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PAKISTAN'S POLYCRISIS

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Implications for regional stability and security

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by

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Summary

- Pakistan currently faces a 'perfect storm' of economic, political and security crises. The restoration of political stability is a prerequisite for addressing the country's pressing economic and security challenges.
- The political crisis in Pakistan is the most serious since the 1971 civil war in which half of the country seceded.
- The continued impasse with the International Monetary Fund (IMF) brings Pakistan closer to default, which would trigger hyperinflation and potentially lead to mass unrest and riots in the country.
- Political and civil unrest could consume the army's bandwidth, leaving it overstretched and preventing it from devoting resources to addressing the challenge from resurgent militant groups that it is already struggling to contain.
- The EU should develop a set of policy options aimed at promoting a consensus-based settlement to Pakistan's political crisis, upholding the constitution and civil, democratic rule.

INTRODUCTION

Pakistan is in the throes of a multifaceted crisis that could result in the collapse of the economy and of the country's semi-democratic system. Over the course of its history the country has seen three periods of military rule, totalling 33 years.

Since 2008, Pakistan has been ruled by a hybrid regime featuring an elected civilian government that informally (and, to some extent, unwillingly) shares power with the country's army. The army's role in politics has become more overt since 2018 as both coalition governments that have ruled since then came to power as a result of collaboration with the military against common political foes.

Given Pakistan's large population, strategic location, and nuclear weapons arsenal, instability in the country may result in cascading negative and disruptive effects not just in South and Central Asia, but also beyond, including in Europe.

The aim of this Brief is to identify the chief drivers of instability in Pakistan today, their potential ramifications beyond the country's borders, and to provide guidance for EU policymakers on steps that can be taken to help restore economic and political stability in the country.

The first section of the Brief examines the simultaneous economic, political and security challenges that have been impacting the country over the past year — what some observers are calling a 'polycrisis' [1]. The next section looks at the interplay between these three crises and assesses their impact on order, stability and social cohesion in Pakistan.

The third section explores how Pakistan's crises could impact the immediate region, including the stability of the Taliban regime, the behaviour of Islamist terrorist groups in Afghanistan, and the ceasefire along the Line of Control in Kashmir [2].

Pakistan is now teetering on the brink of default.

The final section assesses the implications of a meltdown of government and society in Pakistan for the EU, addressing policy priorities such as democracy and human rights, economic stability and migration, competition with China, and climate. It concludes with policy recommendations for the EU as a whole and its Member States.

UNPACKING PAKISTAN'S POLYCRISIS

Pakistan is currently facing numerous and mounting threats to order and stability. In particular, intersecting economic, political and security challenges

Foreign exchange reserves near 10-year low

Net liquid foreign exchange reserves with the State Bank of Pakistan, monthly, $ billion

Data: Pakistan Bureau of Statistics, 2023

undermine the political system's authority, legitimacy and overall ability to function, with potential repercussions beyond Pakistan's borders.

First and foremost, Pakistan's economy is in deep distress. Since early 2022 Pakistan has had to contend with a balance of payments crisis and surging inflation, which has risen to almost 40 % [3]. Pakistan's macroeconomic woes date back even further to 2018 and are part of recurring boom-bust cycles, generated by unbalanced growth. The pattern is as follows: periods of growth in Pakistan are fuelled by domestic consumption and debt-driven public spending, but exports and foreign direct investment remain at modest levels. Then, to plug the fiscal and current account deficits, Pakistan seeks relief from the International Monetary Fund (IMF) and must constrict the economy to achieve macroeconomic stability.

Pakistan is now teetering on the brink of default. Foreign exchange reserves have fallen to less than a month's worth of imports [4], raising concerns about Islamabad's ability to repay its external debt. Due to its depleted foreign currency reserves, Pakistan has imposed severe curbs on imports, which have hurt domestic manufacturers, including in the pharmaceutical and textile industries [5]. The current economic crisis is the result of the aforementioned imbalances in the Pakistani economy, exacerbated by borrowing to finance infrastructure projects related to the China-Pakistan Economic Corridor (CPEC), as well as by the Russia-Ukraine war and the decision by Islamabad to introduce fuel subsidies when global energy prices soared last year.

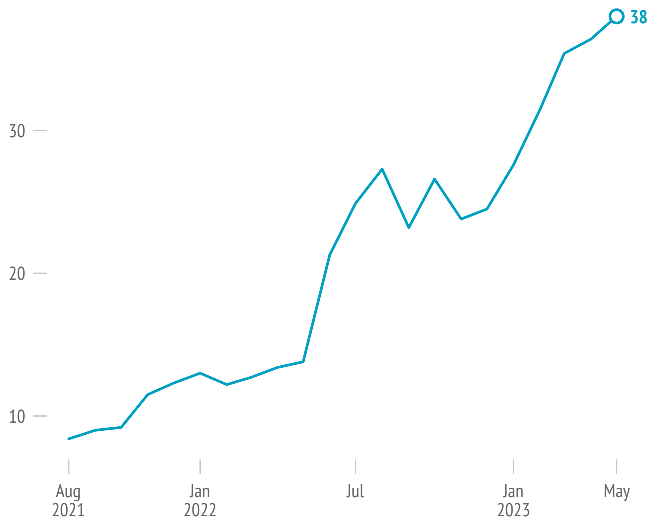
To avert default, Pakistan needs to revive its IMF Extended Fund Facility (EEF), which remains stuck at the ninth review and expires in June 2023. The country faces a chicken-or-egg situation: it needs the IMF programme to get back on track to attract inflows of foreign investment that would help reestablish macroeconomic stability. But it also needs guarantees of external financing from friendly states and other multilateral partners to complete the EEF's ninth review.

By early summer, Pakistan's default risk will climb to dangerous levels should it fail to complete the ninth review. A recent editorial in Pakistan's leading English-language daily newspaper, *Dawn*, has warned that default is now 'almost inevitable' [6].

Pakistan's struggles with its current IMF programme jeopardises its prospects of securing another urgently-needed EEF once the current one expires. A new IMF programme will likely require even tougher policy choices on the part of Islamabad, including the renegotiation of debt with partners like Beijing, its largest bilateral creditor [7]. The largest share of Pakistan's external debt is owed to multilateral

Soaring inflation

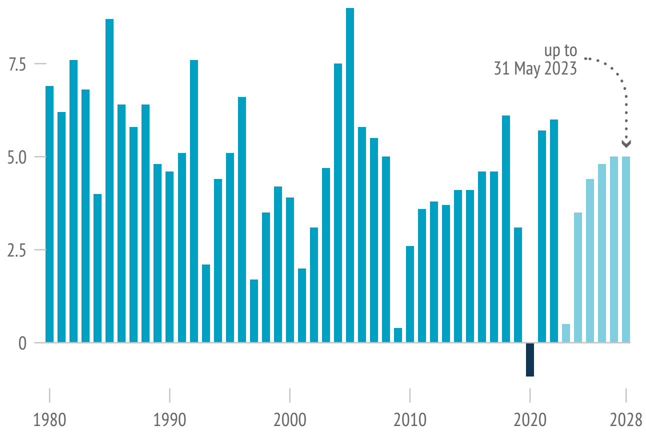
General year-on-year inflation rate, monthly, %



Data: Pakistan Bureau of Statistics, 2023

Real GDP growth

Year-on-year growth rate, %



Data: IMF, 2023

institutions like the Asian Development Bank (ADB), the IMF and the World Bank[8].

The case of Zambia is illustrative of the uphill task Pakistan could face. After defaulting in 2020, Zambia — whose largest bilateral creditor is also Beijing — remains mired in contentious talks with international creditors, including China, over debt restructuring. Zambian President Hakainde Hichilema said in April 2023 that he feels his country 'is more or less like a guinea pig now', caught in the tussle between China and more traditional international creditors like the United States over how to restructure developing countries' debt[9]. Beijing is demanding that Lusaka's multilateral lenders also take a haircut.

With or without an IMF bailout, in the short term, Pakistan could be locked in a stagflationary cycle. The economy is forecast to grow at a rate of under 1 % in the current fiscal year[10]. Inflation reached a six-decade-high in April 2023[11]. As core inflation is proving to be stubborn, some economists also warn of potential hyperinflation[12].

Last year was the deadliest for Pakistani security forces in a decade due to attacks by militant groups.

The second challenge to the socio-political cohesion of the Pakistani state is a renewed campaign of ethnic separatist and jihadist terrorism[13]. The Tehreek-e Taliban Pakistan (TTP) terror network has reconsolidated in Taliban-controlled Afghanistan. It is regenerating and expanding its networks within Pakistan, including in Balochistan. The TTP and ethnic separatist terrorists are waging attacks against security forces at levels unseen in years. Last year was the deadliest for Pakistani security forces in a decade, with 282 fatalities due to attacks by militant groups[14].

These attacks are claiming the lives of not just rank-and-file soldiers, but also army officers and top personnel of the Inter-Services Intelligence (ISI)[15]. Ethnic separatists in Balochistan and Sindh have also been able to carry out a wave of strategically important attacks against Chinese nationals and institutions in Pakistan, in a bid to deter construction and investment related to the CPEC.

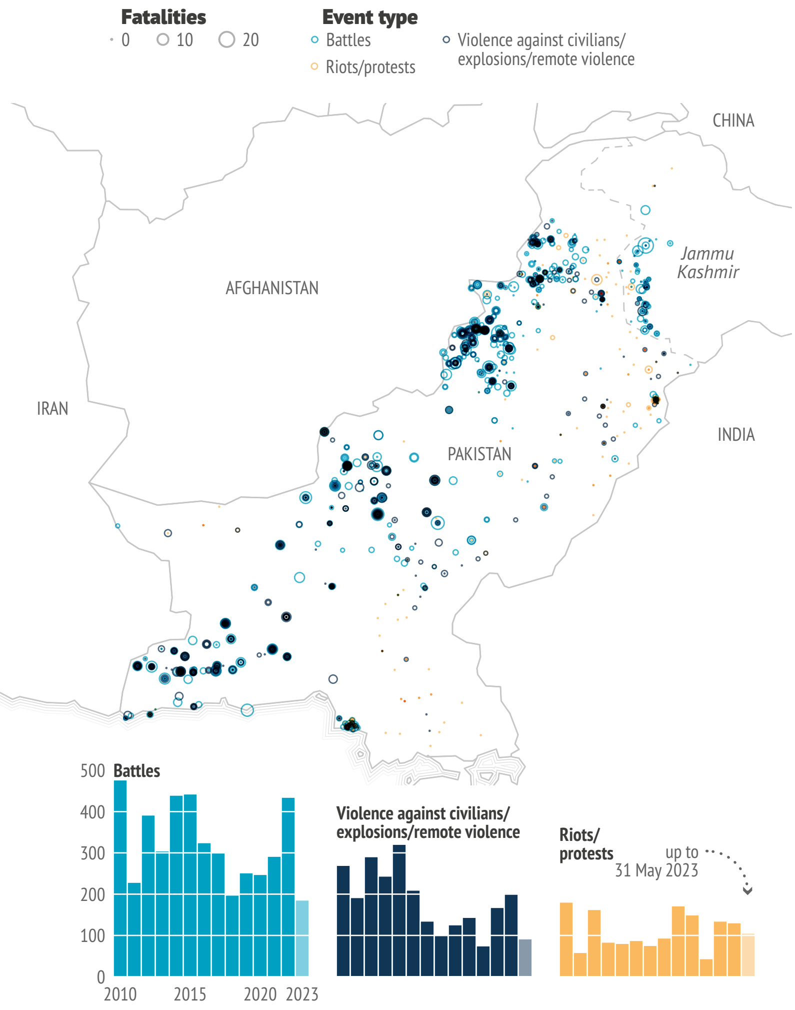
Compounding Pakistan's economic and security challenges is the political crisis that has its origins in the removal of Imran Khan from the premiership through a vote of no confidence in April 2022. Political support for Khan has only grown since he was ousted from power[16]. Aware of this groundswell of popular support, the former prime minister has been pushing for general elections to be held earlier than the deadline this autumn, but the unpopular coalition government and army leadership are resisting such pressure[17].

Should Pakistan's National Assembly complete its full term on 13 August 2023, general elections must take place within 60 days, or by 12 October. If the National Assembly is dissolved any time before that, elections must take place within 90 days of its dissolution[18]. As a result, the latest possible date for general elections, barring a declaration of emergency, would be 10 November 2023.

As public support for the ruling coalition and Army erodes, the authorities have resorted to heavy-handed tactics in an attempt to neutralise Khan, who blames top civilian and military officials for a failed assassination attempt on him in November 2022[19]. In the wake of violence targeting military installations on 9 May 2023 following Imran Khan's arrest after he had travelled to attend a court hearing in the capital[20], the army is now working to dismantle Khan's Pakistan Movement for Justice (Pakistan Tehreek-e-Insaf-PTI)

Violence

Violent events involving state forces, Jan 2020–May 2023



Data: ACLED, 2023; European Commission, GISCO, 2023

party, forcing defections among the party's senior ranks [21]. Khan has enjoyed support from prominent retired army officers as well as low/mid-level serving officers [22]. However, the current army chief, General Asim Munir, has taken severe measures to crack down on the ex-cricketer's supporters within the army and among family members of current and retired officers [23].

In the current tense climate there remain risks that Pakistan's rulers could seek the deferral of elections well after October 2023. This would mark the first time since 2013 that general elections were not held within the constitutionally-mandated period.

Intra-elite discord also extends to the Supreme Court. The government-backed Election Commission of Pakistan violated a Supreme Court ruling in March 2023 that ordered the holding of elections in the Khyber Pakhtunkhwa and Punjab provinces within or near to the constitutionally-mandated 90-day period after the dissolution of their assemblies [24].

Given the government's refusal to hold provincial elections, the exasperated Chief Justice of the Supreme Court of Pakistan said that the article of the constitution outlining the election schedule has been effectively put in 'cold storage' [25].

The parliament has also defied the Supreme Court by refusing to release election funds to the Election Commission [26]. The Supreme Court itself is divided into two factions, one led by the Chief Justice Umar Ata Bandial, said to be aligned with Khan, and the other led by Justice Qazi Faez Isa, regarded as being aligned with the current government [27].

In the assessment of one veteran Pakistani political analyst: 'We are now witnessing a complete breakdown of the system as the ongoing power struggle threatens to bring down the entire structure' [28].

WHAT'S AT STAKE?

The polycrisis represents the most significant challenge to the Pakistani political system since the 1971 civil war, which resulted in the secession of the country's eastern wing.

The potential combined effect of the current three-headed crisis is that Pakistan could descend into a new spiral of chronic instability and state failure, marked by a paralysed, factionalised elite, leaderless protests, and even mass violence. Yet outright state collapse is highly unlikely given the tremendous coercive power and cohesion of Pakistan's armed and police forces. Even more fragile states, such as Afghanistan, Syria and Yemen, have survived as *de jure* entities in recent years despite decades of armed conflict.

Pakistan's future is more likely to share characteristics with contemporary Iraq, Lebanon and Sri Lanka. The predatory and corrupt ethno-sectarian system of power-sharing that prevails in Iraq and Lebanon has an analogue in Pakistan's coalition politics [29]. Recent political stalemates in these countries also mirror Pakistan's politico-constitutional crisis. And Pakistan faces the real risk of sovereign default on external loans this year, much as Sri Lanka did last year. Over the next three years, Pakistan will need to repay nearly USD 80 billion in external debt [30].

Unlike recent periods of tumult in Pakistan, two safety valves no longer function as they once did. Firstly, international financial institutions and Pakistan's chief foreign allies are reluctant to disburse further funds to Pakistan unless stricter conditions are attached. Pakistan's previous boom-bust cycles have been cushioned by the largesse of Gulf Arab states, China and the United States — countries that viewed it as geostrategically important. Now Pakistan, like

Egypt, faces a hard landing as its benefactors demand front-loaded reforms, including increased collection of domestic tax revenue, as mentioned by Saudi Minister of Finance Mohammed Bin Abdullah Al-Jadaan in January [31].

An economic meltdown in Pakistan could severely deplete the coffers of the Taliban regime.

Secondly, the reputation of the army — at times perceived by the public as a non-partisan force that could intervene and establish order — is now tarnished, as it is seen as politically aligned with an unpopular government against a popular opposition party. A fifth of Pakistanis surveyed in late March and early April see the army as 'primarily responsible' for Pakistan's ongoing crisis [32]. The army has taken a commanding role in the political crisis; in doing so, it has established a degree of order, but one that may prove fleeting should economic and security conditions deteriorate further.

In seeking to degrade or eliminate the PTI, the army has created a political void in Khyber Pakhtunkhwa, where the party is popular and a jihadist insurgency has flared up. Repression of the PTI requires continued heavy coercion that could strain the resources of the army and intelligence agencies — a state of affairs of which the TTP would be quick to take advantage.

In the coming months, should Pakistan default, the country could see the same type of leaderless mass protests and outpouring of anger against the elite witnessed in Sri Lanka last year. Thousands of PTI workers and supporters have been detained [33]. Further unrest would put the prison system and security services under significant strain.

The economic and social impact of default would be extraordinary: a sharp recession, hyperinflation, massive job losses, and a severe shortage of essential items — including imported food, fuel and medicine. In such dire circumstances Pakistan would experience widespread industrial shutdowns and massive disruption to the country's electric power supply, and long queues for food and fuel.

IMPACT ON REGIONAL STABILITY

Ordinary Pakistanis would bear the brunt of a full-blown economic and political crisis. The impact could extend beyond Pakistan's borders, particularly to neighbouring Afghanistan, given the economic and security interdependence between the two states.

The Taliban regime is reliant on imports and inflows from Pakistan, including smuggled dollars [34] and taxes on coal exports, for its fiscal stability [35]. Customs revenue provided 58 % of the Taliban's total financial resources in the first 10 months of the 2022-23 fiscal year, according to an assessment by the World Bank. [36]. An economic meltdown in Pakistan could severely deplete the coffers of the Taliban regime, depriving it of funds to pay for its military forces, and raising the risk that disaffected fighters could defect to other forces, including the Islamic State-Khorasan (ISIS-K). Deteriorating economic conditions in Pakistan could also result in more forceful calls for the expulsion or repatriation of Afghan nationals by political parties, such as the Muttahida Qaumi Movement – Pakistan (MQM-P), exacerbating the humanitarian crisis in Afghanistan.

Yet, somewhat paradoxically, the Taliban's reliance on informal and illicit financial and trade networks may actually endow it with the resilience to weather economic tumult in Pakistan. Turmoil in Pakistan could deepen the economic integration of the two 'sick men' of South Asia, with an increase in illicit activities like the smuggling of narcotics and other goods.

Deteriorating economic and security conditions in Pakistan may also bolster transnational terrorist networks, including the TTP, al-Qaeda, or ISIS-K, particularly if the Pakistani army's political activities limit the resources it can devote to counterterrorism and counterinsurgency operations and the Taliban faces internal challenges from its rank and file.

In contrast to Afghanistan, India is largely insulated from potential upheaval in Pakistan, given the hard border regime between the two countries. It could actually stand to benefit from turmoil in Pakistan that consumes the country's leadership but does not spill over into India or Indian-controlled territory. As for the Kashmiri insurgency, policies of economic coercion, such as the greylisting of Pakistan by the Financial Action Task Force (FATF), have proven effective in curbing the Pakistan Army's support for militants in Indian-controlled Kashmir [37]. The present Pakistani civilian and military leadership appear committed to adhering to the ceasefire along the Line of Control in the disputed region of Kashmir and engaging New Delhi, as the recent participation of Foreign Minister Bilawal Bhutto Zardari at the Shanghai Cooperation Organisation (SCO) meeting in Goa indicates. This was the first visit to India by a senior Pakistani official in 12 years.

For its part, China is considerably exposed to the polycrisis unfolding in Pakistan. Ethnic separatist terrorist groups in Pakistan have acquired the power to derail future China-Pakistan economic relations due to their ability to strike Chinese targets, including language teachers, construction workers and engineers. A 2021 terror attack targeted a hotel hosting the Chinese ambassador [38]. These attacks necessitate the deployment of Pakistani security personnel to guard Chinese nationals, raising the cost of Chinese electric power and infrastructure projects undertaken as part of the CPEC. Pakistan's failure to prevent attacks on Chinese nationals has angered Beijing [39] and may deter future aid and investment, especially in more dangerous areas like Gwadar. Pakistan's economic misgovernance is, however, a bigger source of strain in Sino-Pakistani relations.

Immediate security risks to China from rising instability in Pakistan are low given the tight control over the overland border route and the large police state apparatus in Xinjiang. The primary challenge for Beijing right now is diplomatic: as Pakistan's largest bilateral creditor [40], it is being pressed to renegotiate Pakistani debt, much as in the case of Sri Lanka. Beijing is worried about a precedent being established. In the longer term, however, should conditions in Pakistan and Afghanistan deteriorate, China faces the dangers of two fragile states along its western frontier.

An economic meltdown and socio-political upheaval in a country of 220 million people would also have global ramifications. Pakistan already experienced a significant jump in regular emigration in 2022 [41]. First-time asylum applications lodged in the EU by Pakistani citizens rose sharply in 2022 compared to 2021 [42]. Pakistani nationals made up the sixth-largest nationality of asylum-seekers in the EU in 2022 [43]. More and more desperate, young Pakistanis in search of a better future, unable to obtain visas for entry to Western countries, will be forced to choose the path of irregular migration, undertaking perilous journeys to reach Europe. With a whole generation of young people deprived of legitimate opportunities for gainful employment, human trafficking, the smuggling of narcotics and other illicit goods, as well as cybercrime, will likely rise in Pakistan.

POLICY RECOMMENDATIONS FOR THE EU

For EU Member States, the main impact of the turmoil in Pakistan may be a rise in irregular migration. The deterioration in domestic security conditions could impact many other core dimensions of the 2019 EU-Pakistan Strategic Engagement Plan (SEP) [44], including democracy and human rights, sustainable development, and trade.

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The multifaceted nature of Pakistan's crises complicates the potential EU policy response. For example, the EU's agreement to renew the Generalised Scheme of Preferences Plus (GSP+) status for Pakistan, which is under biennial review, is dependent on an assessment of its record on human rights as well as environmental protection, labour rights, and good governance [45]. Yet the programme is also vital for Pakistan's macroeconomic stability. The EU is Pakistan's second-largest trading partner and the destination for over a quarter of its exports [46]. Pakistani exports to the EU have grown by 65 % since GSP+ status was granted to the country in 2013. [47]

The expansion of exports is key for Pakistan to exit its balance of payments crisis. As a result, the non-renewal or suspension of GSP+ due to worsening human rights and good governance conditions in Pakistan may cause unintended harm. The EU should identify a range of more targeted responses to a military takeover, a potential high-profile assassination perpetrated by Pakistani state actors, or egregious human rights abuses. A more effective response, for example, could be the imposition of sanctions on individuals under the European Magnitsky Act of 2020 [48].

Supporting democratic continuity in Pakistan not only reflects the EU's liberal values, but is also critical for Pakistan's political stability. The EU should both privately and in discreet public utterances affirm the need for all actors in Pakistan to uphold the constitution and human rights. It should also encourage a negotiated resolution to the political crisis within the bounds of the Pakistani constitution.

The EU has a potential role to play in Pakistan's economic transformation beyond the present crisis, including in green energy and technology. Through its Global Gateway strategy, the EU should consider supporting green hydrogen projects in the Balochistan and Sindh provinces. Replacing imported fossil fuels with domestic renewable fuel sources in the industrial and heavy transportation sectors would also help Pakistan conserve its foreign exchange reserves [49]. The European Investment Bank (EIB) can also consider working with startup funds that are active in Pakistan, helping accelerate the growth of the country's technology industry, building on the 'Accelerate Prosperity in Asia' project [50] which is jointly funded by the Aga Khan Foundation and the EU.

The EU, through signature initiatives, can assert its strategic autonomy and provide an alternative to Pakistan and other countries in the Global South that currently feel compelled to choose between the two protagonists in the climate of US-China rivalry.

CONCLUSION

The polycrisis in Pakistan represents a significant threat to the stability of a pivotal state at the crossroads of South and Central Asia, bordering China, India and Iran, with potential ripple effects and repercussions in Europe. Without a broad-based political consensus, Pakistan is unlikely to be able to overcome these multiple crises.

While the Pakistan army's campaign to sideline Imran Khan appears to be succeeding so far [51], it is severely undermining fundamental rights [52], judicial independence, press freedoms [53] and Pakistani democracy itself in the process. Given the popularity gap between Khan and his rival politicians [54], excluding Khan is unlikely to yield stability, at least without sustaining a system of fearsome coercion. The military's arm of repression in the ongoing crackdown on dissent is beginning to extend beyond the network of the PTI and its supporters [55], and may eventually trigger a backlash against the army from non-PTI activists and politicians.

On the economic front, the outlook is similarly gloomy. As the window of opportunity for Pakistan to revive its IMF bailout programme closes, the potential for an even deeper and more painful economic crisis grows. There are some reports that the government in Islamabad may dedicate its efforts instead towards negotiating a new EFF with the IMF later this summer, enabling it to first pass a budget in June that is friendly to voters [56]. But that will do little in the coming weeks to arrest the decline in Pakistan's foreign exchange reserves. By kicking the can down the road, Pakistan's rulers will only exacerbate the deepening crisis as they must secure an IMF agreement to avert default prior to transferring power to a caretaker government to oversee elections in the autumn. The odds are against them and the risk of a declaration of emergency is real.

It is neither desirable nor possible for outside powers, including the EU, to become enmeshed in Pakistan's factional disputes at such a volatile time. Ultimately, these are Pakistani problems that require Pakistani solutions.

However, the EU and other Western economies have the policy tools that can help dissuade Pakistan's leaders from an escalation that would take the crisis beyond the point of no return and result in full-scale military rule. The EU also has instruments, such as the Global Gateway, that support sectors that would foster green and sustainable growth and overall macroeconomic stability in Pakistan.

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