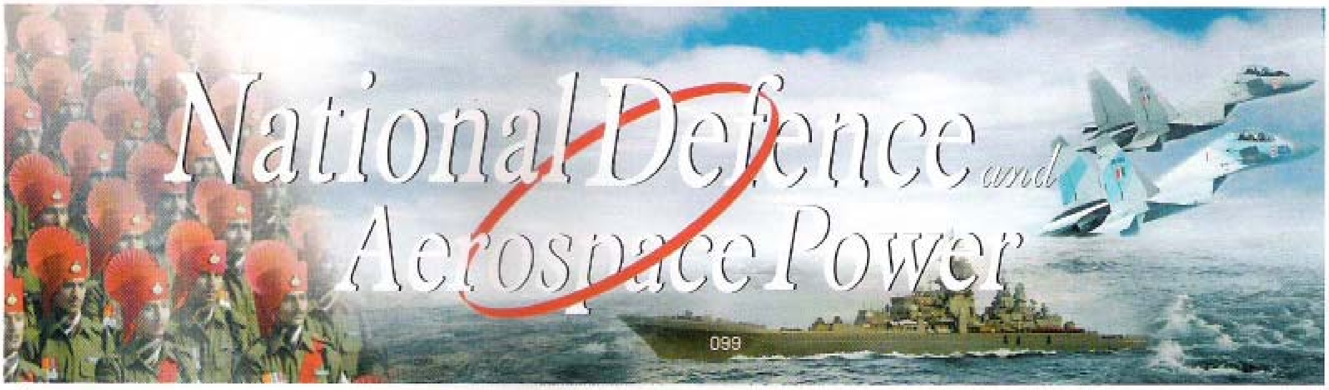

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Pakistan's Economic Desperation and High Defence Spending

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The Executive Board of the International Monetary fund (IMF) on November 24, 2008, approved a 23–month Stand-By Arrangement for Pakistan in an amount equivalent to US $ 7.6 billion to support Pakistan's economic stabilization programme. Out of the total package of US $7.6 billion, US $3.1 billion becomes available to Pakistan immediately and the remaining amount would be phased out on the bases of quarterly reviews.[1] The main objectives of the IMF supported programme are, firstly to restore macroeconomic stability in Pakistan and secondly to secure social security by ensuring adequate support for the poor and vulnerable sections in Pakistan.[2] Besides the IMF, the World Bank and the Islamic Development Bank will reportedly provide Pakistan approximately $3.8 billion during this fiscal year, and $4.5 billion will come from the Friends of Pakistan club and other donors.[3]

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Pakistan has got some breathing space with the IMF loan as the nation's credit rating was reduced to nearly default level (the lowest level in 10 years) and its currency reserves have gone down significantly, barely to enough for about a month's import of essential commodities such as food and oil. The Pakistani rupee has lost 25% of its value this year and the stock market has dropped 35%. Pakistan had little choice other than approaching IMF despite domestic resentment against the loan, in order to step back from the brink of financial disaster. Pakistan reenters an IMF programme after a seven-year gap. The democratic governments in the 1990s failed to complete the two earlier IMF standby agreements. The IMF has reportedly prescribed cuts on defence expenditure (by 30%), devaluation of the local currency, tax increases, slower economic growth and an increase in the benchmark discount rate. [4]

Looking into Pakistan's economic track record it would not be inappropriate to say that Pakistan has slipped into a debilitating cycle of once-every-decade balance of payments crises. Post 9/11, Pakistan received not only American aid and assistance but also assistance from other countries and financial dividends from the international financial agencies like the International Monetary Fund and Asian Development Bank. It received enormous financial support packages from the international community which included Paris Club rescheduling of external public debt. This rescheduling agreement with the Paris Club received 'stock' treatment, and, thus, took into account the entire outstanding stock (principle plus accumulated arrears). Pakistan badly needed the external assistance as 1990s represented the decade of economic decline in Pakistan with the GDP growth rate going down to 1.9 per cent in 1996-97. Pakistan's debt servicing shot up significantly and stood at 11.8 per cent of the GDP by 1999-2000. The civilian leadership in the 1990s was blamed for its economic mismanagement and leading the nation into economic crisis. Economy in Pakistan is weak and has gone through a cycle of depression and revival following the flawed economic policies by different civilian and military regimes. Some signs of recovery are visible each time there is an inflow of foreign aid and thus the economy clearly lacks a self-sustaining character.

The enormous funding Pakistan received after its new role in the war against terrorism brought in direct and indirect financial assistance in the form of aid, debt rescheduling, waiving off of the loans and fresh loans on easy repayment terms. The economy did project signs of recovery immediately after 9/11 under the military leadership and the GDP grew at an astonishing rate, which in 2004-05, was viewed as an "artificial economic boom" by national and international experts. The economy grew at 5.1 percent in 2003, 6.4 per cent in 2004 and 7.0 per cent in

2005.[5] The US$72 billion economy grew into a US$ 108 billion economy in 2005. Pakistan's average export growth increased to 13 per cent during 2003-05 from 1.2 per cent per year. Pakistan's debt, which has been a major suffocating factor in the 1990s, reduced to 50 percent of the GDP in 2005 as compared to 82 per cent in 2002.

Although political instability, increasing violence and other changes taking place in Pakistan are being blamed for the decline in the growth figures and rise in inflation but the fact remains that the macro-economic issues have not been dealt with any seriousness in recent years.

The artificial economic boom which was a result of rapid inflow of money and debt relief has ran out of steam as the military governance avoided dealing with any of the major economic problems existing in the country. The official Economic Survey for the outgoing year (2007-2008) paints a disappointing picture of the economy giving signals of the economy slipping once again into economic doldrums. Pakistan missed its macro-economic targets and the GDP growth fell down to 5.8 per cent against 6.8 percent last year and the target of 7.2 percent for the year 2007-2008. Unlike in the fiscal year 2006-2007, when consumption, investment and net exports contributed 38.3 percent, 45 percent and 16.7 percent, respectively, the growth pattern for the fiscal year 2007-2008 projects a different picture where the economic growth is entirely driven by consumption. But contribution of consumption declined from 45 percent in the fiscal year 2006-2007 to almost 12 percent in the fiscal year 2007-2008. Fiscal deficit is reported in the range of 7 per cent as against the target of 4 per cent owing to spiraling oil and gas prices and food prices. The government was forced to import 1.7 million tons of wheat at "all time high prices".[6] The public debt is estimated to go up to 56 per cent of the GDP for 2007-2008 against 53 per cent for the previous year. The external debt reported an increase of $5.4 billion as compared to previous year. There has been a downfall in foreign direct investment (FDI) and Pakistan attracted US $3481.6 million of foreign investment in the first ten months (July-April) of the fiscal year 2007-2008 as against $4180.8 million in the same period in the fiscal year 2006-2007.[7] It is interesting to note that 57 percent of the FDI has come from three countries, namely the U.A.E, US and UK. The US, with 33.4 percent share, is the single largest investor in Pakistan, followed by U.A.E (15.4%), UK (8.7%), Norway (4.4%), Switzerland (4.1%), Hong Kong (3.5%), and Japan (2.9%).[8] The annual report of the Asian Development Bank also suggested that Pakistan was the largest borrower of ADB in the fiscal year 2007. [9]

The *Economic Survey 2007-08* suggests that the fiscal year 2007 has been a difficult year for Pakistan. Although political instability, increasing violence and other changes taking place in Pakistan are being blamed for the decline in the growth figures and rise in inflation but the fact remains that the macro-economic issues have not been dealt with any seriousness in recent years. The *Economic Survey 2007-2008* points various factors such as, soaring oil and food prices for the declining trends in the economy and asserts, "the most important aspect, however, has been the non-responsive stance on account of political expediency in addressing domestic and external challenges during most part of the fiscal year, further accentuating macroeconomic difficulties." The economy needs a prudent fiscal policy and structural reforms to be able to sustain it and grow. External aid has always played a strong role in the economic revival of Pakistan.

The causes of the current desperate economic situation are long term and not conducive for a 'quick fix'. There has been a failure on the part of successive governments to channel the external resources into economic productivity and invest in social sector. The Recent terrorist attacks in Mumbai on November 26 would have unintended consequence. Escalation in India-Pakistan hostilities would further damage foreign investors confidence in Pakistan which is likely to face international pressures in the wake of its continuing role in terrorism. Revival of Pakistan's economy is not only in the regional interest but also in the global interest. An unstable economy with declining growth rates would invariably contribute further towards violent jihadi culture absorbing the unemployed frustrated youth in Pakistan. If the Zardari government goes bankrupt the Islamist forces supported by the Taliban, who already enjoy the support of the local tribes in the NWFP and FATA would be much more active in the major cities of Pakistan. Pakistan military is already facing accelerated guerrilla operations from the non-state actors, and the destabalisation (due to economic suffocation) of the *state* would make the matters worse.

Economic Decline and Defence Spending

Pakistan has been engaged in major modernisation of its military in the last 7 years focusing on the build up of its Air Force. Given the past experience, it is evident that Pakistan relies on aggressive offensive military strategy against India which is unlikely to change in future. Now, with the current state of economy and consequently, the IMF loan to Pakistan the question arises: *How*

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would Pakistan's defence spending shape up? And, more importantly, *How will the economic mess affect the ongoing military modernisation?*

The current economic problems in Pakistan and its reliance on the IMF is unlikely to affect its spending on defence and modernisation. Pakistan's possible/acquired equipments are hardly dependent on its national funds.

Military spending in Pakistan has always been a debatable issue and has remained a matter of concern for the economists and academicians within Pakistan and the financial institutions abroad. Till 1990 defence spending averaged at the rate of 6% of the GDP. Economic crisis in the 1990s compelled the political leadership to bring down the *official* defence spending figures. Defence budget by the end of 1990s was kept low by excluding the pensions from the budget which comprised approximately 11 per cent of the budget.

Post 9/11 the GDP growth rate went up with an accelerated pace but the defence budget was maintained at an average of around 3.5 % of the GDP. Although, the projected rate of military spending is relatively lower but the actual estimated defence spending in Pakistan is much higher than projected in the official budget. According to reliable Pakistani sources, the defence expenditure figures do not include the costs of acquisition of major weapon systems.[10] Major arms acquisition in Pakistan take place from the military and economic assistance provided by the United States, Arab world and other nations.

The current economic problems in Pakistan and its reliance on the IMF is unlikely to affect its spending on defence and modernisation. Pakistan's possible/acquired equipments are hardly dependent on its national funds and thus the estimated expenditure on defence would in all probability remain unaltered. Pakistan would continue its defence modernisation.

US Aid and Military Assistance

Pakistan received approximately $11 billion aid from the United States (post 9/11), out of which 85% has been spent on defence and only 15% has been allocated to the social sector. The American aid is likely to continue and in fact, grow in the coming years. The US Congress has appropriated billions of dollars to reimburse Pakistan for their operational and logistical support to the US-led counter terrorism operations under the banner of *Coalition Support Funds* (CSF), which have constituted a major part of the US assistance to Pakistan since 2001. The total CSF for the 2002-2008 is estimated at $5,678 million which works out to approximately $80 million per month, that is equal to more than one-quarter of Pakistan's total military expenditure. Apart from this Pakistan has received aid under various heads like the Economic Support Funds, Foreign Military Financing etc.

In 2006, the US signed arms transfer agreements with Pakistan in excess of $ 3.5 billion and Pakistan occupied the top position in the list of US clients for that calendar year.

American military supplies have been much easier for Pakistan in the last 7 years. Pakistan has received/ will receive significant amount of long-desired high technology American equipment. The "Non-NATO Ally" status granted to Pakistan in 2004 provided it a distinct advantage in terms of obtaining the latest high technology equipment technology weapons, spare parts and also priority in the delivery of weapons from the US. One of the added advantage of this status is that Pakistan is now in a position to obtain *Excess Defence Articles* (EDA). These are weapons and equipment which the US may not need anymore and which may be transferred to Pakistan at a very low cost or even free of cost. For example, Pakistan received two F-16s ($6.4 million each) and P-3C aircraft (free of cost) under this category where Pakistan paid substantially below the market price for the equipment.

In 2006, the US signed arms transfer agreements with Pakistan in excess of $ 3.5 billion and Pakistan occupied the top position in the list of US clients for that calendar year. [11] Apparently, the total value of Pakistan's 2006 arms purchases from the US is close to the total value of all Foreign Military Sales (FMS) programme purchases by Pakistan from the US for the entire period of 1950-2001 (more than $3.6 billion in current dollars).[12] The major acquisitions from the US include F-16s (the number would go up to 107), Harpoon missiles, surveillance radars, P-3Cs (8) and P-3B aircraft as Excess Defence Articles grants (that are likely to be modified to carry the E-2C Hawkeye airborne early warning suite).

The table below gives a clear picture of Pakistan's Air Force modernisation by 2010:

Table : Modernisation Effect

	1990	**2010**
•High performance MRCA	11%	42%
•AEW/AWACS	Nil	12
•Attack Helicopters	10	60+
•Maritime Strike Aircraft	3	17

Despite the American administration expressing its serious dissatisfaction with Pakistan's half hearted support in counter terrorism efforts and misuse of the American aid, there are no signs of cutting down of the US military and economic assistance. The fact remains, that Washington cannot manage the war on terror without Pakistan and American aid would continue in order to fetch support from the civilian leadership as well as the military in Pakistan.

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Chinese Support

Pakistan views China as a much more reliable partner and support from China has kept up Pakistan's military modernisation. Sino-Pakistan military cooperation flourished under the US sanctions and easy credit facilities from China have been a major incentive. Chinese equipment is cheap, efficient, and available at low interest rates for Pakistan, obviously due to Chinese strategic interests in Pakistan to counter America's growing military alliance and balance India's growing superiority.

Pakistan's actual defence spending (much higher than the budgeted amount) would remain high as long as US assistance continues besides the Chinese support.

China is producing JF-17, a high combat aircraft with Pakistan. J-17 is currently being assembled in Pakistan and according to recent reports Pakistan would be able to undertake the complete production by next year in 2009. In fact, the PAF Chief distinctly stated on Nov 25 this year at the defence exhibition IDEAS 2008 that the PAF was capable of serial production of about 40-45 JF-17 for which it would require between $750 million and 800 $ million and the government had been requested to secure soft credit from China for realizing that objective. Pakistan is also positioning itself to buy up to two squadrons of Chinese J-10 which, along with the JF 17, would form the backbone of the PAF.

Pakistan's actual defence spending (much higher than the budgeted amount) would remain high as long as US assistance continues besides the Chinese support. Military modernisation would continue, as the monetary assistance from the US is likely to increase given the worsening security situation in the region. Pakistan is receiving high technology equipment at a much lower cost. Chinese equipments and joint projects would continue to contribute in the military build up. Thus, even with a weak economy, which reportedly is unable to sustain itself the defence spending and modernisation in Pakistan would continue to grow.

Following conclusions can be drawn:

1.Pakistan's economy is on life support threatening serious internal disorder.

2.Weak political government and strong army is unlikely to reduce the galloping defence budget.

3.Pakistan Air Force modernisation is likely to continue along the recent high momentum in spite of IMF conditions.

4.Air Force capabilities would be critical in a future crisis/conflict.

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End Notes

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