

POST COVID FUTURES



PAKISTAN'S MACROECONOMY AND THE COVID-19 PANDEMIC

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Chapter 1: Pakistan's Macroeconomy and the Covid-19 Pandemic

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Nothing has had a more deleterious impact on the global economy in about a century since the Great Depression than COVID-19.¹ Pakistan has by and large evaded the pandemic's worst fallout as the disease has had a varying intensity as elsewhere in the region, and our partial lockdowns allowed both industry and transport to remain functional through this period. COVID's third wave is reportedly on the decline across Pakistan, but the shocks felt through the economy over 2019-20 continue to reverberate into the current financial year. After close to 70 years, a negative GDP growth rate was

recorded in 2019-20, FBR revenues were nominally below GDP growth and the budget deficit was at a historic high. The pandemic also exacerbated the rising the levels of poverty and inequality across the country.²

As 2020 progressed, some indicators of Pakistan's macroeconomy improved. The current account deficit turned into a surplus for the first six months of the year – largely on the back of increasing remittances and low oil prices – and revenue growth also improved. Still, all prognoses of Pakistan's economy going into the future are far below countries that have had a much more severe impact from COVID-19 than Pakistan, and experienced longer and stricter lockdowns. According to the latest estimates by the International Monetary Fund (IMF), Pakistan will keep facing anaemic economic growth numbers in the range of 1.5% as opposed to 6% for

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¹ The IMF declared the economic downturn due to the Covid-19 pandemic to be the worst since the Great Depression.
<https://www.imf.org/en/News/Articles/2020/03/23/pr2098-imf-managing-director-statement-following-a-g20-ministerial-call-on-the-coronavirus-emergency>

² According to a study conducted by Dr. Hafeez Pasha and Shahid Kardar, the worst-case economic scenario could push up to 15 million below the poverty line. Dr. Hafiz A. Pasha and Dr. Shahid Kardar, "Revisiting economic impact of coronavirus," *Business Recorder* 14 April 2020, <http://epaper.brecorder.com/2020/04/14/14-page/833587-news.html>.

China, 11.5% for India, 6.7% for Malaysia, and 4.4% for Bangladesh.

This chapter will contextualise the weak structural foundations of Pakistan's economy, necessary to mark out a prognosis for recovery in a post-COVID future. Subsequently, we critically appraise the policy instruments used by the government in the midst of the pandemic on the benchmark of their impact on growth, stabilisation and on alleviating the stress that the poor and vulnerable have been subjected to.

Binding Structural Constraints that Inhibit Sustainable Growth and Development

In the last two decades, Pakistan's economy has gone through a boom and bust cycle in terms of growth and macro-economic stability. The booms are generally predicated on a comfortable external balance situation and the reverse is the case with busts. The usual formula is that once the economy is stable in terms of external finances, governments in Pakistan – irrespective of regimes in power – tend to lower interest rates and over-value the currency to create a veritable consumption boom. This inevitably leads to a current account deficit, which in turn feeds into an increasing budget deficit and depletes foreign exchange reserves, pushing the economy back into crisis mode. This leaves the government no option but to seek recourse from the IMF.

Successive governments have been unable to break this cycle to pursue an alternative, more sustainable path to economic growth because of deeply set structural constraints plaguing the economy.

- a) *Inability to Allocate Resources to Productive Sectors and Firms:* During the last forty years, cotton textiles and related products, food processing, cement and automobile assembly have been responsible for more than three fourths of industrial value added. Not only have these sectors cornered the bulk of state-created rents, but have also created effective entry barriers for more technologically dynamic and internationally competitive industries and firms to enter and grow. As a result, Pakistan has steadily lost its competitiveness in the global market. The outcome is that Pakistan's exports have been stagnant over the last decade, and brought about an unsustainable current account deficit.
- b) *Low Tax-GDP Ratio:* The state's inability to collect adequate revenues has been a constant predicament over the last two decades. Hovering in the range of 9-11% of GDP, Pakistan's tax revenues are roughly half the average for similar middle-income countries. There are two

over-arching implications of this failure. Firstly, the inability to broaden the tax net has meant that incremental output remains outside the tax net and further informalises the economy. Developing economies formalise over time by bringing a wider array of economic activities in the tax net. This improves tax revenues and enables the state to regulate markets in public interest. Second, a low tax-to-GDP ratio reduces fiscal space for the state. This is most evident in the lag on key social sector indicators (health, education, water supply, sanitation, social protection, climate change), physical infrastructure and to support public welfare in times of emergency.

c) *Energy Sector Bottlenecks:* Pakistan's energy concerns are perennial. Starting with generation related bottlenecks in the 1980s, it has now taken the shape of high energy costs because of institutional sclerosis on transmission and distribution. The circular debt created in the wake of this breakdown has increased consistently over the past two decades, creating a corresponding rise in the cost of energy, which has further drained public finances.

a) *Low Levels of Fixed Investment:* Perhaps the most critical

chokehold on Pakistan's economy is the low level of fixed investment as a proportion of GDP. Pakistan's aggregate rate of fixed investment has hovered in the range of 12-15% of GDP for the last two decades – with the exception of a few years in the early 2000s – whereas economies in the region such as India, Bangladesh, Vietnam and Thailand have investment levels that are close to double those of Pakistan. Up until the 1980s, Pakistan's investment rate was largely driven by public sector investment, with roughly a third of investment coming from the private sector. Since the liberalisation of the economy in the early 1990s, public sector investment has steadily reduced to 2-3% of GDP. The hope with liberalising the economy was that slack in public sector investment will be picked up by the private sector. This did not materialise and instead Pakistan has landed itself in a significant deficit of fixed capital formation.

Low levels of aggregate investment have prevented a virtuous growth loop that could replace the boom and bust cycles. The steady erosion of public sector investment has created low quality physical infrastructure, and bears some responsibility for low private investment too, by not 'crowding in' private

investment. Productive private investment has also shied away from Pakistan because of persistent political instability and the perception of religious intolerance and extremism prevalent in the country.

In any economy where rent-seeking is endemic, the inability of the state to lure this surplus into private fixed investment has resulted in the creation of speculative bubbles through channels of real estate, commodity speculation and the stock exchange.

That these systemic constraints have not been addressed over a long period of time and across political regimes points to their deep rootedness in the structure of state and society. After failing to address these structural bottlenecks, successive governments have no option but to traverse the boom-bust cycle.

Addressing Growth, Stabilization & Poverty during the Pandemic

Despite the fact that official lockdowns in Pakistan have been relatively short-lived, the impact on unemployment and poverty has been multi-faceted through multiple waves of COVID-19. Several

jobs have been lost, particularly in the urban domestic services sector and in small scale manufacturing.³ Moreover, younger people have had to take time off to care for the elderly who have fallen sick. Eminent Pakistani economists have estimated that COVID-19 would push around 15 million additional people into poverty in Pakistan.⁴

Soon after Covid-19 emerged, the government announced a seemingly large Rs. 1.2 trillion rupee (or 3% of GDP) stimulus package. This package contained Rs. 200 billion (0.5% of GDP) for social protection meant to address poverty and unemployment. This amount was distributed among the beneficiaries of the BISP, albeit with an enhanced amount. While the disbursement was swift, it was mis-targeted, as most beneficiaries of BISP happen to reside in rural areas, whereas the impact of COVID-19 was more prevalent in urban areas. In order to compensate those most affected by the pandemic, the government could have geographically targeted working class neighbourhoods in the urban areas where vulnerable communities live.

The rest of the stimulus package announced by the government was riddled with double counting of routine activities such as wheat procurement and tax refunds. These two routine

³ Pakistan Bureau of Statistics (PBS) survey shows the unemployment rate increased by 34.1% between pre-lockdown and the first wave of the Covid-19 pandemic.

⁴ See Hafiz Pasha and Shahid Kardar in <https://www.brecorder.com/news/585150/>

activities comprised a third of the economic stimulus package. Only PKR 875 billion was the actual cash outlay envisaged in the package, and thus far only PKR 330 billion has actually been disbursed since March 2020.⁵ Against such meagre public expenditure, it should not come as a surprise that no meaningful poverty alleviation has occurred, nor has there been a stimulus for economic growth.

The paltry economic stimulus can be attributed in part to constraints imposed on Pakistan by the International Monetary Fund (IMF), which has been widely criticised for prescribing business-as-usual policies for emerging economies struggling with COVID-19. The Fund advised advanced economies to ramp up public investment and not worry about the sustainability of their public debt in the immediate outbreak of COVID-19, what can be described as the Fund's 'Keynesian moment'. But in the case of Pakistan, the IMF's focus has barely shifted from fiscal and external account consolidation.

The only growth initiative – which contained both fiscal and monetary elements – introduced by the government was for the housing and construction sector. There are several issues with the efficacy of this approach as a tool for growth revival. For starters,

unless there is a rise in real incomes, no real economic turnaround can come about regardless of the concessions granted to housing and construction. The government's economic recovery strategy focuses solely on the supply side hoping that dividends will 'trickle down'. There may be some increase in private construction, as evidenced by increased output of cement, but the impact of public sector investment in infrastructure would have created greater externalities for the economy and generated employment for a larger number of the poor. Recovery through private sector construction, in reality, appears to divert rents to builders and land speculators through a tax amnesty. Anecdotal evidence suggests that land speculation has increased precipitously in the months since the government's economic assistance package was announced.⁶

Given the focus on fiscal consolidation, the government's main economic thrust has come from the monetary side. This includes a reduction in the policy interest rate, liquidity support for the payroll for formal sector manufacturing, interest rate subsidy for capital investment, and a credit line for the housing and construction sector. In an environment of low effective demand and under-utilised capacity, is the recourse to monetary policy sufficient to

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<https://www.imf.org/en/News/Articles/2020/03/23/pr2098-imf-managing-director-statement-following-a-g20-ministerial-call-on-the-coronavirus-emergency>

⁶ See Khurram Husain, "The Great Covid Dole", Daily Dawn, March 4, 2021.

<https://www.dawn.com/news/1610608>

revive growth, address poverty and economic uncertainty during a global pandemic? To rehash some Keynesian theory, unless demand is created in an economy by injecting money from the fiscal side, monetary policy is not as effective as fiscal policy to address the challenges, although monetary levers can be used for stimulating demand. A multiplier needs to be created to increase aggregate demand, and pull the economy out of recession.⁷

The strategy to propel growth through monetary instruments is best exemplified by the recently circulated bill to enhance the independence of the State Bank of Pakistan (SBP). Purportedly carried out to assist with price stability, the SBP's independence initiative appears to be in line with IMF's austerity and fiscal consolidation agenda imposed on borrower nations. The bill – which has been put on the back burner for now after severe criticism from the opposition as well as independent economists – is insidious for several reasons.

Firstly, SBP's intention to not support the government's economic policies will invariably slow down post-COVID economic recovery, thereby negatively impacting the most vulnerable segments of society. Ultimately, who bears the brunt of economic policies in a

⁷ Keynesian theory holds that if an individual's income goes up after obtaining a job, there is increased consumption, which, in turn, raises the income of firms that sell consumer goods to newly employed people, further enabling those firms to

constitutional democracy is a decision that needs to be taken by the political leadership and not by technocrats. Second, there are serious political implications when SBP plans to focus on maintaining price stability when unemployment is already a grave social crisis. Third, IMF-SBP forcing austerity and fiscal consolidation on the Pakistani government, amid a pandemic no less, will impede the government's current and future ability to pay for public services like health, education and clean drinking water. Any ensuing social unrest would become a serious political challenge, and should be carefully be considered. Finally, and perhaps somewhat alarmingly, the new SBP bill all but does away with accountability for the central bank as the SBP leadership would not be answerable to even the Prime Minister of Pakistan. Holding such a *carte blanche* over autonomy can potentially create a situation where the SBP and the Pakistani government work at cross purposes.

While a fiscally driven Keynesian stimulus could be the preferred response to revive growth and address poverty in the economy, there is little traction for this – within government circles as well as among neo-liberal economists – as it is argued that it is debt creating. This explains the government's

create more jobs. Simply put, the final impact of an extra unit of money would be far greater than the initial amount injected into the economy.

oft repeated claim that it lacks the fiscal space for such manoeuvres. We argue that there are three distinct ways through which additional fiscal space may be created on the fiscal side:

(i) It is possible to re-prioritise expenditures in the short to the medium term. Some security related expenditure could be diverted towards a well-designed and appropriately targeted BISP/Ehsaas programme in the short to medium term, thereby injecting the necessary economic stimulus from the fiscal side. Recent statements by senior state officials underscore the importance of a robust economic system without which larger national security goals can get compromised.⁸

(ii) The fiscal envelope can also be enlarged through domestic borrowing. Where such additional borrowing adds to the stock of domestic debt, it is not as debilitating for the economy since a sovereign government can always roll over or service any loan in its own currency. Indeed, this is what economists like L. Randall Wray and Stephanie Kelton associated with the Modern Monetary Theory (MMT), school have argued. Injecting money from the fiscal side will bring about economic growth for the most

vulnerable segments, and the decreasing incidence of poverty will assist overall human development, thereby creating positive feedback for the economy through a healthier and more productive labour force.

(iii) Fiscal side injections through domestic borrowing invariably pay for themselves as well. They increase economic growth through the multiplier and Marginal Propensity to Consume effects.⁹ Economic growth will increase the size of the economic pie, and enlarge the revenue streams that come back to the state. In this sense, fiscal injections create additional space even after servicing domestically borrowed loans.

Conclusion

While COVID-19 continues to storm through Pakistan and region, the government can take some comfort in the fact that it has stabilised the economy in some measure, evidenced through a significant reduction in the current account deficit, build-up of foreign exchange reserves and a stable (in fact appreciating) exchange rate. However, the persistent increase in supply induced inflation raises legitimate

⁸ <https://www.dawn.com/news/1613207>

⁹ MPC refers to the ratio of change in aggregate consumption compared to change in aggregate income. In other words, MPC refers to portion of consumption in each additional unit of income. For example, if a certain person has a MPC of 0.6 then,

they are going to spend 60 paise out of additional 1 rupee in their income. People at the bottom of the socio-economic ladder—poor people, if you will—have high MPC because they tend to spend a higher fraction of their incomes on food, shelter, clothing and entertainment.

questions regarding the governance approach of the present government.

There appears to be a change in the tone and tenor on economic policy since the induction of new decision-makers. The newly appointed Finance Minister has spoken against some of the key tenets introduced by the IMF, such as a significant increase in electricity tariffs, removal of exemptions on export related taxes and unrealistic targets on revenue collection and fiscal deficit. In other words, the Finance Minister appears to be on track to abandon fiscal consolidation through increasing public sector spending and embark on another round of a consumption-led boom. Whether the IMF will allow these deviations while continuing the Program remains to be seen. This obviously raises the question why the government does not quit the IMF program; it certainly is in a comfortable position as far as external balances are concerned, and can tread the familiar growth path chosen by its predecessors over the last two decades.

However, as argued earlier, the growth path put forth by the new Finance Minister is not sustainable without addressing the structural bottlenecks outlined above. While budgets usually have a short time horizon, it is an appropriate time to initiate medium and long term structural changes in the economy also. Based on the discussion above, we will put forth short, medium and long term policy proposals.

1. Short run expenditure on social protection through BISP/Ehsaas should be doubled – from 0.5% to 1 % of GDP. With successive Covid-19 waves still raging, this will protect those impacted directly or indirectly by the pandemic and create demand through the MPC affect. For this to be effective, the transfer through BISP/Ehsaas should use geographical targeting for lockdowns. Recent discussions on increasing development spending needs to be reflected in the budget also. Usually development spending gets the first axe when deficits start bloating. This temptation should be resisted because the positive externalities of development spending – in terms of employment creation and replenishing depleted infrastructure – are large. This is certainly a better route to employment creation than through private sector amnesty schemes for a construction. The budget should also present a medium term plan to incrementally broaden the tax base based on principles of progressivity. Successive governments – including the present one – have hitherto failed to pursue this path, which is central to turning the tide on sustainable macro-economic stability and growth in the country.

2. Another medium term target for the budget is a credible, realistic and fair plan on reducing circular debt. Non-credible agreements with IPPs – and that too through stealth – is a non-starter. It only goes to damage sovereign credibility for foreign investors and

opens the door for international arbitrations. Instead, the focus should be on structural changes in the transmission and distribution sectors to reduce line losses and theft. These structural changes can take many forms – from complete privatisation to re-nationalisation of the distribution network – but it is important this issue is addressed in its entirety over the medium term.

3. Long run growth and development requires robust commodity producing sectors and a high rate of investment in the economy. Over the last three decades, Pakistan’s agricultural and manufacturing sectors have both stagnated. Clearly thought out and enforceable agricultural and industrial policies have to be put in place. Recent episodes of food price inflation have brought to the fore the need for food security. Similarly, to take Pakistan out of its long run stagnation in exports requires an industrial policy that can enable the country to diversify its exports and become competitive across a range of products. An industrial policy that allocates resources towards productive sectors and creates competitive niches is imperative for both employment creation and reducing external account vulnerability over time. It goes without saying that a robust and sustainable economy will need doubling of the investment-GDP ratio in the country, which in turn requires removing structural hurdles that are mostly political in nature.

Ultimately, overcoming structural bottlenecks necessary for sustainable growth and development in Pakistan requires an inclusive, democratic and federal political settlement. Only under such a settlement can rational policies appropriately aggregate societal interests and be pursued over a period of time.

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