

## **Pakistan: Dynamics of Economic Stabilization**

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1. Developing countries by and large have been impacted by the unfolding international economic and financial market events as well as unprecedented soaring energy and food prices. Smaller, open and oil import dependent economies such as Pakistan, Vietnam, Ghana, and Kenya have been hit harder. The economic stress in case of Pakistan is intense and magnified as the country adopted a high growth path which was unsustainable. Pakistan and its population has time and again shown its resilience to withstand economic shocks but the sheer size and intensity of the current shock facing the economy has magnified the demand pressures which were already brewing in wake of the persistent and growing resource imbalances, i.e. the investment-savings gap.

2. Unless we deal with the root causes of the endemic problems, Pakistan's economy will not be able to effectively take-off. Enacting measures to correct the widening macroeconomic imbalances is certain to entail difficult policy choices and trade-offs but evidence confirms that appropriately planned and sequenced reforms offer rich dividends, improving resilience of the economy to shocks and allowing for a more sustainable long term growth path. Reforms, however, require disciplined implementation over an extended period, as the economy wears off the stresses from accumulated imbalances and adjusts to a tougher operating environment.

3. Based now on the experience of working within the public sector in Pakistan, I would like to offer a brief diagnosis of the current economic situation and then offer selective perspectives and recommendations for the consideration of the Planning Commission.

4. Diagnostics suggest that Pakistan's model of economic growth has been consumption rather than investment-driven. It is a country with a low level of domestic savings and a low tax-base and yet has aspirations to maintain a bloated public sector that has been found to be riddled with inefficiencies and ambitious development plans that often are abandoned half-way given the perennial resource constraint dilemma. In absence of self-financing, the Government resorts to either external financing (which though financially a low interest cost option, has higher implicit costs), and central bank financing which in net terms has zero financial costs but is highly inflationary as the currency generated beyond system's capacities magnifies demand pressures beyond its productive capacities.

5. Aside from this core problem that has ailed the economy for years, economic adversities in FY08 were compounded by (i) extraordinary and unanticipated rise in food and energy commodity prices – Pakistan, on an average, paid US\$ 91.9 per barrel for oil in FY08 relative to US\$ 40.8 in FY05, (ii) the protracted delays in hard core structural

reforms both at the macro and sectoral level, (iii) rising cost of doing business, and (iv) governance issues which ail the industrial and services sector. Domestic production was hit by electricity shortages, disappointing harvest of some key cash crops (led in part by pricing anomalies) and low productivity. At the same time, an expansionary fiscal policy spurred domestic demand. Not surprisingly, the combination of weaker domestic production, high international commodity prices and strong domestic demand, led to a significant acceleration in inflationary pressures, offsetting the impact of repeated moves by SBP to tighten monetary policy.

### ***Short Term Macroeconomic Stabilization Program***

6. To shore up the dwindling confidence in the economy arising from the destabilizing impact of the twin deficits on domestic and external accounts and to check the snowball impact on inflation expectations of the above mentioned adverse shocks, the new Government has taken the following set of policy measures since it took over:

- (i) Fiscal deficit has been scaled to 4.7% of GDP – an adjustment of 2.7% of GDP. To facilitate adherence to this, current expenditure growth has been scaled back and cuts are being envisaged in development expenditures. The Government has reiterated its commitment to curb its recourse to central bank financing to zero and will be trying to adhere to this on a quarterly basis too. With this intention, the new Government has moved on the long pending issuance of Islamic paper (Ijara Sukuk) – the first issue of which will aim to mobilize close to Rs10 billion – and issuance of short term Government commercial paper that will be targeting public sector organizations. In addition, there are efforts underway to mobilize funding through the privatization program whose counterpart proceeds help in reducing demand for or settlement of central bank financing. The Government is also contemplating Securitization of Remittances in the range of US\$ 500-700 million or so.
- (ii) Efforts are underway to curb subsidies by allowing a significant pass-through, for example 31.6 percent weighted average increase in POL products with gasoline and diesel prices now 66.3 % up relative to the July 07 position is likely to improve the cash-flow of the petroleum-related industries. Similarly, with the rise in electricity tariff by 14.1 percent since Jan 07 and another average 31% hike in power tariff on the cards, the stuck up funds with the IPPs and WAPDA would be released. This bodes well for the OMCs specially PSO which has an 84% share in furnace oil business. Moreover, if oil prices continue to remain stable at these levels, there would be no issue of further piling up of PDCs claims. However, the old dues still remain a concern.
- (iii) The Government is allowing the regulators to move to a formula-based approach to pricing adjustments. For instance: OGRA (Oil and Gas Regulatory Authority) announces ex-refinery prices of various oil products fortnightly, on the basis of their respective average prices in the Arab Gulf market over the preceding 15 days. Out of the 6 scheduled fortnightly price revisions in a

single quarter, 5 revisions have been announced by OGRA so far during the ongoing Q1-FY09, whereas, the last one is likely to be announced any time after Sep 16, 2008. This is likely to result in a slowdown in fuel demand.

- (iv) For FY09, the Government plans to raise tax revenue by 24.5% with additional measures to yield Rs 84 billion through increase in the sales tax rate, duty on import of mobile phones, and rationalization of the withholding tax rate on imports etc.
- (v) The Government has facilitated the need for public utilities through raising funds backed by guarantees to allow the generation of electricity to avoid productive disruptions.
- (vi) Public sector payables amounting to Rs 227.1 billion are being partly settled by the Government. Ministry of finance plans to use some of the public sector cash and current account balances being held in the commercial banks at low yields to pay off the circular debt partly and remunerate public sector holdings better.
- (vii) A range of power sector initiatives are underway. These include mandating the Pakistan Electric Power Company (Pvt) Ltd (PEPCO) for the implementation and management of reforms and restructuring of Pakistan's power sector comprising 14 entities (9 DISCOs and 4 GENCOs), and inviting investors for establishing power plants in the country on a fast track basis. Addition to the existing capacity, about 4000 MW in the period from July 2008 to June 2011 is under implementation by the private sector while about 2600 MW are under implementation in the public sector.
- (viii) Recognizing the growing needs of the economy and to save the nation from the cost of rising food imports that rose to \$ 3.5 billion in FY08, and are anticipated to be in the range of US\$ 3.8-4.2 billion for FY09, the Government has launched efforts to promote agriculture production. SBP has enhanced credit availability to the agriculture sector to Rs250 billion and will be more accommodative, while the Government is providing input subsidies on fertilizer of close to Rs 32 billion (Rs 1000 per 50 kg bag).
- (ix) To rein in mounting demand pressures and inflation, SBP incrementally (a) tightened monetary policy resulting in a cumulative increase of 350 bps in SBP's policy rate over the last 18 months or so (b) raised CRR and SLR for effective liquidity management, and (c) imposed a floor on deposit rates to improve the return on savings and mobilize the required financing for both the growing public and private credit requirements,
- (x) To address the woes of the foreign exchange market, a range of measures were taken. These include: (a) reduction in CRR on FE-25 deposits, (b) restricting advance payments on imports to 50 percent, (c) abolishment of Nostro account of exchange companies, (d) launching a campaign for realization on

overdue export proceeds, and (e) tightening of LC margin requirements as well as imposition of additional duties ranging from 35 percent to 50 percent to quell import demand of non-essentials etc.

(xi) SBP has launched a 10-year blue print for Banking Sector. The broad objectives of this strategy are to improve efficiency, transparency, price discovery and transmission of monetary policy signals; increase access to financial services and financial sector depth both at the household level as well as for small and micro-businesses; strengthen competition, risk management, corporate governance, ethical standards, consumer protection, prudential regulation and supervision; foster financial stability, reduce systemic risks, and develop a financial safety net. SBP has already established a Consumer Protection Department. Furthermore, SBP directed banks to gradually increase their minimum paid-up capital to Rs 23 billion (net of losses) by 2013. In addition, the minimum capital adequacy requirement (CAR) has been increased from 8% to 10% which banks are supposed to meet by 31<sup>st</sup> December 2008. Banks will also be required to maintain variable CAR, which will be based on CAMELS rating assigned by the SBP to each bank.

7. Pakistan's stock market faces challenging times. The stock market index has plunged by 35.3% -- in line with trends observed in regional markets. Except growing economic and political vulnerabilities did adversely impact confidence and are now reflected in the outlook on company earnings. Brokers and investors incurred losses as market capitalization fell by US\$ 33.5 billion and there was significant outflow of foreign portfolio money. The bottoming of the stock market, while not a welcome development, provides an opportunity as the upside of the lower share prices (not reflective of strong fundamentals of some key companies) is going to be strong and will trigger a revival. Companies are contemplating buy-backs and as of July 2008, banks are holding between 8-9% of their total investments in listed shares in anticipation of this upside.

8. In FY08, Pakistan's exports recorded a healthy growth of 17.5% despite weak performance of the textiles sector. In FY09 Pakistan is set to post export growth in excess of 20 percent. This optimism is based on the fact that Pakistan's main non-textile exports i.e. rice and cement continue to enjoy good demand. While the impact of rising prices may not be as dominant in FY09 as it was in FY08, the rise in quantum is likely to offset the fall in the prices. Exports may also put up better performance in FY09 due to the depreciation of the Pak rupee.

9. Workers' remittances have shown impressive performance in recent years, growing on average by 14.0% during FY06-FY08. While a large part of this increase was contributed by oil-rich gulf countries and the US, the Euro area and Canada are also contributing positively. Importantly, remittances appear to have shown resilience to the weakening macroeconomic indicators. This rising trend is expected to continue in the wake of continued growth in the gulf countries, network expansion of major exchange companies and rising costs of living of migrant's families. In absolute term, remittances are likely to reach US\$7.3 billion during FY09 compared with US\$ 6.5 billion in the previous year.

## ***Short Term Stabilization Efforts Need to be Complemented by a Medium Term Stabilization Framework Coupled with Deeper Structural Reforms***

10. To achieve a higher and sustainable economic growth path – a prerequisite to address deep-rooted poverty and growing regional disparities in Pakistan – it is imperative that Pakistan now takes a significant U-turn. The country now needs to move away from the ad hoc and weakly coordinated economic policy-making process, and dealing exclusively with the short-term crisis and exigencies to formulate a coherent, comprehensive and well designed economic policy framework.

11. While this task is best handled by the Planning Commission's distinguished Panel, I would offer views on selective but core elements of this policy framework -- a compromise on these would not result in sustainable macroeconomic stability. It is important to however qualify that what is being proposed below is a *necessary* but not *sufficient* condition for Pakistan to achieve a major breakthrough from its past economic trends that have seen sharp swings. It ought not to surprise you that what I propose to discuss has an inherent bias typical of central bankers.

### ***Fiscal-Monetary Policy Coordination***

12. Barring some years, Pakistan has often adopted an expansionary and unsustainable fiscal stance without a supportive broad based taxation policy. Over the past three decades, Pakistan's tax/GDP ratio has hovered around 12.6%. In the best years, it has been 14.5% and in the last five years, the tax/GDP ratio has fallen and has stagnated around 10.4%. With current expenditures, on an average, growing (19.2% during last five years) at a faster pace than current revenues, the Government has to borrow to meet a part of the current expenditures and 100% of the development expenditures.

13. In general, the tradition has been to develop budgets which are beyond the country's resource envelop, be it domestic or external financing. Paradoxically, in most budget documents that I have seen, residual requirements are visibly shown to be financed by the Central bank. From day one, in the budget making process, the central bank is expected to issue Market Related Treasury Bills (MRTBs) --an instrument of monetization -- created automatically whenever the Government is in deficit. From being a "ways and means" support provider, the central bank has historically been designated as "financier of budget deficit," irrespective of the Government in place. Consequently the monetary policy continues to remain subservient to fiscal policy but ironically, this is where the hard budget constraints are lifted from public expenditures.

14. The build-up of inflationary pressures, while are now more supply-driven, were aggravated in line with the rising monetization of the fiscal deficit. During FY08 the government borrowed Rs 688.7 billion from SBP for budgetary support which is almost 90 percent of the total financing requirement of the government for FY08. As a result, the stock of MRTBs with SBP reached Rs 1,053 billion by end-June 2008 from Rs 452.1

billion at end-June 2007. Consequently, despite continued monetary tightening, the reserve money growth reached 21.6 percent during FY08, compared to 20.9 percent in FY07. Demand for domestic credit (both for the government and the private sector) rose steeply to 29.3 percent during FY08 from 15.8 percent in FY07. Furthermore, liquidity injections from unpredictable government borrowings have weakened the transmission of policy rates to retail rates.

15. Recognizing the issue surrounding this problem, successive Governments have attempted to artificially and half-heartedly address this problem. For instance, there is upfront the cost of mobilization of MRTBs as they are priced in line with 6-month T-bill rates. However, the Government gets the interest income earned by the central bank on the MRTBs by way of transfer of central bank profits. Also, while the Central Bank Act legislates some safeguards mandating the central bank Board of Governors to “impose limits on central bank borrowing and to enforce such limits”, the Governments in power have not respected the discipline recommended in the legislation.

16. Reinforcing central bank provisions, in 2005 the Parliament introduced a *Fiscal Responsibility and Debt Limitation Act* to impose additional discipline in fiscal management, underscoring the need for zero revenue deficit by end-June 2008 and reduction in the public debt/GDP ratio to 60 percent by end-June 2013.

17. In general, in the past the central bank did not exercise its powers and in recent years there have been slippages of the fiscal legislation too. For the first time in the history of the central bank, invoking Section 9A, the SBP and its Board of Directors advised the Government to retire SBP borrowings. Rather than retiring Rs63 billion – a figure consistent with the Monetary Policy framework projections prepared in July 2007, there was additional drawdown of central bank financing. Retrospective analysis of budget slippages categorically reveals the previous Government’s heavy under-estimation of the budget and the over-estimation of the development expenditures.

18. The lesson learnt is that fiscal-monetary-planning coordination is critical to ascertain realism in the budget-making and implementation process, and ensuring that spending is within the resource envelope. Needless to add that such a resource envelope needs to not count on central bank financing as a revenue item. Although the central bank would like to see a faster settlement of the outstanding MRTBs and hence had recommended at least a modest retirement of less than Rs100 billion, the Government has advised that given the backlog it would be contemplating net zero borrowing – this would be a starting point. Over the medium term, however, it would be advisable to conduct a thorough review of the fiscal policy, including the budget-making process and its management which I understand has been done through a DFID-TA program and this will go a long way in restoring fiscal discipline. SBP on its part would recommend following measures:

19. In line with a number of economies SBP is working on a new central bank legislation to, among others, eliminate completely monetary policy subservience to fiscal policy and to remove the ability of the Governments (both federal and provincial) to

resort to central bank financing beyond standard ways and means. Concurrently it is proposed to:

- (i) Amend the Fiscal Responsibility and Debt Limitation Act, 2005 to acknowledge and address the risk to macroeconomic stability from unrestrained borrowings from the central bank.
- (ii) Introduce a phased 4-5 years program for the reduction of the over Rupees one trillion of SBP borrowings. SBP has submitted a working paper to the MOF for further deliberations in this area.

20. These measures can however be only implemented if there is a medium term program for restructuring Pakistan's public finances. The agenda at minimum would have to include continued efforts to increase the tax/GDP ratio from the current 10% to at least 16-17%. The level of effort is critical to not only settle past liabilities but also allow space for development expenditure growth. Notwithstanding, less public sector and more private investment will be critical to managing public finances prudently.

### ***Curbing of external account imbalances***

21. The strong impetus to demand from the doubling of the fiscal deficit/GDP ratio together with the rising international commodity prices, contributed to a dramatic rise in the external current account deficit to 8.4% of GDP. Financing of this was complicated as the global financial crisis unfolded, impacted global liquidity and induced risk aversion. Furthermore, Pakistan's country risk perception was heightened by domestic political developments impairing the country's ability to tap the international capital markets resulting in the decision to defer the planned privatization and sovereign debt transactions. Events unfolding subsequently have also resulted in the outflow of portfolio investments.

22. Lower availability of financing of the external current account deficit resulted in depletion of foreign exchange reserves. Market fundamentals and sentiments also disrupted the exchange rate stability during FY08 which was also partly impacted by mounting speculative activity in the forex market. Consequently, by end June FY08, reserves stood at US\$ 11.4 billion, witnessing a depletion of US\$4.2 billion during the year. These trends are clearly unsustainable since the depletion occurred despite record high remittances' flows and foreign direct inflows of over US\$ 5 billion.

23. These developments reinforce the need for Pakistan to continue pursuing effective demand management policies, while promoting export orientation to finance for import requirements. Preliminary estimates for FY09 point to imports rising to around US\$ 38 billion – almost 1.8 times the export target of MOC. However, as pointed out by SBP in various reports, the external current account deficit was not sustainable given the risks associated with foreign financing inflows in particular, portfolio investment that is notoriously volatile, and the rising share of these in the financial flows of recent years was a concern. Aside from restoring the privatization program, encouraging other forms

of non-debt creating inflows and concessional loans from multilateral agencies to finance these requirements, the country needs a fresh campaign to build up reserves.

### ***Debt Sustainability***

24. An examination of debt sustainability indicators reveals that Pakistan's capacity to sustain the current level of debt has weakened. After consistent improvement from FY01-07, Pakistan's stock of debt and liabilities grew by 27%. The ratio of total debt and liabilities as a proportion of GDP, after having fallen for 7-years is on a rising path. The acceleration in the growth of domestic debt not only reflects the larger FY08 fiscal deficit but also the relatively lower availability of external financing. The rising growth in the rupee value of external debt in FY08, on the other hand, not only reflected a larger external current account deficit but also a decline in non-debt external flows as well as a depreciation of the rupee. Underlying these trends are also concerns regarding the increased reliance on short term debt particularly more pronounced in the domestic debt profile which the Government has opted for in its increased reliance from SBP borrowings -- SBP debt as proportion of total domestic debt has risen from 15% in FY05 to 31% in FY08 and has financed 90% of the fiscal deficit. Meanwhile, commercial banks, the other major subscriber to Government debt, are positioning themselves and factoring in changes in the interest rate outlook.

25. The external debt liabilities also grew and have witnessed an emerging growth in short term and private debt, with the former serving trade-financing requirements, while the latter is financing development of infrastructure. Despite the rising stock of external debt, Pakistan's debt sustainability indicators, whether as a proportion of GDP or export earnings, have been falling and the maturity profile of the debt and interest payments are smooth.

26. Undoubtedly with the fall in reserves adequacy, there are apprehensions regarding the country's ability to service its debt service obligation on a timely basis but the Government is now working to secure the required financing package to continue to smoothly honor its obligations. The technical engagement with the IMF on the Pakistan's comprehensive economic policy framework owned and developed in-house would lend comfort to foreign creditors in this area.

### ***Inflationary Pressures***

27. One of most critical priorities of the Government is the containment of inflation, particularly of food items. However, two points need to be highlighted upfront.

- (i) High inflation during the last year will permeate and have a strong impact in the first few months of FY09. For example, even if consumer prices remain constant (at August 2008's level) from September onwards (i.e. monthly inflation change is zero), average inflation could be close to 17% for FY09.

- (ii) The pass-on of international oil prices to domestic consumers, adjustment in power tariffs, revisions in GST and import duties, depreciation of rupee, and expectations of higher wages due to high inflation are all likely to add to the inertial effect of last year's inflation. Thus, the average inflation for FY09 could be higher.

28. The persistent pressures on the external front and rising inflation, call for the continuation of demand management policies. The need for monetary tightening is not obviated by the fact that a part of the recent inflation spike stems from the global price shock, which may be temporary and outside the control of SBP. Firstly, domestic inflation cannot be sustained without excessive domestic demand. Secondly, even if the recent price shocks were temporary, the sheer scale and magnitude of the rise in global commodity prices indicates that a monetary response is required to curb inflation expectations and limit the second round impacts. Thirdly, even if commodity prices weaken somewhat in the near future, they would remain high. Fourthly, the pass-through of these high global prices was expected to increase in the months ahead. The latter expectation reflects both, the substantial depreciation of the rupee in recent months, as well as the government's courageous decision to pass on to consumers the true cost of imported inputs in order to avoid allocation inefficiencies.

### ***Domestic Savings Mobilization Drive***

29. Countries frequently rely on inflows of foreign savings to finance their domestic investment needs. However, international borrowing can rise or decline depending on cyclical movements, exchange rates, external shocks, and a host of other factors. Given the geopolitical challenges faced by Pakistan, foreign inflows have been highly volatile. Hence, for sustainable growth, Pakistan must find ways to finance its investment needs by domestic savings.

30. Savings rate in Pakistan is neither in line with domestic resource needs nor is consistent with that of other comparable countries at the same level of development. Moreover, the responsiveness of the Pakistan's domestic savings rate to changes in the GDP per capita growth is lower than in the comparator countries. The low levels of savings is mainly attributed to: (1) the fact that a high proportion of household savings remain in informal instruments and/or physical assets, (2) mostly negative real interest rates on savings instruments, (3) consumption-oriented nature of society, and (4) despite SBP's efforts towards financial inclusion, outreach of the financial network has remained limited, thus funds of small savers could not be tapped into the formal sector.

31. In the medium term, efforts are required to extend financial services in far-flung rural areas to tap savings of small savers. The role of public savings is also important as these not only add to domestic savings but also help keep inflation at low levels, which is crucial to raise private savings. In addition, a national campaign on the merits and necessity of domestic savings may also help to bring a cultural change. Financial institutions also need to design a range of innovative and flexible saving schemes to include all in this drive. A good example of such innovation is the recently launched

Young Savers Account, which can be opened with Rs 5 only. These types of innovative products could help inculcate a saving culture in the economy. In the long run, the country will have to resolve its geopolitical challenges and to strengthen its markets and institutions in order to complement its domestic resources with FDI to meet its domestic investment needs.

## **Conclusion**

32. Empirical evidence clearly suggests that inflation of the magnitude that is currently prevailing is detrimental for the growth prospects of the country. An inflation rate that is consistent with a sustainable growth path for Pakistan is approximately 6.5 percent. Thus, bringing inflation down in the vicinity of this level over the medium-term is essential for restoring and sustaining the growth momentum. It may also be noted that since current inflation is extraordinarily high it would be prudent to consolidate growth at a relatively low level for couple of years to ease the inflationary pressures. The government needs to dramatically reduce its role in the determination of key prices in the economy. Pakistan's recent history is testament that the excessive involvement of government in the pricing mechanism can distort both consumption and production decisions. For example, the government's politically understandable desire to subsidize the consumption of key fuels, contributed directly to the expansion of the fiscal deficit (the burden on the exchequer spiraled as a sharp rise in international prices was not passed on to the consumers) as well as the widening of the external deficit in FY08 (as domestic consumption was not rationalized).

33. Once the high inflation subsides, it will be easy to introduce pro-growth policies and to achieve sustainable growth of 6 percent over the medium-term. Simultaneously the focus should be to bring both the external current account and fiscal deficits within sustainable limits over the next 5 years. The sustainable level of these deficits, consistent with price stability and growth, are estimated to be around 3.5 percent and 3.0 percent, respectively. The realized external current account deficit for FY08 at 8.4% is clearly unsustainable. It is imperative that this deficit be brought down gradually by enhancing exports through diversification of markets and products and by restraining imports without hurting the export industry and overall growth prospects. In addition to curbing this deficit, efforts are required to mobilize external resources through official channels and more importantly, in the form of foreign direct investment. These much needed inflows would not only help in building up foreign exchange reserves over the medium term but would also ease pressure on the exchange rate, calming the sentiments in the foreign exchange market.

34. Part of these inflows would also finance the government's fiscal deficit and reduce its dependence on inflationary SBP borrowings that escalated to record high levels in FY08. The reduction in SBP borrowings, which the government has vowed to bring to zero (on net basis) for every quarter of FY09, will go a long way in restraining the reserve money growth. The growth in reserve money during the past two years remained over 20 percent and explains high inflation in the country to a large extent. Thus, sustainability of balance of payments and fiscal sector consolidation are

fundamental in controlling inflation and ensuring a resilient growth trajectory. Failure to do so could lead to a prolonged period of even higher inflation and low economic growth.

35. The key to fiscal consolidation is the much needed broadening of the tax base and a gradual improvement in the tax to GDP ratio in addition to keeping a vigilant eye over unnecessary expenditures. Presently, the tax to GDP ratio is hovering around 10 percent and needs to be increased to around 17% over the medium term with more upfront effort to generate enough resources for development expenditures. These expenditures are essential to build strong infrastructure; a prerequisite for inducing private sector investment necessary for sustainable growth. Such fiscal consolidation measures would go a long way in reducing the reliance on volatile and imprudent inflationary sources of deficit financing. This will not only make the fiscal sector less vulnerable to the vagaries of external shocks (global liquidity crunch) but would also enhance the effectiveness of monetary policy.