# Macroeconomic Brief

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Pakistan's economy has been hit hard by the triple blows of devastating floods, crippling energy shortages, and fragile domestic security situation. Economic growth remains anemic, inflation is stubbornly high, and public finances are in disarray. Worse still, macroeconomic stabilization policies are not working, not least because of a lack of coordination between monetary and fiscal policies. What is more, policy reversals and procrastination on vital economic issues—signs of a lack of political consensus—have only added to the prevailing uncertainty with adverse consequences for consumer and business confidence. In this scenario, restoration of macroeconomic stability and revival of economic growth have become serious challenges. Urgent, decisive and bold steps are needed to put the economy on the path of sustained recovery with a stable macroeconomic environment and robust growth.

The economic recovery witnessed in 2010-11 suffered an unexpected setback at the hands of unprecedented floods in August 2010 that caused widespread devastation in the economy. The floods not only caused a slowdown in agricultural growth, the manufacturing sector, already battered by energy shortages, also took a hit as a result of supply disruptions and damage to physical infrastructure including power plants, gas fields, and power grids. The industrial production, as reflected by Quantum Index of Manufacturing (QIM) after having registered positive growth in 2009-10 slid once again into the negative zone in August 2010 and has remained so in the next four months. On an annual basis, the manufacturing sector contracted by 2.3 percent during July-November 2010. It is worth noting that manufacturing output shrank despite a 20 percent increase in exports during July-December 2010, and this is due mainly to the fact that upsurge in exports has been driven largely by increase in prices of cotton-related products rather than increase in export volumes.


The double-digit inflation experienced in the aftermath of global hike in commodity prices in 2008 showed a brief respite in 2009, only to be on the rising course again reaching as high as 15.5 percent in December 2010 on a year-on-year basis. Why has inflation persisted despite a prolonged spell of tight monetary policy? A number of factors are at play here. First and foremost is the lack of coordination between monetary and fiscal policies. In particular, excessive monetization of fiscal deficit results in higher than targeted growth of money supply thus nullifying the impact of high interest rates on the price level. Second, the fact that inflationary expectations are fairly entrenched blunts the effectiveness of monetary policy as agents base

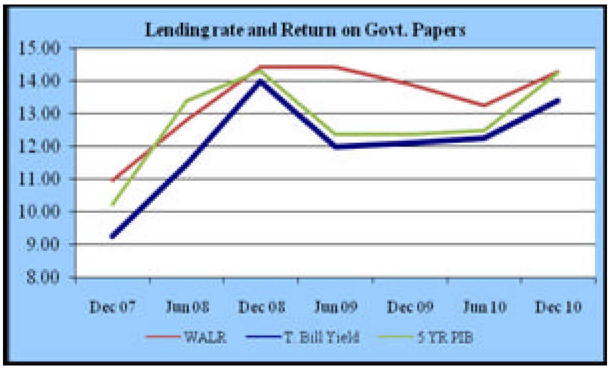
their contracts on their expectations of high inflation in the future. Other factors that may explain the persistence of inflation include actual and perceived disruption in supplies caused by the devastating floods, frequent revision in energy prices, rising international oil and commodity prices, and market power of the oligopolistic industries.


Public finances remain under pressure due mainly to flood relief and rehabilitation costs, non-implementation of structural reforms like the introduction of RGST, continued payment of subsidies, and massive losses of the state-owned enterprises. To meet the financing gap the government resorted to monetization of fiscal deficit, rather than borrowing through government papers, which is a costly alternative in the present interest rate environment. The monetization of fiscal deficit has without doubt stoked inflationary pressures in the economy. In an attempt to curtail the fiscal deficit, the axe has unfortunately fallen on the public sector development program (PSDP) while big-ticket expenditure items remain off limits to fiscal pruning. Cuts in development spending including on critical physical infrastructure needs do not augur well for the country's long term competitiveness. Difficult decisions shall have to be taken to restore fiscal discipline. In particular, public spending needs to be rationalized through phasing out of all but targeted subsidies, restructuring of the state-owned enterprises, reduction in current expenditure, and reprioritizing the public sector development program. With the tax to GDP ratio at the abysmal level of 9 percent, the need to generate more revenues also has a sense of urgency. Past efforts to enhance tax revenues have been hampered by the lack of documentation in the economy. The imposition of RGST would not only generate more revenues but also help the process of documentation. Much against the popular perception, the expert opinion suggests that RGST would be inflation neutral. We feel that not only the RGST should be imposed but other potential sources of tax revenues including agriculture, services, and real estate be brought under the tax net.

**Box 1: Coping with Stagflation**

With the economy in the throes of stagflation, policymakers are struggling to find ways to achieve macroeconomic stability while at the same time boosting economic growth. They are faced with a classic dilemma: policies to achieve macroeconomic stability stifle economic growth whereas policies to boost economic growth create macroeconomic instability. International experience has shown that stagflation is not easy to deal with and that there is no one-size-fits-all approach to address stagflation. The solution may depend on initial conditions and the sources of stagflation. In Pakistan, a combination of factors may have contributed to stagflation including supply shocks on the back of energy shortages and disruptions caused by the floods, and inflation driven partly by excessive growth of money supply as a result of monetization of fiscal deficit. So how can policymakers deal with stagflation? To begin with, it is important to realize that the two objectives of high growth and low inflation cannot be achieved with a single set of policies - the tightening policies, whether monetary or fiscal, though good at curbing inflation are inimical to growth and vice versa. Since a major source of stagflation appears to be supply shocks, part of the solution may lie in boosting supply by removing supply side bottlenecks. Also, stopping monetization of fiscal deficit should help curb inflationary pressures in the economy. Once macroeconomic stability gains traction, both monetary and fiscal policies can be attuned to prop up the economy and revive economic growth. To achieve high and sustained growth over the long run, a host of institutional reforms aimed at redefining the role of the state in the economy from an active player to an enabler, fostering competition, plugging leakages and curbing rent seeking are required.

Credit to the private sector has not shown a marked improvement in recent years as demand for credit remains depressed on the back of tight monetary policy. In addition, some supply side factors are also responsible for credit squeeze to the private sector. For example, the banks have little incentive to lend in the present interest rate environment where they can earn more or less the same return on risk-free government papers as they would on risky loans to the private sector. No wonder that loans to deposit ratio fell from 75 percent in December 2008 to 63 percent in September 2010. The banks would tend to lend to the private sector only after exhausting their option to invest in government papers. Here too, the heightened risk aversion of the banks as a result of a rising portfolio of non-performing loans may constrain credit to the private sector.




**Box 2: Monetary Policy and Supply Shocks**

The tight monetary policy stance has come under fire from the business community and many interested observers. It is argued that the monetary policy has failed to curb inflation on the one hand and has stymied economic growth on the other. While there is a certain element of truth in these arguments, the real question is: can the monetary policy be eased when the economy is experiencing supply shocks amid energy shortages, disruptions caused by floods, and domestic security situation? While an easing of monetary policy at this time would do little in addressing supply side bottlenecks, it would certainly unleash demand pressures in the economy thus stoking inflation. For this reason alone, there is a need to maintain the current monetary policy stance. This should be accompanied by a better coordination between monetary and fiscal policies so that both policies work in lock step to control inflation.

The external sector registered a surplus on current account during July-December 2010. The surplus is as much a reflection of low level of economic activity as it is of improved receipts as a result of healthy growth in remittances, increase in exports, and aid inflows on account of flood relief. Whereas growth in remittances has been helped by new initiatives to facilitate quicker and easier transfer of money from abroad through the formal channels, exports have mainly risen on account of higher prices of cotton-related products. Foreign direct investment and portfolio investment continue to remain low due mainly to security concerns and weak economic growth. Given that relief aid is a one off phenomenon and that international commodity prices, especially of oil, are on the rise the surplus on current account may not last for long.

Both domestic and external debts have grown rapidly in the past couple of years raising concerns about debt sustainability. The Fiscal Responsibility and Debt Limitation Act (FRDL) 2005 entails that

**Box 3: Fiscal Decentralization: An opportunity as well as a challenge**

The fiscal decentralization, envisaged under the 18th amendment and the 7th NFC Award, is a welcome development that holds a significant promise to enhance the country's long term development and growth prospects. Yet, the move towards fiscal decentralization is a major leap forward in largely unchartered territory and hence poses significant challenges too. For one thing, it has introduced an element of uncertainty about potential growth trajectory of the economy in the immediate future. For example the provinces can now borrow abroad; what impact this would have on the national debt level and the consolidated fiscal deficit remains to be seen. Whether the greater amount of resources transferred under the 7th NFC Award will encourage the provinces to undertake more developmental work or introduce laxity in their own revenue generation efforts is yet another unknown. Other challenges include devising appropriate frameworks for macroeconomic management and development planning, capacity building of relevant ministries, and introducing competition among provinces for fiscal discipline and better service delivery.

(i) the total debt be reduced to 60 percent of GDP by 2013 and that (ii) after achieving the 60 percent benchmark the total debt to GDP ratio be reduced by 2.5 percentage points annually. Since 2008-09, total debt has exceeded 60 percent of GDP with an upward trend. The rapidly growing debt threatens to pose a serious challenge to macroeconomic management in the future as growing debt servicing payments would leave little room for crucial public expenditures on physical infrastructure and social sectors.

In summary, the economy continues to be bedeviled by supply shocks while macroeconomic stability remains elusive. The immediate challenge before the policymakers is to restore macroeconomic stability which is a pre-requisite for sustained economic growth. There is an urgent need to stop monetization of fiscal deficit that has fuelled inflationary pressures in the economy. Such a move would also make monetary policy much more effective in controlling inflation by containing demand pressures at a time when supply is constrained by various bottlenecks including energy shortages. Policies to address supply side constraints and boost economic growth do not have to wait until full restoration of macroeconomic stability and can be initiated in tandem with macroeconomic stabilization policies. For instance, though fully addressing the energy crisis would take some time, some immediate steps can help in mitigating the energy shortages. Experts believe that if the issue of circular debt is resolved together with an up gradation of the existing power infrastructure, up to 1500-2000 MW of electricity can be brought into the power system which could help boost supply in the short run. Meanwhile, there is a need to think beyond stabilization and put in place reforms to free up private enterprise and enhance productivity for sustained economic growth which is essential for job creation and poverty reduction.

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*Source:* The data for the graphs are taken from the State Bank of Pakistan, (Various Statistical Bulletins).