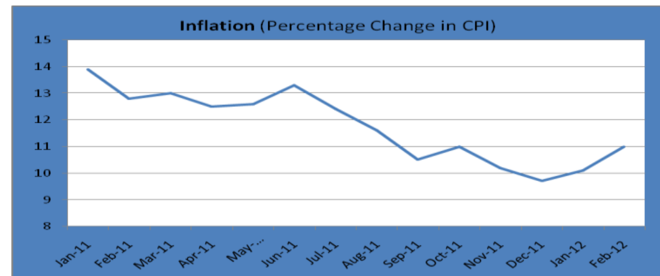
Macroeconomic Brief

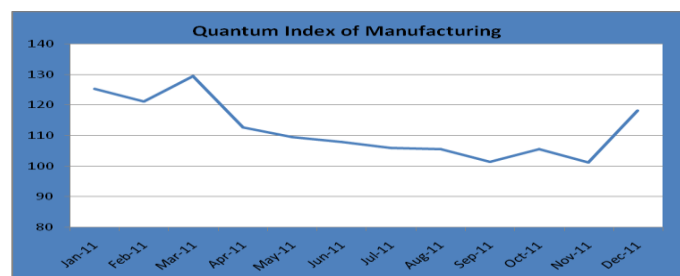
March 2012 No. 3

Despite some positive developments including easing of inflation and reduction in fiscal deficit, Pakistan's economy remains in a precarious state with sluggish growth, fragile macroeconomic fundamentals, and heightened vulnerability to balance of payments shocks. Sadly, the key problems afflicting the economy including energy shortages and a host of structural impediments that have held back investment and growth have not been tackled effectively, showing signs of misgovernance and policy inertia. More worryingly, with the government embroiled in political controversies and the election year approaching, pressing economic issues are likely to remain on the backburner dimming hopes of a reversal in economic situation at least in the near term. At the same time, the government may be tempted to adopt populist measures ahead of the elections that could further compound economic difficulties. Challenging times thus lie ahead.

After a prolonged spell of tight monetary policy, inflation eased to 9.7 percent in December 2011 from 15.5 percent in December 2010 on a year-on-year basis. Citing reduced inflationary pressures, The State Bank of Pakistan moved rather aggressively to cut the policy rate by a cumulative 200 basis points to 12 percent in September 2011. Since then, the SBP has rightly signalled a more cautious approach by keeping its policy rate unchanged. There are significant risks to inflation outlook emanating from weak supply response as a result of power shortages, recent hike in fuel and energy prices, and pass through of currency depreciation. In this scenario, monetary policy needs to be carefully calibrated to balance the objectives of robust growth and price stability.

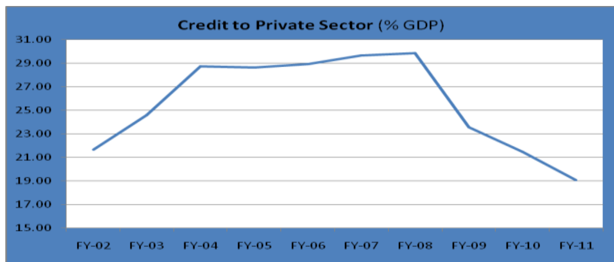


Economic growth remains stunted as energy shortages have continued to inflict a heavy toll on the economy. Though the large scale manufacturing sector has shown a modest recovery, its growth remains far below potential. The agriculture sector appears to be recovering from the aftermath of floods and is expected to achieve its target growth of 3.4 percent in FY12 due mainly to expected increase in the production of rice and sugarcane. Despite this however, the economy is likely to miss the overall growth target of 4.2 percent in FY12 with the intensification of the energy crisis in the recent months and continued weaknesses in the manufacturing sector.



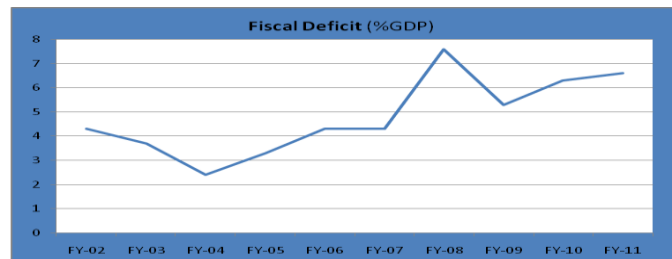
Despite an easing of interest rates, demand for credit by the private sector remains depressed indicating sluggish investment activity. The loans to the private sector shrank by Rs 9.1 billion during July-Nov FY12 as against an expansion of Rs 73.6 billion during the same period in FY11. To be sure, this could also reflect bottlenecks on the supply side of credit especially banks' increasing proclivity towards risk free government securities especially

in the face of rising share of non-performing loans in their portfolios.



Though the government managed to reduce the fiscal deficit in the first half of FY12, the target for fiscal deficit at 4.7 percent of GDP is unlikely to be achieved with slow growth in revenue collection, continuing losses of the state owned enterprises, and increased pressure on public spending ahead of the elections. The preliminary data for tax collection show that much of the increase in tax collection is accounted for by sales tax on rising imports of petroleum and fertilisers and that this increase is unlikely to be matched by tax collection from domestic sources in view of the sluggish economic activity in the commodity producing sectors. The Federal Bureau of Revenue's (FBR) target of Rs 1,952.3 billion for the current fiscal year thus looks rather optimistic. On the expenditure side, government continues to pour billions into the haemorrhaging state-owned enterprises which together with sticky current expenditures leaves little room for curtailing public spending. The government's fiscal troubles do not end here. With fiscal decentralisation, the state of provincial public finances can have important repercussions for overall fiscal stability. So far, the provincial budgets are reportedly in deficit as revenue growth has been slow and, if this trend continues, provinces would be unable to generate the required surpluses thus putting further pressure on government finances. Furthermore, the government may be inclined to ramp up public spending in the coming months to gain popular support thus imperiling already strained fiscal balances.

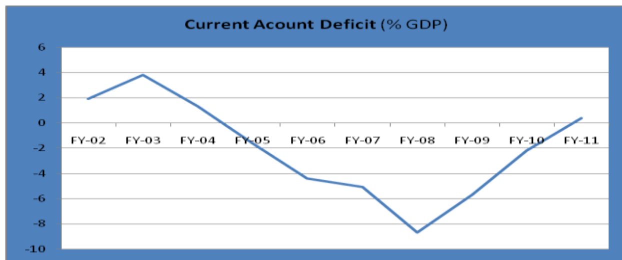
In its efforts to achieve better coordination between fiscal and monetary policies, the government has curtailed its borrowings from the central bank in recent months. What is disturbing however is that this has been achieved on the back of escalating government borrowing from the



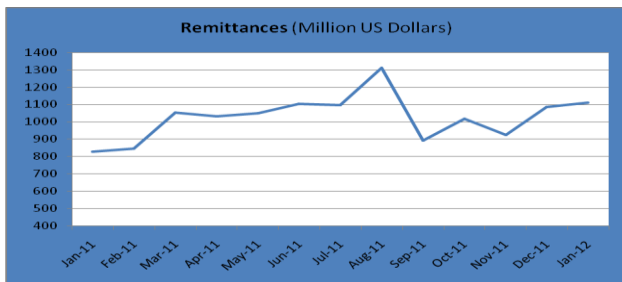
commercial banks: public borrowing from commercial banks increased sharply from Rs 61.3 billion in July-November FY11 to Rs 665.0 billion in July-November FY12 while the government debt through the banking system during this period increased by Rs 500.7 billion. Worse still, public borrowing from the commercial banks has been helped by massive liquidity injections by the central bank. Such a policy is clearly counterproductive as it crowds out private investment on the one hand and erodes the effectiveness of monetary policy to control inflation on the other.

Box 1. Remittances

Remittances from overseas Pakistanis have been historically an important source of foreign exchange providing not only critical support to balance of payments but also stimulating the domestic economy while helping to alleviate poverty. In recent years, remittances have surged from US$8.9 billion in FY10 to US$11.2 billion in FY11. This trend has held up with remittances amounting to US$ 5.2 billion (76.5 percent of current transfers) in the first quarter of FY12 alone, up from US$ 4.4 billion during the same period in FY11. Yet, heady growth in remittances should be no cause for complacency as over reliance on remittances makes the balance of payments susceptible to slowdown in the Gulf region and other countries where Pakistani migrants are concentrated. To reduce such vulnerability and to strengthen its external accounts position on a lasting basis, Pakistan needs to undertake wide-ranging structural reforms including tariff reforms to increase competitiveness, industrial and export diversification to boost exports and reduce import intensity, move towards high value added exports, and encourage foreign direct investment. It is only through these long term measures that Pakistan can strengthen its external accounts on a sustained basis.



A combination of factors including weakening exports, shrinking foreign capital inflows including loans and aid, rising petroleum prices, and approaching loan repayments has heightened Pakistan's vulnerability to balance of payment difficulties. The balance of payment situation has worsened during the ongoing fiscal year with the current account turning from a surplus into a deficit of US$1.7 billion during the first quarter of FY12. Though foreign exchange reserves have held up on the back of strong remittances, the rupee has come under severe pressure not least because of fears of a build-up of external account imbalances. This situation is not helped by an uncertain global economic outlook with the US still struggling to recover and the euro zone caught in a fast spreading debt crisis that threatens the very survival of the euro itself.



Pakistan's macroeconomic imbalances are rooted in deep structural problems—poor tax collection with narrow tax base, massive leakages in state-owned enterprises, low savings, and lack of export diversification, to name just a few—and unless these are effectively addressed macroeconomic stability cannot be achieved on a sustained basis. There can be no exaggerating the fact that there is an urgent need to improve the tax to GDP ratio through widening the tax net, rationalising the tax rates, streamlining the tax administration, and removing exemptions. Similarly restructuring of the state-owned enterprises must receive the highest priority. There are solutions available, short of full scale privatisation, including public private partnership and restructuring and corporatisation of these enterprises through independent and professional boards of directors. To encourage domestic savings, there is a need to deepen the financial sector with improved variety of savings instruments that can provide better choice and incentives for savers. On the external front, Pakistan's balance of payments position would continue to remain vulnerable to external shocks as long as weaknesses in the export sector including high concentration in a few products persist.

Box 2. Financial Sector Reforms for Growth

Pakistan's financial sector is dominated by the banking sector while the non-bank sector including the debt markets remain shallow and small. The lack of depth in financial markets have limited the access to credit while the banks enjoy wide interest rate spreads due to lack of competition. Financial intermediation in Pakistan is still limited with deposits as a percentage of GDP at 30 percent in FY11, much lower than 51 percent in Bangladesh and 63 percent in India. Correspondingly, currency in circulation as a percentage of total deposits at 31 percent is very high as compared with 15 percent in Bangladesh and 18 percent in India. This indicates that there is ample scope to increase financial intermediation through promotion of micro-finance, branchless banking, and removal of fiscal levies on financial transactions. Investment banking activity in Pakistan is extremely limited and needs to be further developed by bringing it under the same regulatory framework as the commercial banks to provide it a level playing field. Deepening of the domestic debt market will introduce competition in the financial system and facilitate the issuance of public and private debt through market based debt instruments thus helping to improve the capacity for investment and growth.

Source: PIDE Seminar Presentation by Mr Salim Raza, ex-governor State Bank of Pakistan on "Financial Sector Reforms: Deepening and Widening Pakistan's Financial Sector." February 2012.

Though the present government may have little inclination to undertake structural reforms at a time when it has its energies focused on the next elections, we believe that it still has an opportunity to implement a minimum agenda focused on correcting macroeconomic imbalances as well as on setting the future direction for sustainable economic growth. Pakistan cannot afford to lose time and the cost of policy paralysis would be very high in terms of macroeconomic instability and lost opportunities for growth. To begin with, the forthcoming budget should aim at achieving fiscal stability by avoiding politically driven public expenditures, cutting

wasteful spending, and channelling resources into key public investments in energy, infrastructure and human resource development, the key drivers of economic growth and development. These measurers need to be supported by prudent public debt management through induction of professionals in the debt management office which will help reduce the cost of public debt. The government has already approved the Framework of Economic Growth developed by the Planning Commission which lays out a comprehensive strategy for long term competitiveness and growth focusing on governance and institutions, markets, connectivity and cities. The government would do well to expedite the process of operationalising this growth strategy by initiating specific policies and programs in key strategic thrust areas of the growth strategy. By acting on this minimum agenda, the government has a chance to set the stage for lifting the economy out of the current morass.

Looking forward, with the elections approaching, there is considerable uncertainty prevailing about the future course of economic policies. The major political parties have largely confined their attention to popular sloganeering and have not come up with their detailed economic strategies so far. They would be better advised to clearly spell out their economic visions along with coherent macroeconomic frameworks and economic policies and programs for accelerating economic growth and development.

Box 3. Drivers That Can Ignite Economic Growth

In these challenging times, it is easy to be pessimistic about the revival of economic growth. Yet there is a brighter side of the economy too that, if carefully nurtured, has the potential to generate robust growth on a sustained basis. For a start, recent research based on Pakistan Social and Living Measurement (PSLM) survey shows that Pakistan's middle class has grown over time and is currently estimated at 35 percent of the population [Nayab (2012)]. Given its substantial size and composition—primarily urban and associated with professional white-collar occupations—this class can play a pivotal role in bolstering economic growth. A vibrant middle class not only provides a strong impetus to economic activities through buoyant spending on consumer durables and other goods and services but also funds productive investments through savings. In addition, middle class households tend to invest more in human capital providing the economy with professional and skilled labour force which is an essential ingredient for long run growth. Second, with a sizeable and growing middle class, the consumer goods industry can also be an important driver of economic growth. Indeed this sector has already shown a healthy growth performance despite an overall slump in the economy and the potential for its further expansion is substantial due to the continuing strong demand from the middle class. Third, there is a growing trend for youth entrepreneurship in Pakistan. Many young entrepreneurs have succeeded in establishing diverse businesses that are thriving and this has produced a strong demonstration effect for others to emulate. If properly harnessed, young entrepreneurs have the potential to lead a major turnaround in the economic fortunes of Pakistan. Finally, the opening up of trade with India is a welcome initiative that holds great promise to be an engine of growth entailing benefits in terms of greater market access, scale economies, and easy availability of raw materials for domestic producers. It must, however, be cautioned that these drivers of economic growth would succeed only if macroeconomic stability is maintained and the binding constraints including energy shortages are removed.

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