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# Pakistan's Macroeconomic Situation

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**Abstract**

*As a result of policy inaction in addressing structural issues over a protracted period and a wrong set of economic priorities followed over the past several years, Pakistan's economy faces a grave set of challenges. Among the many issues, which range from high inflation to power deficits and water stress, the most immediate and pressing is the need to restore fiscal order. While pressure on the coalition government to reduce the economic hardship of the electorate is understandably intense, the policy response needs to balance the alleviation of palpable hardship in the short term, with the ability to provide sustained benefits over the longer term. Given the sharp constriction in available fiscal space, adopting a policy course in the short run that raises expectations of "relief" may not be wise, in either political or economic terms. In the longer term, however, it is a misconception to view the available choices in purely binary terms, i.e. that "macroeconomic stability" (a much-maligned term, loath to politicians not just in Pakistan) is mutually exclusive to "pro-poor" agendas. Raising revenues by broadening the tax base meaningfully, in conjunction with rationalizing bloated government/public sector expenditures can free fiscal resources, which can be diverted to targeted subsidy programs. Ignoring macroeconomic stability, on the other hand, will eventually also undermine the ability of the government to influence economic growth, as growing fiscal and monetary constraints limit its ability to run appropriate policies. As experienced in the 1990s, this will slowdown both investment as well as growth, hurting the poor.*

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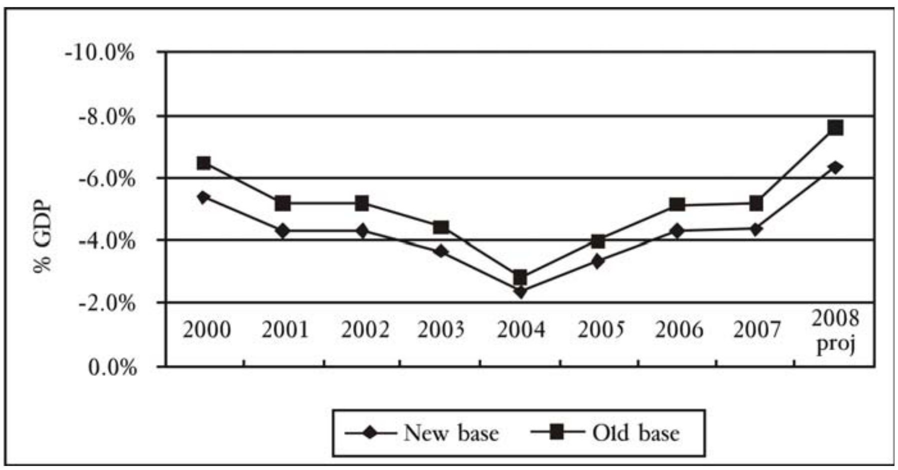
**Overview**

The incoming government is being greeted by a less-than-sanguine picture of underlying economic conditions. Over the course of the past approximately two years or so, fiscal profligacy on the part of government has seriously eroded macroeconomic stability. The fiscal deficit has reversed course sharply, and for the first half of the fiscal year FY08 (July-December) has been recorded at 3.6% of GDP, only 0.4 percentage points lower than the full year target set in the budget. On current trends, the budget deficit for the full fiscal year is likely to cross 6% of GDP, even after countervailing measures. To put this in perspective, and to allow for a comparison with the 1990s, the estimated outturn for the fiscal deficit in FY08 translates into the equivalent of 7.5% of GDP using the previous series of national accounts (with 1990-91 as base year – see Chart-1).

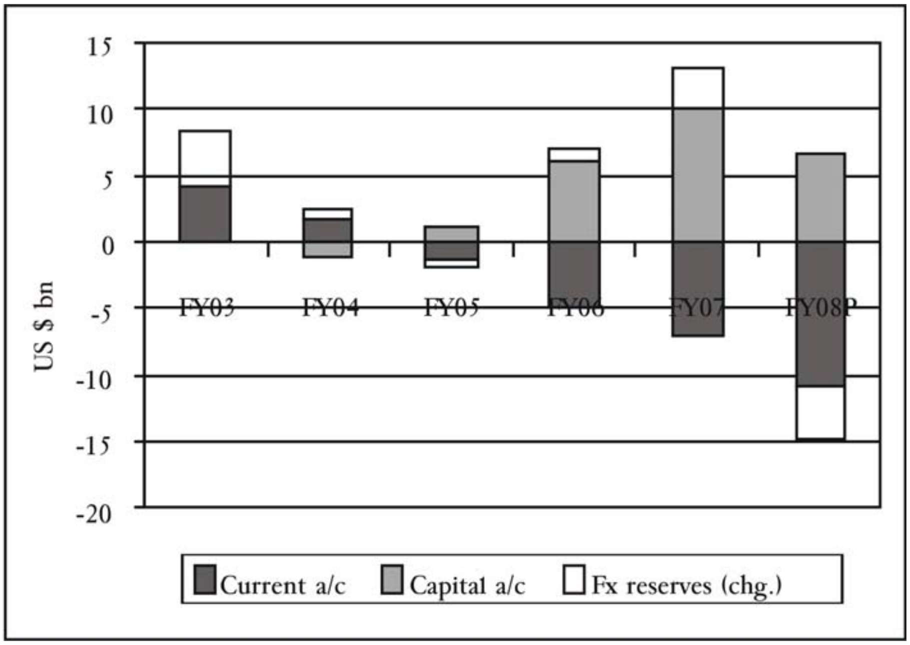
**Chart-1: Fiscal Deficit as % GDP (On Current Versus Previous Base)**




***Source:*** Ministry of Finance, Government of Pakistan

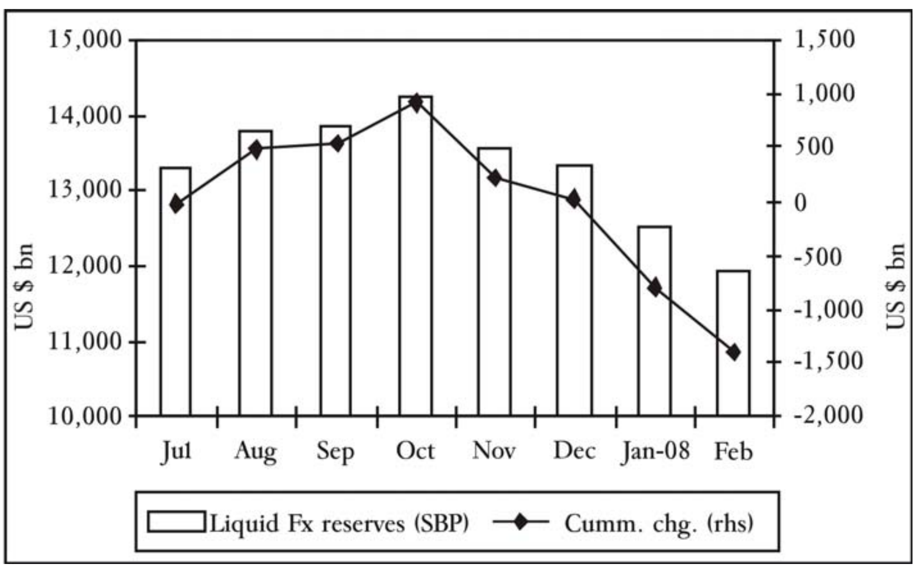
In addition, the external account has posted widening imbalances, with the current account on course to cross US$10.5 billion in FY08 (to around 6.6% of GDP – Chart-2). Foreign exchange reserves have been depleting since the start of the fiscal year (Chart-3), with a net hemorrhaging of US$3.6 billion from July 2007 to March 15, 2008 (net foreign assets of the banking system, based on weekly monetary data). Based on the last available numbers, the unencumbered liquid foreign exchange reserves with the central bank are estimated to total US$11 billion (net of forward sales/swaps) for the week ending February 29, 2008.

**Chart 2: External Account**




***Source:*** State Bank of Pakistan (SBP)

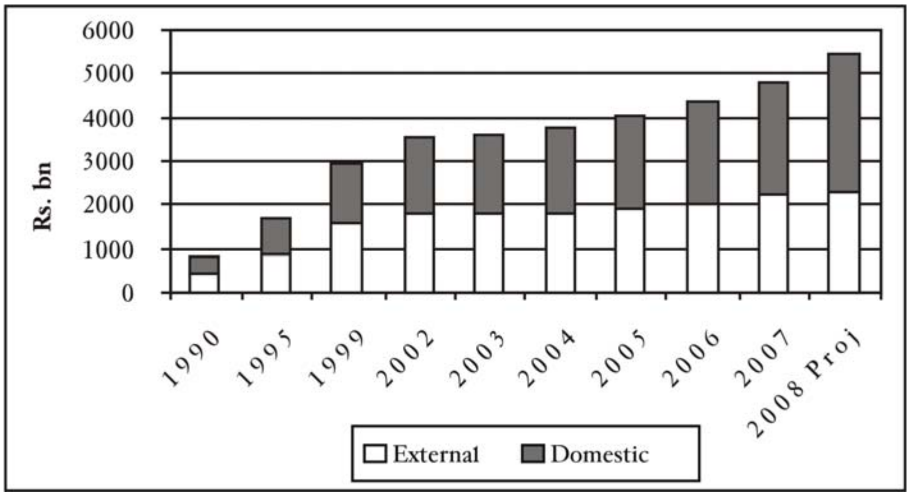
**Chart-3: Foreign Exchange Reserves with SBP**




***Source:*** State Bank of Pakistan (SBP)

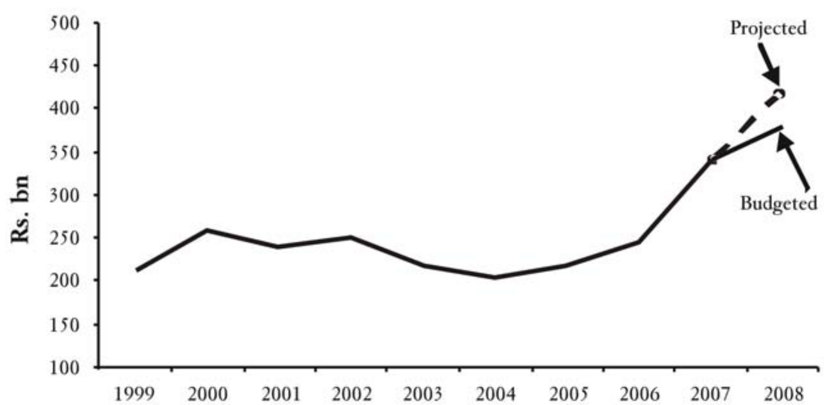
As a consequence of widening imbalances, government budgetary borrowing has risen sharply, with public debt increasing by an annualized 16% by the end of the first quarter (July-September FY08) – reversing the trend of relatively tame growth over the 2002-2006 period (Chart-4). A corollary to higher government borrowing is a fairly rapid increase in debt servicing costs. Interest payments in the first six months of FY08 have soared by over 52% versus the corresponding period in FY07, after recording a 50% year-on-year jump in FY07 (Chart-5).

**Chart-4: Public Debt**




***Source:*** Ministry of Finance, GoP

**Chart-5: Interest Payments**




***Source:*** Ministry of Finance, GoP; ABN Amro Bank (Pakistan) Ltd.

A large part of the increase in public debt has come via monetization of the fiscal deficit, with government sector borrowing from the central bank for year-to-date FY08 touching Rs 367 billion (US$5.8 billion, or the equivalent of 3.7% of full-year GDP) as of March 15, 2008 (for more details see next section). In conjunction with the oil/commodity price shock, fiscal indiscipline has been a major contributor to the underlying inflationary pressure in the economy, with an unfavorable dynamic for domestic inflation in the near term. We expect full-year CPI inflation to cross 9% by end-June 2008.

Unsurprisingly, at the core of the deterioration in the macroeconomic environment is a rapid weakening of the fiscal position.

**Fiscal Numbers**

The most recent official data released paints a worrying picture, especially on the fiscal side. The budget deficit for the first half of the fiscal year (July-December 2007) has been recorded at 3.6% of GDP, only 0.4 percentage points lower than the full year target set in the budget. While "one-off" items such as expenditure overruns in the run-up to the elections, energy-related subsidies, and disruptions to revenue collection in December 2007 exacerbated the outturn, the underlying trend of high government spending and a narrow revenue base is at the root of the growing imbalances.

Compared to the corresponding period of FY07, the fiscal deficit has widened 111% for H1FY08 (July-December 2007). Expenditure growth has outstripped revenue collection. Current expenditures have ballooned 33%, accelerating a trend recorded over the past several years. On the back of higher public sector borrowing, a turn in interest rates, and unanticipated lumpy repayments of national savings scheme instruments, debt servicing (interest portion) has recorded a substantial increase, rising 52.6% in H1FY08 versus H1FY07. In addition, defense spending has also registered a 14.7% increase.

The other big contributor to the sharp rise in public expenditure is the "development" spending head under the Public Sector Development Program (PSDP). PSDP expenditures have risen nearly 53%, making the second biggest contribution in absolute terms to the increase in the fiscal gap for the first half of FY08 (after interest payments). The increase in PSDP spending is a continuation of the trend over the past few years.

While the rise in PSDP spending has been touted as an achievement of the Musharraf-Shaukat Aziz era, there are serious misgivings both about the size of the outlay as well as the quality of the projects portfolio. Apart from the fact that some portion of "non-civilian" spending is parked under this head (such as construction of "strategic" highways and new cantonments), the PSDP appears to have been used as an instrument of political patronage, especially in the run up to the national elections. In addition, project selection has remained less rigorous than desired, with the result that projects with questionable economic value, or a lower-order priority, appear to have been pushed through, attracting sizeable funding commitments from the budget.

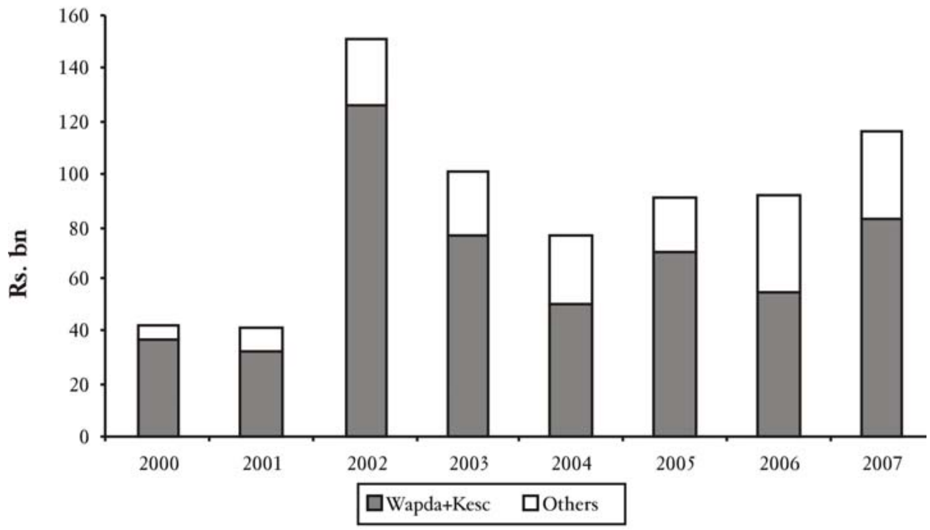
Finally, there is the question of the substantial leakage that occurs from the PSDP – a feature of the 1990s that appears to have remained largely intact. Anecdotal evidence such as the dramatic collapse of a large section of the Northern By-pass in Karachi a few months after construction, or the construction of a major portion of the "strategic" Makran Coastal Highway at least twice in the space of a few years (owing to substantial damage caused by heavy rain), among other examples, only serves to reinforce public skepticism.

With elections out of the way, the release of the pending tranche of logistics payments by the US, and a slow transition to the new political government inevitably putting the brakes on big-ticket public spending, the second half's fiscal numbers should be better. Even after adjusting for one-off factors, however, the FY08 fiscal deficit is likely to be around 6.2% of GDP.

To put this in perspective, and to allow a comparison with the 1990s, the estimated outturn for the fiscal deficit translates into the equivalent of 7.5% of GDP under the previous series of national accounts (with a base year of 1990-91). In comparison, the average fiscal deficit recorded during the decade of the political governments (1989-1999) was 7%, with the budgetary gap touching a peak of 8.8% of GDP in 1991.

Going forward, with the unrelenting upward march of world oil prices affording no respite, and the very real possibility of the government footing a huge subsidy bill on the new wheat crop (by rough estimates, to the tune of around Rs 30-40 billion), the incoming administration will face a pretty severe constriction of fiscal latitude – not unlike the 1990s. In addition, the continued large fiscal strain imposed by strategic enterprises such as Wapda, Kesc, and PIA (see Chart-6), combined with a standstill in the tax-to-GDP ratio, will also exert pressure on the budget, pointing to the painful lack of progress in the more difficult structural reform over the past several years.

**Chart-6: Fiscal Health of Strategic/Public Sector Enterprises (PSEs)**




***Source:*** Ministry of Finance.

The net result of expenditure overruns and declining momentum in revenue collection, in conjunction with the commodities price shock, is likely to be a breach of two key provisions of the Fiscal Responsibility and Debt Limitation Act in FY08.

1. The budget will record a revenue deficit for fiscal year FY08 ending June 30, 2008.

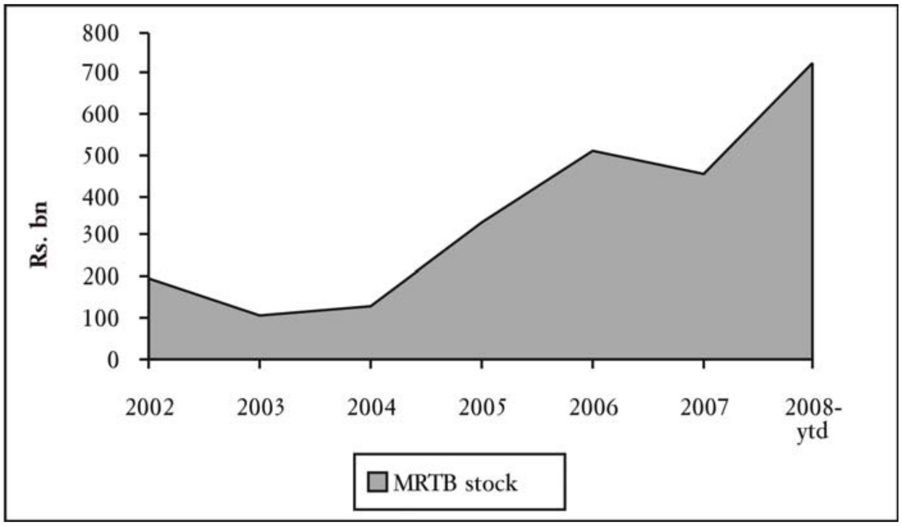
2. Public debt will not decline by a minimum of 2.5 percentage points of GDP for the second consecutive year.

If indeed this is the case, the change in the path of the public debt trajectory should be a cause of concern. Mainly on the back of healthy increases in nominal GDP, the public debt to GDP ratio declined each consecutive year, from 100% in 1999 to 55.2% in 2007. Hence, a reversal of course viz. the public debt path will represent the first increase in the ratio in nine years.

The previous government's funding strategy is also likely to compound the woes of the next government. Since 2005, the Ministry of Finance has relied excessively on borrowing from the State Bank of Pakistan (SBP), i.e. monetizing the deficit, in an effort to limit the increase in interest payments. In doing so, it has cumulatively borrowed Rs 593 billion (equivalent to US$9.8 billion at the average exchange rate for the period, or

7.2% of average GDP) directly from the central bank over the past three and a half years. For the current fiscal year, almost 70% of the incremental increase in domestic public debt has come from budgetary borrowing from the central bank, significantly raising the short term component of the government's local currency debt.

**Chart-7: SBP Holding of Market Related T-Bills (MRTBs)**




***Source:*** State Bank of Pakistan (SBP)

From the Ministry of Finance's perspective, and purely from an annual budgetary point of view, the funding strategy involving borrowing from the central bank appeared to be "low cost" in that:

1. On the one hand, the government was paying "below-market" interest rates (from what counterfactually would have been the case had the Government of Pakistan (GoP) borrowed from the primary market), while on the other, it was "recovering" its interest payments via higher central bank profits;

2. Private borrowers could be protected from being "crowded out";

As a perennial exercise, this debt strategy's shortcomings are obvious – and have repeatedly been pointed out by the central bank. Apart from the fact that the government's unchecked borrowing from SBP has served as a counter-weight to the tight monetary policy the central bank is running to fight inflation, this strategy is purely short term in nature. Ultimately, the central bank has to reverse the stockpile of net domestic assets (NDA) on its balance sheet, by offloading the same to banks. At that stage, it could crowd out private borrowers as well as pressure interest rates upward. Given the excessive reliance on borrowing from SBP – an avenue which is now increasingly restricted – the new administration could face an up tick in interest payments on public debt as the floating debt is "re-priced" at market clearing rates.

All in all, the incoming government is more than likely to face a fairly substantial constriction in fiscal space, unless it is offset by significant expenditure containment – or, in the short run, by budgetary grants such as the one-off Saudi oil aid amounting to US$300million.

**Policy Fixes**

Despite the gravity of the challenges at hand, all is not lost. With prudence and determination, and a bit of luck, the situation is largely retrievable, in our view. Some suggestions follow.

In the short run, the new government should:

- Be prepared to sacrifice economic "growth" (in the near term). A growth-centric paradigm aiming to achieve impressive headline rates of GDP expansion via fiscal stimulus and a surge in domestic liquidity is at the root of Pakistan's current imbalances.

- Instead, policymakers should focus on the "quality" of economic growth that they hope to attain – i.e. on its sustainability, equity, and, importantly, on the poverty-elasticity of growth.

- Reduce the subsidy burden on the budget by running more targeted programs.

- Run a small, but efficient, government. Reduce the size of the cabinet which was bloated under the Shaukat Aziz-run administration. Cut the number of federal ministries and divisions, by reducing overlap of functions.

- Re-prioritize all spending, especially within development spending. The portfolio of projects under the PSDP needs to be critically re-examined for "importance", "criticality", and "economic benefit". Projects with questionable benefits need to be axed, while leakages due to delays in execution, faulty implementation, and/or corruption need to be minimized.

- Discretionary current expenditure needs to be curbed. Some suggestions: a wage freeze for military personnel/civil servants can be affected, together with a halt to any further generous perks and privileges accorded to parliamentarians. No new vehicles and/or office furnishings for government servants should be allowed for the next three years.

- Redirect borrowing for budgetary support from the central bank to non-bank sources such as Pakistan Investment Bonds (PIB), with a re-profiling of the maturity structure of the debt into longer term tenures.

- Introduce a ceiling on annual government borrowing from the central bank by an amendment to the Fiscal Responsibility and Debt Limitation Act 2005.

- Enhance revenue generation by allowing the capital gains tax exemption on equities to lapse on June 30, 2008, and introduce a tax on real estate transactions. This will promote equity in taxation, as well as serve to deflate elevated real estate prices which are hindering new investment. It will also re-start mortgage financing and construction activity.

- Aim to achieve a neutral or a surplus revenue deficit situation by end-September 2008;

In the longer term:

- Initiate measures to increase the tax to GDP ratio by at least 1 percentage point a year through "structural" improvements – i.e. by widening the tax base. More than agriculture, the services sector appears to offer greatest prospects for further revenue enhancement. Recent growth has come mainly from the services sector, which now accounts for 53% of GDP but contributes only 26% to total tax revenue.

- Reduce the huge strain on fiscal resources imposed by the remaining state-owned enterprises, mainly PIA, Wapda and Kesc. This can only be achieved through a more effective restructuring effort on the part of government, which will require, first and foremost, that these enterprises are not viewed as "quick fixes" for creating new employment.

- Develop alternate energy sources, and expand conservation efforts. Make energy conservation targets more ambitious.

- To ensure better supply of food grains, and to reduce the import bill, maximum focus should be directed towards enhancing agricultural productivity. Pakistan has reached the frontier of its ***extensive*** farming strategy, and now needs to re-orient its agriculture sector towards higher value-added (and less water-intensive) crops. By galvanizing crop research and extension services, productivity levels can be raised substantially. In terms of administration, the agriculture sector is a provincial subject. However, a lack of ownership (and funding) of the sector is apparent, and needs to be reversed.

**Rising to the Challenge?**

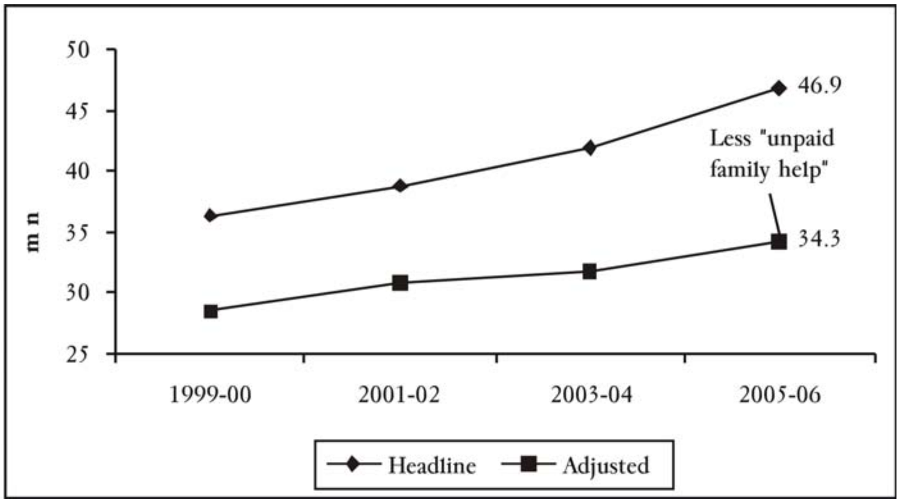
Given the foregoing, the key question is whether the coalition government is up to the task. On this score, the new government may be handicapped on at least three fronts.

The first, and possibly foremost, handicap stems from the fact that the economic hardship on a large swathe of the populace is both palpable as well as real, increasing the pressure on the coalition parties to deliver some immediate steps towards alleviation. A period of viciously high inflation, especially food inflation, has burdened the average Pakistani over the past few years. To put this in perspective, using the Consumer Price Index (CPI) as the inflation gauge, the price level has risen over 27% cumulatively over the past three years. Food inflation has been a major contributor, rising 32.6% over the 2005-07 period.

A toxic combination of domestic crop shortages and the sharp run up in global commodity prices, was compounded by bad governance, with reports of extensive hoarding and smuggling of sugar and wheat in particular. (In 2006, the President shelved a National Accountability Bureau inquiry into the sugar crisis, reportedly citing a threat to the "stability" of the government).

Compounding the economic misery of the population has been the fact that while top-line economic growth appeared impressive over the past several years, the headline figure masked the extremely skewed nature of gains. In addition, the economic expansion generated under the finance team led by Prime Minister Shaukat Aziz was relatively "jobless" in nature, with employment gains artificially inflated via the use of the "unpaid family help" category – a statistical construct that accounted for the bulk of the jobs created over the past five years (Chart-8).

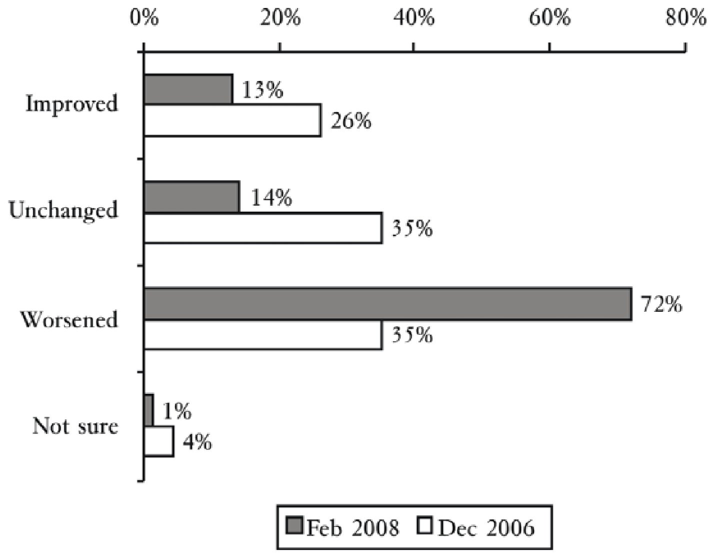
**Chart-8: Headline Job Creation Versus Adjusted for "Unpaid Family Help"**




***Source:*** Federal Bureau of Statistics; Author.

The combination of high inflation, limited job creation, and extremely skewed income gains proved electorally lethal for President Musharraf's political allies. Little wonder that when polled in February 2008, 86% of the respondents reported either a "worsening" of their individual economic condition, or "no change" over the previous year – up from 70% in December 2006 (Chart-9), and a surprisingly high percentage for an economy supposedly experiencing a "miracle".

**Chart-9: Change in Personal Economic Condition (% of Respondents)**




***Source:*** International Republican Institute (IRI)

Hence, the platform on which the anti-Musharraf parties ran was mainly an economic one, as encapsulated in their manifestos (see Table-1), though antipathy towards the ex-General's actions against the judiciary, his pro-US stance, and the military operation against the Red Mosque in Islamabad appear to have also contributed to his allies' heavy electoral defeat.

**Table-1: Party Manifestoes (Extracts)**

| | PPP | PML-N |
|---|---|---|
| **Main Goals of Economic Policy** | • Full employment<br>• High, sustainable growth<br>• Contain inflation through prudent monetary and fiscal policies<br>• Growth with equity | • Reduce rich-poor divide<br>• Expand employment opportunities<br>• Achieve 100% enrollment levels |
| **Major Policy Commitments** | • Guaranteed employment of "at least" 1 year to one working member of poorest 25% families via labor-intensive Public Works Program<br>• Employment guarantee of two years to all youth completing Intermediate, Graduation and Post-Graduation in a given year<br>• All children in government primary schools to be provided stipend<br>• Minimum wage to be enhanced<br>• Conditional cash transfers to poor families<br>• Special programs for least developed districts<br>• Senior citizens over 65 years with no source of income to be provided financial support | • New employment opportunities to be provided to over 3 million persons in public as well as private sector<br>• National Employment Fund, National Education Corps and Land Development Corporations to be established<br>• Tax holiday of 3 years for all new industries<br>• New industrial estates alongside motorway<br>• Education in public sector institutions up to higher secondary to be free of cost<br>• Minimum wage to be enhanced<br>• Reasonable food prices to be maintained throughout the year |

***Source:*** Party Manifestos

The second limitation the incoming coalition government may face in dealing with the fiscal situation is "ideology". Both the PPP and the PML-N are growth-centric in their approach, and broadly prefer supply-side responses over demand-management. This bias is clearly reflected in not only the two parties' election manifestos but also their performance viz the economy while in government during the 1990s (Table-2). High government expenditures coupled with weak revenue collection led to persistently large fiscal deficits, averaging 7% over the 1989-1999 period. Between the two, the PPP appears to have been moderately more successful in containing expenditures, as well as the budgetary gap.

**Table-2: Economic Performance of Political Parties FY89-07**

| Fiscal Years | Party in Power | Real GDP Growth (%) | Fiscal Deficit | Gross Revenue | Exp. | Avg. CPI Inflation (Y/Y %) | Real Pvt. Inv. (y/y % Chg) |
|---|---|---|---|---|---|---|---|
| FY89 - FY90 | PPP-P | 4.7 | 7.0 | 18.3 | 25.9 | 8.2 | 10.0 |
| FY91 - FY93 | PML (N) | 5.0 | 8.1 | 18.1 | 26.2 | 11.0 | 6.1 |
| FY94 - FY96 | PPP-P | 5.4 | 6.0 | 17.6 | 23.6 | 11.7 | 4.4 |
| FY97 - FY99 | PML (N) | 3.1 | 6.7 | 15.9 | 22.7 | 8.4 | 0.0 |
| FY03 - FY07 | PML (Q) | 7.0 | 3.6 | 14.4 | 18.5 | 6.6 | 9.4 |
| Memo: | | | | | | | |
| FY03 - FY07* | PML (Q) | 7.0 | 4.3 | 17.3 | 22.2 | 6.6 | 9.4 |

**Using 1990-91 as base*

***Source:*** Ministry of Finance; Author.

Quite obviously, a note of caution is in order regarding the outturn during the 1990s. Definitive conclusions about the effectiveness of policies of different political governments since 1988 cannot be readily drawn from the data presented above for a number of reasons.

First, successive governments faced a difficult set of conditions from 1988 onwards. The first PPP government with Ms. Bhutto as Prime Minister inherited a stock of public debt whose dynamics were already unfavorable, while the first PML-N government in 1990 was faced with a crippling round of US economic sanctions relating to Pakistan's nuclear program, which had a far-reaching impact on investor perceptions and capital inflows. Similarly, the country was sanctioned yet again during the second PML-N government (1997-1999) on account of its response to India's testing of nuclear devices with its own round of tests.

In fact, Pakistan's economy lurched from crisis to crisis in the 1990s, with devastating floods and a ruinous viral attack on the key cotton crop in the early part of the decade, and a prolonged period of ethnic strife in Karachi that cast a shadow over the economy. To make matters worse, the transition to democracy that began in 1988 was uneasy, with at least seven different governments coming to power (including caretaker set-ups charged with overseeing elections) between 1988 and 1999.

Hence, considerable extraneous influences – from geopolitics to weather-related – exerted themselves over this period, worsening already fragile economic conditions. In addition, the outturn on the parameters chosen in Table 2 does not reveal an important dimension of economic policymaking – the extent of reform introduced. In this context, the 1990s saw considerable progress in the liberalization of the economy – particularly in the case of tariff reform and financial sector liberalization – under both PML-N as well as the PPP governments.

That said, not all economic outcomes during the 1990s were exogenously determined. Policies adopted by the two mainstream parties in power largely worsened an already precarious situation – both economic as well as political – with a dangerous drift towards polarization in the country.

In addition, there were a number of substantial offsets to the otherwise dire economic situation. Liberalization of the capital account in the early 1990s by the first PML-N government – combined with tax exemptions and constitutional guarantees against expropriation – encouraged reverse capital flight and a very rapid build-up of balances in onshore foreign currency accounts (FCAs). The hard currency from these accounts, coupled with inflows of "hot money" under the FE45 scheme for offshore institutional investors, was used by the authorities to finance the growing external imbalances through the 1990s. The other significant offset was the Saudi oil facility (essentially a grant), which was made available after Pakistan tested its nuclear devices in 1998, and continued until 2003. In total, this grant amounted to several billion US dollars.

Returning to our argument concerning potential impediments to running an economic program with a stabilization thrust, the third handicap is embedded in politics. Almost by definition, pursuing a course of action that may be deemed to increase the economic hardship of the electorate may be a non-starter for a four-party coalition. The fact that the PPP is coming back into government after a twelve year interregnum, while the PML-N is staging a comeback after being removed by General Musharraf's coup in 1999, reduces the likelihood of stabilization policies, in our view. Hence, the "natural" instinct for the coalition government may be to finance its way out of the current situation, rather than to adopt a path of adjustment, not unlike the course of action chosen by the previous administration. If so, it will only be delaying the inevitable.

## Conclusion

Pakistan faces a difficult economic situation, even as the political transition to a popularly elected government has proceeded far more smoothly than anticipated. The current rough patch for the economy is not entirely unexpected, given the deeply flawed growth strategy that was being pursued since 2002. By and large, and despite the exogenous shocks, Pakistan's imbalances are policy-induced. Herein lies one important piece of good news – that the situation can be reversed.

It remains to be seen what policies are introduced, and how effective they will be in addressing the imbalances. However, one thing is clear: a "muddle through" approach will not succeed. Without forceful measures, including possibly politically unpalatable ones, Pakistan may be unable to successfully navigate out of the current difficult situation.