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A look at challenges to growth beyond stabilization policies

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Beyond Stabilization: Moving Towards a Growth Economy

The growth trajectory of Pakistan's economy has remained visibly low since 2008.[1] Over the years, supply side bottlenecks owing to persistent energy shortages and inefficiencies within the sector have strained fiscal resources. Structural impediments, such as low tax to GDP ratio and a fragile foreign exchange reserve, have resulted in destabilized macroeconomic indicators, high inflation and low GDP growth. After two years of pursuing stabilization, the federal government insists that the proposed budget for FY16 will give a substantial push to the economy and accelerate growth. Yet the proposed budget falls short on aggressive measures to expand the tax base, increases pressure on existing tax paying sectors of the economy, and lacks incentives for accelerating investment.

In 2013, the federal government faced the difficult task of stabilizing the economy by bringing down the fiscal deficit, building up reserves and containing inflation. In the succeeding two years, exogenous factors such as a sharp fall in global commodity prices and a one-off foreign currency inflow precipitated a decline in inflation and improved foreign exchange reserves. Between FY09 and FY13, GDP growth averaged at 2.8 percent while the average annual inflation was 11.8 percent, with average fiscal and current account deficits at 6.6 and 2.2 percent respectively. In 2013, the finance ministry was tasked with undertaking a stabilization programme before it could think about boosting growth.

Yet the road to stabilization was marred by State Bank liquid foreign exchange reserves nose-diving in the early days to touch a low of $2.8 billion in Feb 2014. In anticipation of this, the federal government entered into a more stringent IMF programme, spreading quarterly releases over a 36-monthExtended Finance Facility. After more than a year and a half, the Ministry of Finance has largely managed to meet quarterly IMF targets, with Pakistan receiving tranches on time.[2]

The nod from IMF was instrumental in raising $3billion through Euro Bond and international Sukkuk issues, as well as securing concessionary commitments from the World Bank and other multilateral agencies.[3] Although rates were high on bonds, the response from global investors was overwhelming.

The government has envisaged to raise another $1 billion by issuing Euro Bond in FY16. Although government debt is not at an alarming level and the share of foreign debt is not out of proportion, there is little reason to pursue expensive options. The retiring foreign debt is mostly concessional and the new commercial issuances are at exuberant rates.

Further, the conversion of domestic banking debt to foreign commercial loans has possible demerits. Increased exposure in foreign loans can add to currency risk vulnerabilities. It is therefore more advisable to either negotiate better rates or refrain from fresh foreign bonds. Nonetheless the swaying away from domestic to foreign debt creates space for private borrowing at home. Coupled with successful privatization of the government's holding in large commercial banks, this has not only reduced fiscal financing reliance but has also added to reserves build-up by attracting foreign buyers' interest.[4]

Consequently, by mid-May 2014, SBP liquid reserves had reached $12.5 billion to cover 3.5 months of imports. External factors (sharp decline in oil prices) have helped in taming imports and keeping the Current Account (CA) comfortable – the CA witnessed surplus in the third quarter of FY15 and the full year deficit will be around 0.6 percent of GDP for FY14.

Poor Growth Performance

However, teething issues related to competitiveness of Pakistan's export sectors and increase in non-oil imports continue to hamper growth after two years of stabilization policies. A global slowdown coupled with low commodity prices has stalled export growth and worryingly, imports are replacing domestic industries. Simultaneously, the overvaluation of the currency has made the trade situation worse.[5] As a result, not only has growth been a distant mirage over the past two years, but exports have declined by 3 percent during July 2014–April 2015. Similarly, while overall imports have declined by 2 percent during the same period; accounting for the decrease in global oil prices shows that barring petroleum products and palm oil the import bill has gone up by 8 percent.

In order to bridge the trade deficit, the government has some generously lowered export refinance rates to 4.5 percent – higher than the industrial demand of 5 percent. The rate was 9.4 percent two years ago and has been brought down since in a staged manner. Falling interest rates will keep the subsidy component from rising too much, and exporters are likely to gain some benefit from the refinance facility. Such steps are welcome, especially when the currency is overvalued and competitors are not only depreciating their currencies but also giving fiscal incentives to retain and expand their share in the global trade pie.

Similarly, other steps have been proposed, such as reducing long term finance facility to 6 percent, removing anti-export bias in imports, promoting export development initiatives, marinating zero rated duty on import of textile machinery and encouraging investment in plants and technology up gradation. The government hopes that Pakistan's textile exports can regain their lost share through these measures.

However, this may not to be enough to rein in the trade deficit, as Macroeconomic numbers indicate that while domestic production is suffering, any upsurge in demand is being met by imports. This is also reflected in the less than desired performance of the LSM sector, which grew by just 2.5 percent during July 2014 – March 2015 as compared to 4.6 percent the previous year.

With the proposed cut in rates of custom duties, imports will become even cheaper. In the interest of the trade balance, the currency has to be allowed to depreciate and adjust at its equilibrium level. At the same time, the 5.1 percent target for GDP growth has also been missed this year. Despite a decrease in inflation to less than 5 percent, increase in foreign exchange reserves and a marginal improvement in fiscal deficit, growth has been diminutive in generating employment.

While the finance ministry's focus on stabilization during its first two years in office is understandable, it is now time to go beyond stabilization and shift the economy towards growth. So far, the improvement in overall business sentiment has not translated into increased investment. As Pakistan enters FY15, the federal government will need to employ both monetary and fiscal stimuli to spur economic activities over the coming fiscal year. Unfortunately, the finance ministry has shown no inclination to impress upon the IMF for the need to move beyond stabilization policies and place greater emphasis on the revival of the economy if Pakistan is to achieve its target of over 5 percent growth in 2015-16.

Restructuring Taxation

Policy measures that place additional burden on existing tax payers do not sit well with the government's own growth-oriented agenda. The finance ministry started with revising up the sales tax by 1 percent in FY14 and increasing the turnover tax for a few sectors. This led to an increase of 0.5 percent in the tax to GDP ratio which reached 10.6 percent in FY14, but has failed to reach 11.5 percent budgeted for FY15 despite a substantial increase in withholding tax (WHT). The idea was to enhance documentation as higher WHT was levied on non-filers. However, the gap between filers and non-filers has widened for WHT/GST in FY16 (2-3% increase for non-filers with no change for filers). The budget speech offered no explanation about the about the benefits accrued from this policy in the outgoing fiscal year. . A numerical analysis suggests that there has not been a significant increase in tax filing due to the policy. All the same, the federal government has been pocketing taxes by imposition of higher rates as advance income tax. With tax filers finding it hard to claim refunds, non-filers find it more convenient to pay whatever is charged by passing the price impact to the consumer.

Thus WHT behaves like an indirect tax with consumers bearing the entire burden, while business margins remain largely unaffected. The government should do away with continued reliance on WHT and instead make the FBR proactive to identify tax-evading industries, businesses and individuals to expand the tax base. The continuation of this regressive taxation regime will not only hurt growth potential but might also incentivize the documented sector to evade taxes, if refund problems continue and remain unresolved.

Employing Fiscal Space

In order to contain the fiscal deficit within the permissible limits of IMF, the government has also had to compromise on development spending. Both federal and provincial PSDPs were slashed by 25 percent against budgeted amounts during FY14.

The practice of placing curbs on development spending on account of a shortfall in revenues has to stop. Even the gift of Rs157bn received from Saudi Arabia last year originally envisaged for infrastructure development under the Pakistan Development Fund was shrouded in statistical discrepancies to curtail the deficit.

The budgeted PSDP outlay of Rs1.5 trillion should be fully disbursed and spent to spur economic growth. According to one study, the immediate impact of every rupee spent on PSDP increases GDP by a factor of two. The projected increase of Rs500 billion in fiscal spending will therefore have a net increase of Rs1 trillion in the overall GDP. The influx of Chinese money for the China Pakistan Economic Corridor can also create additional fiscal space for expansion of the PSDP.

Despite an increase in allocation, there is a visible change in spending priorities. The ministries/divisions have been allocated Rs252 billion (83 percent of what they spent in FY15), with a higher share allocated for the Water and Power Development Authority (WAPDA) and the National Highway Authority (NHA) (collective increase of 70 percent to Rs272 billion). Infrastructure emerges as the top priority of the federal governed in the budget for the forthcoming fiscal year. Tweaking of accounts is also visible in the proposed budget, with a special development programme for Temporary Displaced Persons (TDP) and increase in security related expenditures in the development budget. The government should note that the FBR’s continued failures to meet revenue collection targets can drive back necessary investments in infrastructure and development projects and make it increasingly difficult to meet growth targets.

The other fiscal boost is further reduction in the corporate tax rate. The government decreased this rate to 32 percent from 35 percent over the last three years and plans to bring it down to 30 percent by FY18. In neighboring India, it has been kept as low as 25 percent in this year’s budget. In order to encourage fresh investment, the rate should have been brought down to 30 percent this year instead of waiting till FY18.

But the proposed budget does not include any further incentives for existing industries. There appear to be few advantages for existing businesses apart from the already announced 1 percent reduction in corporate tax. Similarly, no incentives were announced for Balancing, Modernization and Replacement (BMR). Instead, there is a disadvantage for big companies in the form of a one-off super tax of 3 percent on non-banking and 4 percent on banks making profit over Rs200 million. Most banks come under this category and may collectively contribute Rs9-10 billion additional tax revenues. Further, almost all the KSE-listed firms in cement, chemical, fertilizer, auto, power, E&P and OMC companies a host of other sectors also fall in this category.

In agriculture value added sector, there are some incentives for businesses, especially in the livestock sector. Relief measures have been introduced for rice mills as the sector has been badly hit by the fall in international commodity prices. The incentives should help allay some concerns of rice exporters.

A 3-year tax holiday for setting up and operating cold chain and warehousing facilities has also been proposed. This is a welcome move to encourage investment in the dairy sector. Similarly, in Halal meat production, income tax exemption is allowed for up to 4 years from time of inception, given that the Halal certificate is obtained by December 2016. The crop and livestock insurance schemes are already in operation. Collectively, these incentives can potentially attract significant investor attention towards the agricultural value added sector.

On the revenue front, a more stimulating policy could have been to reduce the GST to 16 percent as well. Taking advantage of expansion in the tax base, the GST can potentially be brought down this year as a growth-inductive measure. A fundamental mistake committed earlier in FY14 by the current government was to increase the GST before there had been a significant increase in growth.

Monetary Policy

There has also been little improvement in the investment and saving metrics. Investment as a percentage of GDP fell from 19.2 percent in FY08 to 14 percent in FY14. While public investments stagnated, private investment slid downwards. On the other hand, there has been no growth in national savings to channelize investments. As a percentage of GDP, national savings grew from 11 percent in FY08 to 14.2 percent in FY11, but were down to 12.9 percent again in FY14. Of concern here is the ratio of domestic savings, which was as low as 7.5 percent in FY14. Foreign savings, which have averaged 5.3 percent of GDP during FY12-14, has plugged the gap to some extent. While higher one-off flows over the last two years may have helped, foreign direct investment has mostly dried up. This is not sustainable and therefore the government will have to revive the investment climate while promoting a savings culture at the same time. A period of low inflation has given an excellent opportunity to create some monetary stimulus. The SBP is doing so by easing the monetary policy at a time of falling inflation – policy rates have come down by 300 bps since Nov 2014 and currently stand at 7 percent – the lowest in 42 years. However, the real interest rate continues to be in the range of 200-250 bps and further easing can be done if inflationary pressures do not resurge.

In its last policy statement, the SBP wisely eased the monetary stance by lowering the discount rate by 1 percent and - for the first time ever- setting a 'target rate' at 50 bps lower than the discount rate This will be the main policy rate and the central bank will ensure that the overnight rate remains close to it. The objective is to reduce the volatility in interest rates corridor. With a reduction of 50 bps in the floor and 100 bps in the ceiling, the interest corridor has been narrowed from 250 bps to 200 bps. Additionally, banks' savings deposit rates have been linked to the floor of the interest rate corridor, implying lower reduction in returns to depositors as compared with relief to borrowers. This measure bodes well for investment as well as savings. But there is only so much that the SBP can do. There are other impediments constraining private sector credit off-take, such as energy shortages and a discouraging security situation. There are both supply and demand side issues that need to be fixed by the government – credit supply is restrained by government's excessive reliance on domestic banking sources for financing fiscal deficit while demand is constrained by limited energy resources available to the industry. Private credit off-take for FY15 has so far been half of what it was in the corresponding period last year, while monetary growth has remained same. This has resulted not only from a tight monetary policy pursued before but also from increased government reliance on borrowing from commercial banks, ultimately crowding out private investment.

On the supply-side, the government plans to add 7,000-10,000 MW of energy by 2018. If the plan materializes and the projected amount is added to the national grid, there will be little or no energy gap. With oil prices expected to remain low, the cost of production will not be too high either. This has had a positive effect on business sentiments, with expectations placed on how well Chinese investment plans materialize. Foreign direct investment may increase up to $3-4 billion in FY16, with most of it concentrated in power and road/mass transit infrastructure.

It may be necessary for the government to negotiate with the IMF for not restricting the fiscal deficit at 4.3 percent (including 0.3% an account of extraordinary security expenses and rehabilitation of IDPs), since doing so would have a bearing on PSDP disbursements and might also increase pressure on provincial governments to generate surpluses. As a mark-up from the federal government, the finance ministry has offered dividends for provinces on achieving budget surpluses.

The finance ministry is also under pressure to slash development spending budgets for various departments to make room for CPEC-related projects. The shift of fiscal financing from central bank to commercial banks is another problem. To adhere to the ceiling on central bank borrowing set by the IMF, the government has, on a cash basis, retired Rs482 billion (last year:Rs20 billion) from central bank in FY15,while its reliance on commercial banks increased to Rs1.1 trillion (last year:Rs275bn). This has been an additional drag on private sector credit off-take, despite substantial monetary policy easing. The government should therefore transfer the domestic borrowing burden from commercial banks to central bank.[6]

Onwards towards Growth

With the help of these monetary and fiscal stimuli, the economy can backtrack to a higher growth trajectory within the space of a few years, given an increase in energy supplies as planned. With a high backlog and limited investment over the last many years, it will take a few years of pro-growth policies to take the economy forward to achieve 7-8 percent of growth. Additionally, low productivity and high cost of power generation will keep the demand burden on imports, while exports loose competitiveness. There is nothing new about Pakistan's balance of payments crisis, and similar episodes have been witnessed in 1998 and 2008. However, if key impediments, including a massive undocumented economy, energy deficit, and poor law and order are addressed, public debt will come down to a substantial extent and there will be significant room for indigenous improvement of the trade balance.

Nonetheless, there are signs of improvement too. Per capita income has picked up lately and is expected to touch $1500 in FY15. This is deemed to be an inflection point of shifting patterns in middle class spending. Indonesia (a country with similar demographics as Pakistan) switched gears in consumerism when the per capita crossed $1500 threshold in 2006; today it stands at $3,500 per capita income with GDP approaching a trillion dollars. Pakistan's $300 billion economy can also hit the trillion dollar mark as long as the policy framework is kept growth-oriented and redistributive at the same time.

Notes

[1]From FY09 to FY14 average growth rates in India, Bangladesh and Sri Lanka were much higher than in Pakistan – FY09 regional average: 6%, Pak: 0.4%; FY10 regional average:8.2%, Pak: 2.6%; FY11 regional average: 7.1%, Pak: 3.7%; FY12 regional average:5.7%, Pak:3.8%; FY13 regional average:5.8%, Pak:3.8%; and FY14 regional average:6.1 %, Pak: 4.1%. The gap with the regional average has been shrinking but there is significant room for Pakistan to accelerate growth.

[2]Except one, which was postponed due to protests in Islamabad last summer.

[3]$2billion in Euro Bonds and $1billion in Sukuks.

[4]However, selling banks like HBL and UBL may not be good in the long term since doing so would imply forgoing health dividend income.

[5]According to SBP, there is room for rupee to depreciate by over 10 percent, based on the Real Effective Exchange Rate (REER).

[6]This can have dual advantage –crowding in of private investment by creating credit space for private sector, and creating demand in money through note printing (potential seigniorage). Research indicates that there is a 1 percent demand potential in Pakistan based on central bank lending to the government.