Macroeconomic Stability and Sustained Growth

A PBC Position Paper by the Macroeconomic Panel

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MACROECONOMIC PANEL

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INTRODUCTION:
ACHIEVING MACROECONOMIC STABILITY WHILE POSITIONING FOR SUSTAINED GROWTH

Pakistan's economy was battered by multiple shocks by mid-FY08

Pakistan's economy was under extreme stress by mid-2008, principally owing to exceptionally large twin deficits (the fiscal deficit for the FY08 eventually rose of a 10-year high of 7.6 % of GDP and the current account deficit to an all-time high of 8.5 % of GDP). The resulting macroeconomic risks were compounded by the international commodity price shock, the crisis engulfing the international capital markets and domestic political turmoil. The economic situation became more complicated due to severe energy shortages, terrorism and the influx of IDPs. Supply shortages of key staples – despite substantial domestic production – also contributed towards increase in social unrest.

Key macroeconomic indicators other than fiscal and current account also presented a bleak picture:

- The burgeoning twin deficits, coupled with the international commodity prices shock, and depreciating rupee pushed up inflationary pressures, with CPI inflation trending up sharply, from 6.4% in July 2007 to a high of 25.3% by August 2008
- There was a sharp decline in external financial inflows, putting severe pressures on the country's foreign exchange reserves, and the Pak rupee.
- Rupee parity deteriorated, with the cumulative depreciation of 22% against the USD during January-November 2008.
- Not surprisingly, the resulting shocks to aggregate demand and business confidence impacted economic activities, with negative growth in LSM, and as a consequent decline in overall GDP growth.

Pakistan entered into an IMF supported Macroeconomic Stabilization program in November 2008. Progress so far has been mixed...

It was against this background, the Government entered into an IMF Stand-By Arrangement in Nov 2008. The agreement, inter alia, aimed at reduction in both fiscal deficit and borrowings from SBP, through implementation of VAT, reduction in subsidy in power sector, and increasing the tax net, etc.

Initial progress in implementing IMF reforms and attendant improvement in foreign currency reserves helped support a revival in the domestic economy, This process was helped by a gradual improvement in the global economy, and declining domestic inflation (following a tightening of monetary policy and weakening international commodity prices) and strong agri-sector performance. The current account deficit dropped to sustainable limits. However, significant structural problems remained unaddressed including the continuing fiscal imbalances, enactment of legislation for greater autonomy to the central bank, elimination of subsidy on power, issues of circular debt in energy etc.

Pakistan's economy showed resilience post- floods, despite the drag from the ongoing struggle against militancy…

Pakistan's economy showed resilience after suffering enormous damages from the devastating floods of 2010. A buoyant agriculture sector helped by a surge in commodity prices eased the pressures arising from the floods and gave a boost to the rural economy. Purchasing power generated in the rural areas had positive impact on demand for some consumer goods manufactured domestically. Strong export performance and higher than expected remittances have brought about a significant improvement in the external current account. Foreign exchange reserve position remained satisfactory and the pressure on rupee-dollar parity remained muted.

FY11 real GDP growth is likely to be in the range of 2 – 3 percent. Inflation, which was initially feared to rise to around 20%, will be close to 14.5%, though higher than 11.7% seen in FY10.

… however, unfinished structural reforms continue to raise risks to a sustained economic revival

Despite this resilience, Pakistan's economy is facing a number of risks. The disruption of the arrangements with the IMF coupled with the deteriorating security situation has given rise to some erosion of confidence in the economy. Low growth rates since FY07 are not enough to generate employment opportunities for the increasing labor force. In addition, stubbornly high food inflation during recent years has also eroded the purchasing power of low income groups. Poverty levels and depth of poverty in urban areas have probably increased due to the combined impact of low growth and high food inflation. The situation becomes even worse for the poor as government has limited fiscal space to implement effective anti-poverty measures.

Similarly, government's fiscal policy is a major risk. Given the pressures to pursue populist policies, deep rooted reforms such as bringing incomes from agriculture and services sectors under the tax net, implementation of RGST, adjusting energy prices in line with the world price movements are likely to prove difficult unless major political parties reach a consensus on these issues. If these corrective measures are not taken, debt and debt-servicing burden will continue to squeeze the fiscal space. Consequent upward pressures on interest rates will also continue to crowd out demand for private sector credit. Recent revenue generation efforts are a step in the right direction (despite continuing reversals) but implementation path is uncertain and much more needs to be done.

Government will also not able to resolve circular debt issue without sufficient revenue generation measures. This single issue is impacting banking liquidity, capacity utilization in energy sector and production activities in manufacturing sector. Implementation of reforms in energy sector, rationalization of energy tariff is the case in point here, is also needed to resolve the energy shortages.

Although, external sector is doing well in FY11, this situation can be reversed if international oil prices continue to rise due to the Middle East political situation and domestic demand begins to push up on the back of higher growth in exports and increased farm incomes, A resurge in imports could potentially push up the current account deficit. Debt repayments to the IMF and Paris Club creditors would also put pressure on the external account.

Also, investment (both foreign and domestic) is inadequate to achieve a respectable growth rate in coming years. Reduction in terrorist activities may help boost foreign investors' confidence. However, government needs to take serious actions to improve domestic law & order conditions. In particular, the government needs to address the cases of ransom, looting and extortions, which are now commonly reported in the media.

KEY PRIORITY ISSUES

- Reducing fiscal weaknesses i.e. lack of revenue mobilization efforts, uncontrolled non productive expenditures and poor debt management.
- Keeping IMF program on track.
- Reviving role of government as a development agent.
- Energy Sector Reforms.
- Industrial restructuring.
- Restructuring of PSEs.

RECOMMENDATIONS

Fiscal Measures

- Several studies that have been carried out recently show that Government could generate an additional Rs.300-400 billion in revenues within the present tax regime through better coverage and enforcement. Taxation measures should focus on documentation and broadening the tax base for direct taxes.
- Presumptive basis of taxation should be replaced by net income tax earned basis. Wealth tax in the old form need not be introduced but a tax on assets created out of untaxed income be levied.
- Reforms are needed to address over-invoicing, mis-declaration and Afghan Transit Trade leakage issues. Use of IT tools in customs could help in this regard. Gradual reduction in Custom duties on smuggling prone items will discourage these malpractices.
- Provincial Governments do have the necessary legislations in place to tax income on agriculture. The threshold levels, exemption limits should be reinforced, the collection machinery, compliance and enforcement measures strengthened. Urban immovable property Tax in major cities can substantially augment the tax base of the local governments if a more realistic valuation is arrived at through periodic surveys and assessments
- Expenditures can be reduced by restructuring of Public Sector Enterprises that will staunch operating losses; by Subsidy rationalization and targeting subsidies to the poor only through Benazir Income Support program (BISP); better implementation and avoidance of waste in development projects.
- If the above measures are implemented, and a policy that taxes incomes from all sources above threshold of Rs 300,000 is implemented it is expected that Tax -to- GDP ratio would reach 15% in five years time and sustained fiscal deficit would not exceed 4 % of GDP.

- As banking sector cannot accommodate the fast rising levels of Government debt a Debt Management Authority be established to efficiently plan and manage the cost, maturity and wider distribution of Govt debt.

Reviving role of Government in development

- Public sector expenditures should be cut in ways that protect investment in infrastructure and social services. One of the ways to do so is to promote well structured Public-Private partnerships in these sectors.
- Development of financial markets particularly the long term debt market is another way to raise funding for large lumpy power, energy and transport projects
- Comprehensive government support to improve agri-productivity and raise value-addition i n agriculture and livestock sectors would give a big boost to food security and cash incomes in the rural areas of Pakistan
- Collusive and anti competitive practices can be curbed by strengthening regulatory bodies and respecting their independence
- Institutions such as Infrastructure Development Fund and Mortgage Refinance Corporation need to be established to help the financing needs of the private investors in these sectors

Energy Reforms

Despite its key role in enabling economic growth the policy approach to the energy sectors is highly fragmented, with responsibilities for various sub-sector distributed across a number of ministries in the Government. These include the Ministry for Petroleum and Gas, Ministry for Water and Power, the Alternate Energy Board, Pakistan Power Infrastucture Board. In addition, the two energy sector regulators OGRA and NEPRA report to the Cabinet Division.

As a result, the country has no clear consolidated vision of future energy needs, composition of energy mix, etc. with a resulting a lack of coherence in energy policies and implementation. This can, and has, inflicted serious costs to the domestic economy.

In order to frame and implement a consolidated energy policy for the country a Ministry of Energy should be established. Other recommendations for the short term are:

- Stock of energy sector circular debt is manageable *provided* the flow is stopped. TFCs can be sold to the market to liquidate the circular debt stock.
- Energy pricing needs to be rationalized in order to curb excessive consumption and priority allocation be provided to productive activities.
- Differential taxation of energy sources is advisable.
- Work on gas fields with significant potential is mired in legal disputes. These should be resolved expeditiously.
- Existing electricity generating units should be refurbished to improve efficiencies offers potential for quick gains in supply

Industrial Restructuring

- Business laws including the Companies' Ordinance, laws governing mergers and acquisitions and conglomerates need to be revised and modernized.
- Much of the spadework on Bankruptcy laws, as Corporate Rehabilitation Act has been done. These need to be enacted soon.
- Accountability of audit firms for professional misconduct can be accomplished by improved regulatory and enforcement mechanisms by ICAP.

Restructuring of PSEs

- The direct role of administrative Ministries in controlling PSEs should be replaced by a single Government holding company such as Khazana in Malaysia. Independent boards of Directors should be formed and empowered to govern these public enterprises with clear mandates, targets and accountability. PSEs must improve or be privatized / closed.

Reform of Civil services

- The recommendations of the National Commission for Government Reforms (NCGR) in regard to the Civil services of Pakistan and that of the 2010 Pay and Pension Commission in respect to the restructuring of Education, Health, Police and Judiciary should be examined and implemented