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Elusive economic stability

Taking a break from our series on economic reforms, let’s reflect on some important developments affecting the economy. Few data announcements would have caught public attention as much as the recent data on debt released by the State Bank of Pakistan. The data on central government debt is published on a monthly basis, with a gap of at least one month. It relates to the period between July and November 2018. The figures are alarming.

Public debt has increased from Rs24.2 trillion to Rs26.5 trillion, an increase of Rs2.3 trillion or nearly 10 percent in just five months of the fiscal year. Before we say more on this, it should be noted that the size of public debt is significantly less than what the prime minister has been told, and which he has been citing frequently in his public statements. Even before the elections, he would cite the debt as Rs30 trillion or more, which were grossly out of line with the actual figures. The most recent number is way below the Rs30-trillion mark. The simple definition of ‘public debt’ is that it goes into and is serviced out of the federal consolidated fund.

On a more substantive note, the debt accumulation implicit in this development has an explosive path. On an annual basis, it would mean an increase of 23 percent in public debt. Even at an inflation rate of 10 percent and projected growth of three percent, it would add 10 percentage points to the debt-to-GDP ratio, pushing it from 73 percent to 83 percent. This would be a very large increase in the debt burden.

Technically speaking, a change in public debt is equal to the fiscal deficit. The marginal increase of Rs2.3 trillion is, however, not the extra money spent by the government in five months. The larger share of the increase was due to foreign debt, which rose by Rs1.3 trillion from Rs7.8 trillion to Rs9.1 trillion. Much of this increase is the loss we have suffered on account of depreciation in the rupee during the period.

An explosive debt-accumulation path is just one indicator – albeit the most significant one – pointing to continuing instability dodging economic managers. The external account remains under pressure. Undoubtedly, the data for the month of December is somewhat heartening as exports were up by 13 percent over November and 5.5 percent over November 2017 as compared to a decrease of four percent and nine percent in imports for the same period.

However, the six months figures (July-December) aren’t too encouraging as exports are up barely 2.2 percent and imports are down by merely 2.3 percent, and the trade account are improving by 5.1 percent. The question is: how reliable is the relatively favourable outcome of December? A similar point was noted in August 2018 when exports were up 23 percent and imports were marginally increased by 3.2 percent as compared to July whereas the increase in exports was 8.4 percent and the decrease in imports was 1.4 percent as compared to August 2017.

This was sharply reversed in subsequent months. Accordingly, it may be a bit early to pass judgement on whether the external account has changed its course for good. Last year, the current account deficit (CAD) was $19 billion, which has to be brought to less than half to stabilise the economy. Not correcting it and focusing on finding money to finance a higher level would deepen the pains of adjustment.

The key to adjustment is the fiscal deficit, which is still not under control. The most worrying development is the shortfall in FBR revenues. In the first six months (July-December), the shortfall is reportedly around Rs172 billion. At this pace, there would be a shortfall of nearly Rs350 billion (or nearly one percent of GDP), which is significantly less than Rs4 trillion whereas its target for the year was Rs4.3 trillion. The tax-to-GDP ratio is likely to fall significantly, continuing the declining trend for the third consecutive year.

This poor tax performance is the direct result of three important concessions either given by the present government or condoned by it. First, the inconsiderate concession given under the Abbasi-Miftah budget to individual taxpayers by lowering the maximum rate from 35 percent to 15 percent, partially reversed and raised to 29 percent in the mini-budget, and a threefold increase in tax-free income from Rs400,000 to Rs1,200,000, which was left unchanged. The cost of this concession was Rs150 billion.

Second, the Supreme Court has stopped the government from collecting taxes on mobile phones. An estimated Rs125 billion is involved in this suspension. The government has so far not asked the court to reconsider its decision as it would lead to a significant shortfall in revenue. Third, out of the five petroleum price adjustments, which the present government has made, it has sacrificed the sales tax for dropping prices, keeping them constant or passing on less than the prescribed increase by the regulator. Only for the month of January has it brought the rate at the statutory level. But in the process, close to Rs100 billion have been lost.

On the expenditure side, no amount of cutting development expenditures could make up for the revenue shortfall and rising debt-servicing costs. The policy rate increase of 350 bps has resulted in major increase in debt-servicing costs. At the base level of domestic debt outstanding on June 30, 2018, the policy rate increase implies an increased debt-servicing cost of Rs847 billion.

Initially it was budgeted at Rs1,620 billion, but was revised upward in the mini-budget to Rs1,842 billion or an adjustment of Rs222 billion. However, not considering any further accumulation of debt during the year, the increased cost of debt-servicing is still pitched significantly below the likely cost. Hence, the budget deficit, as in the first quarter, would be well above the 5.1 percent target set at the time of the mini-budget.

There are other pressures on the budget that haven’t been fully recognised. The IMF was urging the government to either pass on the prices of utilities as determined by regulators or put them in the budget. Those are still missing. Then there are unbudgeted subsidies on fertiliser imports, LNG and electricity use by the textile sector and export rebates. Taken together, these items could easily add up to one percent of GDP.

We are thus heading for another year of high fiscal and current account deficits. These are classic symptoms of macroeconomic instability and will persist so long as the IMF programme is shunned.

The writer is a former finance secretary.

Email: waqarmkn@gmail.com

Waqar Masood Khan