

PRESENTATION ON 'FISCAL POLICY IN A DEFLATIONARY ENVIRONMENT'

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Outline Of The Presentation

What is Deflation?

Has Pakistan Landed in Deflation?

Consequences of Deflation

Fiscal Policy in Deflationary Environment

Expenditure Policy

Perverse Incentive

conclusions

DEFLATION

❖ What is Deflation

❖ What Causes Deflation

- Lack of domestic demand
- Decline in purchasing power of the people

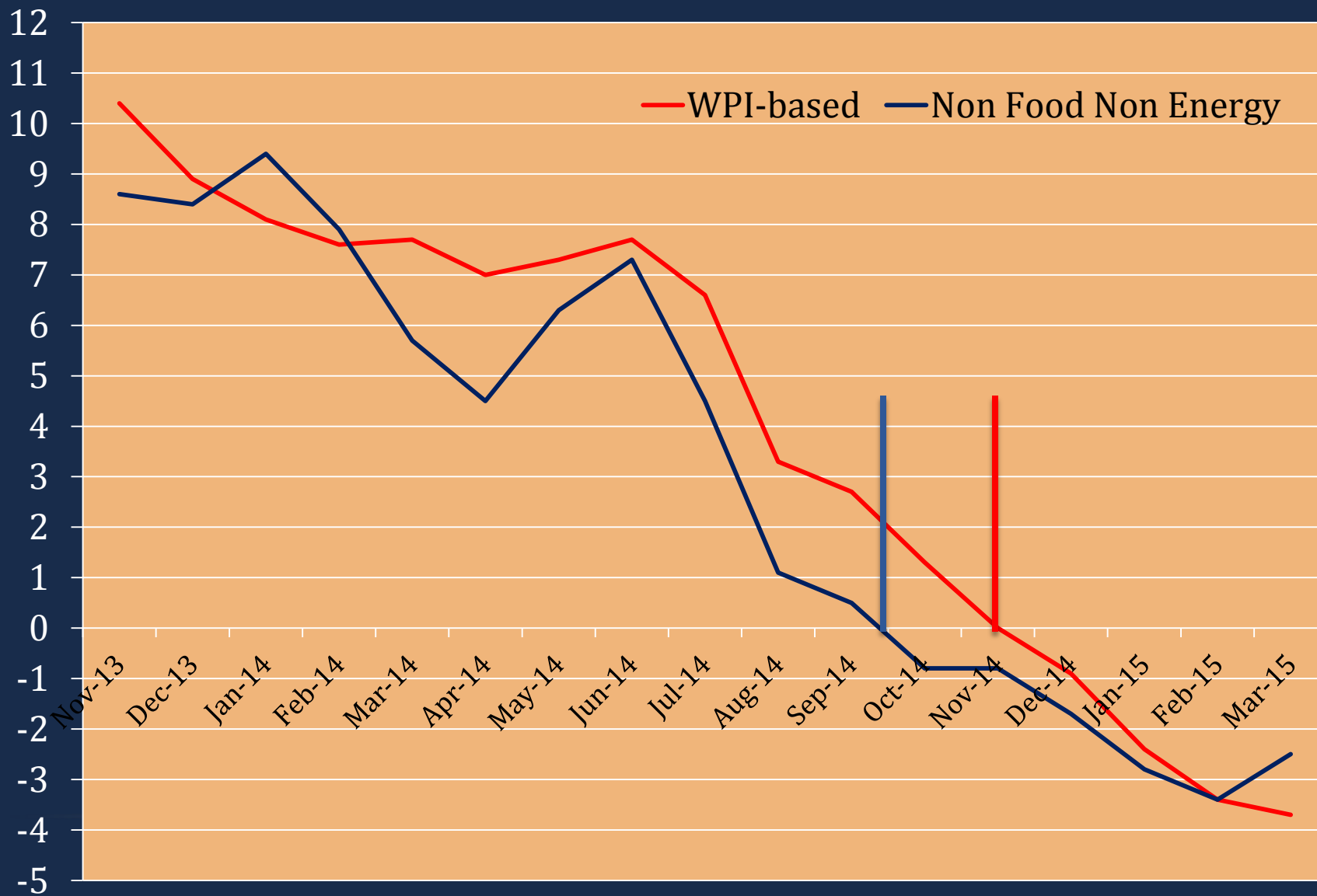
❖ Consequences of Deflation

- Disincentives for businesses to expand their operation
- Decline in borrowing of the private sector
- Decline in Investment rate
- Slow Down of Economic Growth

DEFLATION: INFLATION TURNING NEGATIVE

Years	WPI-based	Non Food Non Energy
Nov-13	10.4	8.6
Dec-13	8.9	8.4
Jan-14	8.1	9.4
Feb-14	7.6	7.9
Mar-14	7.7	5.7
Apr-14	7	4.5
May-14	7.3	6.3
Jun-14	7.7	7.3
Jul-14	6.6	4.5
Aug-14	3.3	1.1
Sep-14	2.7	0.5
Oct-14	1.3	-0.8
Nov-14	0	-0.8
Dec-14	-0.9	-1.7
Jan-15	-2.4	-2.8
Feb-15	-3.4	-3.4
Mar-15	-3.7	-2.5

DEFLATION



CONSEQUENCES OF DEFLATION

- ◆ Deflation is a rare phenomenon that does not occur in the course of normal economic cycle
- ◆ Existence of Deflation signals that something has severely gone wrong with the economy
- ◆ In Deflationary phase
 - Economic activity slows
 - Domestic demand becomes weaker
 - Economy fails to generate sufficient jobs
 - Unemployment and Poverty Rise
 - Private sector do not expand businesses as prices of their products fall and hence, their profitability is down
 - Investment declines which further slows economic growth

◆ **Such an economic environment breeds**

- Civil unrest
- Social chaos
- Breakdown of law and order
- Weakening of the writ of the state

◆ What is happening in the economy?

- Exports are falling. Exports are down by 13% in February 2015; down by 5% in July – February 2014-15
- LSM growth for the month of January 2015 is 1.1% and 2.2% in July – January 2014-15
- Imports are down by almost 8% in February and 3.8% in July – February 2014-15.
- Growth in tax collection is only 13% in July – February 2014-15; less than one – half the growth required to achieve the re-revised revenue target. Performance in the month of March is even worse
- Sales tax at domestic stage (whose tax base is domestic demand) has collapsed altogether. It has grown by 0.5 percent in July – February 2014-15

- Private sector is shy and reduced its borrowing from commercial banks to less than one – half level of last year. In other words, private sector is not expanding its operations
- All these statistics say one thing. The economy has slowed compared with last year.
- Pakistan's Economy has been growing in the range of 3.0 – 3.5 percent p.a over the last six/seven years. Unemployment, particularly youth unemployment is on the rise. Young university graduates are finding difficulties in getting jobs.
- The anger and frustration of youth are visible in every nook and corner of Pakistan

◆ What Kind of Fiscal Policy Required?

- Stabilization First and Growth Later

or

- Job-rich growth
- The current IMF Program has forced Pakistan to suffocate its economy. Too much fixation on budget deficit. In the process we have destroyed revenue and budget deficit statistics.
- John Maynard Keynes stated in 1937 that “*the boom, not the slum, is the right time for austerity at the treasury*”
- G-20 nations also advocating for job-rich growth and stabilization later
- In 2003, the IMF arranged a symposium at its headquarters to deal with deflationary threat. Consensus emerged to pursue easy monetary policy and expansionary fiscal policy to take the economy out of deflation.

- ◆ Why this policy has not been suggested for Pakistan? Is it IMF or EMF?
- ◆ Macroeconomic policies should not focus narrowly on reducing budget deficit. Policies should be supportive of growth and employment generation.

- ◆ How to design fiscal policy to achieve developmental goals of macroeconomic policies?
 - One thing has to be noted. Such macroeconomic policies do not in any way advocate lax fiscal policy or encourage fiscal indiscipline.
 - Rather they give greater emphasis to domestic resource mobilization and quality of expenditure
- ◆ Domestic resource mobilization through
 - Tax system and tax administration reform
 - Broadening tax bases
 - Improving efficiency of tax administration through training and retraining
 - Tightening regulation on tax heavens

◆ Composition and quality of expenditure

- greater budgetary allocation to

- education

- Health

- social safety nets

- skill developments

} Human Capital

- infrastructure

- roads and highways

- communication

- energy

} Physical Infrastructure

- ◆ For the purpose of development what matters is where and how fiscal deficit is being spent
 - Is it spent on building human Capital that would improve productivity and hence growth?
 - Is it spent on building or strengthening physical infrastructure that could contribute to promoting growth and employment generation
 - Is it spent to support poorer segment of society
- ◆ If the answer is yes! Public debt, even though it is high and rising in the short-term, would be sustainable.
- ◆ As long as fiscal deficit is being used to enhance debt carrying capacity of the country, higher and rising debt is not a burden to the economy
- ◆ It is important to note that public debt does not contribute positively to growth contemporaneously, its contribution to growth comes with a lag
- ◆ Public debt – to – GDP ratio therefore, may rise in the short-term

- ◆ Countries that often face serious debt problem are the ones that failed to mobilize domestic resources or that failed to enhance tax – to – GDP ratio on the one hand and never bothered to scrutinize the composition or quality of expenditure
- ◆ The rising debt caused serious balance of payment crisis (for example Pakistan, Euro zone). Countries landed in IMF program, implemented stabilization first policy and experienced low economic growth and human sufferings
- ◆ Bottom line: from the perspective of addressing deflationary environment, overall fiscal deficit or public debt matters for short – term macroeconomic stability
 - But for development purpose, what matters most is where the fiscal deficit is being spent.
 - Domestic resource mobilization and quality of expenditure are key to achieving developmental goals of macroeconomic policies.

◆ Perverse Incentives

- Giving Incentives to provinces for not spending money
- Encouraging provinces to not to clear bank loan for financing commodity operations

◆ Conclusions

- Pakistan's economy has landed in deflation. Expansionary fiscal policy is required to take the economy out of deflation
- Macroeconomic Policies should not focus narrowly on reducing budget deficit policies should be supportive of growth and job creation.

THANK YOU

