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The economy in 2019, writer Hammad Azhar

The economy has slowed down, the Rupee has been devalued, interest rates have gone up and there has been some increase in the rate of inflation in the country. Why has this happened? And what prospects does the economy hold in 2019? This article answers the above questions in an honest and as simple a manner as is possible.

Pakistan's economy is recovering from what can be best described as a 'consumption led' growth period that was financed by short term debt instruments and a stifling of investment climate. Consumption as percentage of GDP went up from the already worrying figure of 91.8% in FY14 to 94.5% in 2018. Correspondingly, total gross investment (that includes government investment also) in Pakistan was reported at just 16.4% of GDP in FY18 whereas India's figure stands at close to 30% and Bangladesh is at 31% of GDP. Additionally, our spur of consumption spree was associated with policies in the past that instead of channeling the countries resources into savings, investments and industrialization further aggravated the problem of private investment. And here's how:

To begin with, we saw a very visible deterioration in the economy's fundamentals as the country exited the last IMF program in 2016 and all forms of fiscal and monetary discipline were abandoned. What this means is that we were fuelling growth in the economy by spending from resources that we did not have. For example, in the last financial year alone, RS 1300 billion of government spending was financed by printing money and monetization of public debt. The previous government was also happy to ask FBR to withhold genuine refunds to the tune of hundreds of billions of Rupees of businessmen and entrepreneurs that further squeezed their working capital and halted all their expansions. This whole model broadly represented the previous government's fiscal policy and it's no surprise that it fuelled only consumption growth. And it also led to whopping RS 2300 billion or 6.6 % of fiscal deficit in the system i.e. the excess of government spending over government's income.

Now let's take a look at the monetary side. In the first 4 years of the previous government, the Real Exchange Rate (the buying power of the currency in comparison to other currencies) appreciated by 28% without any improvement in the trade deficit to justify this increase. This means that our exports became that much uncompetitive in the international markets and we began subsidizing our imports. This led to the closure of hundreds of export houses and fuelled a largely consumption led increase in our imports. From a point where we had a Current Account deficit of just USD 2.5 BN in 2013, the figure soared to USD 19 Billion in 2018.

The second aspect of monetary policy is Interest Rates. The interest rates were kept low in the past but that also did not translate into any notable increase in private sector borrowing, the loans that our entrepreneurs use for investments and setting up businesses and industry. The reason that private sector was not advanced these loans by the banks is that the government was doing what the economists call 'crowding out' the private sector. The banks were more than happy to lend to the government in the form of Treasury Bills. So in effect, the lower interest rates actually did not lead to any investment and the whole monetary scheme of things further fuelled the consumption spree.

The result of the above mentioned fiscal and monetary policies was not surprising for any economist. The country came on the verge of bankruptcy at the close of the last financial year (FY2018). Once both the IMF program ended and oil prices began to rise, the superficial nature of the whole economic model unfolded and the State was left with nothing to finance its fiscal expenditures and its huge import bill.

So what has the new government done about this? And what does it plan to do in order to make sure that the repeat of the above does not take place?

The first and foremost plank of the new government's economic priority in 2018 has been that the country must meet its financing obligations in terms of debt repayment due this financial year (USD 9 billion) and that the current account deficit is reduced to the range from USD 11-13 Billion from the current USD 19 Billion. The fiscal side also has to show improvement as the last reported fiscal deficit of 6.6% is not sustainable. The above priorities are necessary and overarching in order to keep the economy functioning and not defaulting on its both external and internal obligations.

The good news is that as a result of adjustments by SBP in the exchange rate and the imposition of Regulatory Duties by the government on non-essential items, we have seen a sharp reduction in the growth of imports that has gone down from the figure of 26% growth to a negative figure. Some commentators have criticized the steep adjustment in the exchange rate. However, one has to take into account the fact that the exchange rate was allowed to appreciate in real terms and the need for corrections had been piling up for at least 4 of the last 5 years. Therefore the country had deviated significantly from its Actual Exchange Rate value and a one-time steep adjustment had become inevitable.

The foreign remittances, another foreign exchange source, have also shown a very encouraging rise of 12.5% in the first quarter and the export sector is also showing a positive growth. In 2019, the government shall announce a comprehensive incentives package for overseas workers to send their remittances through the formal channels. Improving the speed, security and reducing the red tape that is currently surrounding the formal channel procedures is a central aspect of the upcoming incentives package for foreign remittances.

The new government's successful foreign policy has led to friendly countries offering us sizeable support for our Balance of Payments. Bilateral assistance in the form of funds and deferred oil payment facilities from KSA, UAE and other countries has begun to pour in. As a result of the above, the country has successfully averted the balance of payments crises and all economic trends indicate that our deficits are coming down rapidly to within manageable ranges.

The second economic priority of the PTI government is that growth shall now have to be led by exports, investment and productivity instead of consumption and imported finance capital. I mention exports first because a country earns its foreign exchange primarily by virtue of this sector. And foreign exchange earnings are required to fill our huge financing gap and escape from the debt dependency trap. The readjustment of the exchange rate by bringing it at par with its actual market value has helped in restoring competitiveness of our exports. Furthermore, the government has also reached an agreement with the export sectors with regards to freeing up their entire stock of working capital stuck up with FBR in the shape of pending refund claims. This government will no longer use the entrepreneur's capital to cover up and finance its own shortcomings in raising revenues or funding showcase projects. On this same note, the government has also taken the unprecedented step of bringing at par the energy costs that our exporters face. LNG and Natural Gas mix is now being supplied to them at the regional average rate of USD 6.5 per MMBTU. A similar approach is being worked out when it comes to the electricity tariffs that shall be notified at 7.5 cents/KWH for the export sector. With these measures in place, the export sector in 2019 will be able to unleash its real comparative advantage and earn the much needed foreign exchange for Pakistan.

Another much debated subject these days is interest rates. One would be justified to ask the question that how the government on one hand claims to be promoting 'investment led growth' whilst on the other hand is raising interest rates, the act that in theory discourages investment? Firstly, the need for raising interest rates arose when the rupee was devalued. Devaluation causes inflationary pressures to rise in the economy and in order to prevent the rise in prices from forming a spiral and going out of control, the interest rate had to rise simultaneously. However Pakistan's interest rate in Real Terms (adjusted for inflation) is approximately 4% now. That's the same rate in real terms that is prevalent in all countries in our region. Furthermore, fresh data with regards to interest rates and investment is painting a very different figure from what many would predict. The 'private sector credit off take' in the economy in the first quarter has risen by more than 400%.

This means that current interest rates are not stifling investment at all. The explanation for this seems to be that once the ‘crowding out’ phenomenon that was mentioned above was eliminated, the suppressed appetite of the private sector for loans came into play. This phenomenal growth in private sector loans is a much needed development and this trend shall continue into 2019.

Studies point out that apart from restrictive economic policies that were hindering savings and investment in Pakistan, there are two additional features in play. Security and Taxes. The security situation has significantly improved over the years following the successful ‘Zarb-e-Azb’ operation conducted and led by the military. However, little attention has been paid to the most complicated and business unfriendly tax policies and laws in place. Whilst Pakistan is 136th in the rank of the ‘ease of doing business’ index, we are 173rd when it comes to ‘complicated tax systems’ as per a World Bank report. This means that taxes are right now the single biggest hindrance in the way of investment in the economy and the current government is formulating bold initiatives in this regard that shall be rolled out in 2019. For example, ‘With-Holding’ taxes on filers is nothing but a ‘red tape’ as most of the sums under this head are adjusted in the annual return anyway. Similarly, for the non-filers, this tax has only acted to reduce the ‘Cash to Deposits’ ratio in the economy. As per some calculations that take into account the ‘multiplier effect’ of deposits and subsequent lending in the banking system, it is estimated that up to Rs 6 trillion can potentially be made available for private sector lending if the disincentives from transacting in the banking system are removed and the government in 2019 fully intends upon beginning to phase out these distortionary taxes.

I now turn towards the question that affects each one of us; overall economic activity. As mentioned above, the general policy paradigm was in need of a shift, from ‘consumption’ towards ‘investment’. This shift in economic priority entailed a readjustment in the fiscal and monetary policies of the country. ‘Change’ is always accompanied by a certain degree apprehension and uncertainty. We indeed see that in our economy now and it is understandable. We are witnessing a correction or a ‘hang over’ from the over consumption of the past as we sail away from that approach towards a more sustainable and structurally sound economic model. However, as the contours of this new economic approach become clear and an investment focused and pro-business set of policies and framework is put in place, we expect this uncertainty to be swiftly replaced by investor confidence and growth.

2019 shall be a year in which Pakistan shall take significant steps towards improving its ‘ease of doing business climate’. A new tariff policy aimed at rationalizing duties on imports of raw materials, machinery plus simplification in taxes and filing procedures for Individuals, Corporations and Businesses shall be announced. Taxes shall no longer be used purely to raise revenues. The aim of the separation of Tax Policy Division from FBR’s administration is precisely to phase out all taxes that have added to the cost of doing business in Pakistan and replace them with measures that create incentives for SME’s and businesses.

Reforming Pakistan’s tax laws is an extensive subject and a Tax Reform Implementation Committee that I head has already been notified. It is composed of the original authors of the famous and well written Tax Reform Commission Report that was never followed up with policy. My next article will be devoted purely towards the issues of upcoming ‘Tax Reforms’ so I leave this subject with the comment for now that the government will not shy away from undertaking bold measures at simplification and ease of filing taxes and reforming FBR into a business friendly entity in 2019.

Entrepreneurs and businesses in Pakistan have to deal with multiple government departments that require extensive time and workforce to deal with. The methods these departments employ in the name of compliance with outdated legal statutes and their wide ambits mean that businesses and especially SMEs are put at a serious disadvantage and feel harassed. Therefore, the scope and powers of these departments is being revisited and shall be reviewed in conjunction with the provincial governments.

2019 is also expected to be the year for foreign investments in Pakistan. CPEC shall be entering its second phase that shall be more focused on trade and industry, moving on from infrastructure. This shall play a pivotal role in terms of technology and skills transfer to our economy. Multi-national companies from sectors ranging from automobiles, telecommunications, energy, electronics and others have also expressed their interest to invest in Pakistan. Our sizeable population and a young demographic holds great and yet untapped potential for any investor. In the coming year, we are confident to see these interests transforming into tangible foreign investments.

To sum up, the economy has averted the immediate severe balance of payments crises and all macro-economic indicators are showing positive trends towards stabilization. The general paradigm of fiscal and monetary policies has been realigned towards exports, investment and productivity growth. In the days to come, bold steps will be put in place to facilitate both foreign and local investment and dramatically improve the ease of doing business climate in the country.

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