

Dr Akhtar calls for structural reforms to address fiscal and external account deficits in the context of changing global economic environment

ISLAMABAD March 11, 2008: Dr Shamshad Akhtar, Governor State Bank of Pakistan has stressed the need for structural reforms to address fiscal and external account deficits in the context of changing global economic environment. Delivering her keynote address on 'Policy Tradeoffs and Structural Issues' on the occasion of Golden Jubilee Ceremony of the Pakistan Institute of Development Economics at a local hotel here this afternoon, she also called for increasing national savings to reinvigorate growth and strengthen economic resilience.

While highlighting key features of strong economic performance of the past few years, SBP Governor said the strong growth performance of the last five years coupled with overall sound economic policies gave a lot of confidence to most segments of society while increasing their incomes. As a consequence people started demanding more goods and services, both from domestic sources and from abroad, and felt willing to pay higher prices to enjoy the benefits. "This resulted in, among others, an increase in imports which along with oil imports has registered an average growth of 24.7% over FY03-07 outpacing export growth (13.4%) leading to a widening external current account deficit," she said and added that until FY07, capital inflows funded fully the external current account deficit and the residual helped in building foreign exchange reserves (growing by \$5.6 billion over FY03-07). "Even if the oil prices come down and the growth in foreign inflows restored, the balance of payment position sustainability will still be under stress as export growth may be impacted by global slowdown," she said.

Referring to the challenges, she said that the country faces global shocks created by international financial market turmoil and the unprecedented increase in global commodity prices, which has generated widespread financial costs and have serious economic consequences that risks the progress achieved on various fronts.

The Governor also spoke about domestic vulnerabilities triggered by rising twin deficits as the fiscal and external account imbalances widened. "In the backdrop of relative slowdown in foreign inflows given Pakistan's protracted and complicated political transition, these vulnerabilities have resulted in pressure on exchange rate/foreign exchange reserves and heavy government borrowings from the SBP," she said and added that aside from problems of short-term economic management, this has created complications for monetary management which had succeeded in bringing the core inflation down to 5.2% by May 2007-- below the peak levels of 8.3% in October 2005.

She said these international shocks and domestic deficits are interrelated and entail stringent tradeoffs when it comes to devising and implementing well-coordinated, timely, and enduring policy responses.

Commenting on the policy responses in the wake of global financial market turmoil, Dr. Akhtar said that not only is Pakistan facing different sets of complex challenges, but the emerging global economic scenario itself underscores that Pakistan does not mimic the policy response of advanced economies. Advanced countries that are selectively lowering interest rates are those that have enjoyed low inflation for sometime

but are now facing steeper risks of downturn. As such, their trade off for growth supportive policies relative to inflation is understandable as risks associated with US slowdown would threaten global economic outlook and financial vulnerabilities. Pakistan on the other hand has relatively stable financial system, but mounting aggregate demand pressures that are visible in rising inflation and rising inflationary expectations. “Tightening of monetary stance and flexible exchange rate management are the two key central bank policy responses. These however will have more distinct impact if the Government reverts to fiscal prudence and efforts to this count are visible through recent reduction in oil and other subsidies”, she said.

Dr. Akhtar said that the new political Government will need to strengthen the Medium-Term Macroeconomic Stabilization Program while at the same time accelerating the implementation of structural reforms. “These steps will be crucial to re-invigorate growth and strengthen economic resilience,” she added.

She said keeping this in perspective, the new Government’s broader economic strategy for the next few years will need to include increasing domestic resource mobilization to raise revenue/GDP ratio by at least 5 percentage points of GDP. She pointed out that the current revenue generation capacity is limited owing to narrow tax base, tax holidays and exemptions and tax administration inefficiencies. “The efforts on this front would reduce the government’s needs to borrow from the central bank and help eliminate the financial market distortions”, she said. The existing tax regime collects almost 68% of taxes from manufacturing and corporate sector, while agriculture and services sectors (aside from banks) are exempt and some segments of the economy are outside the tax net.

SBP Governor said that there is a need to restore the momentum of privatization of state-owned enterprises, which has been one of the most successful in Asia. The Government has sold off cumulatively almost \$7 billion of assets over FY2000-FY2008 and there are around 61 state entities in the pipeline, she added.

Dr Akhtar stressed that public sector organizations should be given more autonomy, with effective leadership and management, to improve their operational and financial efficiencies accompanied by a program to strengthen their balance sheets which should allow them to graduate from budgetary allocations to seeking funding from the market. In addition, she said there is also a need to raise private investment/GDP ratio from 23% to at least 28% which involves significant tapping of additional resources both from domestic and international financial markets.

She said that in addition to above-mentioned strategies, there is also need to introduce reforms to address the structural weaknesses key sectors of the economy including agriculture and industry. She emphasized that modernization of agriculture sector is the key for food security domestically, while industrial sector should be diversified to avoid high concentration of few industries and low value-added goods.

She said that the twin deficits represent significant demand pressures which, given the overall inflation situation, does not bode well for the overall macroeconomic stability. She added that the borrowings from the SBP are leading to enormous expansion in reserve money and overall monetary expansion and could potentially crowd out private sector credit, which could hurt the investment potential in the economy.

SBP Governor traced Pakistan’s economic growth trajectory and experience of structural reforms during the last three decades and highlighted economic complexities

faced by the country. She said the economic scene over the last three decades is characterized by distinct economic growth periods: late-1970s-1980s witnessed average growth of 6-7%; 1988-2001 growth faltered to 4.4%; followed by rejuvenation of economic growth to an average of 6.3%.

Dr Akhtar raised the questions why is Pakistan vulnerable to these cyclical downturns? Why cannot we have good economic performance on a sustainable basis? She said her assessment is that Pakistan's economy suffers from several structural weaknesses which inhibit the sustainability of growth and persistence of macroeconomic stability for a long period. "Unless we demonstrate ability to properly diagnose and resolve issues, while committing to effective implementation of broad ranging structural reforms, we will remain prone to such bouts of growth and slowdown, stability and instability," she added.

SBP Governor said there is a need to conduct counter-cyclical policies to curb demand pressures reflected in widening twin deficits and achieve well-defined short-to-medium term objectives (like inflation and growth prospects) and to initiate structural changes to address the root cause of these deficits; the sustainable and enduring solution is not only how to finance these deficits but more importantly how to introduce structural changes to improve the deficit situation itself.
