, Pakistan requested a two billion dollar loan, including $510 million for defence, from the United States in October 1947. This negated the very spirit of independence from the colonial masters.

Number Four: The secession of former East Pakistan negated the assumption that religion alone could keep a nation or a country united. Enough has been written about this. Do we need more discussion on this? If religion alone could define a nation, we won't have more fifty Muslim countries. Never in the history of Islam, there was one country.

Number Five: Pakistan's current constitution does not represent the thinking of the founders of Pakistan. The terms like "Islamic Ideology" and "Nazariya-e-Pakistan" were coined by Jamaat-e-Islami. This party has done great damage to the cause of both Islam and Pakistan in the name of Islam. Jamaat's main issue is not that it is a religious party. The greatest irony is that its rise was supported by the long standing official policy of the United States to encourage religious extremism in the Muslim world to prevent the rise of anti-imperialist nationalist leaders. The US and the CIA did it with the help of Saudi Arabia's corrupt royal family.

Much of what has been projected as Jamaat Islami's "Nazariya-e-Pakistan" is an extension of this historic US-Saudi policy. Jaamat had close ties with Said Ramadan who worked with the CIA. Said Ramadan was the de-facto head of the Akhwan-ul-Muslimeen or the Muslim Brotherhood and son-in-law of its founder Hassan al-Banna. The Muslim Brotherhood was supported and encouraged by the CIA (with Saudi help) as it plotted against Jamal Abdul Nasir, one of the greatest nationalist leaders Arab world has produced in the modern times. It was not a coincidence that Jamaat-e-Islami's Chief Mian Tufail Mohammed worked closely with Zia ul Haq before and after the coup against Z.A. Bhutto. They both subsequently worked to further the US interests in Pakistan and the region.

More material on the Islamic fundamentalists-US relationship has been documented in detail in this book "The Devil's Game" by Robert Dreyfus. To some people, it may appear as a paradox, and it is a pity that Pakistan's media has not published much on this but it is hardly a secret that a nexus of the American, British, and Saudis interests have supported and financed the so-called Islamic fundamentalist groups for over decades and continue to do so (e.g. Jundullah) because these groups are considered a buffer against the potential threat (real or perceived) of the Muslim countries falling under the influence of Russia and/or China and thus ending the historic dominance of the US and UK over the Muslim world, particularly in the Middle East.

It is a tragedy that a lot of this distorted, CIA-Saudi financed version of Islam has been peddled through the popular media and through reactionary establishments like the Jang and Nawa-e-Waqt groups and now forms part of day-to-day political discourse. Pakistanis must probe deeper into history and inside their souls to face some difficult, perhaps harsh, facts. Asif Zardari is perhaps symptomatic but not the cause of our problems dating back to 1947. There are some grave historic contradictions which we, as a Nation, never faced and have failed to resolve. It is time for some deep soul-searching, collective introspection and recognition that we need to grow up and that we have the potential to do just fine only but we need to come to terms with what I would call a troubled childhood.

July 5, 2010

Limits of military power

IN a rare press briefing last month, Gen Ashfaq Kayani said the success of military operations in the tribal regions have caused a substantial decline in cross-border attacks on Nato forces in Afghanistan and warned that it was essential to address Pakistan's long-term strategic concerns for stability in the region.

A month later, Indian Prime Minister Manmohan Singh concluded a historic three-day visit to Saudi Arabia and signed 10 bilateral agreements and the Riyadh Declaration. In a rare honour, Manmohan Singh was invited to address the Majlis-ash-Shura, the Saudi parliament, where he not only sought investments from the Islamic kingdom but also pressed the need for Pakistan to "act decisively against terrorism". Earlier, when he landed in Riyadh, Singh was accorded an unprecedented welcome when, setting aside protocol, the Saudi crown prince and the entire cabinet turned up at the airport to receive him.

Manmohan Singh's Saudi visit came two years after another landmark visit by him to China, which was a turning point in Indo-China relations. The joint communiqué issued after Singh's 2008 visit to China declared "a shared vision for the 21st century of the People's Republic of China and the Republic of India". It went on to state: "China and India are the two largest developing nations on earth representing more than one-third of humanity. The two sides recognise that both China and India bear a significant historical responsibility to ensure comprehensive, balanced and sustainable economic and social development of the two countries and to promote peace and development in Asia and the world as a whole."

On March 18, 2010, the Royal Institute of International Affairs in London published a report in which Jim O'Neill, the chief economist of Goldman Sachs — the world's largest and most powerful investment bank — declared that China's yuan was destined to become a global reserve currency rivalling the dollar and the euro. "The dollar-based monetary system is no longer adequate for a larger and more integrated world economy," the report said.

These events are not necessarily related but deserve a thoughtful analysis by Pakistan's security establishment which has nothing much to boast about except a series of historic blunders and massive policy failures since 1958.

In the recent months, the Pakistan Army's leadership has shown a newfound confidence as a direct consequence of the success of its military campaigns in the northwest. The writ of the state of Pakistan appears to be extending to the areas that were lost or were never under its writ. Emboldened by its illusory success, the army's high command has once again taken to actively and publicly calling the shots in all areas of governance from domestic polity to conducting strategic dialogue with Washington, to even matters like scolding Punjab's chief minister over the latter's extremely irresponsible remarks about Taliban leaving Punjab alone.

However, somebody ought to tell Gen Kayani: not so fast! The army leadership would do well to remember some lessons from Pakistan's and contemporary international history.

1. Economic strength and size is the primary and the ultimate source of power. Note how Japan and Russia have been demoted to second-rate powers since the 1970s.

2. Pursuit of projection of military power beyond the economic capacity of a nation has disastrous consequences. The collapse of the Warsaw Pact alliance and then that of the Soviet Union in the 1980s and the decline of the US in the last decade clearly show this.

3. The participation of the military in the formulation and conduct of foreign policy may seem an illusory necessity but the Russian experience in the 1980s, Pentagon's failures in Afghanistan and the Pakistan Army's own debacles including the defeat in 1971, the heavy price of the Afghan jihad, Kashmir's tragic fall from a freedom movement to a 'terrorist problem', and Kargil's humiliating experience are stark reminders of what happens when generals suffer from megalomaniac ambitions that stretch their intellectual and military capabilities.

We must keep these lessons in mind as we face the gravest crisis since 1971. The so-called war on terror and a serious economic crunch have brought Pakistan to the brink again. The state is now imploding from within primarily because the establishment has considered submission to external hegemony a convenient means to rule. Since it does not derive its power and legitimacy from the people, it has shown callous disregard for even the security and minimal needs of its people. This is evident from years of autocratic governance, economic plunder, and neglect in building infrastructure. Yesterday, India was the threat and today Afghanistan has become an excuse to put aside nation-building economic development on the back burner.

Pakistan can learn a lot from the East Asian experience, particularly from China's policy to focus on economic development and put conflicts in cold storage. Pakistan must put its house in order now and make economic development its most important domestic and foreign policy objective. This process must start with a gradual disengagement from the conflicts in Afghanistan and Kashmir and redefining 'security' to include energy, water and food security as being more important, and reallocation of resources through a restructuring of the armed forces with more emphasis on brains than brawn. All the army divisions combined could not have accomplished what a brilliant prime minister and a few scientists achieved for Pakistan's nuclear programme.

Today Pakistan faces a more crucial challenge than the Taliban. It must find a way to transform itself from a dysfunctional client national-security state to a modern democracy with a sustainable economic development model which is appropriate for a country with one of the world's largest, fastest growing, and youngest populations. It cannot hope to move towards that goal unless it disengages itself from overt and covert conflicts, realigns its foreign and economic policy focus from the West to the East, and empowers its people.

Disengagement, realignment and empowerment are the essential pre-conditions for the process of institution-building and economic development to start and take root in a meaningful sense. Otherwise the country's progress will remain a mirage with a higher and growing risk of failure as a state. Peace, independent foreign policy and a plural democracy have to be the pillars of a modern Pakistan that is not a client, debt-ridden security state with a large, illiterate and impoverished population.

March 22, 2010

The establishment strikes back

The Supreme Court`s verdict on the NRO and the way it has been decided to enforce it leaves no doubt in my mind that the establishment is once again out to get the PPP and bring back its favourite civilians to power.

Familiar forces are once again trying to seize the initiative they lost after a decade-long military rule which gave us the `war on terror` and has brought us to a state where Pakistan is bracketed with Afghanistan and is considered one of the hottest spots in the world that can explode anytime.

Never mind the blunders of the masters of `strategic lack of depth` and architects of the policies that have turned Pakistan into a client state of America with few friends; they seem to have decided to strike back again.

Now faced with the question of how to justify this attempt to take back power, they seem to have decided to divert the public`s attention to an easy target and a handy dog to whip; the government of Asif Zardari. It is even speculated that the very reason why the establishment facilitated the entry of Zardari into the corridors of power was because he was considered so vulnerable that getting rid of him would be a piece of cake.

When I wrote about this almost 14 months ago, some PPP stalwarts and senior media pundits dismissed the idea saying the United States was firmly behind him forgetting a basic tenet of Washington`s policy the US is always with the Pakistan military.

The humiliation of Defence Minister Chaudhry Ahmad Mukhtar may have come as a shock to some but it was hardly a surprise as it was a demonstration of who really runs the country, a warning to Mr Zardari and an ominous sign of things to come.

If withdrawal of cases on charges of plundering of the national wealth are acts that are void ab initio then so is the deal between Nawaz Sharif and Musharraf that, in effect, washed away all the former`s crimes in exchange for exile, confiscation of property and the Sharif brothers` promise to stay out of politics for five years according to Nawaz Sharif`s own public admission — and 10 years per the documents released subsequently and according to the Musharraf government`s account of the events.

Let`s see how far the court goes to pursue the loan write-off cases, with the amount totalling billions and allegedly involving the Ittefaq Group, the Chaudhry brothers and many retired generals, regardless of technicalities. Wasn`t that the plunder of national wealth? Or is there one standard for the politicians from Sindh and Balochistan and another for those from the land of the five rivers?

I can already hear screams of `provincialism` and anticipate charges of fanning ethnic discontent but it is just not a coincidence and is an indisputable fact that the judiciary`s every decision has so far favoured Nawaz Sharif and has gone against the PPP.

This is a continuation of the pattern witnessed during Zulfikar Ali Bhutto`s trial by the Lahore High Court in 1978, the rejection of his appeal by a split 4-3 verdict of the Supreme Court, Nasim Hasan Shah`s restoration of Nawaz Sharif`s government dismissed by Ghulam Ishaq Khan, and more recently the failure of the Supreme Court to take suo motu notice of the `deal` between Musharraf and Nawaz Sharif that effectively whitened all the latter`s wealth.

I have no love for Mr Zardari and think it is a tragedy that he heads a party that was founded by a political giant like Zulfikar Ali Bhutto, but personal dislike for Mr Zardari should not blind us to the sinister and dangerous game that is being played by the establishment.

For better or worse, we have a parliament and it is parliament that should be sovereign. But it is the judiciary that seems to be sovereign, with no accountability whatsoever.

It is now too obvious that the judges got rid of Musharraf when he became a liability to the establishment. Now they could be part of a hidden agenda because an overt exercise of powers by the establishment does not fit in with the current internal and external environment.

One has to be politically quite naive or a paid journalist (it does not matter by which agency, IB or the ISI) to eulogise all this as the triumph of justice or some rubbish like that. Why doesn`t the Supreme Court order the ministry of information and broadcasting to publish the names of all those media persons who have been the beneficiaries of secret funds during the past 20 years? Why does only the PPP (not that it is innocent) have to face `accountability`?

Why is that only Benazir Bhutto had to explain where the funds for Surrey Palace came from and the Sharif brothers can continue to enjoy their escapades to London and stay in their luxury apartments in Park Lane, one of the most exclusive and expensive neighbourhoods in London, and certainly more expensive than Surrey?

It is time to wake up and face the ugly reality. In Pakistan, the judiciary has been used as an instrument of the establishment. Could it be that this time the modus operandi has become rather sophisticated compared to the cruder methods employed in the past?

December 26, 2009

The Axis of Trouble: America, Army, Mullahs

Pakistan's so-called Islamic parties and groups never get tired of blaming America for all the country's problems. The military has traditionally blamed the politicians. The Americans blame the extremists and terrorists for Pakistan's current woes. So do Pakistan's liberals.

In the context of the recent past and Pakistan's history, Pakistan's biggest tragedy and the principal reason for its break-up was and has been the axis of trouble between America, Pakistan's army, and the religious parties.

Until and unless the axis is broken, neither the reconstruction of the Pakistani state nor the so-called democratisation of Pakistan will bring peace or prosperity to the latter's 170 million people, nearly eighty per cent whom live below the poverty line of $2 a day. Pakistan's elites have little interest in the reconstruction of the state because they have the most to lose if power is truly exercised by the people.

The army has no incentive to break the axis of trouble (a legacy of the great game) because it thrives on the perpetuation of conflicts in the region and the largess it receives from the United States.

The Americans cannot afford to antagonise the army for the simple reason it is the only power that matters. And the mullahs? They have thrived due to a combination of factors. Most important among the factors is the failure of the so-called mainstream parties to provide honest and credible leadership.

It is customary to blame Zia and his successors, including Musharraf, for the growth of the Frankenstein forces of extremism and terrorism, but the buck does not stop there.

In many other countries, for example, in Latin America, the unholy alliance between the local military, rightwing forces and Americans undermined democracy but the nationalist and democratic forces eventually triumphed because they had capable and credible leadership.

Pakistan has been cursed by civilian and military leaders who are too eager to follow the US agenda. From Ayub to Kayani, there is not a single army chief who can claim to have pursued Pakistan's strategic interests independent of US goals in the region. Since US interests have largely been military and revolved around the containment of Russia and China in the region, its most natural ally has been the military at the cost of democracy and democratic governance.

Politics has been demonised to a degree that save for incompetent and allegedly corrupt individuals like Mr Zardari or Mr Nawaz Sharif, or creations of the establishment like Altaf Hussain or Maulana Fazlur Rehman, few wish to navigate the treacherous and murderous waters of stormy Pakistani politics.

It is easy to say that we need democratisation and decentralisation of power and the provinces should be given full autonomy. But how? We have had many elections since 1985 after Ziaul Haq imposed martial law in 1977 but virtually nothing has changed.

It is even more ironic when otherwise well-meaning intellectuals and civil society leaders lecture about democratic governance and the fight against extremism as if these were the only important issues.

Some believe the judiciary offers some hope. An independent judiciary is an oxymoron in Pakistan's current objective conditions. The so-called revolt by some in the judiciary against Musharraf was a manifestation of a power struggle inside the establishment.

The judiciary is as much part of the collapsing Pakistani state structure as some of the big media personalities, some whom also openly admit to have been offering advice to the powers that be. The ugly reality is that the business of the state and politics has become a mafia enterprise with the usual mix of big money (read business, drugs, land) interests and crime.

This criminal enterprise has the active support of the Americans who find it convenient to use a corrupt instrument that a puppet state is, be it military or quasi-military. Either in its pure form or in a diluted form; that is, in a coalition with some corrupt politicians.

Many developing countries have passed through this phase. But the will of the people ultimately triumphs. So Pakistanis must not despair.

However they need to be clear that the forces of oppression and corruption have thrived not only due to the support from the US but also due to the fact that the people themselves have allowed autocratic and corrupt forces to divide, coerce, silence and deceive them.

The people must unite. But for a movement to succeed in Pakistan's current conditions, it must and has to involve, mobilise and relate to the masses and not just the educated few. It is therefore the need of the hour that all citizens think seriously about what is the crux of the issue. The country needs freedom from corrupt leadership (civil or military) and America and the axis of trouble.

It is not the sole privilege of any political party or a civil rights group to fight for this. This should be the common goal of every Pakistani who wants to see the rule of the people. The two main obstacles to the creation of a free, just and democratic Pakistan are the establishment (including its civilian collaborators) and America. It is logical that Pakistanis raise their voice against both as well against the religious extremists.

From Ayub Khan to Yahya to Ziaul Haq to Musharraf, it is the United States that has sided with the generals as it historically did in all developing countries. To expect that a democratic movement can succeed without confronting the dictatorship's biggest and most powerful supporter is hoping against all hope.

If civil society and journalists forget this and continue to focus on issues like the repeal of the 17th Amendment, it is unlikely that such an agenda would capture the imagination of the masses who are quite aware of who really pulls the strings in Pakistan.

Until and unless a movement emerges that appeals to popular sentiment and represents the people's real aspirations to create a genuinely democratic state, Pakistan's chances of survival in its current state are slim.

December 6, 2009

War of terror: America's quest for hegemony

On Nov 12, 2008 the Washington Post reported that CIA Director Michael V. Hayden was likely to lose his job in President Obama's administration. The following day, Hayden raised the bogey of Osama bin Laden again saying he was "hiding in the lawless tribal areas of the Pakistan-Afghanistan border but was spending most of his time on his own security, making him ineffective." Hayden described Osama bin Laden's network as a "determined and adaptive enemy" in a "war that is far from over" and warned: "If there is a major strike on [the US], it will bear the fingerprints of al-Qaida."

Hayden is closely linked to the Bush administration's controversial warrantless wiretapping program, the so-called Terrorist Surveillance Program. Hayden was the head of the National Security Agency, which was responsible for intercepting phone conversations and e-mails, when the program was initiated. Hayden has also publicly supported the enhanced interrogation techniques authorized by President Bush and used by the CIA against high-value terrorists caught overseas and held in secret prisons around the world.

Now Hayden claims Al Qaeda leaders have extended their tentacles to North Africa and Somalia and were using partnerships to establish new bases. Elsewhere, Mr. Hayden said, Al Qaeda was "strengthening" in Yemen, and he added that veterans of the fighting in Iraq and Afghanistan had moved there, possibly to stage attacks against the government of Saudi Arabia.

Can we take Mr. Hayden's unsubstantiated claims on their face value or even seriously? Mr. Hayden's statement implies he knows about the whereabouts and activities of Osama. This is ridiculous. How can he even imply this after more than seven years of 9/11 and with no success in getting even anyway nearer to Osama or his deputy Ayman al-Zawahiri let alone capturing them? No US official or journalist or think-tank has ever raised or answered the question that Alan Greenspan posed in his book, The Age of Turbulence:

"There was no bigger question in Washington than, Why no second attack? If Al Qaeda's intent was to disrupt the US economy, as bin Laden declared, the attacks had to continue. Our society was open, our borders porous, and ability to detect weapons and bombs was weak. I asked this question of a lot of people at the highest levels of government, and no one seemed to have a convincing response."

Mr. Greenspan is no ordinary person. He is not just a former Chairman of the Federal Reserve. He has known George Bush, Dick Cheney, Donald Rumsfeld, and other top leaders for years and has had access to everyone who is anybody in Washington. The reason he did not get a convincing response is that the people at the highest level of [US] government do not have one. Why?

On December 21, 2007, US Defence Secretary Robert M. Gates said a resurgent al-Qaeda terrorist network has shifted the focus of its attacks to Pakistan. "Al-Qaeda right now seems to have turned its face toward Pakistan and attacks on the Pakistani government and Pakistan people," Gates told press reporters.

The Washington Post noted that the Pentagon chief did not specify the nature or location of the group's operations in Pakistan, and quoted Pentagon specialist on counterterrorism efforts on the Afghanistan-Pakistan border, who dismissed the defence secretary's assessment.

"Gates is drinking the . . . Kool-Aid like this administration has for the last six years". He also said that the fighters there are not affiliated with al-Qaeda. He spoke on the condition of anonymity because he wants to keep his job.

Nor is it clear that al-Qaeda is the real threat in the rest of Pakistan, commented Teresita C. Schaffer, a former deputy assistant secretary of state for South Asia. "Clearly, extremist violence has emerged as the biggest danger to the Pakistan state," she said. "I don't know if it is al-Qaeda or not."

On Sept. 17, 2008, Time magazine published a story "Risking War with Pakistan" written by an ex-CIA officer (for the Middle East) Robert Baer. He wrote:

> ***"As Wall Street collapsed with a bang, almost no one noticed that we're on the brink of war with Pakistan. And, unfortunately, that's not too much of an exaggeration. On Tuesday, the Pakistan's military ordered its forces along the Afghan border to repulse all future American military incursions into Pakistan. The story has been subsequently downplayed, and the chairman of the joint chiefs of staff, Mike Mullen, flew to Islamabad, Pakistan's capital, to try to ease tensions. But the fact remains that American forces have and are violating Pakistani sovereignty.***
>
> ***You have to wonder whether the Bush administration understands what it is getting into. In case anyone has forgotten, Pakistan has a hundred plus nuclear weapons. It's a country on the edge of civil war. Its political leadership is bitterly divided. In other words, it's the perfect recipe for a catastrophe.***
>
> ***All of which begs the question, is it worth the ghost hunt we've been on since September 11? There has not been a credible sighting of Osama bin Laden since he escaped from Tora Bora in October 2001. As for al-Qaeda, there are few signs it's even still alive, other than a dispersed leadership taking refuge with the Taliban. Al-Qaeda couldn't even manage to post a statement on the Internet marking September 11, let alone set off a bomb."***

Professor Anthony DiMaggio of Illinois State University, who teaches American Government and Politics of the Developing World, commented on Robert Baer's report in the Counterpunch:

> "The comments above, cited from Time magazine, are the only commentary I've managed to find in all of the American press that warn about the dangerous game the US is playing in destabilizing Pakistan. American media coverage, conversely, is driven by a warmongering that's remarkably indifferent to the dangers involved in escalating the conflict. US attacks on Pakistan inevitably carry the risk of further inciting Pakistani anger against the US. In the New York Times, editors depict the conflict in an Orwellian fashion, framing Pakistan, rather than the US, as the true threat. Illegal US attacks are framed innocently as a response to terrorism, with the Pakistani government's promises of reprisals against invading troops seen as "threatening" the safety of US troops. American reporters have long been known for their stenographic role, faithfully reflecting the official debate in Washington, rather than independently promoting their own reasoned, critical dialogue."

Prof. DiMaggio could have added; they have also buried critical and troubling facts about 9/11, Al Qaeda, and the role of the US and Pakistani establishments. Here are some concrete and well documented reasons why the US claims about Al Qaeda are not credible and cannot be taken at face value.

John S. Pistole, Deputy Assistant Director of Federal Bureau of Investigation's Counterterrorism Division, testified before the US Senate Committee on Governmental Affairs on July 31, 2003. The following part of his testimony is extremely intriguing:

"The FBI conducted a detailed financial investigation/analysis of the 19 hijackers and their support network, following the September 11th attacks. This investigation initially identified the Al Qaida funding sources of the 19 hijackers in the UAE and Germany. The financial investigation also provided the first links between Ramzi Binalshibh and the 9/11 operation. A continuing investigation, in coordination with the PENTTBOMB Team, has traced the origin of the funding of 9/11 back to financial accounts in Pakistan, where high-ranking and well-known Al Qaida operatives played a major role in moving the money forward, eventually into the hands of the hijackers located in the US"

There was no investigation into the grave and startling revelations made by the FBI. The FBI testimony was consistent with what the Wall Street Journal had published on Oct. 10, 2001. The WSJ never followed up or contradicted this story but other sources such as AFP confirmed it.

Quote from the Wall Street Journal:

Our Friends the Pakistanis

Yesterday we noted a report from a Pakistani newspaper that Lt. Gen. Mahmud Ahmad had been fired as head of Islamabad's Inter-Services Security agency after US linked him to a militant allied with terrorists who hijacked an Indian Airlines plane in 1999. Now the Times of India says Ahmad is connected to the Sept. 11 attacks: Top sources confirmed here on Tuesday, that the general lost his job because of the "evidence" India produced to show his links to one of the suicide bombers that wrecked the World Trade Centre. The US authorities sought his removal after confirming the fact that $100,000 was wired to WTC hijacker Mohammed Atta from Pakistan by Ahmed Omar Sheikh at the instance of Gen Mahmud. Senior government sources have confirmed that India contributed significantly to establishing the link between the money transfer and the role played by the dismissed ISI chief. While they did not provide details, they said that Indian inputs, including Sheikh's mobile phone number, helped the FBI in tracing and establishing the link.

Unquote.

Cover up of 9/11 Investigation

The 9/11 commission itself charged the US government of a cover up. On January 2, 2008, Thomas H. Kean and Lee H. Hamilton who served as chairman and vice chairman, respectively, of the 9/11 commission wrote an op-ed piece in The New York Times, accusing the US government of a cover up as no one in the administration ever told the commission of the existence of videotapes of detainee interrogations. "As a legal matter, it is not up to us to examine the CIA's failure to disclose the existence of these tapes. That is for others. What we do know is that government officials decided not to inform a lawfully constituted body, created by Congress and the president, to investigate one the greatest tragedies to confront this country. We call that obstruction", they concluded.

The commission itself was not keen to pursue the full facts. On page 172 of its report, it stated that ultimately the question of who financed the attacks "is of little practical significance", noting that "to date the US government has not been able to determine the origin of the money used for 9/11 attacks." That's right. The 9/11 Commission concluded in its report that it wasn't important to follow the money trail leading to those ultimately responsible for the crime.

Ahmed Omar Saeed Sheikh, who was alleged to have wired money to the 9/11 hijackers, was sentenced to 'death' in 2002 but his "appeal" has been pending since then. He kidnapped Daniel Pearl of the Wall Street Journal. Musharraf wrote in his book Omar was an MI6 agent. Pakistan's former chief of Intelligence Bureau; Brig. (retired) Ijaz Shah was the handler of Omar Saeed Sheikh. Sheikh surrendered to him in Lahore although Daniel Pearl was kidnapped from Karachi. Brig. Ijaz Shah was also accused by Benazir Bhutto of plotting to assassinate her.

It is a matter of record that even after more than five years of his arrest, the US government has refused to try the alleged master mind of 9/11, Khalid Sheikh Mohammed, in a normal civil federal court. He was arrested in March 2003 and handed over to the US but never faced open trial. According to the 9/11 Commission Report he was "the principal architect of the 9/11 attacks." On October 12, 2006, Time magazine reported that "KSM confessed under CIA interrogation that he personally committed the murder" of WSJ journalist Daniel Pearl.

Four critical questions

1) Why would the US government not pursue the Al Qaeda money trail leading to 9/11 attacks?
2) Why would the CIA destroy video tapes containing hundreds of hours of interrogations of Al Qaeda detainees in Guantanamo Bay?
3) Why would it obstruct independent investigation by members of the 9/11 Commission?
4) Why would the Pentagon and the CIA not try Khalid and other Al Qaeda members in a normal court?

These are crucial and extremely important questions. Unless the US government can answer these critical questions, its critics can rightfully and legitimately question its theory that the Al Qaeda has safe havens in Pakistan from which it can launch terrorist attacks on the America. The US government and its intelligence agencies have a major credibility issue. Their record, unfortunately, includes lies, deliberate disinformation and doctored intelligence - all designed to promote and implement hidden agendas.

Credibility of US intelligence claims

In the past, the US intelligence had concluded that Saddam Hussein had weapons of mass destruction. It was a lie that has been so well documented that it needs no further comment. The real motive was to conquer Iraq and control its oil fields.

In October 2007, President Bush had suggested that a nuclear-armed Iran could lead to "World War III" and Vice President Dick Cheney promised "serious consequences" if the government in Tehran did not abandon its nuclear program. But the US establishment and its intelligence agencies had decided to shift their focus away from Iran. In December 2007, a National Intelligence Estimate that represented the consensus view of all 16 American spy agencies, concluded that Iran halted its nuclear weapons program in 2003 and that the program remained frozen, contradicting its own judgment in 2005 that Tehran was working relentlessly toward building a nuclear bomb.

Given that the US has thus far failed to establish the responsibility for 9/11 attacks, the fact that there has been no attack by Al Qaeda on the US soil since 9/11, the real motive behind Iraq War, and the systematic disinformation campaign about Iran's nuclear program, it is perfectly logical to question the real motives of the US policy in Pakistan.

The nuclear dimension

The issue assumed greater and urgent significance by the mischievous remarks of Joe Biden, the democrat vice presidential candidate, made in the debate with Sarah Palin. "Pakistan's (nuclear) missiles can already hit Israel," Biden thundered. But what was he talking about? Pakistan does not have the capability to hit Israel. It has never threatened Israel. Jackson Diehl of Washington Post (Oct.3) commented: "a good deal of what Biden said was exaggerated, distorted or simply false — especially in his nominal area of expertise, foreign policy."

Robert Fisk, writing in the UK's The Independent (Oct. 4) ridiculed Biden's statement that there have been 7,000 madrassas built ... and that's where bin Laden lives and we will go at him if we have actually (sic) intelligence. Fisk chided: "Seven thousand? Where on earth does this figure come from? Yes, there are thousands of religious schools in Pakistan – but they're not all on the border". Fisk warns about the real US agenda, "We must gird ourselves for the next struggle against 'world evil' in Pakistan".

Islamic militants are America's intelligence assets?

Despite all the propaganda in the US media and think tanks about the alleged threat of Al Qaeda, the ground realities tell a different story. On August 5, 2008, The News International reported, "Impeccable official sources have said that strong evidence and circumstantial evidence of American acquiescence to terrorism inside Pakistan was outlined by President Musharraf, General Kayani and DG (ISI) Nadeem Taj in their separate meetings with US Chairman Joint Chiefs of Staff Admiral Mullen and CIA Deputy Director Stephen R Kappes on July 12 in Rawalpindi." The top US military commander and the CIA official were also asked why the CIA-run predator and the US military did not swing into action when they were provided the exact location of Baitullah Mehsud on May 24, 2008.

It is a matter of record that Abdullah Mehsud, Baitullah Mehsud's cousin and former leader of the so-called Taliban-e-Pakistan, was captured by the US troops in Afghanistan in December 2001 and kept in custody till March 2004 when he was released from Guantanamo Bay and allowed to return to Waziristan. Abdullah played a key role in organising the 'militants' before he was killed by Pakistan's security forces when Musharraf came under heavy pressure from the Chinese after Abdullah Mehsud kidnapped two Chinese engineers.

Al Qaeda and Taliban rescued by Bush

The story of how thousands of 'militants and Al Qaeda' ended up in Waziristan reads like a chapter from a spy fiction. How did Al Qaeda manage to establish its base in north-western

Pakistan? The Al Qaeda stronghold was established in the months following the US-NATO invasion of Afghanistan. The military campaign commenced in early October and was completed in late November 2001.

In late November 2001, the Northern Alliance supported by US bombing raids took the hill town of Kunduz in Northern Afghanistan. Eight thousand or more men "had been trapped inside the city in the last days of the siege, roughly half of whom were Pakistanis. Afghans, Uzbeks, Chechens, and various Arab mercenaries accounted for the rest." [See article by Seymour M. Hersh, The Getaway, The New Yorker, January 21, 2002]

A large number of these "foreign fighters" that included the Taliban and Al Qaeda leaders were never brought to justice, nor were they detained or interrogated. In fact quite the opposite, they were rescued. As confirmed by Seymour Hersh in New Yorker and documented in detail by Ahmed Rashid [Descent into Chaos, pp. 91-92, published 2008)), they were flown to safety on the orders of Vice President Dick Cheney and Defence Secretary Donald Rumsfeld, following a special request made by Musharraf to Bush. The Bush Administration ordered US Central Command to set up a special air corridor to help insure the safety of the Pakistani rescue sorties from the air bases in Chitral and Gilgit to Kunduz.

The end game

Why would the United States use the Islamic militants even as intelligence assets? A passage from "Devil's Game" by Robert Dreyfuss (pp. 336-337, published 2005) deserves serious thought. Citing the infamous policy memo written by leading neocons in 1995, entitled, "A Clean Break" to then Prime Minister Netanyahu of Israel to 'contain, destabilise, and roll back' various states in the region, Dreyfuss concludes:

"Neoconservatives want to control the Middle East, not reform it; even it means tearing countries apart and replacing them with rump mini-states along ethnic and sectarian lines. The Islamic right, in this context, is just one more tool for dismantling existing regimes, if that is what it takes."

What does it all add up to for Pakistan? Where all this is leading to? What is the current strategic objective of the United States in Pakistan? Michel Chossudovsky, a professor at Ottawa University and the director of the Centre for Research on Globalization, Canada offers a chilling explanation:

"The political impasse is deliberate. It is part of an evolving US foreign policy agenda, which favours disruption and disarray in the structures of the Pakistani State. Indirect rule by the Pakistani military and intelligence apparatus is to be replaced by more direct forms of US interference, including an expanded US military presence inside Pakistan. This expanded military presence is also dictated by the Middle East-Central Asia geopolitical situation and Washington's ongoing plans to extend the Middle East war to a much broader area."

October 11, 2008

Obama must remove Pakistan’s fears

The election of Barack Obama is a historic turning point for the United States. Son of a Black Muslim immigrant from Kenya, an under-privileged child born of a mixed marriage, raised in a broken home, and a Washington outsider; Obama represents a new emerging post-race, post-gender, younger and more diverse America. But that is so far as the optimism can go. Forty seven per cent of the voters still went with John McCain. That is, despite George Bush’s catastrophic presidency and economic meltdown, a large number of Americans supported a 72-year-old white male Republican who strongly supported the invasion of Iraq and did not offer any plan for economic recovery.

Obama promises to be an agent of change but his presidency may not change much for Pakistan. It may actually make matters worse in the immediate future if he follows Bush’s failed policy in Afghanistan, expands American military presence, continues to support Karzai’s extremely unpopular and corrupt regime, and retains the same people who are currently conducting the covert operations in Afghanistan and Pakistan.

On Aug. 1, 2007, Senator Obama made a major policy statement on national security at the Woodrow Wilson Centre. He said:

“We will wage the war that has to be won, with a comprehensive strategy with five elements: getting out of Iraq and on to the right battlefield in Afghanistan and Pakistan; **developing the capabilities and partnerships we need to take out the terrorists and the world's most deadly weapons** [emphasis added]**;** engaging the world to dry up support for terror and extremism; restoring our values; and securing a more resilient homeland.”

This statement suggests that Barack Obama’s idea of taking the war from Iraq to Afghanistan and Pakistan involves more than taking out the terrorists. It includes taking out ‘the world’s most deadly weapons’, as he put it euphemistically or plainly, Pakistan’s nuclear programme.

Obama is likely to continue the present US policy of encouraging India to play an active role in Afghanistan because he believes - as he wrote in a February 28, 2008 article in *India Abroad*, a newspaper on Indian affairs published in New York - that Washington and New Delhi must work together to combat the common threats of the 21st century because "both countries have been victims of catastrophic terrorist attacks and we have a shared interest in succeeding in the fight against Al Qaeda and its operational and ideological affiliates".

But is concern about terrorism really driving US-India relationship? What about China? At the April 2007 debate among Democratic candidates, Obama said China is “neither our enemy nor our friend. They're competitors.” This view echoes that of Condoleezza Rice who was one of the early proponents of ‘China containment’ policy. She spelled that out in a systematic way while serving as a foreign-policy adviser to George W Bush, then governor of the state of Texas, during the 2000 presidential campaign. In a much-cited article in *Foreign Affairs*, she suggested that China, as an ambitious rising power, would inevitably challenge vital US interests. “China is not a status quo power but one that would like to alter Asia's balance of power in its own favour. That alone makes it a strategic competitor, not the "strategic partner" the Clinton administration once called it,” she wrote. “Add to this China's record of cooperation with Iran and Pakistan in the proliferation of ballistic-missile technology, and the security problem is obvious. China will do what it can to enhance its position, whether by stealing nuclear secrets or by trying to intimidate Taiwan.”

Rice was among the first among Bush's top officials to advocate a case for building India as a counter weight to China's influence in Asia. She wrote in the same article, "It [the US] should pay closer attention to India's role in the regional balance. There is a strong tendency conceptually to connect India with Pakistan and to think only of Kashmir or the nuclear competition between the two states. But India is an element in China's calculation, and it should be in America's, too. India is not a great power yet, but it has the potential to emerge as one."

President Obama's basic policies in South and Central Asia are more likely to be the continuation of Bush administration's but with less dependence on the use of military force as the principal instrument. In Afghanistan, the UN, Britain, and America's NATO allies in general, do no longer believe that a military victory is possible in Afghanistan. Outright defeat of the Taliban is no longer the goal. Nor do the western diplomats envisage a perfect democracy emerging from the rubble of three decades of war. The West will settle for military stability (or dictatorship), effective government and a squeeze on drugs.

When a departing British commander said the war against the Taliban cannot be won, his remarks were dismissed as defeatist by US Defence Secretary Robert Gates. But Gates later said reconciliation with the Taliban was needed to end the conflict. The Pentagon has to be more realistic now that the US 2009 budget for the wars in Iraq and Afghanistan has been cut by about 40 per cent compared to the previous years'.

The US's Afghan war has been based on a dangerous premise - 40 per cent Pushtun population of Afghanistan is Talibans or its sympathisers. A military solution to bring peace and stability to a war torn narco-state of Afghanistan, in the face of growing religious sentiment combined with nationalist Pushtun feelings, was doomed to fail. The US failure in Afghanistan fuelled an insurgency that created civil war like conditions in the North West frontier region of Pakistan. It was this failure that spilled over into Pakistan and not vice versa as the US government officials wrongly allege.

The US failure has been compounded by the CIA; notorious for its botched operations and intelligence failures. The drone attacks are controlled and executed by the CIA. They have proved to be highly counter-productive but continue even after Obama's election. One would think the Pentagon and the CIA would take a pause and let the new administration formulate its policy. The intelligence agencies' briefing to Obama on Nov. 7 must have included the situation in Pak-Afghan border and one can only make a guess about Obama's reaction at this point.

Much is at stake! The 'great game' and the covert wars of the intelligence agencies have destabilised Pakistan and could lead to a bigger catastrophe in the coming years. The worst outcome will be a Pushtun rebellion on both sides of Pak-Afghan border. At the least, it would make Pakistan ungovernable. Is weakening of Pakistan and defang it by 'taking out' its nuclear weapons, an objective of the US policy?

Even Indians have now started to recognise the apprehensions of some Pakistanis. A Press Trust of India report (Nov. 8) quotes analysts who say, "Pakistan should not be pressured, because its security establishment believes that it is threatened by a US-India-Afghan alliance to dismember Pakistan."

It is in this context that Barack Obama's actions in Pakistan would be judged as to whether he really meant what he said in his first speech as President-elect:

“And to all those who have wondered if America's beacon still burns as bright – tonight we proved once more that the true strength of our nation comes not from our the might of our arms or the scale of our wealth, but from the enduring power of our ideals: democracy, liberty, opportunity, and unyielding hope.”

The US-NATO operation in Afghanistan and the covert operations inside Pakistan being conducted by its elite Special Operations Forces are viewed with deep suspicion within Pakistan. If the objective is to capture Al Qaeda elements because they pose a security threat to the United States, then this claim is plainly absurd although the US intelligence continues to propagate this myth. There has not been a single attack on the US soil since September 2001 but thousands of innocent Afghans and Pakistanis, including soldiers, have died in this war.

Still, if Mr. Obama is sincere about taking out Al Qaeda or its remnants, he should demonstrate this by inviting China and Russia to join the international security force in Afghanistan. This would be a concrete step towards removing the trust deficit with Pakistan and its apprehension that the West is playing a ‘great game’ in Afghanistan, which has little to do with Al Qaeda or combating terrorism.

November 12, 2008

Pakistan must avoid debt trap

Pakistan is the only country outside Europe to have gone to the IMF for a bailout. The western financial meltdown hit the United States and Europe hard, no country in Asia, Latin America, Middle East or even Africa has so far needed IMF's help. However, Pakistan's fragile economy and the inability of its leadership to secure the confidence of even its best friends have forced it to seek a $7.6bn aid package.

The IMF's assistance opens doors for aid from the World Bank and donor countries. But Pakistan's official foreign exchange reserves may still not hold above $8 billion level (equivalent to four months of imports) for long because the IMF will only disburse $4bn during this fiscal year and the current account deficit continues to be under pressure. Still, the country has got some breathing space. In the near term, the IMF aid should help stabilise the reserves, currency value, inflation, and prevent capital flight. However, the economic development is likely to slow and hurt employment. It would be a mistake to relax, talk vaguely about the so-called 'home grown' economic plan and practically do little to raise tax revenues and cut criminal waste in government expenditure.

If the past is any guide, the government may not perform on its commitment to reduce the fiscal deficit to a manageable level and lead Pakistan to sink deeper into the debt trap. It should not wait till 2012 to repay the IMF loan. It must come up with a viable strategy to repay the $4bn within the next 18 months and resume economic growth.

Pakistan must achieve a minimum growth rate of seven per cent to reduce poverty which has climbed sharply. This growth rate is necessary due to around 2 per cent population growth rate, and skewed income distribution which results in transfer of less than one third of annual growth in national income to about three-fourth of the population. The mantra of economic stabilisation to reduce inflation will not be enough to achieve this. The lower income groups living at or around the poverty line of US$2 a day income (eighty per cent of the population) are worst hit by food inflation and the prices of staples are most relevant in this respect. The discussions about inflation being a regressive tax should take into account that the food inflation has less to do with monetary policy and more with the supply side issues in trade, agriculture, and administrative policies.

The government must work hard to restore investor confidence in its policies and competence. Credibility has emerged as a major issue in both domestic and foreign affairs; be it government's relationship with the other political parties or its dealings with old friends like China and Saudi Arabia. One instance is the government claims that it negotiated the IMF loan on its own conditions. This is just technically correct. The World Bank had advised the government to remove most subsidies as far back as March this year, and it followed its advice.

Mr. Praful Patel, then a vice-president at the World Bank, met Mr. Zardari, Mr. Gilani and the government's finance managers on March 26-27, 2008 and warned that "Pakistan will need the international community's support over the coming months". Mr. Patel added: "If action is not taken, the economy will start to falter."

Despite the warnings, the government failed to mobilise the necessary amount of financial assistance for almost seven months and had to seek IMF's help. This is a poor reflection on its competence and credibility. But that is one aspect of the story.

The politics of the Pak-US relations is equally if not more important. Highly placed sources draw attention to a series of apparently un-related but simultaneous developments. The US was not happy with the PPP's decision to form an alliance with Nawaz Sharif. The World Bank decided to suspend its planned aid (about $550 million) for Pakistan for 2008 as far back as March this year. This was part of WB's three-year $6.5bn aid programme announced in April 2006. The size of the actual disbursements was to be determined by 'the strength of the government's policy performance and macroeconomic management' per the programme's terms. Apparently, the WB was not comfortable with the PPP's government economic plan, or its lack thereof, to continue its aid. But how come it decided to suspend disbursements even before the cabinet was formed. It should resume its aid now but this year's assistance will not be more than $1bn and not 1.4bn as was claimed by the government's finance adviser.

It became clear that the IMF wanted an interest rate rise during informal consultations with the IMF officials in Islamabad and Dubai, in September and October respectively. The State Bank Governor claims that Nov. 12 decision to increase the central bank's policy rate by two percentage points was independent and aimed at controlling inflation but the reality is that the IMF wanted a slowdown in growth through tightening of fiscal and monetary policies.

The monetary expansion by itself was not responsible for a surge in inflation. In Pakistan, diesel and furnace oil are such major components of transportation and fuel energy (out of line with Asian averages because we did not develop hydel and coal energy) costs respectively, that there is a high correlation of inflation with oil prices. The yearly inflation which was 11.9% in Jan. 2008, jumped to 24.3% in July as, for example, light diesel oil price went from Rs 32 to Rs 56 per litre during the same period. During these months, fuel prices were revised frequently to adjust to market levels as well as to play catch up since previous increases in the international price of oil had not been not passed on to consumers.

The solution is to have an automatic price adjustment mechanism for oil prices, so the price signals get transmitted quickly and circular debts do not accumulate. The new pricing formula should remove the subsidy for oil refineries and do away with formulas that favour the oil marketing companies. The $55-a-barrel oil translates into about Rs 28 per litre. Even a fifty per cent mark-up and twenty per cent tax would not imply a price of more than Rs 50 per litre.

Data from other Asian countries points to a more gradual increase in inflation cushioned by higher level of subsidies although most of Asian countries are large oil importers. Reason: their rich pay more taxes and their governments can afford more subsidies. The rich and the ruling elites in Pakistan would rather borrow, beg, or steal and mortgage Pakistan's future than pay more taxes. Pakistan's consumers have been paying more than their fair share of taxes due to a convoluted oil pricing mechanism while governments and oil companies have been earning super-normal profits. The subsidies increased above the cost levels only during July-2007 and October 2008 period. Before this, taxes and duties on petroleum products were one of the top contributors to the total government revenues. The oil pricing policy and low taxes - not the government's borrowings per se - are the principal reasons for the current budgetary imbalances.

Wrong economic policies – that favour the vested interests – together with Pakistani establishment's dependence on Washington as the main source of power, are responsible for the country's fundamental economic and political imbalances. Both issues must be addressed if the country is to avoid the debt trap and make progress that benefits its people.

November 18, 2008

Leadership not IMF is the issue

Pakistan's current economic meltdown is a crisis of competence if judged in light of the recent past. In the context of history, it represents a colossal failure of the establishment's long-term foreign and economic policies. Pakistan desperately needs four to five billion dollars to avoid default on its external obligations. The government is working on the multilateral institutions and Friends of Pakistan to raise this sum within the next few weeks failing which it will go to the IMF.

The government does not want to borrow from the IMF to keep its hands relatively 'free' and avoid the likely political fallout from following the IMF's prescriptions. Does Pakistan have an option? Unfortunately, no. The World Bank has not disbursed any aid so far for this fiscal year. Its yearly aid to Pakistan is about \$500-\$600 million and is unlikely to come through now, that is, before the IMF puts its seal of approval on Pakistan's economic plan.

Friends of Pakistan group include Saudi Arabia, China and the United States. Saudi Arabia has observed a meaningful silence for several months regarding Pakistan's request to supply oil on credit. China's commitment to help with specific projects is welcome but its ambivalence about outright cash loans is understandable given its own policy to channel foreign aid through project assistance. It did provide emergency loans to Pakistan in the past (in Dec. 1996 and April 2008) but not to the tune of billions of dollars.

The People's Party government took charge in April 2008 and put the privatisation programme on hold without making alternative funding arrangements. It did not act upon proposals from global banks to raise money from international markets at a time when market conditions were relatively stable. It kept hoping it would get Saudi oil facility whilst the oil price shot up and the foreign exchange reserves evaporated. Capital flight ensued as the market confidence sank and business sentiment turned negative.

The government's team of economic managers and advisers lacked international financial markets' experience to anticipate or manage what was about to hit the economy. This writer warned on these pages of DAWN (May 30, 2008), *"If the economy continues its present slide, even the US may not be able to bail Pakistan out. Its own once mighty financial giants are being rescued by Chinese and Arab investors. Pakistan's last resort would be the IMF with its usual conditionalities and the inevitable pain they would cause. For Pakistan, the most sensible course would be to put its house in order now"*. But the government devoted almost its entire attention to the judges' issue and power politics as the country headed towards its worst financial crisis in a decade.

Crisis of competence

Although Pakistan seems to have little option but to go the IMF; it could have raised and still can try to raise \$5 billion in a short period. Raising \$5 billion will take Pakistan's foreign exchange reserves to about \$12 billion. This would represent a comfortable level of four months worth of next 12 months of imports as Pakistan's annual import bill is likely to drop sharply to \$33 billion from \$40 billion in FY 2007-08 due to the collapse of the price of oil and that of other commodities such as edible oil. Four months of import cover is considered a reasonable level and the country can use this time to take steps, such as privatisation or joint ventures in strategic areas, to mobilise funds for its medium term needs.

Just consider the following four of the many ways the government can use to raise five billion dollars for meeting the current crunch. Some of these are not necessarily the most desirable options and are appropriate as emergency measures but are far better than carrying a begging bowl around the world.

- Pakistan has about $1.8 billion in gold reserves. Borrowing or leasing against gold is a standard international practice. Pakistan can borrow for six months at the rate of around 2.1% from the central bank of a friendly country such as the United Arab Emirates. India did this in 1991 for a short period.

- Pakistan can borrow (not beg) at least US$1.5 billion from China on commercial terms by putting its shares in large government-owned corporations as collateral. China has, in the past year, extended loans to other countries (e.g. Congo) on the basis of proper collateral. The cost of loans secured against collateral can be significantly cheaper compared with other options.

- Pakistan can get another $800 million in a few days if the US reimburses the remaining amount for 2008 it should pay under the Coalition Support Fund relating to expenditure incurred on combating terrorism. Pakistan has received only one instalment ($364.7 million in September 2008) for this year's expenses. A senior military source told Internews that the amount for reimbursement was calculated on the basis of six-monthly reports. He said all bills related to the expenditure had been audited jointly by a team of Pakistani military officers and the US embassy.

- Mr. Shaukat Tarin, the Finance Adviser, said Oct. 20 that the government would move ahead on remittances securitisation without any delay. Countries like Brazil and Turkey have used this to raise billions of dollars in foreign currency funding over the years. Pakistan can probably raise $500 million but the question is: has the government moved?

And here is something the US can arrange to do in the next 48 hours if it is really serious about helping Pakistan.

On Oct. 29, the US Federal Reserve agreed to provide $30 billion each to the central banks of Brazil, Mexico, South Korea and Singapore, expanding its effort to unfreeze money markets to emerging nations for the first time. The Fed set up ``liquidity swap facilities with the central banks of these four large systemically important economies" effective until April 30, the Fed said in a statement. The arrangements aim ``to mitigate the spread of difficulties in obtaining US dollar funding."

The Fed had earlier, on Sept. 24, extended similar facilities of 10 billion dollars each to the central banks of Australia, Denmark, Norway and Sweden in exchange for their currencies. These swap facilities – granted against another currency or a government bond - are meant to ease short term liquidity needs (from a week to a few months) and do not require approval of the US Congress.

Pakistan does not need 30 billion dollars. If the US Fed can extend a facility of even just a billion dollar against Pakistan government bonds, it will go a long way in stabilising the Rupee and the market sentiment. But only if US wants to help – not through 'aid' but just through market means.

Foreign policy failure

Pakistan turned to China at the last hour and after it was turned down by the US and Saudi Arabia. It would have eminent sense to deal with China on a bilateral basis but its inclusion in the Friends of Pakistan group in late September 2008 complicated the matters. Required home work and preparations did not precede President Zardari's October 2008 visit to China. The Chinese were a little embarrassed by Pakistan's desperate plea of help but reiterated their commitment to help their 'old and dear friend'.

The trouble was that the government continued Musharraf's Washington-centric foreign policy. Yet, in the hour of its greatest need, the US not only ditched Pakistan but a third-ranking state department official publicly humiliated its 'friend' by saying that Friends of Pakistan' "wouldn't throw money on the table". This wasn't surprising given Condoleezza Rice's more subtle remarks earlier on Sept. 26 at Friends of Pakistan group meeting in New York: "We are very engaged with Pakistan, through the international financial institutions, to help Pakistan as it takes the difficult decisions that it is and must take on economic reform." Translated: Pakistan should go to the IMF and reform its economy.

Clearly, the US pressure on Pakistan to go the IMF has political undertones as well. The US has not reimbursed the government $800 million it owes under the Coalition Support Fund relating to expenditure incurred on the military campaign in the tribal areas. The World Bank has not disbursed a penny and even cancelled $300 million budgetary support assistance that was scheduled to be disbursed by the year-end.

Aid syndrome

However it is also true that Pakistani rulers' historic tendency to indulge in profligate spending and corruption has left them with few sympathisers despite the much trumpeted 'geo-strategic' importance of Pakistan. Pakistan's total debt of $90 billion at 56% of GDP is more than five times of its tax revenue base and yet its government's net borrowing from the banking system during just four months from July to October 2008 was 123 billion rupees ($1.6 billion) against the full year target of 149 billion rupees.

The United States has historically directed most of its 'aid' to make Pakistan fight its wars. The aid has been primarily used for military purposes (e.g. Pakistan's arms purchase orders in 2006 alone totalled $5.1 billion) but the indirect cost of the conflicts since 1980 has been catastrophic, although some people continue to believe in the "benefits" of such "aid".

The 'aid syndrome' stymied any serious effort to reform the economy, Infrastructure investments and tax reforms were neglected because the so-called austerity programmes advocated by the multilaterals hit subsidies but not the pockets of the vested interests. Oil and food subsidies played a major role in Asia and the European Union respectively in keeping the prices low because the governments had fiscal space, of which Pakistan never had much.

Cutting fat in defence and establishment expenditures and taxing the rich were not high on the multilaterals' reform agenda as the focus was usually on indirect taxes (e.g. sales tax) that inevitably hit the lower income groups. For example, the IMF program in 2000 forced Pakistan to impose sales tax on fertiliser and all agricultural inputs but accomplished little else in widening the tax net. The program also introduced a quarterly price adjustment mechanism for all major petroleum products. The mechanism was designed to benefit the oil marketing and refining companies and increased the burden of indirect taxes. In the fiscal year 2005-06, the indirect taxes on petroleum products increased by 56.8% and accounted for almost one-fifth of the total indirect taxes collected. It is true that IMF too has learned from its mistakes in the past and may not try to fix the entire system by imposing its ideological biases. But one of the basic lessons should always be remembered: contractionary policies (e.g. increasing interest rates and/or imposing more taxes) can add to economic woes when introduced at a time of economic downturn.

Credibility and confidence

But what is the point in complaining about the US's 'real agenda' or the IMF's 'conditionalities' when the country's leaders are unwilling to tighten their belts and undertake necessary reforms and are known to own assets worth hundreds of millions of dollars abroad. Confidence and credibility are important issues and cannot be wished away.

Today, there is hardly major country in Asia or the Middle East that owes any debt to the IMF except Turkey and Pakistan. Turkey is the largest borrower of the IMF and accounts for about 40 per cent of its $18.3 billion total lending worldwide before the current world financial crisis started. Pakistan owes about $1.3 billion borrowed in 2004, notwithstanding the false claims to have broken the 'begging bowl'.

Turkey went to the IMF in 2001 and the ruling Justice and Development (AK) party came to power in 2002. During the last six years, Turkey's inflation fell to single digits (though it has risen again due to higher energy and food prices) and foreign direct investment (FDI) rose, helping it to repay almost two-thirds of its loans from the IMF. Turkey still has issues (e.g., a persistent current account deficit) but AK's economic record is one reason why it easily won July 2007 elections.

India was nearly bankrupt in 1991 when a balance of payments crisis forced the country to pledge its gold by actually shipping 20 tonnes of it abroad. It was left with no choice but to approach the IMF. Its then Finance Minister Finance Minister Manmohan Singh recalled later: "There was a silver lining though. India launched the most sweeping economic reforms that year dismantling decades of license raj, and didn't ever look back although progress was fitful in the first few years."

Pakistan can learn from the experiences of India and Turkey. They had serious problems, although their nature differed. However, their leaderships demonstrated sincerity and political acumen to undertake difficult reforms to enable their economies to recover. The reform process was led and executed by people who were highly respected for their integrity and competence. In Pakistan's case, the real problem is not the IMF; it has been and continues to be the country's leadership.

Note: Condensed version of this article appeared in two parts in *DAWN* [October/Nov. 2008]

Time to cut interest rates

Given that the current account deficit is now likely to continue to shrink for the next several months, the month-on-month core inflation rate has fallen every month since May 2008, the fuel subsidies (the principal cause of deterioration in the fiscal position) have been withdrawn, and the manufacturing production is falling, growth of credit to the private sector is negative in real term, the balance of risk in Pakistan's economic outlook has shifted from inflation to growth. Do the IMF and Pakistani officials, who are negotiating the package, understand this? Have they taken into account these recent developments and trends, and their policy implications?

Apparently not; because there are indications that the IMF wants an increase of three percentage points in the central bank's benchmark discount rate to 16% as part of its bailout package for Pakistan. Would that be a right move at this time? Superficially yes, if one compares it with Iceland which raised interest rates by six percentage points to get $2 billion from the IMF but Pakistan's external debt to GDP ratio of 28% is tiny compared to Iceland's 545% and much smaller than Ukraine's 71%. In both the cases, most of the external debt comprises short-term borrowings by the private sector. In contrast, most of Pakistan's external debt represents official long-term borrowings from foreign governments and the multilateral institutions. Therefore, Pakistan's case is not comparable with either Iceland or Ukraine. How about inflation? Vietnam has cut central bank's discount rate twice to 12% in the past three weeks, although Vietnam's year-on-year inflation rate is 26.72%. Even if we ignore Vietnam's example and that of some other countries, would an interest rate hike be justified in Pakistan's case? Probably! However, a careful analysis reveals a different picture.

On July 29, 2008, Dr Shamshad Akhtar, Governor State Bank of Pakistan increased the central bank's policy rate by 100 basis points to 13 per cent stating the bank had decided to do so *"considering the risk related to rising external current account and fiscal deficits and worsening inflation outlook to contain further aggregate demand pressures which are contributing to the inflationary pressures"*.

The effectiveness of monetary policy in controlling Pakistan's current inflation is questionable. A recent report (Oct. 2008) of the Asian Development Bank (ADB) underscores this point: "To the extent that inflation in Pakistan is driven by high commodity prices, monetary tightening will have a limited impact on inflation and will most likely aggravate the economy's other structural problems," the report warns. "A more effective anti-inflation tool would be identifying and eliminating fiscal programs that induce an inflationary bias in the economy", the ADB report suggests.

In any event, since July, the international as well as Pakistan's economic scenario has dramatically changed. The balance of risk has shifted from inflation to slower economic growth and liquidity crunch. The global financial meltdown and a severe credit crunch in the United States and Europe have sparked fears of a deep and prolonged recession. In October, commodities had the biggest monthly drop since at least 1956 and Reuters/Jefferies CRB Index of 19 raw materials plunged 22 per cent on concern that a slump in global economic growth will sap demand for raw materials.

Inflationary pressures have eased not just in the developed world but throughout Asia as well. China and India announced interest rate cut in October, and growth in both the countries is expected to slow down to the slowest pace in four years. South Korea, Taiwan, Indonesia, the

Philippines and Thailand reported slower inflation during the first week of November, and the central banks in Australia, Hong Kong, Japan, South Korea, Taiwan and Vietnam have all announced rate cuts since the last week of October.

In Pakistan's case, the economic growth could be 3.5 per cent or even lower during the current fiscal year. For the first two months of the current fiscal year, the large-scale manufacturing production index, including cotton yarn and cloth sectors, reported a drop of 6.46% compared to the same period in the prior year. The economic outlook for the next twelve months is clouded by the prospects of a slowdown in growth as investment activity has visibly dropped and business confidence is low. Pakistan sends about 42% of its exports to the United States and Western Europe. With both these regions facing recession, Pakistan's mostly low-valued added exports and workers' remittances could be at risk.

However, the current account deficit is likely to shrink sharply in the next twelve months. Over sixty per cent of last fiscal year's $7 billion rise (over 100%) in the current account deficit was due to high oil and other commodity (notably edible oil, wheat, fertiliser, metals, etc.) prices, which have dropped by 40-60% from their peak levels in 2008 and below the average import prices paid by Pakistan in 2007-08. Since July 29, the crude oil price has fallen by 47 per cent to $64 a barrel, palm oil's by 48 per cent to about $437 a metric ton and wheat price by about 35 per cent to $192 a tonne.

Fuel subsidies constituted the largest contributor to the federal government's ballooning fiscal deficit but have been almost completely eliminated. Still the net government sector borrowing from the monetary system grew by 10.1 per cent during the four months to October 30, or at annual rate of 30 per cent. This was due to the fact that the government did have substantial fiscal burden during the first quarter of July-Sept. and it took time to phase out the subsidies.

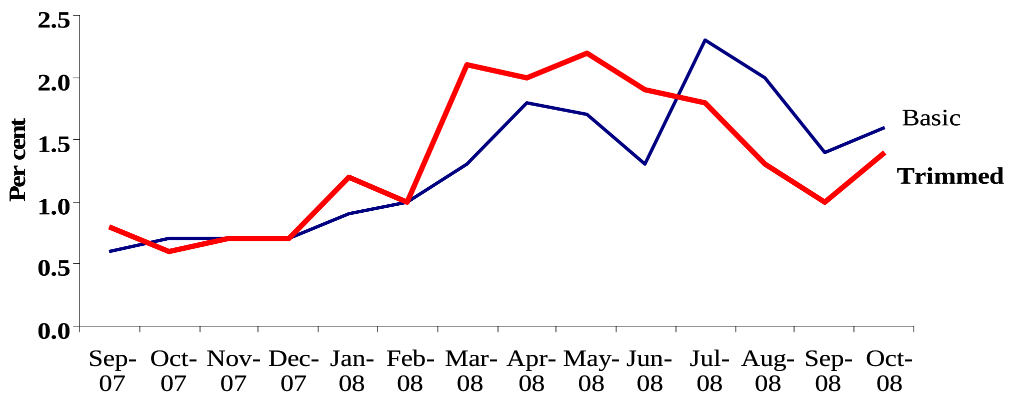
However, the credit to the private sector has contracted in real terms since the beginning of the current fiscal year in July. The slump in the private sector activity was clearly evident in a nominal increase of just 4% in overall lending to the private sector during this period. At the same time, the interest costs have climbed sharply as illustrated in the graph for the three month Karachi inter-bank offer rate; a key benchmark for lending rates, which traded around 15.27% on Nov. 7. In the past, KIBOR trended upwards after the central bank announced raise in the policy rate in July 2007, January 2008, May 2008 and July 2008. The actual lending rates for borrowers are obviously higher than the KIBOR

The

inflation is expected to come down as food, fuel and transportation account for 55% of the consumer price index in Pakistan and contributed to even so-called non-food, non-energy inflation.

The latest data from the central bank confirms this view. As shown in the graph, the core (non-energy non-food) **month-on-month inflation rate has declined steadily since peaking in May 2008**. Its refined version called the trimmed inflation - as it excludes abnormal or extreme movements to get a better picture of average trend- has shown a decelerating trend in the most recent months, as indicated by 1.4% increase in October 2008 and 1% increase in September 2008 (over the previous month) compared to 2.0% in August 2008 and 2.3% in July 2008.

CORE INFLATION
Sequential Month-on-Month
September 2007 - October 2008



If the current monthly rate of core inflation stays at one per cent or, the expected core inflation rate for the next twelve months would not be more than 12.7%. On this basis, the expected real borrowing rates in Pakistan are currently positive. That was not the case in January or July when the central bank increased the policy rate.

Following a sharp increase in the lending rates in the recent months, the average interest spread (the difference between average lending rate and the average cost of funding) has increased every month since June 2008, and was reported at 7.49% in September 2009 compared to 6.78% in June 2008. This is not a healthy trend and indicates that while the large banks are earning higher spreads, both the private sector borrowers as well as depositors have been the losers since the monetary tightening began.

Another worrisome development during this period has been that the central bank had to take unusual measures to pump more liquidity into the banking system following an outflow of deposits (around Rs 230 billion) to the higher yielding national savings schemes, and apparently abroad (through the money changers), while the credit to the private sector contracted in real terms.

In the current economic scenario, it would make more sense to cut the policy rate by 100 basis to provide a stimulus to the private sector. The central bank should also increase the minimum interest rate on saving deposits (of banks) from 5% to 7% and require the banks to calculate interest on average monthly balance instead of minimum balance as currently is the practice. Saving deposits account for over 40 per cent of the total banking deposits and this raise together with the change in the methodology for calculation should help in attracting funds to the banking sector and contribute to increasing the savings to GDP ratio in the longer-term.

At the same, the State Bank should bring the activities of the money changers under its closer supervision and monitoring to ensure strict compliance with the laws dealing with tax evasion and money laundering. The government should also impose a 3% tax on the sale of foreign currency through the money changers to encourage more flows to go via the banking system.

Above all, both the IMF and Pakistani government officials should remember the advice given by Joseph Stiglitz, a Nobel Prize winning economist, to the governments going into an IMF programme. In an article titled, '*Lessons From Argentina's Debacle*', published in January 2002, Stiglitz wrote that there were seven lessons to be learnt from what he described as IMF's fatal mistake that precipitated Argentina's collapse (in 2001) inciting the largest default in history:

1) In a world of volatile exchange rates, pegging a currency to one like the US dollar is highly risky.

2) Globalisation exposes a country to enormous shocks. Adjustments in exchange rates are part of the coping mechanism.

3) You ignore social and political contexts at your peril. Any government following policies which leave large parts of the population unemployed or underemployed is failing in its primary mission.

4) A single-minded focus on inflation - without a concern for unemployment or growth - is risky.

5) Growth requires financial institutions that lend to domestic firms. Selling banks to foreign owners, without appropriate safeguards, may impede growth and stability.

6) One seldom restores economic strength - or confidence - with policies that force an economy into a deep recession.

7) Better ways are needed to deal with situations like Argentina's.

Hopefully the IMF has learnt from its past blunders and would not precipitate a recession in Pakistan by insisting on a rate hike when it may actually need a rate cut.

November 10, 2008

Need for a new era of strategic partnership with China

Pakistan has a rare opportunity to redefine its relationship with China and open a new chapter that has the potential to change its status from a client 'security state' to that of a typical growing Asian country. The moment may have arrived for Pakistan to make a great leap in its historically close and strategic relationship that has taken a back seat since 9/11. The global economic power balance is undergoing a historic shift. "End of US era - now China calls the tune", declares a headline of Sydney Morning Herald, Australia's oldest and most respected newspaper. "Can Chinese Cash Save the World's Banks? ", runs a lead story in Time. "Is this the end of the American era?" is the title of an op-ed by noted historian Paul Kennedy in the UK's Sunday Times.

Billionaire investor George Soros predicted Oct. 12 that the financial crisis would mean the end of a US-led market system that has dominated the global economy with debt and deregulation since the 1980s. "This is now over. The game is out. It does mean a very serious adjustment for America," Soros said in a CNN interview. China should lead rescue efforts for the US financial crisis, Mexican tycoon Carlos Slim, one of the world's richest men, told the press last week. " China is now the most important country to help responsibly in this crisis," he said.

"China owns us, lock, stock and barrel, so it's more important than ever that the US monetary authorities coordinate their monetary policies with China," Chris Rupkey, New York-based chief financial economist at Bank of Tokyo-Mitsubishi – Japan's largest - told Bloomberg.

The headlines and stories convey a dawning realisation in western capitals that the biggest casualty of the Western financial meltdown might be the US dominance of the global financial system, the linchpin of its global power. And that it is China, with over $1.8tr in foreign exchange reserves- growing at a pace of $40bn a month, which holds the key to the financing of the astronomical budget deficit that the US will have to run to finance the bailout of its financial institutions.

The reports of the death of American capitalism may be exaggerated but there is little question that the financial meltdown means the end of its sole super power status in what was described as a unipolar world. Its western allies – Britain, France, Germany, and other European countries have committed over $2tr to rescue the banking system from collapse and will face mounting fiscal deficits to finance them. Meanwhile, in 2009, the GDP of Asia (ex-Japan), on purchasing power parity basis, is likely to reach the level equal to that of the US and Western Europe combined, with China certain to overtake Germany as the world's third largest economy.

Barack Obama or John McCain will walk into the Oval Office Jan. 20 facing the grimmest economic landscape in decades: perhaps 7-8 per cent of the nation's workforce unemployed, millions more families who have lost more than $12tr of wealth in the values of homes and stocks, a global recession, a crippled banking system, ailing state and local governments – some on the verge of bankruptcy, jittery foreign creditors and a budget deficit near the landmark $1 trillion mark and forecast to cross $2tr in the next twelve months, and $10tr in the federal government debt or 72 per cent of its GDP. This year, net interest on the federal debt is projected at $244 billion, about $100 billion more than the annual cost of the wars in Iraq and Afghanistan.

Even before the meltdown started, it was expected that the US would find an exit strategy from Iraq. Now it looks almost certain that it will have to find an exit strategy from both Iraq and Afghanistan. In any event, the US was not planning to send more troops to Afghanistan till early 2009 with little signs of support from its NATO allies. The US has spent an average of $12.1bn a month on these wars, including $9.8bn in Iraq and $2.3bn and civilian aid.

The Bush administration came under heavy criticism for its handling of the economy in the past year and spending over one trillion dollars on the "War on Terror" in Iraq and Afghanistan since 2001. It is not a coincidence that it recently decided to review its entire strategy in Afghanistan and gave a nod to the Saudis to conduct secret negotiations with the Talibans with the objective of finding a way out of the quagmire. "During the talks, all parties agreed that the only solution to Afghanistan's conflict is through dialogue, not fighting," CNN reported Oct. 5.

The so-called terror war will be the biggest casualty of the budget cuts that a financially crippled US government would have to make but axe is also likely to fall on the foreign aid. The US government's budget for foreign aid was about $20.3bn in 2008. Joe Biden, Democrat vice presidential candidate said on Oct. 2 that the $700 billion bailout might force Barack Obama to reassess his promise to double foreign aid if elected president. "The one thing we might have to slow down is a commitment we made to double foreign assistance. We'll probably have to slow that down," Biden said during a debate with his Republican vice-presidential rival, Sarah Palin.

The escalation in the US military campaign on Pakistan's northern borders can be viewed in the context of its economic crisis. It shows all signs of desperation. It cannot help Pakistan yet it wants to "win" the war in Afghanistan. It appears to be using the multilateral lenders to pressure Pakistan to "do more" on the one hand, while conducting a psychological warfare through drone attacks and covert operations inside Pakistan's borders through its Special Operations Forces, on the other.

The good news for Pakistan is that the US has run out of money to continue its quest for military hegemony in the Middle East and Central Asia. Given its financial meltdown and astronomical debt levels, the US has no option but to forget about its ambitions to be the dominant military power in the region and seek truce with the Talibans, pursue diplomacy to resolve conflicts with Iran, and equally importantly, recognise China's strategic interests in the region.

After all, China is the largest creditor of the US with nearly one trillion dollar in the holdings of treasury bills and government-guaranteed debt and US cannot finance its gargantuan deficits and service its $10tr debt without a steady flow of funds from China. True, China has a stake in the financial stability of the US but the extraordinary turn of events has given it a leverage that was unthinkable only a year ago. "If the world economy darkens further, China will emerge as the likeliest saviour", concluded the Economist in a recent issue.

Pakistan enjoys historically close relations with China and the financial meltdown provides it with a rare opportunity to reduce its dependence on Western aid, disengage from playing the 'new great game' on behalf of the West, and make a bold and decisive shift in its foreign policy that is driven by its own long-term economic and strategic interests.

Pakistan may wish to look beyond the immediate need for financing its external deficit that has bled its foreign exchange reserves. China has a long-term strategic interest in a strong, stable, and economically independent Pakistan. It is the only major power that has both the will and the capacity to exploit Pakistan's natural resources and help build its infrastructure that is in dire need of huge investments. In contrast to the US, China sees itself, and not India, as the leader of the future Asian century and has a natural interest in a Pakistan which is more than a client state of the West.

But Pakistan may need to do more than just ask for help and talk about the history of Pak-China friendship. It may have to demonstrate through its words and actions that it considers China and - not the US - its best friend. In this context, it is important to recall that while the Chinese were happy to see the Taliban regime fall in 2001, they viewed Musharraf's complete surrender to the US commands, without prior consultation with Beijing (as should have been done), with considerable misgiving. Pakistan should address China's concerns about Pakistan's support for the Talibans in the past, its regional repercussions, and its spill over effects on China's provinces. It may also be expected to demonstrate a stronger commitment with the members of the Shanghai Cooperation Organisation (SCO). But all this would require that Pakistan undertake a comprehensive review of her foreign, economic, and defence priorities and policies and build a national consensus to demonstrate that it is indeed ready to enter into a new era of its strategic relationship with China.

October 14, 2008

Global financial meltdown

The worst global financial crisis since the 1930s is more than just an economic phenomenon. It may turn out to be the most important event since the collapse of the Soviet Union and the fall of the Berlin Wall in 1989. A unipolar world emerged following the disintegration of the Soviet Union. The year 2008 may go down in history as the year in which the Anglo-Saxon financial model collapsed and the balance of global economic power shifted from the West to the East.

Since January 2008, the US stock market capitalisation has fallen by about 40 per cent, its worst performance since 1937, wiping out almost $7.3 trillion in wealth equivalent to about 53 per cent of US's GDP. Some of its biggest and most powerful banks have collapsed. About 3.6 million Americans have their lost homes since the subprime-mortgage crisis began and more continue to lose as property prices drop. The US is now in a recession and the unemployment rate is rising rapidly and forecast to reach 7.1 per cent early next year, according to Goldman Sachs. The US budget deficit for 2009 could be close to $2 trillion, or 12.5 per cent of its GDP.

In just last few weeks, the governments in the US, UK, Germany, France, Belgium, Iceland, and Sweden have announced bail-outs totalling $1.8 trillion to rescue the troubled banks. In September, the US nationalised its two biggest mortgage banks or virtually half of its mortgage lending market to save them from bankruptcy. On Oct. 7, Britain announced that its largest banks are to be part-nationalised to avert a banking collapse. Under the UK bank rescue, the government is to put up to £250 billion into the banking system in an effort to keep banks lending. It will also offer a guarantee to banks issuing medium term debt, which could mean backing a further £250 billion of bank borrowings. But it is likely to demand dividend cuts and the end of big bonuses at the banks in return. In addition, the Central Banks in the US, Europe, and Japan have pumped nearly one trillion dollars into the money markets to restore confidence and to avert more bank failures.

The UK move came as central banks around the world announced an unprecedented co-ordinated cut in interest rates in response to mounting fears about the impact of the financial crisis on the world economy. The US Federal Reserve, the European Central Bank, the Bank of England, and the central banks of Canada, Switzerland and Sweden and the United Arab Emirates all cut their main lending rates by 0.5 percentage points.

In Latin American, central banks are being forced to draw on record foreign reserves built up during the six-year commodities rally to stop their currencies from sinking. In the last couple of days, Brazil sold dollars for the first time in five years and Mexico offered $2.5 billion in the spot market after their currencies fell the most in at least a decade. Chile may follow suit after its peso fell to the lowest in almost four years.

What began as a banking crisis due to the defaults in the $2.3 trillion subprime loans (home mortgage loans given to low income people) market has turned into a global financial meltdown. Joseph Stiglitz, a Nobel Prize–winning economist from the US, recently wrote, "A unique combination of ideology, special-interest pressure, populist politics, bad economics, and sheer incompetence has brought us to our present condition." Subprime lending was just one of the reasons. The collapse of America's financial giants was brought about by excessive greed of banks, mindless deregulation, lax supervision, and a false belief represented by bipartisan Washington consensus that financial markets knew best. But the financial market shot themselves in their feet.

Warren Buffet – one of the world's richest men and the best investors – had warned in 2003 that derivatives were "financial weapons of mass destruction" and that, while the Federal Reserve System was created in part to prevent financial contagion, "there is no central bank assigned to the job of preventing the dominoes toppling in insurance or derivatives".

In simple terms, derivatives are financial instruments whose value changes in response to the changes in underlying variable such as bonds, stocks, commodities, interest rates, credit risk, etc. The US regulators historically focused on banking companies and actually encouraged them to transfer their risky assets to their less-regulated affiliates or third parties such as investment firms and hedge funds. The result was the growth of what's now often termed as the shadow banking system of securitisation and derivatives.

The over-the-counter (OTC) derivatives are not traded on any exchange. The OTC derivatives market is (or rather was) dominated by the investment banks. By the end of 2007, the total notional amount of all the derivatives had risen to \$596 trillion from \$220 trillion in June 2004.

One type of derivatives is a credit default swap (CDS). It resembles an insurance policy, as it can be used by a debt holder to hedge, or insure against a default under the debt instrument. According to the International Swaps and Derivatives Association, the notional value of CDS totalled \$62.2 trillion at the end of last year. Since there is no clearinghouse to administer these transactions, in effect it is impossible to know who could be hurt the worst.

AIG had a credit default swap portfolio of \$400 billion notional value, but it cannot be fairly valued because there is literally no real market for many of these contracts. The collapse of Lehman Brothers triggered an enormous crisis in derivative markets. Prior to the firm's dramatic demise, no major player in the world's biggest financial market had ever gone under. A major counterparty failure exposed the delicate web of trading in securities that are gargantuan in dollar amounts but totally lacking in transparency.

The sheer magnitude of challenges, questions and uncertainties facing investors of all types — from those engaged in commodities to corporate credit to commercial real estate — is more daunting than most people at the Wall Street have experienced in their entire careers. While the banks have announced losses from the mortgage loans to the tune of nearly \$700 billion, losses from derivatives pose a much bigger and unknown risk. The risk that the bank next door could be sitting on large losses led banks to stop trading with each other and sparked fears of banks falling like dominoes, shattering the confidence in the whole system.

The IMF has warned that the world economy is now entering a major downturn in the face of the most dangerous shock in mature financial markets since the 1930s. "The situation is exceptionally uncertain and subject to considerable downside risks," the IMF said. The US may face its longest recession in a quarter century despite its \$700 billion plan to rescue the battered banking industry. Economists say it now appears the economy shrank in the third quarter as credit- crimped consumers cut spending for the first time since 1991. The stock markets continue to fall, the money markets in the US and Europe are practically shut, and the credit has dried up and is bound to hurt all those who borrow from international markets.

Asian stock markets have not been immune to the crisis and have fallen sharply reflecting slower growth forecasts. However, according to the IMF, Chinese economy is still likely to grow by 9.3 per cent, Russia's by 5.5 per cent, and India's by 6.9 per cent. Their foreign exchanges reserves are reported around $1.8 trillion, $582 billion, and $283 billion respectively. The reserves of these three countries represent 38 per cent of the world's total and 12 times the reserves of the European Community (EU).

With the US and Europe in turmoil, the governments piling up huge deficits to rescue banks, and their capacity to provide aid to the developing countries' seriously impaired, a dozen sovereign wealth funds, none of them from the US or Western Europe, are now the world's largest and most powerful investors group. These funds, controlled by Asian and Arab governments, are sitting on an estimated 7 to 8 trillion dollars. A few have selectively helped some Western banks.

Japan and China are the two largest foreign creditors of the US: Japan holds $593 billion of US Treasury bills, followed by China with $519 billion. The US is now completely dependent on Asia for financing its losses and deficits and hugely dependent on the Middle East and Venezuela for its meeting its oil needs. The shift in the global economic power balance, once a matter of long term projections, has been dramatically cut short by what has been described as the fall of the Anglo-Saxon financial capitalism as we knew for a long time.

October 11, 2008

The price of being a security state

The nation took a sigh of relief as a most painful phase ended with Musharraf's resignation. Should the matter end here? My problem with General Musharraf was not that he dismissed judges or that he violated the constitution. All dictators of Pakistan were guilty of that. His greatest crime was that he compromised Pakistan's national interests to consolidate his power when he was an international pariah and brought Pakistan to the brink of Balkanisation by his dual track policy of covertly supporting the Afghan Talibans yet allowing the Americans to conduct air strikes on Pakistan. But it is impossible to forgive him for insulting the people of Pakistan by telling them in the full glare of TV cameras that they should eat chicken if pulses are expensive (daal mahngi hey to murgi khain). Queen Marie Antoinette of France said, "Qu'ils mangent de la brioche" ("Let them eat cake"), when confronted by the poverty of the people and shortage of bread. She was executed by guillotine at the height of the French Revolution in 1793 for the crime of treason.

A section of English-speaking elite believes Musharraf was trying to save them from Talibans. This makes me wonder how much more and ridiculously ignorant one can be. He secured the evacuation of more than three thousand Talibans and militants between 15th and 23rd November 2001 from Kunduz in Afghanistan, where they had been trapped, to Pakistan's tribal areas from where they were to later organise and conduct terrorist attacks. His close friend Brig. (retired) Ijaz Shah, who served as the head of intelligence bureau (IB) from 2004 to March 2008, was alleged to have provided covert support to the religious extremists for a long time and was named by Benazir Bhutto as one of those who were plotting to assassinate her.

Musharraf used the intelligence agencies including the ISI to rig the elections in 2002 to enable the supporters of religious militants and Lal Masjid extremists, such as Chaudhry Shujaat Husain and Ijaz ul Haq, to gain power in the centre and the religious extremists to gain ground in the NWFP and Balochistan. The politics of fear and blackmail was practiced that fully exploited the fact that both Pakistani people and the West were apprehensive of the religious extremists.

This double game was played to a degree that it forced a former General and Corp Commander Faiz Ali Chisti to make a shocking statement on January 27, 2008 that he would "not be surprised "if Musharraf had engineered terror attacks to manipulate his image in the West."Musharraf is an intellectually dishonest person. He is a clever ruler, who makes the US and the West believe that they can only effectively deal with 'Al-Qaeda' as long as he is in power," Chishti told the French news agency AFP in an interview. "But what is 'Al-Qaeda' and who are 'Taliban'? I will not be surprised if this clever ruler is behind all suicide attacks," Chisti told AFP.

The UK's Times newspaper claimed (August 19, 2008) that a Congressional investigation had revealed that the Pentagon knew of the diverted military aid but chose not to disrupt relations. This report said that a diplomatic showdown took place when the CIA uncovered evidence that Pakistani intelligence agents had helped to plan the bombing of the Indian Embassy in Kabul. "Ultimately Mr Musharraf's double game may have left Pakistan more precarious than before", the Times concluded.

The allegations of the diversion or misuse of aid were earlier made by US Congressman Gary Ackerman, the head of the House of Representatives panel on issues relating to South Asia.

On May 15, 2008, chairing a hearing on US foreign assistance to South Asia, Ackerman said that in Pakistan, over the past six years, the Bush administration provided 1.5 billion dollars in "foreign military financing" and 5.56 billion dollars in "coalition support funds." The military financing was to buy radars, and anti-submarine planes to track what Ackerman called "the non-existent Al-Qaeda air force and navy." The coalition funds "disappeared into the Pakistani Treasury for unspecified services allegedly rendered," he claimed. "Yet Pakistani officials complain, and have done so to me directly, that they lack the capabilities and training to conduct effective counter-insurgency operations," Ackerman said.

Some so-called pragmatists advocate a cautious approach to Musharraf's accountability lest the Khakis get upset. But Pakistan's history tells us that letting the dictators go unpunished for their crimes against the state and the people has not deterred the Bonapartists and adventurers to strike again in the darkness. Bhutto did not try the Generals as he was recommended to do by the Hamoodur Rahman Commission.

Bhutto was to later regret his policy of appeasing the army. He wrote these prophetic words from his death cell in his book, "If I am Assassinated": "If a coup d'état becomes a permanent part of the political infrastructure, it means the falling of the last petal of the last withered rose. It means the end." He added, "If India had suffered from martial laws and military dictatorships on the pattern of Pakistan, India would have been in three or four separate pieces by this day. India is more heterogeneous than Pakistan but India has been kept in one piece by the noise and chaos of her democracy."

Bhutto faced two coup attempts within the first couple of years of his five and half year rule and then the third fatal one on July 5, 1977. Why? The Bonapartist Generals were sure nobody could touch them. Democracy and democratic institutions cannot exist and grow without accountability. Musharraf committed grave crimes against the people including handing over hundreds of Pakistanis to the US without due process of law; allowing the murder of Benazir Bhutto to happen by withdrawing security and then presiding over the cover up. He should be held responsible for the deaths of several hundred Pakistanis including those who died on May 12, 2007 in Karachi as he stood in Islamabad moving fists declaring, "I will have the last punch."

But it would be wrong to single out him for Pakistan's descent to the brink of a failed state. Musharraf represents the mindset of those arrogant and megalomaniac Generals who consider themselves a special breed that is above any law and accountable to no one. This breed was responsible for the ignominious surrender on December 16, 1971 and the breakup of Pakistan. Its ugliest face, Zia ul Haq was responsible for the murder of Pakistan's first ever elected prime minister and turning Pakistan into a CIA base and one of the biggest hubs of narcotics and arms trafficking in the world.

It was another General- Aslam Baig who sabotaged democracy by forming and supporting the IJI and encouraging the MQM to turn Karachi and Hyderabad into war zones. His ISI chief Hameed Gul had little idea – and still does not - that by supporting the so-called 'jihadis', many of whom have been tools of suicidal raw power games conducted in the name of 'national security' and strategic depth', he and his likes were creating Frankensteins who instead of undermining the neighbouring 'enemies' would threaten the very future of Pakistan itself. Musharraf was and is part of that reckless, irresponsible, and dangerous stupidity called the strategic depth. These Generals should learn to manage just Islamabad before they dream of controlling Afghanistan and Central Asia. The price of this policy is a failing state that is a haven for terrorists, religious bigots, robber barons, and drugs and arms traffickers.

Pakistan cannot repair these deep wounds by pretending that there is nothing wrong or that Musharraf received some bad advice or made some mistakes. No individual or army can be a substitute for the collective wisdom that the politicians are forced to choose as the modus operandi because democracy, not matter how imperfect, cannot function otherwise. Collective wisdom and decision making processes may not appear to be particularly efficient but serve as safety value to prevent disasters like the 1971 defeat.

The malaise of military rule is cancerous, deep, and may prove fatal. It needs a surgical operation and the operation must start at the top. It must start with not just impeachment but with an open trial by a judicial commission that should consist of only non-PCO judges. It will need to be followed by a healing process but healing does not and cannot start before an operation.

August 19, 2008

Drone attacks and charade of protests

The first-ever ground military attack on Pakistan's soil by the US-led troops on September 3 provoked strong condemnation and outrage in Pakistan. Now the cat is out the bag. The New York Times said the raids were authorized by President Bush 'without the approval of the Pakistani government.' The Chairman of the US Joint Chiefs of Staff Admiral Mullen declared Sept. 10 that the US military "will revise its strategy for Afghanistan to include militant safe havens in Pakistan in its areas of concern." Translated in simple terms, the US attacks are part of a well planned strategy. Gen. Pervez Kayani rejected US claims that the "rules of engagement" gave the coalition forces the right to enter Pakistan. He denied that there was "any agreement or understanding with the coalition forces whereby they are allowed to conduct operations on our side of the border." Prime Minister Gilani backed Kayani's statement while President Zardari has so far chosen to keep quiet and talk about Kashmir. His decision to visit Britain first and not China, as was earlier reported, may be seen as a capitulation to the US pressure.

The ground attack had come after a number of airstrikes and artillery attacks which have intensified this year. Foreign Minister Shah Mahmood Qureshi termed the attack as shameful, regrettable and surprising and an 'unforgivable incident.' Since Mr. Qureshi's statement, more missile attacks have killed dozens of innocent people near the Afghanistan border. Qureshi said he was surprised at the attack but was the attack really a surprise or the attacks were purely unilateral American acts? A careful review of the developments and reports since January suggests otherwise.

A New York Times report of February 22, 2008 offers some insights into what has been brewing. The paper reported that 'American officials reached a quiet understanding with General Musharraf in January [2008] to intensify secret strikes against suspected terrorists.' The paper noted that the new agreements with Pakistan came after a trip to the country on Jan. 9, 2008 by Mike McConnell, the director of national intelligence, and Gen. Michael Hayden, the CIA director. The American officials met with Mr. Musharraf and the army chief, Gen. Kayani, and offered a 'range of increased covert operations' aimed at thwarting intensifying efforts by Al Qaeda and the Taliban to destabilize the Pakistani government.

On March 22, 2008, the Newsweek magazine confirmed these reports and disclosed that although some news reports said at the time that Musharraf had "rebuffed" US proposals to step up combat operations inside Pakistan but US officials and Pakistani sources, who asked for anonymity discussing sensitive information, said the recent wave of Predator attacks are at least partly the result of understandings the high-level visitors reached with Musharraf and other top Pakistanis, 'giving the United States virtually unrestricted authority to hit targets in the border areas.'

Alarm in Pakistan about possible American intervention rose after a surprise visit July 12 by the chairman of the Joint Chiefs of Staff, Adm. Mike Mullen, to Islamabad, where he met with the army chief, Gen. Kayani; Prime Minister Yousaf Raza Gilani; and President Pervez Musharraf. It was Admiral Mullen's fourth visit to Pakistan in six months. Days afterward, reports about a build-up of NATO forces on the border between Afghanistan and Pakistan added to Pakistani anxiety.

On August 28, Admiral Mullen again met his General Kayani secretly on board a US aircraft carrier in the Indian Ocean. After the news was broken by the New York Times, Mullen conducted a press briefing and heaped praise on Kayani. Mullen said, "… as I've come to know him [Gen. Kayani], he's been very clear to me, and not just in saying it, but what his actions are, that his goal — my view — is to do the right thing. He's an extraordinary individual and his ultimate — his goals are — his principles and goals are to do what's best for Pakistan. And everything he's done, our engagement, indicates that's absolutely the case". However, Admiral Mullen refused to give more information about his meeting saying, ""I'm not prepared to discuss in great detail the specifics of everything that we covered. But I can tell you I came away from the meeting very encouraged that the focus is where it needs to be at the military to military relationship."

This theme was earlier articulated by Lisa Curtis, an influential analyst and a former CIA official, in a Heritage Foundation (a think-tank) paper dated Aug. 7. "The army's full attention should be on the real threat to the country's future: the advance of Taliban militants along the border with Afghanistan and in some of the settled areas of the Northwest Frontier Province", she wrote. In an obvious reference to the charges that the US actions could destabilize Pakistan, Curtis stressed that Islamabad must accept that regarding terrorism, 'a convergence of US interests with those of Kabul and New Delhi does not translate into a wider conspiracy to undermine core Pakistani national security interests.'

The US attaches the top most priority to stop the infiltration of the militants into Afghanistan from Pakistan's tribal areas and deny them a 'safe haven' from which to launch attacks. It has been dealing directly with Pakistan's military leadership under Musharraf and now with the tacit approval of the PPP government which has not shown any serious will to stand up to the US policy of conducting military operations from across the borders. They may now be reaching the point where they could cost it popular support and, consequently, its ability to fight militancy. Apparently, while the US is satisfied with the cooperation of Pakistan's military and political leadership, notwithstanding its reservations about the role of the ISI or elements within it, the Bush administration seems to place a low priority on supporting democracy. It remains to be seen if a Democrat President would follow a substantially different policy.

The attacks came just days before the presidential election and were coincided by a stinging personal attack on Mr. Zardari in the conservative The Wall Street Journal on Sept. 2 In an article written by a member of the editorial board, the paper alleged that the Pakistani government agreed to stop its air strikes on the Taliban, in exchange for which Jamiat Ulema-e-Islam agreed to throw its support to Mr. Zardari. The paper described him as a caricature of everything that's morally bankrupt with the country's Westernized elite, and thus an inviting propaganda target for al Qaeda and the Taliban. "Al Qaeda and the Taliban feed on chaos, and a Zardari presidency will almost certainly provide more of it."

Whether or not, these views reflect the thinking of the White House and US establishment, Pakistan is likely to face more military strikes and even greater pressure from Washington, directly and indirectly, overtly and covertly, in both political and economic terms, to aggressively fight the Talibans, and to 'do more' sans negotiations with the 'terrorists'. Hence, the 'hot pursuits' and airstrikes are likely to intensify in the coming months despite "strong protests" from Pakistan's leaders. If allowed to continue, they will further inflame the insurgency and may ultimately lead to a military takeover by destabilizing the civilian government.

September 14, 2008

Zardari, his own nemesis?

Would Asif Zardari's presidency be better or worse than Musharraf's? Would it lead to a fall of the PML(N)'s government in Punjab and a full scale confrontation with Nawaz Sharif that would inevitably follow? Would it be a replay of the ineptitude and corruption that characterized the civilian governments in the 1990s? Would Asif be able to provide the kind of leadership that is required to face the violent insurgency in the NWFP and Balochistan and a precarious economic situation? Would he be able to work with the establishment? The list of questions is long. He would probably restore the judges and that may turn out to be a non-issue in the much larger scheme of things if he gets elected as the President of Pakistan.

Is it a big IF? Yes if you read reports that discuss growing murmur among the army officers and comments by 'senior' members of the establishment. But it seems highly improbable that an establishment that is so heavily dependent on the United States for both its military and financial needs would support Nawaz Sharif whose past is tainted by a record of collaboration with the right-wing extremists and accusations that he received $10 million from Osama bin Laden in exchange for the pledge that he would turn Pakistan into a Sharia state and become its Amir-ul-Momineen.

Assuming Asif Zardari wins the Presidential elections, his biggest challenge may not be the 'war on terror', or the economic crisis, or for that matter Nawaz Sharif. It could be himself unless he can overcome his shortcomings. There is little doubt that many accusations of corruption were right. The argument that the charges were never proved does not carry any weight in Pakistan's context. How many past rulers were tried and convicted on corruption charges? None. Does this prove that they did nothing wrong and there was no corruption? Sons of former Generals openly boasted of having hundreds of millions of dollars but were never touched by the establishment that has one standard for the generals and another for the politicians. Zardari's court cases were kept alive because the establishment wanted to use Asif as a tool to pressurize and manipulate Benazir Bhutto because she deeply cared about his life as he was the father of her three children.

But that was the past. Today, like it or not, he is the leader of the largest and the only truly national party of Pakistan but he has not done any favour to his reputation and credibility by repeatedly reneging on his public commitments and pledges to restore the judges. He shrewdly used Nawaz Sharif because he needed him to get rid of Musharraf but he may ultimately have to pay a heavy price for his apparently wily tactics and overconfidence. Even Maulana Fazul Rehman, that master of double speak and byzantine politics, could not digest Zardari's somersaults.

However, concerns about Zardari should be kept in perspective. Those who believe Musharraf and the establishment protected the security interests of Pakistan and acted responsibly should do their home work and learn from history. The following passage from the US State Department report of April 30, 2001 titled "Patterns of Global Terrorism", highlights Pakistan's number one problem – the use of militancy as a policy tool:

"Pakistan's military government, headed by Gen. Pervez Musharraf, continued previous Pakistani Government support of the Kashmir insurgency, and Kashmiri militant groups continued to operate in Pakistan, raising funds and recruiting new cadre. Several of these groups were responsible for attacks against civilians in Indian-held Kashmir, and the largest of the groups, the Lashkar-e-Tayyiba, claimed responsibility for a suicide car-bomb attack against an Indian garrison in Srinagar in April.

The United States remains concerned about reports of continued Pakistani support for the Taliban's military operations in Afghanistan. Credible reporting indicates that Pakistan is providing the Taliban with materiel, fuel, funding, technical assistance, and military advisers. Pakistan has not prevented large numbers of Pakistani nationals from moving into Afghanistan to fight for the Taliban. Islamabad also failed to take effective steps to curb the activities of certain madrassas, or religious schools, which serve as recruiting grounds for terrorism."

The unpleasant truth is that Pakistan's own establishment has been its biggest security risk due to its faulty judgments and adventurous policies. There are two reasons why Pakistan today is considered at the epicentre of global terrorism and security threats; the Talibans and nuclear proliferation. Pakistan's nuclear program, even its cold nuclear test in 1983, was tolerated by Washington but what really sent the alarm bells ringing was the reckless idea of selling nuclear weapons and equipment to the countries that the US considered unfriendly.

The establishment conceived, formulated and pursued the policies that have brought Pakistan to a stage where both the issues threaten its security. General Aslam Beg reportedly told Benazir Bhutto in 1989 that Pakistan could make hundreds of millions by selling nuclear technology to Iraq, Iran, and Libya but she refused permission. He subsequently acknowledged, in 2001, that Pakistan 'used to sell atomic material and equipment quietly and secretly'. It did not stop in 2001.

The issue, therefore, is not whether Mr. Zardari's rule would be any more of a threat to the national security than a military general's was but whether he would demonstrate enough maturity to build the consensus that is vital to reign in the reckless and irresponsible establishment which has played havoc with grave national security issues for decades in addition to destroying democratic institutions including the judiciary. His initial success in consolidating his grip on the party and more recently his victory against Musharraf has given him a misplaced sense of over-confidence. He needs to understand that the power was bequeathed to him by that larger than life figure, Benazir Bhutto, and Musharraf's exit had more to do with his own blunders and with the policy of the United States that never really trusted him in the first place and had become increasingly frustrated with his 'double-dealing' particularly since February 2007.

Mr. Zardari started out with the right ideas and spirit but his performance has fallen short of his often lofty and grandiose pronouncements about changing the system and strong institutions. His government has been paralysed for months due to a highly personalized style of governance that is full of rhetoric and short on delivery. It seems to have woefully inadequate intellectual and administrative capacity primarily due to Zardari's biggest weakness - his tendency to rely on old friends and place loyalty above competence. This together with his over-confidence could mean Mr. Zardari may turn out to be his own nemesis. For Pakistan's sake, I hope not.

September 4, 2008

State within a State

The PPP government made a faux pas in trying to bring the Inter-services Intelligence Agency (ISI) under its control and it is probable that the move may have come under great pressure to do so after the July 7, 2008 bombing of the Indian mission in Kabul, but let it be clear that the notion ISI spends most of its time on external defence is false. That the civilians should therefore not bother about it is an equally flawed and dangerous argument. The history does not support this view. It is also wrong to believe that the US administration's reservations about rogue elements in the ISI are a recent or post 9/11 phenomenon.

The most important lesson from history is that intelligence agencies when not accountable to the elected government and are not subject to checks and balances can become a state within a state. Shah of Iran's Savak was notorious for its repression, the FBI under Edgar Hoover was even suspected of carrying out the assassination of John F. Kennedy and the CIA was directly involved in assassinations of foreigners before it was forbidden to do so by an executive order of President Ford in February 1976.

In Pakistan, the then–Deputy Army Chief of Staff General R. Cawthorne formed the Inter-Services Intelligence (ISI) agency in 1948. Prior to the 1958 coup and the implementation of martial law, the ISI reported directly to the Army Chief. After the implementation of martial law, the ISI began to report to then-President Ayub Khan and the martial law administrator. It was not Mr. Bhutto who started the use of the ISI for domestic intelligence. It was under General Ayub Khan, the ISI became responsible for monitoring Pakistani politicians, especially those in what was then East Pakistan. Khan expanded the ISI's role to the protection of Pakistan's interests, which included the creation of a covert action division within the ISI to assist Islamic militants in Northeast India, as well as to assist the Sikh Home Rule Movement in the 1960s.

Altaf Guhar, one of the most powerful bureaucrats to serve Ayub Khan, wrote a revealing piece about the nature of the ISI operations in the daily Nation on August 17, 1997: "The President used to receive regular reports on the political situation in the country from the ISI and the MI. These reports in sealed envelopes marked 'Eyes Only' were usually handed over to the President by the C-in-C. On a few occasions the President gave me these reports and it seemed to me that the agencies were keeping the politicians, particularly the East Pakistanis, under close surveillance. I rarely found anything insightful in these reports. The DIB had direct access to the President and his weekly reports used to be fairly exhaustive. It was during the presidential election in l964 that the ISI and the MI became extremely active (emphasis added)."

According to Altaf Guhar, the crisis of intelligence failure came during the 1965 war. Brigadier Riaz (then ISI chief) told Altaf Guhar that he had contacts inside the Occupied Kashmir and in other major Indian cities. "I will flood you with news. Don't worry". When the war started there was a complete blackout of news from all the intelligence agencies. When Guhar got nothing out of the ISI for two days he went to Brigadier Riaz only to learn that all his contacts had gone underground.

The ISI played a key role in the Afghan war and worked closely with the CIA in what was its biggest covert operation since the Vietnam War. While much is made of its role, most Pakistani analysts have either ignored or not given due importance to the fact that the oil price collapsed in the 1980s and the Soviet Union became bankrupt. Notwithstanding this aspect, by 1985 the tide of the war had shifted in favour of Moscow according to analysis produced in that same year by Richard Clarke, the then US Deputy Assistant Secretary of State for Intelligence. According to his memoirs, his boss told him: “Don’t just tell me we’re losing, Clarke, tell me what the (expletive deleted) to do about it.” The decision to send Stinger missiles by then Secretary of Defence Casper Weinberger in 1986 was crucial in turning the tide in favour of the Afghan fighters trained and backed by the ISI. By this time, the US aid had also been increased to US$600 million from $35 million in 1982.

Following the end of Afghan War, the CIA and the Americans abandoned Afghans but the ISI continued to play a key role in Pakistan’s Afghan policy including training of Taliban in Afghanistan and support of right wing extremists in Pakistan. What complicated the matters was Talibans’ involvement with Osama bin Laden.

The Taliban regime had provided sanctuary to Osama bin Laden who was wanted by the US even before 9/11. President Clinton ordered cruise missile attacks on Afghanistan in August 1998 on what he described as one of the most active terrorist bases in the world. In his television address on August 20, 1998, Mr Clinton named “exiled Saudi Arabian dissident” Osama bin Laden as the mastermind behind the embassy bombings in Nairobi and Dar es Salaam. On the same day, a spokesman for the ruling Taliban, Mullah Abdullah, told CNN and Reuters that “bin Laden is safe and no damage has been done to any of his companions.” The top officials of Clinton administration suspected, even in 1998, that if “Pakistan’s ISI wanted to capture bin Laden or tell us where he was, they could have done so with little effort”, according to Richard Clarke, the chief of counter-terrorism for Bill Clinton.

The ISI’s name figured again in the aftermath of 9/11. The DAWN published the following story on October 10, 2001.

“Director General of Pakistan’s Inter- Services Intelligence (ISI) Lt Gen Mahmud Ahmed has been replaced after the FBI investigators established credible links between him and Umar Sheikh, one of the three militants released in exchange for passengers of the hijacked Indian Airlines plane in 1999. The FBI team, which had sought adequate inputs about various terrorists including Sheikh from the intelligence agencies, was working on the linkages between Sheikh and former ISI chief Gen Mahmud which are believed to have been substantiated, reports PTI website. Informed sources said there were enough indications with the US intelligence agencies that it was at Gen Mahmud’s instruction that Sheikh had transferred 100,000 US dollars into the account of Mohammed Atta, one of the lead terrorists in strikes at the World Trade Centre on Sept 11, it adds.”

While this news was disturbing to say the least, the objective fact remains that Gen Mahmud Ahmed, the ISI chief, was replaced barely a month after he had returned from Washington after spending about ten days meeting top officials of the Bush administration.

The record speaks for itself. The support for Taliban and parties like the JUI and various local militant groups blurred the distinction between its foreign and domestic roles. The ISI has played a key role in elections beginning in 1964 and thereafter, and in conducting Afghan policy and operations. We have hardly ever had free and fair elections and Afghanistan crisis now threatens the very survival of Pakistan as it exists today.

August 9, 2008

The coming economic tsunami

Pakistan's economic outlook for the next 12-24 months is serious even it gets around $3 billion in external financial assistance in the next few months. It is not unlikely that the key macro indicators would deteriorate as follows:

1. The GDP growth may drop to 3% or less. This would imply a drop in the real per capita income of around 80 per cent of Pakistanis due to around 2.4 per cent population growth rate and skewed income distribution.
2. The current account deficit could exceed 9 per cent of the GDP.
3. Inflation could accelerate to 25%+ sparking widespread social unrest and pushing more people below the poverty line.
4. Rupee could depreciate to 75/US Dollar with a fair chance of overshooting in the interim as the trade gap widens.
5. Stock market could fall to 11,000 level or below.
6. Fiscal deficit could reach 8% of the GDP.
7. The foreign exchange reserves may drop to just 2 months of import cover.

If the deterioration continues, a downgrade in the sovereign ratings cannot be ruled out.

Why Pakistan is especially vulnerable?

Based on the latest available key economic indicators of the twenty five largest developing countries (excluding the Middle Eastern oil producers), Pakistan has the worst fiscal and current account deficit level (measured as a percentage of GDP), fourth highest inflation rate, and the second worst performing currency when measured in terms of its depreciation till May 9 against the US Dollar since January 1, 2008.

It is common to blame the oil crisis for Pakistan's current economic woes but the rapid deterioration of its macroeconomic indicators has exposed the reality of the claims of the 'economic progress' made by the previous government during its tenure. It is just not the high oil price or the 'atta' crisis or some administrative issues that can be fixed quickly as one journalist remarked on a PTV show last Saturday evening.

Among all the major developing countries, Pakistan's economy is the weakest and most vulnerable to rising oil prices and international financial crisis. Why? Many analysts here do not seem to understand this. I had lunch with one of the top TV anchors last week and he did not seem to understand why we would be among the worst hit by the global oil crisis. I explained to him the concept of vulnerability when there are systemic and fundamental imbalances in an economy. For example, please take a look at this table.

COUNTRY	Fiscal Deficit %	Current A/C %	Inflation (%)	Currency YTD (%)
Malaysia	-3.1	12.5	2.8	3.5
China	-2.1	8.4	8.3	4.5
Venezuela	0.0	7.0	29.3	0.0
Russia	2.5	5.4	14.3	2.9
Taiwan	-1.8	5.3	3.9	5.7
Philippines	2.0	3.9	8.3	-3.0
Argentina	1.1	2.8	8.9	-0.9
Chile	7.0	2.6	8.3	5.4
Thailand	-3.0	2.1	6.2	-7.5
Indonesia	-1.9	2.1	9.0	1.7
Israel	-1.4	1.5	3.7	10.9
South Korea	0.2	0.3	4.1	-10.8
Egypt	-7.2	0.3	16.4	2.8
Brazil	-1.8	-0.8	5.0	3.7
Mexico	0.0	-1.2	4.6	3.0
Peru	-0.8	-2.1	5.5	8.7
India	-3.1	-2.4	7.9	-5.3
Czech Republic	-2.5	-3.2	7.1	10.9
Colombia	-1.7	-3.5	5.7	13.1
Slovakia	-3.4	-4.2	4.2	10.2
Poland	-2.3	-4.9	4.1	10.7
Hungary	-4.1	-5.9	6.7	4.8
Turkey	-2.0	-6.1	9.7	-8.6
South Africa	0.4	-7.8	10.6	-11.8
Pakistan	**-8.0**	**-8.2**	**14.1**	**-11.3**

Note: The statistics are based on Bloomberg data and the Economist (May 10, 2008) issue

Fourteen of these countries do not have a deficit at all because their exports and other earnings are more than their imports, a dozen have inflation of 6% or less and only four countries, Venezuela, Russia, Pakistan and South Africa have double digit inflation. Overall, Pakistan has one of the worst levels of external deficit and inflation. This combination makes a country more vulnerable to rising oil prices. When an oil crisis is compounded by an international debt crisis, a country with such indicators finds quite difficult to raise debt, usually at steep costs.

There is a debate that the common man has been hit hard by inflation and is not so much concerned by the judges' issue. The supporters of the judges' issue rightly say that the issue does not stop the government from addressing the economic issues. Some others however believe the economic situation deserves more attention and due to the constitutional crisis, the government cannot give its full attention to the economic issues as the most of the time and energy of the leaders of the coalition partners is being spent on the judges' crisis. It would be in the best interest of the country and the PPP if the latter can move quickly to resolve the judiciary issue because if it does not, an economic tsunami is waiting to happen and is likely to be the biggest reason why the government may not survive for long. The establishment knows this and is gleefully watching as the coalition partners drift apart amid a growing trust deficit.

The grim situation demands that the PPP and PML(N) resolve the judges' issue as soon as possible. In an interview to ARY One World on Wednesday May 7th, Mr. Asif Ali Zardari ruled out any possibility of impeaching President Pervez Musharraf, although he said that he did not recognise him as a constitutional president. "I spent five years in his prison… but, can we afford it… can our economy afford it?" he asked. Is that the only reason or is it because the United States sees him as its man who can deliver on the War on Terror?

Mr. Zardari should know better than many others that Musharraf is the biggest destabilizing factor for the PPP's coalition government. Mr. Zardari's desire to maintain a good working relationship with the army is understandable but Musharraf may be past his expiry date to perform that function. The PPP should explore other options. The initiative has slipped out of the PPP's hands. If the party does not seize it now it may get trapped in a 1988-like situation when Benazir Bhutto became Pakistan's prime minister with no real powers, little control over the biggest province Punjab and yet got the blame for all the problems. One way out of this impasse may be to convene a joint sitting of the parliament and move a resolution asking Musharraf to resign. It will be hard for him to ignore such a public call by the elected representatives.

It is a mistaken belief that the state of the economy cannot afford to see Musharraf make an exit. Investors and markets do not like uncertainty and he is the biggest cause - real or perceived - of uncertainty on the political horizon. As far as the Americans are concerned, they will have to work with whoever is there. The longer he stays, the more this uncertainty will grow.

But Pakistan, with one of the weakest economies, cannot afford political uncertainty. Those who believe that Pakistan would be bailed out again are underestimating not just the severity of the economic crisis but also the damage that the high oil price is going to inflict on the weaker economies. If the economy continues its present slide, even the United States may not be able to be able to bail Pakistan out. Its own once mighty financial giants are being rescued by Chinese and Arab investors. Pakistan's last resort would be the IMF with its usual conditionalities and the inevitable pain they would cause.

Pakistan may need as much as $10 billion a year in economic aid if the oil prices stay at the level of $125-a-barrel or may require more if they move to $150-$200 range which is not unlikely. The Financial Times commented in an editorial (May 10, 2008), "for rich countries, the $125 oil price will be a noticeable drag on economic growth; for poor countries, when combined with higher food prices, it will mean more poverty. Oil supply should grow in response but if it does not, $200 oil is just about conceivable. It would cause serious economic disruption, international tensions and currency crises for some poor nations."

The unpleasant truth is that Pakistan is among the most vulnerable developing poor nations to external shocks.

May 14, 2008

Crisis, political will and competence

On March 17, 2008, fourteen days before the new federal government was formed, I wrote:

"Pakistan faces grim economic prospects in the next 12 months and the situation calls for emergency measures to control one of the highest rates of inflation in the world and a probable drop in the currency value due to the widening current account deficit and dwindling foreign exchange reserves. Pervez Musharraf's regime has allowed the crisis to develop to a degree where the new government may not have any option but to take tough decisions if it wants to control the situation within 12-18 months because it would take at least that long for the measures to take effect. It is disappointing that the political parties, who won the elections, have not come out with any major policy statement about their plans to address the immediate economic issues."

Two months later, it seems the two largest parties were not ready to assume power and face an unusually tough economic situation. There are no signs that the government has a comprehensive strategy and it took about 45 days to come up with just some administrative measures for energy conservation. Finance Minister Ishaq Dar has departed from the scene after spending much time blaming the previous government and doing little to come up with solutions. In the meantime, the rupee value has dropped by over 7 per cent, inflation has jumped to 17 from 14 per cent and the foreign exchange reserves have fallen by more than a billion dollars while the oil price has spiked by 19 per cent setting new records. On May 15, 2008 the Standard and Poor's cut Pakistan's credit rating by one notch to B with a negative outlook.

The top leadership of the country is out of the parliament and has devoted most of its time to the judges' issue inside and outside the country. The jury is out whether Mr. Asif Zardari will prove to be a "Sonia Gandhi" but we certainly do not appear to have a Manmohan Singh or Chidambaram -the two finance wizards- credited with India's economic success. Where are we headed? If we are moving towards an 'economic meltdown' as Mr. Zardari put it, how ready we are or more pointedly, are we capable enough to face and manage a period of severe economic distress?

In normal circumstances, economic policy matters can be left to a team of economic experts but even they are in short supply though a lot of bankers and failed bureaucrats abound. Pakistan is currently passing through a critical phase of political transition where the old order is very much in place and the new leadership is cautiously navigating the troubled waters while trying to save a fragile coalition and manage internal and external powers that matter. A practical implication of our vulnerabilities, a consequence of failed polices and incompetence, is that our economic, political, defence and foreign policy issues have become extremely entangled and complex.

A strategy that treats the inflation or foreign investment as a 'finance ministry issue' is doomed to fail because of the multitude and inter-relatedness of the issues involved and the capacity required to deal with them.

One of the country's most pressing needs is the financing of external deficit otherwise rupee will inevitably fall further, notwithstanding the Central Bank's interventions, and add to the inflationary pressures. External financing needs a multi-pronged approach involving foreign governments, multilaterals, and private investors. The government claims it would be able to raise around $3.5 billion in the next few months but this won't be enough. It must also take measures to build the confidence of foreign investors and lenders that the government is fully alive to the gravity of the situation and has a plan to deal with it beyond passing on higher energy costs. Free markets cannot be controlled by governments. They need to be persuaded that the overall policies are on a sound footing and the government has the will and capacity to implement them.

While we have been the partners of the United States and the UK in the War on Terror, their capacity to help us financially is rather limited given their own constraints. US administration's fiscal year 2009 "base" budget request for South Asian states - Afghanistan, Pakistan, Bangladesh, India, Nepal, Sri Lanka, and Maldives - was about than two billion dollars. Gary Ackerman, the head of the US House of Representatives panel on issues relating to South Asia said recently, "The United States is one of the largest donors in South Asia, if not the largest. But, we can't do it all".

The largest pools of money are in the Middle East, China and other Asian countries. Our foreign policy must recognise the changing world economic power balance, rethink its strategies, and redirect its efforts accordingly. Although some people may think it is a long term issue, it is not. We have failed to leverage our long standing ties with countries like China and Saudi Arabia. Consider this. We raised a little over $6 billion in privatisation deals during 2000-2007. Compare this with Congo – a small and poor country with exports of only $2.6 billion. Last September Chinese Export-Import Bank, through which the Chinese government disburses all its foreign aid, signed an agreement with Congo to finance $6.5 billion-worth of improvements to the country's infrastructure and $2 billion-worth of construction and refurbishment of mines, using mineral reserves as collateral. We must start top level strategic dialogue now with the oil-rich Arab countries, China, Russia, Singapore, and Taiwan to attract large scale investments as well as short-term financial assistance on commercial terms because it takes time for such efforts to yield results.

Another pressing issue is the level of government's highly inflationary domestic short-term bank borrowings that have increased by over $5 billion during the current fiscal year. They must be replaced, to the extent possible, with longer term local and foreign market instruments such local medium term bonds and foreign currency syndicated loans. Equally important is addressing the issue of subsidies that have contributed to the ballooning debt. Oil subsidies must be eliminated quickly along with those given to the refiners but sales tax must be cut to 5 per cent (from 15) on diesel. In the absence of any fiscal space, the subsidies cannot be sustained.

However, the question of food subsidies is more complicated. It is fashionable to talk about targeted subsidies but in a country where 74 per cent of the population lives on $2-a-day or less, nearly 50 per cent are at risk of going short of food due to a surge in prices, and more people are likely to be pushed below the poverty line, targeted food subsidies are an oxymoron, impractical, and do not represent the ground realities. In an Asian Development Bank study released on May 14th, Pakistan was ranked at the bottom, that is, 31st out of thirty two countries on the Social Protection Index. The index provides a combined measurement tool of the extent to which Asian and Pacific countries provide welfare, labour market, social security, health insurance, micro-credit, child protection, targeted education, and health support programs to their citizens, especially those living below the poverty line. Given the abysmal state of social protection and poverty levels, the government should at least provide wheat subsidy by cutting other current expenditures and raising revenues.

Moving on to the overall situation beyond the immediate funding needs, the government must take some bold and tough steps to reform the tax system. It may no longer have any option but to take the risk of a radical restructuring of the tax regime to stimulate economic growth and boost revenues. The basic premises behind these suggestions is that elimination of special treatments, reduction in the number of taxes and rates of taxes, and simplification in collection procedures have universally proven to be a successful combination needed to expand the tax base and increase revenues. We should stop trying to reinvent the wheel and consider the following:

1. Cut the maximum income tax rate to 15 per cent for publicly listed companies (except banks) and to 20 per cent for all other companies and businesses.
2. All green field projects should have a 5 year tax holiday <u>after</u> they become profitable and provided they are publicly listed within 3 years of incorporation.
3. The government should apply a withholding tax of 15 per cent on purchases of all crops. It should aim to maintain the prices of grains at a level similar to India's to prevent smuggling.
4. Reduce the general tax rate (GST) to 10 per cent to provide some respite from inflation to the people.
5. Abolish excise duty, rebates, and special treatments and loop holes like R&D allowance to the textile industry.
6. Impose capital gains tax at the rate of 20 per cent on all stock transactions where the holding period is less than one year. For holding period of more than one year, the tax should be 10 per cent. Turnover taxes e.g. CVT should be abolished.
7. Abolish Employees Old Age Benefits and Workers Welfare Fund. They essentially represent payroll taxes and do not contribute to workers' welfare. Eliminating them could actually help the employers to pay more cash compensation to the staff.
8. The rate of withholding tax on interest income should be increased to 15 per cent where the gross interest income is more Rs50,000 per annum and to 20 per cent where it is more than Rs 150,000 per annum.
9. Import duties on all industrial equipment and machinery should be abolished.
10. Import tariffs on electricity generators, cars, mobile phones, processed foods, and other such items used by higher income groups should be revised upwards.
11. Capital value tax on property transactions should be raised to 15 per cent.
12. Declare agriculture as an industry for lending purposes provided the borrowing farm is organised as a limited company.

Finally, a word about the monetary policy. A judicious mix of monetary measures involving interest rate hikes, elimination of subsidised lending, restrictions on imprudent consumer lending, and increase in cash reserve requirement should be considered to control money supply to non-productive channels. But this has to be a forward looking and dynamic process.

But all of the above would require political will and leadership at the highest levels of government and the political parties. Managing serious economic crises requires focus and leadership at the highest level as many leaders including Z.A. Bhutto, Margaret Thatcher and Bill Clinton demonstrated in the recent history. The task should not be and cannot be delegated to just some 'experts' and bureaucrats.

May 19, 2008

The government surrenders to the brokers

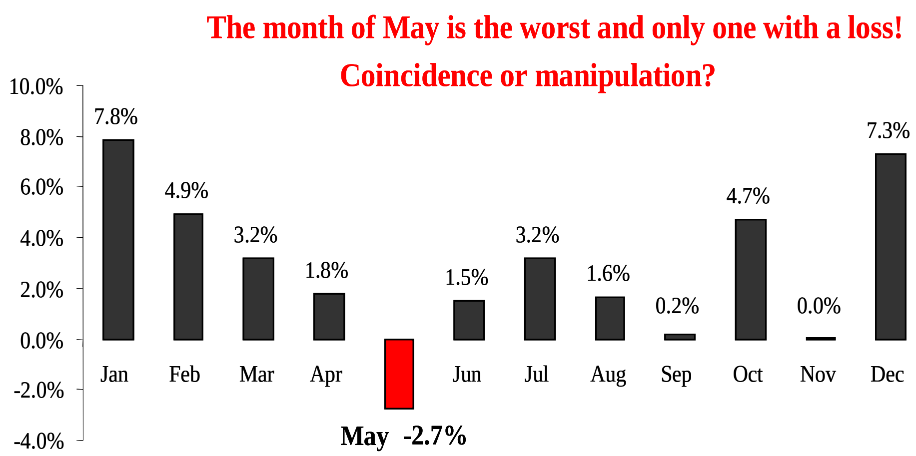
The PPP government apparently panicked and surrendered to the pressure of the brokers' community by extending the capital gains tax exemption by not one but two years in an unusual move well before a week of the announcement of the federal budget. Besieged by the PML(N) and the lawyers, feeling the heat from the media, and faced with worsening economic indicators, the government decided to make peace with Karachi's powerful brokers' mafia.

It was the first test of its political will to undertake difficult reforms – a test it failed. That it could not wait even for a week to make this announcement along with the budget speech shows its increasingly vulnerable political position. Even greater irony is that the whole case for the exemption of the so-called 'capital gains' is based on half truths and massive distortion of facts because it is patently false to claim that what goes on the stock exchanges here has anything to do with real investments or that imposition of tax on trading will adversely impact foreign investment.

The stock market plunged by 19.78 per cent during May 2008 in its worst percentage loss for a single month since May 2000 when it dropped by 19.17 per cent; weeks before the Musharraf government was to present its first budget. The market had fallen by about 7.5 per cent for the month till May 21, 2008 but the monetary tightening measures announced on May 22 pushed it further into red by another 12 per cent in just seven trading sessions. It is hard to say how much of the fall was engineered or not but one fact is clear. May has been the worst month for the stock market during the last ten years as illustrated by the following graph:

Karachi Stock Market

Average Percentage Monthly Gain/Loss 1999-2008



Whether or not there was a deliberate manipulation to put pressure on the government to continue the exemption of capital gains from tax; let us examine the arguments in favour of this exemption. However, it is important to clear one widely held and absolutely wrong notion. **Pakistan is one of the few countries where the financial intermediaries like brokers claim the trading income to fall under the definition of capital gains. Most countries tax the trading income of brokers as ordinary business income at standard rates and not as capital gains, because trading forms part of their ordinary business.**

Unfortunately, the policy makers and the public opinion in Pakistan have been mislead to believe otherwise by the vested interests and some inexperienced and naïve media persons who do not always do their homework.

In India, trading income from stocks (where the delivery of the shares is not taken) is taxed as speculation under section 43(5) of the Income Tax Act at the standard rate of 30 per cent plus other surcharges. India has had a tax rate of 10 per cent on short-term capital gains (from disposition of securities where the holding period is 12 months or less) for many years for both locals and foreigners. Indian government increased this tax to 15 per cent in March 2008 budget. India however continues to exempt long term capital gains (where holding period is greater than 12 months) from tax. The policy objective has been to encourage longer term investment and minimise short term volatility in the financial markets and this tax regime has served Indian market well. The income from trading of shares was tax-free in Vietnam till November 2007 when it imposed a 20 per cent tax to discourage excessive and volatile trading.

Another argument in favour of the tax exemption is that Pakistan needs foreign investment. This is true but the appropriate way to encourage this is to grant tax exemption to pre-qualified foreign institutional investors as India and Taiwan do. This prevents the abuse of the "foreign investors' window. In any case, about 70 per cent of Karachi's daily trading volume is attributed to the local investors who not only trade excessively but on very low (10-15 per cent) collateral. This highly leveraged and excessive trading contributes to higher volatility, is potentially destabilising for the system, and a drain on scarce credit resources of the country that is already under the burden of excessive government debt.

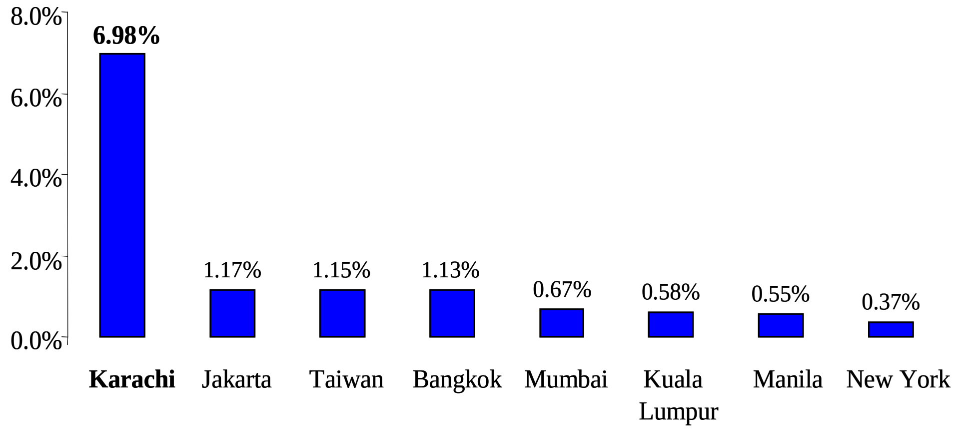
Karachi's stock market is probably the most speculative in the world when measured in terms of the ratio of average daily trading volume (in value terms) to free-float market capitalisation. Free float denotes those shares that are available for trading and excludes stakes of the government and strategic investors or sponsors. This is the most appropriate way to measure the market size. Pakistan's free-float size has ranged between $6 and $8 billion recently and gives a realistic picture compared to the $60 billion figure cited by the previous government. The following chart compares the average daily traded value (in the past six months) to the Morgan Stanley Capital International's free-float index of Karachi's stock exchange with those of some Asian countries and the New York stock exchange. Karachi's ratio is 6 to 19 times higher compared to the ratios of these exchanges.

For example, Karachi average daily trading volume has been a staggering $400 million compared to $486 million for Kuala Lumpur's although Malaysia's market is much bigger with a free float market capitalisation of $83 billion compared to Pakistan's about $6 billion. Even if the free float is taken to be $10 billion, Karachi's relative volume ratio would still be seven times that of Malaysia.

A leading broker and a former director of the Karachi stock exchange speaking on the condition of anonymity, confirmed estimates that about 50 per cent of the local daily trading volume is conducted by 3-4 big brokers. The Securities and Exchange Commission of Pakistan (SECP) is a weak and toothless regulator with little capacity to properly regulate the market in accordance with international standards. The result is a market which is an insiders' dream. The monthly volatility of Karachi's free float index has been as high as 88 per cent on an annualised basis compared to the 24 per cent average for the emerging markets. In simple terms, a big trader can make 1-5 per cent a day on traded volume.

Pakistan's Stock Market is the most speculative in the World

Daily trading volume as % of free float market capitalisation



A large part of the trading is conducted though borrowed funds or the so-called CFS (which stands for Continuous Funding System) market. The CFS borrowings have averaged about Rs 51 billion (or $840 million) during the past 12 months. [The Mumbai stock market used to have a similar system which was banned by the regulators in July 2001. That did not inhibit its growth.] This level of borrowing (not to mention borrowings through other channels) when put together with a daily average daily trading volume of around $400 million indicates that the so-called investment activity of the local punters is actually a highly leveraged trading game that uses public money and yet claims full tax immunity. Given that a large part of this activity is conducted with borrowed funds, there is little merit in the argument that this would move off-shore if taxed, especially if the exemption continues to apply to the long term investors including foreigners.

The tall, vociferous, and often exaggerated claims about the importance of the stock market in Pakistan obscure the fact its growth has come from the increase in the float of public sector or privatised companies and it has played a negligible role in mobilising capital for the private sector. During 2006 and 2007, the new capital raised at the Karachi stock exchange was just around $170 million or less than 0.1 per cent per annum of Pakistan’s GDP. Because easy money is made in trading, there are no incentives for the brokers to develop other areas of business such as underwriting of shares, quality research, corporate finance, corporate bonds, etc.

It is argued that speculators provide much needed liquidity to the market and help determine the fair values of the shares, especially when the government sells its stakes in the public sector enterprises. There is no doubt that active investors or speculators provide liquidity and perform an important function but it is seriously questionable that the excessive level of leveraged trading, such as in Pakistan, is necessary or even healthy for the system and the economy. It is actually counter-productive because this degree of speculative trading has a huge opportunity cost in terms of funds or credit resources that otherwise could be more productively utilised in producing goods and services. Further, excessive volatility adds to the risk premium of Pakistan’s market and ultimately to cost of raising equity in the market. Both have a negative impact on resource mobilisation for real investment activities.

The stock market currently contributes about $75 million a year to the tax revenues through different taxes such as capital value tax (CVT). The market can contribute a lot more if the trading activities are properly taxed and administered in a manner that involves no harassment of its participants by the tax officials. This can be achieved by rationalising the existing system and introduction of measures, such as acceptance of certification of tax calculation by chartered accountants and use of technology, which would prevent the tax officials from abusing their powers.

The continued exemption of the trading income (and not capital gains as most Pakistanis have been erroneously led to believe) represents a serious and harmful distortion in the fiscal policy. It sends a wrong signal to those who want to invest in manufacturing, agriculture or some other industry. Why bother with the pain and effort involved in running a factory? Just borrow some money and play the market! There is nothing wrong with playing the market and making money but it should not be at the cost of the exchequer and public money.

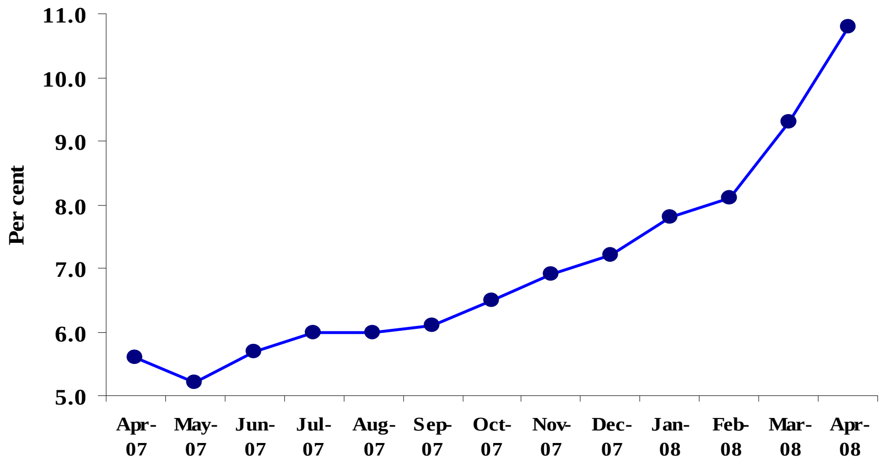
June 9, 2008

The monetary policy: behind the curve

Last Thursday on May 22, 2008, the State Bank appeared to have woken up to the fact that the country was facing high inflation and increased the benchmark rate by a record 150 basis points. This followed the earlier four hikes of 50 basis points each in April 2005, July 2006, July 2007, and January 2008. These abrupt and harsh measures could undermine the credibility of the bank. The State Bank Governor's statement contained many contradictions that need careful examination but the knee-jerk nature of the measures points to a major shortcoming: the bank failed to anticipate the rapid deterioration in inflation, growth and other key macro indicators. For example, its January 2007 monetary policy statement had noted, "*while **inflation is likely to ease-off further** it may remain above the target 6.5 per cent target for unless come additional administrative measures are taken to reduce food inflation.*"

A core function of a central bank is to **anticipate** inflation and growth trends and conduct its monetary policy accordingly because it can take around 18 months or so before the impact of its tightening or otherwise is felt on inflation. This requires analysis of historical information as well as judgements about the future trends especially in a developing country like Pakistan where the data is not always up-to-date and reliable. The bank had maintained in its July 2007 monetary policy statement that its earlier monetary tightening measures were succeeding and "one measure of core inflation, the non-food non-energy CPI, continued its downtrend from 7.8 per cent year-on-year (YoY) high in October 2005, to 6.3 per cent YoY at end-FY06, and to 5.1 per cent YoY by the end of FY07." This rather benign and relaxed view of inflationary trends (even if food and energy are excluded) subsequently stood in marked contrast to the monthly trend from April 2007 to April 2008 as shown in the graph:

Non food non energy inflation April 2007 - April 2008



The problem goes beyond just the failure to anticipate. Pakistan is the only one among the major Asian countries whose inflation rate has been persistently higher than its GDP growth rate since 2005. The policy makers thought it was acceptable to have an inflation rate (CPI) of 7-8 per cent during 2005-2007 (see table below) when almost all Asian countries had inflation rate of 4 per cent or less and there was no oil or food crisis.

Table: Average Annual Inflation (percentages)

Fiscal Year	Overall Inflation	Non-food and non-energy inflation
2003-04	4.6	3.8
2004-05	9.3	7.2
2005-06	7.9	7.5
2006-07	7.8	5.9

It is also a matter of record that the real interest rates in Pakistan continued to decline throughout 2006-2007 after reaching their peak in April 2006. This writer noted in the EBR issue of January 22, 2007, *"The real interest rates in Pakistan depict a declining trend since mid-2006 while those in India show an upward trend. Declining real interest rates can portend a higher inflationary environment 18 months down the road."*

It appears that despite modest increases in interest rates in 2005 and 2006, the State Bank's monetary stance was quite accommodative to the consumption driven and liquidity fuelled economic policies of the previous government which failed to appreciate that around 8-9 per cent inflation rate was simply unacceptable and ran the risk of running into double digits in the event of supply or external shocks.

Now, the State Bank has cited the rapid deterioration in the budget deficit, recent widening of the external current account, pressure on the exchange rate, and increase in domestic lending as the key developments that led to the extraordinary monetary policy tightening measures. The reasons are valid and the monetary tightening is justified in principle but was the shock necessary? Let us examine some of these reasons.

The usual logic behind such a sharp increase is it would restrain the growth in credit demand and money supply. From July 2007 to May 10, 2008, the government's net borrowings (for the budgetary support) from the entire banking system were Rs362.1 billion and accounted for 98.7 per cent of the money creation or increase in the money supply (M2). As of May 19, 2008, the net government borrowings from SBP stood at Rs 544.1 billion compared to the previous year's level of Rs 35.9 billion. The stock of outstanding Market Related Treasury Bills (MRTBs), an instrument through which Government borrows from SBP on tap for replenishment, reached Rs 945.9 billion; highest ever in Pakistan's history and more than double of last year's level of Rs 452.1 billion. These extremely high levels of government's borrowings from the central bank lie at the heart of the problem.

The private sector credit grew by 19.9 per cent during July 2007 to May 10, 2008; compared to 15.9 per cent growth during the corresponding period last year. However, the increase in demand for working capital rose as (1) delays in the settlement of price differential claims led the independent power plants and the oil marketing companies to resort to financing from bank sources, and (2) a sharp surge in raw material prices, both in the domestic and global markets, pushed up the credit demand from the corporate sector. Other data indicates a deceleration in growth in lending to the manufacturing and consumer sectors.

The bank's contention that extraordinary growth in the non-oil and non-food imports represented import demand pressure during the first four months of 2008 may only be partially true because the increase in the imports of fertiliser and other chemicals (the largest group in non-oil and non-food imports) is largely due to the sharp increase in the international prices and not due to increase in demand which is fairly inelastic.

The reality is that the economy is slowing down and faces the prospect of stagflation in the wake of high global commodity prices and serious domestic imbalances. This year's GDP growth estimate has been revised downwards to 5.7 per cent (which may still be overstated) given just 4.8 per cent growth in the large scale manufacturing sector and only 1.7 per cent growth in the agriculture sector. Private sector accounts for around 63 per cent of the total lending in the system and the rate increase together with other restrictive measures will hurt.

The recent upturn in prices is driven primarily by government's deficit financing, supply side factors and rise in the energy costs. While a tight monetary policy is consistent with dampening inflationary expectations, the timing and size of the increase could be disruptive for the industry. It also indicates that the State Bank has been caught by surprise by the severity of the crisis which has been building up for over a year. Indian regulators have adopted a more gradualist approach. Its central bank in mid-April 2008 announced the raising of the cash reserve requirement (CRR) by 50 basis points to 8 per cent, in two steps of 25 basis points with effect from April 26 and May 10. The CRR was last increased by 50 basis points to 7.5 per cent in November 2007, following similar hikes in August, April, and February and December 2006 to bring the cumulative increase to 300 basis points.

This brings us to the crucial question of the capacity of the bank to face the turbulence ahead. The administration of our monetary policy suffers from two fundamental flaws. The bank is not completely independent and the finance minister enjoys a clout (in real terms) that few finance ministers do in this day and age. The board of governors consists of mostly political appointees and do not seem to add much value to its governance.

The lack of complete autonomy has not allowed it to grow as a vibrant and strong institution with the capacity to face the challenges of an increasingly open economy. While its decision making processes appear to suffer from many flaws, here is a major one. Although the State Bank claims to monitor and review economic developments and its monetary stance regularly, the system is less than transparent. It makes its monetary policy statement only twice a year. If it conducts monthly meetings to review its monetary policy, it does not disclose this and does not publish its minutes.

The crisis may serve to reinforce the need to reform the system so that the State Bank is made completely independent with the government no longer able to borrow from it and its capacity strengthened to conduct its operations, including its core function of managing monetary policy, in a better and completely transparent manner.

May 26, 2008

Huge challenges, puny response

There seems a dangerous disconnect between the economic challenges confronting Pakistan and its response to it. The leadership's inability (past or present) to anticipate their gravity and the inadequacy of its response could prove disastrous for Pakistan. Last week, Finance Minister Ishaq Dar presented the 'balance sheet' inherited from the previous government as of March 31, 2008 in the presence of the top bureaucrats who had been closely associated with the past regime. He rightly pointed out that the budget deficit has hit unsustainable and highly inflationary level and cut the real GDP growth estimate for the current fiscal year to 6 per cent from 7.2 per cent.

This growth picture does not fit in with the overall picture nor is it supported by the government's own data. But he perhaps did not have sufficient time to examine the growth and inflation data prepared by the finance ministry officials to question their validity. If the growth is indeed 6 per cent, it contradicts his own view that the economic growth under the previous regime was unsustainable because it is a respectable number. This is a crucial question. If we do not have the full appreciation of the seriousness of the economic issues and right picture of the economic growth and trends, the fiscal and monetary policy responses to the issues will prove to be inadequate and run the risk of failure. The rot is far greater than just the budgetary overruns and current account deficit. Pakistan faces the looming threat of a sharp economic down turn in the backdrop of high inflation, global financial, oil and food crises, energy shortages, capital flight, stagnant exports, falling foreign exchange reserves, a depreciating currency, and slowdown in investment activity.

The reason that the real economic growth cannot be 6 per cent during FY2008 is simple. The forecast real GDP growth rate was 7.2 per cent with the target inflation rate of 6.5 per cent. During the eight months from July 2007 to February 2008, the cumulative rise in the consumer price index (CPI) was 9.15 per cent and 11.31 per cent in the whole sale price index (WPI). Obviously, these numbers will be higher for the entire 12-month period. Based on the eight months' rise, the annualised inflation rate works out to be 14.03 per cent for the CPI and 17.43 per cent for the WPI. It is important to note that much of the real GDP data is calculated using the whole sale price index (WPI). In any case, pick any inflation index, the real GDP growth cannot be more than 3.5 per cent in FY 2008 unless the (previous) government's economic managers can provide a convincing explanation of the glaring inconsistencies in what are the some of the most important macroeconomic indicators.

To say that the economic position is worse than what has been previously acknowledged is an understatement. It is a ticking time bomb which together with a historically weak commitment to reforms can cause far more damage than the unfortunate violence seen in Lahore and Karachi during the past week. The establishment must not give in to the temptation to play the familiar power games to put pressure on the ruling coalition because the failure to stabilise the economy would have serious repercussions and no future administration would be able to fix it without a prolonged period of severe economic stress. Precious time has been lost in the formation of the governments since the February 18, 2008 elections whilst the economic managers had already been paralysed by the political developments since March 2007. While the media's attention has been riveted on the judiciary issue and more recently on the violence in Lahore and Karachi, it would do the country a huge favour by also focusing on the economy teetering on the verge of a sharp slowdown compounded by a global economic crisis.

Rising food prices could spark worldwide unrest and threaten political stability, the UN's top humanitarian official warned last Tuesday after two days of rioting in Egypt over the doubling of prices of basic foods in a year and protests in other parts of the world. Sir John Holmes, undersecretary general for humanitarian affairs and the UN's emergency relief coordinator, told a conference in Dubai that escalating prices would trigger protests and riots in vulnerable nations. He said food scarcity and soaring fuel prices would compound the damaging effects of global warming. Prices have risen 40% on average globally since last summer.

According to the officials of the World Food Programme (WFP), nearly half of Pakistan's 160 million people are at risk of going short of food due to a surge in prices. The WFP survey covering the year to March showed the number of people deemed "food insecure" had risen to 77 million from 60 million in the previous year. The WFP estimates that anyone consuming less than 2,350 calories per day is below the food security line. Sahib Haq, an official with the WFP's Vulnerability Analysis & Mapping Unit in Pakistan, says food prices rose at least 35 per cent in the past year compared with an 18 per cent rise in minimum wages. "There is a very big gap between the increase in prices and increase in wages ... the purchasing power of the poor has gone down by almost 50 per cent," Haq said.

Given the ground realities, the policy options are difficult and demand a full reappraisal of the fundamental issues and formulation of a comprehensive reforms programme. While there is a broad consensus that we need to control inflation, cut fiscal and current account deficits, and increase investments, the challenge is to come up with a comprehensive response because the time for piecemeal solutions is up. Although there is no choice except to borrow to finance the current deficits, this is not a sustainable option. The government is trying to raise about $2.5 billion in foreign exchange funds by the end of June.

It is an established fact that a democratically elected government’s best time to introduce difficult economic reforms is around the beginning of its tenure, especially during a crisis period. It takes time to formulate and implement a programme. Under the current circumstances, the government faces the seemingly contradictory challenge of raising tax revenues and stimulating investments. It must cut the deficit but it also needs the fiscal space to allow for subsidies and development expenditure or face popular backlash.

In the wake of past fiscal crises in other developing countries, introducing tax reform that can provide incentives for growth, can meet needs of the poor and can increase revenue collection proved central to state viability and effectiveness. Because taxation affects incentives and distribution of resources simultaneously, tax reform requires either a degree of social consensus that such policies are in the collective interest and/or it requires a state with the ability to coerce those who challenge its allocations. Since the purely coercive approach has not worked in Pakistan due to the general absence of the rule of law, its rulers need to write a new social contract with the upper income classes and convince them that without an adequate revenue base, the system itself is in great danger. This would necessitate a radical restructuring of the tax system including reduction in the number of different types of taxes, reduction in the maximum rates of taxes, and removal of incentives to evade provided there is clear road map to raise the tax revenue base to Rs 2,000 billion.

However, expanding the revenue base and tax net alone will not be sufficient to mobilise the resources required for boosting investment spending. Investments cannot grow at the required pace without a high rate of domestic savings. Hence, the government would need to introduce special schemes to enable commercial banks to mobilise long term funds. For example, it should allow the banks to operate tax and zakat free long term deposit accounts on the pattern of the retirement savings accounts in other countries where contributions to such accounts are tax-exempt.

These are just some examples of the type of reforms needed and point to the need for the government to start a dialogue with the business and other elites of the country to write a new social contract with the objective of introducing a comprehensive package of imaginative reforms because tax reform at the end of the day is essentially a national and political policy issue and not just an economic problem.

April 14, 2008

Faltering economy

The State Bank of Pakistan's quarterly report covering the country's economic performance for the first six months (July-December 2007) of the current fiscal year confirmed what was already in the public domain. Key economic targets for the current fiscal year will be missed and the government's finances are under pressure. But a close examination of the official data has led us to raise the following critical questions:

1. Is the government revealing the correct real GDP growth numbers by understating the rate of inflation? Is the economy growing by 6-6.0 per cent?
2. Is oil price the only or real reason for the ballooning fiscal deficit and consequently for the rapid growth in money supply and inflation?

The answer to both the questions is a NO in light of the information published by the bank itself. The report begins with a rather benign view of the economy by stating, "the country's economy continues to show resilience to domestic and international shocks. Although these have taken their toll, the economy is expected to turn in a reasonable growth performance during FY08, albeit substantially lower than target." The SBP has revised the key targets for the full year as follows:

Major Economic Indicators

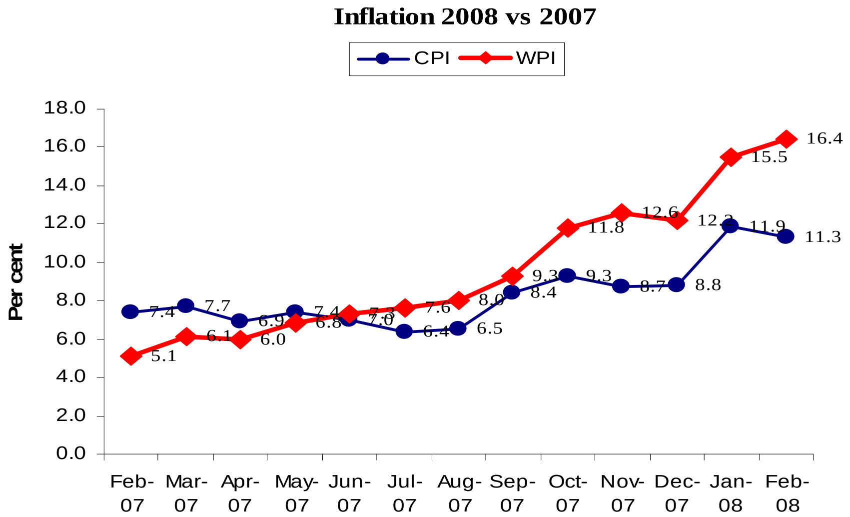
	FY 2007	FY 2008 (July 2007 - June 2008)	
		Original target	SBP projections
Growth rates (per cent)			
GDP	7.0	7.2	6.0 - 6.5*
Inflation	7.8	6.5	8.0 - 9.0
billions US dollars			
Exports	17.1	18.9	19.7
Imports	30.5	32.3	35.1
Remittances		5.8	6.0 - 6.5
per cent of GDP			
Budget deficit	4.3	4.0	5.2
Current account deficit	5.3	5.0	6.0

* Estimate based on the assumption of 12.7 million bales of cotton and 24.0 million tonnes of wheat crop

Two of the most important indicators, real GDP growth and inflation, if correct would justify the SBP's remarks about the performance and growth expectations of the economy. But are they correct even if the estimates about cotton and wheat crops turn out to be right? Remember that the wheat crop estimates were deliberately overstated last year to present a better picture of the GDP growth but the previous year's growth numbers have still not been officially adjusted.

In simple terms, GDP (gross domestic product) is the short hand for the income of a country. The real growth rate is calculated (in lay man's terms) by adjusting nominal growth for inflation. For example, if the income of person grows by 10 per cent from Rs 100 to 110 in a year and the inflation during the year was 4 per cent, it can be stated that his real income grew by approximately 6 per cent, leaving aside mathematical complications. The key to calculating the real growth is the inflation rate. If a rate lower than the actual rate is used, real growth rate will look better or vice versa.

The government maintains that the inflation rate during the current fiscal year will be in the range of 8.0 – 9.0 per cent. That is, no more than 0.2 to 1.2 percentage points higher than 7.8 per cent for FY 2007. However, its own month by month data comparing inflation rate in the current fiscal year to FY 2007 does not support this as shown in the following graph. It illustrates that increase in the consumer price inflation (CPI) and wholesale price inflation (WPI) during the current year has been much higher than 1.2 per cent as the government or the SBP appears to suggest.



This graph shows for the CPI and WPI, the percentage increase in a given month in 2007 and 2008 over the corresponding month of the previous year. For 2008, this number is significantly higher than 8 or 9 per cent as indicated by the sharp upturn from August 2007 onwards.

During the eight months from July 2007 to February 2008, the cumulative rise in the CPI was 9.15 per cent and 11.31 per cent in the WPI. Obviously, it will be higher for the entire 12-month period. Based on the eight months' rise, the annualised inflation rate works out to be 14.03 per cent for the CPI and 17.43 per cent for the WPI. It is important to note that much of the real GDP data is calculated using the whole sale price index (WPI). In any case, pick any inflation index using 11 or 12 per cent average inflation rate, the real GDP growth may be around 3.5 per cent or even less in FY 2008 unless the (previous) government's economic managers can provide a robust and full explanation of the glaring inconsistencies in what are the most important set of macroeconomic indicators.

Revision of growth estimates and even that of the entire set of national income accounts is not uncommon even in the developed world. The new government may wish to do this by appointing a permanent head of the federal bureau of statistics and conducting a full and independent investigation into the data to get a picture of the true state of the economy.

Coming to the budget or fiscal deficit, the SBP report candidly acknowledges, "another troubling aspect is that the fiscal deficit may be understated. Evidence suggests that at least a part of the subsidy on fuel prices during Jul-Feb FY08 was not financed from government account." It goes on to explain as follows:

"Instead, in order to mitigate the financial difficulties of the various institutions (particularly the oil marketing companies) with unpaid price differential claims, the government provided

guarantees against which these public and private sector institutions could borrow the amounts from financial institutions. Such a financing structure simply shifts most of the cost of the financing from the current fiscal year to the fiscal deficit in future years."

Leaving aside the issue of understating the real level of fiscal deficit due to the non-inclusion of guarantees to the oil companies, let us take a look at the government's revenue and expenditure for the first half of FY 2008 in the table below:

Table: Revenue and Expenditure Summary

	Jul-Sep		Oct-Dec		First Half Total		Change
	FY 2007	FY 2008	FY 2007	FY 2008	FY 2007	FY 2008	
Total revenue	255.7	312.6	359.1	313.0	614.8	625.6	1.8%
Tax revenue	191.6	215.6	241.8	235.1	433.4	450.7	4.0%
Non-tax revenue	64.1	97.0	117.3	77.9	181.4	174.9	-3.6%
Expenditure	342.4	470.7	441.4	511.2	783.8	981.9	25.3%
Budget deficit	-86.7	-158.1	-82.3	-198.2	-169.0	-356.3	110.8%

Government officials and many others have attributed the ballooning deficit to the rise in the oil prices but the data does not fully support this contention. Against a full year's revenue target of Rs 1475 billion, the government's revenue for the first half were Rs 625.6 billion. That is, the total revenue grew by only 1.8 per cent against the target of 20 per cent (per annum) and the tax revenues grew by only 4 per cent against the target of 21 per cent (per annum).

The weakness in Q2-FY08 fiscal revenues stemmed from a variety of factors. For example, direct taxes declined due to a fall in expected taxable profits of key industries (e.g. banks, cement, etc.). Similarly, the weakness in non-tax revenues mainly reflected the delayed disbursement of logistic support grant (indicated by a fall in defence receipts), and low collections of surcharges on petroleum and gas. On the other hand, expenditures appeared to have gone out of control in an election year as summarised below:

Expenditure

	July - Dec.			YoY Change	
Rs. Billions	**FY 2006**	**FY 2007**	**FY 2008**	**FY 2007**	**FY 2008**
Current and unexplained	506.7	635.9	756.1	25.5%	18.9%
Development and net lending	127.8	147.9	225.8	15.7%	52.7%
Total	634.5	783.8	981.9	23.5%	25.3%

In the back drop of 1.8 per cent increase in the total revenues, no effort seemed to have been made to control the expenditures that grew by 25.3 per cent. While current and unexplained expenditure increased by Rs 120.2 billion (18.9%), development expenditure jumped by Rs 77.9 billion or 52.7%. The net result was a deficit of Rs356.3 billion (3.6 % of full year GDP) for just the first six months only against the full year target of Rs 398 billion or 4.2% of the GDP. At this rate, the deficit is likely to exceed 6% of the GDP.

Contrary to the widely held view, the subsidies for oil and other commodities contributed to no more than 5 per cent of the total current expenditure during the first half of FY 2008. This is evident from the following table in which subsidies are included in the Economic affairs' expenses.

Composition of current expenditure

Rupees billions	July- December			YoY Change	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Current expenditures	**525.3**	**581.4**	**775.1**	**56.10**	**193.7**
of which					
Interest payments	111.4	155.8	237.7	44.40	81.9
Domestic	89.8	131.3	208.8	41.50	77.5
Foreign	21.6	24.5	28.9	2.90	4.4
Defence	119.1	114.9	131.8	(4.20)	16.9
Economic affairs	24.7	18.6	50.9	(6.10)	32.3
Health	2.2	2.3	2.7	0.10	0.4
Education	7.4	10.6	10.5	3.20	(0.1)
Provinces	149.0	176.7	210.1	27.70	33.4

Interest payments on debt, defence, payments to provinces, and expenditure other than subsidies accounted for Rs 161 billion or 83% of the increase in current expenditure during the half-year ended December 2007 or 86% of Rs 187 billion rise in the budget deficit during the period.

Here it should also be noted that the sharp rise in the oil price came only towards the end of October 2007 when it broke the $90-a-barrel level after trading in the $70-80 range during July-September 2007. The hard fact is that interest payments, defence, and payments to the provinces were the three largest items and accounted for 75 per cent of the total current expenditure.

The overall picture emerging from this analysis is that President Musharraf's administration did not exercise any financial discipline in the election year and did not take any action to stop the politically-driven escalation in spending even when the revenue growth stalled. This came at the cost of overall higher inflation and an all-time record fiscal deficit.

The deficit was financed mostly by borrowings from the State Bank or in simple terms by printing money as illustrated in the following table:

Financing of deficit (July - December)

	FY 2007		FY 2008	
	Rs. Billion	%	Rs. Billion	%
Total deficit	**169.0**	**100.0%**	**356.3**	**100.0%**
Sources of Funding				
External (net)	96.2	56.9%	68.0	19.1%
Domestic Resources	72.7	43.1%	288.3	80.9%
Banking system	31.5	18.6%	228.6	64.2%
Non-bank	25.3	15.0%	58.0	16.3%
Privatisation	15.9	9.4%	1.7	0.5%

Compared to the first half of FY2007, the deficit more than doubled to Rs 356.3 billion. The worst aspect was that 64% of this was financed by highly inflationary bank borrowing compared to only 18.6% in the previous year. In conclusion, the hard evidence points to some unpleasant facts. The economic growth during FY08 is probably going to be much less what the government claims and which the multilateral lenders seem to accept without much questioning. The inflation is a lot higher than what the previous economic managers have been telling us. And most importantly, low single digit growth in tax revenues, election year spending spree together with interest on past borrowings, and not the oil price or subsidies, are the principal reasons behind the record level of budget deficit during the first-half of the current fiscal year.

April 7, 2008

Economic policy: continuity or change?

Pakistan's inflation rate in the first seven months of current fiscal year (July 2007- June 2008) has hit nearly 17 per cent – the highest in Asia, its exports growth has stalled and the budget and current account deficits are reaching one of the highest levels among the major developing economies. The fundamental and structural imbalances and weaknesses – and not the just the high oil price – have contributed to the gradual but predictable deterioration in the country's macroeconomic fundamentals over the last two years.

Do we need continuity or a change in our economic policies? Many businessmen and bankers argue that the successive governments in Pakistan have followed basically similar economic policies since 1988 and it is a reassuring factor for domestic and foreign investors. This argument is convenient but simplistic and dangerously flawed.

Pakistan does not have a comprehensive energy policy; it has made limited progress in agricultural productivity; its main industry – textiles – is struggling to compete in global markets; its real interest rates remain negative; and the domestic capital markets do not have the depth to mobilise capital to meet its development needs.

The local stock markets have thrived mainly on trading activity in the large companies of the public or privatised sector. During 2006 and 2007, the new capital raised at the Karachi stock exchange was just around $170 million or less than 0.1 per cent per annum of Pakistan's GDP.

The foreign direct investment (FDI) in Pakistan remains significantly less than its potential particularly if we exclude mobile telephone and financial sectors. During the seven-year period from 2001 to 2007, Pakistan received about $10 billion ($64 per capita) in foreign direct investment (excluding privatisation) compared to $26 billion by Indonesia ($117 per capita) and $53 billion by Turkey ($736 per capita). Pakistan's two close friends - China and Saudi Arabia - who are also two of the world's largest sovereign investors have not invested much in commercial projects in Pakistan. Why?

Pakistan has privatized and liberalised its financial sector but both China and India were able to make great economic strides before they even started to privatize or liberalise their financial sectors just a few years ago. In both Taiwan and Korea, the privatisation of the financial sector started only in the late 1990s, that is, much later than the beginning of the boom in the real sectors of their economies in the 1970s and the 1980s.

The policy makers in Pakistan do not appear to have carefully studied or drawn lessons from the economic development in East Asia. These economies – small or big- attached the highest priority to the development of the real sectors – underpinned by infrastructure and human resources development – and manufactured exports played a pivotal role in their growth. In Pakistan, the economic managers privatized the 'low-hanging' fruits – principally to finance budget and current account deficits - but did not address the fundamental challenges of today's global economy. Any further delay would only exacerbate our economic woes because we can no longer afford to continue policies that do not take into account the global economic slowdown, tight liquidity environment and the tug-of-war between globalising and protectionist forces.

The world faces an unprecedented energy crisis, record high prices of agricultural commodities, and global competitive markets for manufactured products. We are short of energy, low in agricultural productivity and have a small and uncompetitive manufacturing base that is responsible for stagnant exports – a major cause of the trade deficit.

There is an urgent need to redefine our national economic priorities and formulate our development strategy. While **Agriculture, Energy, and Exports** must be our top economic priorities, we must take cognizance of the following:

1. Despite all the rhetoric about free trade, major producers of agricultural commodities continue to follow protectionist policies that include the use of subsidies. The European Union's subsidies on agriculture alone exceed an amount that is twice the agriculture GDP of Pakistan.

2. The governments and not private sector companies control 80% of world's oil resources. India and China are not selling their oil companies but buying oil assets abroad.

3. Only those manufacturing industries that have the scale and expertise to compete on a global scale can succeed in a world of low trade barriers.

Agriculture

The government must try to develop a consensus among the provinces on water and hydel power issues. Regardless of the reservations of small provinces, they all must come to an agreement on what our long term needs are.

A recent World Bank report says**, "without adequate irrigation resources, power, and transport infrastructure, the very sustainability of Pakistan as an independent nation may be at stake as shortages could lead to increased social discontent and disharmony amongst the federation and the provinces."**

While massive investments are needed in water and power, the key to improving to agricultural productivity in the near to medium term may lie in technology and crash adult education programs.

According to a study by Zhejiang University of China, "technology is at centre of the "advancement of agricultural productivity growth in China. Many studies have shown that institutional technical changes accounted for most contributions to the increase of total factor productivity of Chinese agriculture."

The first step should be to upgrade the ministry of water and power and staff with it top quality personnel. Traditionally, the foreign and finance ministries have attracted the best talent but water, power and agriculture ministries need to be radically reorganised and upgraded to meet the enormous challenges ahead.

Energy

Despite the growth of free markets and globalisation since the early 1990s, the state continues to play an important role in agriculture and energy. In agriculture, the primary objective has been to ensure low food prices. In the field of energy, most countries, including the United

States, Russia, China and India, have treated it as a matter of economic and national security and have comprehensive energy policies.

Pakistan does not have an overall energy policy. It has been working on ‘pipelines’ for over a decade. Its policy makers while making the current year’s budget assumed an oil price of $60-$65 while major investment banks had predicted the oil price to hit $100-level as far back as May 2005. This writer in some articles – published by DAWN in 2006 – called for the development of energy policy in view of the growing energy crisis but the policy makers continued to focus on privatisation. The only meaningful progress has been the on Iran gas pipeline, an initiative taken before 1999.

We have privatised some refineries, plan to sell the biggest oil marketing company and have attracted merely $300-$350 million in foreign direct investment in the energy sector. India and China are not selling its oil companies. On the contrary, they are busy making and exploring overseas acquisitions with the government playing a lead role. A private Indian company – Suzlon – has emerged as one of the largest global players in wind energy in the last four years.

There is an urgent need to develop an overall energy policy including for alternative and renewable energy sources. As a practical measure, it would make sense to combine different divisions and departments to form a ministry of energy as some countries, for example the United States – have done to formulate and coordinate energy polices at national and international levels.

Exports

The scarcity of energy resources has driven the state to play a central role in the world energy politics and has encouraged protectionism but globalisation – in the form of export-led growth – has been the principal driver of growth in East Asia. The lower trade barriers provided a boost to trade and manufacturing and the old philosophy of ‘producing for the home market and exporting the surpluses’ became obsolete. The manufacturers must have the necessary economies of scale, competence, and technology to survive and compete in a global market place. The Asian countries played the game well and took advantage of globalisation, without being taken advantage of by globalisation.

China followed expansionary macro-policies (contrary to the wisdom imparted by the IMF) and the government invested billions in setting special economic zones (SEZs) in the coastal areas and in railroads to facilitate low cost transportation. Taiwan and Korea followed similar policies.

China built these SEZs near the sea ports to attract foreign direct investment and about 80 per cent of the FDI into China went into these zones during the 1990s, mainly due to liberal economic framework and integrated infrastructure at very competitive prices. Another reason was their ability to facilitate production on a mega scale at globally competitive costs. China’s largest SEZ in Shenzhen region was set up in 1981 and has achieved nearly 50 per cent per annum GDP growth rate. Following the success of China, there are more than 3,000 projects taking place in SEZs in 120 countries worldwide.

Pakistan is far behind its competitors and needs to make giant strides to become globally competitive in manufacturing. A patchwork of fiscal and financial incentives for industries that are inefficient and a drain on the economy will not help grow its exports.

Some interest groups feel these policies should be continued but Pakistan does not need to continue the policies that failed to address important national priorities even in the benign global economic environment that lasted from 2000 to 2007. Faced with energy and food shortages and highly competitive globalised markets for goods and services, Pakistan does not need to reinvent the wheel. It only has to look east to see what has worked for the rest of Asia.

March 10, 2008

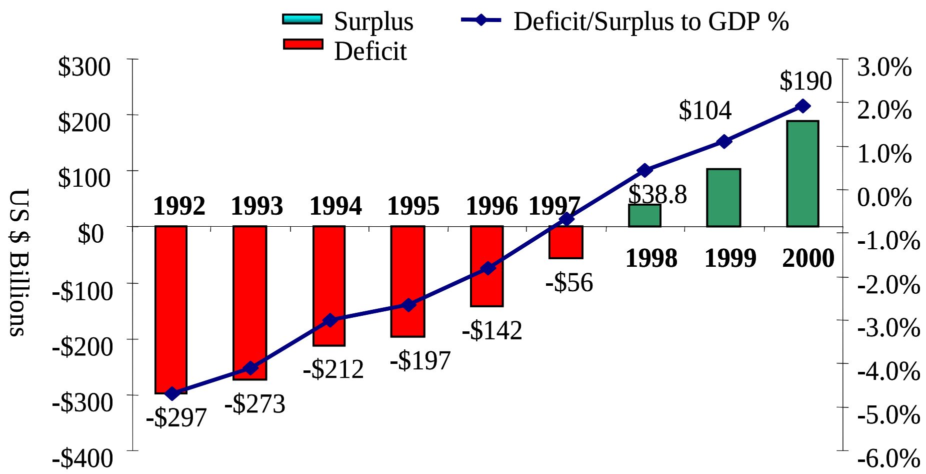
The fiscal imperative of tax reforms

"Pakistan's fiscal crisis is deep and cannot be easily resolved. Taxes are insufficient for debt service and defence. If the tax to GDP ratio does not increase significantly, Pakistan cannot be governed effectively, essential public services cannot be delivered and high inflation is inevitable. Reform of tax administration is the single most important economic task for the government." [Quote from Report of General Musharraf's June 2000 Task Force on Reform of Tax Administration]

If the big business and landed aristocracy could be convinced that by eliminating the budget deficits, they stand a good chance of trebling the value of their property and stock holdings, they might start paying taxes. But what might persuade them to do that?

When President Bill Clinton took over in January 1993, the US economy was in recession and government finances were in bad shape. The fiscal deficit had hit a record level of almost $300 billion (or 4.7 per cent of the GDP), that is, more than double its $145 billion-level in 1987. He introduced his historic deficit-reduction budget in 1993, worked to reduce the deficit every year and within a matter of six years, was able to turn it into a surplus of nearly $40 billion. Under his leadership, the US economy grew at a rate of more than 4% in the late nineties compared to 2.7% average during 1987-1992 period. Inflation dropped to an average of less than 2 per cent compared to over 4 per cent annual average period during 1987-1992, and the stock market skyrocketed and trebled in value by 1998 from its depressed levels in 1992.

United States budget deficit/surplus 1992-2000



There were a host of factors that helped the US at the time but one lesson is unmistakably clear: deficit reduction can translate into huge benefits for the entire economy; for consumers, businesses, and property owners. And this is why the businesses and agriculturists should pay serious attention to the deficit and demand that the government reduce it to less than 2% of the GDP as soon as possible.

The number one reason of persistent budget deficits is the low tax-to-GDP ratio, which is around 10% compared to average of 18% for the developing countries. It may sound like a paradox but if these businesses and agriculturists start paying taxes and help cut the deficit, they will be the greatest beneficiaries of not only lower inflation and interest rates, but more significantly of the rise in value of their assets that will follow. Historically, taxation has been treated as a political patronage tool in Pakistan or the public debate has focused on the administrative aspects.

But the current crisis demands that a political economy approach be adopted to expand the revenue base and cut budget deficits. The stakeholders need to appreciate that the current system is weakening the state, is regressive, inflationary, and unable to mobilise the resources needed to enable the state to perform its core functions of maintaining law and order and developing the infrastructure. In other words, it is in the interest of the large stakeholders that comprehensive tax reforms are introduced.

The history of tax reform around the world provides more than ample evidence that the single most important ingredient for effective tax administration is clear recognition at the highest levels of politics of the importance of the task and the willingness to support good administrative practices even if political friends are hurt in the short term. The institutionalization of corruption, the extent of criminalization of politics and standards of public morality are generally regarded as significant factors upon which the extent and nature of feasible tax administration reform depend. Public acceptance is a necessary condition for a tax system to work successfully. If the taxpayers have doubts about either the fairness of the system or the legitimacy of government spending, they may not cooperate to make a reform programme work. Pakistan has generally treated tax reform as an administrative issue with the most commonly heard refrain being, ‘it is only a matter of implementation.’ Wrong!

Pakistan has not made any significant progress in reforming its tax administration during the past decade. Its ministers and bureaucrats have been misleading public opinion by just quoting numbers of absolute growth in tax revenues which is meaningless if not adjusted for inflation and size of the economy. A recent study, “Paying Taxes 2008” published jointly by the World Bank and PricewaterhouseCoopers (one of the biggest accounting firms in the world), compares the ease of paying taxes in 178 countries around the world. The study is subject to a system of ranking based on three indicators; namely, the number of tax payments, the number of hours to comply with the company’s tax obligations, and the Total Tax Rate (TTR). Pakistan’s rankings are as follows:

Ease of paying taxes (overall rank)	146
Number of tax payments	138
Time to comply	156
Total tax rate	80

These rankings point to not just an urgent need to introduce tax reforms but also to Pakistan’s failure to address what was described as the single most important economic task for the government in June 2000. But designing tax reforms cannot be left to just bureaucrats and accountants. The political leadership must get the help of economists and public finance professionals. Turkey got help from external professionals of a World Bank study group and Egypt utilised the services of the experts from the Organisation Economic Cooperation and Development (OECD).

Pakistan’s current tax structure is anti-development, anti-growth and anti-poor. It discourages investment in the real sectors, particularly manufacturing. It passes on most of the ultimate burden of the taxes to middle and lower income classes and is one of the reasons for persistently higher inflation rate compared to other Asian countries. While the salaried class pays more than Rs14 billion in taxes, textile barons and stock brokers combined pay less than that. The indirect taxes currently account for 62% of the total revenues. The largest among the indirect taxes is the general sales tax (GST) which accounts for 39% of the total tax collections. Such indirect taxes are regressive, inflationary, and hurt consumer spending which is a key driver of economic growth.

Many countries have benefited from the experience of East Asian countries and followed their policies. In Bolivia, a highly complicated tax system existed until 1985 with around 400 taxes and it had one of the highest rates of tax evasion in the Western hemisphere. The Tax Reform Law of 1985 repealed all the previous taxes and replaced them with seven new taxes. More recently, Turkey and Egypt have made notable progress in introducing and implementing tax reforms. Some key common features of successful reform programmes have been as follows:

1. The overall numbers of taxes are reduced to a dozen or less.
2. Maximum rates are slashed as high rates have historically encouraged tax evasion.
3. Rebates, exemptions and special treatments are eliminated or reduced to a few.
4. Tax administration is simplified using technology.

High tax rates can force companies into the informal sector. In the Democratic Republic of Congo, with taxes twice as high as the commercial profit for a company with a profit margin of 20%, businesses have a strong incentive to evade taxes. Indeed, half the country's manufacturing activity is in the informal sector. Even countries with a smaller informal sector can gain from this strategy. Greece saw its corporate tax revenue grow from 4% of GDP to 5% after reducing the corporate tax rate in 2005. Egypt saw the number of complying taxpayers increase by 47% to 2.5 million in just one year after reducing both corporate and personal income tax rates in 2005. Turkey reduced the top rate for corporate income tax from 30% in 2005 to 20% in 2006 and introduced a new corporate tax code. Turkey also reduced the tax on interest from 18% to 15% in 2006 and simplified other taxes, such as the property tax and the tax on cheque transactions.

Pakistan's tax regime resembles, in general, to more that of Latin America countries where indirect taxes, and in particular sales tax, occupies a relatively higher share within the overall tax. Pakistan indirect tax to GDP ratio is around 6 per cent, and its direct tax to GDP ratio is 4 per cent and less than 2 per cent if withholding taxes are excluded. The following data contains a comparison of the structure of direct and indirect taxes between East Asia and Latin America over selected periods during 1975-2002.

Comparison of Sales Tax in East Asia and Latin America
(as percentage of GDP)

	1975-78	1985-88	1997-2002
East Asia	2.0	2.3	2.9
Latin America	2.5	3.6	5.6

Comparison of Tax on income and capital gains in East Asia and Latin America (as percentage of GDP)

	1975-78	1985-88	1997-2002
East Asia	5.7	6.0	6.9
Latin America	5.0	4.1	3.9

Source: IMF Government Finance Statistics, and International Financial Statistics

East Asia countries (even if exclude China and India) have enjoyed high growth rates for decades compared to Latin American countries. They grew at an annual average rate of 5.25 per cent during the last twenty years, which is almost double the average growth rate for Latin America. Pakistan's political, agriculture, and industry leaders should ask themselves: which taxation and growth model they want to follow?

April 28, 2008

The economy can destabilise democracy

Pakistan faces grim economic prospects in the next 12 months and the situation calls for emergency measures to control one of the highest rates of inflation in the world and a probable drop in the currency value due to the widening current account deficit and dwindling foreign exchange reserves. Pervez Musharraf's regime has allowed the crisis to develop to a degree where the new government may not have any option but to take tough decisions if it wants to control the situation within 12-18 months because it would take at least that long for the measures to take effect. It is disappointing that the political parties, who won the elections, have not come out with any major policy statement about their plans to address the immediate economic issues.

With oil price having broken the $110-a-barrel barrier and the international commodity and food prices touching record levels, it is easy to forget that the reasons for the country's economic woes go beyond that. But before we discuss those, it is important to list the most serious near term issues:

1. Pakistan has the **fifth highest inflation rate in the world** after Venezuela, Russia, Egypt, and Sri Lanka, according to Bloomberg data. Clearly oil price is not the only reason for our inflation. The overall inflation in the current fiscal year is around 16.5% compared to the widely cited range of 8%-9% by the government officials. The food inflation rate reached 21% during the period July-2007 to February-2008.
2. The **budget deficit could reach 5.9% of the GDP** from 4.3% in the previous year. A revenue shortfall of around Rs 100 billion or more in the Federal Board of Revenue's tax collections and Rs 140 billion gap on account of **higher oil prices** will be two major reasons for this deficit. The government's borrowings from the State Bank increased by Rs 240 billion during the first seven months of FY 2007-2008, and have contributed to the inflation already under pressure due to the supply side factors.
3. The central bank's **liquid foreign exchange reserves** (excluding gold) dropped to about $10.3 billion at the end of February 2008 and cover only three months of imports. The government may need to raise about $2 billion in medium term foreign debt to help pay for the rising imports and prevent a further decline in the reserves. Saudi Arabia has recently extended a grant of $300 million but this will not be enough. A further drop of $1.8 billion in the reserves can be expected by end-April.
4. The **currency** has depreciated by about 3.3% since the imposition of the emergency on November 3, 2007 and a weak US dollar has prevented a sharper fall. However, with high inflation rate and weakening current account and foreign exchange reserves position, further depreciation of Rupee appears to be unavoidable. This will fuel more inflation, and discourage investment flows.

A comprehensive set of actions is needed to control the twin deficits and inflation. A piecemeal and adhoc approach will only exacerbate the economic woes and is likely to backfire in the next 12 months. A tablet of aspirin cannot work when a strong doze of anti-biotic is needed to kill a fast spreading virus.

Fiscal deficit and oil prices

Fiscal deficit is one of the core causes of a persistently high inflation rate in Pakistan compared to the other countries. There are three structural reasons for the fiscal deficit:

a) Narrow tax base and low tax-to-GDP ratio
b) Wasteful government expenditure
c) Protection and favourable treatment given to special interest groups

While there has been a lot of discussion on the first two, I will focus on the third in the context of the current situation and rising oil prices. Oil is a scarce resource but the government does not have an energy conservation policy. Also, it has done nothing about the poor and decrepit state of the railways in the country due to which road traffic – both passenger and freight - accounts for 91 per cent of national passenger traffic and 96 per cent of freight.

Given the high dependency of commerce on road transportation, high oil prices have a more than disproportionate effect on the cost of transportation and therefore on the inflation. High oil price is a reality but it is also true that the taxes and tariffs do almost always favour the special interests and impose undue burden on the consumers.

Oil pricing formula

One example of undue and unfair treatment is the oil pricing formula. The discussions about oil subsidy (of around Rs 160 billion for 2007-08) are misleading as they do not take into account the pricing policy which not only guarantees high profits for the refiners, oil marketing companies and petroleum dealers but is also 'rigged' to ensure increasing profits when the oil price is going up. This scandalous policy has resulted in refining margins in Pakistan, which are 2-3 times higher than the comparable margins in Asia.

The new parliament must immediately form a special committee to investigate into this and hold public hearings to bring full transparency to the oil pricing policy. The space here does not permit for a full discussion of the formula but the main components and anomalies, taking diesel oil as an example, are as follows:

Oil price component	**Anomaly**
Import parity price plus	Diesel Price is based on low sulphur diesel while high sulphur diesel is produced and imported in Pakistan. This gives a benefit of $18 per ton to the refiners
Deemed custom duty	10% deemed duty is not paid to the government but is retained by the refiners on locally produced products.
Petroleum development levy	About Rs 25 billion collected by the government out of which only Rs 15 billon is used for subsidy
Inland freight equalization charge	Oil marketing companies use artificially high rates
Marketing margin	3.3% of retail price before tax. It is calculated as a percentage of price and not on per litre and results in super profits to oil companies at the cost of consumers
Dealer margin	3.75% of retail price before tax and not based on per litre
General sales tax (GST)	15% tax

The oil pricing formula benefits the oil companies at virtually every stage in an unfair and opaque manner. It violates the fundamental principles of market-based pricing and deregulation. It protects the oil companies at the cost of the consumers without giving them the right to know how exactly the price is calculated.

The government must immediately cut the deemed duty to 5% from 10%. If the refineries cannot compete without government subsidies, it is against the interests of the consumers to protect them. It is better to import the refined products at a cheaper price. The government should also revise the marketing and dealer margin policy so that these are calculated on per litre basis. This will ease inflationary pressures, to some extent, due to increasing cost of fuel and rising government deficit needed to finance the payments to oil companies.

While the general sales (or value added) tax is a common practice in many countries, it is part of the indirect taxes in Pakistan that account for more than 70 per cent of the total federal tax collections. The GST in Pakistan has become a tool of avoiding placing the burden of taxes where it is just and appropriate. The following are some examples of areas that can bear the burden of more direct taxes.

Income tax rate on bank profits

Given the expected short fall of more than Rs 100 billion in the tax collections, a 10% special energy surcharge should be levied on the pre-tax profits of the scheduled banks. According to the State Bank, the pre-tax profits of the banking industry were around Rs 170 billion during the six months period ended September 2007. Assuming that their annual pre-tax profits could exceed Rs 350 billion, given the rising quarterly trend, an additional 10% surcharge could yield Rs35 billion.

Business or trading income from stocks

Another source of additional revenue is the income of the brokers from trading stocks. The capital value tax (CVT) on stock market transactions yielded around Rs 2.24 billion during 2006-07 but this is peanuts compared to the revenue potential from taxing the trading income.

The short term gains (defined to include periods up to one-year holding period) from trading stocks made by brokers, banks and other financial institutions are treated as business income worldwide and not as capital gains as the policy makers in Pakistan have been led to believe. These trading profits are treated as business income and not as 'capital gains', and therefore taxed at normal tax rates.

While the government need not tax the capital gains of bonafide foreign institutional investors and long term investors (or tax them at a lower rate), the business income of stock traders should be taxed at normal corporate tax rates. It is estimated that about 70% of the trading volume is due to the activity of local short-term traders – that too on borrowed funds. The taxation of this activity – as is the practice in all countries without almost any exception - is unlikely to hurt investment activity or trading. The argument that it may cause flight of capital does not have much merit because the locally-borrowed short term funds just cannot be invested offshore.

Active trading is healthy for capital markets and the government should encourage it by withdrawing CVT on trading but the trading income should be taxed at normal tax rates.

While estimates vary and depend on the trading volume, this could bring in a minimum of Rs25 billion in additional revenues.

Trade deficit – oil accounts for only 28% of imports

It is common to blame high oil prices for the rising import bill and the trade deficit. The State Bank data for the first seven months of the fiscal year (July 2007-January 2008) reveals that it is only part of the problem as illustrated below:

Table: Imports during the 7-months- US $ millions

	FY 2007-08	FY 2006-07	Increase
Food	1,830	1,565	265
Industrial Machinery	1,919	1,787	133
Power generators	547	324	223
Telecom equipment	753	792	-39
Transport equipment	682	685	-3
Petroleum	5,236	4,382	854
Textiles	1,023	661	362
Fertilizer and others	2,891	2,363	529
Metals	1,273	1,154	119
Industrial Materials	428	380	48
Others	259	178	81
Imports other than banks	1,718	1,310	408
Total	18,560	15,580	2,980

The petroleum imports accounted for 28% of total imports of $18.56 billion and around 29% of the total increase of $2.98 billion in the imports during this period. The government needs to take urgent steps to cut imports of non-essential items like mobile phones, generators for private use, motor cars, branded food items for high income groups, and "other" imports through non-banking channels. This should be done through increase in import duties as well as through administrative measures.

A rationalisation of import policy and review of national priorities has become over due. We must discourage non-essential imports and facilitate imports of raw materials and primary food items at lower tariffs. This will not only help to reduce the current account deficit but would also be anti-inflationary. Why not import raw cotton through road transport from India if it is cheaper to do so and will help reduce costs of our textile mills?

The government must remove fiscal, trade, and monetary policy distortions. It must stop giving favourable and unjustified special treatment to special interest groups at the cost of high inflation, budget and trade deficits and ultimately the destabilization of the economy which can damaging for the democratic process.

March 17, 2008

Challenges for the new government

The new government's economic managers may hold the key to its success or failure. Inflation, energy crisis, and stagnant exports would need immediate attention. While there is a tendency to look at the economic issues in isolation from politics, the economic policy would need heavy engagement from the new leadership. It will need to demonstrate that it has the capacity to take bold and imaginative decisions.

The new leadership may not have the luxury of any honeymoon period and is likely to face not only a rough ride but also the risk of the bureaucracy or former World Bank types would drive its policy and ensure its failure.

Pakistan's major economic issues are usually cited as inflation, energy crisis and the growing current account deficit. This is deceptively simple. While energy crisis is a huge issue and no quick fixes are possible (except perhaps import of electricity and oil from the Gulf countries and Iran at terms), inflation, and current account deficit represent symptoms not causes.

Low agricultural productivity, narrow tax and export bases, trade policy distortions, and big government non-development expenditure are among the major reasons why the government has not been able to address these issues for a number of years. While the media, government and the opposition talk a lot about inflation, there is little discussion on its causes and remedies. One reason is the absence of quality research in our business and academic institutions and lack of meaningful and substantive debate in public forums.

Take, for instance, the issue of food inflation. The last year's GDP growth of seven per cent was helped by a five per cent growth in the agriculture sector, which accounted for 20.9 per cent of the GDP. However, the growth in the crops sub-sector (which accounts for only 47.9 per cent of the agriculture sector, the livestock's share being 49.6 per cent) masks the fact that the (i) 7.5 per cent growth in major crops was from a low base as prior year's growth was negative and (ii) the minor crops grew by only 1.1 per cent during 2006-07.

However, going beyond a single year's production data, the last seven years' record indicates more fundamental and structural problems with the growth trend of the agricultural crops. The production of cotton, wheat, rice, and sugar cane grew by a yearly average of 1.63, 1.23, 0.59, and 1.87 per cent respectively during the seven years from 1999-2000 to 2006-2007 and was below the estimated average population growth of 2.2 per cent or so during this period. An examination of a sample of the production of other agricultural produce reveals similarly low and volatile rates of growth.

The government needs to pay immediate attention to food crops' production. The international price of rice and wheat has doubled in the past year while freight costs have also increased sharply on the back of rising fuel prices. International food prices are rising on a mix of strong demand from developing countries; a rising global population; more frequent floods and droughts caused by climate change; and the bio fuel industry's appetite for grains, analysts say. Soya bean prices on February 22nd hit an all-time high of $14.22 a bushel while corn prices jumped to a fresh 12-year high of $5.25 a bushel.

Given the soaring food prices worldwide, the most immediate decision it may have to make is about the issue of procurement price of the next wheat crop. The caretakers have fixed a price of Rs 510 per/40 kg but this is too low and should be at least Rs 800/kg otherwise this may not be enough to encourage the farmers to grow more wheat next year due to escalating prices of food crops and inputs. Also, it would provide a natural incentive for smuggling due to higher international prices.

Another issue is rural poverty - an area where the PPP would need to deliver to keep its vote bank. It is a common misconception that the improvement in agriculture alone holds the key to lift rural population out of poverty. Not entirely! Let see why? Rural population accounts for 70 per cent of the total and 80 per cent of Pakistan's poor live in the rural years.

Agriculture (including both crop and livestock production) accounts for only about 40 per cent of rural household incomes and the poorest 40 per cent of rural households derive only about 30 per cent of their total income from agriculture.

The new government must undertake massive infrastructure, particularly in water and transportation, investments to benefit the rural areas besides taking steps to solve high quality seeds, fertiliser, and related issues to attack poverty and increase incomes in rural areas. A key to improving crop yields would be modern technology with a special emphasis on growing high-yielding varieties of grains by encouraging free flow of technology transfers and investments from countries such as the United States, China, and Mexico.

Massive infrastructure investments in the rural areas may sound counter-intuitive to some but the fact is fiscal deficits are not necessarily harmful. However, they can be deadly if they are used to finance wasteful spending rather than productive investments. We have been guilty of big government and wasteful spending. This brings us to the most immediate and pressing issues of inflation and fiscal deficit. The situation calls for a holistic approach involving a comprehensive reorientation of fiscal and trade policies **(a) from protectionism and big government to fair competition and less government in areas where it is least effective or non-productive; and (b) from consumer-led growth to exports-led growth.**

To rationalize the fiscal regime, the government must (i) allow duty free import of all food items to lower inflation as a short-term measure and make increase in crop yields a top priority, (ii) increase taxes on non-productive areas (such as imports of cars) or those not under the tax net to reduce deficit, (iii) cut taxes on productive areas (e.g. manufacturing) to boost production and exports, and (iv) eliminate guaranteed profits to oil companies to lower or minimise increase in oil prices, and (v) last but no less important, undertake rightsizing of the bureaucracy.

Fiscal incentives and lower energy costs would give a shot in the arm to the industry to increase exports. The removal of restrictions/lowering of tariffs on food imports would help lower overall inflation through more supplies and perhaps lower costs. Cutting the overall deficit through new (or higher) taxes would also lower government borrowings and interest rates but that effect will not be felt until after 18 months or so.

The areas where tax policy needs a review include: (a) a cut in income tax rates for the public listed companies (excluding financial sector) to 15 per cent, (b) increase in income tax rates for the banking industry, (c) imposition of income tax on trading income from stocks (d) imposition of tax on capital gains from land and property, (e) withdrawal of blanket exemption to all income from agriculture regardless of income level, etc.

The government should also rationalize payroll and sales taxes for public listed companies because levies such as Employees Old Age Benefits do not profit the workers. Instead, the government should encourage stock options and direct cash compensation to allow the benefits to flow through to the employees. In this respect, the government while doing away with schemes that are de-facto indirect taxes should increase the minimum wage to Rs 8000 per month. In the arena of monetary and foreign exchange rate policies, the government needs to replace borrowings from the State Bank with market instruments, allow the exchange to be determined by market forces and phase-out subsidized lending schemes prone to abuse.

The measures suggested here are just some examples but illustrate and underscore the need for a qualitative change in policies rather than the so-called continuity that has failed to deliver. Agriculture, energy, and exports-led growth should be the top priorities of our economic policy if serious economic disruptions are to be avoided in the coming months and years.

To implement this three-pronged strategy, we need policy changes that would send a clear message to local and foreign investors that the new government means business.

March 03, 2008

Balkanisation, not Talibanisation is the real threat facing Pakistan

The statement of US Defence Secretary Robert Gates on November 11, 2007 that Pakistan's unrest could distract its military's War on Terror is appalling. The people of Pakistan with their country under emergency and thousands of freedom loving lawyers and activists in jail are worried about their country's future, put at stake due to the blunders of a US-backed military general. They consider the insurgency on their northern frontiers – War on Terror for the US – a disaster brought upon them by a thoughtless American-designed and American-funded military campaign. Senator Joe Biden likens Pakistan to Iran in 1979. Both views appear to lack depth and show inadequate understanding of the issues. War on Terror is not at stake nor is Pakistan Iran of 1979. Pakistan could however become another post-2001 Iraq or God forbid, another, Balkan, if the US continues to use the two-pronged approach of military rule (direct or in disguise with a civilian facade) in Pakistan and military approach to the War on Terror in Afghanistan as a solution.

The US policy is wrongly focused on Afghanistan because Pakistan's stability and progress depend ultimately on peace with India. With Afghanistan in turmoil and the insurgency spilling over to Pakistan's northern frontiers, it is in the best interest of both the south Asian nations to bring peace and stability to Afghanistan. NATO can never hope to succeed where the Russians and the British failed when they used their armies. President Bush and General Musharraf have collectively created a catastrophic mess in Afghanistan and in the thinly populated tribal areas in neighbouring Pakistan.

Almost twenty-eight years ago, in its cover story of January 16, 1979 issue, TIME magazine quoted a Western diplomat to make its point about Pakistan, "is that there is another [Colonel Muammar] Gaddafi down there, some radical major or colonel in the Pakistani army. We could wake up and find him in Zia's place one morning and believe me, Pakistan wouldn't be the only place that would be destabilized."

Misguided analysis and faulty judgement can bring hallucinations of a bloody revolution. In 2007, the talk of an extremists' takeover in Pakistan has become a cliché in the West. It was nonsense to talk about a radical junior army officer taking over in Pakistan in 1979 and it is equally absurd to talk about extremists or Al-Qaeda supporters taking over Pakistan today. Religious extremists form probably less than one per cent of 160 million population of Pakistan - World's sixth largest - and most of the so-called 'jihadi' groups owed their creation and sustenance to the former military dictator General Ziaul Haq and will not have a leg to stand on without the sympathy of some well-known and not-so-frequently mentioned forces inside Pakistani establishment. What has made the matters worse is the role of Bush administration and the inexperience in international affairs of officials like Donald Rumsfeld and Condi Rice. The problem has been compounded by a dearth of Pakistan experts in the Bush White House and an abundance of megalomaniacs among neocon strategists.

Pakistan's campaign against the militants in the North West Pakistan has unleashed a backlash on an unprecedented scale. For the first time since 1971 Bangladesh war, there have been desertions among the troops in a manner and on a scale that has shook General Musharaff's regime. He has lost the trust and confidence of the people and is widely seen as a puppet of an unpopular American President, in cahoots with corrupt and wily 'mullahs', and one who does not hesitate to use helicopter gunships to attack villages in his own country to please his masters in Washington. May not be wholly true, but that is the general perception and hence there is virtually no popular support for the so-called War on Terror. Even former

Prime Minister Benazir Bhutto believes “IEDs [Improvised Explosive Devices] are being placed and have been hushed up under the name of suicide bombings”.

While the core of the militants remained limited to a few thousand Taliban in Pakistan’s tribal areas until 2004-2005, the insurgency has erupted in other areas and a wave of violence and bomb attacks threatens to destabilize Pakistan. The policy of using force to combat extremism is producing thousands of supporters instead of isolating the militants. General Ehsanul Haq, who has recently retired from the army as Joint Chiefs of Staff Committee chairman and who also served as Pakistan top spymaster, recently said that a predominantly military approach to counter-terrorism was deeply flawed and might not take the world anywhere. “It can at best achieve tactical effects of affording time and space for the application of a comprehensive strategy aimed at addressing the root causes that drive radicalisation of Muslim societies and recruitment into the ranks of extremists and terrorists,” he recently told the participants of the annual conference of the Middle East Institute at the National Press Club in Washington, D.C.

That is one aspect but an equally important issue is Islamabad has no real interest in actually containing the Taliban because the insurgency has become the raison d’être for Musharraf’s regime. It has also indulged in disinformation campaign in the media. Most recent example was the story planted in the local newspapers before the arrival of Benazir Bhutto on October 18 that a Taliban leader Baitullah Mehsud had threatened to kill her. No such threat was issued and was strongly denied by Mehsud.

Adrian Levy and Catherine Scott-Clark recently wrote in San Francisco Chronicle, “The organised electoral momentum of the jihadists is negligible. They have rarely been able to scoop more than 10 per cent of the vote in previous Pakistani elections, so the chance of electing a theocratic regime in Islamabad is slim. Their military capability, when compared to the vast, wealthy and well-trained Pakistan military, is equally diminutive, too. However, their prime asset is Musharraf, whose wielding of jihadis at times of necessity has empowered them immeasurably, while his refusal to whole-heartedly crack down on their camps and training bases has emboldened them.”

Musharraf imposed a de-facto martial law to protect himself and perpetuate his rule. He is cracking down hard on the democratic forces in the country and not on the terrorists. One of his senior aides told The New York Times that Musharraf imposed martial law only after a judge told him that the supreme court was about to declare his election illegal. Musharraf must withdraw emergency, quit as Army chief, reverse all illegal actions, reinstate all judges dismissed in violation of the constitution, and release all political prisoners. He should hand over power to Pakistan Senate Chairman (in accordance with the constitution) who should hold elections under international supervision and transfer power to an elected government by February 2008. With no constitution, no parliament, more than half the senior judges sent home, media gagged, a quarter of the country’s lawyers in jail and courts shut down, it is simply not possible for Pakistan to move forward under Musharraf. An IRI poll - taken before the emergency was declared - reported his approval rating at an all time low of 21 per cent.

The presence of American troops has given the extremists a casus belli to enlist thousands of supporters to fight the ‘infidels and foreigners’ who have their invaded their land. The time is running out and the only solution is a grand reconciliation between Islamabad, Kabul and moderate Talibans so that the extremists can be isolated. But that will not be possible while Musharraf is in power and American troops are in Afghanistan.

Mark L. Schneider of International Crisis Group told the US House Foreign Affairs Committee on “Counternarcotics and Police Training” in Afghanistan, on October 4 2007, “there was a disturbing failure to commit sufficient resources — either military or reconstruction aid to Afghanistan — by the US and by the international community; an even greater failure to require the Pakistan government to close Taliban command and control centres, sanctuaries and Taliban recruiting in Jihadi (a misused term) mosques and madrassas; and an absolute refusal to recognise the links between exploding opium trafficking, insecurity and a corrosive culture of impunity.”

Clearly, the US has been wrong to assume that those who benefit from perpetuation of the conflict [e.g., General Musharraf] would help to end it. Furthermore, this military campaign is based on a dangerous premise - 40 per cent Pushtun population of Afghanistan is Talibans or its sympathisers. A military solution to bring peace and stability to a war torn narco-state of Afghanistan, in the face of growing religious sentiment combined with nationalist Pushtun feelings, is doomed to fail. The US pays lip service to the development but its record in this respect is dismal and is scoffed at by the locals. The US failure in Afghanistan has fuelled an insurgency that has created civil war like conditions in the North West frontier region of Pakistan. The ‘great game’ and the covert wars of the intelligence agencies have already destabilized the military regime in Pakistan and could lead to a bigger catastrophe in the next five years. The worst outcome will be a Pushtun rebellion on both sides of Durand line, the border between the two countries. At the least, it would make Pakistan ungovernable with unpredictable consequences.

But Pakistan’s establishment and sections of its media have perfected the art of projecting the most irrelevant topics as national issues of paramount importance. They have now been joined by the Bush administration. Musharraf’s ‘doffing’ of his uniform is one such example. Some newspapers even published comments to the effect whether it was the beginning of a drastic transformation. Really? Transformation to a completely failed state from a ‘failed state’? Another general? So what? Hitler was not from the Army. He never really wore a general’s uniform. So he never had to take it off. But that did not alter the fact that he was a dictator whose third Reich led to Germany’s worst defeat and complete destruction.

Ayub Khan took off his uniform in 1962 but ruled for another seven years as a military dictator without many problems. He was the most ‘moderately enlightened’ of all generals. He introduced private enterprise to the Army as well as to his family and institutionalized corruption at the highest level of government for the first time in Pakistan’s history. He wore fine dinner jackets to the state dinners in Western capitals and swam with beautiful British call girls in his leisure time. But the extreme inequalities and regional and ethnic polarisation caused by his misrule led to the dismemberment of Pakistan (presided over by another general) after two years, eight months, and twenty two days of his exit as the President of Pakistan. So much for the stability that his ‘economic achievements’ had supposedly brought to Pakistan.

One would think that Pakistan’s elites (although intellectually depleted to a debilitating degree due to massive brain drain over the past three decades) having lived most of their lives under military dictatorships, would have learned that only two generals in the modern history brought about any positive political change through their coups, Napoleon and Ataturk. And they would therefore focus on more substantive issues. Is this too much or too rational to expect?

Let us now look at some real issues: The history teaches us that all generals behave in exactly the same manner when they have power. Their policies revolve around self-preservation and protection of the military's institutional interests, and absolute concentration of power inevitably leads to greater problems than the ones, they supposedly seized power to solve. It is therefore of little consequence if they rule with or without uniform, as one-man dictatorship or as a group; or with 'rubber-stamp' parliaments or without even the pretence of having an election or a parliament.

Musharraf's both coups were desperate acts of a man who saw his career coming to an end. Both the coups showed complete and contemptuous disregard for the constitution and the interests of the country. He acted with impunity in a brazen display of naked power that showed no regard for any consideration other than his own self. What really led to his 'dismissal' by Nawaz Sharif was his misadventure into Kargil; a historic blunder whose sole purpose was to sabotage the peace process initiated with Indian prime minister Atal Bihari Vajpayee; a peace process that could have led to a period of greater stability and development in the sub-continent and a reduced role of the military. After eight years of his misrule, what has Pakistan really achieved?

- Pakistan is as corrupt, if not more, a country as it was on October 12, 1999. The biggest loan defaulters and arguably one of the most corrupt family in Pakistan's history – the Chaudris of Gujrat – are Musharraf's principal backers and lead the ruling party.
- Pakistan has been declared the most dangerous country in the World by the Americans, his best friends. It ranks 12th on the failed states index, has the highest inflation rate in Asia and the second highest rate of suicide bombings in the world. It also achieved the dubious distinction of becoming the largest buyer of arms in the developing world in 2006.
- Pakistan's judiciary had a tainted record but it still operated with some semblance of respect. Now it stands completely destroyed.
- And the economy? The massive inflow of funds (over $65 billion) during the eight years has been a wasted opportunity. The greatest beneficiaries have been the generals, bankers, stock brokers and their friends without any real development in the country. As far as the $11 billion aid from the United States is concerned, a little over 90% of this amount is military aid and has nothing to do with economic development. The largest source of external funding has been the remittances ($26 billion), which would have come any way regardless of which government was in power.

The general was shrewd enough to use the 9/11 to end his own international isolation but in his desperation to undo the blunders committed by the generals (himself included) that earned Pakistan the reputation of a 'terrorist state', his regime has made the biggest compromises on Pakistan sovereignty and independence in the country's history; compromises that may ultimately lead to Balkanisation, and not Talibanisation, of Pakistan.

Why Balkanisation? The term usually refers to division of a place or country into several small political units, often unfriendly to one another. The term balkanisation comes from the name of the Balkan Peninsula in Europe, which was divided into several small nations in the early twentieth century.

A major fallout of the prolonged periods of military rule (1977-1988 and 1999-to date) since the break-up of Pakistan in 1971, has been that the country no longer thinks nationally. For example there is no real national party. The PPP which once played that role was squeezed out of that role by the Army generals and their minions, like Nawaz and Chaudris, with the slogan “Jag Punjabi Jag” and mindless repression and persecution of its followers, leaving aside its own blunders for a moment.

The ANP, MQM, MMA and PML(N) are either purely ethnic parties or at best Provincial entities. Similarly on issues such as Kalabagh Dam, division of resources, etc; the discussions, regardless of which Government is in power, are conducted on the basis of provincial rather than national interests. Musharraf says that the Army provides the glue to Pakistan’s integrity but implicit in this dangerous argument is the admission that nothing else holds the country together.

As the situation exists, Balochistan has been in the midst of an insurgency for some time, and the Northern territories of Pakistan are on their way to forming autonomous entities with their own justice system, tax collection regime, and militias. From a Federation we seem to be descending into an abyss. Can we stop this march to self-annihilation? That is the challenge Pakistan faced in 1969-1971 and failed. The apologists for the generals dismissed the possibility of disintegration then. But they should take it seriously now instead of worrying about the ‘manufactured threat’ of a Taliban takeover of Pakistan. The Talibans hardly have any roots in Punjab, Sindh or Balochistan but the threat of Balkanisation has never been so real since 1971.

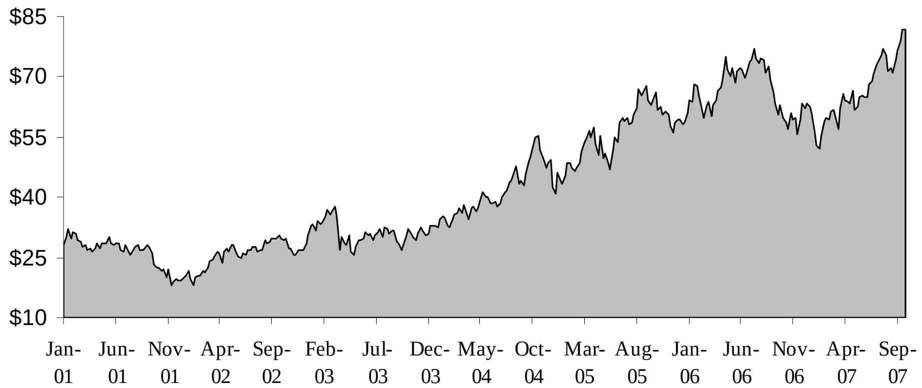
November 25, 2007

The long term trend of rising oil price

"All the various components (of the global energy crisis) came together after 9/11, and 9/11 was a major factor in bringing them together. Once we realise this, many other developments fall into place: the war on terror; the invasion of Iraq; the rise of Iran; the radicalization of Islam and the increasing sectarian tensions within Islam; the decline in American power and influence; nuclear proliferation; China's pursuit of natural resources and its negative effect on curing the resource curse; and Russia use of gas supplies to suborn its former empire and the larger danger it poses for Europe. The core of the crisis is the tight supply situation for oil." So wrote George Soros, probably the world's most influential hedge fund manager, in 2006 (*The age of Fallibility*).

Oil price has hit record levels and has been trading over $80-a-barrel level since September 13. While seasonal and speculative factors do play a role, the oil price is in a long-term upward cycle with little signs of weakness. Oil has always been a subject of great importance for the global economy and politics but what is new this time? Why the oil price has more than trebled during the last five years after hitting last decade's low of $11-a-barrel during November 1998?

Crude Oil Price
January 2001 - September 2007
US $ per barrel



Could it may break all previous records and why it has come to occupy a central place in the United States foreign policy are questions that directly concern Pakistan. Hence, it is important to examine these issues in a holistic manner. Recently, the subject has received greater attention in the global media since Goldman Sachs, an American investment bank, said last July that we could be months away from $100-a-barrel oil price. On October 4, Merrill Lynch, the world's biggest brokerage firm, raised its oil-price forecast for the fourth quarter 19 per cent because of 'insufficient supply from producers outside of the Organisation of Petroleum Exporting Countries (OPEC).' Alan Greenspan, the former US central bank head and who was once called the second most powerful man in the world, wrote in his recently released book, "Iraq war is largely about oil." This hit the headlines globally, causing embarrassment to the Bush administration and reignited the debate about oil's crucial role in the US foreign policy.

It is pertinent to recount some basic facts about oil. Oil meets about 40 per cent of global energy requirements but 96 per cent of its transportation energy needs. Despite the development of many alternative sources, oil's share of global energy needs has only marginally declined from 46 per cent in 1980. Its global consumption has continued to outstrip the discovery of new reserves by a wide margin. While the seasonal factors can influence oil price in the short term, the long-term demand and supply factors ultimately determine price. Since 2001, the world oil consumption has been rising at faster rate of 1.7 per cent a year compared to its 27-year average of 1.4 per cent. The ratio of proven reserves to oil production (measured in terms of number of years) has declined from 41.0 in 1990 to 40.5 in 2000 to 39.5 in 2006. The world production has increased from 65.4 million barrels-a-day (mbd) in 1990 to 81.7 mbd in 2007 but the sources from which the incremental supply has come through have made it a major issue of global politics.

Middle East accounted for about 50 per cent of the increase in the oil supplies, Africa 20, Latin America 15 and Kazakhstan 5 per cent during 1990-2006. The oil production in the US declined from 8.9 mbd in 1990 to 6.9 mbd whereas its consumption increased from 17 mbd to 20.6 mbd. The US accounts for about one-fourth of the global demand but its oil production has been declining since it peaked in 1970. The US accounted for 21 per cent of the increase in global oil demand during 1990-2006 but China contributed the most accounting for 30 per cent of the total. The demand-supply situation assumes a special geo political importance given that nearly 70 per cent of the increase in global oil supply in the last 17 years has come from Middle East and Africa and 63.5 per cent of the increase in demand has originated from Asia led by China, India and Korea.

The role of China has now assumed great significance in global energy security. China accounts for about 9% of world's oil consumption but its consumption has grown at 7.7% since 2000 - at 4.4 times the world average. Moreover, due to lack of any large discoveries in the last two decades, its oil production remains flat but its imports have doubled in the last five years to about three mbd. China's imports could to rise to 7 to 8 mbd by 2012, with a predominant dependence on Middle East imports.

In anticipation, China has spent over $17 billion since 2002 on acquiring oil companies/assets in Sudan, Kazakhstan, Nigeria, Russia, Angola, Ecuador, Columbia and Argentina – all outside the Middle East – as part of the strategy to reduce its dependence on oil imports from the Middle East. China is fostering closer relations with Russia and Iran to meet its future natural gas needs. India competed with China (and lost) for the acquisition of above oil assets in Kazakhstan, Nigeria, Russia and Angola. Note that while China and India are making acquisitions, Pakistan is selling off its energy assets. The situation in terms of proven reserves presents an even more interesting scenario. The table below summarises the global proven oil reserves:

	1996		**2006**	
	Billion barrels	%	Billion barrels	%
Saudi Arabia	261.4	25.5	264.3	21.9
Iran	92.6	9.0	137.5	11.4
Iraq	112.0	10.9	115.0	9.5
Kuwait	96.5	9.4	101.5	8.4
United Arab Emirates	97.8	9.5	97.8	8.1
Total Middle East	672.2	65.4	742.7	61.5
Africa	74.9	7.3	117.2	9.7
North America	89.3	8.7	59.9	5.0
Kazakhstan	n/a	n/a -	39.8	3.3 -
World Total	1027.0	100.0	1208.2	100.0

While the Middle East's reserves have increased the most in absolute terms, Iran accounts for most of increase although major fields still need to be developed. Iran's natural gas reserves have also gone up 22 per cent during the last decade and it has emerged as the second largest hydrocarbon power in the world. On the contrary, Saudi reserves have not gone up.

What has further compounded the tight oil supply situation is Saudi's inability to increase production despite being under significant western pressure to do so. Saudi oil production declined to 10.86 mbd in 2006 from 11.11 mbd in 2005 after remaining around 10.6 mbd during 2003-2004, although Saudi American Oil Company (ARMACO) has repeatedly denied reports that raised questions about the actual level of reserves and its ability to pump more oil. In 2006, ARAMCO announced an $18 billion plan to increase capacity to 12.5 mbd by 2009 and 15 million by 2020.

However, its demonstrable capacity has not increased significantly since 1980 and 1981 when it produced 10.2 mbd and has not made any significant discoveries or investments in the past two decades. Adding to the concerns about the actual Saudi capacity to pump more oil is the question of the remaining life of the reserves outside the Middle East. At the current production rates, the remaining life of proven oil reserves of some major oil producers is as follows:

<u>Life of remaining oil reserves: number of years:</u>

Middle East	79.5	Russia	22.3
Venezuela	77.6	China	12.1
Kazakhstan	76.5	United States	11.9
Africa	32.1		

Given the growing dependence of both the US and China on oil imports and the level of reserves in Middle East and Africa, energy security has emerged as a major issue in their foreign policies and is likely to generate more tensions with Middle East as the main theatre. Nigeria, Algeria, Libya, Angola, and Sudan account for about 90 per cent of proven oil reserves in Africa and China has emerged as a serious challenger to the western oil interests in the continent.

Some oil analysts think the oil price contains a premium for security or political instability as most of world's oil is in politically turbulent regions. That may be so but the supply situation has not been helped by low level of investments in oil exploration, which have been stagnant in both OPEC and non-OPEC countries since early 1980s. Investments on oil exploration as a percentage of total capital spending worldwide dropped to less than 14 per cent from over 20 per cent in 1996.

This makes it more likely that the world is going to be supply constrained for many years to come. The result has been a highly volatile market focused on short-term shifts in inventories, weather forecasts, and relatively small changes in output in addition to the political developments. However, the spike in oil price has hardly been a surprise for experts. Former US President Bill Clinton while addressing a select gathering in Arkansas on June 21, 2006 had this to say about oil price: "everybody I know who knows anything about this business believes it'll be $100 a barrel in five years or less."

Pakistan meets about 50 per cent of its energy needs from its natural gas reserves that may not last more than 15 years. Hence, it has been eager to secure gas from Iran. Pakistan's import bill increased from $6 billion during FY 2005-2006 to $7.4 billion in FY2006-2007 with most of the increase coming from refined petroleum products while the oil price averaged around $65-a-barrel. The oil price has averaged around $75-a-barrel since July this year and looks set to increase. This will put additional pressure on the balance of payments and fuel inflation.

On the geo political front, Pakistan’s relations with China and Iran could come under more strain in the coming years as the tensions are bound to increase when China tries to secure its energy supplies and routes, the US tries to strengthen its hold in the Gulf, tightens its circle around Iran and Pakistan finds itself in the middle of what many, including the likes of Alan Greenspan, George Soros and Jeff Sachs, believe is not a war on terror but a war for oil with terrorism used as a smokescreen.

October 8, 2007

How subprime lending in the US led to a global credit crunch?

The bankers define it as subprime lending while their detractors call it predatory lending. Simply put, subprime are more expensive (high interest rate) loans intended for people with impaired or limited credit histories, typically belonging to low income groups. Defaults in over $1.3 trillion US subprime mortgages' market have developed into the biggest global financial crisis in almost a decade. Defaults have not been limited to this loan market segment. The $1 trillion Alt-A (or loans to a slightly better quality of borrowers than subprime) mortgage market is also facing defaults.

Hedge funds and banks have been exposed to this market through investments in mortgage-backed securities and other derivatives. Mortgage-backed securities are those instruments through which the lenders sell the loans to the investors who then assume the risk of default by the borrowers. Hence, the defaults have led to investor losses, a global credit squeeze, tight liquidity conditions, growing risk aversion, and a widening of credit spreads.

These mortgages (subprime and Alt-A) represent about 11 per cent of the US private debt securities' market which is as big as the US stock market. A recent IMF report indicates that the losses from the US mortgages sector could reach $200 billion. Could it get worse? Quite likely! Would it lead to a recession in the US? Probably! What are the implications for the emerging markets? Many!

What was once a problem confined mostly to the low-income borrowers and poor communities is quickly becoming a national phenomenon in the US. Last year, there were 1.2 million foreclosure filings in the United States, up 42 per cent from 2005. At current rates so far this year, some estimates put foreclosure filings to hit two to two and half million in 2007, or roughly one per 62 American households — a rate approaching heights not seen since the Great Depression in the 1930s.

It all originated with a global imbalance between the savings glut and the shrinking demand for credit. Central Bankers, led by Alan Greenspan, let monetary policy move to a nearly unprecedented accommodative stance, pumping money into the system since 2001. Interest rates hit historic lows as the Fed funds rate was cut to one per cent. At the same time, corporates, the traditional mainstays in terms of borrowing funds to invest, moved to a defensive stance, having grown much more conservative in the wake of the Enron and WorldCom fiascos. Finally, the major developed countries began to gain a measure of fiscal discipline, with budget deficits shrinking, which further reduced the demand for credit on a global basis. Emerging markets reduced their borrowing as their deficits turned into record surpluses.

That imbalance between investors flush with cash and the traditional borrowers not really needing or wanting that cash meant that investors had to look for new markets to invest in. As the asset-backed securities, (ABS) market had been taking off and coming into the mainstream, a natural target was the subprime borrower - borrowers who in the past had wanted to borrow but who had been locked out of credit markets. Eager lenders met eager borrowers, with the mortgage originators, ABS underwriters, and credit ratings agencies playing the role of matchmaker, and the subprime boom was born.

Over the past nine years, the subprime market in the US produced more than $2 trillion in home loans and its share of total mortgages market went from around 5 per cent in 1999 to over 20 per cent in 2006. Some analysts maintain that lax underwriting practices, dangerous loan products, and a disregard for affordability set up vulnerable homeowners to fail. According to a US research institute, the Centre for Responsible Lending, over 60 per cent of subprime loans were not used for buying homes, but for refinancing existing mortgages. Even in 2006, subprime refinance loans accounted for a majority (56%) of all subprime loans originated. The borrowers took advantage of low interest rates and rising home prices to take equity out of their homes. This phenomenon also supported consumer spending which accounts for over 60 per cent of US GDP.

The subprime boom led to a phenomenal growth in ABS and credit derivatives markets. Only about one in five mortgages is retained by the original lender. The rest — four out of five, roughly — are sold off. About one in four mortgages sold to investors is a subprime loan. This is crucial to understanding why subprime lending has rocked the financial markets. Financial intermediaries active in the mortgage market have complex webs of exposure. Although the largest such institutions—the core commercial and investment banking group are believed to be sufficiently capitalized, diversified, and profitable to absorb direct losses, many hedge funds and smaller banks have proved to be more vulnerable so far. They also tend to be have high leverage, that is, they use short-term funding to invest and can be forced to sell securities in adverse market conditions. Hedge funds are believed to account for around 48 per cent of the ABS and derivatives' market and the banks nearly 25 per cent. About 80 per cent of the total is estimated to be held by the US institutions and the remaining mostly by Europeans.

A major reason for growing defaults appears to be the bad quality of the lending itself. This is borne out by the fact that one in every eight subprime home loans (12.9 per cent) originated in 2000 was foreclosed by May 2005. As the growth in the US economy accelerated during 2002-2005 after only a 0.8 per cent GDP growth in 2001 and inflation fears resurfaced, the Fed started raising interest rates. In series of interest rate hikes beginning in the later half of 2004, the Fed funds rate was raised from one per cent to 5.25 per cent. As most of the subprime lending was at adjustable (or variable) rates, the borrowers had to repay more in loan instalments as the interest rates rose. The compounded the miseries of subprime borrowers and contributed to rising delinquencies.

In June this year, two high profile hedge funds managed by a leading investment bank, Bear Stearns, who had invested in subprime mortgage securities, reported huge losses leading to withdrawals by investors and bankruptcies. The money and credit markets started showing signs of stress in June but the stock markets continued to move ahead. On July 26, Countrywide Financial, the largest US home mortgage lender announced losses of $1 billion on mortgage loans and sparked fears the subprime crisis would spread.

The panic gripped the markets as subprime crisis turned into a liquidity crisis threatening to hurt corporations and other market participants. The correction in the prices of mortgage-backed securities turned ugly and spilled over to the stock market. The Dow Jones lost over 500 points (or 3.8 per cent) over the next two days but the worst hit was the money market. The commercial paper (short-term borrowing instrument) market collapsed as more hedge funds and financial institutions reported losses in the following weeks. Since July 25, the US commercial paper market as represented by total outstanding amount has fallen by $369 billion or about 16.6 per cent.

As the crisis deepened and short-term funding sources dried up; the central banks in the US and Europe responded by massive injections of liquidity in the system. On August 12, the

Federal Reserve (Fed) made a surprise cut in the discount rate (at which Fed loans to banks) of a half percentage-point, to 5.75 per cent. In a rare statement between scheduled meetings, the US central bank's policy-setting committee said risks to economic growth "have increased appreciably" due to global credit crisis and financial market turmoil. The measure was intended to calm the markets and the markets responded positively.

On September 18, the Fed, in an aggressive attempt to keep turmoil in financial markets from damaging the overall US economy, cut the federal funds rate, which determines what banks pay to borrow money from each other overnight, by half a percentage point, to 4.75 per cent. The rate cut, the first in four years, should eventually lead to lower borrowing costs for consumers and businesses.

The Fed may have averted a crisis, but the risk of recession in the US seems to be increasing if the house prices continue to decline. In August, the sales of new homes in the US dropped more than forecast and home prices plunged by most since 1970. Nevertheless, US economy is quite resilient and grew at a rate of 3.8 per cent in the second quarter of 2007 and may not experience a recession but the financial crisis could get worse. Hence, investors can expect subdued economic growth, weaker US dollar, firm oil prices, and another interest rate cut in 2007-2008. Emerging market equities have proved to be remarkably resilient as their economies continue to grow and attract capital flows. However, they will not be immune to a fall out from a recession in the US. In the meantime, they should learn from the lending excesses that led to the crisis and have hurt the US economy.

October 1, 2007

Pakistan is the largest buyer of arms in the developing world

Almost every major newspaper in Pakistan has buried the news of the latest arms sales data somewhere in the inside pages while the stories about Musharraf's election, Supreme Court's actions against the police, suicide bombings, Benazir, wheat flour crisis, etc. dominate the front and back pages. But it is a significant piece of information in terms of understanding what is at stake if you separate the offices of the President and Chief of the Army Staff, in addition to the obvious loss of operational command.

According to the latest Congressional study released recently in Washington, D.C., Pakistan's arms purchases of $5.1 billion during 2006 made it not only the largest buyer of arms in 2006 but accounted for a staggering 18% of the entire purchases of $28.8 billion made by the developing world during 2006. India and Saudi Arabia with purchases of $3.5 billion and $3.2 billion were respectively the second and third largest buyers of arms in the developing world.

According to the official budget documents, Pakistan's defence budget was around Rs 250 billion (or $4.1 billion) during 2006 and Rs275 ($.4.5 billion) for the fiscal year 2006-07. Even if the pensions of the retired defence personnel amounting to about Rs40 billion ($660 million) are added to this number, the total would not add up to $5.1 billion. Now what is missing here?

Pakistan also receives $80-$100 million a month (or approximately $1.2 billion a year) as compensation for logistical support/operations in Afghanistan/Tribal Areas. It appears that the actual defence spending is much more than the nominal sums disclosed in the annual budget; sums that already exceed the combined development spending on health, higher education, water, and power resources.

While the details of the defence budget are never discussed in the parliament, total spending is disclosed. It is possible that the budget document does not include the arms purchases because they were made under bilateral aid agreements with the United States. The US made total arms sales of $10.3 billion to the developing world followed by Russia ($8.1 billion) and United Kingdom ($3.1 billion). This implies that Pakistan accounted for 50% of the US arms sales to the developing nations during 2006. The value of arms deliveries to Pakistan during 1999-2003 was $2.5 billion and $2.1 billion during 2003-2006, making it the ninth largest buyer of arms in the developing world as follows:

Table: Arms deliveries to Developing Countries -1999-2006 [in US$ billions]

Rank	Country	Total Value
1	Saudi Arabia	45.8
2	China	17.1
3	Egypt	10.9
4	U.A.E	10.3
5	India	10.1
6	Taiwan	10.0
7	Israel	9.7
8	South Korea	7.8
9	Pakistan	4.6
10	Kuwait	2.4

Pakistan was not only the largest arms buyer in the developing world in 2006 but also set a new record in that its arms purchases in 2006 exceeded the total value of the arms delivered to her during the eight-year period from 1999-2006.

It is quite possible that Pakistan is spending more than 5% of its GDP on defence and not around 3% as is commonly believed. This spending level would be equal to the entire public sector development program (PSDP) or the total federal development budget. The government needs to explain the vast discrepancy between its defence budget and actual defence purchases as disclosed in US Congress study. Globally, arms business is notorious for clandestine deals and kickbacks. Generally, the standard kickbacks range from 5%-10%.

When the amounts reach levels equal to the entire development spending of country as they have in Pakistan's case and are shrouded in mystery, serious questions about political motives, hidden agendas, national priorities, decision making process, reliability of national accounting and macro data, transparency and good governance are bound to arise because the stakes are huge.

October 3, 2007

Budget largely irrelevant for common person

This year's budget is populist in tone, inflationary in substance, neutral for the agriculture sector, pro corporate in general, disappointing for the textile industry and largely irrelevant for the common person although it offers some relief to the government employees. While there has been no significant policy change, it is an attempt to address two of the most pressing near term issues. Faced with a record trade deficit and double-digit food price inflation, the government has been forced to levy a special surcharge of one per cent on all imports excluding vegetables/pulses, edible oil/ghee, petroleum products, medicines and fertilisers. This small levy is unlikely to make a dent in the import bill and hence in the trade deficit. The reduction in the prices of essential items at the utility stores and expansion in their network was announced last year as well but failed to control the food price inflation. This is a cosmetic measure for public consumption rather than a serious effort to address the real supply side issues.

The government can draw satisfaction from a 7 per cent GDP growth, record level of foreign investment, good wheat production, record tax collections and a booming banking sector that has fuelled a consumer boom. The tax collections grew by 18 per cent to Rs840 billion and the next year's target of Rs1030 billion is ambitious given no new taxes have been announced. The growth in taxes has been concentrated in a few sectors and withholding taxes. The government continues to define all withholding taxes on utility bills, contracts, bank transactions, etc. as direct taxes but the reality is that the withholding taxes together with the direct taxes still account for three-fourth of the total tax revenues and have contributed to inflation. The budget has not made any attempt to remove the distortions that have been the subject of public debate in the recent months. Perhaps, it is a little too much to expect a government to take concrete measures to expand the tax net to large landowners, big industrialists and stockbrokers in an election year.

However, the budget speech was perhaps more important in respect of the issues that it did not address. While the growth has been impressive, it has come at a time of unprecedented growth in the global economy and abundant liquidity. Pakistan's total banking deposits (of individuals and private businesses) grew by almost $20.3 billion during 2001-2006 and were driven by an equal volume of remittances. The demand-driven growth has obscured the fact that the growth of major crops, that is cotton, wheat and rice, has averaged 2.1, 1.6 and 0.8 per cent per annum respectively during the past seven years while the population growth has average more than 2 per cent. The inadequate growth rate in the agricultural crops lies at the heart of persistently high food price inflation. Subsidies and credit without massive investments in water, energy and human resources have proved to be inadequate to grow crops at the required rate.

The government has responded to this criticism by pointing to the record size of the Public Sector Development Programme (PSDP). Last year's budget was Rs435 billion but the revised estimates point to only Rs395 billion. This year's budget of Rs520 billion includes higher allocations for water and power but no significant allocation for higher education that remains a tiny 6.5 per cent of the defence budget of Rs275 billion. It is alleged that this amount does represent not the true level of defence spending because it does not include about Rs60 billion received from the Pentagon for the logistics support and about Rs40 billion spent on the pensions. If these estimates are correct, the actual level of defence spending may be close to 4 per cent of the GDP and not 3 per cent as claimed. Even if it is Rs275 billion, it is four times more than the combined allocation for water, electricity, higher education and motor highway construction in the current budget. While a lot has been written about the lack of investment in the power generation sector in the past years, another important fact is rarely mentioned. Overall water availability has remained constant around 134 million acre feet for the rural areas in the last seven years and is a major impediment to the agriculture growth.

The total budget deficit of Rs395 billion will represent about 4 per cent of the GDP compared to last year's 3.7 per cent. The tax revenues have increased in absolute terms but they still represent 9.5 per cent of the GDP compared to over 12 per cent ten years back. The government needs to cut the deficit to control its borrowings that have contributed to a reduced availability of credit to the private sector as well as to high interest rates. Therefore, an interest rate cut by the State Bank seems unlikely in the next 12 months. This is not a good prospect for the exporters who are already facing stiff competition from China and India.

The exports have grown by only 3.3 per cent this year and the current deficit has swelled to 5 per cent of the GDP. While the government maintains that financing this is not an issue and points to $4.2 billion in FDI, it will be a challenge to maintain this level given the political situation. These investments were concentrated in 5-6 companies and the current account, foreign exchange reserves and the rupee can come under pressure if these FDI levels drop. The government should cut non-essential imports sharply as the oil bill accounts for only 22 per cent and only $3 billion have been spent on the import of industrial machinery out of a total of $25 billion so far in the current fiscal year.

It appears that in its last budget, the current administration has chosen not to take difficult decisions regarding increasing the tax base and cuts in non-development expenditure because it would rather leave it for the next government to make tough policy choices when the crunch comes.

June 10, 2007

Real incomes' growth stymied

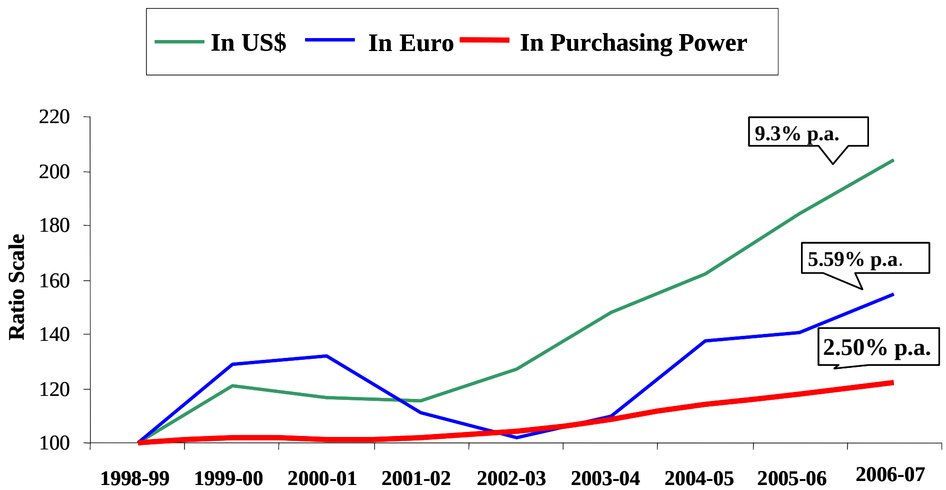
The government frequently points to the growth of mobile phone users as an evidence of progress. But this argument misses some crucial points. The spread of technology, its tremendous benefits, and its ever-declining cost combined represent a global phenomenon that has made it possible for people to buy phones – sometimes on even borrowed money- as long-term investment. Take Kenya's example. In 2000 some 300,000 people used mobile phones; now, in that country of 35 million plus, nearly 9 million do. Statistics from other African countries like Nigeria, Ghana, Swaziland, Egypt, and Senegal reveal a similar trend.

The efficiency gains from mobile phone usage, particularly savings in transportation costs, have made this a self-financing investment for hundreds of millions of low-income people around the developing world. It is therefore incorrect to present this as evidence of a significant change in living standards or of success of a government's economic policies.

The only objective measure of a government's performance is the improvement in real (or inflation-adjusted) incomes across all income classes. Now, how do we reconcile two seemingly contradictory facts that Pakistan has one of the lowest growth rates in real per capita (person) income in purchasing power terms despite having recorded one of the highest GDP growth rates among the Asian countries in the last four years? A major reason is higher inflation compared to the rest of Asia. Pakistan's current inflation rate is 7.8% compared with 5% in India and about 1.50- 2.4% in Thailand, Malaysia, Korea and the Philippines and 3.40% in China. Hence, it is important to measure progress and growth in real or inflation-adjusted terms.

The government cites the increase in per capita income from $586 in 2002-03 to $925 in 2006-07 as one of its principal achievements and its claim to a significant poverty reduction rests to a great degree on this argument. While it is true that Pakistan's GDP growth since 1999-2000 has been higher than it was in the 1990s, real measure of the improvement in the well being of the population compared to other economies is the GDP per capita in purchasing power parity terms.

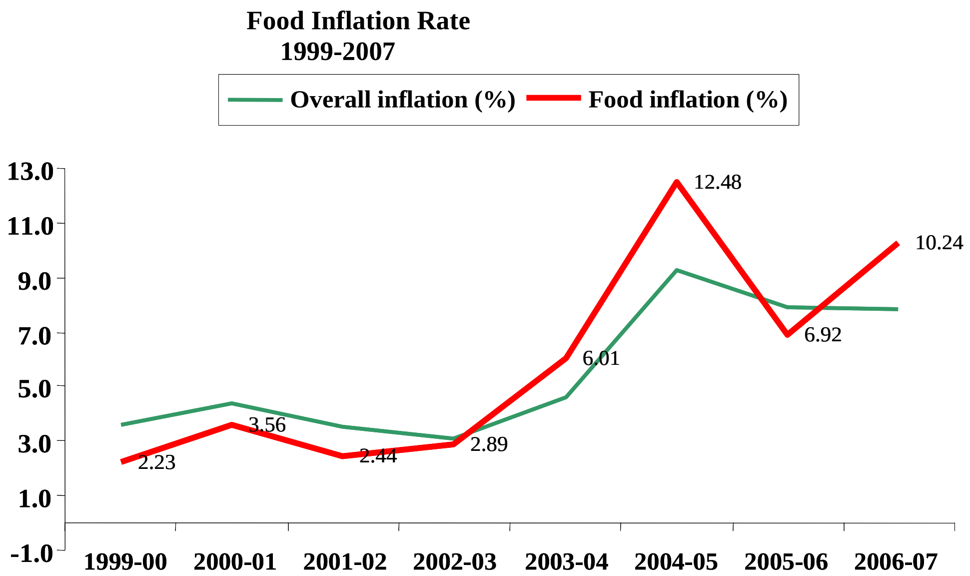
GDP Per Capita Growth Per Annum
1999-2007



Source: Based on World Bank Development Indicators April, 2007 and Economic Survey of Pakistan

Pakistan's GDP per capita (or per person) increased at an average of 9.3 per cent per annum during 1999-2007 when measured in nominal US dollar terms but since the dollar has depreciated against Euro, this growth rate falls to 5.59 per cent when measured in Euros and to only 2.5 per cent when measured in real or purchasing power parity terms in 2000 constant dollars as shown in the graph above.

In other words, the average real income of a Pakistani has increased by only 2.5 per cent per annum since 1990-2000 and as income inequalities have not improved according to the government's own admission, it is only logical that the incomes of the upper and middle classes have risen more rapidly than the average. It therefore follows that the per capita real income growth for more than 80 per cent of the population has been less than 2.5 per cent. According to a World Bank report released on March 30, 2007, Pakistan's agricultural GDP per capita growth rate during 1999-2000 to 2004-05 was only 0.3 per cent annually. What has made it worse for the lower incomes group is the well-established fact that the food inflation has been higher than the overall inflation. The food inflation accounts for about 40 per cent of overall inflation and is therefore critical to improvement or deterioration in the purchasing power. The current food inflation rate is four and half times as high as it was in 1999-2000 as shown in the graph below.



The surge in food inflation to 10.24 per cent during July 2006-May 2007 followed a fall of 4.1 per cent in the major crops (wheat, rice, cotton, sugarcane) and a negligible increase of 0.4 per cent in minor crops (potatoes, pulses, other grains, etc.) during 2005-06 despite an overall GDP growth of 6.6 per cent in that year. Both crop groups staged a recovery during 2006-07 and it remains to be seen if the recent gains in their production would translate into lower food price inflation.

The last year's GDP growth of 7 per cent was helped by a 5 per cent growth in the agriculture sector, which accounted for 20.9 per cent of the GDP. However, the growth in the crops sub-sector (which accounts for only 47.9 per cent of the agriculture sector, the livestock's share being 49.6 per cent) masks the fact that the (i) 7.5 per cent growth in major crops was from a low base as prior year's growth was negative and (ii) the minor crops grew by only 1.1 per cent during 2006-07

However, going beyond a single year's production data, the last seven years' record indicates more fundamental and structural problems with the growth trend of the agricultural crops. **As shown in the table, the production of cotton, wheat, rice and sugarcane grew by a yearly average of 1.63, 1.23, 0.59 and 1.87 per cent respectively during the seven years from 1999-2000 to 2006-2007 and was below the estimated average population growth of 2.2 per cent or so during this period.** An examination of a sample of the production of other agricultural produce reveals similarly low and volatile rates of growth.

Table: Production of select major and minor crops
(all figures in thousands of tons except cotton which is in thousands of bales)

	Cotton	Wheat	Rice	Sugarcane	Onions	Barley	Potatoes
1999-00	11,240.0	21,078.6	5,155.6	46,332.6	1,648.0	117.5	1,868.4
2000-01	10,731.9	19,023.7	4,802.6	43,606.3	1,563.3	98.9	1,666.1
2001-02	10,612.6	18,226.5	3,882.0	48,041.6	1,385.0	99.8	1,721.7
2002-03	10,210.6	19,183.3	4,478.5	52,055.8	1,427.6	99.6	1,946.3
2003-04	10,047.7	19,499.8	4,847.6	53,419.0	1,449.0	97.6	1,938.2
2004-05	14,265.2	21,612.3	5,024.7	47,244.1	1,754.8	91.7	2,024.9
2005-06	13,019.0	21,277.0	5,547.0	44,666.0	2,055.7	88.0	1,568.0
2006-07	13,000.0	23,520.0	5,438.0	54,752.0	1,760.9	83.0	2,622.3
7-year average growth rate	**1.63%**	**1.23%**	**0.59%**	**1.87%**	**0.95%**	**-4.84%**	**4.96%**

The country witnessed unprecedented drought during the first two years of the decade, (that is, 2000-01 and 2001-02), which resulted in contraction of overall agricultural production or negative growth in these two years. However, the 7-year growth rates of agricultural crops compared with even the more normal levels in 1999-2000 are quite low and have failed to keep pace with the population growth rate of over 2.2 per cent annually.

The official statistics on fertiliser, water, and improved seeds distribution indicate some improvement. However, water availability has not materially changed during the past seven years not to mention the worsening power shortages and higher oil prices.

	Fertiliser consumption (N/thousand tons)	Water availability (million acre feet)	Improved seeds distribution (thousand tons)
1999-00	2,833.5	133.3	194.3
2000-01	2,966.0	134.8	193.8
2001-02	2,929.0	134.6	191.6
2002-03	3,020.0	134.5	172.1
2003-04	3,222.0	134.8	178.8
2004-05	3,694.0	135.7	213.8
2005-06	3,804.2	137.8	253.9
2006-07*	2,824.8	137.8	N.A.

*July-March

The Economic Survey for 2006-07 claims that this year's wheat crop was higher due to a number of reasons including a more seed availability, greater subsidy on fertiliser, introduction of three new higher yielding wheat varieties, etc. This begs the question as to why these measures were not taken in the earlier years because wheat production remained stagnant during 2000-2004 and even in 2005-06, it just managed to recover to its 1999 level.

This underscores the need to undertake major reforms in the crops sector to bring the long-term growth rate to a level that is consistent with the population growth trends. However, improving growth rates in crops production alone will not be enough to bring the 74 per cent poor out of poverty; that is those who earn around or below $2 a day. Rural population accounts for 70 per cent of the total but 80 per cent of Pakistan's poor live in the rural years. Agriculture (including both crop and livestock production) accounts for only about 40 per cent of rural household incomes and the poorest 40 per cent of rural households derive only about 30 per cent of their total income from agriculture.

According to the World Bank, a major reason for the large proportion of rural non-agriculture poor in Pakistan, as well as poverty levels among small farmers, is the prevailing "highly unequal distribution of land and access to water". According to the 2000 Agricultural Census, only 37 per cent of rural households owned land, and 61 per cent of these land-owning households owned fewer than five acres, or 15 per cent of total land. Access to usable water is also quite unequal, a major cause of lower productivity in the dry lands (barani) relative to irrigated land, land at the tail end of watercourses relative to land at the head end, and areas with saline groundwater as compared with areas that have sweet groundwater.

"Because of this skewed distribution of ownership and access to productive assets, much of the direct gains in income from crop production, particularly irrigated agriculture, accrue to higher-income farmers" according to the World Bank study. This implies that much of the gains from the recent growth in the crop production in 2005-07 have accrued to the higher-income farmers. It is ironic that the same higher-income farmers pay little or no income taxes while the small farmers and the poor are regressively taxed in the form of higher inflation. This reinforces the view that despite higher overall GDP growth, higher food inflation and inequitable distribution of resources have prevented the flow of benefits to the vast majority of the people and no amount of the so-called "trickle down" can have a significant impact on their incomes and living standards in the absence of radical reforms in the agriculture sector as well as about an estimated $17 billion in investments in large and smaller dams to ensure more water and electricity without which 7-8 per cent growth rate is likely to remain a dream in the long-term.

June 18, 2007

Real income growth lags behind Asia

Pakistan ranks as the seventh most dangerous country in the World after Iraq, Sudan, Israel, Russia, Nigeria, and Columbia in a 121-nation study undertaken by the Economist Intelligence Unit. While such rankings can be subjective (it may be the 10th or 11th), this is not good news for the present government which claims that Pakistan has made unprecedented economic progress during its tenure and has recorded one of the highest GDP growth rates in the world. The reality is Pakistan's per capita GDP growth has been one of the lowest in Asia and below the average of all low-income countries in the world during 1999-2006, when measured in purchasing power parity terms as per the data contained in the World Bank's Development Indicators released on 15 April 2007.

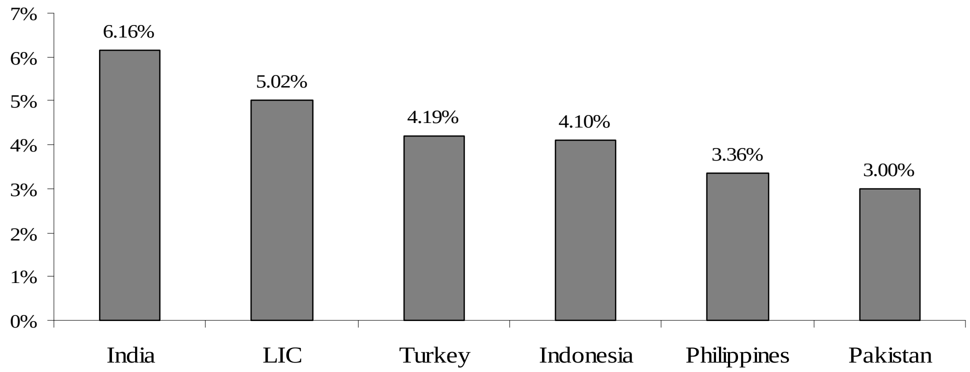
The government uses statistics to make claims that cannot stand simple logic tests and independent validation. For example, it cites the rise in per capita GDP to $833 in 2006 to support its claim that incomes in Pakistan have doubled in the past 6-7 years and Pakistan will soon become a middle-income country. This is simply misleading. The following analysis based on the World Bank's recently released statistics reveals the true picture of the economic growth in Pakistan relative to the other developing countries.

A widely recognised indicator of the level of prosperity of a country is gross domestic product (GDP) on purchasing power parity (PPP) basis. Since nominal prices of different goods and services vary from country to country, this method of measurement neutralizes those nominal differences by comparing what a similar basket of goods and services would cost in different countries. Hence, GDP measured on purchasing power parity basis is considered a more accurate measure of income level and standard of living.

Measured on this basis and as shown in the graph, Pakistan's yearly per capita income growth rate was only 3.0 per cent during 1999-2005 and lagged behind not just India's 6.16 per cent but also that of similar developing countries with large populations, like Indonesia, Turkey, and the Philippines. These growth rates were derived from GDP per capita data on purchasing power parity basis in constant US dollar terms, as published by the World Bank.

While one-year data should not be used to comment on longer term trends, the above data for the seven years belies government's claims about one of the highest growth rates in the world and confirms the belief that the benefits of growth during the recent years have been somewhat eroded by a persistently high inflation. It is only logical that Pakistan with one of highest inflation rates in the developing world should see a slower growth in the real incomes and living standards when the rest of it is growing at 6-7 per cent with lower inflation averaging about 4-5 per cent compared to Pakistan's 8-9 per cent. Hence these indicators are unlikely to change materially in one or two years.

GDP per capita growth on purchasing power parity basis
(Average per year: 1999-2006)



LIC = Average for low income countries

Other important World Bank development indicators (2005) also confirm the view that Pakistan remains behind its peers as shown below:

	Pakistan	India	Indonesia	Philippines	Turkey
GDP per capita (PPP) US$	2370	3452	3843	5137	8407
Domestic savings % of GDP	14.0	29.7	26.6	10.5	18.2
Infant mortality rate (per 1000 live births)	79	56	28	25	26
Primary school enrolment (%)	68.1	89.7	94.3	94.0	89.3
Electric power consumption (KWh per capita)	425	457	478	597	1781
Military expenditure as % of GDP	3.36	2.87	0.94	0.82	3.22

Among this select group, Pakistan has the lowest per capita income in purchasing power terms, the lowest primary school enrolment rate, the highest infant mortality rate, the lowest electricity consumption per capita (a measure of progress as well as industrialisation), and the highest level of military spending as a per cent of GDP. This is not surprising except for one indicator. Contrary to the widely held view among apologists and supporters of military dictatorships in Pakistan, the real per capita income is not only higher in India but the gap has increased since 1999. In that year, India's per capita income was 25 per cent higher than Pakistan's and in 2005 it was 46 per cent higher in purchasing power parity terms.

This is not to say that Pakistan has not made any progress but to put it in a more realistic perspective beyond a narrow set of indicators like GDP growth, bank lending, consumption, foreign investments, etc. Progress in GDP growth terms has been good for most periods of Pakistan's history when military ruled the country. Yet, after the end of every military regime, the so-called progress turned out to be a bonanza that benefited a few at the expense of critical national development priorities while exacerbating social and regional polarisation.

Assuming the elections will be held as per schedule even though the possibility of the imposition of emergency or even martial law cannot be ruled out; it is an appropriate time to judge the performance of this regime in the context of Pakistan's history that has revolved around a debilitating cycle of military intervention, half-hearted reforms, failure, demoralization and breakdown. We now appear to be passing through the disenchantment and demoralization phase.

Hitherto friendly international media has turned negative and some leading American papers have commented editorially on the gravity of the crisis. The New York Times in its May 23 editorial commented, “A succession of uniformed dictators has misruled Pakistan for more than half of its 60-year history. All have advertised themselves as great friends of Washington, but all have fanned extremism while discrediting America's reputation among ordinary Pakistanis. There is no security with General Musharraf. The United States belongs on the side of Pakistani democracy.”

Never mind the crisis, the Prime Minister’s statements about the state of the economy and its prospects appear to be oblivious of worsening macroeconomic indicators and of growing anxiety in the street and the ‘bazaar’. It is claimed this year’s GDP growth will touch 7 per cent, but the credibility of the government’s statistics is seriously questionable. According to its own data, inflation and exports target are going to be missed, development spending level is way short of target, current account deficit is forecast to reach 5.5-6 per cent of the GDP, and large scale industrial production growth has slowed down to 8 per cent compared to 10 per cent in 2006, notwithstanding the fact the Federal Bureau of Statistics has not released quarterly manufacturing data after the first quarter of the current fiscal year as it did in the past.

The stock market continues to rise, charges about manipulation notwithstanding, but the foreign investors’ buying has reduced to a trickle (about $5 million during May) after hitting a peak of $112 million during March 2007 and dropping to $52 million in April. Government borrowings have almost trebled to Rs 212 billion during the current fiscal year from Rs73.5 billion last year. The crowding out of the funds to the private sector, accompanied by a more than 100 basis points increase in the average lending rate during the past year, cannot but negatively affect the growth in the next twelve months.

Given the below average growth in rural areas and the concentration of 50 per cent of the urban population in the six largest cities to which bulk of the so-called ‘trickle down” seems to have been taken place; the high food inflation, growing income inequality and ostentatious consumption have only served to alienate the lower and lower middle income groups from the current regime. According to a public opinion poll conducted by the International Republican Institute (IRI) in March 2007, the economic issues received a much higher intensity of responses than did the non-economic issues with 92 per cent of Pakistanis terming inflation as the most important issue followed by unemployment (85 per cent). The country needs to face more fundamental questions of far reaching implications in the coming months in what is supposed to be an election year. The opposition parties should offer concrete and comprehensive programs to address core economic issues instead of merely criticising the government for its failures.

With the growing political uncertainty, the economic growth in Pakistan faces greater risks compared to its Asian competitors given its mush higher dependency on foreign exchange flows including remittances, investments and aid in that order. The foreign investors’ buying of stocks has slowed, the privatisation program is in trouble and the property market in Karachi is quiet. The biggest risk is the General will use the spreading disorder and the actions of an increasingly assertive judiciary and lawyers' community as justification to tighten the autocratic grip on power. This may cause the foreign capital flows to dry up, trigger a fall in stock and property markets, exacerbate the current account position, and increase pressure on an over-valued rupee to depreciate. A beleaguered administration is not in a position to impose new taxes and may find it difficult to contain the budget deficit at the current level. Neither it can afford to make big cuts in the development expenditure and is therefore likely to borrow more or print money. This will keep the upward pressure on interest rates to the detriment of the overall economy.

Even if the General manages to come out of this crisis, it may come at a cost of sharing greater power with the politicians with his authority considerably weakened in the process. In this scenario, although the overall direction of the economic policies is unlikely to change, the uncertainty will not disappear as any alliance between the generals and the 'liberal' parties may serve to unite the rest of the opposition and provoke them into challenging the government with even greater force. In any event, a greater period of uncertainty seems to lie ahead and will continue to cast its long shadow on the economy until the current crisis resolves.

June 4, 2007

Economy: illusion of progress

Seventy four per cent of Pakistan's population survives on a daily income of less than Rupees 120 (or $2) a day according to the recently released World Bank's World Development Indicators. While the government uses a different definition of poverty, the international definition of extreme poverty implies daily income of less than $1 and that of moderate poverty, income of $1 to $2 a day. The percentage of Pakistanis living below the poverty line (income of less than $2 a day) is much higher compared with 58, 43 and 9 per cent in Kenya, the Philippines and Malaysia respectively.

Given that 74 per cent of people survive on less than the official minimum wage of Rs 4000, it is rather hard and even absurd to argue that anyone living on an income of less than the minimum wage is not poor. But that has not stopped the government from claiming a figure of 29 to 34 per cent as the one representing those who are poor. Furthermore, since even the official inflation rate has doubled from 3-4 per cent in 2002-03 to 7-8 per cent in 2006-07, the claims about any significant poverty reduction appear to be far removed from reality because the poor are most vulnerable to inflation particularly food price inflation which has been persistently higher than the overall consumer price inflation (CPI), which remains stubbornly high at 8 per cent and is unlikely to come down to this year's original target of 6.5 per cent despite the central bank's tight monetary policy.

The debate about the actual poverty levels points to the difficulty of commenting on the true state of the economy and development in a country where the statistics about even some key indicators like the GDP growth, employment, public sector spending, livestock and industrial production are not prepared and published on a quarterly basis; a norm in many developed and developing countries including India, Thailand and Vietnam for example. In the absence of transparent, reliable and regular flow of information, the discussions about the economy can often be quite subjective.

Most official estimates put current fiscal year's GDP growth to be around 7 per cent, driven principally by the services sector and to a lesser degree, by livestock and wheat production. However, other economic indicators like private sector credit, exports, foreign exchange reserves, textile production, and development spending show a deteriorating overall trend that stands in marked contrast to the rosy picture being painted by the government. The textile industry - with slowing exports, heavy debt-burdens and declining profits - is struggling against its more efficient international competitors although growing cement sales do point to a rise in construction spending. However, the electricity generation – an important indicator of overall economic activity- recorded a slower growth of 9.7 per cent during the first half of FY 2006-07 as compared with 12.9 per cent growth during the same period of last year.

Thanks to a double-digit growth in the banking, telecommunication, and oil/gas industries in FY 2005-06, the tax revenues in the current fiscal year are expected to cross their target of Rs 835 billion. However, the development expenditure for the first half of FY 2006-07 has achieved only 34 per cent of its annual target compared to 45 per cent during the corresponding period in FY 2005-06.

The defence spending appears to be flat but it is not clear how the government accounts for about Rs 60-70 billion per year in defence assistance that it receives directly from the United States. On the other hand, the government has not supplied any explanation for the lower level of the development expenditure during the current year. Still, it claims that the fiscal deficit will remain within the target of 4.2 per cent of the GDP. It is possible that the development spending (including spending on higher education) has been curtailed to meet this target.

Also significant is the drop in the bank-lending growth to around 3 per cent in real terms. A liquidity boom, best represented by a surge in the bank lending and consumption levels, has driven the GDP growth since 2002. During the period July 2006-April 2007, the bank lending growth slowed down to 12.6 per cent in nominal terms compared to 19.8 per cent a year earlier. If one agrees that the bank lending is one of the most critical economic indicators in Pakistan's context, the economy is likely to slow down in the next fiscal year.

The current account deficit for the first nine months of the current fiscal year has widened to \$6 billion (\$4.3 billion in the corresponding period last year) and may reach around \$8 billion or 5.4% of the GDP – its highest percentage level since 1996-97. This has been caused by 15 per cent deterioration in the trade deficit to about \$11 billion during July 2006-March 2007 from \$9.6 billion a year earlier, as exports growth of 3.6 per cent has fallen behind an 8 per cent growth in imports. However, the record foreign direct investments of \$3.9 billion during the first nine months of the current fiscal year (\$2.2 billion in the corresponding period last year), \$1.7 billion in overall portfolio investments (\$1.1 billion last year) and remittances of \$3.9 billion (\$3.2 billion last year) have prevented a deterioration in the foreign exchange reserves position and have limited the depreciation of Pakistan rupee to only 0.7 per cent against the US dollar since July 2006.

The stock market has hit an all time high with foreign investments setting another record of \$770 million during a single fiscal year, notwithstanding slower corporate earnings growth. However, the privatisation process – a key driver of the stock market performance since 2002 - appears to have come to a grinding halt, the bidding for the sale of Pakistan State Oil Company has run into legal and other problems, and it now looks improbable that it will be privatised by the next month as was planned.

The Prime Minister and his economic managers maintain that Pakistan is all set to become an Asian tiger with the GDP growth to continue at the rate of 6 to 8 per cent or even higher in the foreseeable future. Some international institutions (some respectable and some with questionable credentials) have also come up with favourable views about the current economic situation and the outlook. Some of the World's most famous and powerful investment banks have tarnished their reputations in the past by presenting rosy prospects of the issuers whose paper (company shares or bonds) they were trying to sell. It is therefore important to take note of the latest World Bank report on Pakistan (released on March 30) that maintains that the rural growth is crucial to Pakistan's future since *"two-thirds of the country's population and 80 per cent of the poor live in rural areas; unless there is sustained progress in these areas, rapid overall economic growth and poverty reduction are impossible."*

The report observes, *"not all improvements in incomes are the result of government policies or sustainable increases in private-sector productivity."* It maintains that the "impressive gains" in agricultural output and real incomes of the rural poor relative to 2001-02 levels is in part a reflection of low output and incomes in that year due to drought and other adverse shocks. It points out that the longer term agricultural GDP per capita growth rate (1999-2000 to 2004-05) was only 0.3 per cent annually and much of the improvement in total incomes can be attributed to a steep rise in net private unrequited transfers from abroad (including workers' remittances). By 2006-07, these transfers rose to more than Rs 3,000 per person for

Pakistan's entire population, equivalent to more than two-thirds the real output of crop agriculture or livestock production. Yet, these transfer incomes may not continue to grow at the rates of recent years.

Hence, the discussions about the potential "population dividend" appear to be out of touch with ground realities. Pakistan has received a massive liquidity injection of about $50 billion in remittances, aid, debt relief, earthquake assistance and privatisation proceeds during the last five years, and a cyclical consumption boom accompanied by an extraordinary rise in the real estate prices in the urban areas has created an illusion of progress.

However, highly speculative stock and real estate booms and busts cannot enable Pakistan to compete with India's 8-9 per cent GDP growth rate. A reality check: our national primary school enrolment rate for girls is only 48 per cent (42 per cent in rural areas), compared to 86 per cent in India. High growth rate is impossible without greater female literacy and participation in the work force. Infant mortality – a key health indicator - per 1000 live births is 82 in Pakistan (88 in rural areas), compared to only 62 in India, 56 in Bangladesh and 12 in Sri Lanka. Another reality check: on April 27, Pakistan made a request for a loan of $17 billion from international lenders for the construction of Diamer-Bhasha, Kalabagh and Akhori dams by 2016 to "avert flood, drought and energy crisis" according to the officials.

In conclusion, the economy is likely to slow down in 2008 onwards as the liquidity-consumption-driven growth cannot last for more than a few years and is unlikely to sustain the current growth rate in the backdrop of growing political instability, worsening energy crisis, shortage of skilled and educated workers, and a protection-addicted private sector – often lacking management depth - that is struggling to compete internationally.

May 14, 2007

Political economy model of a security state

The threat of Talibanisation and the alleged ‘deal’ between General Musharraf and Benazir Bhutto have dominated the news recently. The two subjects are perceived to be interlinked in that some analysts see the need for an understanding between these parties as something that would benefit both at a time of a seemingly growing threat from the extremist forces and tensions between Islamabad and Washington. However, some of the fundamental questions raised in last week’s article must be addressed before one jumps to welcome the possibility of a rapprochement between the government and the People’s Party as need of the hour or condemn it as a sell-out.

This article argues that both viewpoints may turn out to be redundant if the establishment, the politicians and the media do not address basic and crucial questions about the future direction of Pakistan’s political economy. Power sharing adjustments between military leaders and civilian politicians have taken place before but failed to bring either stability or prosperity to the country. This time, the stakes are even higher. Pakistan cannot afford to live in a state of continuous external or internal conflict because it is receiving aid to do so. Demands “to do more” to stop the Taliban insurgency in the north have destabilised Pakistan. Asking to provide logistic support in the event of an air strike against Iran may turn out to be a nightmare.

Therefore, the most critical question that merits further and deeper discussion is whether the political economy model of a security state that Pakistan has practiced - and one that can rightly be termed as a failure - can survive in the 21st century. Before one explores that question further, it may be useful to discuss some salient features of that model in the context of Pakistan’s recent history.

The focal point of this security state has been the threat - both real and exaggerated - from India and the stated need for a large standing army and its need for military hardware and money. The army governed with the help of two principal alliances until the 1980s. Externally, by aligning its foreign policy with the global and regional interests of the United States; and internally by forming partnership with the economic interests of the big feudals and businessmen. The external alliance provided weapons and money that benefited the military and provided the ‘aid’ that was used to finance fiscal and current account deficits.

The development issues such as land reforms, the need to broaden the tax net, develop export-oriented industries were put on the back burner. A combination of aid, subsidized loans, protectionist trade policies and a lax tax regime benefited the civil and military bureaucracy, inefficient industries and tax evading business magnets. This bought the military their support at the expense of the vital economic reforms that should have been undertaken to prepare Pakistan for the 21st century.

While China, Korea, Taiwan and the rest of East Asia countries adopted policies for exports-led growth, the trade regime in 1988 [at the end of Zia ul-Haq’s rule], according to a World Bank report, *“still seems to be biased in favour of import substituting production. Domestic markets are insulated from foreign competition through non-tariff barriers and high tariffs.”* In 1988, Pakistan’s nominal tariff rates (around 66 per cent) for manufacturing industries were among the highest and Pakistan’s tax-to-GDP (13.6 per cent) was among the lowest in the developing countries.

These policies were instrumental in promoting the robber baron culture under a patronage-driven protectionist economy that was incapable of standing on its feet in increasingly competitive international markets where skilled and educated workforce and not the size of its army became a measure of a country's potential.

The average expenditure on education as a percentage of GNP was criminally low at 0.8 per cent in the 1980s as General Zia and his corrupt cronies (who made fortunes) boasted of defeating the Soviets. While Afghan war, nuclear program, Islamisation, non-party elections, ethnic and sectarian conflicts and other such issues dominated the headlines, the real 'political economy' or the game was mostly about protecting the security state apparatus that provided the maximum benefits to key stake holders, that is, the army, big business and landed elites.

In 1985, Mohammed Khan Junejo appointed Mahbub ul-Haq as finance minister. Haq called for the vigorous collection of revenues through taxation to generate economic growth from domestic resources. His reformist agenda drew loud protests from these vested interests. The protests led to his removal as finance minister in January 1986, after less than a year in office.

Junejo wanted a quick end to the Afghan war, which had provided a steady source of billions in income for the military establishment's supporters through arms and drugs trafficking. Junejo met the fate of his finance minister and was dismissed in May 1988.

In the backdrop of Zia's death, the end of Afghan war, and the stoppage of aid from the United States, the economy was in a bad shape with the fiscal deficit reaching 7 to 8 per cent of the GDP. Zia left Pakistan close to $22 billion in external debt (50% of the GDP) that had climbed from $8.7 billion in 1978. During his tenure, overall debt, including domestic and external debt, increased to around 80 per cent of the GDP, while defence expenditure rose annually by 9.2 per cent, with public spending on social development a mere 3.2 per cent per annum, or negative in real terms. By the time of his death, the army had become quite unpopular and the establishment decided wisely that it was time to share power with the politicians (although real power stayed with the military) because that was "the need of the hour."

During the 1980s, the military-business-feudal alliance was expanded to officially co-opt the extremist religious forces. The militants were given a virtual license to carry on all kinds of illicit trade to finance themselves, make illegal encroachments to build mosques and madarassas, to receive money from abroad, etc. The Afghan war involved the biggest covert operation ever undertaken by the American CIA, which provided nearly $700 million in secret funds to the military [during 1982-1987] to finance the jihadis. This gave birth to a Frankenstein that was going to do irreparable damage to the rule of law, criminalise the society and haunt the masters of the political economy of aid and patronage for decades to come.

The Afghan war ended but the political economy of a security state needed another conflict to sustain itself. Abandoned by the United States and eager to flex its muscle like a spoiled brat, the establishment decided to start the jihad in Kashmir forgetting conveniently that it had all but officially abandoned that 'cause'. The establishment clashed with both Benazir Bhutto and Nawaz Sharif, who wanted to make peace with India and disengage Pakistan from adventurous and costly pursuits. The jihadis' cross-border operations reached to a point that Pakistan came quite close to being declared a terrorist state.

The adventures culminated in Pakistan exploding the nuclear device in 1998 although the wisdom of doing so was highly questionable because as long as Pakistan had the nuclear weapons capability, it did not really matter whether it announced this with a bang or not. This led to the first ever default of its foreign currency deposits' obligations and sanctions from the United States. The 9/11 provided a godsend opportunity to end Pakistan's international isolation and repair historically close relations with the United States. Since then, the economy has done well by traditional measures (so it did in GDP growth terms during Zia's regime) following an injection of $10 billion in the US aid and $22 billion in remittances. But more crucially, the biggest casualty of 'easy money' has been the reforms agenda that General Musharraf undertook to implement when he took power.

The economy remains largely un-documented, the tax-to-GDP ratio has fallen to a level even below that of 1988, stories of mega corruption abound, and no land reforms have been introduced although the establishment and its supporters have never stopped criticising Bhutto even 28 years after his death for not doing enough. The underground economy continues to flourish with tax and money laundering havens in real estate and stock trading while Pakistan's external debt-to-GDP ratio remains worse than even that of Sub-Saharan African countries. Yet, some Pakistanis mistake the presence of BMWs on roads as a sign of progress. If a nuclear-armed Pakistan, with claims of one of the fastest growing economies in Asia, is as strong as the government leaders would have us believe, why it is that just some articles in the New York Times and press briefings of the US state department can cause tremors in the corridors of powers in Islamabad?

Until and unless Pakistan's establishment and the political parties are prepared to undertake critical economic reforms to mobilise domestic resources to produce economic growth and reduce dependence on sporadic flows of 'aid money', it would be naive to expect any real change. Pakistan does not need "aid money" any way if the military wants to make peace with India as most of the aid goes to buy military hardware that may never be used. Unless of course, the establishment has found a new nemesis in Afghanistan's Karzai or a bogeyman in Lal Masjid to continue to justify its insatiable appetite for aid and arms to keep its hold on power at the expense of a stable, democratic and well governed Pakistan.

April 16, 2007

Political economy model and instability

The lawyers' community has shown remarkable unity in rising against the unprecedented actions against the Chief Justice of Pakistan. The political parties are calling it an assault on the judiciary while the government has maintained that the opposition is politicising what it calls a 'constitutional matter'. This characterisation is an oxymoron because politics, by definition, concerns all matters concerning governance and the three branches of government including the judiciary. The media has been outspoken in its coverage. Prominent former judges have termed this crisis as a defining moment in the history of Pakistan. Some analysts have described it as a pre-emptive strike by General Musharraf to continue to don the uniform and tighten his grip on power in the backdrop of growing unease in the West over his failure to stop the Taliban insurgency but more importantly the perception that his support in Washington may be waning.

This article argues that military rule, by systematically damaging the rule of law, has imperilled Pakistan's development prospects and the current crisis needs to be debated in that broader and fuller context. It is old news that the Pakistan's military rulers have always operated above the law and have never been accountable to the courts despite pretensions to the contrary. The conquest of the judiciary will remove even that pretence and will destroy whatever is left of that institution.

The business community seems to be watching from the sidelines hoping that this crisis will somehow get resolved and it will be business as usual. Pakistan's successive ruling establishments, business elites and many former World Bank trained economists have been admirers of the economic growth achieved during different military regimes and point to the higher levels of aid flows, in particular the aid from the United Stated, as an important element of "better" economic performance.

The role of economic aid has been exaggerated and is not supported by facts. From 1980 to 2007, remittances from Pakistanis abroad accounted for a much greater share of external financing requirement than foreign aid and borrowings from all sources combined. For example, while the US aid package for General Zia's regime was $3.2 billion during 1982-1987, remittances were five times as high at $15.2 billion during this period. Furthermore, it must not be forgotten that the remittances during the five years post 9/11 reached an aggregate of $22 billion compared to just $5.3 billion during the five-year period before 9/11.

While it is true that since 9/11, US military aid alone totalled almost $4.75 billion from October 2001 to August 2006 in addition to the $3.6 billion five-year economic assistance package, one cannot build a model of political and economic development that involves a continuous state of external conflict be it the "jihad" against the soviets in the 1980s or the "war on terror" since 2001. It can be argued that costs of the conflict, that is, the breakdown of the rule of law, criminalization of society due to drugs and arms trafficking, and the decline of the state power due to the rise of powerful non-state actors such as violent extremist groups, have far outweighed the economic benefits that may have accrued from such 'aid'. Equally importantly, the 'aid addiction' has encouraged the governments not to undertake critical economic reforms. For example, Pakistan will hardly need any external aid if it could increase its tax-to-GDP ratio from a lowly 10% to 15%.

Going beyond the issue of aid, the question that has not received the level of in-depth attention it deserves is whether the model of the political economy of a security state that

Pakistan has followed since the late 1950s, except through a brief interlude during 1972-1977, can survive in the 21st century? The role of the government, super power or not, is shrinking and the private capital has emerged as a powerful driver of economic change in an increasingly globalised economy with international competitiveness emerging as a measure of a nation's strength and not its military prowess. The net aid flows to the developing countries account for just 10 per cent of private capital flows. The power of the World Bank and the IMF is on the decline, the future of multilateral institutions like the Asian Development Bank is being questioned, and the United States has resorted to the use of military power, in part, because its economic power has declined over the past two decades. The spectacular growth of China and India has been underpinned by stable political systems and skilled human resources and not by arbitrary governance, aid, or nuclear weapons.

For those who believe that Pakistan can progress under a military or quasi-military rule supported by the US, the supremacy of the constitution and the rule of law have been largely academic questions. This school of thought believes that so long as the military can maintain law and order - a euphemism for autocratic rule - and allow the private sector to do business and make money, Pakistan can do without the 'luxuries' like a sovereign parliament, an independent judiciary and the rule of law. Hence, it has never objected to the gradual and systematic emasculation of the judiciary. A top industrialist remarked that he is not concerned about this crisis and only thing that matters is that uncertainty is removed as soon as possible otherwise the economic growth may suffer. But GDP growth is not the most meaningful measure of progress and development.

Pakistan's average GDP growth rate was 6.66 per cent during the five-year period from 1963 to 1968. The GDP growth rate was 9.79 per cent in the fiscal year 1969-70, the highest ever in the last 50 years. Within the next two and half years, neither the 'record GDP growth' nor the military or the famous tilt of President Richard Nixon towards Pakistan could save the country from dismemberment and a complete collapse. Thirty seven years later, some of us do not appear to have learned that the military and the support of a super power cannot ensure the survival let alone success of a state. In the absence of a truly representative and sovereign parliament, an accountable executive, an independent judiciary and a genuinely free media there can be no hope of building a sustainable politico-economic system that can compete in today's highly competitive global markets.

The Global Competitiveness Report (2006-2007) published by the World Economic Forum, the elite club of World's political and economic leaders, states that while factors underlying competitiveness of nations are as diverse as they are numerous, the presence of macroeconomic stability is not enough. The report argues that equally important is **"the institutional environment within which economic actors operate, including the protection of property rights, the quality of judicial system, even-handedness in the political process, and the reining in of corruption."**

The report lists the institutional environment as among the most basic and critical pillars of development for poor countries like Pakistan; even more important than business sophistication and innovation. Pakistan is ranked 93rd out of 122 countries on the basic requirements while the report lists government instability/coups, corruption and policy instability as the top three most problematic factors for doing business in Pakistan.

Why then Pakistan has received a record amount of foreign investments in the last few years? The answer is not that difficult. The period since 2000 has seen the highest ever level of global liquidity accompanied by an all time high global GDP growth since the 19th century industrial revolution. But even during this period of extraordinary benign global economic environment, foreign investment flows into Pakistan have remained concentrated in three sectors (telecommunications, financial sector, and oil and gas) and have largely come from oil-rich states. These investment flows together with the US aid seem to have convinced the current establishment that Pakistan does not really need a real democracy and the rule of law. This is a short-sighted and dangerous view and suggests that those who so fondly remember Ayub Khan's economic performance have not learned the lesson that growth without development of the people but more importantly growth without building strong democratic institutions and establishing the rule of law could not be sustained and failed to stop the precipitation of the crisis that had been brewing under the Field Marshall for a decade and ultimately led to Pakistan's dismemberment soon after he left the stage.

April 9, 2007

External debt: false sense of achievement

Pakistan's official external debt has not gone down since 1999 although it has received record aid, investments, and remittances flows. It has gone up to $36.9 billion from $33.6 billion in 1999 despite receiving at least $10 billion in economic, military and development aid from the United States, over $6 billion in privatisation proceeds, and a relief of $1.6 billion in loan write-offs by foreign governments during the last seven years. The rescheduling of Paris Club debts provided an additional relief of $ 1.2 to $1.5 billion annually in terms of debt service payments. Is the government's debt management policy as sound and successful as it claims or a historic opportunity to restructure country's high debt levels has fallen victim to political expediency or a false sense of achievement?

Even after having received such generous assistance, Pakistan external debt to GDP ratio is 28% - slightly worse than Africa's 26.2%, which also happens to be the average for all the developing countries. The average external debt to GDP ratio of all emerging markets declined from 42.1% in 1999 to 26.2% in 2006, underpinned by strong growth in the global economy and record investment flows into the developing countries.

It is argued that the former Prime Minister Nawaz Sahrif left a heavy external debt burden at 53% of the GDP and the current levels represent a substantial improvement. The net debt flows (disbursements minus repayments) into Pakistan during 1990-1999 aggregated $5.4 billion compared to $1.1 billion during 2000-2006. Hence, the growth in the debt slowed down during the last seven years. However, post-9/11, Pakistan received generous foreign aid as well as much higher levels of foreign direct investment. Remittances averaged around $4 billion a year during 2003-2006 compared to an average of $1.5 billion in the 1990s.

Nevertheless, Pakistan's liquid foreign exchange reserves, after jumping to $10 billion-level in 2002-03, have more or less stayed around that level on average. The foreign exchange reserves of even Sub-Saharan countries (excluding South Africa and Nigeria) doubled to $50 billion during the same period. Brazil and Argentina repaid all of their $25 billion debt - by utilising their foreign exchange reserves - to the IMF in early 2006 to rid their countries of its influence.

In contrast, Pakistan has not able to reduce the external debt burden in absolute terms or build up its foreign exchange reserves. In fact, it has become the fourth largest borrower of the World Bank and the fifth-largest recipient of American aid to foreign nations. This shows its continued reliance on foreign governments and multilateral institutions - despite declarations of economic sovereignty - and a failure to mobilise domestic resources to pay for the development expenditure. Leaving aside all the technicalities and vague statements, there has been no convincing explanation for not having used the privatisation proceeds to reduce the external debt in a completely transparent manner?

Some policy makers argue that it is acceptable to borrow if the borrowing is for productive purposes. That is theoretically correct. However, if the borrowing record is littered with corruption and wasteful spending, and major sectors of the economy (large agriculturists, stock brokers, property barons, etc.) do not pay any tax at all, the proposition becomes quite debateable and the motives questionable. This is a critical issue for Pakistan's political economy because the subject of external debt has been a highly political one for most of Pakistan's history since it has relied heavily on the US and institutions under the US influence for its external financing needs. So have many other developing countries - though not necessarily to Pakistan's extent - in the past but most no longer do. This type of aid has been associated with corruption, waste and increasing debt burdens. It has even been viewed as a payoff to the third world dictatorships for their support and aid in helping the US in achieving its foreign policy objectives that have often clashed with the national interests of the borrower countries.

For example, the recently proposed US law, aimed at punishing oil companies that deal with Iran, will make it even more difficult to construct the Iran-Pakistan-India gas pipeline. Pakistan must import natural gas from Iran to meet an imminent shortage during the next few years. On the other hand, recent moves in the US congress threaten to cut military aid to Pakistan if it fails to "do more" and stop the Taliban insurgency from its tribal areas.

The government claims that it no longer borrows from the IMF and does not carry around a begging bowl. This is quite misleading because it has been borrowing more and more from other multilateral institutions like the World Bank (WB) and the Asian Development Bank (ADB). The borrowing from multilaterals has outpaced the borrowing from the Paris Club since 1999-2000. Its share in total public and publicly guaranteed debt has increased from 37.5 per cent to 50.2 per cent in 2006. Consequently, whilst the government has made progress in raising money from the international capital markets – a welcome and positive development - official sources still account for 90 per cent of Pakistan's external debt, including the WB/ADB [48%] and foreign governments [38%]. IMF's loans rarely exceeded 5-6% of total external debt as it normally provided the balance of payments support and not long terms loans that constitute the bulk of our external debt.

The present government has criticised the previous governments for the accumulation of almost $ 18 billion debt in the 1990s and increasing Pakistan's debt burden. While it is true that the debt accumulation in the 1990s was large, critics of the civilian governments conveniently overlook a key statistic: 77.2% of the gross disbursements during 1990-1999 were utilized to repay the old debts. The debt-service to gross disbursement ratio jumped to 82.8% during 2005-2006. The continuing increase in this key ratio throughout the 1990s and even during 2000-2006 indicates that more and more of new loan disbursements were used to repay the past debts; a significant percentage relating to the borrowings during the previous military regime of General Zia-ul-Haq. Pakistan's total external debt that stood at $8.7 billion in 1978, reached about $22 billion (50% of the GDP) by the end of the 1980s. That Pakistan had to borrow more later in the 1990s just to service some of the old debts indicates that the loans were not properly utilized as they did not contribute to the development and therefore to the debt servicing capacity. This raises serious questions about the whole wisdom of politically motivated borrowings from the foreign governments and the institutions under their control.

It is therefore fair to ask whether any cut in aid from the foreign governments would be of real significance from a development perspective and particularly in a global economic environment when the private capital flows (through foreign direct investments and international capital markets) have become the dominant source of financing to the developing countries. As a group, they reduced their total external debt to the foreign governments and multilateral institutions (WB, IMF, ADB, etc.) through net repayments of $48 billion in 2006 whilst attracting a staggering $502 billion in net private capital flows. Pakistan's vicious cycle of borrowings from foreign governments and multilateral institutions, graft, waste, and accumulation of more debt to repay the old debts leads one to believe that the rulers have been putting excessive burden on the people and mortgaging their future by borrowing more and more while indulging in wasteful and unproductive spending

while the ‘big fish’ get away with not only benefiting from the “development projects” financed by external borrowings but also with paying no taxes.
Pakistan’s foreign (or hard currency) debt to total debt (that is, including domestic debt) ratio of 47 per cent is high compared to an average of 28 per cent for emerging economies. Given our long term track record of using foreign debt to indulge in wasteful expenditure, it would be in the best national interest to set up a special fund (in a hard currency, be it US dollar or Euro) to accumulate all the privatisation proceeds and use that for the early retirement of our external debt. Some countries, like Russia, have set up hard currency stabilization funds to provide for the rainy days.

However, this would be just one among a series of measures needed to reduce dependence on foreign debt. We must cut imports and reduce the rapidly deteriorating current account deficit that has prevented a build-up of foreign exchange reserves since 2003. We must also strive to increase the tax to GDP ratio from 10 per cent (one of the lowest) to 17 per cent within the next 5 years instead of making far-fetched 10-year plans.

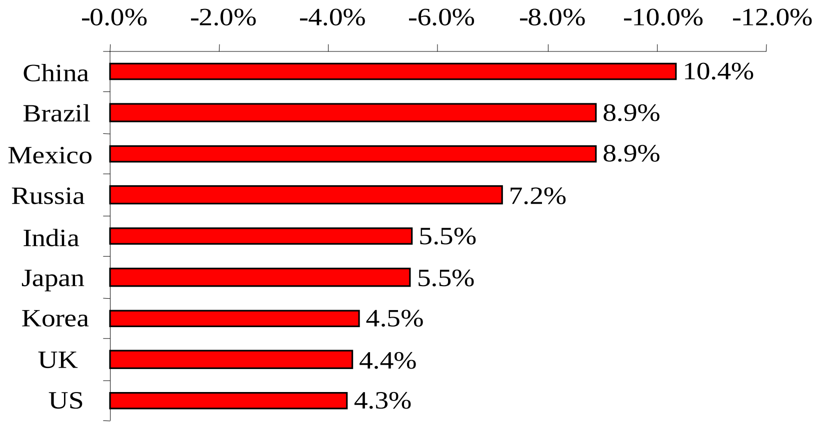
The world today is experiencing unprecedented economic growth with huge pools of liquidity seeking investment opportunities. If Pakistan can reduce its macro imbalances by reducing foreign debt and mobilising domestic resources, it can attract a much greater level of foreign direct investment and achieve greater economic freedom. Shall we rise to the challenge or we will once again squander away a historic opportunity?

March 12, 2007

Global stock markets turmoil: more to come?

The sell-off in global stock markets started during the last week of February 2007 wiped off about $1.2 trillion of investors' wealth worldwide. It started with nearly a nine per cent plunge on Tuesday February 27 - worst in a decade - in China's main stock market, which had a hit a new high only a day earlier. The US market followed the plunge same evening and fell by 3.5 per cent – a daily record decline in more than three years. Asian markets, which had all shrugged off Tuesday's decline in Shanghai, dropped sharply on Wednesday morning in response to the heavy selling in Europe and New York. Most stock markets finished the week down five to nine per cent.

Major Stock Markets
Per cent decline last week



The markets had started the New Year on a generally positive note but last week's fall erased gains of the major equity indexes and sparked fears of a general flight from risky assets, such as equities and emerging markets, to cash and bonds. The VIX index, a measure of volatility (or risk) in global financial markets, shot up by 75 per cent to its highest level since July 2006 as the markets swung wildly during the week.

Was this a healthy correction or the beginning of a bigger tumble in weeks or months to come? In 2006, US stock markets dropped by about 8 per cent during May-June and Emerging Markets by about 20-25 per cent but recovered four/five months later to climb to even higher levels.

Shanghai's index – dominated by state-owned banks and property companies- is hardly a barometer of the Chinese economy and accounts for less than one per cent of the world's market capitalisation. Domestic retail investors drive the market as China restricts the foreign investors to a quota. The market has more than doubled in one year and almost tripled since June 2005 and currently trades at a price to earnings (P/E) multiple of 31 compared to 15 in the United States. Stock trading has spread like a mania in China's big cities with taxi drivers, office workers and sundry taking punts on their favourite stocks. Earlier, the Chinese government had warned banks about improper loans to finance stock speculation. Hence, the plunge, though large, was not without precedent when such feverish conditions exist. What was surprising that its tremors were felt globally.

The timing of the comments of former Federal Reserve chairman Alan Greenspan did not help the US markets. On Monday, he said that a US recession is possible (but not probable) by the end of this year. “Profit margins suggest the economy is in the later stages of a cycle”, he added. The following day, the data for the orders placed with US factories for capital goods reported the biggest drop in four months indicating slowdown in investment spending. More negative economic data came on Friday. The US consumer confidence for February fell to 91.3 from 96.9 at the end of January, reaching a five-month low as concerns over incomes and jobs in a slowing economy weighed in. The US stocks finished the week with their biggest weekly decline in almost four years.

Nevertheless, it is difficult to attribute last week’s record drop to just economic causes or fears of a slowdown in the US or China. These concerns have been frequently voiced in the recent past but the markets continued their rise. While it is always easy to have the benefit of hindsight, it appears that investors were simply looking for excuses to take profits. A decline looked overdue. Wall Street had enjoyed its longest period without a 2 per cent daily fall for more than five decades. Margin debt— the money investors borrow from brokers—had just passed its previous peak in March 2000, recorded during the dotcom bubble.

Last Tuesday, it was not just the stock markets that dropped. US dollar lost 2.25 per cent against Japanese Yen while it gained against most emerging market currencies. The yen's recent strength has been a concern to stock-market investors, as many hedge funds borrow in yen to fund trades made elsewhere in the world. Should the yen appreciate too rapidly, the "carry trade," a popular strategy in which investors borrow in low-yielding yen to invest in higher-yielding assets, could unwind further and exacerbate market declines and volatility.

Many analysts believe that the fall in the Chinese market may simply have been the wake-up call the bulls needed to take a closer look at the risks they have been taking and at the stock valuations. While this may be true from a short-term view, the fundamental reasons for longer-term bullish behaviour go beyond the US economy or complacency of the investors.

The over arching reason is actually quite simple. Since 2000, world GDP per head has grown by an average of 3.2% a year, beating the previous record of 2.9% annual growth during 1950-73, when Europe and Japan were rebuilding their economies after the war. This means that the first decade of the 21st century could see the fastest growth in average world income in the whole of history.

Emerging economies are now a key driver of global growth and have a far greater influence on the performance of the rich economies than is generally realised. The rich countries no longer dominate the global economy. In 2005, the combined output of emerging economies reached an important milestone: it accounted for more than half of total world GDP (measured at purchasing-power parity). They no longer are net borrowers as they were in the 1980s and 1990s and are running record current account surpluses. Their combined foreign exchange reserves now represent nearly 60 per cent of the world’s total and are a major source of financing the US current account deficit and of liquidity to the global financial markets.

This emerging economies’ growth has coincided with a tripling of the oil price since 2001. The oil producing countries in the Middle East have generated excess liquidity of around $400 billion in the last five years and their estimated investment portfolios (since they do not disclose their foreign exchange reserves) are believed to have crossed $3 trillion.

A lot of this money has been recycled by professional investment managers into global financial markets through different instruments like treasury bonds, debt products, hedge funds, private equity and stocks, etc. If bulk of this money was invested in real assets globally, the financial markets will not be so flushed with liquidity. An abundance of liquidity has increased risk-taking appetite - particularly for higher yielding assets - as volatility has declined to historic lows, except for periodic surges, compared to its long-term averages. Hence, investors have been willing to make bigger and often more leveraged bets on risky assets than they were in the past.

Any surge in volatility drives the investors to sell investments perceived to have higher risk or those that involve the use of debt such as the “carry trades”. Emerging Markets stocks are one example of assets perceived to have higher risk.

It is clear that the emerging markets were hit harder last week, compared to the developed markets despite their relatively higher growth potential and lower valuations. This appears to have been anticipated by some investors who withdrew money from emerging markets funds. Emerging markets equity funds had net outflows of $600 million in the week ended Feb 28, 2007 after 19 weeks of inflows out of 20. Since October 4, 2006, when flows turned positive after $18 billion of outflows that started with the May 2006 sell-off in emerging markets, cumulative aggregate inflows stand at US$19.2 billion, with Asia accounting for 72% of the total. During 2007, aggregate flows of $6.1 billion compare to $14.5 billion during the same period in 2006 and US$2.4 billion in 2005.

Pakistan received about $275 million in foreign investors’ flows in 2007 and this together with strong support from local investors enabled its market to post good gains in January. It lost about 4 per cent last week. With the reversal of global equity flows, local investors will be watching the foreign funds’ managers to see if they will trim their bets on Pakistan’s market. If they do, Pakistan’s market may have more downside in the coming weeks and months. But is there a bubble in the global stock markets that is about to burst? If valuations are any indication, the answer is a NO.

March 5, 2007

The myth of energy routes through Central Asia

Prime Minister Shaukat Aziz told the third annual Oil & Gas conference that Pakistan plans to proceed with plans to build a gas pipeline from Iran even if India pulls out from the project because its energy needs are expected to more than double by 2020. It has taken a few years for the government to realise that transporting gas from the Central Asian republic of Turkmenistan is not a practical option. On December 27 in 2002, Foreign Minister Kasuri signed an agreement - in the presence of Afghan President Hamid Karzai - in Turkmenistan to construct a gas pipeline that was supposed to pass through Afghanistan. It was announced that the trans-Afghanistan pipeline would export Turkmen gas via Afghanistan to Pakistani ports, from where it could reach world markets. Nothing has happened since then because little or no thought was given to the fact that laying any pipeline through Afghanistan might not be possible for a long time to come, and Turkmenistan - a dictatorship with a rather closed economy - sells most of its nearly 60 billion cubic meters (bcm) annual output of gas to Russia and has a history of reneging on agreements.

It has been almost 15 years since the governments and the military strategists in Islamabad have been talking about the potential for trade from Central Asia and citing that as one of the drivers of their Afghan policy. Now the prospect of building an energy corridor has been given as a principal reason for building the Gwadar port. Given the global energy security situation, Pakistan's own gas reserves and the geo-political considerations, the country must give top priority to its own needs as a matter of national and energy security. More specifically, while Pakistan imports about 80 per cent of its oil requirements, it may become an importer of natural gas by as early as 2010. Therefore, it can no longer afford to waste time on some far-fetched plans for building trade routes. Its hopes of becoming an energy corridor for the West or China have turned out to be just pipedreams while Turkey and China have already built or in the process of building oil/gas supply routes to the Central Asian republics, principally Kazakhstan and Azerbaijan.

It appears that some vested interests in the establishment have exaggerated the real potential of trade/energy routes from Central Asia through Pakistan to further their own agenda. Ironically, while there was no tangible progress in the past decade toward meeting even our own energy needs let alone building energy routes for others, Turkey has emerged as the new "silk route" of the 21st century and the energy corridor for Central Asia and Europe. On the other hand, China has been working to establish direct oil/gas pipeline routes with Russia as well as with Kazakhstan - Central Asia's largest oil producer, estimated to account for about 3.3 per cent of world's proven oil reserves and 1.7 per cent of gas reserves.

Pakistan is one of the most gas-dependent economies globally. Natural gas meets more than 50 per cent of Pakistan's energy needs compared to a global average of 23 per cent. Power generation sector is the largest consumer of gas at 45 per cent of consumption, followed by fertiliser and household at 22 per cent and 18 per cent respectively. In addition, the government estimates that by 2010, Pakistan will have to increase its power generating capacity by more than 50 per cent to meet increasing demand. Hence, gas is much more critical to Pakistan's economy and industry than it is in many other countries.

Over the past three years, gas has gained further prominence over oil as an energy source in Pakistan. The three-year annual average growth rate in demand for gas was 12.1 per cent while for oil it was actually a minus 6.4 per cent and for electricity 10 per cent. The decline in the use of petroleum products in the household, agriculture, transport and power sectors was due mainly to the availability of alternative and relatively cheaper sources of fuel e.g. liquefied petroleum gas (LPG). Furthermore, compressed natural gas (CNG) for transport has been an additional growth segment.

Although Pakistan's proven natural gas reserves are officially estimated at around 821 billion cubic meters (bcm), many experts believe it may need to start importing gas by 2010. Pakistan's gas consumption rose to about 33 bcm in 2006 from 20.6 bcm in 2002. A February 7, 2007 report by Goldman Sachs – the American investment bank - states, *"recognising that Pakistan will face an imminent gas shortage, the government is currently in discussions with Iran, Qatar and Turkmenistan for potential gas importation to Pakistan. We believe a sub-sea pipeline or shipment of LNG from Qatar is likely to prove an expensive option, while gas ownership uncertainties make Turkmen gas imports improbable in the near-term. In our view, piped gas from Iran seems to be the most likely option although pricing disparities need to be resolved."*

According to a new formula proposed by Iran, the cost of gas will translate at the Pakistan-India border as $4.93 [India is not willing to pay more than $4] per million British thermal units (mBtu), plus $1.5 per mBtu that India would have to pay to Pakistan as a transit fee. Iran has offered to pay as much as 60 per cent of the estimated $7 billion cost of building the pipeline However, Indians have not yet come on board, as is implied in Prime Minister's remarks, and are keeping their options open including that of buying LNG from Iran under their $22 billion bilateral agreement.

Unlike oil, which is traded and transported globally, natural gas tends to have regional markets due to the obvious logistical and cost constraints. Outside North and Latin America, 60 per cent of the world's natural gas reserves are concentrated in just three countries – namely - Russia, Iran and Qatar who account for 29%, 16% and 15% respectively of the world's total reserves outside Americas. Turkmenistan's proven gas reserves are barely 1.6% of this total [though Turkmenistan officials claim these to be much larger] and it sells all its gas to Russia and Ukraine through the old network of pipelines from the Soviet era. Not only that it cannot meet Pakistan's gas needs let alone of other western countries according to an Asian Development Bank study, it's small size (population of 4.8 million and GDP of $7 billion) and unstable political regime do not qualify it to be a reliable long term source of gas for Pakistan specially given the fact that any pipeline from Turkmenistan will have to pass through Afghanistan.

It is a pity that the policy makers have only recently recognised that importation of gas from Iran is the only viable option for Pakistan after spending over a decade on the unrealistic pursuit of building an energy corridor from Central Asia through Afghanistan. Iran consumes almost all of its current gas production but is producing only a small share of its huge gas reserves. This means that Iran is one of the few countries capable of supplying much larger amounts of natural gas in the future.

While it is true that Kazakhstan and Azerbaijan have large oil reserves, they have never shown any serious interest in transporting oil through Afghanistan. In fact, secular and liberal Kazakhstan has always been weary of the Taliban and the warlords and is highly unlikely to participate in any project that involves Afghanistan. Oil and minerals exports dominate the economies of these Central Asian states and account for about 73 per cent of their exports. Much of their other trade is with Russia and other former Soviet republics according to a February 2006 World Bank report.

Historically, these states have depended entirely on Russia to export their oil but that complete dependence ended on July 13, 2006 with the inauguration of the $4 billion world's second longest Baku-Tbilisi-Ceyhan (BTC) pipeline, the east-west hub intended to connect energy supplies in the Caspian region and Central Asia to Western markets. Earlier in March 2005, Kazakhstan and Azerbaijan agreed to build the Aktau-Baku pipeline, connecting the Kashagan offshore oil fields in Kazakhstan to the BTC in Baku via a sub-Caspian in 2008. The Kashagan field is expected to produce 1.2 million bpd by 2016, when 600,000 bpd of its production is to be shipped across the Caspian Sea to be fed into the BTC line.

The BTC pipeline will account for only a small per centage of global oil, that is, about 1 million barrels/day (bpd) by 2009. However, the West considers a stable -- and not Moscow-controlled -- supply to be worth the financial and political costs. Planning for the pipeline that carries oil from the landlocked Caspian to the Mediterranean Sea -- while avoiding Russia and politically unstable areas such as Armenia -- began in 1999 and construction commenced in September 2002. The Western governments and oil firms intended for it to rival the Russian-backed Blue Stream pipeline, which sends Russian gas to Turkey and Italy.

Blue Stream gas pipeline between Turkey and Russia was officially inaugurated in November 2005. Its construction, undertaken by Russia, Turkey and Italy -- involving a joint venture between Russia's gas giant Gazprom and Italy's energy major ENI – took eight years.

Another gas pipeline project underway is the $5.8 billion Nabucco pipeline; a major part of the European Union's strategy to diversify its gas sources away from Russia. This will carry natural gas from Azerbaijan and will go through Turkey, Bulgaria, Romania, Hungary and Austria. Construction is slated to begin in 2008 and conclude in 2011. Nabucco is expected to achieve a maximum transport of 30 billion cubic meters of gas per year. In addition, Turkey is in discussions to build another pipeline that would send Russian gas through Turkey to Italy and Greece.

It is clear that Turkey by capitalising on its position as the geographic link between Europe and both Central Asia and the Middle East and on its ties with both the European Union and Russia, has emerged as the pre-eminent strategic supplier of energy routes between Central Asia, Russia and Europe.

On the other hand, China has been busy building direct supply routes from Central Asia and Russia. In December 2005, the state-owned China National Petroleum Corporation (CNPC) inaugurated an oil pipeline running from Kazakhstan to northwest China. The China-Kazakh pipeline opening is one part of a massive Chinese plan to secure as much of Kazakhstan's oil riches as possible. Earlier in October 2005, China spent $4.2 billion on acquiring PetroKazakhstan that produces 12 per cent of Kazakhstan's oil output.

With completion of this major project, China will for the first time have secured a source of imported energy not vulnerable to US aircraft carrier battle groups, as is the case with oil deliveries from the Persian Gulf and Sudan at present.

Before opening the new pipeline, China imported only 25,000 bpd from Kazakhstan. Once the link between Kenkiyak and Kumkol is finished, connecting existing infrastructure near the Caspian with the portion inaugurated in December 2005, the project will pump 1 million bpd. That would be about 13 per cent of China crude oil needs.

In summary, the above facts indicate that our energy policies and security strategies have been grounded on either some great misperceptions or deliberate distortion of facts to serve some vested interests. While India or China may or may not participate in building supply routes through Pakistan given their economic and geo-political considerations, the government's decision to go ahead with Iran pipeline is a right one because it is eminently sensible for Pakistan to secure the future gas supplies from its next-door neighbour that also happens to have the second largest natural gas reserves in the world after Russia.

February 26, 2007

Untaxed billions while 74 per cent live on less than $2 a day

Effective taxation of agriculture income and capital gains from short-term stock trading and real estate investments can raise around Rs 200 billion (equivalent to about 66 per cent of the budget deficit) in additional government revenues. Large areas of economy get away with paying no tax at all. This has little to do with the income tax department or the Central Board of Revenue (CBR). The culprit is the lack of will of the successive rulers (past and present) who have never attempted to address the core issues and mobilise political support to undertake the tax reforms that are essential to reduce fiscal deficits.

Pakistan must widen its tax net to raise sorely needed revenues for the development of a decrepit physical infrastructure and for educating and training one of the six largest and youngest (albeit relatively illiterate) working populations in the world. This will also reduce the dependence on foreign aid, especially at a time when the democrats-controlled US Congress is considering a ban on US assistance to Pakistan.

During FY 2005-06, the government's collections from direct taxes amounted to Rs 224.6 billion or about US$3.7 billion. The trading volume at the Karachi Stock Exchange averaged around US$500 million a day during 2006 or about US$120 billion (almost equal to Pakistan's GDP) for the entire year. Stockbrokers do not pay taxes on capital gains and nor do those who make millions and billions on property and land deals or from large agricultural estates. Now the government is considering eliminating all taxes on textile exporters who collectively earned about US$7.2 billion in export revenues during 2005-06. Who says there is no such thing as a free lunch?

It is not difficult to understand why the government of Pakistan is so poor and runs budget deficits that result in higher interest rates and inflation – a form of regressive tax on the middle and poor classes. Pakistan has one of the lowest tax to GDP (gross domestic product) ratios in the world and this ratio has declined in the recent decade despite growth in the absolute amount of taxes. As the size of the economy has grown, so has the volume of taxes but is the situation any better than it was ten years ago? According to the data released by the Ministry of Finance last week, the tax collections (direct and indirect) amounted to Rs 383 billion during the first half of FY07 (July-December, 2006) as against Rs 324 billion in the corresponding period last year as given below:

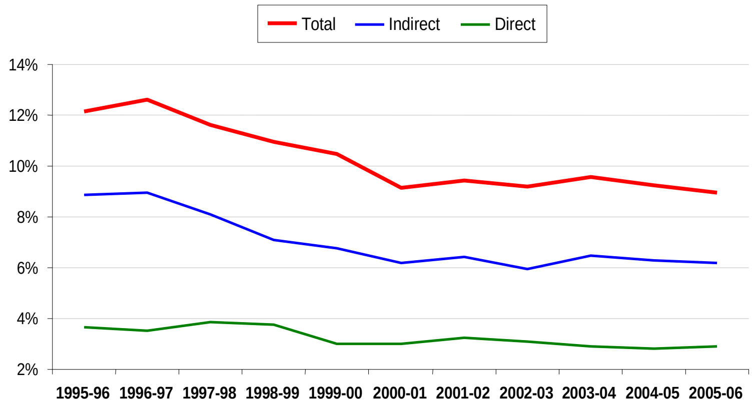
	Rs billions	Per cent increase over 2005-06
Direct taxes	151.6	45.4
Sales tax	143.5	8.1
Custom duty	59.8	(2.8)
Excise duty	28.5	12.5
Indirect taxes	231.8	5.5
Total	383.4	18.4

That the share of direct taxes has gone up to 39.5 per cent is good news and it appears that the Central of Board of Revenue (CBR) is working hard. But the direct taxes include withholding taxes (introduced in 2005-06 budget) on bank withdrawals and stock trading – activities with hundreds of billions in turnover -and account for approximately two-thirds of direct taxes. Hence, it is not surprising that direct tax collections have gone up. However, the indirect taxes' 5.5 per cent growth is negative in real terms given the inflation rate of 9 per cent. Moreover, over 50 per cent of the increase in the indirect taxes is attributable to the (largely public sector) oil and gas industry that has been booming due to higher energy (petrol/gas) prices.

Notwithstanding these issues and going beyond the six months data, the real picture of government's domestic finances has not changed much during the past decade. In fact, it has gotten worse and is a major cause of growing income inequality and social tensions. Let's see why?

The most relevant indicator to determine if a tax regime has improved is the tax to GDP ratio. As GDP or country's income grows, so does the volume of taxes. But if the growth in taxes lags behind that of the GDP, tax to GDP ratio declines. This is usually due to an increase in tax evasion and/or because major sectors are exempted from paying taxes.

Tax to GDP Ratio
1995-96 to 2005-06



As shown in the graph, the Central Board of Revenue's tax to GDP ratio that stood at 12.64 per cent in 1996-97 has steadily declined to 9.97 per cent to in 2005-06 and even if this year's target of Rs 835 billion in tax collections is met, this ratio will not be significantly higher than 10 per cent. Even making allowance for change in the base year in 2000, this ratio has not gone up.

Failure to increase this ratio has caused the fiscal deficit (excluding the impact of earthquake and grants) to grow both in absolute and relative terms as shown below:

Fiscal year	Total deficit (Rs Billion)	As per cent of GDP
2003-04	129	2.3
2004-05	217	3.3
2005-06	259	3.4
2006-07 budget	294	3.4

An inequitable and unfair tax regime is the principal cause of not just low taxes to GDP ratio and persistent fiscal deficits but also for creating distortions in the economy that are harmful for investment in manufacturing in particular and capital formation in general. The uneven mismatch between sectoral contributions to growth and tax revenue lies at the heart of this regressive tax regime.

The following table compares the per cent contribution or share of some key sectors in national income (or GDP) to their per cent share in national taxes in 2005-06.

	Share in GDP	Share in Taxes
Agriculture	22	1
Manufacturing	18	62
Wholesales & Retail Trade	19	3

Agriculture with 22 per cent of national income contributes to just 1 per cent of the taxes while manufacturing sector shares bulk of the burden. Now why should the local capital go to manufacturing when it can find tax shelter in land, agriculture, stock investments or in just trading goods and services?

The growing deficit can be reduced by extending the tax net to three major areas. First is obviously agriculture income, which was taxed - for the first and only time in history - in January 1977 by late Zulfikar Ali Bhutto but General Zia never implemented the law. Even merely a 10 per cent tax on income from agriculture, which accounts for 22 per cent of national income, would yield Rs 160-190 billion in income tax revenues. It is grossly unjust that while a salaried person pays not just income tax but more and more withholding taxes on utilities and bank transactions, large landlords' incomes should go completely untaxed.

Two other main areas are property and stocks. It seems that the government by levying very nominal capital value tax (CVT) on real estate and stocks (CVT has little economic justification and discourages active trading which is necessary for market development) has tried to divert the public opinion from the more fundamental and much larger issue of the exemption of tax on capital gains from property and stocks.

The most common international practice is to exempt capital gains tax on one property (usually the primary residence of a household) if it is held for a certain number of years or tax it at a lower rate by treating it as a long-term capital gain. Any other capital gains resulting from buying and selling of property are treated as usual income and taxed accordingly. Uniform indexed values and low standard rates are and can be used to value and tax properties to avoid the usual issues of understatement of values and corruption. Few years ago, India imposed capital gains tax on property at 20 per cent based on an indexation system. Property taxes account for about 10-11 per cent of total tax revenues in the United States, United Kingdom and Japan. Based on the assumption of even 3 per cent of the total tax revenues, there is potential to raise Rs 20-24 billion from property taxes in Pakistan. There is little justification to continue to exempt capital gains from property especially when it comes to gains on plots and houses whose aggregate values run into hundreds of millions of dollars.

Last and not the least is the matter of capital gains tax on stocks. Apologists of this exemption argue that its imposition may deter foreign investors. This assertion is simply a distortion of facts. Foreign investors' share of investment in average daily volume at the Karachi Stock Exchange is about 3.5 per cent. Nearly 70 per cent of the trading activity is speculative and does not result in actual delivery of shares. The brokers themselves undertake almost all of this trading and there is no reason why it should not be taxed like any other business income. True the foreign investors hold about 17 per cent of the float-adjusted market capitalisation but most foreign investors can use international tax laws and double-taxation treaties to avoid paying taxes on genuine long-term investments.

Therefore, imposition of capital gains tax on the short-term trading profits of local investors (mostly brokers) would make little difference to foreign investors. India grants exemption from capital gains tax only if the stocks are held for a period of one year but taxes short-term capital gains at 30 per cent. Even if we assume that short-term capital gains account for just one per cent of the value traded on our stock exchanges, a 30 per cent tax would still yield Rs 22 billion compared to about a billion rupees being collected from CVT on stock market trades. Given the vastly untapped tax revenue potential in the above sectors, the least the government can do is to make a start by bringing the 'big fish' under the tax net even at initially low tax rates, lowering tax rates on manufacturing concerns and salaried persons to bring more equity and reducing the number of small taxes to streamline tax administration.

This may lend some credibility to its claims of reforming the tax regime. Unless it is prepared to do so and bring some fairness to the tax regime, it should not complain about the tax evasion culture since unfair tax regimes do not generally command legitimacy and compliance from taxpayers.

January 29, 2007

Monetary policy: rising inflation and difficult choices

Making the half-yearly monetary policy statement, Governor Shamshad Akhtar told a press conference on January 18, 2007 that the State Bank of Pakistan (SBP) will maintain its (tight) monetary policy stance while ``effective administrative measures" are needed to control food prices.

The SBP appears to be saying it has done as much as it can to control inflation and it is now up to the government to take corrective measures on the administrative or supply-side to bring down food price inflation that has led to Pakistan's overall inflation rate to accelerate to a twelve-month high of 8.9 per cent in December. The Governor left the benchmark policy rate (3-day Repo Rate) unchanged at 9.5 per cent.

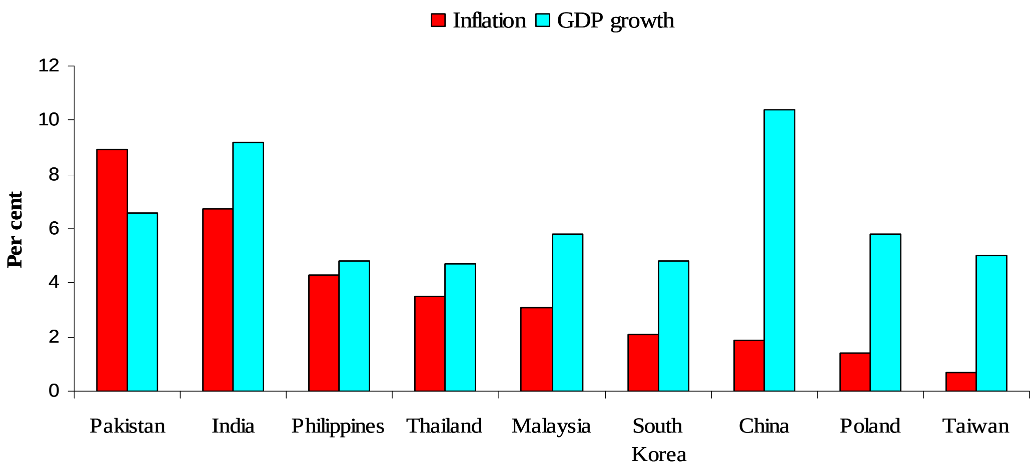
The monetary policy statement of the State Bank of Pakistan (SBP) makes two other important points: (a) inflation remains stubbornly high and is likely to exceed the 6.5 per cent target for the current fiscal year, and (b) the monetary policy continues to be supportive of the economic growth as threshold level of inflation for a stable economic growth is in the range of 4-6 per cent for Pakistan.

The assertion that Pakistan, being a developing country, needs a high inflation rate (6 per cent or so) to support a 6-8 per cent GDP growth is seriously questionable and is not supported by hard evidence from the most recent comparable GDP growth and inflation data of some major emerging markets as shown in graph 1.

Graph 1: Inflation and GDP Growth: Selected Emerging Markets – 2006

Pakistan's inflation rate is the highest among major Asian countries

Pakistan is the only country where inflation is higher than the GDP growth rate



Pakistan stands out with the highest inflation rate and the only country in the group whose inflation rate (8.9 per cent) is more than its GDP growth rate (6.6 per cent). This suggests that either there is something so unique about the structure of Pakistan's economy that the divergence of its GDP growth and inflation data from the norm of even other developing and oil importing countries (leave aside those of the developed markets) has a valid and legitimate reason or the data itself is questionable.

However, even if we take Pakistan's data at its face value, the graph shows that most of these developing countries are growing at around 6 per cent or more while their inflation rate is around 4 per cent or thereabouts. The only exception is India whose inflation rate is 6.7 per cent but then its current GDP growth rate of 9.2 per cent is also significantly higher than Pakistan's 6.6 per cent. The monetary policy statement does acknowledge that the inflation in Pakistan is relatively higher compared to its competitors and trading partners and this higher domestic inflation has offset the gains emanating from nominal depreciation of the Rupee against other currencies. Is it making a case for an accelerated depreciation of Rupee in the coming months because the monetary policy has failed to achieve the inflation target?

When most of major developing countries are recording healthy GDP growth while keeping overall inflation (this includes food and energy inflation) under 5 per cent, should not the government set 5 per cent inflation rate as target for the next fiscal year? This assumes additional significance - aside from domestic economy and political considerations in an election year - since the relatively higher inflation is hurting Pakistan's competitiveness and its exports growth instead of supporting the declared policy objective of encouraging economic growth.

Still, it is fair to say that the SBP, primarily through open market operations and changes in the reserve ratios, has managed to bring down the overall growth rate in the private sector borrowings. Based on the monthly average loans outstanding of the scheduled banks, the loan growth during the six months to December 2006 was 14.5 per cent compared to 25.3 per cent growth during the previous year.

However, the impact of the overall tightening in the credit supply has been somewhat diluted by a Rs 34.7 billion increase in loans under Long-term Financing for Export Oriented Projects (LTF-EOP) and Rs 26.8 billion increase in loans under Export Finance Scheme (EFS), both offered at concessional or reduced rates. The combined increase in loans under these financing schemes accounted for 54 per cent of the Reserve Money (M_0) growth during the first half of the current fiscal year. Although there may be legitimate reasons for offering export financing at concessional rates, the reports about the abuse of such facilities abound with money being diverted to real estate and stock market investments. Such schemes can offset the benefits of a monetary tightening and derail the progress made since late 2004. Given their large proportion in overall money supply growth, it is fair to argue that their rapid build-up may have adverse effects on the core function of the monetary policy, that is, achieving low inflation in the next 12-18 months.

Notwithstanding this, the impact of the monetary tightening is visible in rising interest rates and a deceleration in the principal indicator of the money supply, that is M2, during the first six months of FY2006-07. The three-month Karachi interbank offered rate (KIBOR) averaged 10.39 per cent during December 2006 compared to 8.98 per cent during January 2006. While raising interest rates is a perfectly legitimate response to building inflationary expectations, there is another side to it.

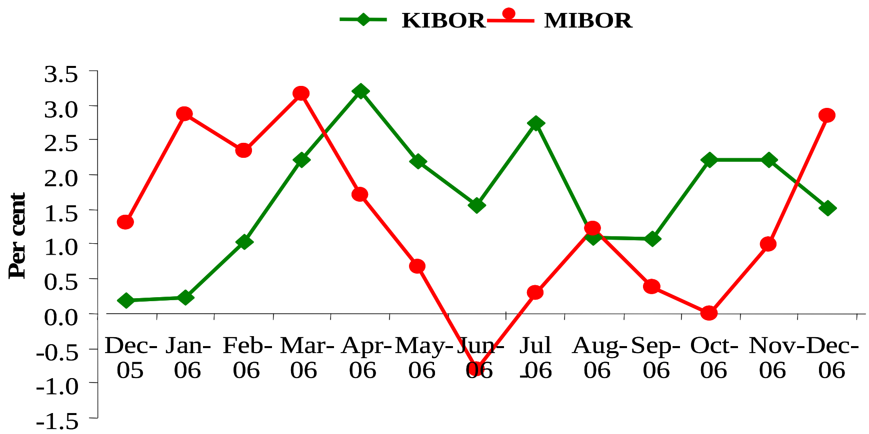
If real interest rates, that is, nominal interest rates minus inflation, are higher compared to a country's competitors, they can hurt growth, particularly exports. Some policy makers argue that the local businesses and industrialists should not just look at the lower nominal interest rates in India because Pakistan's inflation rate is higher. Simple enough, but a comparison of the real interest rates between Pakistan and India reveals a somewhat different and more complex picture.

Graph 2 shows real interest rates in Pakistan and India. The monthly averages of 3-month KIBOR and 3-month MIBOR (Mumbai interbank offered rate) and monthly inflation (CPI) rates were used to calculate the real rates. The graph shows the real interest rates in Pakistan have stayed generally higher during 2006 compared to India's. Although it is difficult to quantify the impact, higher real interest rates do contribute to higher cost of production and hurt international competitiveness.

Moreover, the data has some difficult implications from a monetary policy standpoint. The real interest rates in Pakistan depict a declining trend since mid-2006 while those in India show an upward trend.

Graph 2

Comparison of real interest rates: Pakistan vs. India



KIBOR = Karachi interbank offered rate minus monthly CPI
MIBOR = Mumbai interbank offered rate minus monthly CPI

Declining real interest rates can portend a higher inflationary environment 18 months down the road, as monetary tightening takes at least that long to make a dent in inflation. Here, it is relevant to note that the SBP's last Thursday statement starts with a rather bold assertion that "monetary policy measures adopted in July 2006 augmented earlier tightening and reduced core inflation (Non-Food Non-Energy – NFNE) to 5.5 per cent by December 2006 from 7.4 per cent a year earlier." Given the widely accepted view, acknowledged even by the SBP Governor, that monetary policy takes 18 months or so to impact inflation rate; it is not clear how the July tightening has caused headline inflation to drop in just 6 months?

While this may be excused as a statement made more for public consumption rather than on a serious note, more important issue is the recent and growing trend of emphasising core inflation as opposed to overall inflation that includes food inflation. Maybe it is just a better number to talk about because it looks good. On the other hand, one may argue that core inflation is also followed closely in the developed economies such as the United States.

However, there is a major difference between Pakistan's inflation (CPI) measure and those of the developed world. Food inflation is the single largest component of Pakistan's CPI and constitutes 40 per cent of this index compared to only 17 per cent or so in the US and some other developed markets. Together with energy, food inflation accounts for almost 48 per cent of the CPI or overall inflation in Pakistan. Therefore, in Pakistan's context, core inflation (that is, Non-Food Non Energy inflation) is not as meaningful a measure as in some other developed countries.

While supply-side factors do play a role in inflation, this should not detract the central bankers from targeting the overall inflation rate as the primary focus of the monetary policy. Monetary tools, such as margin requirements, do play a role in commodity financing and should be used appropriately to respond to the financing needs of essential items.

Moreover, while financial deregulation and innovation have made the money supply harder to interpret in the developed markets, domestic money supply control can be a relatively more effective tool of monetary policy in economies like Pakistan where private sector access to foreign borrowing and markets is fairly limited. The fact that a large sector of the economy is undocumented has little to do with the effect of money supply growth on inflation as has been well established in high inflation developing countries like Brazil and Turkey.

The SBP maintains it is capable of skilful management of the often difficult and complex objectives of meeting national growth priorities, liquidity and demand management, and controlling inflation. As central bankers around the world know too well from history, it is difficult to manage just one goal – low inflation – let alone many. Given the propensity of the borrowers in Pakistan to abuse concessional credits and the difficulties in managing multiple and sometimes conflicting near-term policy objectives, the SBP will be better off to make achieving an inflation rate of 5 per cent or less as its core target for next 12-18 months. That by itself will facilitate growth and price stability. Failure to achieve low inflation will hurt growth and exports down the road as monetary policy mistakes can take up to 18-24 months to show up in even higher inflation numbers. But by then, elections will be over.

January 22, 2007

Development strategy and the myth of liberalisation

Pakistan's trade deficit hit an all time record of $6.5 billion for the six months ended December 2006 as exports growth continued to stagnate while imports rose to new record. The trade policy whose stated objective has been to facilitate exports-led growth does not seem to be working. Pakistan's trade liberalisation policy, pursued since the early 1980s, has not delivered the exports-led growth experienced in the East Asian economies for more than two decades. Pakistan's GDP growth while impressive during the past four years has been led by consumption and an exports-led growth seems like a distant dream. The government's top economic managers continue to espouse the benefits of trade liberalisation and maintain that in an age of globalisation, this is the only way forward. Free trade agreements abound and Pakistan's markets have never been so open. The proponents of 'free trade' appear to give the impression that it is the widely accepted way forward to development. Is it?

Even renowned western economists like Joseph Stiglitz, former chief economist of the World Bank and a Nobel laureate, have rejected the notion of free trade as a panacea for development and the so-called Washington Consensus as a means to lift the developing countries out of poverty. In the context of the 'free market' policies being pursued by the current government (over which even the main opposition parties do not seem to have any substantial difference of opinion), it is instructive to go back to the early 1990s.

Trade and capital market liberalisation were two key components of a broader policy framework, known as the Washington Consensus – a consensus forged between the IMF (located on 19th Street in Washington D.C.), the World Bank (on the 18th Street), and the US Treasury (on the 15th Street) on what constituted the set of policies that would best promote development. It emphasized downscaling of government, deregulation, and rapid liberalisation and privatisation. Many Latin American and East European countries took it as a gospel and religiously followed its prescriptions. Almost two decades later, the two countries that have grown the fastest, that is China and India, are the ones that did not follow these policies.

Our political leadership, be it in the government or in the mainstream opposition parties like the PPP or the PML (N), seems to believe that once the economy is liberalised and privatised, sustained economic development will follow and benefits will trickle down to the poor. Is it that simple? Not just that, this notion is out-dated and has been rejected by some of the World's leading development economists as well as by the World Bank itself.

Latin American and East European countries that followed the policy framework laid down by the Washington Consensus have had mixed success with their share of disasters but it is those Asian countries who devised their policies in accordance with their own individual circumstances and environments have been the most successful. These Asian countries believed in the importance of markets, but they realised that market had to be created and governed, and that sometimes private sector might not do what needs to be done. While China and Korea were slow to privatise, they focused on exports-led growth, especially in the early days of development, and limited imports that would undermine local manufacturing and agriculture.

Asia tigers followed a course markedly different from the Washington Consensus, with a role for government far larger than the minimalist role that is being currently articulated in Islamabad. Both China and India did not rush to privatise large-scale manufacturing, banks, or the oil and gas industry nor did they allow unrestricted short-term capital flows. While they opened up their markets for long-term investors, they made sure that the foreign investors transferred technology and trained local workers, so that they contributed to the nation's development.

While it is true that China and India are very competitive in terms of labour productivity, they did not gain this competitive advantage through any 'market' reforms. For example, since 1978, China has been the world's most successful economy, growing at an average per capita rate of 8 per cent per year. At that rate, its per capita income has doubled every nine years (our planners should note this simple mathematical rule that it takes an average of 8 per cent growth to double an income level in nine years). China did not start privatising until only a few years ago. Paradoxically, the foundations of China and India's historic successes were laid down during the much castigated 'socialist' period. Both invested heavily in education, particularly science and technology education, as well in heavy engineering and other capital-intensive industries. In China, the liberalisation started from the agriculture sector in the early 1980s as it was ready for the markets after the Green Revolution of the 1970s, which promoted the use of better farming techniques and new seeds and increased crop yields many times over.

The next steps of China's reforms, in the early 1980s and early 1990s, involved liberalisation of international trade and investment, but initially only in specially designated free-trade zones, known as special economic zones (SEZs). Foreign investors looking for trained and low-cost workers found no shortage of human talent as the 'communist' China had invested heavily in basic education and these SEZs jump started the labour-intensive exports-led industrial revolution that has transformed China and indeed the global economy. The government took an active and leading role in planning and building these SEZs as the trained human resources were already available. Both China and India continue to follow five-year official planning cycle with clearly defined goals and policies. We also did that but the critical difference is that our policies provided just protection and subsidies to a selected few while China and India made large investments in basic education and heavy industries.

In contrast, Mexico, which signed the North American Free Trade Agreement (NAFTA) with the United States and Canada in 1994, has not seen the benefits the free trade advocates thought it would bring to Mexico. NAFTA did not result in rapid growth during the first decade following the signing of NAFTA (per capita income grew by only 1.8 per cent) and its economy grew more dependent on the United States. Mexico followed the Washington Consensus and rapidly privatised and liberalised its economy while not investing enough in infrastructure and human development. Today, Mexico's exports are having a tough time competing with China's goods despite the existence of a 'free trade' agreement with the United States. It is just not tariffs or subsidies that make goods cheaper or competitive. Labour productivity in China (as well as in Korea, India or Taiwan) is higher simply because of decades of investment in education and training. Tariffs played a limited role in China's success.

Now more importantly, and our policy makers should make a careful note of this, the Washington Consensus is no longer the accepted conventional wisdom it once was. Following the success of Asian economies and disappointing results of following its straight jacket policies in Latin America and Eastern Europe, even some of the World Bank's top officials, like its former President Jim Wolfensohn and the Chief Economist Joseph Stiglitz, began to accept that that the strategy of just getting government out of the way of the private sector and markets had failed. By the late 1990s, following the collapse of the Russian economy in August 1998, the policy of just privatising and liberalising had been abandoned even by the World Bank which came up with what was called the comprehensive approach to development – with emphasis differing from country to country and from time to time. According to Mr. Stiglitz's own admission, the comprehensive approach to development did not contain anything new: "they were variants of the strategies that had worked so well and for so long in East Asia but had been ignored" by the believers of what he called market fundamentalism.

We would be better off if we can come up with our development strategy, learn from the successes of China and other Asian countries and stop following the now discredited and out-dated strategies advocated by the market fundamentalists and believers of rapid liberalisation and privatisation as a panacea for development.

January 15, 2007

Pakistan economic outlook

The year 2007 may turn out to be a challenging and difficult one for Pakistan after the above average economic growth during the past three years. Specifically, there is an increasing likelihood that:

- Pakistan's GDP growth, though still healthy, will drop to under 6 per cent.
- The Rupee will gradually depreciate to 64 against the US dollar by end 2007 with the current account deficit rising to $9-10 billion - its highest level ever.
- The industrial growth rate will moderate mainly due to the textile sector
- The property market will see price declines in some major urban areas.
- The fiscal deficit will exceed the government's target of 4.2 per cent of the GDP.
- Income inequalities and poverty indicators will worsen as the poor, lower income and salaried households will be hit harder because even the official statistics are now reporting double-digit inflation.
- Energy crisis will become acute and an increasingly important factor in Pakistan's external relations.

Next year may well be an election year but it is unlikely that the political developments will have a significant impact on the economic policy or direction, barring some extraordinary developments or surprises, besides creating some noise. The country enters the New Year at a time of generally sound global economic environment, hopes of a breakthrough in relations with India and growing foreign investment flows, particularly in the banking sector.

However, the economic outlook is clouded by a widening current account deficit (around 6 per cent of the GDP - among the highest in emerging markets), persistently high inflation, slowing textile exports growth, tight monetary policy and a looming energy crisis in the backdrop of the oil price holding above $60/barrel and reports that Pakistan's existing natural gas reserves may not able to cope with the growing demand in another three to four years.

Moreover, the sensitive price indicator (SPI) has hit the double-digit levels from 7 per cent in 2005-06. The SPI – the index that measures inflation in the prices of food items, petrol, gas, tea, cigarettes, etc. – climbed to 11.25 per cent during the five months period of July-November 2006. This will put further upward pressure on wages and production costs in the coming months with adverse implications for labour productivity and international competitiveness.

Meanwhile, the country's stock market has been the worst performer among all major emerging markets (except Turkey) during 2006 despite being 'cheap'. It may remain cheap in 2007. Another negative signal from the capital markets is the performance of the recently issued global depository receipts (GDRs) of the Oil and Gas Development Company and the Muslim Commercial Bank. Both have not done well on the London stock exchange after their listing recently and have traded below or around their initial offering price levels. This type of post-issue performance is usually not a good omen for future equity issuances of a country.

Now why the GDP growth may slip below 6 per cent? Last year, the services sector, which represents about 52 per cent of the GDP, accounted for about 68 per cent of the GDP growth. This masked the rather moderate growth rates in the agriculture and industry. Agriculture, with 21.6 per cent share of the GDP, accounted for just 8.7 per cent of the overall GDP growth and the industrial sector, with 26 per cent of the GDP, accounted for 23.3 per cent. The services sector that led the overall growth includes the following:

Sub-sector	Per cent of total GDP	Contribution to GDP growth (Per cent)
Wholesale and retail trade	27.9	27.8
Transport and communication	19.2	11.2
Finance, banking and insurance	4.2	13.9

The relatively disproportionate contribution of the finance and banking sector to the overall GDP growth was due to a heady 30 per cent yearly growth in the net domestic credit or lending during FY2004-06. With the monetary tightening underway, the banking sector assets' growth is slowing down to around 10 per cent or less but only 2-3 per cent in real or inflation-adjusted terms. The reduced availability of credit, not to mention the higher borrowing costs, will affect not just the banking sector but industry and trade as well. Hence, as the services sector cools down to grow at a more sustainable pace, its overall contribution will fall more in line with its size after three years of double-digit growth. Therefore, the GDP growth is more than likely to be less than what the government and some other agencies are projecting.

Let us now take the agriculture sector in which the livestock sector's size is as large as that of major crops. This year, 3-4 per cent growth is expected in this sector compared to last year's exceptionally high growth of 8 per cent and the average of 2.5 per cent during 2002-2005. Among the major crops, the cotton output will be around 12.5 million bales, less than the earlier forecast of 12.8 million bales because the crop has been damaged by insects and disease. Overall, although the outlook for agriculture remains generally positive for 2007-08, with the wheat production forecast to rise by 3.7 per cent to 22.5 million metric tons next year, there is little reason to believe that the agriculture's growth rate will exceed 3-4 per cent. It may even be less depending on the weather conditions.

The bottom line is Pakistan is entering a rather challenging phase of growth. The economy is cooling down after three years of above average growth produced by a combination of benign global economic environment and domestic consumption-driven economic recovery - facilitated by abundant and cheap liquidity- after the slump of the late 1990s in the aftermath of Pakistan's nuclear explosion in 1998.

Pakistan has come a long way from a precarious state of its domestic and external finances in the late 1990s when it defaulted on its foreign currency deposits obligations. However, even after seven years of the "reforms", its industry and trade remain heavily dependent on cash crops and low value-added textiles. While the government has managed to improve the finances, particularly through its debt and fiscal management policies, it still has no credible and comprehensive industrial and foreign trade strategy to achieve 6-8 per cent growth target in the next few years, mainly because it does not seem to have the political will or vision and perhaps both, to change the fiscal and trade policies that favour special interest groups and hinder efficient allocation of resources. Pakistan's narrow industrial, exports and tax bases together with the looming energy crisis combined represent the biggest risk to its growth prospects as well as the greatest challenge for its leadership.

The challenge may have arrived sooner than the government could have expected. While the fiscal situation appears to be still under control with the government likely to achieve its revenue targets, the trade deficit for the first five months (July-November) of FY2006-07 widened to $5.4 billion – an increase of 17.9 per cent compared to a year earlier. With this development, the current account deficit is estimated to be around $5 billion for the first six months of the FY2006-07. This means the government will need an estimated $7-8 billion in foreign investments (including the privatisation proceeds) and borrowings during the next six months to maintain the current level of $10.8 billion in foreign exchange reserves (excluding gold) assuming the foreign workers' remittances reach the level of $5 billion as being currently projected.

The government's top economic managers maintain that given the record foreign inflows in 2006, there should be no cause for concern about Pakistan's ability to attract more foreign investments and finance current account deficit. They continue to maintain a highly optimistic stance about the growth trends and point to the successful privatisations of a large number of companies and foreign banks' acquisition of local banks. A note of caution is warranted here. Judging from the Latin American experience in the 1980 and 1990s, privatisation alone is not enough to produce stable or high growth nor is foreign ownership of banks and insurance against an economic collapse. Argentina went from a boom in 1997-98 to a bust in 2001 when its privatised but corruption-ridden economy collapsed despite the fact that at the time, foreign banks controlled 52 per cent of its banking system after a record number of acquisitions of the local banks by the US and European banks in the mid-late 1990s. Argentina's corrupt political system, failure to undertake critical fiscal and trade reforms, and its currency peg were largely held responsible for the collapse that was not helped by IMF's classic prescriptions for stabilisation.

Back to Pakistan. To be fair, that the government raised over $6.1 billion through the privatisation proceeds during its seven-year tenure is an impressive achievement. But just to put things in perspective, foreign direct investment (FDI) flows into Turkey and Egypt amounted to $23 billion and $6 billion respectively in 2006 alone. Here it took seven years to raise $6.1 billion and the proceeds were concentrated in a few large transactions. Just two privatisation deals - out of nearly 40 - involving Pakistan's largest telephone company and its biggest oil and gas exploration company, accounted for 56 per cent of this amount. The sale of stakes in two of the five largest commercial banks raised another $600 million. Pakistan has few such mega companies left to privatise.

Given the current pipeline of the privatisation transactions (the most imminent being the planned sale of a 51 per cent stake in the Pakistan State Oil with a market capitalisation of $800 million) and their values as reflected in their share prices on the stock exchange, it seems improbable - particularly during an election year - that the government will be able to raise anywhere close to $7-8 billion it needs to bridge the external financing gap in 2007. It seems to be in a rush to sell its stakes in large oil and gas companies - a relatively easy-sell in an energy scarce world - to raise as much money as it can to finance the current account deficit.

Leaving aside the seriously questionable wisdom of privatising the strategically sensitive and highly profitable oil and gas assets for a moment, this is unlikely to matter much in the short term as these transactions take 12-18 months to complete and depend on capital market conditions. Hence, the most likely scenario is that the government will have to resort to external borrowing or cut imports sharply to maintain the current level of liquid foreign exchange reserves that represent about 4.6 months of imports.

Pakistan is among the largest recipients of World Bank financial assistance. In FY2006, World Bank support to Pakistan totalled $1.5 billion, making it the World Bank's fourth largest borrower. Pakistan will need a much higher level of external financial assistance next year. Although there is no concrete indication yet, most of this is likely to come from the friendly oil-rich neighbours. Flushed with petro-dollars, the oil states can become a major source of financing to the private sector in addition to buying state-owned assets and 2007 may well see a higher volume of 'Islamic finance' deals in Pakistan.

The United Arab Emirates has been the single largest foreign investor in Pakistan so far but there has been little investment by the Saudi Arabian government in the private sector except the $98.5 million acquisition of a local bank by the Saudi government-controlled bank SAMBA. Saudi Arabia with hundreds of billions of investible dollars can be a major source of investments into Pakistan but it is not, despite close political ties between the two countries. Meanwhile, Saudis have poured money in investments and projects within as well as outside the region.

This suggests that even some of Pakistan's closest friends do not find it as attractive an investment destination as some Pakistanis would like to believe. Another such friend is China, whose investments in Sudan alone have reached a staggering $10 billion (mainly in the oil sector) within the past five years; more than double the $4.5 billion US military and civil aid to Pakistan since 2001. In contrast, FDI flows from China have remained insignificant although it has provided invaluable official assistance in terms of loans, grants and project aid.

The government must accelerate the development of human and physical resources on a war footing on one hand and make aggressive cuts in the non-development expenditure, including defence, on the other if it wants to ensure a steady level of FDI flows necessary to sustain a 6-8 per cent growth rate.

The IMF estimates that Pakistan needs at least $5-6 billion in yearly FDI flows to sustain this growth rate for the next few years. Pakistan's level of national savings declined from 21.9 per cent of the GDP during 2002-03 to 16.1 per cent in 2005-06. With a declining savings rate, low or negative real returns on bank deposits and continuing fiscal deficits, Pakistan's dependence on foreign capital is likely to grow. However, the level of FDI it needs to attract is unlikely to materialize on a sustainable basis in the absence of massive investments needed to upgrade its workforce and physical infrastructure. After all, the FDI investors look for more than just GDP growth numbers and debt ratios.

January 1, 2007

Rupee depreciation: The wrong debate?

It is a hot topic: is rupee devaluation around the corner? But is it the right question? Perhaps not. The real and more important question is whether the government is prepared to review and change the policies that have contributed to a widening trade deficit in the first place? If not, difficult days may lie ahead.

Prime Minister Shaukat Aziz has denied that the devaluation is on the cards. The State Bank Governor criticized the media reports for creating "misperceptions and misunderstanding" at a rather unusual Sunday press conference. The Governor maintained that the central bank abandoned fixed exchange rate regime a long time ago and moved to a floating exchange rate regime since early 2000 and the IMF has not advocated, in its consultations with Pakistan, any depreciation and has just provided its perspective and analysis of the movements in the real effective exchange rate. The World Bank's Pakistan representative has also commented on economic outlook and exchange rate policy at a media briefing in Islamabad, noting that China and India have allowed their currencies to depreciate while Pakistan has not. This is factually incorrect as shown below:

	% Change Against US Dollar Since	
	January 2006	January 2004
Pakistan Rupee	(1.79)	(5.96)
Indian Rupee	+0.70	+ 1.99
Chinese Renminbi	+3.16	+5.80

Pakistan Rupee has depreciated against US dollar while Indian and Chinese currencies have appreciated.

A few observations are in order:

1. The IMF is not the ultimate authority on macroeconomic policy. Its often controversial and questionable prescriptions have sometimes proved harmful for the countries that were under its programs and drew sharp criticism from some of the world's leading economists. Pakistan is currently not under any IMF program and is not bound by its 'advice'. Moreover, the IMF has provided estimates of the "real" exchange rate using different methodologies. That is, what is the real purchasing power of Pakistani Rupee vis-à-vis a basket of currencies given the different rates of inflation in their respective economies? The hard fact is, according to the IMF report, Pakistan's currency appreciated by 10% in real terms, relative to its trading partners, from December 2004 to June 2006. The correct and relevant question is: does it need an adjustment to bring it in line with its inflation-adjusted value?]

2. Pakistan is not under a 'free' floating exchange rate regime. It is under what is called a 'dirty float' or a 'crawling peg' regime with Rupee de-facto pegged to the US dollar. What it means that the market forces alone do not determine its value freely and the central bank through a variety of controls and interventions plays a key role in determining its value.

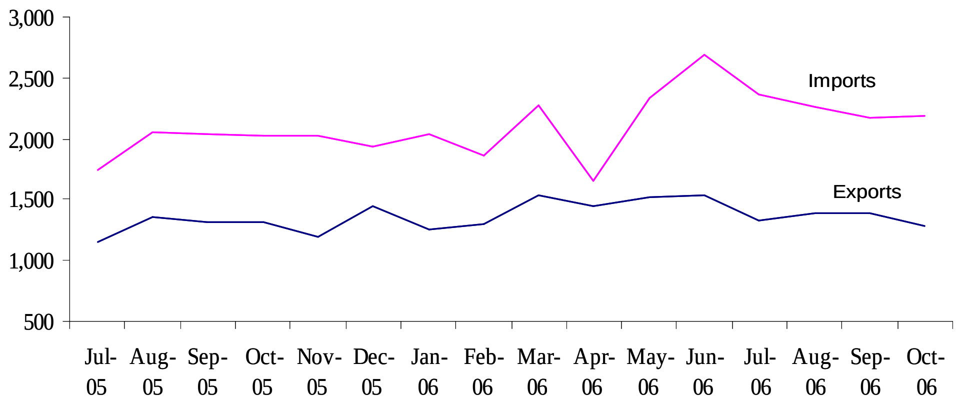
3. The principal reason for the current debate is not the IMF report or some 'misunderstanding' but the recent trade performance and the widening current account deficit.

The crux of the matter is the government believes it can run current account deficits year after another as long it can fund them through capital flows or more precisely through borrowings, foreign direct and portfolio investments and privatization proceeds. In a worst-case scenario, foreign exchange reserves can be used to meet shortfall on a temporary basis.

This approach is faulty, short-sighted and fraught with considerable risks. Industrial and trade strategy should drive financing strategy and not vice versa. It seems that we are treating privatization as a means of financing the expanding current account deficits while not paying sufficient attention to address the structural and fundamental reasons that are causing the deficits.

The month-wise imports and exports data for the 16 months to October 2006 reveals a clear trend of declining exports and rising imports.

Monthly Exports and Imports
July 2005 – October 2006
US$ Millions



During the first four months of the current fiscal year, the exports growth of 1.3% compared to a year earlier is not only behind a much higher 7.7% growth in imports but reveals a worrying trend given Pakistan's huge dependence on Textile and Clothing exports. They account for 60% of exports but are concentrated in low-value added products: yarn and bed wear/towels account for 45% of textile exports while ready-made garments account for only 15%.

During the four months from July-October 2006, textiles and leather exports declined in absolute terms and the small overall export growth was achieved only due to higher rice exports. The low value-added textiles (yarn, cloth, and bed wear/towels) have seen the sharpest decline in the current fiscal year.

The textile industry is blaming higher energy and interest rate costs while the Commerce Ministry has blamed short-sightedness and immaturity of the business community for their current woes. "The community in their quest for easy short-term gains, compromises on their long-term interests," said a spokesperson for the ministry, adding had the entrepreneurs and traders read the signals being given by the government and restructured their businesses accordingly, they could have fared better.

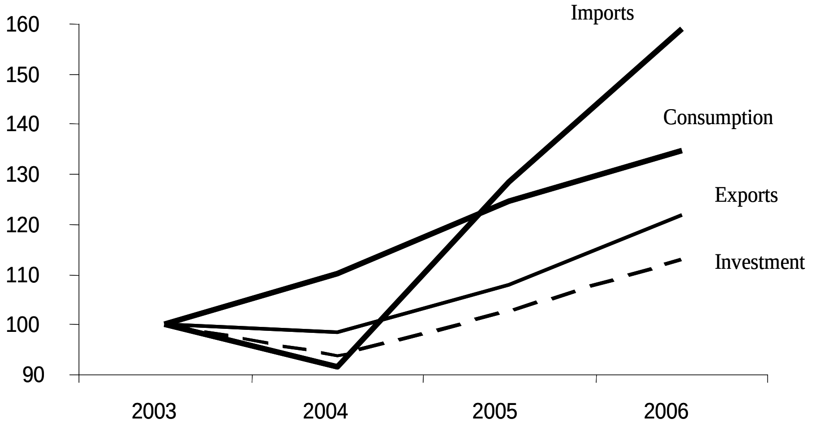
While the government and the industry have traded accusations, Pakistan's balance of payments deficit widened 52% in the first four months of the fiscal year 2006-07. The deficit, the amount by which imports exceed exports, remittances and other incomes from abroad, widened to $3.34 billion in the July-October period, from $2.19 billion a year earlier. The cost of importing oil in the first four months climbed to $2.73 billion by $594 million. Pakistan imports about 85 per cent of the oil it uses. What is not disclosed in the figures is the yet unexplained and even larger increase of $862 million in ‘other imports’.

Here, it needs to be highlighted that the data provided by the Federal Bureau of Statistics is not detailed enough to facilitate more in-depth and meaningful analysis and even the Ministry of Commerce has cited shortcomings in the statistical data as an issue in taking appropriate and timely policy actions. In addition, the quality of reporting is not generally at par with those of some other Asian countries.

Notwithstanding these issues, all other major imports, including industrial machinery, commercial and consumer vehicles and metals, reported a decline during July-October compared to a year earlier. In summary, given the rise in “other imports’ and decline in machinery and vehicles’ imports, the assertion that the current difficulties are largely the consequence of a higher oil import bill is not supported by the facts nor does it tell the whole story.

It is not just the current year’s data that points to a rapid and unsustainable growth in non-oil imports. During the FY 2005-06, Pakistan’s non-oil imports grew by 32.8% to US$21.6 billion from US$16.3 billion in 2004-05 and by 76.6% compared to level of non-oil imports (US$12.2 billion) in 2003-04. The government has maintained that the rising imports represent overall economic growth and higher investment spending. If that is case, it should result in correspondingly higher investment spending. However, that is not the case. Why? No doubt, the GDP has been increasing at a healthy rate but the growth has been fuelled by an extraordinary surge in consumption.

Key Economic Aggregates Growth
FY 2002-03 to FY 2005-06
Index 2002-03=100



During 2005-06, private consumption spending was higher by 34.7% in real terms compared to FY 2002-03 as shown in the graph. In other words, it increased at an average of 10.4% per annum (in real terms without adjusting for inflation) during the four-year period to June

2006, faster than the overall average GDP growth of 7%. In sharp and somewhat curious contrast, the investment spending grew by an average of only 4.2% per annum during the same period. Simply put, we have been spending more than we have been producing and that spending boom has been supported by a rapidly expanding banking sector that has been one of the principal beneficiaries of the growing remittances since 2001.

What has also contributed to the deterioration is the lack of proper incentives to encourage the rising foreign exchange flows to go into the productive channels. Fiscal and trade policy distortions have contributed to a record boom in private consumption (cars, mobile phones, real estate, consumer imports) while the investment spending has not risen as fast although the net banking credit to the private sector grew by 29% in 2003-04, 33% in 2004-05 and 30% in 2005-06. This issue lies at the heart of the current debate.

When a credit or a liquidity driven boom is used to finance an ever-increasing level of consumption and does not result in higher capital formation and investment spending, it causes higher inflation. The problem is exacerbated when higher consumption also involves finished goods imports that put additional pressure on the current account.

The trade policy should eliminate or lower tariffs on imported raw materials and discourage consumption of luxury imports on one hand and discourage exports of raw materials and low value-added goods on the other. We seem to have been doing the opposite: importing more and more of finished goods and exporting more and more of raw materials and low value-added goods. The problem has been further compounded by the fact the central bank is not completely independent in reality and has not focused on containing the inflation rate as the most important goal of its monetary policy as do most central banks. The policy makers and the businesses must address these fundamental issues on a top priority basis instead of quibbling about the exchange rate.

December 18, 2006

The drug threat from Afghanistan

The recently concluded NATO summit decided to set aside around 15 per cent of their "caveats" which restrict the deployment of soldiers in dangerous areas. Officials at NATO's heads of government summit in Riga said on November 29 that the concession was the equivalent of making available an additional 2,000 troops. The NATO secretary general said it was unacceptable that allied forces in south Afghanistan were 20 per cent below the required strength.

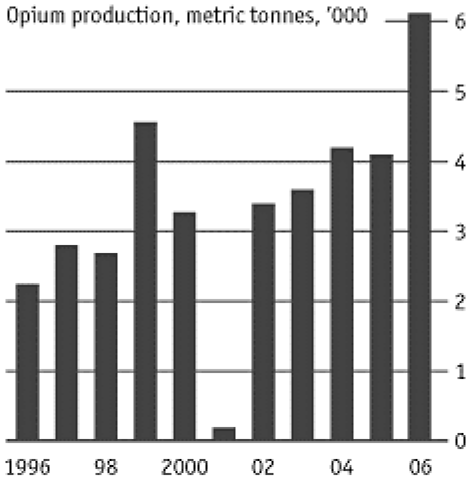
Although they have a total of 2.4 million men under arms, NATO's European members have dragged their feet to meet requests for an extra 2,200 soldiers, and vital equipment such as helicopters, to make up a reserve for the Afghan mission. The problem is made worse by the countless “caveats”—restrictions placed by governments on what their troops on the ground can do, where they can go and what equipment they may share. What these “caveats” mean in simple terms is that most NATO countries have been unwilling to engage in operations that may involve injuries or casualties. So much for the commitment to fight the war on terror!

As the NATO nations have quibbled over the provision of a few thousand troops, President Karzai has left no occasion to accuse Pakistan of supporting the insurgency in South Afghanistan and the western media has been full of reports complaining incessantly that Pakistan has not done enough even though it has lost nearly 1000 of its soldiers, it is time that Pakistan’s detractors take notice of the rapidly worsening drugs crisis in Afghanistan.

While not a single Afghan has been arrested for any terrorist act outside Afghanistan or Pakistan elsewhere in the world since 2001, there is absolutely no doubt that Afghanistan is on its way to earn the dubious distinction of the world’s largest narco-state after remaining under five years of NATO/US control.

Efforts to stamp out Afghanistan's record-setting opium trade have been stymied by corruption, and the drug trade is now run by a few powerful players with strong political connections. It is no secret that Karzai government’s writ, if there is any, depends on war lords and criminal thugs, according to reports in some of the leading American and British newspapers.

According to a new UN report released on November 28, the opium trade in Afghanistan has reached an all time high, largely due to corrupt government officials who have been protecting drug production. Opium production in Afghanistan rose 49 per cent this year to 6,100 metric tonnes and accounted for more than 90 per cent of the world's opium supply Poppies take up less than 4 per cent of the total cultivated area in Afghanistan, and most districts do not grow opium but the $3.1 billion export value of last year's crop accounted for about 35 per cent of the GDP, and employed about 13 per cent of Afghans.



The 210-page report, titled "Afghanistan's Drug Industry: Structure, Functioning, Dynamics, and Implications for Counter-Narcotics Policy", a joint effort of the World Bank and the United Nations Office on Drugs and Crime (UNODC), shows a "probability of high-level (government) involvement," particularly in the Interior Ministry, which controls Afghanistan's police force.

"The majority of police chiefs are involved," one senior police officer told the report's authors on condition of anonymity. "If you are not, you will be threatened to be killed and replaced." Without naming officials, the report said it was possible that powerful interests in the Interior Ministry are appointing district police chiefs "to both protect and promote criminal interests." The result is a "complex pyramid of protection and patronage, effectively providing state protection to criminal trafficking activities." According to a Radio Free Europe report, Karzai's office acknowledged that Bush telephoned Karzai on November 25, ahead of the NATO summit in Latvia, to demand more action against Afghanistan's drug trade. It is a matter of record that the drugs trade flourished during the 1980s during the so-called jihad against the Soviets and introduced the drugs and Kalashnikov culture in Pakistan leaving deep wounds within its civil society. While the terrorism and extremism are some of the major issues that Pakistan faces, the harmful effects of being a neighbour of the world's largest narco-state cannot be underestimated. For example the UNODC report says that Heroin prices in Herat and Kandahar appear to be pushed upward by the large cross-border profits related to the Pakistani and Iranian markets.

Drug trafficking, money laundering and illegal weapons purchases are closely aligned and can pose a potent challenge to the authority of a government, as they did in Columbia. If Pakistan Army wants to maintain its writ in the NWFP and Balochistan in the long term, it must confront Karzai and its international backers to tackle the drug trade in Afghanistan on war footing. It is high time that Islamabad take up this matter at the highest level with both NATO and the United States. Pakistan has already paid a high price for the 1980s 'jihad". Afghanistan's opium trade is not just a "drugs" problem. Its growing size and repercussions pose a grave threat to Pakistan's political, social and economic fabric and failure to control this will have extremely harmful consequences for Pakistan.

December 9, 2006

The stock market crash

Those who have worked in the financial industry for a long period may have come across an adage: "the balance sheet of a bank is like a bikini. What it reveals is interesting; what it hides is vital."

The US experts' report (conducted by a firm called Diligence) containing the findings into the alleged causes of the stock market crash in March 2005 includes some glaring contradictions and omissions for it to assert categorically that *"under the existing circumstances, and on the basis of the evidence examined to date, we render findings and conclusions that greatly differ, in many respects, with the findings and conclusions rendered by the Taskforce [of Justice Saleem Akhtar]. Most significantly, we do not find sufficient evidence to support the paramount scheme of manipulation in the manner put forth by the Taskforce for the period in question. Nor do we find sufficient evidence to support the alleged scheme's primary element (withdrawal of COT) that was ostensibly responsible for the fall of market prices. We find no patterns of activity or credible evidence to support a theory that, during March 2005, certain influential brokers systematically and manipulatively inflated and then deflated market prices, reaping substantial profits in the process."*

The report should have stated that it did not find sufficient evidence to support *or refute* findings of the task force. Here are the reasons why?

1. The report admits that trading information on unregulated Badla ("in-house Badla") is not readily available from exchanges or the public domain, but only from individual brokers engaging in such activities. It goes on to state that the data, if any, provided by individual brokers could not be reasonably or easily independently verified or tested for completeness or accuracy with a sufficient degree of certainty. Given these and additional time constraints, reliable and verifiable data related to potential trading levels of in-house Badla was not obtainable. Therefore, Diligence is "unable to provide any conclusive findings in this area." Given the critical importance of the role of Badla in financing highly speculative trading and its contributory role in the volatility of trading on the Karachi stock exchange, no investigation can draw any definite conclusions unless it can find its way through the often murky operations of the Badla market. Some insiders believe that its size was as large as $1.5 to $2 billion at the height of the stock market peak during the first quarter of 2005. This unregulated and undocumented activity probably represented almost 33%-45% of the entire stock market capitalisation on a free-float basis.

   The report acknowledges that the US experts found abundant indirect evidence (e.g. press reports) of the existence of this form of unregulated Badla which, "to the extent it exists, is in violation of Section 16 of the Securities and Exchange Ordinance, 1969." This honest admission raises serious questions about the whole regulatory regime and its efficacy. Free markets do not work well and are open to abuse without proper supervision and regulation. There can be little or no accountability in absence of transparent trading practices because it is simply not possible to track such transactions.

2. The US experts also attempted to analyze whether one or more brokers conducted illicit blank Ready Market sales. This scheme involves selling shares on the Ready Market that the investor does not own and cannot deliver at the settlement date. This

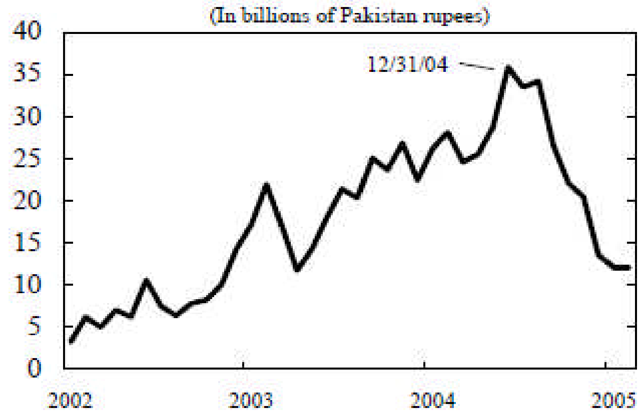
is a key technique that can be used to bring down prices in an artificial manner. The report (page 10) concedes that ready positions cannot be quantified on the basis of KSE activity alone. It adds that "reliable and detailed investor-level share balance information is required in order to determine whether a client has transacted a blank sale on the Ready Market. The use of group accounts at CDC precluded such an analysis for the period at issue." It adds, "without additional verifiable and complete information from individual brokers, it is not possible to determine whether or not this type of illicit activity was perpetrated on the market during March 2005."

Now, if the experts were not able to investigate into the in-house Badla transactions nor they could lay their hands on blank short-selling, supposedly two principal causes of the stock market crash, the whole rationale for hiring forensic experts becomes seriously questionable and their findings suspect at worst and academic at best.

3. The June 2005 report of the task force headed by Justice Saleem Akhtar had held that the withdrawal of the regulated carry-over-transaction (COT) financing facility by some large brokers was a deliberate tactic to push down prices in the ready market. The Diligence report (on page 7) however disagrees with this allegation and found no evidence that regulated COT was restricted or withdrawn from the market in the weeks prior to the market's fall as a result of voluntary and manipulative actions of any influential broker. Instead it contends that although there was, in fact, a withdrawal of certain regulated COT during February and March of 2005, this activity was attributable to two independent factors: (a) the execution of the SECP's previously planned and announced phase out of COT funding for certain scrips, which had begun in October 2004; and (b) the temporary suspension of "New COT" availability for two heavily-traded scrips, Pakistan State Oil (PSO) and Pakistan Telecommunications Company Limited (PTCL), in connection with their respective moves to spot trading to execute announced dividend payments – a necessary trading practice and "normal course of business" event.

Was it normal course of business event? An IMF report on Pakistan (November 2005 IMF Country Report No. 05/408) graphically depicted the total level of COT financing from July 2002 to end-March 2005. The IMF reported that the total COT financing peaked at Rs 40 billion in mid-February 2005 before falling to Rs 27 billion, that is by 33%, at end-March 2005. As can be seen from the graph (reproduced here from the IMF report), it was the steepest fall during the shortest period of time in the recent history. It is therefore rather contentious to say that the drop in the COT financing was a normal business event specially when even the IMF report acknowledged that the concentration of lenders, most of whom were also trading on their account, allowed manipulation of market liquidity and "abuses also reportedly took place, with some brokers raising financing for themselves by posting shares deposited with them by their investors."

Chart: Total COT Financing: January 2002 – March 2005



According to the Diligence report, due to the move to the spot trading in the scrips of PSO and PTCL, the COT outstandings dropped by Rs 7 billion during the period from March 10, 2005 to March 22, 2005. The report absolves the market players of any deliberate attempt to manipulate the market through the withdrawal of the COT and attributes it to the execution of the SECP's previously planned and announced phase out of COT funding for certain scrips, which had begun in October 2004. While this appears to be plausible, it is pertinent to note that the level of total COT outstandings continued to rise till February 18, 2005 notwithstanding the phase-out plan. It should also be noted that while the COT lending rates were capped at 18% per annum at the Karachi Stock Exchange (KSE) , they were not capped at the Lahore Stock Exchange (LSE) and rose to 24% at the KSE and as high as 100% at the LSE during the peak of the stock market boom in February-March 2005. Investors, big or small, indulging in highly speculative trading by borrowing money at such high rates, should not just blame the brokers or the government. This is as good or bad as gambling in a Casino.

Having said that, one cannot help but note that the manner in which the phase-out was managed does raise questions about the wisdom of removing a source of liquidity from the market without providing an alternative system and about the competence level and expertise of the regulators and key decision makers within the government.

The report however does a good job in documenting and illustrating the lack of transparency that has characterized trading practices at our stock markets. But in the absence of transparency and auditable records, it is difficult to prove that market was manipulated or not. The regulators and investing community have been working to improve the workings of the market and reform antiquated practices. Hopefully, they have learnt that periodic crashes and high volatility cannot inspire the confidence of local and foreign investors. If the investors, brokers, companies and the regulators want to develop the stock market on sound lines, they must work together to reform the system to bring it at par with the international standards for margin trading and compliance and adopt best practices for fair and transparent trading.

November 27, 2006

Selling Pakistan's energy assets

The much awaited GDR offering of Oil and Gas Development Company (OGDC), promoted as Pakistan's largest ever, fell short of expectations in terms of size and pricing with a negative impact on OGDC share price in the local stock market. The KSE100 Index dropped by 231 points to close at 10388 on Friday December 1 following the offering in London.

The sale of government's 8.8% (376.79 million shares) stake in OGDC raised US$712 million on November 30, but did not meet the earlier target of selling 10%-15% stake to raise US$1 to US$1.5 billion. The Minister for Privatization had billed this as the largest ever equity offering of a Pakistani company abroad at a press conference on November 12 but this GDS offering did not exceed the US$900 million sale of a 10% stake in Pakistan Telecommunication Company in September 1994. However it is a welcome development that a Pakistani company has been able to raise such a large amount in the international capital markets after a long time and does indicate confidence of the international investment community in Pakistan's economic prospects as well as about OGDC's future.

The government expects to get another US$38 million from the sale of 21 million shares to the retail investors @Rs110/share during the third week of December 2006 and another US$100 million if the underwriters choose to exercise the greenshoe option within 30 days of the issue. The exercise of this option by underwriters is usually indicative of their positive view of a stock's expected performance. Hence, it will be interesting to watch if the underwriters choose to exercise this option. Following the GDS placement, the OGDC share was lower by about 5% in the local market on Friday December 1 amid a dampening sentiment and concerns about a supply overhang. OGDC GDRs will start trading on the London Stock Exchange on Dec 6.

Some analysts feel that the issue could have been better timed as timing and sentiment are important factors that determine success of equity issuances. It was in December 2005 that the Privatization Commission had invited Expression of Interest (EOI) for the appointment of a Financial Advisory Consortium for the divestment of 10 % to 15 % equity (430 to 645 million shares). The EOIs were to be submitted by January 31, 2006. It took the Commission another four months to appoint Citigroup and Goldman Sachs to act as joint global coordinators and joint book runners for the global offering. However, the actual launching of the GDS offering started only on November 15 by which time the oil price in the international market dropped by about 24% off its peak level of around US$78 a barrel reached in July 2006 and the sentiment about international energy stocks turned from bullish to mixed. The offering price of Rs115 a share represented a 9.5% discount to the closing price (Rs128.15) of OGDC shares on the Karachi Stock Exchange but a discount of about 20% to the OGDC share price average during July 2006.

The total proceeds from the sale of Government' stake in OGDC stake would ease the pressure on the growing current account deficit and foreign exchange reserves will exceed US$13 billion mark from existing US$12.4 level.

Prime Minister Shaukat Aziz said on November 6: "we are attracting new investors into the country and opening new avenues for raising money compared to the traditional syndicated loan market." Sale of equity stakes through international capital markets is no doubt a new source for raising money, but sale of oil and energy assets is more than about just raising money.

From Sudan and Nigeria in Africa to all the oil producing countries in the Middle East and from Russia, China and India in Asia to Brazil and Venezuela in Latin America, if there is one sector that remains firmly under government control despite the growing trend towards privatization and deregulation, it is the oil and gas industry. Oil and gas together account for about 60% of world's energy needs and this percentage has not gone down during the last two decades despite massive investments in developing alternative energy sources. The oil price has tripled since 2001 as the demand for oil from the emerging markets grew faster than the oil production growth rates and contributed to about 80% of the growth in global oil demand during 2001-2005.

Of the twenty biggest oil and gas firms in the world, in terms of reserves, sixteen are under national or government control. The national oil companies (NOCs) manage about ninety per cent of world's oil. Exxon Mobil is the world's most valuable listed company, with a market capitalisation of US$448 billion. But if oil companies are ranked by their reserves, Exxon ranks a lowly fourteenth. All 13 of the oil firms that out shadow it are national oil companies (NOCs): partially or wholly state-owned firms. The list is headed by Saudi Aramco, National Iranian Oil Company and Russian Gazprom respectively.

While the NOCs have entered into joint ventures with foreign companies for oil and gas exploration projects, their governments have shunned from privatization due to the extremely strategic and sensitive nature of the role of energy in the world economy and global politics. While both China and India have gradually liberalised their economies, energy sector is a noticeable and conspicuous exception. The Chinese and Indian oil and gas companies not only remain under government control but have been spending billions of dollars on overseas acquisitions to add to their oil and gas assets with the full backing and support of their respective governments.

So does it make sense to sell shares in Pakistan's oil and gas companies, particularly OGDC which is Pakistan's largest oil and gas exploration and production company? It is the largest company in Pakistan in terms of market capitalisation and is extremely profitable. It had revenues of Rs 97.3 billion (or about US$1.6 billion) in FY2006 with a net income of Rs45.8 billion (or US$750 million). During the first quarter of its financial year 2006-2007, that ended on September 30, 2006, its net income rose by 37 per cent to Rs 12.3 billion (or US$203 million) compared to a year earlier due to higher production and prices. OGDC has a 27-year gas reserve life (seven years for oil), and is laying the groundwork for an increase in gas production at 15% per annum over the next three years.

OGDC's strategic importance assumes a critical dimension given the fact that Pakistan is one of the most gas-dependent economies globally. Natural gas meets about 50% of Pakistan's energy needs compared to a global average of 19%. Power is the largest consumer of gas at 40% of consumption, followed by fertiliser and household at 22% and 18%, respectively.

Over the past three years, gas has gained further prominence over oil as an energy source in Pakistan. The three-year annual average growth rate in demand for oil was actually a minus 6.4%, while for gas it was 12.1% and electricity 10%. The decline in the use of petroleum products in the household, agriculture, transport, and power sectors was due mainly to the availability of alternative and relatively cheaper sources of fuel (e.g., natural gas and LPG). Furthermore, compressed natural gas (CNG) for transport has been an additional growth segment.

OGDC is perhaps Pakistan's most important energy asset in that it currently accounts for 25% of Pakistan's hydrocarbon production, 31% of reserves and owns nearly 40% of the licensed acreage for oil and gas exploration. Further, OGDC is embarking on an extensive exploration program, targeting about Rs 36 billion or 120 exploration wells, over the next four years. It accounted for around 40% of the exploration wells drilled over the past ten years. Over the past two years, the figure is closer to 60%. After the current phase of sale of OGDC shares is completed, the Government's ownership will probably get reduced to 80%. The key question is: Will the government stop here and or does it intend to eventually hand over control of Pakistan's highly profitable oil and gas assets to the private (local or foreign) sector? If so, it may earn the questionable 'distinction' of becoming the only government in the developing world to privatize its oil and gas assets.

December 4, 2006

In the line of fire: setting the record straight

General Musharraf's book raised a storm of controversies ranging from Richard Armitage's threat to bomb Pakistan to the Stone Age, Dr. Qadeer's role in the transfer of nuclear technology, Kargil and Pakistan's role in combating terrorism. Whether General's account is a fair portrayal or a self-indulgent narrative will ultimately be judged by history. But many media pundits agree that the book has received unprecedented international media attention and that the General's trip to the United States was a quite a success.

The prevailing wisdom is that General did the right thing in the aftermath of 9/11 and he is here to stay like it or not. Who knows? But it is this conventional wisdom that needs more careful and deeper examination in a broader historic context. There have been a few times in the past when the elites and the pundits were almost unanimous on a national issue, only to be proven disastrously wrong by history. One needs to recall the tragic events of 1971 when the army, politicians, media and the intelligentsia supported the military action launched by a power and alcohol drunk junta led by General Yahya Khan to purify the blood of Bengalis. Almost all (West) Pakistanis took delight in the grossly and sadly mistaken belief that Pakistan had been saved. Yahya Khan, though discredited later, was seen as a straight forward and blunt soldier who could fix the 'traitor' Mujeeb-ur-Rehman and stand up to Indira Gandhi. The rest, as the cliché goes, is history.

Again in 1977, the establishment, the business, the media (barring few exceptions) and the chattering elites held an almost religious belief that Bhutto was the root cause of all Pakistan's problems and his removal from the scene would somehow lead to a more democratic and just society. Decades later, even his most bitter opponents, like late Nawabzada Nasrullah Khan and Naib-Amir of Jamaat Islami Professor Ghafoor Ahmed, admitted that Bhutto was a brilliant, honest and nationalist leader who gave Pakistan its first unanimously agreed constitution and General Zia-ul-Haq's martial law not only had no justification but destroyed the civil society of Pakistan.

Bernard Shaw said, 'we learn from history that people never learn from history." Our country has its more than fair share of power hungry generals, their crony politicians, business magnets, feudals and political pundits who have thrived in a corrupt and elitist society where knowledge and merit have little or no relevance. It is therefore hardly a surprise that while Indian universities, many modelled after the MIT, have produced graduates who have caused the biggest outsourcing revolution in modern history and seem destined to change the way the business is done globally, Pakistan's agriculture and industry is still dominated by cotton., cotton-textile weaving, and spinning units run under a protectionist economic regime. Admittedly India is also poor and underdeveloped, but it has made great strides because its government and business leaders have had in their ranks, some well educated, honest and competent people who played a key role in the recent transformation of India from a sleepy third world country in the early 1990s to an emerging global power in 2006. One can be excused for such cynicism but the point is, judging from history, it can be a sign of trouble or even an impending disaster when some line of thought or viewpoint achieves the status of conventional wisdom among the Pakistani establishment.

This is an attempt to discuss the two most prevalent myths: (a) that General had no option but to do what he did in the aftermath of 9/11 and (b) that the fundamentalists would take over the country if he fails. This debate needs to be conducted now and is not a matter for historians to write about in the future. General Musharraf's version and interpretation of history is not only wrong but has dangerous and extremely harmful implications for the future of Pakistan. Never mind the coverage in the US media. It is absolutely of no consequence from any serious long term perspective. Any student of history would know that Anwar Sadat was a darling of the US media and was the most loved Arab leader in the US after he signed the peace treaty with Israel in 1979 but his policies did not do any good to Egypt which remains a poor and weak country and the Muslim Brotherhood (whose influence peace with Israel was supposed to lessen) is a greater force in Egypt than it was ever before. Anwar Sadat was assassinated by die-hard members of the extremist Muslim Brotherhood and his successor, Husni Mubarak has ruled Egypt with an iron hand. Both failed Egyptian people.

Let us first address the question of General Musharraf's claims and their credibility. His assertion that Kargil was a military success and it was Nawaz Sharif who buckled under the American pressure was categorically contradicted by no less than the person of the former US viceroy to Pakistan, Robert Oakley. In a speech at the US State Department on March 23, 2001, he said: Quote:

"Pakistan is another example. Again, the most powerful political institution in the country was the one with which we didn't want to deal because they were military not civilian. The one time we did deal with them was during a crisis. President Clinton quite wisely asked General Zinni to call upon General Musharraf, someone he had gotten to know before he became the Army Chief. As a result of their conversation, General Musharraf, as an Army Chief, said, "We'd better climb down from Kargil before we have a huge war with India." This was a direct result of their conversation. Zinni didn't threaten; he didn't make any promises." Unquote.

Robert Oakley is not a member of PML (N) nor is he a friend of the MMA. He stated this in 2001 long before the demands for an independent enquiry about Kargil were made by the opposition.

This example highlights three characteristics of General Musharraf's style.

- He jumps headlong into a crisis without thinking through its implications.
- He is too quick and eager to make a policy u-turn under direct American pressure contrary to immature and bold claims about being his own man and having the ability to stand up to pressure.
- He not only denies responsibility for policy blunders but tries to sell them as the right steps taken in the greater national interest.

This is a pattern we see not only in the Kargil debacle but also in his handling of the crisis unleashed by the events of 9/11 and thereafter.

Now let's go behind the public diplomacy and critically look at the widely accepted view that there was no option but to surrender to the list of demands made by Colin Powell and Richard Armitage. This conclusion can only be drawn by people who have not closely followed the background and evolution of the Cheney doctrine since the late 1990s. While a layman can be excused for ignorance, responsible military and civilian leaders are expected to have in-depth knowledge and understanding of the global power politics, particularly the US foreign policy.

The centre piece of Cheney doctrine was oil with Iraq as the first target and Iran the second. Terrorism was to be used only as a pretext for intervention and never was a priority item on the Bush administration's agenda even after 9/11, a theme which has been so well documented by the former US chief of anti-terrorism Richard Clarke in his book "Against All Enemies." Richard Clarke served seven US presidents including Father Bush, Bill Clinton and Bush junior and has been described as the man who knows more than anyone in the US, about terrorism, al Qaeda and the US policy. Now the argument can be made that this is hindsight. It is not. Had our all-wise experts in the military establishment been following the evolution of the neo-cons' thinking since the 1990s, particularly that of Cheney and Paul Wolfowitz, they would have seen through the emptiness of the threats made by Colin Powell and Armitage.

The real targets were Iraq and Iran. The US could not and cannot afford to have an unstable Pakistan particularly when the whole Cheney doctrine centred on controlling the oil reserves in the Middle East and ensuring the safety of supply routes through the strait of Hurmuz. This is and was old news in the establishments in London and Washington. But what it means for Pakistan is while Pakistan may not be indispensable to the execution of the long term US policy agenda, the US can never afford to have an unstable Pakistan as long as there is a hostile regime in Iran. This position is further reinforced by the fact given an ever unstable Afghanistan and the peaceful but bitter power struggle between Russia and the US in Central Asia (which has the third largest concentration of oil reserves in the World after the Middle East and Russia), the last thing US would do is to bomb Pakistan. It would be a strategic suicide. But we panicked without taking the time to formulate a considered and well thought out response in a manner that would have leveraged all the cards Pakistan held and still does, notwithstanding our establishment's ill-conceived, nay, ridiculous strategy of supporting the Taliban (till 2001) to provide the so-called strategic depth.

The second canard of the current conventional wisdom holds Musharraf as the only option because otherwise the militants and fundamentalists would take over the country. The short answer to that is yes they most likely will – albeit in the long term - if the army rule continues and the democracy is denied a fair and uninterrupted chance. The Iranian revolution led by an army of theocrats could not have taken place had the US allowed Iran to function as a democracy under Mossadeq and had not resorted to a coup to over throw a democratic government in 1953. It was the continuation of the US-backed autocratic regime under the Shah of Iran that precipitated the plunge of a liberal Iran into a fundamentalist and authoritarian society. But even the elephants do not learn from history. The US repeated the same mistake in Lebanon. Had it not tried to prop-up a pro-western government in Lebanon through the force of gun in the 1980s, Hezbollah would not have emerged as the most organised popular force in Lebanon and one can argue in the entire Arab world. Had Saudi Arabia not suppressed dissent and allowed political activity, Al Qaeda would not have gained the ground it did after the forced-exile of Osama Bin Laden from Saudi Arabia to Sudan in 1991. And at home, if Zia had allowed political parties and civil institutions to grow, Pakistan's institutions would not have been as weak as they are now.

To present historic follies of monumental proportions as acts of wisdom taken in the supreme national interest is the last disservice our Generals can do to this country. It is time to be humble and admit the blunders. General would do well to learn from the quiet, humble and unassuming style of leaders of modern China and India, who have guided their countries to emerge as major global players, rather than copy the flamboyant style of the Texas cowboy who has made the world most unsafe in the recent history since the Second World War.

November 25, 2006

US Quest for global energy control

Russia on October 2, rejected calls from the European Union to lift economic sanctions on Georgia, saying it had cut transport links to curb a dangerous military build-up by its pro-Western neighbour. In unusually strident remarks, Russian Foreign Minister Sergei Lavrov also took a swipe at the United States, saying its support for Georgia had “stimulated” Tbilisi into taking unfriendly steps against Russia. Russia cut rail, air and postal links with ex-Soviet Georgia in response to the arrest of four Russian soldiers on spying charges. Tbilisi released the four on October 9, 2006 in what it termed a goodwill gesture. But Moscow made it clear the spying row was just part of what it sees as a deeper dispute with Georgia, which has irked Moscow by aggressively pursuing membership of NATO and the European Union and pulling out of Russia’s orbit.

In an apparently unrelated development, Russia announced on October 9, that it would develop Russia’s massive Shtokman natural gas field alone – and switch eventual output from the US to Europe – scrapping the $20 billion joint venture plans with the US oil companies Chevron and ConocoPhillips.

These developments followed the September 2006 summit in Paris between Russia’s Vladimir Putin, French President Jacques Chirac and German Chancellor Angela Merkel. The summit discussed the question of future Russian energy supplies to the European Union, notably, Germany. It is important to remember that Russia is the single largest supplier of oil and gas to Europe.

Russia’s latest moves underscore the re-emerging of Russia as a major global energy power. Putin’s Russia is gaining in influence through a series of strategic moves revolving around its geopolitical assets in energy—most notably its oil and natural gas. The new Russia also feels that if it does not act decisively, it may soon be encircled and trumped by a military rival, USA, for which it has little defenses left. The battle, largely unspoken, is one of the highest stakes battle in world politics today. Iran and Syria are seen by Washington strategists as significant steps toward America’s quest to control world’s energy resources which has also been called the “The War for Oil”.

Since the devastating setbacks two years ago from the US-sponsored ‘color revolutions’ in Georgia, and then Ukraine, Russia has begun to play its strategic energy cards extremely carefully, from nuclear reactors in Iran to military sales to Venezuela and other Latin American states, to strategic market cooperation deals in natural gas with Algeria and pipeline deals with China. The latest move to abandon the proposed Shtokon natural gas joint venture sends a clear message to the US regarding Russia’s political and economic ambitions in Europe: Russia wants to control its energy to extend its influence in Europe.

The ‘Cheney strategy’ has been a US foreign policy based on securing direct global energy control, control by the Big Four US or US-tied private oil giants-- ChevronTexaco or ExxonMobil, BP or Royal Dutch Shell. Above all, it has aimed at control of all the world’s major oil regions, along with the major natural gas fields and energy supply routes. That strategy has moved in tandem with a growing bid by the United States for total military primacy over the one potential threat to its global ambitions—Russia. Cheney is perhaps the ideal person to weave the US military and energy policies together into a coherent strategy of dominance. During the early 1990’s under father Bush, Cheney was also Secretary of Defense.

The Cheney-Bush administration has been dominated by a coalition of interests between Big Oil and the top industries of the American military-industrial complex. An aggressive militaristic agenda has been essential to it. It is epitomized by Cheney's former company, Halliburton Inc., at one and the same time the world's largest energy and geophysical services company, and the world's largest constructor of military bases.

Back in September 1999, a full year before the US elections which made him the most powerful Vice President in history, Cheney gave a revealing speech at the London Institute of Petroleum. Cheney made the following comment:

"By some estimates there will be an average of two per cent annual growth in global oil demand over the years ahead along with conservatively a three per cent natural decline in production from existing reserves. That means by 2010 we will need on the order of an additional fifty million barrels a day. So where is the oil going to come from? Governments and the national oil companies are obviously controlling about ninety per cent of the assets. Oil remains fundamentally a government business. While many regions of the world offer great oil opportunities, the Middle East with two thirds of the world's oil and the lowest cost, is still where the prize ultimately lies. Even though companies are anxious for greater access there, progress continues to be slow. It is true that technology, privatisation and the opening up of a number of countries have created many new opportunities in areas around the world for various oil companies, but looking back to the early 1990's, expectations were that significant amounts of the world's new resources would come from such areas as the former Soviet Union and from China. Of course that didn't turn out quite as expected. Instead it turned out to be deep water successes that yielded the bonanza of the 1990's."

The Cheney remarks are worth a careful reading. While short term trends can cause high level of volatility in oil prices, it is a matter of historic record that oil price has tripled since 1999 and the oil production growth rate of 1.4% per annum has greatly lagged behind the demand represented by the world GDP growth rate of 4.1% per annum.

A second notable point of Cheney's 1999 London comments was his remark that, 'the Middle East with two thirds of the world's oil and the lowest cost, is still where the prize ultimately lies.' However, as he revealingly remarked, the oil 'prize' of the Middle East was in national or government hands, not open to exploitation by the private oil companies. At that time, Iraq, with the second largest oil reserves after Saudi Arabia in the Middle East, was under the rule of Saddam Hussein. Iran, which has the world's second largest reserves of oil and natural gas, was ruled by a nationalist government which was not open to US private company oil tenders. The Caspian Sea oil reserves were already a subject of bitter geopolitical battle between Washington and Russia.

Cheney's remarks take on a new significance in the context of a report titled, 'Re-building America's Defenses', prepared in September 2000. The paper was issued by an entity named Project for the New American Century (PNAC).

Cheney's PNAC group called on the new US President-to-be to find a suitable pretext to declare war on Iraq, in order to occupy it and take direct control over the second largest oil reserves in the Middle East. Their report stated bluntly, 'While the unresolved conflict with Iraq provides the immediate justification (sic), the need for a substantial American force presence in the Gulf transcends the issue of the regime of Saddam Hussein ...'

Buried in the debate leading to the US bombing and occupation of Iraq in March 2003 was a lawsuit under the US Freedom of Information Act brought by Sierra Club and Judicial Watch. The suit demanded that Vice President Cheney make public all documents and records of meetings related to his 2001 Energy Task Force project.

The US Commerce Department in summer 2003 ultimately released part of the documents following a Federal Court order, over ferocious Cheney and White House opposition. Amid the files of the domestic US energy review was, curiously enough, a detailed map of Iraqi oilfields, pipelines, refineries and terminals, as well as two charts detailing Iraqi oil and gas projects. The military occupation of Iraq was the first major step in this US strategy. Control of Russian energy reserves, however, was Washington's ultimate 'prize.'

The surprising and rapid spread of NATO to include East European countries, to the alarm of some in western Europe, as well as to Russia, had been part of the strategy advocated by Cheney's friends at the Project for the New American Century, in their 'Rebuilding America's Defenses' report and even before. The US Committee to Expand NATO also included Project for the New American Century (PNAC) members Paul Wolfowitz, Richard Perle, Stephen Hadley and Robert Kagan. The war hawk Cheney network moved from the PNAC into key posts within the Bush Administration to run NATO and Pentagon policy. The same group also created a powerful lobby organization, the Committee for the Liberation of Iraq (CLI).

During a White House welcoming ceremony to greet the ten new NATO members in 2004, President Bush noted 'We're discussing how we can support and increase the momentum of freedom in the greater Middle East.' Freedom, that is, to come into the orbit of a Washington-controlled NATO alliance.

The defining event in the global energy geopolitics under Vladimir Putin took place in 2003. Khodorkovsky was arrested on October 25, 2003, on charges of tax evasion. The Putin government froze shares of Yukos Oil because of tax charges. They then took further actions against Yukos, leading to its collapse.

What was little mentioned in Western media accounts, which typically portrayed the Putin government actions as a reversion to Soviet-era methods, was what had triggered Putin's dramatic action in the first place.

Khodorkovsky had been arrested just four weeks before a decisive Russian Duma or lower house election, in which Khodorkovsky had managed to buy the votes of a majority in the Duma using his vast wealth. Control of the Duma was to be the first step by Khodorkovsky in a plan to run against Putin the next year as President. The Duma victory would have allowed him to change election laws in his favor, as well as to alter a controversial law being drafted in the Duma, 'The Law on Underground Resources.' That law would prevent Yukos and other private companies from gaining control of raw materials in the ground, or from developing private pipeline routes independent of the Russian state pipelines.

The Khodorkovsky arrest followed an unpublicized meeting earlier that year on July 14, 2003 between Khodorkovsky and Vice President Dick Cheney. Following the Cheney meeting, Khodorkovsky began talks with Exxon Mobil and Chevron Texaco, Condi Rice's old firm, about taking a major state in Yukos, said to have been between 25% and 40%. This would also have given Washington, via the US oil giants, a de facto veto power over future Russian oil and gas pipelines and oil deals. Days before his October 2003 arrest on tax fraud charges, Khodorkovsky had entertained George H.W. Bush, the representative of the powerful and secretive Washington Carlyle Group in Moscow. They were discussing the final details of the US oil company share buy-in of Yukos.

Yukos had also just made a bid to acquire rival Sibneft. YukosSibneft, with 19.5 billion barrels of oil and gas, would then own the second-largest oil and gas reserves in the world after ExxonMobil. YukosSibneft would be the fourth largest in the world in terms of production, pumping 2.3 million barrels of crude oil a day. The Exxon or Chevron buy-up of YukosSibneft would have been a literal energy coup d'état. Cheney knew it; Bush knew it; Khodorkovsky knew it. Above all, Vladimir Putin knew it and moved decisively to block it.

November 4, 2006

Are we ready for $100 a barrel oil price?

The Democratic Leader in the US Senate Harry Reid said on August 21, 2006, "Far from spreading freedom and democracy in the Middle East, the Bush administration has watched while extremists grow stronger, Iran goes nuclear, Iraq falls into civil war and oil and gas prices skyrocket. Simply staying the course is unacceptable." Bush's approval rating has slumped to the lowest point of his presidency, and Republicans are concerned that they could lose control of Congress because of voters' unhappiness. Islamabad should take notice and instead of thumping chests over Pakistan’s cooperation in apprehending the London bomb plot suspects should re-evaluate the question of Pakistan’s cooperation with the US on the war on terror with a cold logic of self interest. While there is no disputing the fact that the extremism and terror are intertwined and violence must be uprooted from our society, there is no excuse for pushing the pressing national issues down the list of government priorities while it is preoccupied with and focused on pleasing Bush-Blair axis of arrogance and stupidity.

What the government and opposition leaders and many public commentators seem to be missing that the most serious economic threat Pakistan faces in 2006-2007, is the prospect of a $100 a barrel oil price. In FY2006, higher oil prices accounted for almost all the increase in Pakistan’s oil imports which touched $5 billion and contributed a sizeable portion of the total imports of about $28.5 billion. Yes, we have imported inflation and we are importing more of it. This was at a time when the average oil price was around $55-$60 a barrel. In the current FY2007, this average is already touching $70. Are we ready if the oil price goes to $100? Do we have a strategy to deal with such a contingency? The US has oil reserves, do we? Or we will stick to the tradition of responding to an issue only when it develops to a crisis situation?

The privatization of the steel mills is an important matter and so is the issue of women’s rights but let’s face it, the continuing rise in the world oil price will push inflation in Pakistan into high teens and put the balance of payments under severe pressure at a time when our exports growth is faltering and the global demand for our exports is likely to go down given the threat of an imminent slowdown in the US and Europe.

According to the State Bank of Pakistan’s Third Quarterly Review of the economy, issued on August 19, the broadest measure of inflation, the GDP deflator, is estimated at 10.3 per cent for FY2006, up sharply from 8.8 per cent year in the preceding year. This rate of inflation is the highest in the any country from Egypt to Japan in the entire Asia, Middle East and Africa region (except Turkey where it is slightly higher at 10.6 per cent). Yet, the economic wizards of the present government tell us we are doing well and the GDP growth this year will be 7 per cent, which is higher than the official figure of 6.6 per cent last year. It is simply not possible that Pakistan’s economic growth rate, with its huge dependence on oil, can continue to go up when inflation is in double digits and the global outlook is clouded by higher inflation and economic slowdown as oil price sets new records and interest rates rise.

Iran’s Supreme Leader Ayatollah Ali Khamenei has vowed that Iran would not be deflected from its pursuit of nuclear energy. Iran’s refusal to accept the UN Security Council resolution last month giving Iran until August 31 to halt enrichment or face possible sanctions is causing anxiety in the world markets. But what is more serious is the statement by an Israeli cabinet minister Rafi Eitan that Israel should prepare for the possibility of a missile attack from Iran. Speaking on Israeli Radio on August 22, Eitan, a former Chief of the Israeli intelligence agency Mossad’s operations in Europe, said Iran could fire missiles at the Jewish state "therefore we must prepare for what could come, and prepare the entire country for a missile strike attack, to prepare all the civilian systems so they are ready for this."

This statement is ominous and may well indicate that Israel is preparing for some kind of a showdown with Iran. In the past, Israel has used the doctrine of 'pre-emptive strike' to justify its attacks on the Arab territories. It cannot be ruled out that this statement is part of a propaganda campaign to prepare grounds for an air strike against Iran. Even if Israel does not attack Iran but the tensions continue to mount, the oil price may cross the $80 barrier in the coming months and may hit $100 level in a year or so. While this does not seem to worry President Bush that much, judging from his remarks at his press conference on August 21, the prospect of $100/barrel oil price should receive more attention from the Prime Minister and his economic policy makers that it currently appears to be getting. This is not just "another economic issue". It may well prove to be more deadly for Pakistan in the long run than the activities of foreign terrorists in Waziristan or the insurgency in Balochistan.

The question that the people of Pakistan are entitled to ask President Musharraff is: Do you have a plan to deal with this contingency? And if yes, what is the plan? But nobody seems to be asking this question? Sadly, we seem to have become a nation of "after the fact". The government woke up to the gravity of the electricity shortage only after the unprecedented power breakdowns this summer and acknowledged that power generation has not kept pace with the growing demand for several years – a consequence of bungled up policies and lack of strategy and clear thinking on the part of the planners. The recent rains in Karachi have played havoc with the lives of its citizens. The incompetence of all the federal and provincial agencies involved has been exposed. The chaos was the result of only 88 mm of rain. In Mumbai last year a total of 944 mm of rain was recorded on July 26 in only a few hours. It is frightening to imagine what would happen if Karachi was to receive that kind of rainfall, let alone a nuclear attack.

It is time to wake up. It is high time that the our leadership (both government and opposition) come out of their slumber and start thinking and debating about the bread and butter issues that impact the livelihood of the people of Pakistan and deserve more urgent attention than Kashmir or the bomb plots, important as they may be.

August 22, 2006

Conclusion: Pakistan's Way Forward

Disengagement, Realignment, and Empowerment can help Pakistan find its way out of the quagmire and move forward. It cannot hope to transform itself unless it **Disengages** itself from overt and covert conflicts; external and internal, **Realigns** its foreign and economic policy focus from the West to the East, and **Empowers** its people through genuine and not 'manipulated or rigged or hijacked' democracy.

It is a cliché to say that Pakistan faces an existential threat from extremist forces. The security establishment is seen by the United States as vital to winning the "War on Terror". Pakistan's so-called Islamic parties and groups never get tired of blaming America for all the country's problems. The military has traditionally blamed the politicians. The Americans blame the extremists and terrorists for Pakistan's current woes. So do Pakistan's liberals. In the context of the recent past and the country's history, Pakistan's biggest tragedy (and the principal reason for its break-up) was and has been the domination of its polity and power structures by the army which is largely responsible for the failing national security state that Pakistan is today. Pakistan's greatest challenge is not extremism. It is whether it can transform itself from a security state that continues to behave with a Cold War mindset whilst the past three decades have seen the world change from a bi-polar to a uni-polar and then to a multi-polar world.

Army's most powerful external ally has been the United States, particularly its defense and security establishment. Internally, the religious right-wing parties and big media have been its two principal allies while the military establishment has historically protected the interests of the rural and urban elites to ensure their support. Until and unless the axis of trouble, that is the axis of Army, the United States and the right-wing is broken, neither the reconstruction of the Pakistani state nor the so-called democratization of Pakistan will alter the fundamental nature of the security state or bring peace or prosperity to Pakistan's 180 million people, nearly seventy per cent whom live below the poverty line of $2 a day.

Pakistan's elites have little interest in the reconstruction of the state because they have the most to lose if power is truly exercised by the people. The army has no incentive to break the axis of trouble (a legacy of the great game and India-centric policies) because it thrives on the perpetuation of conflicts in the region and the largess it receives from the United States.

The Americans cannot afford to antagonize the army for the simple reason it is the only power that matters. And what about the mullahs? They have thrived due to a combination of factors. Most important among the factors is the failure of the so-called mainstream parties to provide honest, competent, and credible leadership.

It is customary to blame Zia and his successors, including Musharraf, for the growth of the Frankenstein forces of extremism and terrorism, but the buck does not stop there. In many other countries, for example, in Latin America, the unholy alliance between the local military, rightwing forces and Americans undermined democracy but the nationalist and democratic forces eventually triumphed because they had capable and credible leadership.

Pakistan has been cursed by civilian and military leaders who are too eager to follow the US agenda. From Ayub to Kayani, there is not a single army chief who can claim to have pursued Pakistan's strategic interests independent of US goals in the region. Since the US interests have largely been military and revolved around the containment of Russia and China in the region, its most natural ally has been the military at the cost of democracy and democratic governance. It therefore does not make sense to expect any change from "civilian' leaders who do not wish to nor can afford to change policies that have been and continue to be made in Pindi and Washington.

President Zardari and Pakistan's main opposition leader Nawaz Sharif have most of their wealth stashed away in Europe and Swiss bank accounts. It was Britain and the United States who brokered the deal in 2007 with the military as a result of which all corruption cases against Zardari were dropped. The MQM's Altaf Hussain has long been beholden to the British for providing him a sanctuary after he escaped from Pakistan in the early 1990s. Can such leaders ever articulate, promote, or defend Pakistan's interests when it comes to dealing with the US or Britain?

The army leadership's record is hardly any different when it comes to coziness with the west and serving its interests. Former military dictators Zia and Musharraf were propped up by the Americans. Zia and his ISI Chief allegedly left fortunes for their families. Musharraf, who used to mock Benazir and Nawaz for living luxurious lives abroad, has been leading a comfortable life in London.

Corrupt and Incompetent Politicians

One of Pakistan's main causes of failure to evolve as a stable country is similar to those experienced by many developing countries in the past; the nexus between corrupt local leaders (e.g. Marcos, Suharto, Mubarak, Mobutu, Noriega, Cordova, etc.) and the west to serve their mutual interests at the cost of the poor and impoverished masses and their future. Pakistanis will have to break this nexus between the corrupt elites and the west if they want their country to be a self respecting sovereign state that works to promote the interests of its people and not of its army or its corrupt and selfish elites.

There are two Pakistans; the real one is of the people which has been hijacked by imposters and the elites. The two Pakistans have become highly polarised due to rising income inequality, persistently high double digit food inflation, absence of social justice, and lack of opportunities for the poor and middle classes. The acuteness of vertical (class) polarisation has been compounded by horizontal polarisation on provincial and ethnic lines. The consequence is a fragmented and fractured society and a very difficult-to-govern country.

This polarised Pakistan suffers from a serious leadership crisis. The so-called mainstream parties have failed to provide competent and credible leadership. In many other countries, for example, in Latin America, the anti-democracy alliances between the local military, rightwing forces and Americans undermined freedom and welfare of the people but the nationalist and democratic forces eventually triumphed in many countries because they had capable leadership.

The prolonged involvement of the army in politics, its manipulation of elections and political governments through corrupt (and at times violent) means and unscrupulous politicians has led to the demonization of politics to a degree that that save for incompetent and corrupt individuals like Asif Zardari or Nawaz Sharif, or creations of the establishment like the MQM's neo-fascist Altaf Hussain or Maulana Fazlur Rehman (infamous for his double dealings), few wish to navigate the treacherous and murderous waters of stormy Pakistani politics.

Most Pakistanis are religiously conservative but not of the Saudi or Afghan bent. They have more in common with Indians than with Arabs in cultural terms, for example, languages, music, racial or ethnic mix, food, customs, etc. It is a mockery of truth to present this country of 180 million as ripe for extremists' takeover. Why? Pakistanis thrice voted a modern woman like Benazir Bhutto – twice during her life and third time as a martyr – into office.

Throughout its 60-year history, Pakistan has consistently favored secular parties, despite the nation's origins as a separate homeland for Muslims of the Indian subcontinent which had a long history of democratic movements. The politically mature, patient, and forgiving people of Pakistan have voted mainstream parties into power in every election in the last forty years despite huge disappointments and rejected the religious or extremist groups. The high-water mark for the religious or Islamic parties, 2002, yielded just 12 % of the national vote; that too due to manipulation by Musharraf to prevent the Pakistan People's Party from gaining a majority.

Yet the US and its cronies in Pakistani establishment, and establishment dominated media would have the rest of the world believe Pakistan could be taken over by the Islamic radicals anytime soon. Nothing could be farther from the reality. Pakistan has been and continues to be an Army with a country as post-independence Pakistan's most liberal and popular leader Zulfikar Ali Bhutto wrote from his death cell in 1978.

Armed Gangs and Militants with roots in the Establishment

Most of the so-called 'jihadi' groups owed their creation and sustenance to the former military dictator General Ziaul Haq – a right-wing fascist and a demented hypocrite. Zia compromised Pakistan's national interests to save his shaky government in 1980 by extending support for the covert CIA operations – the biggest ever till then – in exchange for $3.2 billion in American aid and support for his dictatorship.

Zia's successors continued his policies. The power of the extremists (e.g. Mullah Radio of Swat, Rashid Ghazi of Lal Masjid, or late Azam Tariq of Sepah-e-Sahiba) to openly advocate violence and conduct terrorist attacks would not and could not have grown without the support of the Pakistani establishment. For example, Musharraf and his intelligence chiefs released Azam Tariq from jail in November 2002 to enable him to vote in the National Assembly and provide the crucial one-seat majority to form the government with Zafarullah Khan Jamali as prime minister.

In Pakistan, the so-called radical Islam does not have a popular program or credible leadership around which the masses could or would rally. The people would never want to see a Taliban type of regime in Islamabad. The record of the so-called Islamist parties is tainted with corruption as well as cooperation with successive military dictators and they suffered humiliating defeat in 2008 elections. Even for a national cricket icon like Imran Khan, with a reputation for honesty and record of charity work, it is a politically liability that he is described or perceived by some as a Taliban sympathizer.

The number of the militants of all groups, including the foreigners and the so-called "good militants" does not exceed a few hundred thousand in Pakistan even if the estimates are stretched. Large number of these 'militants' continue to have the support of Pakistan's security establishment and are mostly concentrated in the tribal areas in the northwest or in some pockets of Southern Punjab with hideouts in Karachi. According to the estimates of even conservative US think-tanks such as the Council on Foreign Relations, the Pakistani Taliban collectively have around 30,000 to 35,000 members.

These armed terrorists do pose a serious security challenge to a politically unstable and poorly governed Pakistan but parallels with Iran of 1979 are simply wrong. Their objective is clearly to spread terror but to assert that the bombings – suicide or through improvised explosive devices (IEDs) – can help a tiny minority of ragtag militias and semi-literate terrorist gangs to capture power in the sixth most populous country in the world with the seventh largest standing army is a laughable and ridiculous proposition. Imran Khan warned of an Egyptian style uprising if the American spy Raymond Davis was released but the protests called by the religious parties petered out very quickly. Why? The following is rather a long quote from an article of one of Pakistan's leading columnists Ayaz Amir but worth a careful read:

"Because behind the deal which freed Davis was the deft and powerful hand of the ISI. We have seen protests but they have been of the muted kind, serving only to emphasize the hidden strings of agitation in Pakistan. Spare a thought for political governments which must put up with their own shortcomings and the tender affections of the guardians of national security. More than being an inherited condition, religious extremism is an acquired taste in Pakistan, the godfathers of national security having more to do with this acquisition than we usually care to think."

On the electoral front, there is little evidence that the growth of the anti-American sentiment in Pakistan has translated into more political support for the Islamist parties as the results of the 2010 bye-elections (mostly won by the two largest parties) and that of 2008 elections for national and provincial legislatures clearly indicate. However, resentment and anger runs deep among the masses against the US polices especially because America is identified with the policies of military dictators like Zia and Musharraf or corrupt and unpopular politicians like Zardari.

'War on Terror' – a Misnomer and a Disaster

Zbigniew Brzezinski (who served as National Security Adviser in the Carter Administration) in his testimony to the US Senate Foreign Relations Committee in 2007 called the so-called "War on Terror" a historical myth created and perpetuated by the US government, It is ironic that it was Brzezinski who came to Pakistan in 1979 and encouraged General Zia to fight against the soviets in Afghanistan. It is the same Brzezinski who made startling disclosures in his interview to Le Nouvel Observateur, Paris, 15-21 January 1998, confessing that the CIA"s military-intelligence operation in Afghanistan, which consisted in creating the "Islamic brigades", <u>was launched prior rather than in response</u> to the entry of Soviet troops into Afghanistan with intent to deliberately trigger a civil war.

Perhaps Brzezinski now regrets his past role. He told the US Senate committee on February 1, 2007:

"*A mythical historical narrative to justify the case for such a protracted and potentially expanding war is already being articulated. Initially justified by false claims about WMD's in Iraq, the war is now being redefined as the "decisive ideological struggle" of our time… and 9/11 as the equivalent of the Pearl Harbor attack which precipitated America's involvement in World War II."*

A critical mistake committed by Pakistani establishment (which includes some big media groups) and its "<u>moderately</u> educated and enlightened" English-speaking affluent classes has been their refusal to recognize that the military aggression by the US has been the principal cause of anti-Americanism in the Muslim countries. The US military destroyed Iraq and Afghanistan, and has destabilized Pakistan, intentionally or otherwise. Anyone who points that out is labeled as a Taliban sympathizer or encountered with thoughtless and shallow refrains such as "this is our war." This has proven to be a myopic, unrealistic, self-serving, shallow but ultimately self-defeating mantra. Hence, there is very little informed discussion and/or investigative reporting in the media about the militants, their roots, connections, and antecedents.

What compounded the blunders and short-sightedness of Pakistan's security establishment were the pig-headed and misguided policies of Bush administration and since 2009, the dramatic escalation in the drone attacks conducted by the CIA under Obama's watch. According to independent accounts outside the US, the number of civilian deaths including women and children has far outnumbered those of the alleged terrorists. The authenticity of claims made by the CIA or the US officials regarding the deaths of militants and civilian casualties has been questioned by the United Nations. The claims are not transparent, have not been independently verified, and can't be taken at their face value despite being dutifully and faithfully reported by the mainstream media.

More significantly, the drone attacks have antagonized the public opinion in Pakistan, which does not seem to matter much for the US policy makers as long as they can keep Pakistan army generals on board. This is an unwise, arrogant, and short-sighted approach particularly when the capacity of the militants to conduct operation in the US itself is seriously questionable and is not supported by any evidence. A US Congressional Research Service (CRS) report had concluded in August 2005, "There is no consensus among experts in and outside the US government about the magnitude of the threat to US national interests posed by the Al Qaeda organisation."

It is open to question if the objective of the drone attacks was to target a few hundred militants. If it was so, why did the US wait for two and half years to conduct the first drone attack on June 18, 2004 in Wana? The Americans knew quite well that hundreds and according to some accounts as many as five thousand Al Qaeda, Central Asian, and Taliban militants were in Waziristan since November 23, 2001. They were evacuated through special flights made from Kunduz, Afghanistan to Pakistan's northwestern airports in Gilgit and Chitral. The evacuation was a special operation (dubbed as "Airlift of Evil" by MSNBC), conducted with the approval of Dick Cheney in response to a request made by Musharraf apparently on the ground that many Pakistani officers and agents were also trapped in Kunduz along with the Al Qaeda and Taliban fighters.

Thereafter, the CIA conducted only two drone attacks in 2005, just one in 2006, and four in 2007. Why did the US forces and the intelligence agencies wake up after several years and particularly in 2008 – seven years after 9/11- and realised that the drone attacks were the right way to get a few hundred Al Qaeda members, every third of whom killed was described as a third-in-command of Al Qaeda.

We may not have the answers but what is beyond any dispute is that the number of casualties in bomb attacks and the level of violence inside Pakistan started to rise significantly only during the second half of 2007 (almost six years after 9/11 and American attack on Afghanistan) and has increased more than ten times since.

Leaving aside the issue of controversial drone attacks, the fundamental justification and raison d'être for the attacks – a few hundred Al Qaeda members in Afghanistan were a serious threat to the United States – is something Bush and his top officials themselves did not take seriously as has been corroborated by the accounts of key insiders such as Bush's own former chief adviser for anti-terrorism Richard Clarke. This theme is now being echoed by a growing number of commentators on both sides of the Atlantic.

A Newsweek Sept. 4, 2010 article asked a frank question: "Nine years after 9/11, can anyone doubt that Al Qaeda is simply not that deadly a threat? In every recent conflict, the United States has been right about the evil intentions of its adversaries but massively exaggerated their strength." It admitted pointing out, "The amount of money spent on intelligence has risen by 250%, to $75 billion (and that's the public number, which is a gross underestimate). That's more than the rest of the world spends put together."

According to a September 2010 study by the International Institute for Strategic Studies (IISS), a leading U.K. security think-tank, the threat posed by al-Qaida and the Taliban is exaggerated and the western-led counter-insurgency campaign in Afghanistan risks becoming a "long, drawn-out disaster". The Institute reckons that the west's counter-insurgency strategy has "ballooned" out of proportion to the original aim of preventing al-Qaida from mounting terrorist attacks there, and must be replaced by a less ambitious but more sensible policy of "containment and deterrence".

President Obama addressed the American people Aug. 31 and admitted, "One of the lessons of our effort in Iraq is that American influence around the world is not a function of military force alone." One would think the US would have learnt that lesson in Lebanon. Obama acknowledged in a humble tone, "We cannot do for Afghans what they must ultimately do for themselves", and announced his intention to start the withdrawal of the US troops next July. He may face serious obstacles including from the Pentagon and the CIA Even Selig Harrison, known for his negative views about Pakistan Army, concedes: "The biggest obstacle to the [peace] accord is not likely to come from Pakistan, but from a Pentagon mindset in which the projection of US power is viewed as a desirable end in of itself."

According to Washington Post report (Dec. 27, 2007), Assistant Secretary of Defense Michael G. Vickers was working to implement the US military's highest-priority plan: a global campaign against terrorism that reaches far beyond Iraq and Afghanistan. The post reported that Pentagon officials once jokingly referred to Vickers' efforts as the "take-over-the-world plan".

According to the report, Special Operations Command (Socom), which was growing faster than any other part of the US military, had its budget doubled in a few years, to $6 billion for 2008, and the command was to add 13,000 troops to its ranks by 2011.

The plan involved deploying a variety of elite troops around the world, including about 80 to 90 12-man teams of Army Special Forces soldiers who were skilled in foreign languages and at working with indigenous forces. The plan was focused on a list of 20 "high-priority" countries, with Pakistan posing a central preoccupation for Vickers, according to Washington Post.

Another evidence of Pentagon's imperialist empire building ambition is the fact that the United States forces have 74 bases in Afghanistan, including airfields, but only some are designed solely for counterinsurgency operations. According to the Foreign Policy magazine, the mammoth airfields at Bagram and Kandahar are projected to grow in the years ahead — ambitious new construction projects continue at both bases, despite Obama's pledge to begin withdrawing troops from the country in the summer of 2011. Furthermore, Congress is considering funding requests, totaling $300 million, to establish new bases at Camp Dwyer and Shindand, close to the Iranian border, and Mazar-e-Sharif, near Central Asia and Russia.

This military misadventure must end. There is no alternative to a political solution. Non-violent political solution requires not only Pak Army should not use militants – in Afghanistan or Kashmir – as a policy tool but also the US (and its junior partner Britain) stop playing the "Great Game" in Afghanistan simply because it can no longer afford to, as it belatedly seems to be realising. The Great Game is a term that was used for the strategic rivalry and conflict between the British Empire and the Russian Empire for supremacy in Central Asia in the nineteenth century. The game has been played since then and the west, Russia, and China all have strategic interests in the natural resources and trade routes of the region.

The Great Game

This brings us to the heart of the matter. The US policy and Pak Army's "wonderland" view of the strategic depth have constituted the core of the problem and not terrorism or extremism per se, which is a serious but still a consequence or a byproduct of the core problem. Both the US and Pakistani establishments have been in this game together since the 1980s. This has been and continues to be the root cause of the problem. Sermonizing against extremism in speeches and on TV talk shows without addressing the fundamental reasons and without making major policy changes will not solve the problem.

Even when the American covert operations ended around 1989-1990, US energy firms like Enron and Unocal continued to woo and allegedly bribe the Talibans to secure their commercial interests while some Pakistani generals adopted the use of religious extremists and militants as a permanent feature of foreign policy and as a means to influence domestic politics.

The concept of strategic depth, principally through proxy militant groups, is an extension of Pakistanis establishment's nationalism of the imperial variety which is the core of the mindset of the militaries of the subcontinent. It is not only flawed but has proved to be disastrous. Pakistan's defense does not lie in having Taliban control Afghanistan. Besides, the proud and fiercely independent Afghans will not accept the domination of any outside force for long.

ISI – virtually under the command of the Army chief – historically acted as an extension of the CIA in the "Great Game" at a geo-strategic level, notwithstanding occasional rows, disagreements and turf battles such as witnessed during Raymond Davis affair. In view of the long history of close ties and cooperation between the Pentagon and Pakistan Army since 1980, and even after the disintegration of the Soviet Union, but particularly since September 2001, the ISI-CIA the 'conflict' appears to be more like a turf battle. Otherwise why would the U.S spend nearly a billion dollars for "new and larger" US Embassy facilities in Islamabad and build 74 bases inside Afghanistan while telling the rest of the world that Pakistan's tribal areas provide shelter to the insurgents. However, due to the severe economic crisis in the recent years, more and more Americans are now questioning the logic and value of the heavy military engagement in Afghanistan and Pakistani military has become the easy scapegoat for the US failures in Afghanistan.

Can any serious student of international relations honestly or seriously believe that a weak country like Pakistani, that is so heavily dependent on the US Aid, arms, and the IMF, could have carried on this double game – apparently in direct conflict with US interests in the region – for nearly a decade until and unless it was also part of the bigger game of the Americans? Is this a realistic assumption to make in realpolitik?

If General Musharraf and his fellow generals were so petrified of Bush and his threats, could they have carried on this double game as it is argued by many analysts who show little appreciation of the serious contradiction inherent in the two positions they take?

Benazir Bhutto while visiting Peshawar on December 2, 2007 had made serious allegations and questioned the motives of the security establishment pointing out that although the government claimed that the extremist groups had been banned, they were openly operating in Fata and other parts of the country and they were being funded to carry out their anti-people agenda. The extremists were paying Rs.70,000 rent for a one-room accommodation in Fata, and running FM radio channels, she had charged.

A New York Times report (July 22, 2008) commented: "There have been bitter fights between the CIA station chiefs in Kabul and Islamabad, particularly about the significance of the militant threat in the tribal areas. At times, the view from Kabul has been not only that the ISI is actively aiding the militants, but that CIA officers in Pakistan refuse to confront the ISI over the issue."

The Axis of Trouble: United States, Generals, and Taliban

Many US and Pakistani officials have claimed that Baitullah Mahsud, late leader of Tehreek Taliban Pakistan (TTP), was guided by Mullah Omar as there was no difference between Afghan and Pakistani Talibans. But was it ever a secret that Omar was part of the Quetta Shura protected by Pakistan? Taliban leadership has operated from its base in Quetta city in southwest Pakistan for many years. Who has been trying to fool whom?

In his latest book, "Obama's War", legendary American journalist Bob Woodward, writes an account of a meeting between President Asif Ali Zardari and US diplomat Zalmay Khalilzad, and describes Zardari's passionate elaboration of why he is convinced that the TTP — often called the Pakistani Taliban — are being financed and directed by the United States to weaken Pakistan so that Washington can grab Islamabad's nukes. Not a single mainstream Pakistani newspaper gave prominence to this explosive revelation. Why?

Many Pakistani and Western analysts – often fed disinformation by the officials – can't seem to think straight and see through the huge contradictions in the official positions of both the US and Pakistani defense and intelligence establishments.

How come Gen. Pervez Kayani who was the ISI chief from 2004 to 2007 and presided over the resurgence of the Talibans on both sides of the Durand line during this period and the worst period of violence since 2001 during his tenure (2008 – 2010) as the army chief, for whatever reason, is so close to and favored by the Pentagon and not just that; the top US officials also supported the extension in his tenure as Army chief for an unprecedented three more years. Kayani has been favored by the US for a long time. This is nothing new or a conspiracy theory.

The Stratfor, a US global intelligence company, reported October 2, 2007 that “with President Gen. Pervez Musharraf due to step down as army chief by Nov. 15, Kayani will emerge as his successor, and given Kayani’s strong leadership credentials, Musharraf as a civilian president will be forced to share power with him.”

The New York Times ran a story “US is Looking past Musharraf in Case He Falls” November 15, 2007 concluding that “at the top of that cadre is Gen. Ashfaq Parvez Kayani, General Musharraf’s designated successor as army chief. General Kayani is a moderate, pro-American infantry commander who is widely seen as commanding respect within the army and, within Western circles, as a potential alternative to General Musharraf.”

Sir Simon Jenkins wrote in the Guardian Jan. 9, 2008: “Backing Musharraf has always seemed “a good idea at the time”. The next person to be cursed with Washington’s favor appears to be Musharraf’s successor as army chief, General Ashfaq Kiyani. However, by opting for the realpolitik of dictatorship the west has not just repressed democracy but aided insurgency and terror.”

The fact is that the US establishment had a much more bigger and ambitious agenda in which “terrorism” was to become an excuse for military interventions and promoting American security interests in the ‘arc of crisis.’ Unwittingly, Pakistani establishment was to provide that excuse in abundance till it had a rude awakening during 2006-2008 that the US establishment had plans that went beyond the pursuit of Al-Qaeda’s leadership and remained unaffected by the election of Barack Obama as president in 2008. The Pakistani military establishment was also outwitted and outclassed in a global propaganda war when it tried to resist America’s push to expand the Afghan War into Pakistan beginning in 2009. The whole might of the US establishment with its formidable array of network of think-tanks, analysts, journalists and commentators was deployed to demonise Pakistan’s military establishment. They had plenty of ammunition

Addiction to Arms and Debt

Behind empty rhetoric and public posturing, Pakistan Army generals have historically enjoyed close ties with the Pentagon. Their policies have contributed to making Pakistan heavily dependent on foreign debt that has been used for a massive arms build-up. During 2002-2009, Pakistan was the sixth largest buyer of conventional weapons in the world with total purchases of $12.5 billion according to the US Congress documents. This excludes spending on its nuclear program.

It is not just a coincidence that during this period, Pakistan’s total external debt increased by $13.7 billion to $45.8 billion in the beginning of 2009. While the spending on the nuclear program remains shrouded in secrecy and is not subject to any parliamentary or judicial oversight, some reports indicate that Pakistan has nearly doubled its nuclear arsenal to more than 100 weapons in a few years and appears on track to soon surpass Britain as the world’s fifth largest nuclear power. That may or may not be an exaggeration but Pakistan’s possession of a large number of nuclear warheads is not a secret.

We have been borrowing to buy and build arms and sinking deeper into debt while maintaining the myth that we need to borrow for our economic survival and development. It is important to point that since 2006 the net official aid flows (that is aid disbursements from multilateral institutions like the IMF and the World Bank, and other governments) have been small or turned negative because the government of Pakistan has been paying more in debt servicing (principal and interest) than it has been receiving in new loans or aid.

Price of Conflicts – A Dependent, Debilitated, and Dysfunctional State

"It is often dangerous to be an enemy of the United States, but to be a friend is fatal," Henry Kissinger used to say during the final years of Vietnam War. In October 2007, I wrote , "Would the so-called War on Terror prove to be fatal for Pakistan?" The crux of the matter is that Pakistanis must disengage themselves from fighting America's proxy wars and battles in the region, which, since 1980, have cost them more than the all the aid that they received. Pakistan suffered huge losses to the extent of over US $ 43 billion ($10 billion in direct and $33 billion in indirect costs) between 2005 and 2010 according to the Economic Survey of Pakistan 2010, published by the ministry of finance. In sharp contrast, the net financial assistance from the United States, according to the Congressional Research Service (CRS), was just $4.9 billion during 2005-10, excluding $7.9 billion paid as reimbursements of war-related expenses incurred by Pakistan.

But Pakistan has paid a much greater cost than can be estimated in money terms. Pakistan's support to the so-called Afghan jihad was the starting point when the seeds of its own destruction were sown. In the first phase (1980-1989), 'Kalashnikov and drugs culture' spread in Pakistan and contributed to a gradual break down of the law and order and criminalisation of society and politics at large.

In the second phase (1989-2001), once the Afghan war ended and the Americans left, the militants – under the patronage of the state of Pakistan and its intelligence agencies – organised themselves and formed what came to be known as the Talibans. We have seen the rise of the Talibans since then and the havoc it has wrought.

The sharpest rise in the number and frequency of bomb attacks took place after July 2007 following the bloody siege of the Red Mosque, once a recruiting ground for the Afghan mujahedeens in the 1980s, in Islamabad in which hundreds of people, including militants, seminary students, security personnel, and others died in gun battles between the security forces and the students. Red Mosque was controlled by clerics with old and close ties to the intelligence agencies and pro-establishment politicians. But its top clerics turned their guns on Musharraf when he joined the "war on terror" after 9/11. Yet a policy of appeasement was continued through some of his cabinet members.

Over 3,400 Pakistanis were killed in more than 200 bloody incidents of suicide attacks carried out in the three years alone between July 2007 and July 2010. Official figures show that 16 people were killed on average in 215 incidents of suicide bombings across Pakistan during the above period. A record number of 1,217 Pakistanis were killed by human bombs in 80 suicide attacks carried out during 2009. On average, 15 Pakistanis lost their lives in six suicide attacks every month in 2009. There were only three suicide attacks in Pakistan during 2005 and nine in 2006.

It should be noted that it has been disputed that all of the attacks were "suicide bomb attacks" as claimed by the authorities. Benazir Bhutto had alleged just 25 days before her assassination on Dec. 27, 2007 that about 90 per cent of blasts in the country were simple cases of bombing but the authorities had dubbed them suicide attacks. Kamran Shafi, a well known columnist, questioned why it was that not a single suicide-jacket maker had been apprehended and prosecuted and why not even one explosives supplier has been caught and brought before a court of law. "We must ask why not one, just one, motivator has been exposed," he wrote.

Pakistan's foreign and domestic policies have been inextricably linked and are intertwined but the foreign and defense policies have dominated the domestic policies with economic development taking the back seat, unlike most other Asian countries. Fighting proxy wars for some aid seemed liked a good deal to Pakistan's ruling elites. That 'good deal' has become a nightmare and the threat of the implosion of Pakistani state, teetering on the brink of bankruptcy, is now a global security concern.

A Pro-Western Legacy

Although it is common to blame the Pakistani military establishment, Pakistan's pro-Western policies date back to even before its birth in 1947. Various declassified papers of the British government (e.g. Transfer of Power in India, 1942-47 by Nicholas Mansergh), indicate that the British strategists distrusted Gandhi and were concerned that India, led by the "leftist" Nehru, might fall under Soviet influence. The British found the idea of Pakistan as an independent, pro-Western state quite attractive. Pakistan's founders sought special relationship with the West, particularly the United States. Pakistan's every ruler, save Z.A. Bhutto, followed a completely pro-Western agenda hoping that it would serve as a counter weight to India's threat. However, the world has changed since the disintegration of the Soviet Union in 1989, and the emergence of China and India as global economic powers in the last two decades, particularly since 2001.

Pakistan has continued to follow the old set of policies overlooking the fact in its quest for containing Chinese influence in Asia and Central Asia; the West's long term favorite will now be India. Pakistan's military is strategically useful and relevant to the US and NATO as long as it can serve their objectives in central and west Asia because they (for that matter even Iran or Saudi Arabia) do not share Pakistan's view of India as a threat to the regional security and peace.

On the other hand, since one of the main strategic objectives of the US is the containment of Chinese, Russian, and Iranian influence in the region, a strategic and military alliance with the US puts Pakistan in a natural conflict with the interests of China, Russia, and Iran.

The continuance of the present set of policies implies that Pakistan may be in a perpetual state of military and strategic tension on both its eastern and western borders. This is an untenable and unsustainable position from all angles; economic, geo-strategic, or political. This fundamental contradiction must be resolved if Pakistan wants to transform itself from a dysfunctional national security state to an Asian country with a promise and start a new era of foreign policy that looks toward East.

Rise of East: Multipolar World

I have tried to provide a framework for a basic and fundamental shift in our strategic and defense priorities in articles written for DAWN since 2006. Pakistan needs a national debate on a fundamental shift in her intertwined domestic and foreign policies. This shift will have to start from the foreign policy. It can't happen overnight but a beginning has to be made. Pakistan is in Asia and the future belongs to Asia.

The case for a fundamental and strategic shift in the foreign policy is not based on any emotional notion of national pride or anti-West feeling. I had written in DAWN on October 15, 2008:

"The biggest casualty of the western financial meltdown might be the US dominance of the global financial system, the linchpin of its global power. And that it is China, with over $1.8tr in foreign exchange reserves- growing at a pace of $40bn a month, which holds the key to the financing of the astronomical budget deficit that the US will have to run to finance the bailout of its financial institutions. The reports of the death of American capitalism may be exaggerated but there is little question that the financial meltdown means the end of its sole super power status in what was described as a unipolar world."

The Financial Times said in an editorial Aug. 27, 2010: "Great power shifts are usually accompanied by changes in the international reserve currency. So it is telling that China is taking steps to broaden the use of the renminbi among international investors. Dominance of the global economy, Beijing believes, goes hand-in-and with dominance of the global monetary system." The Economist noted in an editorial Aug. 26, 2010: "An America that is bleeding economically at home, with unemployment stuck at nearly 10% and debts as tall as the eye can see, is losing confidence in its ability, and perhaps in its need, to shape events in far-flung regions such as Central Asia and the Middle East."

The long term shift in the balance of economic power from West to the East and Pakistan's geographical and strategic position makes it an imperative for the country to reduce its heavy dependency on the West in recognition of the reality that this is no longer a unipolar but a multipolar world and China is the second largest economy and financially the strongest country in the world as well as the largest and most powerful Asian country.

Relations with China

Pakistani state is too weak to afford to pursue policies that cause tensions with all of its immediate neighbors – India, Afghanistan, and Iran – and are viewed with skepticism and unease by the Chinese who support Pakistan and put up with its "too close for comfort" relationship with Washington because they also need Pakistan . But they never liked its support for the Islamic militants or its very close ties with Washington.

Hence, while the Chinese gave Pakistan $1 billion during the financial crunch in 2008 as it came close to a default, they in effect told Pakistani leaders to get the money from the West (US /IMF) because that's how Pakistan was perceived in Beijing; an old friend who has been sleeping with a global adversary – America.

A report (China's caution on Afghanistan-Pakistan, July 1, 2010) by an American think-tank, the Council on Foreign Relations, summarised the Chinese concerns about US – Pakistan relations:

"China's geopolitical perceptions are also substantially different from those of the United States. The US role in the region is seen by Beijing as a problem both in its own right, because of the strategic threat that China perceives a US presence to represent, and as a source of destabilization in recent years. Many in China believe that the United States is not purely motivated by counterterrorism concerns if at all but has instead a geopolitical objective: to exert control over the region's energy routes and strategic chokepoints and ''encircle'' China.

It is a precise echo of Beijing's concerns about the Soviet invasion in the 1980s, a period which still deeply permeates Chinese thinking about Afghanistan. China also treats the US presence in Pakistan with suspicion. It sees a commercial threat, believing that its companies may lose the privileged access they have enjoyed, and a strategic one, suspecting that the United States (along with India) intends to weaken China's position, whether by destabilizing its Balochi foothold on the Indian Ocean or by seizing the Pakistani nuclear arsenal that it played a vital role in developing. The Chinese ambassador has publicly raised concerns about the expansion of the US embassy, which is indelibly associated with many rumors swirling in the Pakistani press about a growing presence of US marines and private military companies in the country."

During the five years period (2005-2010), a small country like Sri Lanka received more commercial aid from China than Pakistan. Since 2006, Beijing provided Sri Lanka with $3.1 billion in financial assistance for various projects. Its aid to Sri Lanka, which was a few million dollars in 2005, jumped to $1.2 billion in 2009, over half the total aid the island was offered by various countries. China is Sri Lanka's largest aid donor today – ahead of Japan or the Asian Development Bank.

Pakistan must remove irritants and possible reasons for mistrust in her relationship with China and give top priority to the safety of the Chinese citizens working or living in Pakistan.

It is important here to recount some of the past incidents that caused tensions between Pakistan and China and created misunderstandings. One source of tension between Beijing and Islamabad in the past was the issue of Chinese Uighur separatists receiving sanctuary and training on Pakistani territory. It is part of a covert CIA strategy to let selected Islamic militant groups operate against China and Russia.

Tensions surfaced in Pak-China relations in the summer of 2007 when, according to a former CIA analyst Lisa Curtis, vigilantes kidnapped several Chinese citizens whom they accused of running a brothel in Islamabad. "China was incensed by this incident, and its complaints to Pakistani authorities likely contributed to Pakistan's decision to finally launch a military operation at the Red Mosque in Islamabad." It should be noted that a key character involved in the Red Mosque saga was an ex-ISI officer Khalid Khawaja who had known connections with both the ISI and the CIA.

Around the same timeframe as the Red Mosque episode, three Chinese officials were killed in Peshawar in July 2007. Several days later, a suicide bomber attacked a group of Chinese engineers in Balochistan. In August 2008, Islamist extremists abducted Chinese engineer, Long Ziaowei, in Pakistan's Swat Valley. The Chinese protested vehemently to the Pakistani government and Ziaowei was released unharmed in February 2009.

Following the Mumbai attacks in November 2008, Beijing dropped its resistance to banning the Jamaat-ud-Dawa (JuD–a front organisation for the Lashkar-e-Tayyiba) in the United Nations Security Council (UNSC) in December 2008. China had previously vetoed UNSC resolutions seeking to ban the JuD over the last several years.

However, China would like to reduce American influence in Pakistan and despite the close ties of Pakistani establishment with the US, has made no secret of this desire. That was the main message of the Chinese President Hu Jintao's who visited Pakistan in December 2010. This visit was a manifestation of the new 'aggressive economic diplomacy' of the Chinese government and took place with a lot of fanfare and signing of memorandums of understanding (MoUs), worth $35 billion. It remains to be seen how many of these MoUs would materialise. However, the most concrete part of the agreements related to China building a one-gigawatt nuclear power plant as part of Pakistani plans to produce 8,000 megawatts of nuclear electricity by 2025 to make up its energy shortfall.

China's extensive support for Pakistan's nuclear projects and its ambitions to have land routes all the way to Gwadar port coincide with Pakistan's pursuit of energy security. Pakistan also wants to have access to Iran's huge natural gas reserves. But the interests of the United States and its influence in Islamabad have virtually stalled Pakistan's energy security plans through both open diplomacy as well as covert means.

Selig S. Harrison in his book "In Afghanistan's Shadow", [published in 1981] wrote: "A glance at the map quickly explains why strategically located Balochistan and the five million Baloch tribesmen who live there could easily become the focal point of superpower conflict." That is true but it is Pakistan's military establishment and its harsh and often ruthless treatment of Balochis that has fueled secessionist sentiments.

Balkanisation is a Grave Threat

Pakistan is not Iran but could become another Yugoslavia. Today the gravest threat to Pakistan is not external. Nor is it the Talibans or the Islamic extremists who have little popular support. It is Balkanisation. Why?

It is an irony that the idea of Pakistan, if not the writ, has become a questionable and sore topic in Balochistan which constitutes 48% of the country's land area and despite being rich in natural resources is the poorest of the provinces, with simmering anger and alienation bloodied by a low intensity insurgency. The army establishment has treated the province as part of the grand chess board of the geopolitics of energy and the "great game".

In the northwest and tribal areas, a prolonged armed insurgency by the terrorist groups has severely damaged the capacity of the state. The greatest casualty has been its credibility in terms of its failure to perform its most basic duty; to protect the lives of its citizens by maintaining peace. Floods destroyed hundreds of homes, villages, roads in large parts of the province already traumatized by violence and battles between the security forces and the terrorists.

It has not been safe for years to travel in the rural Sindh during night without the risk of attacks from armed gangs or being kidnapped. The poverty levels there would shock even a lower-middle class office worker living in the big cities. A drive from Punjab to the poorer south is enough to see the stark contrast between the lives of peoples who supposedly live in and are citizens of one country. This is an ugly reality that people in vast areas of the southern Punjab and the rural Sindh have not progressed much beyond the point they were three decades ago.

Pakistan is controlled by a military and civil complex, largely drawn from northern and central areas of its largest province -Punjab, which governs it by striking deals and arrangements with disparate power centers and groups in the minority provinces and areas. Dr. Mubashir Hasan, a founder member of the Pakistan Peoples Party wrote in Pakistan's Express Tribune that a critical limb of state, the civil services, has collapsed and the government and its administration are too feeble, discredited and unpopular.

This situation has made the governance more dependent on the army making the country largely and practically ungovernable. Pakistan Army's narrow power base in the central and northern Punjab – has further alienated the rest of the country, rightly or wrongly, fueling anger and secessionist sentiments, aggravated by a sense of social and economic injustice as central and northern Punjab is also the richest region. In the past four decades, Army has been used to suppress opposition or insurgencies in every province except Punjab.

That only the Army that was effective, to the extent it could, in rescuing the victims of Pakistan's floods in the summer of 2010 and responding to the emergency points to a greater irony. Not much else works in Pakistan. Nothing or nobody is more responsible for this pathetic state than the Army generals themselves.

Hence, Army's intervention, in the form of a coup or a quasi-coup would be a monumental and grave blunder. Pakistan's current and multiple crises present an opportunity to reform the political system and processes so the army never does have to intervene; mainly for its own sake if it wants to keep the country in one piece. But where one does start?

Pakistan Needs to Make Friends in its Neighborhood

To defuse tensions and improve relations with India and Afghanistan, Pakistan

(a) Should not let the Kashmir dispute hold the process of normalization of relations with India. Pakistan must attach the highest importance to the resolution of water disputes with India, given the long-term decline in its water resources and their significance for its agrarian economy. Pakistan's long term water situation is extremely precarious. Water availability has plummeted from about 5,000 cubic meters (m3) per capita in the early 1950s to less than 1,500 m3 per capita in 2007. All forms of communication including travel, telephone, internet, radio and television must be opened between Pakistan and India to help develop better understanding between the two peoples; and

(b) Pakistan must restrict her involvement in Afghanistan only and strictly to the extent it is necessary to maintain peace on the borders and in the north-western Pakistan because it is in her best interests to focus on domestic stability and economic development. Also, the US must end its military and covert operations in Afghanistan and Pakistan and stop the counter-productive policy of supporting corrupt and unpopular elements.

Pakistani policy makers need to realise that they can no longer afford to play the "Great Game" or that Pakistan needs to control Afghanistan to protect her strategic interests from Indian designs. They need to face the bitter reality that Pakistan cannot fight a war for even a short while – few weeks at best – because it will go bankrupt and would have to accept humiliating cease-fire conditions dictated by Delhi and Washington. Kargil provided a miniature sample of this scenario.

Many of the arguments advanced by Pakistani establishment or those of pro-establishment analysts are based on ill-informed and short-sighted considerations and half-baked notions about security threats or delusions about Pakistan's strength as a nuclear power. This lobby works overtime to spread and manufacture conspiracy theories so that the attention of the masses could be shifted to India, Israel, or the US without them raising the difficult questions about the policies carried out by the establishment itself. This mindset sadly reflects a lack of vision for Pakistan's future and its role in the region and the world. Musharraf's misadventure as Army chief that led to the Kargil debacle was a manifestation of such short-sightedness and lack of vision.

For decades, Pakistan's state-dominated education system and media, particular some large Urdu newspapers, have perpetuated myths that created a mindset that has become a hindrance to a realistic appreciation of Pakistan's international standing and its weaknesses as a state in the modern world. This mindset has misplaced notions about (i) superiority of Muslims over Hindus, (ii) a glorious imperial past that is no more; and thrives on clichés like, "only if the Nation could unite, we can defeat India" or "we are a brave and ghairatmund people." There is no place for delusions or hallucinations in the real world. It is time to wake up!

Indian hawks, inside or outside the government, may talk tough sometimes but there is no question, whatsoever, of a full scale military aggression from India because she is a rising global economic power and it would be foolish of her to jeopardize its economic growth and billions of dollars in investment flows to have a fight with Pakistan, which is seen as a small but troublesome neighbor.

As far as Pakistani military strategists' theory of bleeding India through militant activities is concerned, this is a pipedream given the precarious state of Pakistan's economy, turbulent politics, and the emergence of India as one of the fastest growing countries with the fourth largest economy in the world in purchasing power parity terms and among the top ten ranked by foreign exchange reserves. Given the periodic episodes of Pakistan-linked terrorist attacks in India, it may play games in Afghanistan but their significance is overplayed by Pakistani establishment to justify wasteful spending by the Military Inc. and on F-16s.

With respect to Pakistan's relations with Iran, she must not allow any covert activity from its territory against Iran and should seek to improve bilateral ties by focusing on the grievances of Iran, particularly with respect to Pakistan's relationship with Talibans and the United States.

Pakistan must seek greater ties in trade, industry, and technology with countries like Japan, Korea and Taiwan and look more towards the East. It should diversify its sources of oil imports away from Saudi Arabia and explore prospects in Central Asia, Africa, and even Latin America and also develop its own natural resources. Pakistan's excessive dependence on Saudi oil has been a cited as a contributory factor in the growth of extremist groups in Pakistan who enjoyed Saudi support or sympathies.

Economic Development must be the Top Priority

No sustainable economic development is possible without (a) major changes in Pakistan's foreign and defense policies and (b) without the political will to introduce and implement the economic reforms. This is the why even a government comprising of the best technocrats is doomed to fail.

In the introduction of my book, "The Gathering Storm: Pakistan, Political Economy of a Security State", I wrote in December 2007 that Pakistan could not afford to continue the policies of a national security state that failed to address important national priorities even during a period of benign global economic environment that lasted from 2000 to 2007. I added:

*"The cost of these policies has been high: low agricultural productivity, fragmented and uncompetitive textile industry – its largest, incompetent and inefficient security forces, an apathetic populace and a weak and vulnerable economy without sustainable growth prospects. While so far the casualties have been the democratic process and economic development**,** any further delay in addressing the core issues may hurt more than just democracy and development. It may imperil the future of the state of Pakistan.**"***

Pakistan's young and impoverished population is a ticking time bomb. The official poverty indicators have understated the true and real extent of poverty for years, a fact admitted by the World Bank officials in private. Pakistan's social and human development indicators lag well behind similar indicators of poor countries. Overall, Pakistan fares better compared to only Sub-Sahran Africa or exceptions like Tajikistan or Laos. Tertiary education enrollment rates are estimated at about 4% of the eligible age group (17-23), and less than 8% of the workforce has received formal training. Female literacy rates are low at 42%, and under-five mortality rate is the highest in South Asia with chronic child malnutrition around 40%.

A 2008 United Nations assessment estimated that 45 out of 170 million people across the country are severely food-insecure. The vast majority of rural households are more than 10 kilometers away from basic services that include district administration headquarters and health centers and only 2.8% of the rural households in Pakistan use an appropriate drinking water treatment method, such as boiling or filtering.

The military establishment needs to show some foresight and understand that F-16s or nuclear bombs do not provide security but economic development, together with investment in human resources, in a peaceful environment does. Pakistan can learn this from China**.** Pak Army must re-evaluate the balance between Pakistan's relations with the US and China. For starters, its leadership's goal should to be to have as close a relationship with the Chinese leaders as it has developed with the Pentagon and the CIA.

Pakistan can learn from the East Asian experience, particularly from China's policy to focus on economic development and put conflicts on the back burner and not by sinking deeper into more debt or buying more weapons. Pakistan now has little choice but to make economic development its most important domestic and foreign policy objective**.** This process must start with a gradual disengagement from the external conflicts and redefining 'security' to include energy, water and food security as being critically more important. The peace dividend alone, in the form of higher and more stable economic growth, would more than offset the illusory benefits of 'foreign aid', a large percentage of which is used to serve old debts.

The Challenge

"Pakistanis too broken to rebuild in flood crisis", was the headline of a newswire story conveying the feeling of despair and despondency among common Pakistanis after 2010 floods. The challenge for Pakistan is to bring back hope to its poor, hungry, and homeless; for its generals to show that it is not an Army with a country but one that cares for its people and offers them a future; and for its millionaires and affluent to demonstrate that it can survive as a viable country that is not an aid-addicted client national security state which enriches its elites at the cost of the lives of its people.

Pakistan has experienced martial laws or army-controlled governments masquerading as democracies since 1977. It is not going to be taken over by the Islamist extremists or go through a popular revolution. For the foreseeable future, the **army will be the most important and decisive factor in**

shaping the future of Pakistan, **with or without martial law.** Pakistan's fate will also depend on the behavior of its powerful and wealthy elites who will also have to decide whether they would continue to act as bystanders or do something to reverse the march toward self-annihilation. Doing nothing may not be an option anymore! Because the other choice is to let the brittle state of Pakistan wither away and slide further down the path of anarchy and disintegration.

The first and foremost condition to bring hope to the people is to reassure them that the state exists and is relevant to their ordinary lives. While the importance of constitutional, economic, and judicial reforms cannot be denied, the poor and extremely diminished capacity of the provincial and local administrations to perform the most basic of the state functions and deliver essential services is a serious impediment to any reform initiative. Pakistan desperately needs to mobilise financial resources as well as undertake a massive surgery to repair its severely debilitated administrative infrastructure. Developing and rebuilding the physical infrastructure requires both.

The Way Forward

Historically and ironically, the Army establishment – the most powerful force in the country that really matters and can make a difference – has not shown enough realisation that the **cessation of all external and domestic conflicts** is the most critical and essential pre-condition to undertake the urgently needed economic and administrative reforms. It may have arrived at a critical and perhaps the most decisive juncture in the last forty years after the huge devastation caused by the floods.

The army leadership can and must take the lead and put India, Afghanistan, Kashmir, and nuclear issues on the back burner and focus on **nation rebuilding**. It can begin this process setting an example through making **deep and voluntary cuts in military expenditure** and then by asking the "civilians" to do the same. The army cannot and should not 'help' by imposing martial law or some modern form of it but by sincerely **strengthening and helping the civilian institutions stand on their feet** to perform their roles without aspiring to do the job itself.

Pakistan needs effective governance and to create fiscal space to make investments to repair and rebuild its administrative and physical infrastructure. This can be achieved by **downsizing** of federal government's military and civil bureaucracy, **decentralising** governance by empowering provincial and local governments, **strengthening** their **capacity**, and by **mobilising domestic resources**.

Pakistan cannot achieve a sustainable growth rate necessary to support its around 1.7% population growth rate and reduce poverty without huge investment in basic infrastructure and human resources. A February 2008 report by the World Bank warned, "Without adequate irrigation resources, power, and transport infrastructure, the very sustainability of Pakistan as an independent nation may be at stake as shortages could lead to increased social discontent and disharmony amongst the federation and the provinces."

Since Pakistan is so significantly behind other Asian countries with whom it competes in international trade and for investment capital, it should invest much more than the averages to catch up. Pakistan needs to spend 8-10% of its GDP on education and infrastructure. This is not possible without drastic cuts in defense and establishment expenditure, reducing corruption, and more and better tax collection. According to the Transparency International, the most corrupt sector is the government procurement which alone eats away at least 40% (or over US 3 billion) of Pakistan development budget or 2% of the GDP. The country must introduce tax reforms to increase its abysmally low less than 10% tax-to-GDP ratio to at least 15% within the next five years.

But all of the above requires peace and putting an end to all external and internal conflicts and restoration of conditions that are conducive to resource mobilisation, economic reforms, and restoring order in the society. The State (the army in effect) has no any option now but to change its national priorities and external policies to find a way to transform Pakistan from a dysfunctional client national-security state – which has been and continues to be in a state of constant tension with its neighboring countries – to a **modern, tolerant, federal, and plural democracy with a sustainable economic development model** which is appropriate for a country with one of the world's largest, fastest growing and youngest populations.

The forces of exploitation and status-quo have thrived not only due to the support from the US but also because of the fact that the people themselves have allowed retrograde and corrupt forces to divide, coerce, silence and deceive them. Ultimately the people would have to rise and reclaim their country. The main obstacles to the creation of a free, just and democratic Pakistan are the establishment (including its civilian collaborators and pseudo-nationalists) and America. It is a tall order but there is no real way forward unless people recognise that the establishment represents internal hegemony and the US external. The forces of status-quo have prevented progress toward a modern and democratic society while the US has used Pakistan for its regional and global security interests and to fight the proxy wars which drained her energies and undermined development. Hence, there is no way to free Pakistan and move into the 20th century (we have not completely come out of the 19th century) without confronting both internal and external hegemony.

It is ironic but realities cannot be wished away. **Army holds the country together. If it does not take the lead and makes the right initiatives in the right direction, there may not be any rational reason or room for hope for Pakistan.** It may be too much to expect power-broking and scheming mortals with limited intellect and vision to become saviors and nation builders overnight. But the choice is quickly becoming stark. Act to save the state of Pakistan or let it wither away under the weight of its own his history and blunders of the self-serving and short-sighted ruling elites.

Disengagement, Realignment, and Empowerment can help Pakistan find its way out of the quagmire and move forward. It cannot hope to transform itself unless it **disengages** itself from overt and covert conflicts; external and internal, **realigns** its foreign and economic policy focus from the West to the East, and **empowers** its people through genuine and not 'manipulated or rigged or hijacked' democracy.

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Balkanisation and Political Economy of Pakistan

Dr Mubashir Hasan, Pakistan's Minister of Finance (1971-1974):

"Early in 2008 just after the new government had taken over I saw an insightful article in DAWN worth reading again and again to grasp its full economic and political implications. In a very coherent and lucid manner; citing eye-opening facts and figures, Yousuf Nazar was warning all those who cared to ponder about the economic debacle that stared Pakistan in the face."

Daily DAWN Book Review, Pakistan:

In chapter after chapter in Balkanisation and the Political Economy of Pakistan, Yousuf Nazar rips open Pakistan's "political economy" with the ease of a surgeon's knife to dig out the malignancy that he says has been eating into the vitals of the country's economy, and not only the economy.

Daily The News International, Pakistan:

The book offers a powerful and incisive analysis of Pakistan's political economy from a global perspective.

Quotes from the book:

"Pakistan has experienced martial laws or army-controlled governments masquerading as democracies since 1977. It is not going to be taken over by the Islamist extremists or go through a popular revolution. For the foreseeable future, the army will be the most important and decisive factor in shaping the future of Pakistan, with or without martial law. Pakistan's fate will also depend on the behaviour of its powerful and wealthy elites who will also have to decide whether they would continue to act as bystanders or do something to reverse the march toward self-annihilation. Doing nothing may not be an option anymore! Because the other choice is to let the brittle state of Pakistan wither away and slide further along the path of anarchy and disintegration."

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National News Agency
164 A,M Asad Chamber, Ground Floor, Near Passport Office,
Saddar, Karachi.