Macroeconomic Brief

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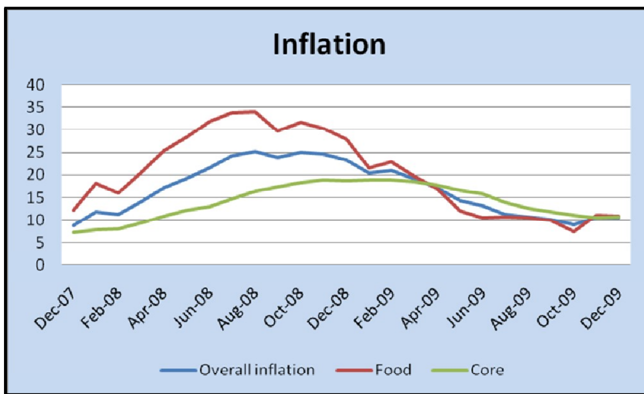
Buffeted by back-to-back external shocks and internal challenges during the past couple of years, Pakistan's economy has begun to show some signs of improvement: inflationary pressures have eased; the current account balance has improved significantly; and the fiscal deficit has narrowed down to 5.2 percent of GDP, a decline of about thirty percent in 2008-09. Despite these signs of recovery, however, growth prospects for 2009-10 remain grim as the economy continues to face serious challenges on both external and domestic fronts. There is, therefore, a need to gear macroeconomic policies towards consolidating the nascent recovery while at the same time laying the foundations of sustainable growth.

The global financial crisis hit Pakistan at a time when the economy was reeling from severe macroeconomic imbalances resulting from the unprecedented hike in oil and other commodity prices. The global financial and economic meltdown combined with crippling power crisis and the security environment exacerbated Pakistan's woes as economic growth slowed down sharply, foreign exchange reserves dwindled, and foreign capital inflows dried up. The surging fiscal and current account deficits, and unavailability of other external financing options forced the government to sign a stand-by agreement with the IMF in November 2008 to achieve macroeconomic stability through fiscal consolidation and monetary tightening. Ironically, when the rest of the world was slashing discount rates and providing fiscal stimuli the Pakistani government revised the PSDP (2008-09) downwards by 150 billion rupees and the SBP kept the policy discount rate at a high of 15 percent.

These stabilisation policies were fairly successful in bringing about some semblance of macroeconomic stability as economic fundamentals improved. Consequently, the government relaxed its stance toward stabilisation and moved toward economic stimulus through a more expansionary fiscal policy coupled with a relative easing of monetary policy. Questions, however, remain regarding sustainability of macroeconomic stabilisation and availability of fiscal space for economic stimulus.

Various economic indicators have shown volatile behaviour in the recent past. Inflation touched the single digit in October 2009, after a marathon run of double digit inflation for twenty one months, only to rise again in November. Manufacturing sector posted positive growth for July (0.63 percent) and August (1.3 percent), went in the negative zone in September (–2.6 percent), and rose again in October (5 percent). Tax collection as a percentage of GDP actually declined, raising questions about availability of much needed fiscal space for economic stimulus.[1] It is our considered opinion that the economic recovery is uncertain and the situation warrants caution in changing gear from stabilisation to stimulus.

[1]Tax revenues as a percentage of GDP have declined to 9% in fiscal year 2008-09 from 9.8 percent during 2007-08.



After following a tight monetary policy under the Stand-by Agreement with the IMF for about six months the SBP has been on a path of steadily lowering the discount rate. This revision was basically premised on ‘substantial improvements’ in multiple indicators—the downward trend in inflation; the improving current account balance; domestic demand contraction; and positive trends in the real sector. The expectation that inflation will remain in single digit is, however, quite unrealistic in view of the rising international commodity prices, recent increase in domestic power and gas tariffs, and the dismal performance of the real sector. To provide further impetus to the sluggish economy, the SBP again revised the policy rate downwards by 50 basis points to 12.5 percent in November 2009. This easing of monetary policy without taking care of supply-side bottlenecks is likely to build inflationary pressures in the economy.

Fiscal activism is also evident as PSDP for 2009-10 (421 billion rupees) is almost twice the PSDP for 2008-09 (219 billion rupees, revised). Total expenditure in the first quarter of FY 10 increased by about 25 percent compared to the same period last year.[2] This fiscal expansion is worrisome, especially when efforts to raise additional sources of revenue have not borne fruit[3]. Increased government expenditure in the past two quarters on account of war on terror, the IDPs and ambitious expenditure outlays by provinces combined with lax taxation efforts do not bode well for fiscal consolidation. Continued dependence on external sources of finance in an environment where global economic recovery is sluggish adds to uncertainties regarding the financing and size of fiscal deficit.

A look at some key macroeconomic indicators presents a worrying picture. Inflation remains stubborn even today. Inflation has receded in recent months on account of strong base effect of the fiscal year 2008-09, and this effect is expected to phase out by early 2010. Monthly Consumer Price Index (CPI) reveals a constant upward trend, though December 2009 witnessed a slight decline in the index.[4] The recent increase in the electricity and gas tariffs will exert an upward pressure on general price level. So, in all fairness, inflationary pressures will build up again. It is interesting to note that the present policy stance completely disregards the supply-side imperfections that inhibit price adjustments in domestic markets. The wheat crisis during Ramadan and the present sugar crisis reflect governance issues (cartelisation, hoarding) in the domestic supply chain and cannot be tackled through monetary policy alone. The support price mechanism also needs review. Last year, the support price for wheat was fixed at Rs 950 per mound when international wheat prices

Box 1. Is It Time to Ease Monetary Policy?

The recent improvement in some macroeconomic indicators has prompted many to call for a loosening of monetary policy to revive economic growth. It is argued that continuing the tight monetary policy would unnecessarily prolong a lending squeeze and hence choke the process of economic growth. With the limited fiscal space, the onus of stimulating the economy falls squarely on monetary policy. However, given the persistent inflationary pressures, a premature relaxation of monetary policy may derail the fragile economic recovery and stall economic growth. What is needed at this time is prudent macroeconomic management to consolidate macroeconomic stability on the one hand and to address supply side constraints that have marred the performance of the real sector, on the other.

[2] While much of this increase is accounted for by the doubling of development expenditure, the current expenditure also rose by 14 percent.

[3] Total tax collection as a percentage of GDP declined from 2.1 percent in Q1of FY09 to 2 percent for Q1of FY10.

[4] The index declined by 1 percent (m-o-m) during December, but it has witnessed decline during November 2008–January 2009 only to rise again.

were going down, without realising its impact on inflation later on. Further, controlling inflation has been problematic due to depreciation of Pakistani rupee, which inhibited pass through of lowered international oil and other commodity prices to domestic consumers in the aftermath of global economic crisis. These prices are showing upward trend again, therefore domestic prices will become under pressure even more.

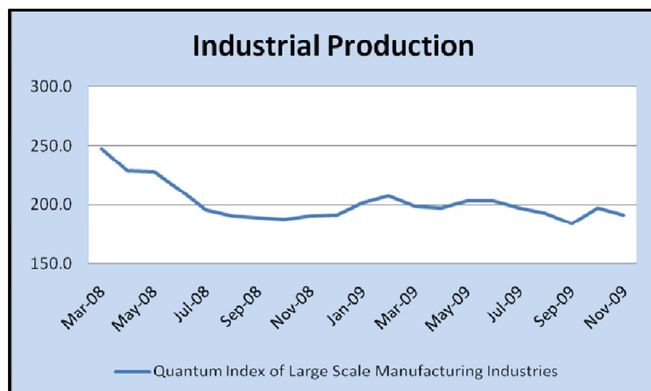
The credit to private sector shows marginal improvement in recent months, but Y-o-Y average shows a contraction of three percent in credit off-take during November. Though total domestic credit expanded by eight percent, the expansion is accounted for by increased allocation of resources for government budgetry support; thus crowding out credit to private sector.

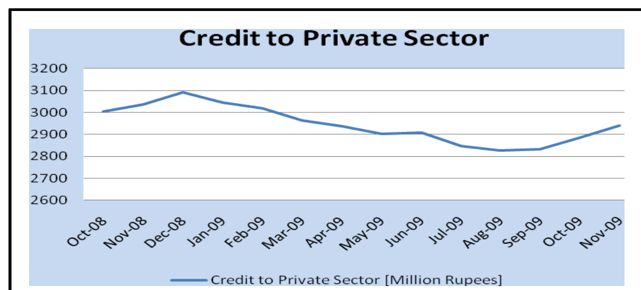
Box 2. Reviving Growth

The growth strategy should encompass both macroeconomic and development policies that may help the economy to sustain robust growth, create more and better jobs, and alleviate poverty. An overriding goal of macroeconomic policies should be to ensure a stable macroeconomic environment that encourages private investment and hence economic growth. Prudent fiscal and monetary policies must be designed so as to avoid the build-up of macroeconomic imbalances that ultimately hamper the growth process. In a shorter term perspective, development policies need to focus on social safety nets as well as on programmes to empower the poor through skill development and productivity improvement. In the long-run, a key challenge is to enhance competitiveness and productivity. This can be achieved by focusing efforts on several key areas including human resource development, technological advancement, physical infrastructure, regulatory and legal environment, export diversification, and institutions and governance.

Source: Musleh ud Din (2010) Global Financial Crisis: Implications for Macroeconomic and Development Policies in Pakistan. Paper presented at the Annual GDN Conference, Prague, January 2010.

The industrial production has shown some recovery during July-November 2009: the Quantum Index Number of Large Scale Manufacturing Industries [QIM] shows positive growth (0.7 percent, Y-o-Y), arresting the downward slide of the index for thirteen months in a row. However, a combination of factors including continued power outages and tariff hike, increased cost of imported raw materials, the law and order situation, and depressed external demand pose significant risks to a lasting recovery in the industrial sector.

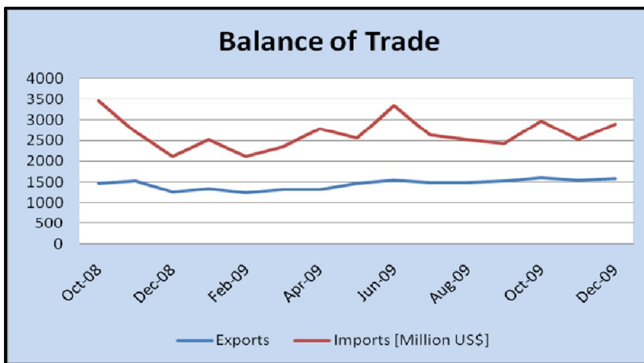


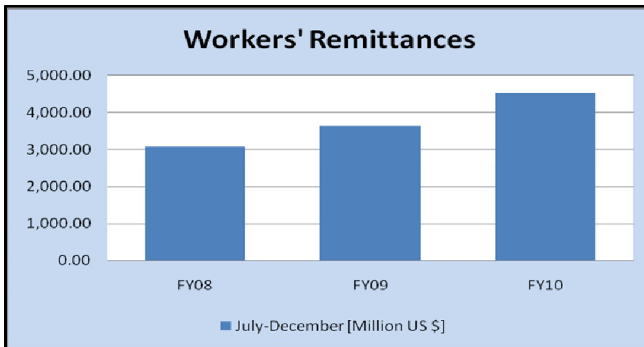


Current account balance showed remarkable improvement in the first quarter of fiscal year 2009-10, declining to $532 million from $4.26 billion during the same period a year ago. In fact, the deficit narrowed down from its peak in October 2008 to post a surplus in September 2009. There are two warning signs in this development. First, much of this improvement owes to a surge in the foreign remittances. Questions arise regarding sustainability and origin of this unusual phenomenon.[5] Second, trade gap is beginning to widen again as import growth has outstripped growth in exports in December 2009 on a year-on-year basis.[6]

[5]Remittances have seen a decline in recent months from US$ 806 million in September 2009 US$ 743 million in November 2009.

[6]Trade deficit declined by 29.6% during Q1-FY10, but the gap for December 2009 grew by 53% (Y-o-Y).

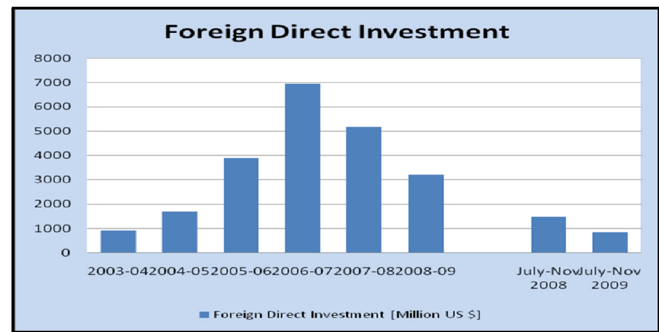




Import of textile machinery has taken a hit, which is 32 percent lower for July-November 2009 as compared to the same period the previous year, implying sluggish economic activity in our main export sector.[7] High cost of inputs, power crisis and dampened external demand pose substantial barriers for rapid recovery of exports. Meanwhile, imports are likely to increase due to upward trend in the oil and other commodity prices, and expansion in domestic demand.

Pakistan's external liabilities soared by almost US$ 3 billion during the first quarter. This does not augur well for the fiscal balance in future. If the increase in external debt remains consistently unmatched by GDP growth and foreign exchange earnings, then Pakistan may once again face debt servicing difficulties, similar to that of the late nineties, when a major part of taxation revenues were being eaten up by debt servicing. This complexity is compounded by the fact that foreign direct investment has dried up due to weak economic growth globally and law and order situation in Pakistan.

[7] On a month-on-month basis, import of textile machinery has picked up, but growth remained negative during this period on a year-on-year basis.



On the whole, the economy continues to face problems on internal as well as external front. Internal structural problems persist in the form of power shortages, law and order situation, and absence of domestically garnered resources. External situation is not optimistic as global economic recovery continues to remain weak, not boding well for our exports and availability of external finance. Overall, persistent inflation, sluggish activity in the real sector, internal security environment and weak recovery in the global economy present a challanging environment for reviving growth. Yet there is a silver lining on the horizon as the emerging macroeconomic stability would help improve macroeconomic fundamentals and restore investor confidence thus providing a basis for durable recovery. However, a balancing act is required on part of the government to keep its stabilisation policies on track while giving impetus to economic activities.

Prepared by
Lubna Hasan and Musleh ud Din

Macroeconomic Brief
Pakistan Institute of Development Economics
Quaid-i-Azam University Campus
P.O. Box 1091
Islamabad 44000, Pakistan

Tel. +92-51-9248027, 9248059
Fax. +92-51-9248065
E-mail: muslehuddin@pide.org.pk / lubna@pide.org.pk
Web: www.pide.org.pk

Sources: The data for the graphs are taken from the State Bank of Pakistan, *Monthly Statistical Bulletins* (Various Issues). Inflation figures for December 2009 are taken from Federal Bureau of Statistics, *Review of Price Indices of December 2009*. Quantum Index Number of Large Scale Manufacturing Industries November 2009 is from Federal Bureau of Statistics, *Provisional Quantum Index Numbers of Large Scale Manufacturing Industries (QIM) for November 2009, and July-November 2009-2010*. Balance of Trade December 2009 figures are taken from the Federal Bureau of Statistics, *Monthly Review of External Trade Statistics of December 2009*.