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Is South-Asia on the brink of a crisis?

The recent economic crisis in Pakistan is vividly reminiscent of a similar crisis in Sri Lanka just last year. Even more alarming is the fact that many of India's neighbors are facing a similar set of economic challenges. Apart from Pakistan and Sri Lanka, even Bangladesh and to a lesser extent Nepal have been grappling with increased economic instability in recent times, in the form of weak external buffers and high domestic inflation. In fact, the similarities are eerie. The dual shock of the Covid-19 pandemic and the Russia-Ukraine war brought the external vulnerabilities of these countries to the fore, which was compounded by short-sighted, and sometimes politically motivated government policies. Consequently, several of these countries are now scrambling for forex resources to 1) fund imports, 2) boost forex reserves, and 3) avoid debt default. All of these countries are in advance stages of talk with the IMF for securing the same.

Major macro-economic indicators

Table:1 Snapshot of key macroeconomic indicators

Country	GDP growth		Inflation rate		Forex reserves (US$ bn)		Exchange rate		Interest rates	
	2021	2022	2022	2023	2022	2023	2022	2023	2022	2023
Bangladesh	6.9	7.1	7.7	8.7	33.7	32.3	93.5	105.6	4.0	4.0
Nepal	3.8	5.5	7.6	7.3	9.5	10.3	125.8	131.5	8.5	8.5
Pakistan	5.7	6.0	19.7	29.6	5.6	4.3	202.3	256.2	16.0	20.0
Sri Lanka	3.3	(11.0)	45.9	51.2	1.9	2.1	325.3	359.9	14.5/15.5	15.5/16.5

Source: CEIC, Central Bank of Sri Lanka, State Bank of Pakistan, Nepal Rastra Bank, Bank of Baroda Reserach|Note: For 2023, latest data as available from source is taken

Pakistan's economic crisis: Years in making?

The economy has been suffering with ballooning of trade deficit and rising import bills, while exports remain stagnant. Foreign exchange reserves have shrunk. Pakistan largely imports commodities for its domestic consumption. ADB back in Feb'22 had noted that Pakistan had the lowest trade to GDP ratio in the World, a valid cause of concern. PKR has crashed and has been trading at 283/dollar. A large number of industries have halted production and even supply chain movement has stopped. Floods added a bigger blow to this ongoing economic meltdown with the destruction of cotton crop-biggest commodity that the country exports.

Geo-political background: The crisis in Pakistan is attributed to multiple factors starting with the political inability to break off from the group of powerful vested interest groups. The country also lacked political will and gave undue privileges to a few elite group in the form of tax breaks and access to easier capital. Heightened polarization, coupled with political instability and catastrophic floods in 2022 added to an already precarious economic situation. This, in addition to piling up of debt and short sightedness of policy makers and accelerating inflation has pushed Pakistan on the brink of the worst economic crisis that it has ever seen. Furthermore, excessive spending on non-developmental expenditure which remained economically unviable, added to the pain. Defense and debt servicing account for about 50% of Pakistan's total budget. The cycle of seeking fresh loans to repay old loans has resulted in the 'debt trap'. The debt burden was further widened with the development of the China-Pakistan Economic Corridor (CEPC) which led to higher expenditure but provided very little stimulus to the domestic economy, thereby creating a need for more external loans.

In Apr'22, the previous government was ousted and the opposition moved against the coalition government and military. The new government continues to struggle with the crisis. The country is expected to have 2 assembly elections in Apr'23 with some political parties suggesting to dissolve the two assemblies in favor of early elections. The general elections in Pakistan are scheduled for the latter half of the CY23 with expectation of new reforms and suggestion of an alternative framework to counter the economic challenges at play. The military and civil relations in Pakistan under the new Chief of Army are also significant in the election year. In addition to the economic challenges, the re-emergence of terrorist groups against the state and support towards extremism have added to its despair.

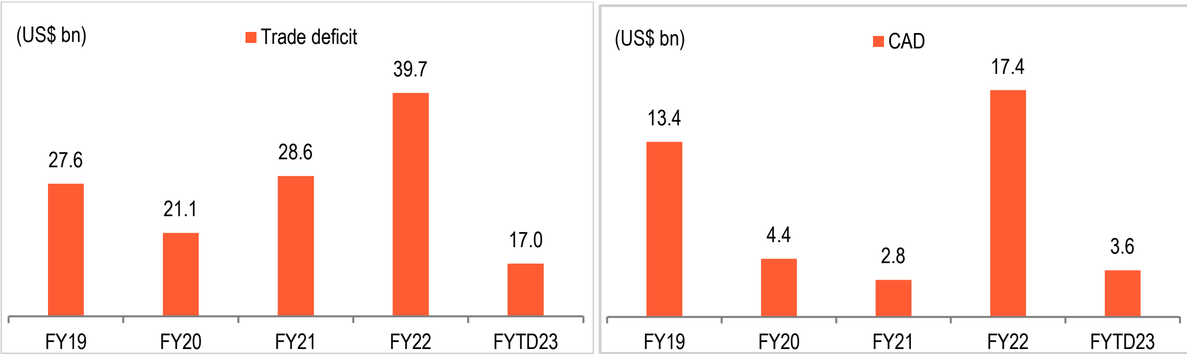
Devastating floods added to the burden: The economic crisis in Pakistan had been brewing prior to the flooding calamity. The disastrous floods in CY22, complicated the economic woes. The country received 190% of its normal rainfall in the months of Jul and Aug'22. There were some areas (such as Baluchistan and Sindh) which received as much as 450% more than normal rains. It had a ravaging impact across the country with over 4 mn acres of agriculture land, 13,000 km of highway and 2mn homes damaged as a result. It was suggested by experts that climate change induced higher temperature had resulted in this above normal rainfall in the country. The floods were also a great humanitarian crisis, impacting over 33mn people, as per the UN. It was also estimated that there are still over 9 mn people that will be pushed into poverty due to the floods.

The estimated cost of rehabilitation and reconstruction stands to the tune of US$ 16.3bn as per the World Bank. These exclude the requirement of new investment and measures needed to support the economy and making it resilient to future climate shocks. According to Brookings, the recovery needs are estimated at 1.6 times of the budgeted national development expenditure. As per estimates, the floods directly resulted in the loss of 2.2% of GDP in FY22. Agriculture sector suffered the biggest decline of 0.9%. There was a widespread destruction of food crops as well as cash crops such as cotton, which forced the country to rely on imports, thus pushing it into a balance of payment crisis.

Balance of payment crisis: Foreign exchange reserves with Pakistan's central bank have fallen sharply in the last few months. From about US$ 17.3bn at the end of Jun'21, forex reserves declined to just US$ 9.8bn at the end of Jun'22 and further to US$ 3.1bn by Jan'23, which is estimated to cover less than 3-weeks' worth of imports. While there has been some upward momentum lately, foreign exchange reserves continue to hover around precarious levels.

As has been mentioned earlier, the devastating floods of 2022 played a significant role in this. Textile exports form an important source of employment as well as dollar inflows into the country. Due to the floods, huge quantities of cotton crop (about 45%), which is the key raw material in the textile industry, was wiped out. Other agricultural crops such as wheat etc. too were impacted and as a result, had to be sourced from outside. Disruptions caused by the Covid-19 pandemic and the war in Ukraine pushed up commodity prices which also made imports dearer. As a result, while exports stalled, imports saw an upshot thus widening the trade deficit. Pakistan's trade deficit swelled to US$ 39.7bn at the end of fiscal year ending Jun'22, which also pushed the current account deficit higher.

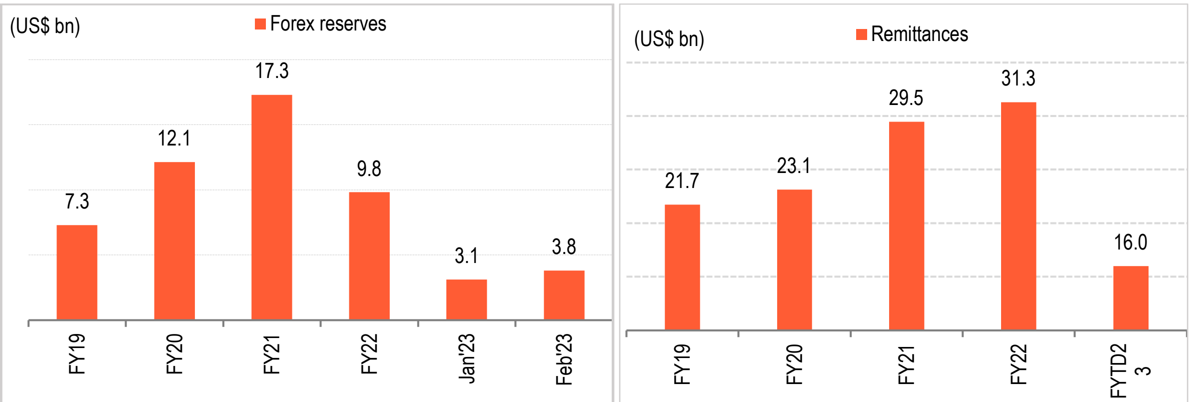
Fig: 1: Trade deficit has swelled putting pressure on CAD



Source: State Bank of Pakistan, Bank of Baroda Research | *Data for trade deficit upto Jan'23 and CAD upto Dec'22

Concomitantly, remittances inflows dried up. As per reports, remittances accounted for ~9% of Pakistan's GDP in 2022, and are also a major source of foreign exchange. In the period Jul'22-Jan'23, remittances have fallen by 11% on a YoY basis to US$ 16bn. This is because expatriates have shown an increased preference for informal channels such as hawala/hundi which offer better price when compared with banks. This is especially true for inflows from the Middle-East.

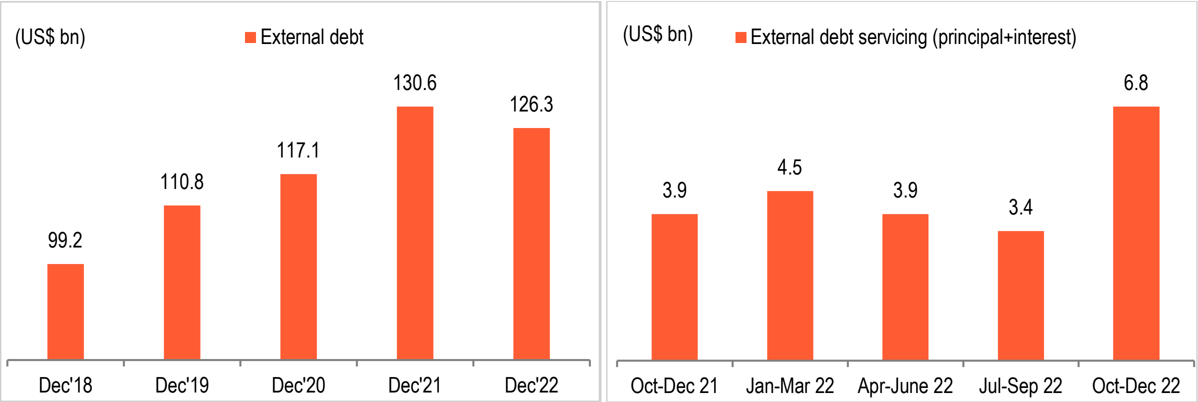
Fig: 2: Falling foreign exchange reserves and remittances receipts



Source: State Bank of Pakistan, Bank of Baroda Research | *Data for forex reserves upto 24 Feb 23 and for remittances upto Jan'23

Another reason for the rapid decline in the country's forex reserves is its huge debt obligations. At the end of 2022, Pakistan's external debt and liabilities had swelled to almost 95% of its GDP at US$ 126bn. Between the period Jul'22-Dec'22, Pakistan spent about US$ 10.2bn to service its external debt. This marked a 70% increase over the last year leading to further depletion of its reserves. Further, around US$ 22bn of its external debt matures in the next 12-months. With forex reserves at precariously low levels, the risks of a default loom large. This has even prompted several rating agencies to downgrade Pakistan's sovereign rating which will make sourcing funds even more difficult.

Fig: 3: External debt and debt servicing a key concern

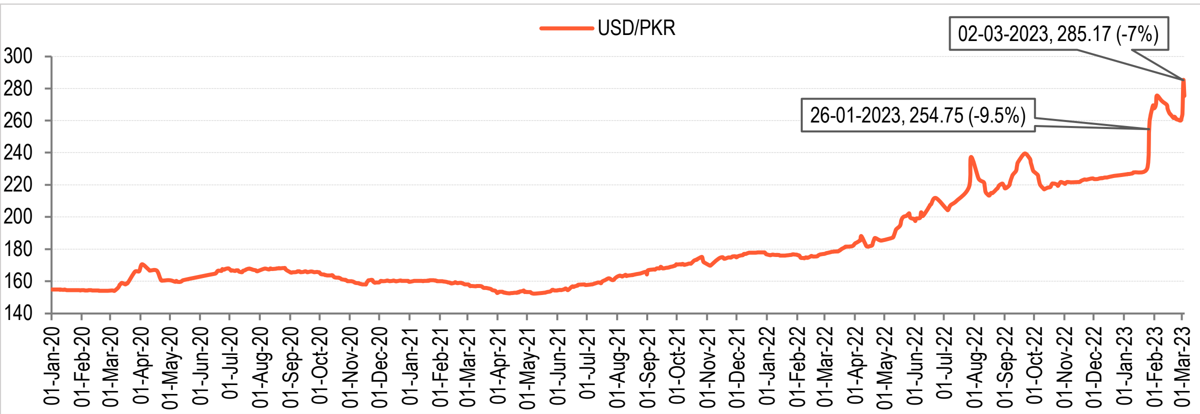


Source: State Bank of Pakistan, Bank of Baroda Research

Additionally, FDI inflows to Pakistan have never exceeded even 1% of their GDP in the last decade, as per the data by State Bank of Pakistan. As a result, Pakistan has found itself in the unenviable position wherein capital account deficit has continued to increase, without a commensurate rise in capital inflows to fund it thus leading to a rapid depletion in forex reserves.

Exchange rate in a free-fall: Pakistan had also been spending its forex reserves to keep its currency from depreciating. To fulfill the IMF conditions to move towards a market-based exchange rate, Pakistan allowed the removal of unofficial caps on the exchange rate. This was aimed at removing the distortions in the market and bring parity between the different rates (official rate, rates by foreign exchange companies and the black market rate). Facing an acute shortage of dollars, the Exchange Companies Association of Pakistan in Jan'23, removed the ceiling on PKR, which led to a precipitous 9.5% drop in the currency in a single day. PKR continued to trail at record lows in the days following the announcement. In fact, it has depreciated by more than 18% in CY22, so far. The rapid depreciation of the exchange rate is further fuelling inflation.

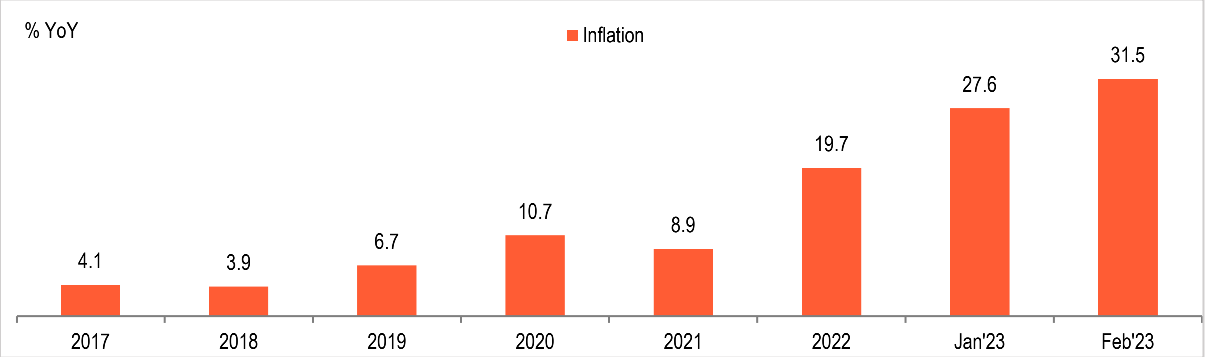
Fig: 4: Pakistan's currency has depreciated to a record-low



Source: Bloomberg, Bank of Baroda Research

Inflation at multi-decade high: Inflation in Pakistan hit the double digit mark in 2022, accelerating to 19.7% compared with 8.9% last year. Price pressures have intensified further with inflation jumping to a five-decade high of 31.5% in Feb'23 owing to higher prices of food and energy commodities. This has prompted the State Bank of Pakistan to hike policy rates by 300bps to 20%; highest policy rate in 27 years. There are expectations of further rate hikes, as inflation is likely to remain elevated.

Fig: 5: Inflation in double-digits



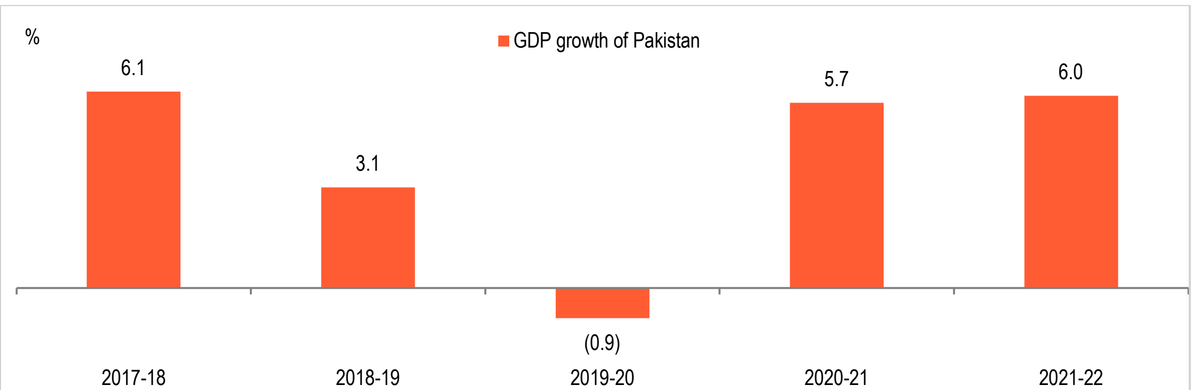
Source: State Bank of Pakistan, Bank of Baroda Research

The cost of basic items such as milk and chicken has surged to as high as Rs 250/ltr and Rs 780/kg respectively. Over 6mn people in the country have been witnessing acute shortage of food due to the disastrous floods last year which created destruction of cropland. Led by shortage of dollar, importers are unable to clear and collect containers, with some corporations also making claims of suspending their operation if the country is unable to make timely payments. About 8,000 containers of raw materials, medical supplies and food items are stuck at the ports, pushing inflation higher. Onion prices are up by 370%, while diesel inflation is at 108%.

Pakistan has also been suffering power outages due to poor state of infrastructure. It was also linked to cost saving measure by the government. As part of such measures, the government also asked shopping malls to close early to conserve electricity. If these outages are aggravated, the impact would be seen even on agriculture sector, given the prices of staples have risen in the last one year. Oil marketing companies have also lowered supply which is resulting in long queues at petrol pumps. Delays in issuing of letter of credit for imports to dealers have further exacerbated the situation.

Economic meltdown: Barring FY20, when the country witnessed negative growth of 0.9% on account of Covid-19 crisis, Pakistan’s economy had been growing at a healthy pace. Growth rebounded in FY21 to 5.7% and then to 6% in FY22. However, with the current economic downturn, the economy is expected to grow at a much more subdued pace. IMF in the World Economic Outlook has projected Pakistan’s economy to slow down to 2% in the current fiscal year. Next year, the economy is expected to rebound by 4.4%. World Bank has also pegged Pakistan’s growth to slow down to 1.7% in the current fiscal. The moderation is on the back of the political uncertainty, accelerating inflation, dire economic challenges and the repercussions of the floods.

Fig: 6: Pakistan’s GDP growth has been moderating



Source: State Bank of Pakistan, Bank of Baroda Research

Response from International community: Pakistan is looking at securing funding to strengthen its forex reserves. One of the key avenues for this is through safeguarding IMF loan, which will help it to fill the financing gap. In 2019, Pakistan signed a US$ 6bn loan programme with the IMF which was further expanded to US$ 6.5bn, based on fulfilment of certain conditions. Pakistan received a US$ 1.2bn tranche in Aug'22 and is now desperately trying to secure the next tranche of US$ 1bn. However, IMF has been steadfast in ensuring that the conditions of the agreement are being met before disbursing the next tranche. In order to unlock loan facility for the next tranche, IMF has laid down conditions of:

- imposing more taxes on the wealthy
- Suggested the country should not fall in to the trap wherein the 'debt needs to be restructured'. I
- Reduce the subsidy burden and these should only be targeted towards the poor.
- Government needs to reduce its defense bill and if that is not curtailed, GST rate on consumer goods should be hiked to 25% in order to finance revenue.
- Additionally, IMF had recommended that Pakistan needs to also lower its fiscal deficit in its upcoming Annual Budget scheduled in Jun'23.

Both the parties have been meeting regularly to discuss the progress being made.

Pakistan has made some headway in this respect.

- This includes, hiking tariffs on fuel and energy, removal of subsidies in export and power sectors, moving towards a market based exchange rate regime, and imposition of new taxes to generate more revenues.
- In Feb'23, the government increased the GST rate to 18% from 17%, which will help in a garnering an extra revenue of ~US$ 639mn in the current fiscal.
- Government has also imposed a GST of 25% on certain consumer goods and luxury items, in line with IMF staff agreement conditions. This will also bring additional revenue in FY23.
- Further, a special finance surcharge of PKR 3.39 per unit towards average power tariff has been levied. The committee has also passed the resolution to discontinue the power tariff subsidies to zero rated industries, beginning from 1 Mar 2023.

However, these measures along with IMF's condition of announcing a lower fiscal deficit in the current year, are likely to further escalate inflationary pressures. Other terms of IMF include securing bilateral and multilateral external financing, but the progress on this front has been inadequate.

Apart from institutional funding, Pakistan is also relying on its allies for financing. So far, China has been at the forefront of extending support to the country by refinancing US$ 700mn. More recently, Industrial and Commercial Bank of China Ltd allowed a rollover US$ 1.3bn loan in three instalments, with the first installment of US$ 500mn already being disbursed.

As per the SBP Governor, out of the US$ 23bn debt repayment, US$ 15.8bn has already been settled through rollover and repayment. Out of the remaining, a rollover of around US$ 4.3bn is expected, implying that the actual repayment will be only US$ 2.9bn. However, market estimates Pakistan's financing gap higher at about US$ 5-6bn. Hence, securing the IMF funding is crucial. If approved, it will provide an additional US$ 1bn to Pakistan.

Way out: Some experts have made suggestions and corrective approach to counter the impact of the crisis in the following ways:

- The government can collect ~PKR 100bn by taxing provinces on property, land and agricultural income.
- Another suggestion has also been made to levy levying a special emergency tax on vehicles.
- Further, electricity tariff on residential properties can also be increased to mobilize revenue.
- Out of the total defense budget, non-combat defense budget can be trimmed down. Additionally, downsizing the federal government or by moving divisions that manage subjects that have been transferred to provincial governments can also bring in more resources.
- State land to be sold via public auction mandatorily only and ban to be put in place on any land allotments. Formation of a privatization programme in order to form an investment-friendly environment.
- Other austerity measures are also being considered such as reducing the budgets of all government departments, trimming down the perks and privileges of the officials. A 15% reduction in salaries of cabinet members. Funds of secret services, Intelligence Bureau and discretionary grant to be capped. Implementation of contractionary fiscal policies by tax hikes, pension reforms and cuts in public expenditure.
- Like most of other South-Asian countries, Pakistan is heavily dependent on imports to meet its energy requirements. Volatility in global oil prices continue to put Pakistan in a vulnerable situation with respect to its external stability. Hence, it is imperative to develop and strengthen alternative domestic sources of power such as hydro, wind, nuclear energy.

Bangladesh: An all too familiar story?

A similar situation is evolving in Bangladesh as well. Fueled by an increase in global commodity prices due to the Russia-Ukraine war, imports have risen. This has led to a depletion in foreign exchange reserves, depreciation of the exchange rate and double-digits inflation. It must be noted that Bangladesh is an import driven economy which relies heavily on import of fuel as well as many essential items. In fact, Bangladesh imports more than 95% of its energy. On the other hand, its export basket is heavily skewed towards textiles, particularly of ready-made garments (RMG), which depends on external demand conditions which have tended to be volatile. Worsening the current account dynamics, remittances which are an important source of funding for the CAD have also fallen in recent months. Just like Pakistan, availability of better exchange rate at the black market has pushed expatriates towards these channels. Even in the capital account, reduction in foreign direct investment (FDI) flows have further exacerbated the misbalance in the balance of payments, putting Bangladesh in a capricious situation.

However, the government has been proactive in managing the impending crisis. To protect the declining reserves, the government put a ban on non-essential imports and reduced the supply of dollars to commercial banks. Following in the footsteps of the crisis struck Sri Lanka and Pakistan, Bangladesh became the third South-Asian nation to seek help from IMF. However, unlike Sri Lanka and Pakistan, Bangladesh did not sought a “bailout package”, but a “stabilization package” and successfully secured it. Recognizing the external risks, Bangladesh sought IMF help to shore up its reserves as a pre-emptive measure for macro stability.

In Jan'23, IMF approved a US$ 4.7bn loan programme for Bangladesh. One of the factors working in favour of Bangladesh is that its external debt commitments are much more comfortable when compared with Sri Lanka and Pakistan. At around 12% of GDP, Bangladesh's external debt to GDP ratio is well within the IMF mandate of 40%. Its total public debt stood at 38% of GDP in FY22, while the debt service payments were US$ 3.7 billion or about 5% of its total foreign exchange earnings, all in a healthy range. Also, it must be noted that despite the Covid-19 pandemic, Bangladesh's economy grew at a healthy rate in the last two years.

Is Nepal headed the same way?

Nepal too faces the same problems. Apart from depleting foreign exchange reserves, depreciating currency and soaring inflation, the country also faces a severe liquidity and banking crisis. In the aftermath of the Covid-19 crisis, while credit growth improved, deposit growth lagged behind. This led to a shortage of loanable fund with the banks. On the other hand, asset quality of banks deteriorated, due to a decline in the repayment capacity of borrowers amidst higher lending rates and rising leverage. As a result, several banks were merged.

Further, remittances which account for about 25% of Nepal's GDP have been impacted ever since the Covid-19 pandemic. The state of government finances too is not rosy. Government revenue generation has trailed its expenditure, as most of it is import based. With the government putting in measures limiting certain imports (which were subsequently lifted in Dec'22) to prevent a further depletion in foreign exchange reserves, government revenues took a hit. As a result, government significantly curtailed its capital expenditure which further aggravated the liquidity crisis and investment. Furthermore, due to lack of meaningful jobs in the country, labor migration is rampant.

However, as per the latest IMF assessment, the conditions in Nepal have improved. Credit growth has moderated on the back of rate hikes by the Nepal Rastra Bank. Inflation too has softened. Further, with improving global growth, remittances receipts have rebounded leading to easing pressures on the external front and a stabilization of forex reserves.

Sri Lanka: Out of the woods?

Sri Lanka was amongst the first South-Asian country to show signs of economic stress as it grappled with sky-high inflation and grossly inadequate forex reserves which led to shortage of basic essentials such as food, medicines and fuels. As we had discussed earlier, a combination of adverse external shocks in the form of the Covid-19 pandemic, along with ill planned policies by the government were the key contributors of pushing the economy to the brink of collapse. This ultimately culminated in the country defaulting on its debt obligations in Apr'22.

Since then, the government has continued to make efforts to secure funding from external sources including the IMF. It is currently awaiting the approval of a US$ 2.9bn bailout package from IMF and is working on meeting the conditions set out in the agreement. Some of these condition which are already being met include: increase in taxes and power tariffs, raising policy rates to control inflation and moving toward a market-determined exchange rates. It is to be noted that IMF has set out similar conditions for Pakistan as well. The country has also received considerable support from the global community. So far, India has provided about US$ 4bn to Sri Lanka as assistance. It has also received financing assurances from Paris club of creditors as well as Saudi Arabia and China, which will help secure the IMF package.

Conclusion

In sharp contrast to the economic situation in its neighboring countries, India has stood out as a bright spot in the region. Growth, inflation and external stability indicators have remained robust despite adverse macro shocks. This is a result of political stability, along with prudent macroeconomic policies along with astute fiscal management. This has been matched with efficient and timely monetary policy adjustments to keep price pressures in check while also ensuring that external risks are minimized. Given its economic superiority in the region, it is no surprise that India has been at the forefront of providing economic aid to some of these countries. However, there are also political and cross-border security issues at play.

Also, bilateral trade between India and each of these countries is significant and there is potential for it to grow further. This is particularly important in the present scenario, where some of these countries are facing an acute shortage of basic commodities such as food and medicines. However, in some cases, such as Pakistan, political interests have taken precedence over economic considerations. Bilateral trade between India and Pakistan has been suspended by the latter since 2019. Hence while it may be beneficial and cheaper for Pakistan to import some of the items which it requires from India, it is forced to acquire these from other countries at a much higher rates.

While India may not be a directly impacted by the economic misfortunes of its neighbors, there may still be some collateral damage in the form of increased immigration (Sri Lanka, Nepal and Bangladesh) or security threat (Pakistan). Further, emergence of China as a major ally of some of these countries also threatens the balance of power in the region, with important ramifications for India.

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