Shamshad Akhtar: Policy tradeoffs and structural issues

Speech by Dr Shamshad Akhtar, Governor of the State Bank of Pakistan, at the Golden Jubilee of the Pakistan Institute of Development Economic, Islamabad, 11 March 2008.

* * *

Resilience of Pakistan's economy in the face of unforeseen global and multiple domestic shocks has been a subject of debate – proponents of outgoing Government arguing that it has strengthened, while opponents criticize the state of the economy. In these circumstances, I propose to provide a neutral, unbiased and economic reasoning for why and where we stand today? I encourage Pakistan Institute of Development Economics (PIDE) to further investigate and provide a professional economic perspective on the economy with the objective of feeding properly into policy advice. In providing my perspectives, I propose to highlight the emerging challenges posed by the weak global economic scenario, its consequent impact on the domestic economy which was already under strain, and then discuss the policy options and solutions, especially the structural changes that are required to put Pakistan on the road to sustainable economic recovery.

Pakistan entered the 21st century after displaying an average economic performance in the 1990s on numerous fronts. In deference to the historical pattern of growth path and associated business cycles, the economy gained momentum. From 2000 onwards: foreign exchange reserves grew, the debt-to-GDP ratio fell, and inflation, in particular core inflation, decelerated. Dynamism of financial sector, benefiting from the change of ownership and management and strong regulation and supervision, helped revive real economy and exploited untapped economic potential. Financial sector assets rose to $180 billion (125% of total GDP) as banks' were capitalized and the stock market remained buoyant. Corporate and banking sector profitability attracted cumulatively foreign direct investment of $11.9 billion, remittances at $22.4, and net portfolio flows were $5.0 billion.

Since late 2004 domestic vulnerabilities reemerged and mounted as the fiscal and external current account deficits rose above 4% of GDP and induced inflationary pressures. Risks to macroeconomic stability just after few years of robust growth and stability are not surprising. A quick review of Pakistan's economic history reveals that episodes of strong economic growth in the 1960s and then in 1980s were both followed by the slowdown in growth and weaknesses in macroeconomic indicators.

Why is Pakistan vulnerable to these cyclical downturns? Why cannot the country have sustainable economic performance? The oscillating growth performance over the years is largely because of inherent domestic structural rigidities which have yet to be effectively tackled to ensure macroeconomic stability and the desired growth path. Proper diagnosis and effective resolution of issues and implementation of broad ranging structural reforms is critical to skirt such bouts of slowdown in growth and instability.

Aside from the broader development debates, what is unusual currently is that Pakistan's economy is simultaneously faced with twin shocks, global and domestic. The global shocks are represented by international financial market turmoil and the unprecedented increase in global commodity prices, while rising fiscal and external current account imbalances characterize the domestic shocks. In the backdrop of (relative) slowdown in foreign exchange inflows in FY2008, these shocks have resulted in pressure on the exchange rate and foreign exchange reserves, heavy government borrowings from the central bank, and a rise in domestic inflation.

Combined, both international and domestic events have complicated short term economic management disrupting monetary management which had succeeded in bringing the core inflation down to 5.2% by May 2007 – below the peak levels of 8.3% in October 2005 and brought to surface more starkly the vulnerabilities economy faces. Like most economic phenomenon, these international shocks and domestic deficits are interrelated and entail stringent tradeoffs when it comes to devising and implementing a well-coordinated, timely, and enduring policy response. Unless immediately addressed, the present economic vulnerabilities emerging in Pakistan's economy risks reversal of the high growth trajectory and even disruption of the gains achieved. Below, I attempt to give the basic reasons for the (re)emergence of these shocks and deficits, highlight the complexities, and suggest some sustainable solutions.

The global scene

Worldwide central bankers, economic policy makers and businesses are overwhelmed as global economy slides in tailspin. Financial market turmoil caused by subprime debacle has sparked numerous debates regarding the origins of this event, effects of its aftermath, both in terms of contagion and policy responses across the globe. Risks of spread of contagion associated with US and UK's credit crisis and liquidity crunch have compounded as the financial and economic losses magnify and thwart global financial stability and economic growth prospects. Combined with record-high international commodity prices (in particular oil and food prices) global inflationary risks have intensified. Emerging markets like Pakistan, which were thus far insulated mainly due to low exposure to the subprime paper, are likely to be impacted by the second round effects of the financial market turmoil which are now visible by way of sluggish world economic growth as US downturn is setting in.

To mitigate these risk, US has launched a unprecedented package involving: easing liquidity through special funding windows, cutting policy rate, in five rounds, to 225 bps and providing US$200 billion fiscal package. This package, while warranted, is fairly controversial because of the associated moral hazard and inflationary consequences of rate cuts and easing of liquidity. Since the appropriate size of the stimulus cannot be calibrated with any precision, the aggressive stimulus by way of a monetary accommodation is likely to compound the global inflationary pressures which were already rising in wake of (i) supply constraints magnified due to world wide shortages of strategic products (such as wheat) and oil substitution efforts that diverted use of corn as a bio-fuel and (ii) growing demand pressures with rising world income. Fuelling the international commodity prices has also been the fall in US dollar which has driven investors to chase gold and oil markets. In a globally integrated world the costs of re-anchoring inflation expectations are likely to be punitive. No wonder, other central banks, with the exception of few such as Federal Reserve and Bank of England, have either further tightened their monetary policy or kept on hold to existing levels of tightening.

Developing understanding of the origins of the financial crisis and adequacy of its policy responses is critical. Analysts have largely identified collapsing US sub-prime mortgage market as the key cause for financial market turmoil. However, the sub-prime mortgage debacle appears more of a symptom rather than a cause of this evolving credit crisis. Underlying causative factors is the sustained decline in inflation and inflation volatility and the associated notable decline in nominal and real interest rates in most developed and developing economies. This resulted in complacency and central banks' adopted accommodative monetary policy for longer period that induced excessive liquidity. Combined with regulatory and supervisory gaps in oversight of off-balance sheet and nonbank transactions, this provided opportunities for overleveraging without appropriate risk management frameworks.

Arguably, these developments increased appetite for and under pricing of risk (although the pricing of risk was (and is) becoming increasing difficult in the face of fast-paced financial innovations), elevated asset prices, increased capital flows across borders in search of better yields (reflecting global macro imbalances), "carry trade" and currency misalignments. Although, monetary conditions had begun to tighten, the sub-prime mortgage crisis caused liquidity squeeze that resulted in loss of confidence and panic among investors and lenders (and now central banks) as they could not offload the complex risky assets and structured financial products. Since banks turned to rescue and bought off chunks of these papers, with low mark-to market valuations these resulted in losses to a number of financial institutions and write offs required capital injections. This fortunately was possible given the growth in sovereign funds which are waiting for acquisition and other deals.

Could it be possible that by accommodating the oil and food prices and (attempting) to revive the economy, US is setting the stage for another round of easy monetary policy and liquidity situation. In my opinion, the key issue for central banks is to differentiate between need for short-term liquidity to rescue troubled financial entities and need for adoption of a credible monetary policy stance which aims to calibrate liquidity management in a way that it does not aggravate inflationary risks which in turn would trigger further complication and protract the global economic recovery. While lowering interest rates, central banks have to weigh inflationary risks against the risk of recession and financial instability. In bailing financial entities, the central banks have to be concerned with “moral hazard” associated with such policy response as it often encourage more risky endeavors by salvaging institutions whose sole purpose of existence is risk taking and profit making.

Not only is Pakistan facing different sets of complex challenges, but the emerging global economic scenario itself underscores that country does not mimic the policy response of advanced economies. Advanced countries that are selectively lowering interest rates are those that have enjoyed low inflation for sometime but are now facing steeper risks of downturn. As such, there trade off for growth supportive policies relative to inflation is understandable as risks associated with US slowdown would threaten global economic outlook and financial vulnerabilities. Pakistan on the other hand has relatively stable financial system, but mounting aggregate demand pressures are now visible in rising inflation and rising inflationary expectations. Tightening of monetary stance and flexible exchange rate management are the two key central bank policy responses. These however will have more distinct impact if the Government reverts to fiscal prudence and efforts to this count are visible through recent reduction in oil and other subsidies.

Turning to the domestic front

Structural Reforms: An Assessment. To understand the economic complexities at hand it is important to trace briefly Pakistan’s economic growth trajectory and experience of structural reforms. Over the last three decades, economic growth has stumbled: While growing around 6-7% in late-1970s-1980s and growth faltered over 1988-2001 to 4.4%. From 2000, efforts launched have resurrected growth to an average of 6.3% over the last few years. The growth path was disrupted frequently by the inability of the government to adhere to prudent macroeconomic management and to consistently implement structural reforms.

There is evidence, corroborated by the IMF Independent Evaluation Office[1] that Pakistan’s macroeconomic framework and structural reforms suffered because of the lack of ownership of economic agenda and excessive focus on macroeconomic stabilization without supportive real sector as well as institutional and structural reforms. This resulted in slippages in conditionalities and/or weak implementation of the reforms at best as releasing disbursement to meet economy’s financial crunch outweighed compliance with structural reforms.

Problems with design and sequencing of structural reforms resulted in suboptimal outcomes of policies adopted. Few striking examples would illustrate this. Macroeconomic stability has often been disrupted as fiscal slippages were a norm given spending was not aligned to resource envelop that has been for years constrained by narrow tax base. These trends

[1] IMF (2002), “Evaluation of Prolonged Use of IMF Resources”, Chapter 9: Pakistan, Independent Evaluation Office, Washington D.C.

made fiscal-monetary coordination difficult. Continued recourse of deficit financing from central bank and other domestic financing sources has prevented containment of inflationary pressures, while constraining private sector credit demands. In real sector, industrialization has suffered because of excessive emphasis on import substitution and the incentive regime carried anti-export bias; consequently Pakistan suffers vulnerabilities stemming from lack of industry and export diversification.

Nevertheless, structural reforms, adopted since 1990s have been refined in the recent decade. Among others, notable are following steps:

Openness of the economy. Deregulation, price liberalization and lowering of tariffs,[2] and the government's increased willingness to cede greater role to the private sectors in the economy has improved the incentive regime.

Greater fiscal space. Broadening of sales tax base, lowering of tax rates and improvements in tax administration together helped in raising the tax revenue; offsetting the losses stemming from tariff liberalization. Tightening of fiscal deficit over FY2002-2005, decline in debt[3] and lower debt servicing (partly through the restructuring of external debt and partly through improved debt management) allowed space for raising development expenditures. Sustaining growth in development expenditures is becoming a challenging as tax base is limited by exemptions and a significant proportion of taxable bodies/incomes remained outside the tax net.

Privatization and deregulation. Government's success in extricating itself from the provision of goods and services in a number of areas by sale off of public companies has helped generate proceeds. This has helped temporary alleviate fiscal needs and would also reduced state enterprises recourse to budget. Privatization has already helped improved accessibility and efficiency particularly in banking, telecommunications, and airline industries as well as the mass media (radio, television, etc.).

Improving demographics. Albeit slow, Pakistan has managed to reduce its population growth rate. Large population offers strong domestic market and human resource for industry, but it does pose challenges and tradeoffs. Feeding population when crop productivity and yields are low, meeting their social services obligation and growing demands overstretch infrastructure and natural resource base. Besides harnessing better population potential, emphasis on slowing population growth is likely to generate significant gains in coming decades.

Governance and institutions. Over the last 10 years, institutional reforms have helped establish regulators and NADRA (that has helped reduce transaction costs through issuance of IDs etc.), unbundled power sector, building capacities for public: private partnership in infrastructure development etc. According to the World Bank's Report on Doing Business 2008, Pakistan ranked at 76th position out of 178 countries in terms of ease in doing business and placed at 11th position amongst Asian economies.

Supported by these reforms and capital inflows, Pakistan's investment rate, which has hovered around 18%, has now risen by almost 5 percentage points to 23% in FY07. Encouragingly, public investment has also risen from 3.9% of GDP in FY03 to 5.2% of GDP by FY07. Enhanced resource mobilization would be key to maintaining momentum for growth in public investment.

---

[2] The average tariff rate has declined from 56% in 1994 to around 7.6% by 2007. The decline in the tariff led to a significant increase in trade volumes (correspondingly the trade to GDP ratio has risen from 25 percent in FY00 to 33 percent in FY07).

[3] In time, the fiscal reforms led to a sustained reduction in the debt to GDP burden (92.9 as % of GDP in FY00 to 57.7% by FY07).

Current challenges. Pakistan is at a critical cross road. On one hand, there are achievements to be recounted. The country's smooth, though protracted, transition to democracy and the preceding few years' economic performance that managed to excite foreign interest in Pakistan lends us confidence that Pakistan has strong economic potential and can attract global capital. On the other hand, there remain key economic risks and challenges that the country faces. Unless addressed holistically these could threaten economic prospects; a luxury Pakistan can ill-afford given the geopolitical context and the emerging global challenges.

Re-emergence of twin deficits has complicated monetary management. Borrowings from SBP induce expansion in reserve money and Government's high recourse to banking system potentially crowds out private sector credit. These complications introduce volatility in overnight and other interest rates weaken the monetary policy transmission mechanism and hurts investment potential.

Growing demand for goods and services, both from domestic sources and from abroad has helped domestic industry, but has also enhanced import reliance. Over FY03-07, import growth (including oil) averaged 24.7% outpacing export growth (13.4%) leading to a widening external current account deficit. During this period, capital inflows funded fully the external current account deficit and the residual helped in building foreign exchange reserves (growing by $5.6 billion over FY03-07). Even if oil prices fall and foreign inflows are restored, sustainability of external account will remain under stress as export growth may be impacted by the global slowdown. Containing both the external and the fiscal account imbalances is one of the challenges for the government.

Solutions, strategy and structural reforms: future agenda. So what is the solution in this situation? The answer is to conduct counter-cyclical policies to curb demand pressures by dealing with the root cause of deficits; the sustainable and enduring solution is not only how to finance these deficits but more importantly how to introduce structural changes to reduce these deficit in a sustainable manner, while reflecting on approaches to meet the country's development requirements.

To resolve macroeconomic imbalances on a sustainable basis and meet the growing development requirements, there is need to as high priority focus on enhancing national saving rate, which is a basic ingredient to increase the productive capacity (possible only through well sequenced structural reforms) of the economy to match rising demand. Saving rate has now been historically low and a combination of policies including a country wide campaign through incentives can help encourage savings. This among others requires to maintain high and stable real interest rate, which given the current high inflationary environment is only possible with high nominal interest rates. In turn, a higher production level in the economy will encourage more savings. The challenge in this context is to remain vigilant about controlling consumption through counter cyclical policies.

Recognizing the need to bring the twin deficits within sustainable levels and to increase national savings, the new Government will need to strengthen the Medium-Term Macroeconomic Stabilization Program and front load it, while accelerating the implementation of structural reforms. These steps will be crucial to re-invigorate growth and strengthen economic resilience. Keeping this in perspective, the Government's broader economic strategy for the next few years will need to include:

i. Increasing domestic resource mobilization to raise revenue/GDP ratio by at least 5 percentage points of GDP. This is possible given the scope for enlargement of tax base, removal of exemptions and further strengthening of tax administration. The existing tax regime collects almost 68% of taxes from manufacturing and corporate sector, while agriculture and services sectors (aside from banks) are exempt and some segments of the economy are outside the tax net.

ii. Restricting large proportion of new resource mobilized for public investment, while prioritizing the recurrent expenditures through a major overhauling of the Government machinery.

iii. Restoring the momentum of privatization of state-owned enterprises, which has been one of the most successful in Asia. The Government has sold off cumulatively almost $7 billion of assets over FY2000-FY2008 and there are around 61 state entities in the pipeline.

iv. Providing more autonomy to public sector organizations, with effective leadership and management, to improve their operational and financial efficiencies accompanied by a program to strengthen their balance sheets which should allow them to graduate from budgetary allocations to seeking funding from the market.

v. And raising private investment/GDP from 23% to at least 28% which involves significant tapping of additional resources both from domestic and international financial markets.

To address the structural weaknesses that are inhibiting Pakistan's long term growth there is need for:

(i) Exploiting agriculture sector, a key driver for economy, to regain food self sufficiency. Conserving agriculture land and dealing with land holding and entitlement issues so that area under cultivation can be expanded, removing infrastructural bottlenecks (such as inconsistent water availability) and promoting right technology as well as research and development, and strengthening wholesale and retail markets will help improve food availability at a time when global food scenario is worrisome. Greater food production will help cater for rising demand both within Pakistan due to the growing population and its prosperity and outside particularly in the Middle Eastern bloc, India and China.

(ii) Development of a diversified industrial sector is now urgent to cater for both domestic and external demand. Private sector has to be provided the right incentive and environment for promoting the required diversification. For promoting industry, there is need to broaden and deepen private equity and debt markets – this will help diversify financial sector too which is exclusively dependent on the banking system that carries its own attendant risks. Closely held companies should be encouraged to move more and more to capital markets and to examine opportunities for mergers and acquisition and to attract foreign investment to achieve scale and efficiencies.

(iii) Instead of focusing on ad hoc subsidies that reach largely the profitable industry, it is best to design incentives to focus on ensuring adequate supply of infrastructure. All new funding, be it taxes or proceeds mobilized from the privatization of infrastructure should henceforth be kept in a separate account and this funding should be exclusively dedicated for developing infrastructure in dedicated industrial sites. For modernization of the industry, SBP and the Government is already focusing on provision of right incentives for import of plant and machinery. These measures will help industrial the sector's ability to compete effectively and achieve an organic and natural growth. Scope for exports is significant only if the industry achieves scale, value addition, diversity, and develops information technology and outsourced businesses from the West.

(iv) Foreign investment would receive a further impetus if the legal system is overhauled to ensure elimination of cumbersome procedures, effective enforcement of property rights and business contracts and availability of timely justice.

In conclusion, Pakistan has an opportunity to draw lessons from past. Among others listed above, a key lesson is need for effective implementation of reform agenda, though there is a case for launching second generation reforms to strengthen the governance of country and institutions which matter in implementation, but cannot be achieved without further institutional reforms. Commitment in addressing the issues and focusing on reforms can go a long way in creating an environment that is conducive to productive economic activity, business friendly environment, and social cohesion.