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Economic revival: trouble ahead

There are signs that the economy is on the mend after the lows it had sunk to last year in the aftermath of the austerity measures implemented over the last 12-18 months by the government.

There has been a sizable reduction in trade deficit, of about 27 percent in dollar terms, for the period July 2019 to February 2020 compared to the same period in the preceding year. Exports are up by 3.6 percent in dollar terms during this time while imports have declined by 14.1 percent compared to the preceding eight months period.

Consumer Price Index (CPI) inflation figures indicate a deceleration in price hikes from an annualized rate of 14.6 percent in January 2020 to 12.4 percent in February 2020. Hopefully, this downward movement in inflation will continue since crude oil prices have plunged to under $30 a barrel from around $50 in early January 2020.

As an aside, one can add that though the oil price windfall may seem like a boon it will only seed the next energy crisis if it lulls policymakers into becoming complacent about taking steps that emphasise greater reliance on renewable energy sources as well as on energy conservation. As the saying goes, the time to fix a hole in the roof of one’s home is when the sun is shining.

From a long-term perspective, some other macroeconomic indicators also provide reasons for encouragement. Thus tax revenues are up by 17 percent in the first seven months of the current fiscal year – short of the target agreed to with the International Monetary Fund (IMF) by the government but consequential nonetheless.

What is missing from the overall macroeconomic picture is data on the level of poverty consequent upon the spike in food price inflation during the last 6-8 months and its impact on low income households. Given the large number of layoffs of workers last year and the estimated annual addition of 1.3 million new entrants into Pakistan’s labour pool (United Nations Development Program projections for Pakistan), unemployment and poverty must have increased.

Pakistan’s economic policymakers are doing now what should have been done by previous governments of all stripes. Centuries before the IMF devised its much criticized structural adjustment programs there was the invaluable piece of advice dispensed by the master political theorist Niccolo Machiavelli who wrote in his magnum opus 'The Prince': “The new ruler must determine all the injuries that he will need to inflict. He must inflict them once and for all…. Benefits must be conferred gradually; and in that way they will taste better”.

In actuality, Machiavelli’s advice to rulers also has relevance to modern-day economic policy in the theoretical framework developed by behavioral economists who argue that a decision maker should 'bundle losses and unbundle gains'. So if a tax increase, say, is necessary it is better to implement it in one go rather than stretch it over several time periods as the psychological pain of losses declines over time. On the other hand, if the government wants to provide economic relief to the population the behavioral economist would argue for doing it in stages that, per Machiavelli, "will taste better". For instance, instead of announcing a major reduction in petrol prices in one fell swoop because of a significant decline in the international price of oil the government should implement a decrease phased over a period of time so as to both gain and maintain its popularity while reaping the benefits of increased tax collections.

Unfortunately, the recent good news on the economic front may soon be overtaken by foreboding developments in the world economy.

The positive is that the foreign currency savings accruing from dramatic reductions in the price of crude oil will be substantial. The windfall to the current account of the balance of payments from reduced petroleum product imports is estimated at a massive $4 billion to $5 billion in the next twelve months depending on the extent of the reduction in average international crude oil prices (and the severity of the impact of the novel coronavirus on domestic economic activity). However, the negative effects of the novel coronavirus are likely to offset the positive impact of reduced oil imports.

There is already a sharp hit to exports because of the lockdowns and closing of borders in major Western markets. The IMF has signaled a slowdown from last year's 2.9 percent global growth without specifying whether the global economy will expand and by how much. However, there is a silver lining for the country's export prospects notwithstanding the grim short-term scenario.

Integrated supply chains which account for about 60 percent of global exports are likely to fragment as a result of the current pandemic. Provided Pakistan does a credible job in containing the spread of the novel coronavirus, the country can stake its claim to be a relatively safe destination for multinationals which now have to contend with the effect of pandemics that can swiftly and without warning upend their supply chains and their human resource base by striking randomly and indiscriminately regardless of geography.

Another cause for concern is the potential decline in our foreign currency remittances which could be substantial because of large scale retrenchments of foreign workers expected in the oil producing gulf countries compelled to tighten their budgetary expenditures due to lower revenues from oil.

Even more threatening is the prospect that short-term capital inflows will now reverse into a torrent of outflows because of the liquidity crunch faced by many investment funds (both equity and bond funds) in developed countries.

The IMF was unusually prescient in its most recent Global Financial Stability Report (GFSR, October 2019) in warning that the search for yield had resulted in non-bank financial institutions such as pension funds and life insurers taking on excessive risk by lending to marginal and sub-investment grade corporate borrowers around the world and that there was likely to be a blowback on this account in the event of a recession.

As the GFSR cautions: “In a material economic slowdown scenario, half as severe as the global financial crisis, corporate debt-at-risk (debt owed by firms that are unable to cover their interest expenses with their earnings) could rise to $19 trillion – or nearly 40 percent of total corporate debt in major economies – above crisis levels”.

It is evident to many leading economists that with the prevalent implosion of global aggregate demand due to a sharp reduction in consumer confidence as well as the disruption of traditional manufacturing supply chains the current crisis has morphed into a global recession.

The 2008 crisis was managed with the use of monetary policy instruments such as quantitative easing and governments’ expansionary fiscal policies. However, we now have a full-blown biological crisis with no obvious solution in sight for authorities around the world except to try and mitigate its effects on businesses using monetary and fiscal instruments. The liquidity crunch on heavily leveraged businesses especially in the energy, tourism, entertainment and transportation sectors with knock-on effects on financial institutions will undoubtedly result in major bankruptcies whose ripple effects will also be felt in emerging economies such as Pakistan.

Investor redemptions due to fear of greater financial losses can only mean that global investment funds would be forced to sell securities at distress prices and exit their positions from emerging markets.

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