BUSINESS RECORDER
Founded by M.A. Zuberi

16th June, 2019

Too much tightening not required

The budget and medium term economic framework have two sides - fiscal and monetary. On the fiscal – main taxation, the direction is right and the policy paradigm shift is towards much needed documentation of the economy where both high tax collection and flow of informal money into the system should ideally reduce the need of monetary tightening.

However, the monetary side seems to be dominating as both IMF and SBP focus is to move towards a market mechanism in interest rates and currency market. A few banks run the market, and formation of a cartel cannot be overruled where the short-term interest rates and currency levels reach much higher than the supposed equilibrium value.

Currency adjustment is good for the economy in the medium to long-term as market-based exchange rate will determine the forward and future market which can help foreign investment - both portfolio and direct, to come in the economy to subside external worries. However, excessively higher interest rates could be detrimental as this could choke the ability to invest in productive sectors owing to higher financial cost.

The medium-term economic framework in the last two pages of 'Budget in Brief' indicates average inflation to be around 11-13 percent which may imply inflation to peak at 13-15 percent in September. Although, this writer's analysis is that inflation is to peak at 11-13 percent in September and full year average may hover between 9-11 percent. But raising expectations by government and SBP, it can become a self-fulfilling prophecy and the number could reach to the level being provided in the document.

The currency is to move accordingly as now new market base mechanism is in shape. At the time of writing, the rupee transacted at 156 against USD, and the noise is that 100-150 bps increase in policy rate is imminent. With such stiff actions, the story of the fiscal is to revolve around the monetary side. The domestic debt servicing cost is budgeted at 50 percent increase from the revised number in FY19. To put it in perceptive, in FY20 the domestic debt servicing would be 90 percent higher than what was in FY18 -it's the biggest component of budget, by far.

The beneficiaries are a few bankers and big size individuals. Money is like magnet - bigger the pile, higher the return. The government aims to collect direct taxes on the interest income earned on government securities - higher income tax on banks, and super tax on top. Now the interest income from individuals would be much higher than what it was earlier.

Higher interest rates amid steep currency adjustment will elude the much-needed investment in productive sectors in short to medium-term. The steps taken to document the economy and to curb practices of easy money making on real estate, and rent seeking practices by enjoying tax exemptions etc, will surely help bring more money into the system.

The steps taken on ease of doing business will surely help, but the cost of doing business or expanding business will likely increase – and may completely offset the benefits. The plants and machinery cost is expected to increase, the debt servicing cost will sky rocket whilst the demand is plummeting. It is hard to see new investment coming till the interest rates cool off.

The risk with monetary policy-based budget is to take the economy into recession based on desktop model through excessive tightening, but the economy might not come back out of recession, as model is predicting. The reality could be different as shocks play with psychology and ability to take risk.

Economies usually take their own time to come back out of recession. Egypt is a classic case in hand, as country's economic indicators - trade deficit, fiscal deficit, overall indebtedness, poverty and unemployment, are not much different before and after the IMF program. Now, Egypt is getting into a follow up IMF loan program for another three years.

In Pakistan, the economic growth projected at 2.4 percent in FY20 is too low and as of now, the growth is likely to be higher than what is projected. Even Fitch forecasted Pakistan GDP to be at 3.5 percent in FY20. However, too much tightening and adjustments can take the economy to lower growth levels. That could be detrimental as if that happens, 4.5 percent growth in FY22 might not be the case. And the fear is that poverty levels could be worse.

Ali khizar