Policy Note

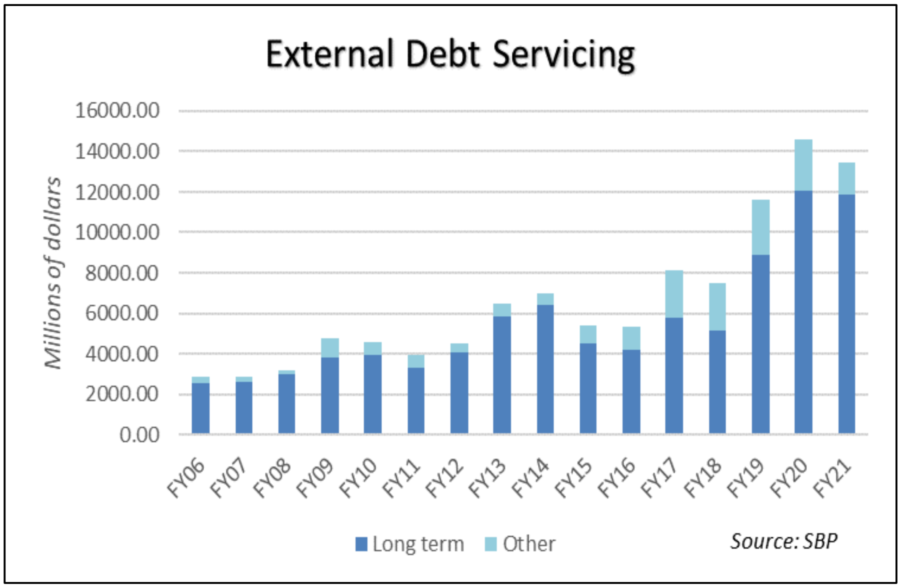
An urgent need for responsible macroeconomic policies

The Economic Advisory Group met to assess the current state of the economy of Pakistan, the challenges for the new government, and the way forward to promote economic stability. The members framed the discussion in the context of the many challenges the country faces, both on the external and internal fronts. While the solution to most economic problems Pakistan faces requires long-term reforms, the EAG recognises the time constraint the new government faces and, therefore, focuses on the immediate steps the government must take to stabilise the economy. The EAG draws the reader's attention to its vision document for long-term reforms necessary for achieving sustained growth.

The EAG noted in its previous statement that the government should rely on the social security system to provide relief to low income households instead of untargeted subsidies. The statement also pointed to the risk it posed to public finances if the energy prices do not normalise in the near term. Since then energy prices have continued to remain elevated. The Russia-Ukraine war and subsequent sanctions on Russia have triggered a sharp increase in Pakistan's credit risk. The credit default risk has increased from around 4% to around 12% since 4th March 2022.

These developments have increased the vulnerability both on the internal and external front. The outgoing finance minister reports that the fiscal deficit for the first nine months of FY22 equals 3.9% of GDP. At the same time, the new government has said that the fiscal deficit for FY22 is expected to be Rs5.6 trillion which is close to 8.8% of GDP under the new base. Taken at face value, an increase in the fiscal deficit by about 5% of GDP in just one quarter will be extremely destabilising both from the point of view of public finances and the external stability.

It is important to recall that the fiscal stimulus of around 2% of GDP during the last quarter of FY21 destabilised the external account for the next few months. A stimulus which is twice the magnitude of the stimulus during the last quarter of FY21 will be extremely destabilising especially at a time when international commodity prices are at their peak.



The increase in vulnerabilities on the external front further necessitates that the government adopts a prudent fiscal policy. Pakistan's external debt servicing has remained north of $10bn every year from FY18 onwards. Most of this is long term debt which is defined as debt contracted more than a year before. Going forward, Pakistan is expected to pay around $35bn in debt during FY22 and FY23. Around two-third of this takes the form of government-to-government debt and loans from Chinese commercial banks. Close to one-third is owed to multilateral institutions. The remaining amount mostly comprises loans from the international financial markets.

While the nature of debt which is to be paid over the next two years is such that it can be rolled over relatively easily, especially once in the IMF program, it nonetheless limits Pakistan's ability to contract new debt. Raising new debt from the international markets at a time when the credit default risk is close to 12% will be expensive, if not impossible.

The implied rating by the international bond markets for Pakistan is at CC/Ca or two notches below the official rating of B-/B3, and only two notches above D default. Most institutional investors in the international money markets, including many hedge funds, are mandated not to invest in "hooks", that is, countries with ratings that are CCC or lower. As things stand, Pakistan is effectively shut out of the international debt markets.

The implication is that it will no longer be sustainable for Pakistan to finance large CAD during these years. A high CAD will also increase debt servicing costs in subsequent years, thus undermining financial stability over the medium-term as well. An expansionary fiscal policy which increases aggregate demand and, as a result, exacerbates CAD will put further pressure on reserves and will ultimately lead to a severe balance of payments crisis. In this context, the recent decision by the new government to not pass on the increase in fuel prices to consumers is a step in the wrong direction.

Going forward, the new government must adopt responsible policies to ensure economic stability. An important first step is to work towards reinstating the IMF program. This is critical both for ensuring that Pakistan can rollover a significant fraction of its existing debt and also for unlocking new funding sources. The decline in SBP foreign currency reserves in recent weeks should instill urgency.

It is equally important that any engagement with the IMF is complemented with adoption of prudent fiscal policy. An expansionary fiscal policy will result in a sharp increase in CAD. However, as discussed above, the difficulty in financing large CAD by issuing new debt in current circumstances and the subsequent increase in debt servicing that comes with it will threaten financial stability over the medium-term. A prudent fiscal policy will require rationalising energy prices. It is reported that the cost of selling oil at the currently subsidised rate equals Rs55bn in April alone. In this context, the EAG hopes the government will review its decision to reject the OGRA recommended petroleum product price increase. Moreover, the government must also avoid the temptation of introducing populist policies when finalising the budget for FY23.

The EAG insists that in an attempt to stabilise the economy, the government should avoid policies which undermine long-term productivity of the economy. In the past, all governments have relied on instituting protectionist policies to limit CAD. These included increasing restrictions on imports, offering untargeted subsidies to business groups in the hope to increase exports, and price controls. These policies have continued to fail in ensuring stability. It is a matter of fact that the countries which succeeded in overcoming their BoP challenges did so by increasing their trade linkages with the rest of the world and implementing necessary reforms to improve the productivity of their respective economies.

The Economic Advisory Group is an independent group of individuals from economics, policy, and the private sector that deliberates regularly on economic developments and shares its views with the government and the public. It is supported by PRIME, an independent think tank.

For media inquiries, contact at info@eag.org.pk **or visit** www.eag.org.pk.