ECONOMY By **Dr Asad Sayeed**

Reap what you sow

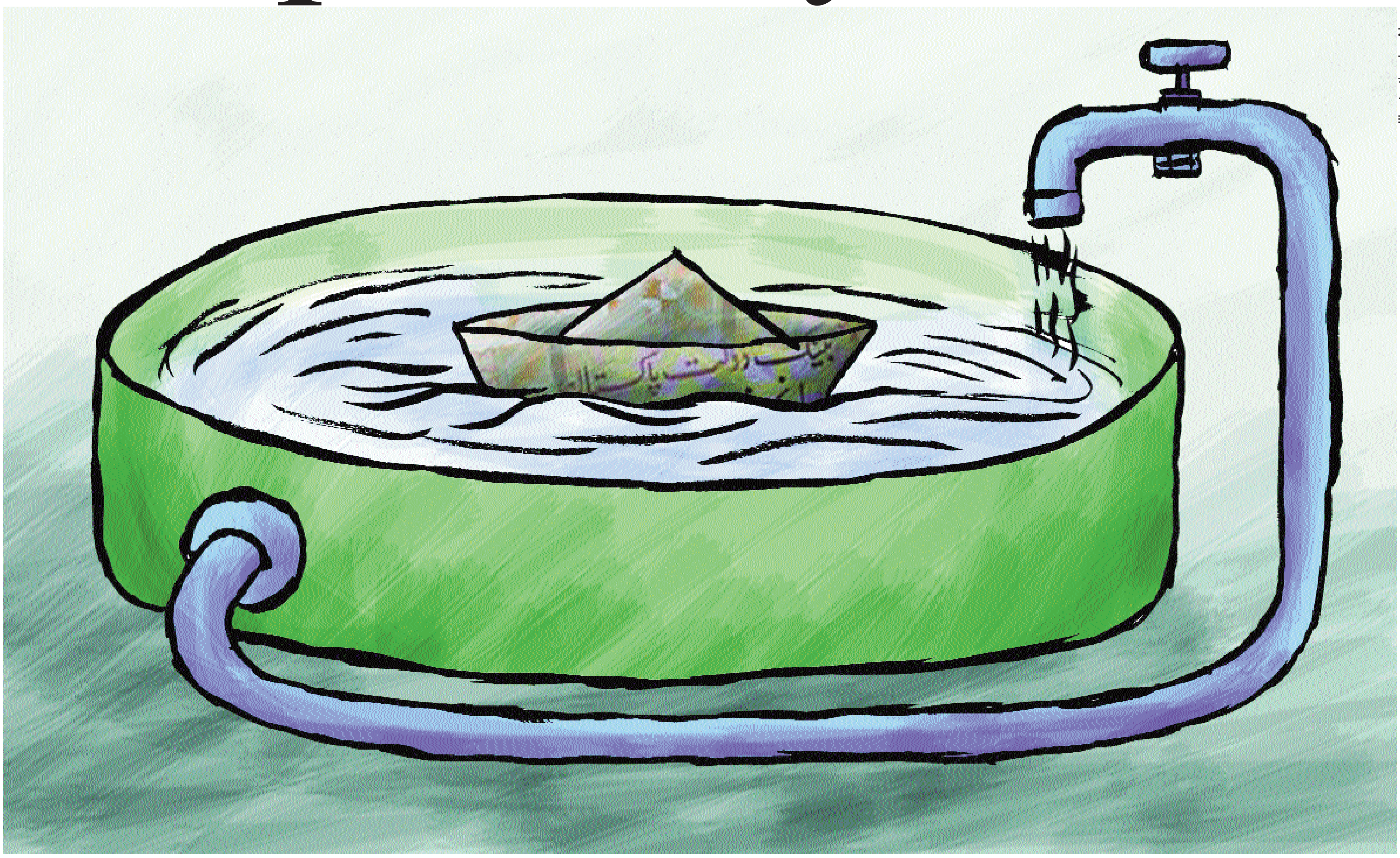


Illustration by Abro

AS 2008 fades out, Pakistan's economic managers could only take comfort in the fact that the rest of the world was also in the midst of an economic meltdown. However, try explaining this to those reeling under high inflation, increasing unemployment and a seemingly endless energy crisis and they will not be amused. The poor and the marginalised in Pakistan voted for change in the February elections. In the increasingly murky local and international political-economic environment, a turnaround in their economic fortunes seems a distant hope at best.

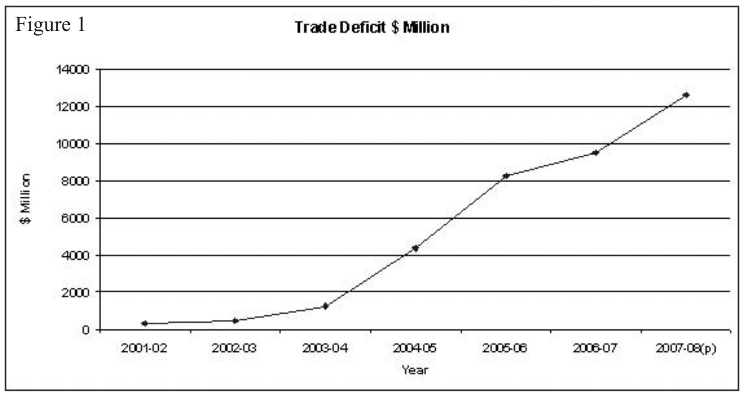
Before we analyse the present economic predicament and what lies in store for 2009, it is important to understand what brought us to this economic precipice. While there is virtual consensus amongst economists in Pakistan that the growth spurt created by the Musharraf regime was unsustainable, there is scant evidence-based assessment of the causes of this predicament in the midst of partisan rhetoric that passes as analysis in the media. Tracking the causes will enable us to rationally evaluate the policy course taken to confront problems at hand.

First, during the 2002-2007 period, Pakistan was running an unsustainable trade deficit. It is now an old story that the 9/11 foreign exchange boom created asset price bubbles in the real estate and the stock markets in Pakistan. With high returns from easy money came a surge in imports that was further facilitated by an overvalued exchange rate and corresponding reduction in duties on luxury items. There would have been no issue if this import surge was matched with a commensurate increase in exports. That it was not is evident from the steeply rising trade deficit in Figure 1. In fact between 2002-03 and 2005-06 we can see the trade deficit virtually doubling every year.

Such profligate behaviour on the part of the government and elite fed into a growing and unsustainable current deficit as shown in Figure 2. Thus when the oil and food price shock hit the global economy, Pakistan's balance of payments went into a tailspin whereas other countries in the region were able to withstand this pressure much better.

Second, another dimension of this profligate behaviour on the part of the state was to preside over the lowest tax-GDP ratio in recent history (see Figure 3). It abandoned the effort to enhance the tax net once foreign resources started pouring in and foreign debt was rescheduled post 9/11. Moreover, generous tax breaks were provided to upper income slabs and to the corporate sector at a time when incomes and profits were increasing. This is contrary to elementary economic logic where incomes are taxed more heavily during upturns and tax relief is provided during downturns.

Figure 1



The third and the final nail in the coffin was the unprecedented monetary expansion that the government resorted to, essentially to keep the price of petroleum products constant between September 2007 and March 2008 at a time when international oil prices were increasing at an exponential rate. In the 2007-08 budget, borrowing from the central bank was budgeted at Rs80bn and the year ended with borrowing a staggering Rs688bn. With so much additional money chasing goods and services, growing at a much slower rate, is bound to create significant inflationary pressures in the economy. While inflation in the economy was also fuelled by increasing international prices of oil and food items, the most significant contribution to inflation has been the surge in money supply, which incidentally continued unabated till September 2008.

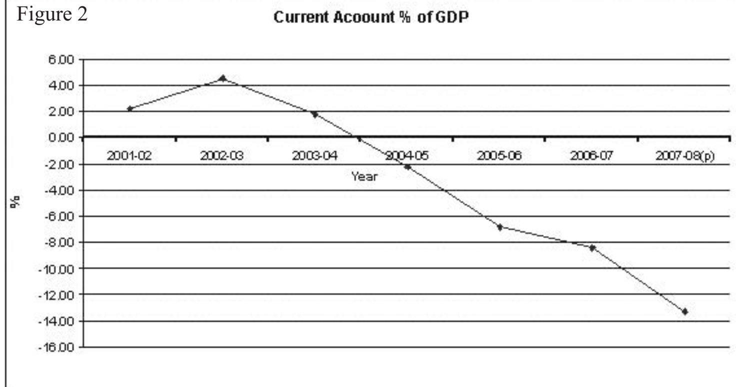
When the new government assumed power in late March 2008, the main issues it was confronted with were unprecedented levels of high inflation and a precarious balance of payments situation. The incoming government seemed not to grasp the intensity of the short-run problems at hand. Perhaps there was a belief — proved unfounded — that the international community would bail the economy out of the BOP crisis.

On the inflation front though, there was realisation that subsidies on fuel financed through monetary expansion would logically lead to runaway inflation. Thus the government moved in swiftly to pass on international oil prices to the consumers. The backlog was so huge — and up until July international oil prices were increasing at an unprecedented rate — that price increases were steep and frequent.

The folly of not having increased the tax-GDP ratio earlier came to haunt the consumer in this period as the only manner in which subsidies could have been provided was through bank borrowing. A higher tax-GDP ratio would have enabled the government to either maintain the subsidy or to remove it slowly if the cushion of tax resources was available.

The first budget presented by the new government was a mixed bag. On the positive side, the government moved to boost the agricultural sector, address the energy crisis and significantly enhance the envelope of social protection. Several incentives were provided to boost agricultural

Figure 2



growth and shift the terms of trade in favour of the growers. In the wake of virtually stagnant agricultural growth in the previous four years and food insecurity as a result of a significant spike in international prices, this policy initiative was overdue. While there is a lot of sound and bluster on the energy front, no significant initiative appears to have materialised as yet on this critical front.

Perhaps the most important initiative of the new political order is to significantly enhance the fiscal envelope on social protection. Up until the 2007-08 fiscal year, Rs11bn were being allocated for direct social protection measures (through Zakat and Baitul Maal). In the current year this has been increased to Rs66bn — Rs34bn through the Benazir Income Support Programme and Rs22bn through the Punjab Food Support Programme. While there are significant issues with regard to targeting that need resolution before the efficacy of this commitment can be gauged, this move also signifies an important policy shift.

This shift is from indirect to direct subsidies. From both economic as well as equity criteria this is a sensible move. Untargeted subsidies — such as those on petroleum and electricity — are simply unaffordable given the low levels of taxation and will result in unsustainably large budget deficits which in turn stoke inflationary fire. Moreover, there is no justification for subsidising the rich by providing them cheap electricity and fuel.

The significant omission in the budget was on the taxation front. Given the low tax-GDP ratio inherited and inequity in the taxation structure, there was only muted effort at taxing luxury consumption. Moreover, the big business lobby successfully thwarted capital gains taxes on real estate and the stock market and increase in the marginal rate of taxation. There was also no significant initiative to broaden the tax net by including in its fold numerous services that remain untaxed. Though agriculture tax is a provincial subject, no effort was made either by the federal or provincial governments to enhance its rate or improve collection.

Thus the budget deficit target of 4.2 per cent of GDP seemed unrealistic. While the exact amount of reduction in the budget deficit is not important, the policy measures on the resource mobilisation front did not seem serious enough to stabilise an economy that was plagued by unprecedented levels of inflation and a looming foreign exchange crisis.

By September, the government finally woke up to the twin crises it was confronted with. By then, inflation was still galloping — though oil and food prices in the international market had started coming down — and as a result confidence in the currency was fast dissipating, leading to a sharp reduction in foreign exchange reserves. All efforts to get financial support from bilateral and multilateral friends were in vain. While there may have been political reasons for ‘friends’ not coming to Pakistan’s rescue, the most salient economic reason for the international community to decline support was the lack of a credible stabilisation plan put forth by the government itself. By the time the government managed to put a plan together, the situation on the reserves front had become so precarious that recourse to the IMF remained the only option.

There is much trepidation in Pakistan about going back to the IMF and justifiably so. In the 1990s, IMF programmes meant virtually choking off public investment and severely restricting aggregate demand. The outcome of IMF programmes then killed growth in the future and bred poverty in the present. The context of recourse to IMF this time, however, is arguably different. Whereas in the 1990s, recourse to the IMF was on account of an external debt crisis, this time round it is because of a balance of payments crisis borne out of profligacy and record monetary expansion in its wake. As such, IMF or otherwise, stabilisation is required if inflation is to be reined in and external imbalances reduced.

Unless there is some unstated understanding, the IMF agreement this time round is also markedly different from the past. Reduction in public investment is not as significant as in the past and the agreement stipulates not only that existing social protection expenditure should be protected but also that it should be enhanced next year. As such, the deleterious impact on future growth will be less than before and there is some protection for the poor.

This is not to say that life for the less privileged will be any better in the short term. Unemployment and poverty are expected to increase in the short run and inflation — again thanks to irresponsible monetary expansion — will remain in double digits at least for the next year or so. But unfortunately, there are no short cuts in the brutal real world of market economics. Looking ahead, only dark clouds appear on the horizon, be they in the form of a global economic depression or serious regional and domestic security threats. In this uncertain and scary future, reduction in inflation and protection of the poor ought to be the two most important economic phenomena tracked in Pakistan.

Figure 3