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A MEDIUM-TERM MACROECONOMIC FRAMEWORK FOR PAKISTAN

SOCIAL POLICY AND DEVELOPMENT CENTRE

A MEDIUM-TERM MACROECONOMIC FRAMEWORK FOR PAKISTAN

By

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The objective of this paper is to develop a macroeconomic framework for Pakistan upto the year 2000-03, the last year of the Nineth Plan period. This framework attempts to raise the growth rate of the economy while recognising the limits to growth placed by the level of investment and savings and the ability to finance external transactions.

Section II reviews the growth performance of the economy and highlights the role of different factors in bringing down the growth rate. Section III focuses on the prospects for 1999-2000. Section IV and V contain projections of the balance of payments and public finances respectively upto 2002-03. Section VI gives the implied projections for savings and investment. Section VII derives the projected growth path for Pakistan's economy. Section VII brings together all the key policy implications and the conclusions emerging from the analysis.

II MACROECONOMIC TRENDS

During the decade of the 80s, Pakistan's economy averaged a growth rate of 6 per cent. This fell to 5 per cent in the first half of the decade of the 90s and declined further to an annual average growth rate of 4 per cent after 1994-95. During the last year, 1998-99, the growth rate was 3 per cent. Therefore, there is clear and perceptible evidence that the growth performance of Pakistan's economy has been

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deteriorating over time. Perhaps the principal task confronting planners and policy makers is that of restoring the growth momentum once again.

Table 1 highlights the trends in key macroeconomic indicators. The level of fixed investment averaged 16 per cent of the GDP in the 80s, which actually increased in the first half of the decade of the 90s to almost 18 per cent of GDP. But the growth rate declined to an average of 5 per cent from 6 per cent. This is probably largely due to a loss of momentum in the manufacturing and service sectors. In the second half of the current decade the rate of investment has sharply declined to 15 per cent of GDP, culminating in a steep fall in 1998-99 to about 13 per cent of the GDP following the nuclear blasts and imposition of sanctions. Much of the decline in the rate of investment from 1994-95 to 1997-98 is due to lower public investment while the fall in 1998-99 is also partly due to a fall in private investment.

The second half decade of the 90s has also witnessed a sharp fall in the rate of national savings, which is already low. By 1998-99 it has declined to about 12 per cent of the GDP compared to an average of 15 per cent in the first half of the decade. Bulk of the decline is in public savings.

The second half of the decade has, however, witnessed somewhat greater macroeconomic stabilisation perhaps at the cost of higher growth, as indicated by the fall in public investment. Throughout the

TABLE 1
KEY MACROECONOMIC INDICATORS FOR PAKISTAN'S ECONOMY

	Indicators	Unit	Decade of 80s[a]	First Half of 90s[b]	Second Half of 90s[c]	1998-99
1.	GDP Growth Rate	%	6.1	5.1	4.0	3.1
2.	Sectoral Growth Rates:					
	Agriculture	%	4.1	4.2	4.0	0.4
	Manufacturing	%	8.2	5.7	4.7	4.7
	Services	%	6.6	5.1	4.0	4.1
3.	Level of Fixed Investment	% of GDP	15.8	17.8	15.4	13.4
	Public Investment	% of GDP	8.6	8.5	6.2	5.0
	Private Investment	% of GDP	7.2	9.3	9.1	8.4
4.	Level of National Savings	% of GDP	13.8	14.8	12.2	12.2
	Public Savings	% of GDP	1.1	2.3	1.5	1.0
	Private Savings	% of GDP	12.7	12.5	10.7	11.2
5.	Current Account Deficit	% of GDP	3.9	4.5	4.6	2.7
6.	Growth of Exports	%	8.5	9.9	-0.4	-10.2
7.	Budget Deficit	% of GDP	7.0	7.1	5.7	4.5[?]
8.	Rate of Inflation	%	7.3	11.5	9.0	5.7

[?] excluding once-and-for-all revenue receipts

[a] average for 1980-81 to 1989-90
[b] average for 1990-91 to 1994-95
[c] average for 1994-95 to 1998-99

Source: Pakistan Economic Survey
SBP Annual Reports

decade of the 90s the current account deficit has averaged at about 4½ per cent of the GDP, with a steep fall in 1998-99 to below 3 per cent of GDP due primarily to containment of imports and sharp decline in oil prices. The budget deficit has also declined steadily from about 7 per cent of the GDP in the first half of the decade to 4.5 per cent of the GDP in 1998-99. This alongwith the debt retirement has been a major factor contributing to containment of inflationary pressures, and the rate of inflation has fallen to below 6 per cent by 1998-99.

III PROSPECTS FOR 1999-2000

What are the short-run prospects for 1999-2000? On the basis of information available for the first six months of the year it appears that there will be some improvement in the growth performance with the growth rate rising to over 4 per cent (see Table 2). However, this is not attributable to any major increase in the level of investment but due primarily to better crop outputs, especially of cotton and rice. The level of production of the former is estimated to have increased from 8.8 million bales in 1998-99 to almost 10.7 million bales this year. If at all, the overall level of fixed investment may even fall somewhat from the already depressed level of 1998-99. Private investor confidence remains low in the aftermath of the sanctions and various measures taken by the government in 1998 including the freezing of foreign currency accounts, imposition of capital controls and imports margin requirements. The transition to a military government and the launching of an accountability, debt and tax recovery drive have heightened the uncertainty and made investors perhaps more shy. The recent reduction in interest rates may not provide a significant stimulus in the absence of restoration of investor confidence. Foreign

TABLE 2
MACROECONOMIC PROSPECTS FOR 1999-2000

Indicators	Unit	1998-99 (Actual)	1999-2000 (Projected)
1. GDP Growth Rate	%	3.1	4.0 - 5.0
2. Sectoral Growth Rates:			
Agriculture	%	0.4	3.8 - 4.8
Manufacturing	%	4.7	4.2 - 5.2
Services	%	4.1	4.0 - 5.0
3. Level of Fixed Investment	% of GDP	13.4	13.0
Public Investment	% of GDP	5.0	5.0
Private Investment	% of GDP	8.4	8.0
4. Level of National Savings	% of GDP	12.2	10.6
Public Savings	% of GDP	1.0	1.1
Private Savings	% of GDP	11.2	9.5
5. Current Account Deficit	% of GDP	2.7	4.0
6. Budget Deficit	% of GDP	4.5	3.5 - 4.0
7. Rate of Inflation	%	5.7	5. 0 - 6.0

private investment has been low in the absence of resolution of the IPP's problem and uncertainty about future policies. Two indicators, viz., the level of private sector credit demand in the banking sector (down by 59 per cent) and the level of import of capital goods (down 6 per cent in the first six months) point to a significant decline in domestic investment in the first six months. It will not be surprising if the already low level of fixed private investment of 8½ per cent of the GDP in 1998-99 falls to below 8 per cent in 1999-2000.

The short-run outlook for public investment is also not promising. In an effort to achieve the budget deficit target imposed by the IMF the government may be compelled to reduce the size of the Public Sector Development Program in the face of revenue shortfalls. There is already some speculation that the PSDP for 1999-2000 is being reduced by about 0.5 per cent of the GDP, from Rs 116 billion to Rs 100 billion. If the overall level of public investment can be sustained at 5 per cent of the GDP then this would represent an achievement given the resource constraints. Altogether, even though the growth rate may improve this year due primarily to higher agricultural productivity, and improved export performance, prospects of growth in subsequent years are dampened by the falling level of investment in the economy.

The large-scale manufacturing sector has exhibited relative dynamism in the first few months of 1999-2000 with the monthly growth rate hovering around 6 per cent. This is supported by higher level of imports of industrial raw materials (up by about 6 per cent in the first six months) and faster growth of manufactured exports, especially textiles (increase of 16 per cent in the first six months). This implies that rates of capacity utilisation have probably improved in sectors like steel, chemicals, cement and textiles. However, the performance for the year as a whole will hinge on sustaining the growth in the domestic market in the face of depressed demand conditions and in maintaining the improved export performance in the face of relatively low international prices and an increasingly overvalued exchange rate. Of particular importance in this context is the performance of the sugar industry in 1999-2000 which is already showing signs of production bottlenecks.

On the fiscal side, tax revenues of CBR have started once again, registering a growth rate of over 20 per cent in the first months. However, much of the buoyancy is concentrated in the general sales tax, (growth of 78 per cent) due to enhancement in the standard rate (from 12.5 to 15 per cent) and a major attempt at broad-basing. Growth in customs duties reflects the higher level of imports despite the fall in tariffs. The government has set an ambitious target of growth in CBR revenues in 1999-2000 of over 23 per cent. Unless the economy grows even faster in the second half of the year it is unlikely that the target will be achieved. Non-tax revenues also appear uncertain given the prospect of lower SBP profits due to falling interest rates, the threat posed to revenues from the petroleum development surcharge due to the underlying increase in international prices and the inability of WAPDA and other public enterprises to honor their debt servicing obligations with the federal government.

On the expenditure side, the government has tried to economise on costs of debt servicing at the margin by reducing sharply the rates of return on government savings schemes. In addition a cut of Rs 7 billion has been announced in defence expenditure, but this is expected to finance the poverty alleviation program launched by the Chief Executive. As mentioned earlier, some cuts are expected also in the size of the PSDP. Overall, it appears that the government will have difficulty in achieving the budget deficit target agreed with the IMF of 3.5 per cent of GDP. Instead, a more realistic estimate is closer to 4 per cent.

The rate of inflation continues to fall sharply. In the first three months of the year the inflation rate on an annualised basis was close to 3 per cent, the lowest rate for a very long time. While this can be interpreted as a positive feature of the economic performance it has been argued that this is a reflection of deep on-going recession in the economy with slackness in aggregate demand. Last year the growth in money supply was only 6 per cent, due primarily to less borrowing from the banking system by the government as a consequence of debt retirement following the relief on external debt repayments. This is exerting, with a lag, a downward pressure on the rate of inflation. In addition, the exchange rate has remained virtually stable in nominal terms during the last six months. However, administered prices have been raised significantly recently in the case of wheat, gas and petroleum products. This will begin to impact on the general price level in coming months. As such, the year is likely to close with inflation at about 5 to 6 per cent.

Perhaps the most adverse development in 1999-2000 is likely to be the major deterioration in the current account deficit. This had been reduced substantially in 1998-99 by forcing a degree of import compression and by the improvement in terms of trade (of almost 6 per cent) due to the unprecedented fall in oil prices. During the first six months of the current year exports have begun to grow (by about 7 per cent) after a long period of stagnation, but this improvement has been overshadowed by the steep rise in imports (of over 11 per cent) following the withdrawal of import restrictions and as a consequence of the precipitous increase in oil prices. Consequently, the trade deficit has increased by 39 per cent in the first six months over the level attained last year. Coupled with a continuing decline in home remittances (of 11 per cent) and reduced inflows into FCAs it is estimated now that the current account deficit could approach the level of 4 per cent of the GDP, equivalent to over $ 2.5 billion.

The sharp increase in current account deficit from $ 1.8 billion in 1998-99 to $ 2.5 billion in 1999-2000 is expected to be financed by a depletion of reserves of about $ 300 million and the remainder from exceptional financing in the form of debt relief and roll over of swap funds, etc. In fact, the quantum of exceptional financing in 1999-2000 is large at over $ 5 billion, with the major part of it being used to finance a deficit of $ 2.8 billion in the capital account, arising from the conversion of non-resident FCAs, etc.

Similarly, in 1998-99 the balance of payments was sustained by exceptional financing of over $ 4 billion, which not only financed both the current and capital account deficits but enabled a reserve build up of $ 1.2 billion. The worsening of the current account deficit position in 1999-2000, due to factors which may persist for some time like limited growth in exports, larger imports due to higher oil prices, lower remittances and inflows into FCAs because of loss of confidence, and the fact that the period of debt relief expires in December 2000, beyond which there is currently no prospect of exceptional financing, raises the fundamental issue of future sustainability of Pakistan's external payments.

The current account deficit has represented the quantum of foreign savings flowing into the economy to finance investment. During the 90s it has financed almost 25 per cent of the investment in the economy. Beyond 2000 - 2001, when the present round of debt relief negotiated with the Clubs of Paris and London comes to an end Pakistan will have very serious difficulty in closing the gap in its balance of payments. If the capital account surplus is small, due to difficulties in accessing to international capital markets because of low credit ratings and continued shyness of foreign investors, then the current account deficit will have to be contained through strong import compression in the absence of rapid growth in exports. This will severely limit the inflow of foreign savings and constrain the overall level of investment in the economy, unless domestic savings rise dramatically. The lack of investment funds will eventually impact on the growth rate of the economy. Clearly, in coming years the state of Pakistan's balance of payments will have a vital bearing on the growth performance of the economy. We focus on projections of the balance of payments upto the year 2002-03 in the next section.

IV PROJECTIONS OF BALANCE OF PAYMENTS

A summary of the balance of payments projections for the period 1999-2000 to 2002-03 is given in Table 3. These projections can be classified as optimistic because they assume relatively high growth rates in exports, home remittances, foreign direct investment, etc., and only modest growth in imports. In the case of merchandise exports, growth is assumed at 10 per cent (as compared to 7 per cent achieved in the first six months) in 1999-2000, followed by 7 per cent annually thereafter. Achievement of such growth rates will replicate the high level of buoyancy in exports during the decade of the 80s and in the first half of the current decade. It will require an appropriate exchange rate policy which seeks at the minimum to avoid any decline in the real effective exchange rate and strong institutional measures to both widen and deepen the export base. It will also require a world trade environment characterised by improvements in international prices for traditional Pakistani exports of rise, cotton and textiles, etc.

TABLE 3
PROJECTIONS OF THE BALANCE OF PAYMENTS UPTO 2002-03

($ Million)

	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003
Trade Balance	-1774	-2000	-1700	-1500	-1100
Exports (f.o.b)	7571	8300	8900	9500	10200
Imports (f.o.b)	9345	10300	10600	11000	11300
Invisible Balance	-2	-550	-400	-300	-100
Current Account Deficit (-)	-1776	-2550	-2100	-1800	-1200
Capital Account Surplus (+) / Deficit (-)	-1067	-2822	-401	900	1100
Exceptional Financing	4097	5072	701	0	0
Overall Balance of Payments	1254	-300	-1800	-900	-100
Additional Financing Required to keep reserves constant?	)	)	1800	900	100
Level of Foreign Exchange Reserves	1740	1440	1440	1440	1440

? At the level prevailing at end of 1999-2000
?? Recent estimates by the Statistical Supplement of the Pakistan Economic Survey indicate that the current account deficit in 1998-99 was lower at $ 1340 million
Source: SBP projections, modified in light of recent estimates.

Imports are expected to grow by 10 per cent (as compared to 11 per cent in the first six months) in 1999-2000 due primarily to the upsurge in prices of oil imports. Subsequently, growth is assumed at about 3 per cent annually. This path becomes more feasible if oil prices start falling from the peak level attained in 1999-2000. However, for import growth to be constrained on a sustained basis, at the minimum a degree of targeted import compression will have to be achieved in a three year framework in Pakistan's major imports of wheat, fertilizer, edible oil and petroleum products. For vigorous import substitution in these areas appropriate pricing and protection policies will have to be designed to encourage domestic production (e.g. gas to substitute for furnace oil in power generation).

As far as the balance of invisibles in the current account is concerned, there was virtually no deficit in 1998-99. This was achieved by at least temporarily transferring payments for travel, health and education to the kerb market during the year and by holding back the repatriation of some profits and dividends. These practices have essentially been discontinued this year with a consequential negative impact on the balance in this account. But the conversion of foreign currency deposits into rupees has permanently reduced the dollar liability of interest payments on such deposits. In addition, home remittances are expected to show some buoyancy once again as the level of confidence is restored, wage levels start rising in the Middle East due to the higher oil prices and an exchange rate policy is followed which minimises the differential between the official and kerb rate (as is the case currently). In view of these developments it is expected that the deficit on the invisible account will start falling after 1999-2000.

The overall consequence of the above developments in the trade and invisible accounts on the current account deficit is a deterioration of almost $ 800 million in 1999-2000 due primarily to a worsening in the terms of trade. Thereafter significant improvements are expected upto 2002-03, with the current account deficit falling from about $ 2.5 billion in 1999-2000 to $ 2.1 billion in 2000-01, $ 1.8 billion in 2001-02 and $ 1.2 billion in 2002-03.

On the capital account side, a large deficit has been converted into a sizeable surplus, due to the access to various forms of exceptional financing, including extra program financing, debt relief, roll-over of swap funds and eurobonds, in 1998-99 and 1999-2000. In the former year, the resulting surplus was large enough (at over $ 3 billion) not only to finance the current account deficit (of almost $ 1.8 billion) but also to permit a significant reserve build up (of over $ 1.2 billion). But in 1999-2000 the capital account surplus of about $ 2.2 billion will be consumed entirely by the current account deficit of over $ 2.5 billion, implying that reserves may be depleted by about $ 300 million during the year.

Beyond 1999-2000, the large capital account deficits will gradually be converted into a surpluses primarily because the process of withdrawal of non-resident foreign currency accounts will come to an end. In addition, foreign direct investment is expected to recover sharply over the next three years, virtually quadrupling by 2002-03 over the level projected for 1999-2000. But the period of debt relief comes to an end in December 2000 and in the absence of an further concessions by international creditors, the quantum of exceptional financing falls sharply to about $ 700 million in 2000-01 and is eliminated thereafter. Consequently, the overall capital account surplus is expected to be only about $ 300 million in 2000-01, which could rise to $ 900 million in 2001-02 and to $ 1.1 billion in 2002-03.

This raises the basic question as to how the current account deficit will be financed beyond 1999-2000. For example, even with relatively optimistic projections, the current account deficit will approach $ 2.1 billion in 2000-01. The available capital account surplus is likely to be about $ 300 million only, as indicated above. This implies a net financing gap of $ 1.8 billion. With reserves at about $ 1.4 billion at the start of the year, it is clear that the balance of payments could become unsustainable and there is a danger that Pakistan may experience once again a foreign exchange crisis after December 2000. Such a crisis could occur even earlier if the optimistic projections made on the trade account do not materialise.

The net financing gap persists beyond 2000-01, albeit of a lower magnitude, at about $ 900 million in 2001-02 and about $ 100 million in 2000-03. What are the different options available to Pakistan to avert a foreign exchange crisis (which is less than one year away) and a default on international payments? These options are listed below:

(i) attempts are made to achieve further compression in imports starting from 2000-01. This will involve, on the one hand, tight aggregate demand management, including attempts at minimising the fiscal deficit, and, on the other hand, direct measures for restricting imports, including the imposition of substantial import margin requirements and cut backs in public sector and defence related imports. However, reduction of the import bill in 2002-03 by almost 17 per cent (equivalent to $ 1.8 billion) is not considered politically or economically feasible. From a strategy currently of economic revival it will require the switch to a policy of virtually engineering an recession to restrict import demand. Such a fundamental policy reversal could place the government in a embarrassing position.

(ii) using the instrument of the exchange rate to reduce the trade deficit drastically. This will imply a steep <u>real</u> devaluation of the currency. Here again, there are doubts about the feasibility of adoption of such a strategy. On the one hand, a large proportion of economists in Pakistan have technical reservations about the success of such a strategy on the grounds that devaluations have seldom improved the trade balance of the country. On the other hand, the political feasibility of making the required adjustments in food, petrol and energy prices following a larger currency devaluation in order to prevent a deterioration in the fiscal balance is considered low.

(iii) renegotiation with the IMF and other international agencies which includes a larger amount of program financing in view of the bigger BOP gap over the next three years than was originally anticipated in August 1999 and / or a second round of debt restructuring which builds in some more exceptional financing beyond 1999-2000. The track record of implementation of IMF conditionalities during 1999 is not good. If Pakistan goes now for additional support from international agencies not only will strong prior policy actions be demanded to restore credibility of commitment to the program but also other concessions of a more political character may be asked for. In addition, Pakistan will probably also to have to agree to a strong macroeconomic stabilisation program which requires a steep path of reduction in fiscal and current account deficits. This will reduce the space available to pursue a program of economic revival and poverty alleviation of the type proposed by the Chief Executive in his Economic Revival Plan.

Altogether, Pakistan can find itself ‘between the devil and the deep blue sea’ towards the end of this year. No easy options are available to create sustainability in the balance of payments beyond December 2000, when the period of debt relief comes to an end. The final choice among the different options listed above will have to be made by the government during the current year. Already, tentative indications from the Chief Executive’s speech of December 15 1999 is that Pakistan will seek a second round of debt restructuring from international agencies.

For purposes of developing macroeconomic projections upto 2002-03 we work with two scenarios for the balance of payments. Scenario I is essentially a more optimistic projection which assumes that current account deficits of the magnitude given above will be financed somehow without having to bring about further compression of imports. Scenario II is based on the assumption that the current account deficits projected in Table 3 will have to be reduced by about 50 per cent each year through mix of aggregate demand management and the instrument of the exchange rate alongwith further targeted compression of imports.

The current account deficit projections for the next few years represent the likely level of foreign savings that will become available to finance investment in the domestic economy. We turn now to the strategy for mobilising public savings, one component of national savings, followed by a discussion on likely levels of private savings.

V PROJECTIONS OF PUBLIC FINANCES

Public savings consist of savings (the revenue surplus or deficit) of government (both federal and provincial governments) and of public enterprises and autonomous bodies (like WAPDA and PTCL). The trend in public savings is given in Table 4. The table indicates that in recent years there has been dissaving by federal and provincial governments combined due to the presence of an overall revenue deficit with total revenues unable to fully cover the current expenditure obligations. Public enterprises and autonomous bodies have been generating an aggregate operating surplus of about 1.5 per cent of GDP, with the biggest contribution coming from PTCL.

TABLE 4
TREND IN PUBLIC SAVINGS

(% of GDP)

Years	SAVINGS BY		Total Public Savings
	Government	Other Public Entities	
1993-94	-0.2	2.7	2.5
1994-95	0.3	1.5	1.9
1995-96	-0.9	2.3	1.5
1996-97	0.0	1.9	2.0
1997-98	-0.2	1.6	1.0
1998-99	-0.5	1.5	1.0

Source: SBP Annual Reports

One of the key elements of the macroeconomic strategy for the next three years must be to target for a major jump in public savings. Such an aggressive resource mobilisation strategy should include the following:

(i) As a first priority, dissaving by the government must be eliminated. This will require balancing of the current budget of the federal and provincial governments combined. Thereafter, the target must be to raise savings by government to about 1.5 per cent of the GDP.

(ii) This increase in government savings is to be achieved primarily by raising the revenue to GDP ratio, with primary emphasis on augmenting the tax revenues (CBR taxes plus surcharges) to GDP ratio. Scope for reduction in current expenditure to GDP is limited. Any potential savings in costs of civil administration, subsidies and defence will need to be diverted towards enhanced expenditure on operations and maintenance of economic and social services and newly established poverty alleviation programs. This is essential if the process of economic growth and human development is to be sustained. Interest payments as a percentage of GDP are expected to stabilise with declining interest rates and smaller budget deficits.

(iii) The strategy and targets imply that the overall tax-to-GDP ratio will have to be enhanced by 2 per cent of GDP in three years, while keeping the non-tax-to-GDP ratio, more or less, constant. This is an ambitious target and will require a focus on broad-basing and more effective collection of the general sales tax and income tax at the federal level and the agricultural income tax, irrigation charges and the urban immoveable property tax at the provincial level. Given the unexploited revenue potential in different areas it is expected that the federal and provincial tax to GDP ratios will rise respectively by 1.5 per cent and 0.5 per cent by the GDP.

(iv) With government revenues rising by 2 per cent of the GDP and current expenditure effectively constant, government savings will rise by about 2 per cent of the GDP. Half of this increase (that is, 1 per cent of GDP) should be used to increase the size of the public sector development program and the remaining half to bring down the budget deficit (by 1 per cent of the GDP). This distribution is justified on the grounds that it preserves a proper balance between the objectives of growth and macroeconomic stabilisation.

TABLE 5
PROJECTED KEY PUBLIC FINANCE MAGNITUDES
(of federal and provincial governments combined)

(% of GDP)

Years	FEDERAL		Provincial and Other Revenues	Total Revenues	Current Expenditure	Revenue Surplus / Deficit[b]	Development Expenditure[c]	Budget Deficit
	Tax Revenues[a]	Non-Tax Revenues						
1999-2000	12.3	3.0	0.8	16.1	16.6	-0.5	3.2	-3.7
2000-01	12.8	3.0	1.0	16.8	16.6	0.2	3.6	-3.4
2001-02	13.3	3.0	1.2	17.5	16.6	0.9	3.9	-3.0
2002-03	13.8	3.0	1.3	18.1	16.6	1.5	4.2	-2.7

[a] Inclusive of surcharges
[b] Corresponding to government savings
[c] Corresponding to the public sector development programme
Sources: Projections made by the Economic Advisers Wing, Ministry of Finance, revised in light of recent estimates.

The resulting estimates of key public finance magnitudes upto 2002-03 are given in Table 5.

As far as savings by public enterprises / autonomous bodies are concerned, these currently aggregate to 1.5 per cent of the GDP, as shown in Table 4. There exists significant scope for enhancing these savings also, given the high levels of operating inefficiency as reflected by billing and technical losses, over-employment, etc. Accordingly, it should be possible to raise this savings ratio by 0.5 per cent of the GDP to 2 per cent of the GDP. The overall projections of public savings are given in Table 6. According to these projections, if the resource mobilisation strategy is successfully implemented the overall level of public savings could rise from 1 per cent of GDP to 3.5 per cent of the GDP by 2002-03.

TABLE 6
PROJECTIONS OF PUBLIC SAVINGS

(% of GDP)

Years	SAVINGS BY		Total
	Government	Other Public Entities	
1999-2000	-0.5	1.6	1.1
2000-2001	0.2	1.8	2.0
2001-2002	0.9	1.9	2.8
2002-2003	1.5	2.0	3.5

VI PROJECTIONS OF SAVINGS AND INVESTMENT

Prior to arriving at an estimate of the future level of national savings we need also to project private savings, which are estimated at about 11 per cent in 1998-99 and as indicated in Section II could fall to 10 per cent of the GDP in 1999-2000 due primarily to rising oil prices (which exacerbate the current account deficit and reduce the contribution of national savings). Clearly, private savings will have to recover to levels attained earlier during the decade of 90s (maximum of 13 per cent of GDP in 1993-94 and 1997-98). For this to be achieved real rates of return on various savings instruments will have to be pitched at relatively high levels. Given lags in changes in inflationary expectations (to a falling rate of inflation) it is possible that the policy of reducing interest rates on government savings schemes (by about 2 per cent points recently) may run counter to this objective. It is also clear that the overall level of private savings will hinge crucially on the rate of growth of the economy which will influence the rate of increase in disposable household incomes. In a relatively high / low growth path the marginal rate

TABLE 7
PROJECTIONS OF PRIVATE SAVINGS

(% of GDP)

	Scenario I	Scenario II
1999-2000	9.5	9.5
2000-2001	10.0	10.5
2001-2002	10.5	11.5
2002-2003	11.0	12.5

of private savings can also be expected to be relatively high / low. It also needs to be recognised that the macroeconomic strategy envisages a substantial increase in public savings primarily through an increase in the tax-to-GDP ratio. To the extent that the additional tax revenues cut into private savings it will be difficult to achieve simultaneously fast increases in savings by households. Two scenarios have accordingly been developed for the rate of private savings in the economy, as shown in Table 7. In Scenario I private savings reach the average rate during the last four years by 2002-03 while in Scenario II they approach the higher rate attained in the first half of the 90s.

Given the projections of public savings and private savings in Tables 6 and 7 respectively we are now in a position to project the overall level of national savings in Table 8.

TABLE 8
PROJECTIONS OF NATIONAL SAVINGS

(% of GDP)

Years	PUBLIC SAVINGS	PRIVATE SAVINGS		NATIONAL SAVINGS	
		Scenario I	Scenario II	Scenario I	Scenario II
1999-2000	1.1	9.5	9.5	10.6	10.6
2000-2001	2.0	10.0	10.5	12.0	12.5
2001-2002	2.8	10.5	11.5	13.3	14.3
2002-2003	3.5	11.0	12.5	14.5	16.0

Therefore, it appears that national savings could rise from the current level of less than 11 per cent of the GDP to almost 14 per cent of the GDP in Scenario I and to 15 per cent of the GDP in Scenario II.

We move next to estimates of total investment, based on the accounting identity that this is equal to the sum of foreign savings (corresponding to the current account deficit) and national savings. The resulting projections in the two scenarios are given in Table 9. In Scenario I, the need to reduce the current account deficit sharply from 2000-01 onwards in view of financing difficulties implies that the investment level could fall initially before rising to the 1999-2000 level by 2002-03. With less pressure on balance of payments in Scenario II the level of foreign savings is higher implying faster growth, as a result of which national savings are higher. Consequently, the overall level of investment could rise by almost 3 percentage points of GDP over the level likely to be attained in 1999-2000.

TABLE 9
PROJECTIONS OF LEVEL OF INVESTMENT

(% of GDP)

Years	FOREIGN SAVINGS [a]		NATIONAL SAVINGS		INVESTMENT	
	Scenario I	Scenario II	Scenario I	Scenario II	Scenario I	Scenario II
1999-2000	4.0	4.0	10.6	10.6	14.6	14.6
2000-2001	1.6	3.1	12.0	12.5	13.6	15.6
2001-2002	1.3	2.5	13.3	14.3	14.6	16.8
2002-2003	0.8	1.5	14.5	16.0	15.3	17.6

VII PROJECTIONS OF GROWTH RATE

Within the context of the macroeconomic framework developed in the previous sections, the stage has finally been reached when projections can be made of the likely growth rate of the economy in coming years. Given the projections of the level of investment we use the incremental capital-output ratio of the economy to derive the resulting growth rate. Although this ratio fluctuates year-to-year, its long term magnitude (from 1980-81 onwards) is estimated at three with respect to the level of fixed investment. As such the investment projections in the two scenarios are converted first into projections of the level of fixed investment, which are then divided by three to arrive at the implied growth rates for the GDP. Results are given in Table 10.

TABLE 10 PROJECTIONS OF THE GDP GROWTH RATE						
	SCENARIO I			SCENARIO II		
Years	Level of Investment (% of GDP)	Level of Fixed Investment (% of GDP)	GDP Growth Rate	Level of Investment (% of GDP)	Level of Fixed Investment (% of GDP)	GDP Growth Rate (%)
1999-2000	14.6	13.0	4.3	14.6	13.0	4.3
2000-2001	13.6	12.0	4.0	15.6	14.0	4.7
2001-2002	14.6	13.0	4.3	16.8	15.2	5.1
2002-2003	15.3	13.7	4.6	17.5	15.9	5.3

In Scenario I with constraints on the degree of access to foreign savings and with somewhat expressed level of private savings, the growth rate of the economy is likely to range between 4 to 4.6 per cent over the next few years. As opposed to this, in scenario II with more financing available to sustain a larger current account deficit and with higher marginal rate of private savings the growth rate of the economy is likely to rise from 4.3 per cent in 1999-2000 and approach 5.3 per cent by 2002-03.

A number of key conclusions emerge from the macroeconomic framework. First, given the low levels of national savings in Pakistan and given the need to restrict the current account deficit, following the end of the period of debt relief in December 2000, it is unlikely that the economy can attain a relatively high growth rate once again of 6 per cent or more in the foreseeable future. Second, policy makers will have to focus on different policy instruments depending upon which gap appears larger ex ante. If the investment-savings gap appears to be larger than the trade gap in goods and services (corresponding to the current account deficit) then interest rates will have to be focused on and a policy of raising interest rates followed. Alternatively, if the trade gap in larger then a depreciation in the exchange rate may need to be considered alongwith tighter aggregate demand management.

There is need to recognise also that the incremental capital output ratio (ICOR) can be reduced below its long run level and the growth rate enhanced somewhat in the short to medium run. Ingredients of a strategy which attempts to reduce the ICOR include the following:

(i) identifying sub-sectors of the economy where there appears to be a margin of excess capacity and micro targeting policy instruments towards these sub-sectors so as to achieve increases in production without significant new investment. Such a policy would focus on industries like textiles, cement and engineering goods where considerable underutilised capacity exists today. In agriculture, the focus would be on crops like cotton where current yields are below peak levels attained in the past.

(ii) orienting the public sector development program and bank credit allocations towards projects and sectors which are less capital intensive. For example, this would imply a shift in public sector development priorities away from sectors like highways to agricultural infrastructure. Also, the distribution of funds in the PSDP would need to be tilted towards low gestation period projects and projects which are nearing completion so as to maximise the development impact. This element of the strategy would also argue for focusing bank credit increasingly towards micro credit for small-scale activities which are traditionally more labour intensive.

Consequences of following the above strategy could be that growth rate of the economy is pushed up to above 5 per cent over the next three years. Also, such a strategy would also be broadly consistent with the objective of poverty alleviation in the process of growth.

VIII POLICY IMPLICATIONS

A medium-term macroeconomic framework for Pakistan has been developed in this paper for the period upto 2002-03 which recognises, first, the, more or less, secular long-term decline in the economy's growth rate over the last two decades and, second, the binding constraints to future growth as the ability to finance current account deficits in the balance of payments (which determines access to foreign savings) and the level of national savings. As such the methodology used for deriving future GDP rates is based on determination of availability of resources, foreign and national, for financing investment in the economy and thereafter applying the incremental capital-output ratio to determine the economy's growth rate given the projected level of investment.

The paper is rich in terms of policy implications, which include the following:

(i) For faster export growth in coming years, to contain the current account deficit to a financable level, an appropriate exchange rate policy will need to be followed which seeks at the minimum to avoid any decline in the real effective exchange rate and strong institutional measures to both widen and deepen the export base.

(ii) Targeted import compression will have to be achieved in a three year framework in Pakistan's major imports of wheat, fertilizer, edible oil, petroleum products and wherever else possible. For vigorous import substitution in these areas appropriate pricing and protection policies will have to be designed to encourage domestic production (e.g. higher extraction of recently discovered gas revenues to substitute for furnace oil in power generation)

(iii) A strong focus on measures to restore investment confidence like evidence of significant support from international agencies (e.g. revival of the IMF program), resolution of the IPP's problem (especially with HUBCO), development of a proper and regulatory framework for privatisation and an exchange rate policy which minimises the spread between the official and kerb rates. The recent buoyancy in the stock market is the first indication that investor confidence is being restored although it may largely represent portfolio shifts in the short run resulting from the decline in rate of inflation and interest rates and changed perceptions of risk about different types of investments. More steps of the type described are required urgently to restore investor confidence. This is essential if international private inflows (including home remittances and foreign private investment) are to increase rapidly in the next few years.

(iv) Even under optimistic assumptions, there is likely to be a large financing gap (of almost $ 1.8 billion) in 2000-01 as the period of debt relief comes to an end. The financing gap will persist beyond 2000-01, albeit at a lower level. It will be critical to pursue appropriate policies on a timely basis to avoid an international default. Policy options with varying degrees of feasibility and effectiveness include measures like tighter aggregate demand management, including lower fiscal deficit, imposition of import margin requirements alongwith cut backs in public sector and defence related imports, a <u>real</u> devaluation of the currency, renegotiation with IMF and other international agencies for a program over the next three years which includes a larger amount of program financing in view of the bigger projected BOP gap than was originally anticipated in August 1999 and / or a second round of debt restructuring which builds in more exceptional financing beyond 1999-2000.

(v) Eliminate in the short run dissaving by government (federal and provincial governments combined) with a sharp rise thereafter in public savings to about 3.5 per cent of the GDP. This should be achieved primarily by raising the overall tax-to-GDP ratio by about 2 per cent of the GDP, while holding current expenditure ratio to GDP constant.

(vi) The target for increasing the tax-to-GDP ratio by 2 per cent can be achieved by focusing on broad-basing and more effective collection of the general sales tax and income tax at the federal level and the agricultural income tax, urban immoveable property tax and irrigation charges at the provincial level.

(vii) While a significant reduction in the overall current expenditure ratio to GDP is not envisaged, changes in expenditure composition are desirable. Any potential savings in costs of civil administration, subsidies and defence should be diverted towards enhanced expenditure on operations and maintenance expenditure on economic and social services and newly established poverty alleviation programs.

(viii) Half the projected increase in government savings should be used to increase the size of the public sector development program and half to bring down the budget deficit. This distribution preserves a proper balance between the objectives of growth and macroeconomic stabilisation. It implies that the budget deficit will fall from 3.5 to 4 per cent of the GDP to 2.5 per cent to 3 per cent of the GDP by 2002-03. This will represent a primary budget surplus annually of 2 per cent to 3 per cent of the GDP and lead to a decline in the public debt to GDP ratio of over 10 percentage points in four years in relation to the level in 1998-99.

(ix) Private savings are likely to fall in 1999-2000. They will need to be restored to at least the level prevailing in 1997-98. For this real rates of return on various savings instruments will have to be pitched at relatively high levels. In addition contractual savings schemes like pension founds will need to be encouraged.

(x) Significant potential exists for raising savings by public enterprises and autonomous bodies. The emphasis will have to be on improvements in operating efficiency including reduction in billing and technical losses, rationalisation of tariff structure to phase out subsidies to particular types of consumers and gradual elimination of over-employment.

(xi) The growth rate can be enhanced in the next few years by focusing attention on sub-sectors like textiles and cement in industry and cotton in agriculture where significant excess capacity exists and production can be enhanced without additional investment. In addition the public sector development program and bank credit allocations will need to be diverted towards projects and sectors which are less capital intensive. This will require major changes in inter-sectoral development priorities and a bias towards low gestation projects and projects nearing completion. Banks will need to increasingly focus on agricultural and micro credit.

A summary of the macroeconomic projections upto 2002-03 in the two Scenarios are given in Table 11.

TABLE 11
MACROECONOMIC PROJECTIONS IN THE TWO SCENARIOS
1999-2000 TO 2002-03

Indicator	Unit	1999-2000	2000-01	2001-02	2002-03
GDP Growth Rate					
Scenario I	%	4.3	4.0	4.3	4.6
Scenario II	%	4.3	4.7	5.1	5.3
Level of Investment					
Scenario I	% of GDP	14.6	13.6	14.6	15.3
Scenario II	% of GDP	14.6	15.6	16.8	17.5
Level of National Savings[?]					
Scenario I	% of GDP	10.6	12.0	13.3	14.5
Scenario II	% of GDP	10.6	12.5	14.3	16.0
Current Account Deficit					
Scenario I	% of GDP	4.0	1.6	1.3	0.8
Scenario II	% of GDP	4.0	3.1	2.5	1.5
Fiscal Deficit[??]	% of GDP	3.7	3.4	3.0	2.7
Federal Tax Revenues[??]	% of GDP	12.3	12.8	13.3	13.8

[?] The implied marginal rate of saving from 1998-99 to 2002-03 is 21.6% in Scenario I and 27.2% in Scenario II
[??] Same in both scenarios

IX CONCLUSIONS

In conclusion, Pakistan has only recently emerged from a major financial crisis following the imposition of sanctions. This has been facilitated by debt relief from international donors. If Pakistan can successfully transit to, more or less, normal external transactions after December 2000 while maintaining a growth rate of 4 to 5 per cent over the next few years then this will represent a significant achievement. The prospect for the economy getting back to a high growth path (with growth rate of 6 per cent or more) in medium run remains low, but if the strategy described above is followed then Pakistan's economy can eventually emerge as stronger and more self-reliant (with the share of financing of investment by foreign savings falling from 25 per cent to about 10 per cent).

A MEDIUM-TERM MACROECONOMIC FRAMEWORK FOR PAKISTAN

By

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February 2000

SUMMARY

The paper develops a macroeconomic framework for Pakistan upto 2002-03. This framework attempts to raise the growth rate of the economy while recognises the limits to growth placed by the level of investment and savings and the ability to finance external transactions. The paper asserts that if Pakistan can successfully transit to, more or less, normal external transactions after December 2000 (when the period of debt relief comes to an end) while maintaining a growth rate of 4 to 5 per cent then this will represent a significant achievement. The prospect for the economy getting back to a high growth path (with a growth rate of 6 per cent or more) in the medium run remains low, but if the strategy described in the paper is followed then Pakistan's economy can eventually emerge as stronger and more self-reliant.

A MEDIUM-TERM MACROECONOMIC FRAMEWORK FOR PAKISTAN

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