BUSINESS RECORDER
Founded by M.A. Zuberi

19th February, 2019

More stagflation

The last few weeks have witnessed deterioration in the state of the economy. This is the consequence of the lagged impact of a number of steps taken earlier including the big cut in development spending, steep devaluation of the rupee, hike in interest rates, escalation in gas and power tariffs, etc. Along with these measures contrasting signals have been given about whether Pakistan is seeking an IMF programme or not. This has added uncertainty in the market place and the rate of investment has been significantly affected.

The first visible development is the sharp slowdown in the economy. Perhaps for the first time in living memory the latest monthly statistics on the Quantum Index of Manufacturing for December 2018 reveal a drop in production of over 10 percent. This is unprecedented. Overall, in the first six months the large-scale manufacturing sector has declined by almost 2 percent.

The decline in production is widespread. Out of the total of 15 industry groups as many as 10 groups have experienced a reduction in output. This includes, first, industries which have been affected by the slowdown in construction activity due to the decline in releases for development projects and the hike in interest rates. The production of cement and iron and steel products have fallen by 2 and 8 percent respectively.

Second, the rise in input costs and the resulting increase in domestic prices due to the devaluation have led to a fall in demand. Industries like tea, petroleum refining, pharmaceuticals, chemicals, automobiles, etc., have witnessed fall in output ranging from 1 percent to 10 percent. Third, the fall in agricultural production has affected agro-based industries like sugar and textiles. Fourth, the lack of response of major export industries like textiles to incentives and the devaluation has also been a major retarding factor.

Overall, the outlook for GDP growth in 2018-19 is bleak. The fall in output in the manufacturing sector coupled with the negative outcome in terms of production during the kharif season of major crops like cotton implies that service sectors like wholesale and retail trade, transport and communications will also be negatively impacted. There is a real risk that the growth rate of the GDP could fall even below 3 percent. The last time this happened was as far back as 2009-10 when both the agricultural and the industrial sectors showed growth rates below 2 percent.

The second worrying development is the recent upsurge in the rate of inflation. During the last three weeks, the year to year change in the Sensitive Price Index has gone up by three percentage points from 6.9 percent to 9.9 percent. A double-digit rate of inflation is being approached rapidly. The rise in the SPI has a greater impact on the lower income groups as three-fourths of the weights in the index are of basic food items.

The broader measure of inflation, the CPI, has increased by 7.2 percent in January 2019 on a year-to-year basis. Almost 56 percent of the inflation is due to the 12 percent jump in housing rents and utility prices and the 15 percent hike in transport costs. The double-digit increases are due primarily to the announcement of big increases in gas and electricity tariffs on domestic consumers and substantial additional taxation of petroleum products.

The economy now has entered the era of stagflation, with falling output in the commodity-producing sectors and an inflation rate approaching double-digits. The impacts on the level of unemployment and on the incidence of poverty are likely to be substantial. With 3 percent or less GDP growth the number of unemployed could increase by as much as 600,000 and the people falling below the poverty line may be almost 4 million. Unfortunately, in an effort to correct the huge imbalances in the economy left behind by the previous Government, the ruling party, PTI, runs the risk of incurring the wrath of the common man.

This takes us to the next issue. Are the imbalances in terms of the large current account and fiscal deficits coming down? It appears that despite the above-mentioned costs there has been little success in stabilizing the economy. The fiscal deficit is likely to rise to a record level of almost 7 percent of the GDP in the face of slow growth in tax revenues and big increases in current expenditure, especially on debt servicing and defense. The former is rising sharply due to the hike in interest rates and the latter because of apparently growing security concerns. The 25 percent cut in development spending is proving to be inadequate in reducing the fiscal deficit. Already, it is estimated that in the first seven months of the current financial year the fiscal deficit has approached 3 percent of the GDP. The rate of deficit creation tends to be even higher in the last two quarters of the year.

Similarly, despite strong corrective measures, the current account deficit remains large. It was $8 billion in the first six months, showing a fall of 4 percent only. Despite an exceptional inflow of support from China of $2 billion, $3 billion from Saudi Arabia and $1 billion from UAE, foreign exchange reserves at the end of January 2019 were down by $1.6 billion in relation to the level at the start of 2018-19. Clearly, the underlying balance of payments position remains precarious.

The big disappointment is the lack of any growth in exports in the first six months despite a battery of measures, including a large devaluation. In the absence of the double-digit growth in home remittances the current account deficit position would have worsened. Hopefully, the measures taken in the recent mini-Budget to boost exports will yield some results.

Overall, there is no doubt that the state of the economy is alarming. The entry into a Fund programme could lead to even more stagflation initially. Unless the current account deficit is reduced substantially the Fund bailout package would have to be significantly larger than $6 to $8 billion as we move into 2019-20 with a fast rising burden of external debt repayments.

The PTI government has unfortunately not been able to begin implementing its election manifesto in the presence of a legacy of huge structural problems. Hopefully, once the initial tightening of the belt is over there will be some relief for the people.

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