PIDE Economy Watch

Quarterly

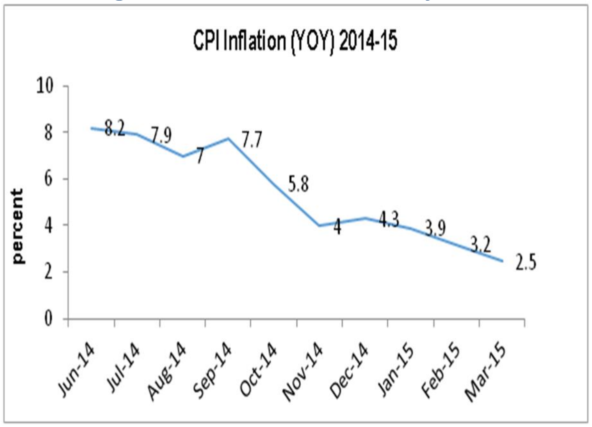
January-March 2015

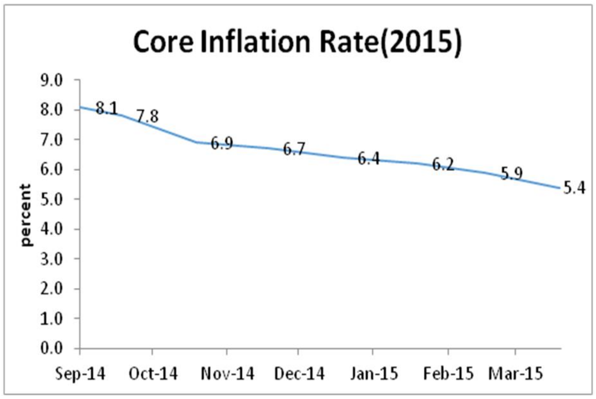
ECONOMIC PERFORMANCE

Macroeconomic indicators of stability like inflation, fiscal deficit, current account deficit, foreign reserves look fine and have registered considerable improvement during the January-March 2015. However, macroeconomic indicators of growth like performance of large-scale manufacturing, credit to private sector and investment do not paint a picture envisaged at the beginning of the current fiscal year.

Inflation has been on the decline since August 2015 and touched the lowest level of 2.5 percent in March 2015 on year on year (YOY) basis. Average CPI inflation for the 10 months of FY15 is 5.1 percent. The decline has been led by food and petroleum products.

Figure 1: Year on Year CPI Inflation

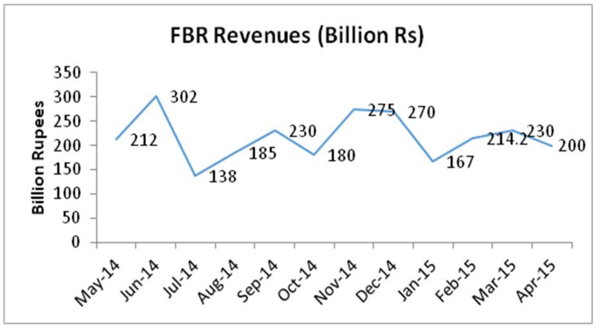




However the core inflation (i.e. non-food and non-oil) stood at 5.4 percent (YOY) in April 2015.

In keeping with previous practice an ambitious target of Rs. 2.81 trillion tax revenue set in budget for FY 15 was twice revised downward to be finally fixed at Rs. 2.69 trillionð a downward revision of 7 percent. Against the revised target of Rs. 1.85 trillion for the first 9 months the FBR managed to collect Rs. 1.77 trillion.

Figure 2: FBR Revenues



The targeted collection of Rs. 230 billion in April 2015 was also missed by a margin of Rs. 30 billion. Seemingly, the FBR would have a hard time in meeting the revised target of Rs. 2.69 trillion in FY 15.

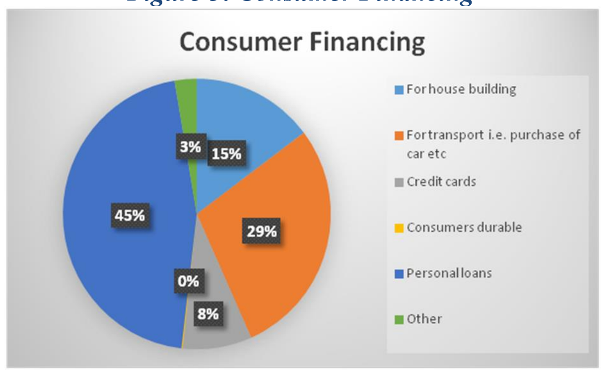
Independent estimates suggest that the increase in sales tax on petroleum has by and large compensated for the potential decline in tax revenue on account decrease in sales price of the petroleum products. While we try to figure out the reasons for missing the revenue target one should not lose sight of the fact that missing revenue target is not something new - this would be 7th consecutive year in a row that the revenue target would be missed. The revenue setting mechanism should draw lesson from this. Missing the revenue target means less than budgeted transfers to the provinces under the NFC which disturbs the development plans of the provinces.

To comply with IMFôs performance criteria, the governmentôs borrowing from the State Bank decreased significantly over the past couple of months however this seems to have been offset by the increased borrowing from commercial banks. Huge government borrowing from commercial banks comes at the back of corresponding amounts being injected into the market by the SBP.

Responding primarily to the rapidly declining inflation the State bank has adopted an easy stance of the monetary policy with the policy rate witnessing 4 downward revisions since November 2014ð with the latest cut of 100 basis point on May 23, 2015 the discount rate has touched a 42 year historic low of 7 percent.

The accommodative monetary policy did contribute to upsurge in economic activity in early 2000s when among other positives, growth in consumer financing led by car leasing played a major role in the upsurge. To pin hopes on car leasing now would call for estimating the potential that the sector carries now. Determinants of car leasing would include the extent to which the auto sector can increase production in a competitive market.

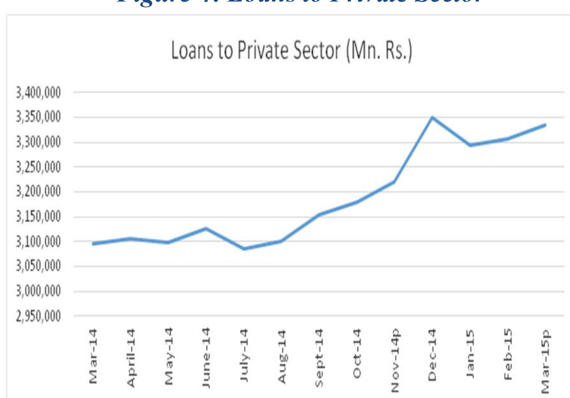
Figure 3: Consumer Financing



Personal loans comprise 45 percent of the outstanding stock of consumer financing as of March 2015. With significant decrease in interest rates this category has the potential to grow which may fuel consumption.

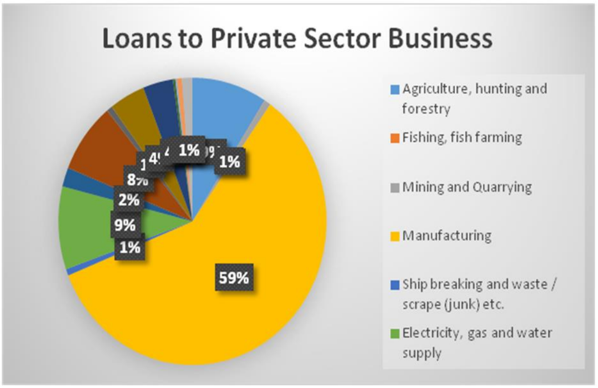
Credit to private sector though low has registered a slight uptick with a year on year growth of 7.7 percent till March 2015.

Figure 4: Loans to Private Sector



During this period, the credit to textile sector showed a negligible increase of 0.7 percent, in fact the credit to textile sector registered a decrease of 1 percent when compared with the stock outstanding as of November 2013. All this is despite the GSP plus status available to Pakistan since January 2014.

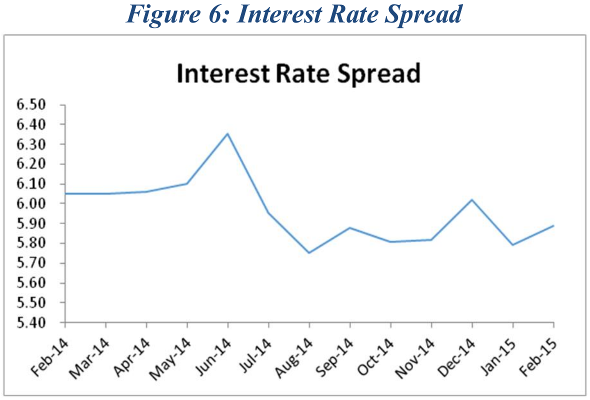
Figure 5: Loans to Private Sector Business



This suggests that structural features like, energy constraint are perhaps inhibiting production and hence credit off take. Therefore while pinning hopes on the recent easy stance of monetary policy and especially on the historic low level of SBP discount rate, one should be wary of the structural features that mar production.

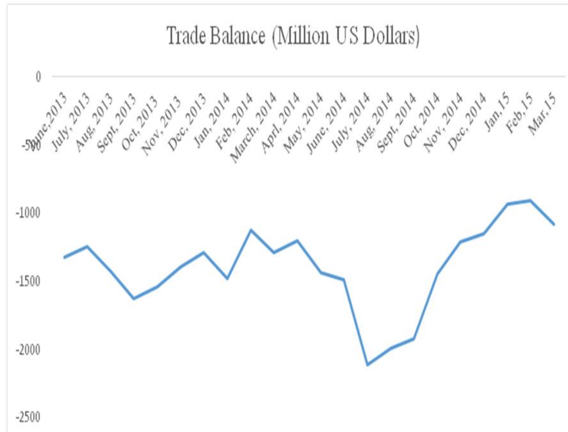
A positive feature of the economy is that the interest rate spread is on a declining course. The average annual spread as of March 2015 was 5.95 while it had declined to 5.57 percent by April 2014 for fresh loans and deposits.

Figure 6: Interest Rate Spread



The current account deficit for ten months of FY15 at Rs.1.36 billion is 53 less than the deficit in the corresponding period of last year. The reduction is owed to improvement in trade deficit and increase in remittances.

Figure 7: Trade Balance

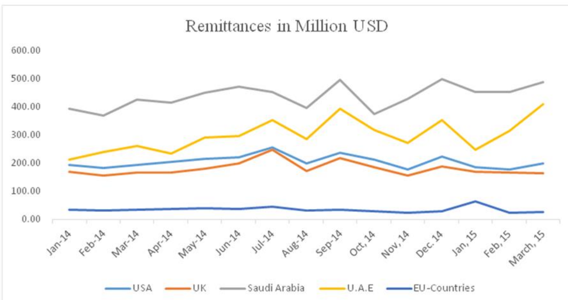


The exports faced a decline during the quarter under review as well as the during the 9 months of this fiscal year (July-March 2015; $18,122 million; July-March 2014 $18,745 million, decrease: 3 .3 pc), however despite the blip in exports the trade balance improved by 24 percent during the quarter, thanks to the oil price driven decline in imports (Trade deficit: January-March 2014; $3,883million, January-March 2015; 2,926 million, decrease: 24 pc).

One view is that interrupted access to energy constrains production and exports, while another view is that with the government borrowing massively from the banks, the financial sector is not keen on lending to the firms ï It is the credit constraint that, that impedes production and hence exports.

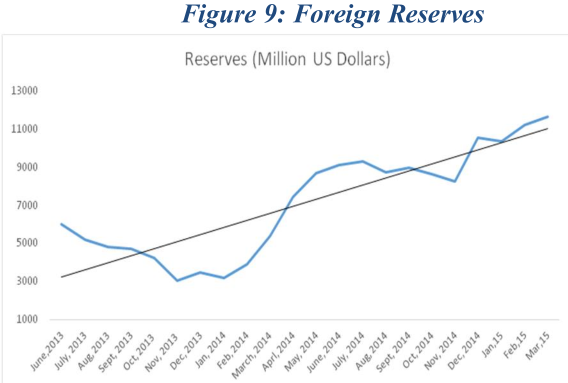
The remittances continue to exhibit a secular upward trend for the last over a decade. In the last nine months remittances have shown a marked increase of 17 percent over the corresponding period of last year. Remittances from the EU, UK and USA show a fairly static trend however those from the Middle East, especially from the UAE and Saudi Arabia continue to be on the rise and do not seem to be adversely affected by the decline in oil revenues of the gulf region.

Figure 8: Remittance Inflows



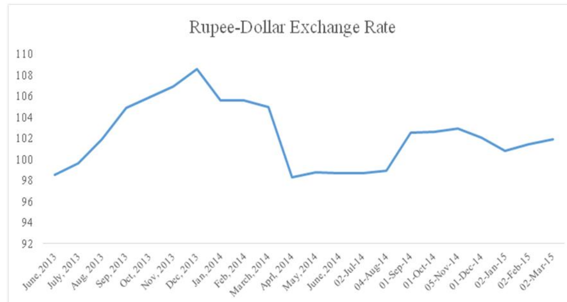
The Foreign Exchange Reserves held with the SBP improved considerably till end of March 2015 relative to last year - the net reserves of the SBP are more than double the reserves last year. (March FY14, $5,365 million, March FY15, $11,615). The reserves are now more than enough to comfortably cover 3 months of imports.

Figure 9: Foreign Reserves



The Rupee depreciated marginally against the dollar during January-March 2015 (January: Rs. 100.8, March: Rs.101.9, Depreciation: 1.1 percent). In recent months the Rupee has depreciated further against the dollar.

Figure 10: Exchange Rate



With the release of Rs.312 billion so far against the PSDP, the utilisation of stands at 60 percent of the allocated amount till May 22, 2015.

The Large Scale Manufacturing (LSM) registered a growth of 2.00 percent during July-February 2014-15 relative to the corresponding period of last fiscal year. Individual products with outstanding performance during July-February 2014-15 include Pakistan Steelôs Coke (394 pc), Electric transformers (163 pc) Pig iron (139pc), Woolen and carpet yarn (67pc), Power looms (64pc), Trucks (57pc) and Tractors (49pc). The sectors that barely managed to post positive growth during July-February 2014-15 include Iron and Steel Products (1pc), Automobiles (0.68pc), Pharmaceuticals (0.48pc), Non Metallic Mineral Products (0.45pc) while negative growth was observed in Food, Beverages and Tobacco (-0.57pc), Wood Products (-0.50pc) and Paper and Board (ï 0.24%). Except for the occasional temporary hikes, the weak performance of large scale manufacturing continues due to variety of factors including energy constraint.

VIEWPOINTS

Keynes versus IMF

Leading economists like John Maynard Keynes and Irving Fisher had forecast prolonged and permanent prosperity, just prior to the Great Depression of 1929. The shock of the Great Depression led Keynes to create Keynesian Economics. According to conventional economic theory, increasing the quantity of money in circulation has only one effect: increasing the level of prices. That is, printing money is inflationary and has no effects on the real economy. Many economists of the time noted that massive bank failures had led to substantial reduction in the money supply. They came to a realisation that these events were related. Contrary to the classical theory that money only affects prices, there was a possibility that shortfall in the money supply caused the massive unemployment of labour and other resources.

Keynesian theory is based on a very simple idea that conduct of the ordinary business of an economy requires a certain amount of money. If the amount of money is less than this amount, then businesses cannot functionð they cannot buy inputs, pay labourers or rent shops. This was the fundamental cause of the Great Depression. The solution was simple: increase the supply of money. Keynes suggested that we could print money and bury it in coal mines to have unemployed workers dig it up. If money was available in sufficient quantities, businesses would revive and the unemployed labourers would find work. By now, there is nearly universal consensus on this idea. Even Milton Friedman, the leader of the Monetarist School of Economics and an arch-enemy of Keynesian ideas, agreed that the reduction in money supply was the cause of the Great Depression. Instead of burying it in mines, he suggested that money could be dropped from helicopters to solve the problem of unemployment.

But what about inflation? Isnφt it true that printing money in massive quantities would lead to inflation? According to Keynesian theories, this would happen *after* full employment was achieved. That is, once the economy reached its maximum production capabilities, further money could not contribute to an increase in production. At this point, printing more money would only lead to inflation, exactly as the classic economic theory predicts. The Keynesian theory gives the central banks of the world an extremely important task: maintaining the money supply at exactly the right level to create maximum production without running the risk of inflation. Keynes also said that monetary policy may be insufficient for the task and the government had the direct responsibility of ensuring full employment using fiscal policies.

Regulation of financial markets, social support for the poor and the governmental responsibility to provide jobs for all led to decades of prosperity in Western economies. The share in the wealth of the bottom 90 per cent increased, while the share of the top 0.1 per cent decreased. This state of affairs did not please the wealthy elite, who launched an extremely successful attack against Keynesian ideas in the 1970s. The Arab oil embargo led to a sharp rise in oil prices and inflation, while simultaneously disrupting productive activities and creating unemployment. Keynesian theory states that we can only have one or the other: óstagflationô or simultaneous presence of high inflation and high unemployment is ruled out.

This weakness in the Keynesian theory was successfully exploited by the rich and powerful to argue that the main problem lay with government interventions. Ronald Reagan dismantled some post-Depression regulations, which limited the powers of wealthy financiers. In particular, with great fanfare, Reagan deregulated the savings and loan (S&L) industry. Exactly as in the Great Depression, the banks took advantage of this to speculate in risky investments with depositorsô money and lost billions of dollars, creating a nation-wide banking crisis. However, the US government had learnt its lessons from the Great Depression and gave a massive bailout to prevent the collapse of the S&L banks. Over the next few decades, deregulation unleashed the power of the financiers, and cuts in social services weakened the labour class, with predictable results. Speculative financiers gambled heavily with the money of others deposited in banks, leading to myriad monetary crises. At the same time, the labour class was squeezed, resulting in rising inequalities and massive concentration of wealth at the top.

In the post-Keynesian era, the clarity of Keynes has been lost. Many central banks have gone back to pre-Keynesian ideas, abandoning the goal of full employment, and focusing solely on controlling inflation. Substantial doubt has been created as to whether or not monetary policy, or helicopter money, can be useful in solving problems of unemployment. When countries spend more foreign exchange on imports than they can earn, they are forced to borrow dollars from the IMF. As a condition of such loans, the IMF insists on austerity ð governments should balance budgets and not print money to finance deficits. According to the IMF, financing deficits with increases in money supply can lead to high inflation, with heavy economic costs. However, according to Keynes, we should increase the money supply in an economy with high unemployment, such as Pakistan. Printing money is not inflationary in such a situation. So who is right? Keynes or the IMF?

Recent research by Princeton economists Atif Mian and Amir Sufi sheds considerable light on the answer, which is obvious in retrospect: both Keynes and the IMF are right. What happens depends on who picks up the helicopter money and what they do with it. If those who get the money buy land, property values will go up. If they invest in stocks, this will create a bubble in the stock market. If they put it in their Swiss accounts, this will lead to depreciation of the exchange rate. However, if the money is used wisely, to invest in projects which increase the productive capacity of the economy, this will create employment and generate the economic returns needed to provide support and backing for the newly created money.

When Keynesian policies of full employment and social support for labourers eroded the wealth shares of the live élite, the counter-attack created alternative policies, as well as theories and ideologies to support these policies. Decades of experience with these policies, codified in the Washington Consensus as privatisation, liberalisation and stabilisation, has shown that they produce increasing inequality but do not produce growth.

Alternative models for successful development are available. The most spectacular recent example is of Brazilian leader Luiz Inacio Lula da Silva. After being elected president in 2003, his deficit-financed programmes of social support and investment created progress and prosperity. Under him, Brazil went from being the most heavily indebted country in the world to the eighth largest economy, and 20 million people rose out of poverty. There are many other examples of wise public spending listed by Ellen Brown in [*The Public Bank Solution: From Austerity to Prosperity*]. Other kinds of examples also exist, where reckless and corrupt governments can wreak havoc on the economy, as the IMF fears. Can we rise to the challenge of spending efficiently on social services and productive investments, leading to the Keynesian outcomes of full employment without inflation?

Asad Zaman, Vice Chancellor, PIDE

Sound bites from Pre-Budget Seminar organised by PIDE in April 2015

1. Chairman FBR stated that the FBR faces the challenge of ôWhy should I pay taxö. Thus he referred to the root of the problem and to what is discussed in relevant literature as the state-citizen bargain ï the citizens pay taxes to the state and in return expect effective public provision of certain goods and services deemed the ambit of the state, for example the security of life and property. Citizenös failure to observe effective public provision, constrains tax collection and the impression of leakages and rent seeking within the state augments this constraint further. To increase tax collection the citizens must enjoy ôbang for the buckö.
2. A major reason for slow growth in tax revenues is slower economic growth. Pakistanös growth performance is typical of an underperforming economy. It has recorded only three episodes of growth acceleration since 1960, with the GDP per capita exceeding 3 percent per annum (1963-66, 1980-83, 2004-07). The economyös long-term óstructuralô growth trend is declining from 6-7 percent in 1960s to less than 3 percent in late 2000. Pakistanös current growth rate is significantly below potential.
3. The economy seems suffering from deflation. We should choose between óstabilisation-first, growth-laterô and ôjob-rich growthö. To increase growth and hence tax revenues, the economy needs a fiscal stimulus of the right kind and the upcoming budget should provide the required stimulus. While giving fiscal stimulus, greater emphasis should be placed on quality of expenditure, particularly an emphasis, on investment in physical and human capital is required.
4. To introduce fiscal prudence, the supplementary budget should be approved ex-ante rather ex-post as is the practice in almost all the countries around the world, barring some exceptions.
5. Multiple tax agencies at the provincial and the federal level should be amalgamated to form a unified tax collection agency. Equity, efficiency, administrative convenience and ease of payment for the taxpayer, all favour a single national tax authority with no counterparts at the provincial level.

6. To induct professionals, into the FBR, who possess the academic knowledge required for raising revenues from specific kinds of taxation, the induction in FBR should be delinked from the CSS. The FBR should be allowed to do job-specific recruitment directly from the market on the pattern an autonomous entity recruits her employees.
7. The FBR should enjoy greater independence and authority then it currently possess. One step towards independence of the FBR could be that the chairman FBR be hired from the market through a competitive process for a fixed tenure of 3-5 years.
8. To incentivise collection at the provincial level, rather than collecting most of the taxes at the centre and then redistributing through the NFC, tax bases like income, including corporate income, be shared between the Centre and provinces in some proportion deemed fit. This may put such provinces where economic activity is rather low at a disadvantage. Such disadvantaged province can be assigned a greater share from the shrunken divisible pool of taxes.

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