

STABILIZATION POLICY VS GROWTH ORIENTED POLICY: IMPLICATION FOR THE PAKISTAN ECONOMY¹

by

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1 Introduction

Pakistan has initiated a comprehensive reforms efforts aiming at tracking the economy on a higher and sustainable economic growth, reduce level of poverty, reducing unemployment, raising their level of standard of living. These objective were to be achieved through a program that would build on the macro-economic stability which encompasses structural reforms, trade liberalization, privatization, fiscal reforms and financial sector.

This paper makes one of the early attempt to analyse the Pakistan stabilization experiences. In Pakistan the stabilization program was started in 1988-89. In this paper we mainly examine the fiscal and monetary policy package since 1988 when the Pakistan committed to a set of conditionalities under the Structural Adjustment Program of the IMF. The fundamental question that has risen was the relative efficacy of stabilization oriented versus growth oriented policies on development and welfare. Admittedly, stabilization and growth are not mutually exclusive and any policy package has to incorporate both the elements. However, the manner in which the policy has been implemented in Pakistan has tended to pursue stabilization at the expense of growth.

The analysis in this study is outcome based and outcomes are: GDP growth, poverty numbers, unemployment rate, inflation and private investment. The target variables are current account deficit and budget deficit. The policy discussed are fiscal policy, monetary policy and trade policy. Since the fiscal policy is main driver in this process we therefore, concentrate mainly on fiscal policy in this study. Other policies and measures are touched upon in this paper but have to discuss thoroughly separately. The analysis is based on the results obtained from SPDC's 257 - equation Integrated Social Policy and Macroeconomic Planning Model for Pakistan. The paper is organized as follows: section 2 present

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review of literature, section 3 presents a review of macroeconomic developments, section 4 profiles the trends in fiscal variables, section 5 examine the implication of stabilization efforts on macroeconomic variables, section 6 analyse the way stabilization are achieved and section 7 presents conclusions and recommendations.

2 Review of Literature

Subramanian (1997) discussed the Egyptian Stabilization experiences and found that the was successful experience in Egypt. In Egypt fiscal adjustment and exchange rate mainpulation were main driving forces supported by prudent monetary policy and liberalized interest and exchange markets reforms. The analysis which is outcome based shows positive-impact of stabilization policy. World Bank (1995) also shows positive result of stabilization policies for Bangladesh.

3 Macroeconomic developments

The basic point of the economic policies pursued under various governments since 1988, when the Structural Adjustment Program came into force, is its continuity. The fiscal policy till 2001-02 constitutes a continuation of the same set of policies, albeit with greater vigour. It is, thus, pertinent to conduct the analysis in the light of the performance of key economic indicators during 1988-2001 and examine the fiscal policy accordingly.

The most important feature of the economic policies of the 1988-2001 period is the dominance of stabilization objectives at the cost of growth. This is evident from Table 1, which shows the stabilization variables, i.e., Current Account Gap to GDP Ratio and Budget Deficit to GDP Ratio have declined according to objectives dictated by international creditor interests. The Current Account Gap to GDP Ratio has declined from an average of 4.0 - 4.5 percent in the decade of the 1980's and 1990's to 1.9 percent in 1999-00 and further to 1.1 percent in 2000-01. Likewise, the Budget Deficit to GDP Ratio has declined from an average of 6.7 percent in the 1980's to 6.1 percent in the 1990's and further to 5.4 percent in 2000-01. Growth variables, i.e., GDP Growth Rate and Fixed Investment to GDP Ratio have also declined contrary to objectives dictated by the needs of the people. The GDP Growth Rate has declined from an average of 6.1 percent in the 1980's to 4.4 percent in the 1990's, to 3.9 percent

in 1999-2000, and further to 2.6 percent in 2000-01. Likewise, Fixed Investment to GDP Ratio has declined from an average of 16-17 percent in the 1980's and 1990's to 13-14 percent in the last two years, i.e., 1999-01.

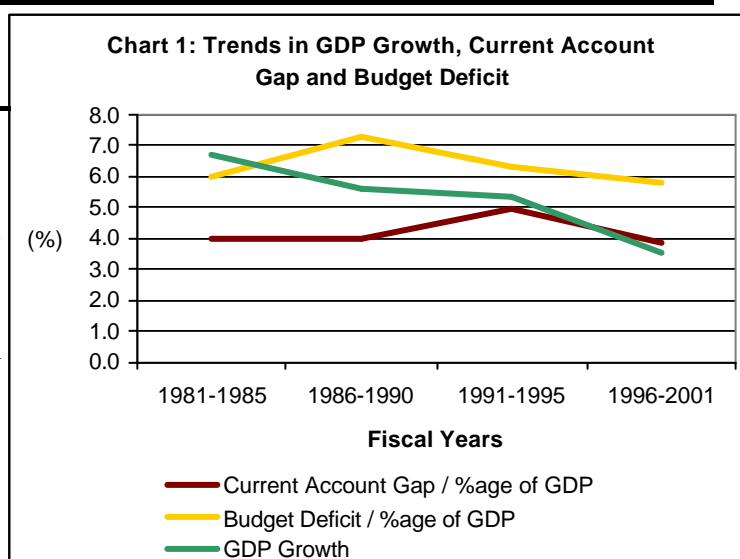
TABLE 1
PROFILE OF MACROECONOMIC DEVELOPMENT

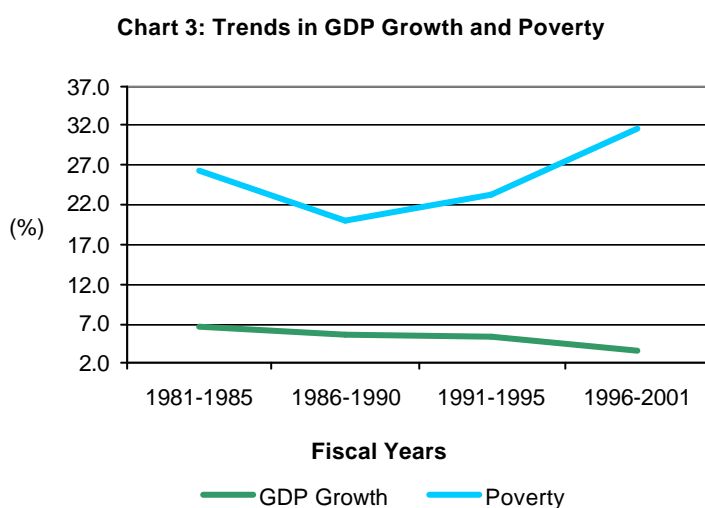
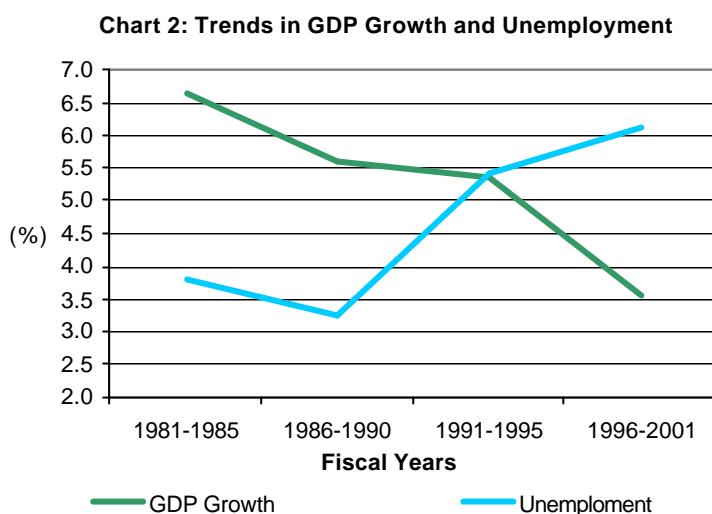
Indicator	(%)					
	1980-81 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	1990-91 to 1999-00	1999-00	2000-01
GDP Growth (fc)	6.1	5.1	3.8	4.4	3.9	2.6
GDP Growth(mp)	6.2	4.8	3.1	4.0	4.4	3.3
Agriculture	4.1	4.2	4.9	4.5	6.1	-2.5
Manufacturing	8.2	5.8	2.0	3.9	1.8	7.1
Services	6.6	5.3	3.8	4.6	3.5	3.5
Inflation Rate	7.2	11.7	7.7	9.7	3.9	5.4
Money Supply to GDP Ratio	39.4	43.0	44.2	43.6	44.1	42.5
Fixed Investment To GDP Ratio	17.8	17.0	15.1	16.1	13.9	13.4
Public Investment	9.8	8.7	6.5	7.6	5.9	6.0
Private Investment	8.0	8.3	8.6	8.5	8.0	7.4
Real Exports to GDP Ratio	13.1	17.9	14.7	16.3	14.6	16.3
Real Imports to GDP Ratio	20.3	17.7	16.5	17.1	14.2	13.8
Current Account Gap to GDP Ratio	4.0	4.5	4.4	4.5	1.9	1.1
Budget Deficit to GDP Ratio	6.7	6.4	5.9	6.1	6.6	5.4
Nominal Exchange Rate	15.6	26.8	42.7	34.8	51.7	57.2
Poverty Rate*	23.2	22.8	29.3	26.0	35.9	40.1
Unemployment Rate*	3.5	5.4	6.0	5.7	6.2	6.7

Source: *Pakistan Economic Survey, various issues.*

*SPDC Estimates.

The impact of such a policy framework has been borne by the people. Unemployment has increased from an average of 3.5 percent in the 1980's to 5.7 percent in the 1990's, to 6.2 percent in 1999-00, and further to 6.7 percent in 2000-01. Poverty has increased from an





average of 23.2 percent in the 1980's to 26.0 percent in the 1990's, to 35.9 percent in 1999-00, and further to 40.1 percent in 2000-01.

4 Trends in fiscal variables

The second aspect of continuity is the persistence of a contractionary fiscal policy despite the rise of recessionary tendencies since the early 1990's. All the budgets in the last decade, including the budgets for 2000-01, have continued to target the lowering of the fiscal deficit through additional revenue mobilization and cuts in development expenditure. This path has been pursued despite the standard text book fact that when an economy falls into a recession, an expansionary fiscal policy needs to

be followed. Expansionary fiscal policy can be attained either through the reduction in the amount of taxes to be paid by domestic producers or consumers and/or through an increase in development and welfare related government expenditures.

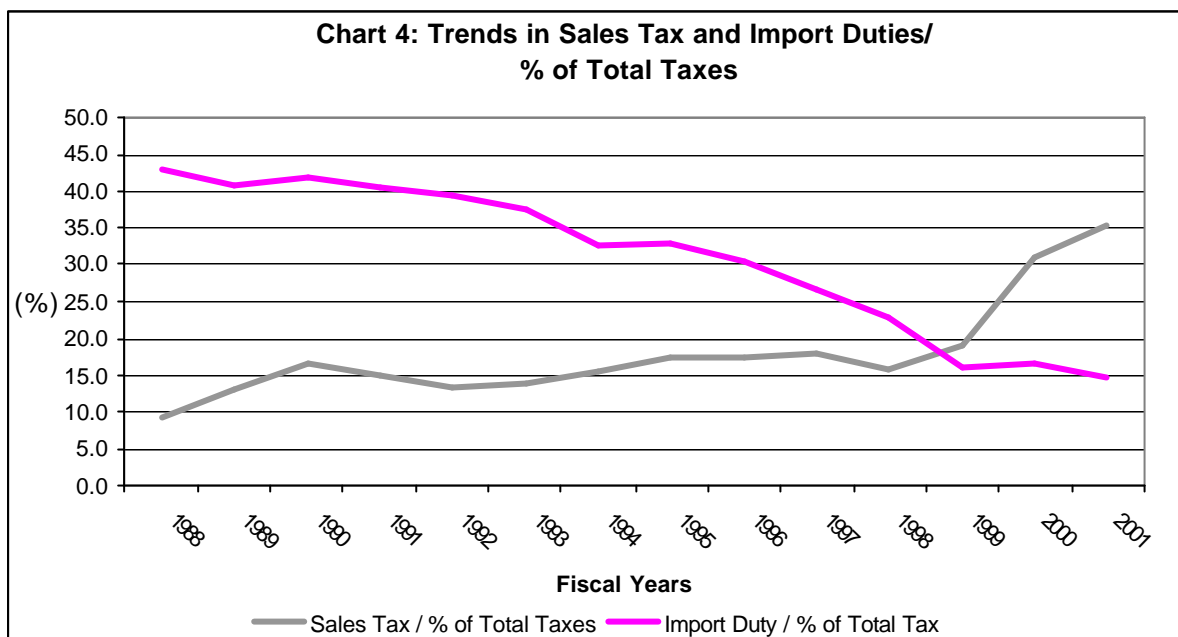
Table 2 shows the trends in fiscal policy since 1987-88 and carried up to 2000-01. The growth rate of GDP is, on the one hand, shown to decline from 6.4 percent in 1988 to 2.6 percent in 2000-01, with average growth over the entire period 1988-2001 being 4.5 percent. On the other hand, total tax revenue has grown at an average of 13.6 percent. Such a high growth rate of taxes relative to GDP growth is inadvisable in a recessionary period. However, the decomposition of this revenue growth

presents a worse picture. Direct taxes have grown at 20.4 percent and indirect taxes at 11.9 percent. Further, while sales taxes have increased at 28.4 percent, import duties have increased by only 6.0 percent; thereby, discriminating against domestic producers relative to competing imports. The growing importance of sales taxes can be discerned from the fact that the contribution of sales taxes in total taxes has increased from 10.8 percent in 1987-88 to 38.3 percent in 2000-01. Correspondingly, the decline of the importance of import duty as a revenue source can be seen from the fact that its contribution to total taxes has fallen from 50.4 percent in 1988 to 15.9 percent in 2000-01.

TABLE 2
TRENDS IN FISCAL AND REAL VARIABLES

(%)

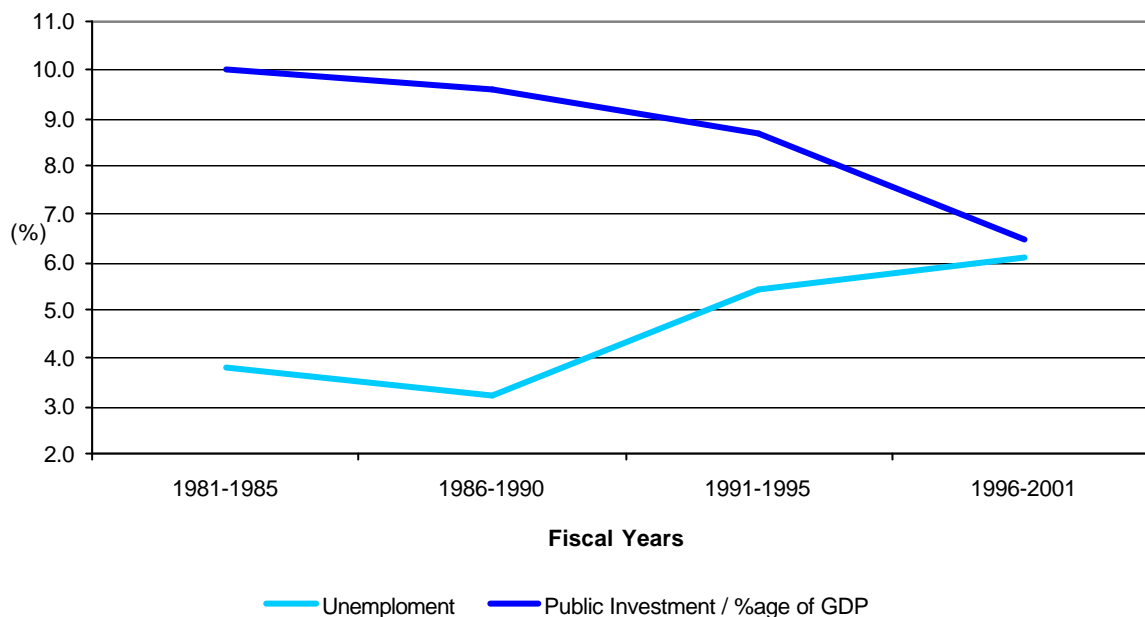
Year	Growth Rate of GDP	Growth of Total Taxes	Growth of Direct Taxes	Growth of Indirect Taxes	Growth of Sales Taxes	Growth of Import Duties	Growth Rate of development expenditure as share of GDP	Growth Rate of Poverty ¹	Growth Rate of Population Below Poverty ²
1987-88	6.4	19.4	16.4	19.8	43.9	23.6	-5.0	-13.6	-11.3
1988-89	4.8	19.4	15.5	20.0	70.7	12.9	-15.5	11.4	14.3
1989-90	4.6	10.8	18.0	9.8	38.4	14.2	3.1	12.3	15.2
1990-91	5.6	13.7	21.3	12.5	3.2	9.7	-4.0	0.2	2.8
1991-92	7.7	19.0	35.1	16.2	7.5	15.5	5.8	1.2	3.8
1992-93	2.3	9.5	33.3	4.6	11.5	5.0	-20.2	2.3	4.9
1993-94	4.5	19.3	30.9	16.3	33.9	3.6	-9.6	3.5	6.1
1994-95	5.2	18.4	23.1	17.0	34.0	19.1	-7.9	4.8	7.4
1995-96	6.8	16.7	29.7	12.6	16.4	7.6	-6.1	6.2	8.8
1996-97	1.9	8.1	17.0	5.0	11.9	-4.7	-15.0	7.7	10.4
1997-98	2.0	10.8	15.7	8.9	-3.4	-5.2	-3.7	5.7	8.2
1998-99	4.2	10.6	10.0	10.9	34.3	-22.1	-5.3	3.1	5.5
1999-00	3.9	1.9	-2.0	3.5	65.2	5.7	3.9	7.3	9.7
2000-01	2.6	13.2	22.0	9.7	29.8	-0.3	-10.2	22.8	16.1
Average Growth	4.5	13.6	20.4	11.9	28.4	6.0	-6.4	5.4	7.3



Source: *Pakistan Economic Survey, various issues.*
Federal Budget in Brief, various issues.

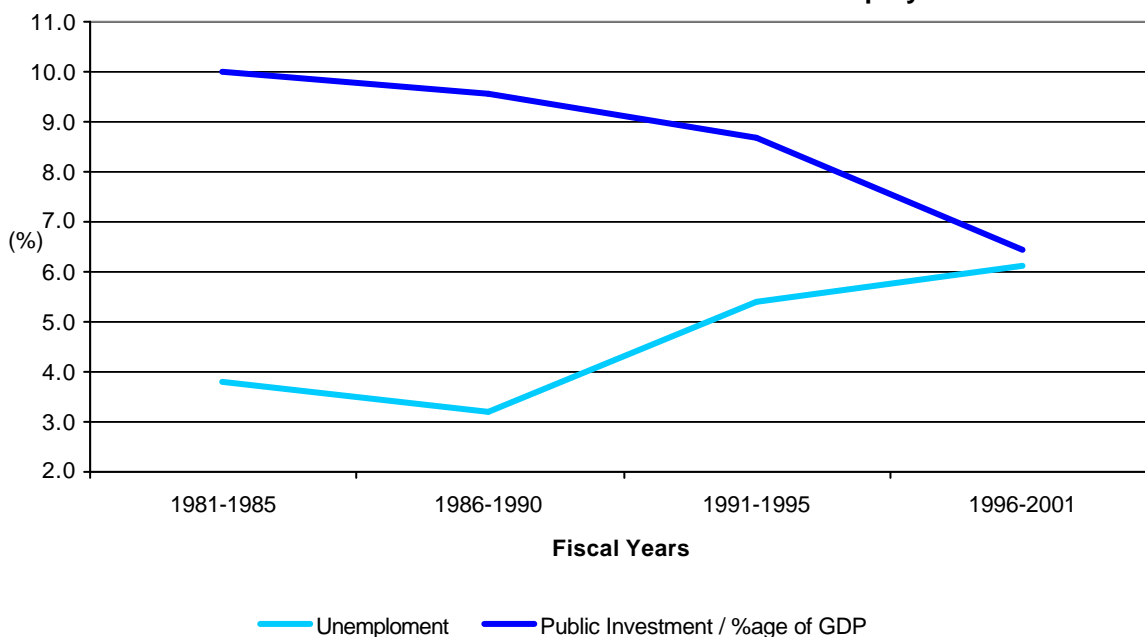
NOTE: ¹Growth rate of the percentage of population below the poverty line
²Growth rate of the number of population below the poverty line

At the same time, the share of development expenditure in GDP over the period 1988-2001 has on average declined by 6.4 percent; thereby, weakening domestic aggregate demand. The decline in Fixed Investment to GDP Ratio, shown earlier in Table 1, is thus understandable. The result has been growing unemployment and poverty, with poverty increasing on average by 5.4 percent and the population below the poverty line by 7.3 percent over 1988-2001.

Chart 6: Trends in Public Investment and Unemployment

5 Implications of Growth vs Stabilization Policies on Major Sectors and Economic Variables

The purpose of this section is to review the policy of growth and stabilization on following sectors and economic variables.

Chart 5: Trends in Public Investment and Unemployment

Manufacturing

Manufacturing sector is one of the most important sector always affected by wrong government policies. In first four decades this sector got unprecedented and unjustified rate of affective protection which made our manufacturer unwilling to prepare themselves against international competitors. This process continued till 1988 when first agreement of structural adjustment facility with IMF was signed. The very high rate of protection was result of very high import duties on finish goods and very low taxes on domestic production. During this period the average rate import duty was between 80 to 90 percent and maximum rate of import duty was 350 percent. As for as the structure of domestic taxes on production was concerned most of the goods were exempted from sales tax and excise duties. Due to these very lenient tax policy the domestic producers have not tried to be competitive internationally. However, after 1988 this situation reverse in such a way that the domestic producers could not find any time or space to make themselves competitive. The average import duty rate fell from 90 percent to 30 percent and during the same time period almost all goods came under sales tax net. Between 1988 and 2001 in all agreement with IMF most of the conditionalities have affected manufacturing sector adversely. Increase in oil prices, petroleum surcharge gas and electricity charges were all the result of stabilization strategy and have damage the manufacturing sector most by increasing cost of production enormously. Last ten years and especially the second decade of 90's was worst for manufacturing sector (Table 3). In two years the growth was negative and in two years growth was less than 3 percent.

TABLE 3
GROWTH IN LARGE SCALE MANUFACTURING
BY INDUSTRY GROUP

Industry Group	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01
Food Beverage and Tobacco	-4.8	-5.0	33.9	1.1	-19.7	8.8
Sugar	-11.2	-6.4	45.7	-0.1	-24.1	6.4
Textile & Apparel	1.2	-0.5	2.0	-0.8	19.0	2.7
Leather Products	-7.3	-12.1	1.0	-9.2	1.2	9.0
Paper & paper Board	-5.7	15.6	-2.2	0.8	19.8	24.9

(%)

Chemical Rubber & Plastic	7.9	-0.7	-3.0	7.5	8.6	8.5
Petroleum Products	9.0	-4.1	3.7	3.9	-0.3	16.6
Tyres & Tubes	25.9	-35.1	29.0	0.4	2.3	0.9
Non-Metallic Mineral Products	15.2	-0.9	-1.2	-0.5	2.0	0.9
Basic Metal Industries	2.1	1.4	-9.1	-10.1	12.5	6.7
Metal Products & Machinery	-2.7	-15.5	-6.6	29.3	16.7	0.2
Automobile	51.6	-4.1	-4.8	7.4	-19.1	23.3
Large Scale Manufacturing	2.8	-2.7	7.4	2.5	-0.2	7.8

Source: *Economic Survey 1999-00 and 2000-01.*

The low growth of the 1990's can be attributed partly to the restructuring of the industrial sector following reduction in protection and partly to increasing cost of production, recessionary tendencies in the economy, and contractionary fiscal policies.

Agriculture

The agriculture sector has to date not been directly 'hit' by Structural Adjustment reforms. However, the extension of GST to agricultural inputs removes the 'protection' that the agriculture sector has had to date. Such extension at a time when the agriculture sector performance has been at its lowest in recent history can be questionable.

The concentration on major crops has rendered the agricultural economy highly vulnerable to shocks. If any one of the major crops performs poorly, the growth rate for the whole of agriculture and of agriculture related sectors stands adversely affected. This in turn affects other macroeconomic variables, i.e., tax revenues, budget deficit, current account deficit, exchange rate, inflation rate, unemployment, and poverty. It is very important to note that this is a first agreement with international agency (IMF) that has asked to impose taxes and remove subsidies in agriculture sector. Removal of all economic subsidies advocated in IMF conditionalities are to attain stabilization will destroy Pakistan agriculture, which has sustained the economy for the last fifty years.

Poverty

As stated above, as of 2000-01, unemployment has grown to 6.7 percent and poverty to 40.1 percent. Poverty has on average been increasing at the rate of 5.4 percent per annum and the number of people below the poverty line has been increasing at the rate of 7.3 percent annually.

The fiscal policy in last few years does take cognizance of the situation and identifies poverty reduction to be "the supreme objective of [Pakistan's] economic strategy." Thus, there is special focus on social safety nets, i.e., employment generation via a public works programme, entitled Khushaal Pakistan, expanded micro-credit through systems such as the Khushali Bank, an attempt to reach the chronically poor through a food stamp scheme, larger Zakat subventions, and a poverty alleviation fund in an attempt to provide additional micro-financing.

However, it needs to be noted that social safety nets in their poverty mitigating role can only just begin to address the worst manifestations of poverty. The overall outcome in the battle against poverty hinges crucially upon broader macroeconomic developments relating to key determinants of poverty, e.g., growth in real capita income and generation of employment.

The continuing increase in poverty can be attributed to adverse macroeconomic developments during the decade of the 1990's and continuing to date. Thanks to the single minded pursuit of stabilization objectives at the cost of growth objectives, there has been a visible decline in the growth momentum of the economy. Growth in per capita income has tapered off from almost 3 per cent per annum during the 1980's to a cumulative growth of only one percent in the last five year period, i.e 1996-2000. Unemployment has increased in the 1990's over 1980's by about two percentage points and, while recessionary conditions has kept the overall inflation rate low, food prices have risen from 2.9 percent in 1999-00 to 4.1 percent in 2000-01.

Issues in investor confidence

Investment holds the key to sustained economic development, as it provides capital that generates growth and employment in an economy. Investment is a function of investor confidence, which is itself a function of economic and non-economic factors. Non-economic factors include political stability, level

of facilitation/harassment by tax authorities, etc. Economic factors broadly comprise cost of production and aggregate market demand. Both are influenced by market and government variables. The former are largely price driven, while the latter include interest, tax, tariff, exchange, etc., rates regimes, utility prices, etc.

The policy package in Pakistan, particularly over the period 1988-2001, has actually been contrary to the requirements of promoting investment. It has served to raise the cost of production and depress purchasing power and aggregate demand. Additionally, there has been introduced the element of a relatively unfair trade regime. On the one hand, the cost of production has increased through enhancement of utility rates, expansion of indirect taxation, raising of interest rates, and depreciation of the rupee, while excessive lowering of import tariffs has rendered domestic industry uncompetitive. On the other hand, the sustained cuts in development expenditure has weakened aggregate demand. Evidence of weak purchasing power and aggregate demand is provided by the fact that the share of Real Demand relative to Real Supply as a component of inflation is estimated at zero [see Bengali and Ahmed (2001)].

The combined impact of increases in production costs, increasingly unfair international competition, and weak aggregate demand has resulted in a loss of investor confidence. Table 1 shows that the investment to GDP ratio has declined from an average of 17.8 percent in the 1980's to 16.1 in the 1990's and further to 13.6 percent during 1999-2001. Public investment declined from 9.8 percent in the 1980's to 7.6 percent in the 1990's and further to 6.0 percent during 1999-2001. Private investment showed a slight improvement of a half a percentage points in the 1990's over the 1980's, but declined to 7.4 percent during 1999-2001.

6 Analysis of Stabilization targets achieved

Behind the Aggregates: 1999-2001

Policy makers have, over the post-1999 period, generally succeeded in reducing the budget deficit, current account deficit, and rate of inflation. As a percentage of GDP, the budget deficit is down to 5.4 per cent, the current account deficit is down to 1.1 per cent, and the savings deficit is down to 2 per

cent. The rate of inflation is down to 5.4 per cent. In theory there are different ways to achieve each target of stabilization and each way has different implication. Now we will discuss what was the best way to achieve each target and this has been achieved in Pakistan.

How has the 2000-01 Budget Deficit been Reduced? Reduction of the budget deficit, current account deficit, savings deficit, or the rate of inflation are all laudable macroeconomic stabilization objectives, However, the way in which these targets are achieved has different distributional implications. There exists a range of policy options to achieve given ends, some of which are pro-poor and others which are not.

For example, raising revenues or reducing expenditures can lower the budget deficit. Revenues can be raised through direct taxation or through indirect taxation: the former impacts the rich, while the latter largely impacts the poor. Expenditure reduction can be attained through cuts in current expenditure or through cuts in development expenditure. The former impacts on existing employment, while the latter impacts on employment generation. However, while development expenditure is likely to create assets and a future stream of income, current expenditure is likely to be consumptive, Generally, labour productivity in employment, generated through development expenditure, is likely to be higher in employment generated through current expenditure, Thus, while employment on account of development expenditure may be productive, employment on account of current expenditure may be non-productive. As such, switching expenditure from current to development heads may increase employment and incomes, and reduce poverty in the future.

It can be seen that, in 1987-88 for example, revenue and expenditure exceeded budgeted targets by 14 per cent.

TABLE 4
EX-POST DEVIATIONS IN BUDGET DEFICIT

Years	DEVIATION IN				Budget Deficit
	Total Revenue	Total Expenditure	Current Expenditure	Development Expenditure	
1987-88	? 14.0	?-35.9	?-42.5	?6.6	21.9

1988-89	? -28.0	?-47.1	?-68.5	?2.14	75.1
1989-90	? 71.7	?-71.9	?-71.1	?-0.7	0.2
1990-91	? -53.6	?-46.4	?-39.1	?-7.4	100.0
1991-92	? -39.2	?-55.1	?-18.7	?-36.4	94.3
1992-93	? -53.9	?-42.7	?-34.1	?-8.7	96.6
1993-94	? -100.0	?64.5	?44.4	?20.0	35.5
1994-95	? -100.0	?19.0	?0.5	?18.5	81.0
1995-96	? -16.4	?-61.0	?-67.0	?6.0	77.4
1996-97	? -100.0	? 33.4	?10.4	?23.0	66.6
1997-98	? -57.0	? -43.0	?-17.9	?-25.0	100.0
1998-99	? -100.0	? 33.8	?11.1	?22.6	66.2
1999-00	? 30.6	? -59.7	?-78.9	?19.2	29.2
2000-01	? -24.9	? 25.4	?-33.4	?58.8	-0.4
Average	? -39.8	? -20.5	?-28.9	?8.4	60.3

Source: *Pakistan Economic Survey (various issues)*

The data highlights the fact that revenue shortfalls, current expenditure over-runs and cuts in development expenditure have been the norm. In two-thirds to three-fourths of the years between 1988 and 2001, revenue targets have failed to be met and current expenditure has exceeded budgeted allocations. The burden of adjustment, in this respect, has fallen on development expenditure, which has suffered repeated and, in some years, heavy declines. The cuts in development expenditure have been sustained since 1998-99 and reached a historic record of nearly 60 per cent of budgeted allocations in 2000-01. Clearly, the major burden of managing budget deficits has been borne by development expenditure, particularly in the last three years.

The table 4 also indicates the distribution of the burden of adjustment between current and development expenditure. For example, in the year 1987-88, the sum of under-collection of revenue and over expenditure totalled Rs. 21.3 billion. The share of the absorption of this additional deficit was (1) under-collection of direct taxes to the extent of 5.1 per cent; (2) over-collection of indirect taxes to the extent of 76.6 per cent; (3) under-collection of non-tax revenue to the extent of 57.5 per cent; (4)

over-spending on current expenditure to the extent of 42.5 per cent; and (5) under-spending on development expenditure to the extent of 6.6 per cent. The residual of 21.9 per cent was absorbed as a budget deficit.

Similarly, in 1990-91, for example, the sum of under-collection of revenue and over-expenditure totalled Rs. 31.1 billion. The share of the absorption of this additional deficit was (1) over-collection of direct taxes to the extent of 3 per cent; (2) under-collection of indirect taxes to the extent of 39.1 per cent; (3) under-collection of non-tax revenue to the extent of 17.5 per cent; (4) over-spending on current expenditure to the extent of 39.1 per cent; and (5) over-spending on development expenditure to the extent of 7.4 per cent. The addition to the deficit was absorbed by the budget deficit to the extent of 100 per cent.

The committed budget deficit target was achieved in two years, namely 1989-90 and 2000-01. In 1989-90, there was an under-collection of 28.1 per cent in tax revenue and over-spending of 71.1 per cent in current expenditure, while development expenditure remained on target. The cushion was provided by a nearly 100 per cent over-collection in nontax revenue. In 2000-01 too, there was a 66.2 per cent under-collection in tax revenue and a 33.4 per cent over-spending in current expenditure. However, unlike 1989-90, the cushion was provided to the extent of 58.8 per cent by under-spending in development expenditure - the highest in the post-1988 period - and 41.2 per cent by over-collection in non-tax revenue.

A perusal of the 'behaviour' of the various budget heads over the period 1988-2001 shows that tax revenue has been under-collected in 12 out of 14 years and over-spending in current expenditure has occurred in 10 out of 14 years. Consequently, the brunt of the budget deficit targeting has been borne by development expenditure, which has been underspent in 9 of 14 years.

An examination of development expenditure 'patterns' shows that there has been over-spending in development expenditure in 4 out of 14 years, particularly in 1991-92 and 1997-98. In 3 out of 4 years, enlarging the budget deficit absorbed the impact. However, under-expenditure has been the

norm, with double digit under-expenditure in 7 out of 14 years: 1988-89, 1993-94, 1994-95, 1996-97, 1998-99, 1999-00, and 2000-01. The extent of under-expenditure in 2000-01 was unprecedented.

On average over the period 1988-2001, the share of the absorption of the additional deficit has been as follows: there has been (1) under-collection of direct taxes to the extent of 5 per cent; (2) under-collection of indirect taxes to the extent of 30 per cent; (3) under-collection of non-tax revenue to the extent of 4 per cent; (5) over-spending on current expenditure to the extent of 29 per cent; and (6) under-spending on development expenditure to the extent of 8 per cent. Up to 60 per cent of the additional deficit has been absorbed as budget deficit.

More recently, over 1999-2001, there has been (1) under-collection of direct taxes to the extent of 17.9 per cent; (2) under-collection of indirect taxes to the extent of 28.4 per cent; (3) under-collection of non-tax revenue to the extent of 47.1 per cent; (4) over-spending on current expenditure to the extent of 33.7 per cent; and (5) under-spending on development expenditure to the extent of 33.5 per cent. Up to 31.7 per cent of the additional deficit has been absorbed as budget deficit.

A comparison of the averages of the periods 1988-2001 and 1999-2001 shows that under-collection of direct taxes has more than tripled, under-collection of non-tax revenue has increased nearly 12-fold, over-spending on current expenditure has increased by about one-sixth, and under-spending on development expenditure has increased 4-fold. It appears that, of late, the burden of achieving the committed budget deficit target has increasingly been borne by development expenditure, with the concomitant costs to the poor in terms of foregone jobs and incomes.

How has the Current Account Deficit been Reduced? The current account deficit can be lowered through changes in both the trade and non-trade related categories. With respect to trade categories, the current account deficit may be reduced on account of higher export receipts of lower import payments. The changes may be the result of an increase in the value or volume of exports or a decrease in the value or volume of imports. Higher export receipts on account of higher value of exports are likely to accrue more foreign exchange for the same level of output, as well as enhancing incomes for

exporters and generating growth. Higher export volume is likely to generate more output and employment, leading to higher income. Lower import volumes, at Pakistan's current level of development, are likely to be reflective of recessionary tendencies, i.e, a slow-down in economic activity, and impact adversely on employment, income and growth.

With respect to non-trade categories, the current account deficit may be reduced through lower debt servicing on account of debt retirement or write-offs or rescheduling. Lower debt servicing on account of debt retirement or write-offs releases resources for investment or consumption without future liabilities, while debt rescheduling transfers liabilities to future generations. This liability can be neutralized if the resources released are employed for the creation of income generating assets.

The decline in import growth is significantly greater than in export growth and import declines are concentrated in capital goods, which correspond to the decline in fixed investment. The conclusion can thus be drawn that the improvement in the current account gap has come about largely through import suppression, partly induced by stabilization policies.

TABLE 5
TRENDS IN FISCAL / ECONOMIC INDICATORS

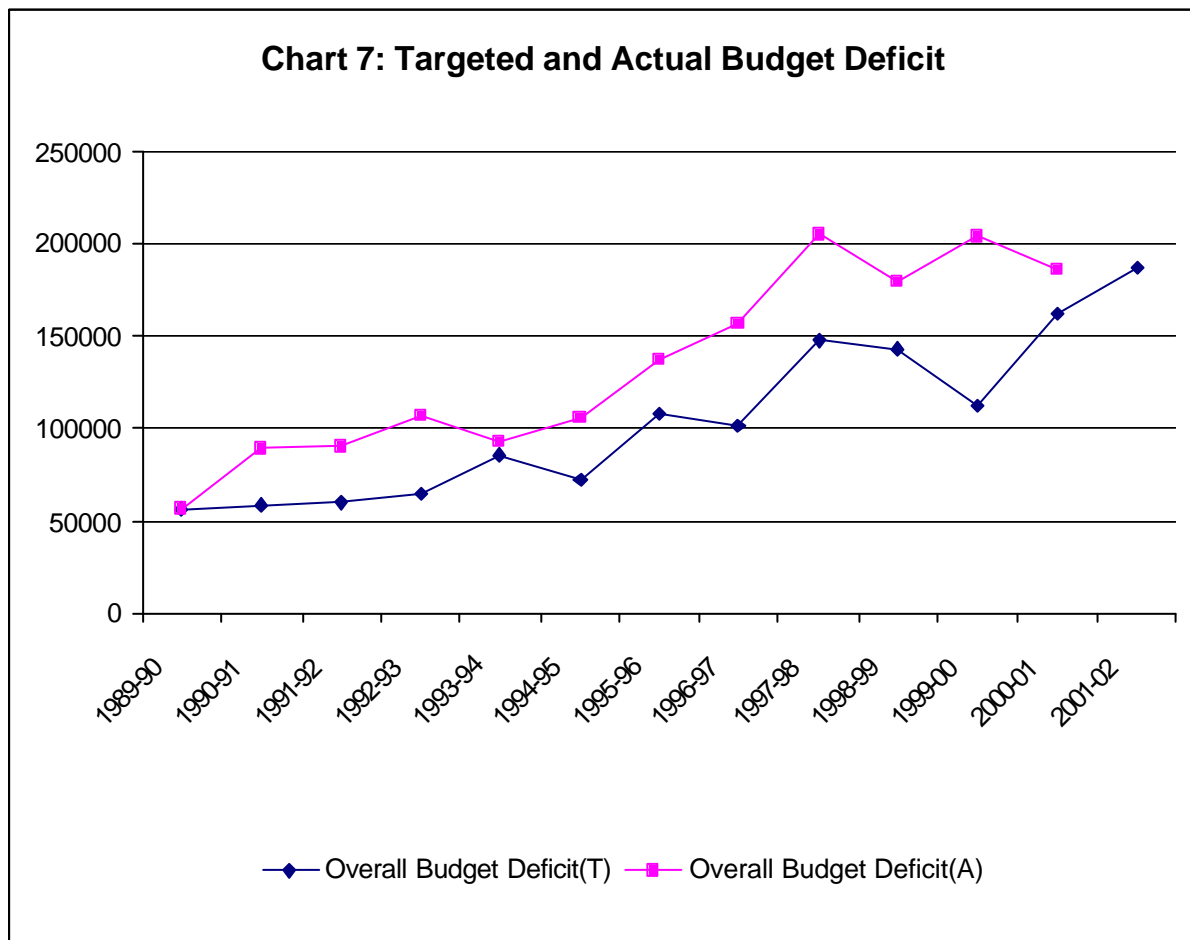
Fiscal Year	Capital Goods	INDUSTRIAL RAW MATERIAL		Consumer Goods
		Consumer	Capital	
1986-87	37	39	7	17
1987-88	36	43	7	14
1988-89	37	39	7	17
1989-90	33	41	7	19
1990-91	33	44	7	16
1991-92	42	38	7	13
1992-93	42	38	6	14
1993-94	38	43	6	13

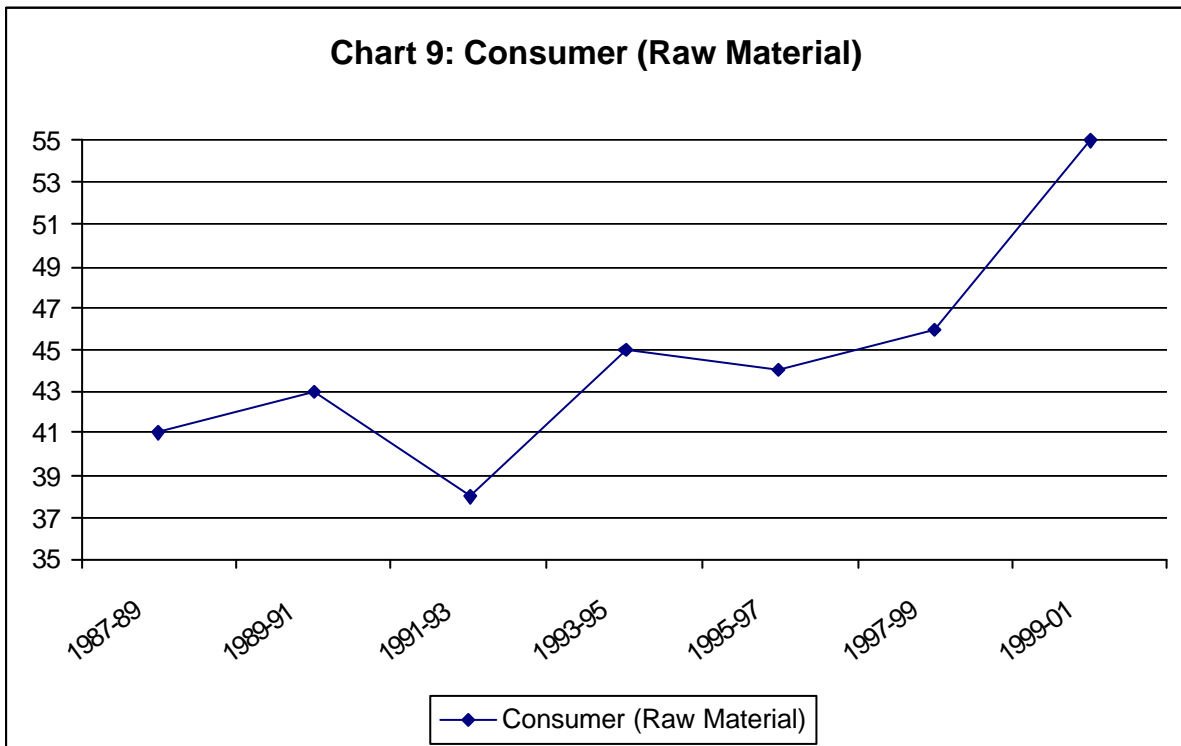
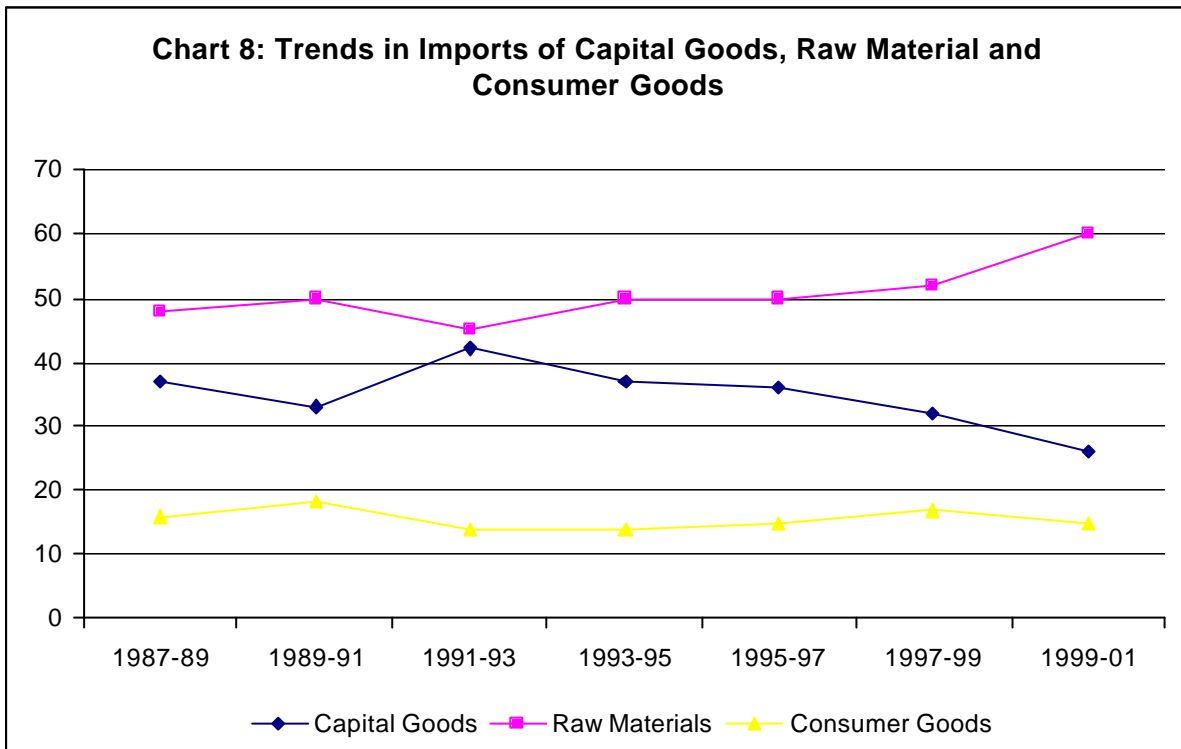
1994-95	35	46	5	14
1995-96	35	45	6	14
1996-97	37	43	5	15
1997-98	32	45	5	18
1998-99	31	47	6	16
1999-00	26	54	6	14
2000-01	25	55	6	14

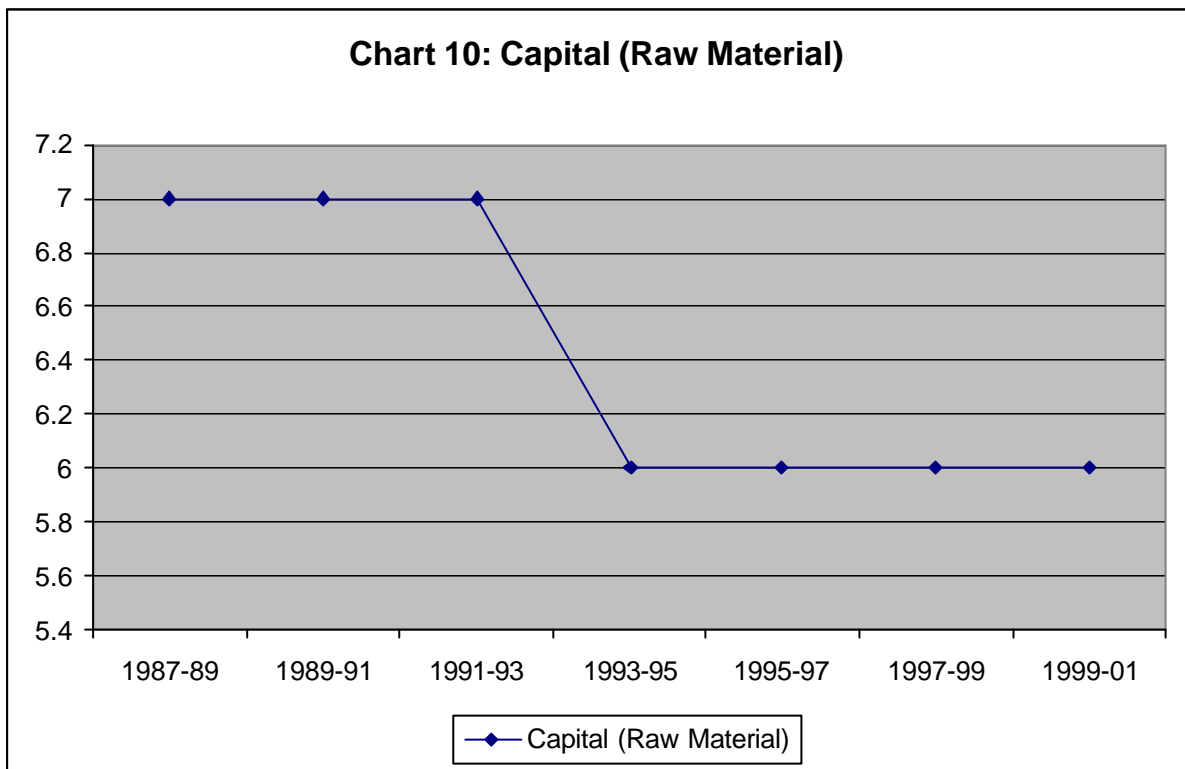
Sources: *Statistical Supplement (2000-01)*
Pakistan Economic Survey (various issues)

How has the Rate of Inflation been Reduced? Inflation can be lowered through controlling cost-push or demand-pull factors. The former involves intervening on the supply side and reducing the cost of production, which tends to enhance product competitiveness. The latter involves intervening on the demand side by curtailing both purchasing power and consumption. Where consumption levels are already below subsistence standards, further reductions can have adverse effects on nutrition and health, as well as on social stability.

A question that has been frequently raised in Pakistan has been why the inflation rate is high. Ironically, the relevant question today is why the inflation rate is currently as low as 4-5 per cent and what impact it has on the poor (see box 2.2). A key factor explaining the reduction in the rate of inflation is 'monetary' in character and, by and large, on account of a contractionary monetary policy. The rate of growth in money supply has declined sharply since 1999, largely on account of the lower monetization of the budget deficit and depressed demand for credit by the private sector. Despite very high cost push inflation the overall inflation is low because of demand pull inflation is negative or at most zero.



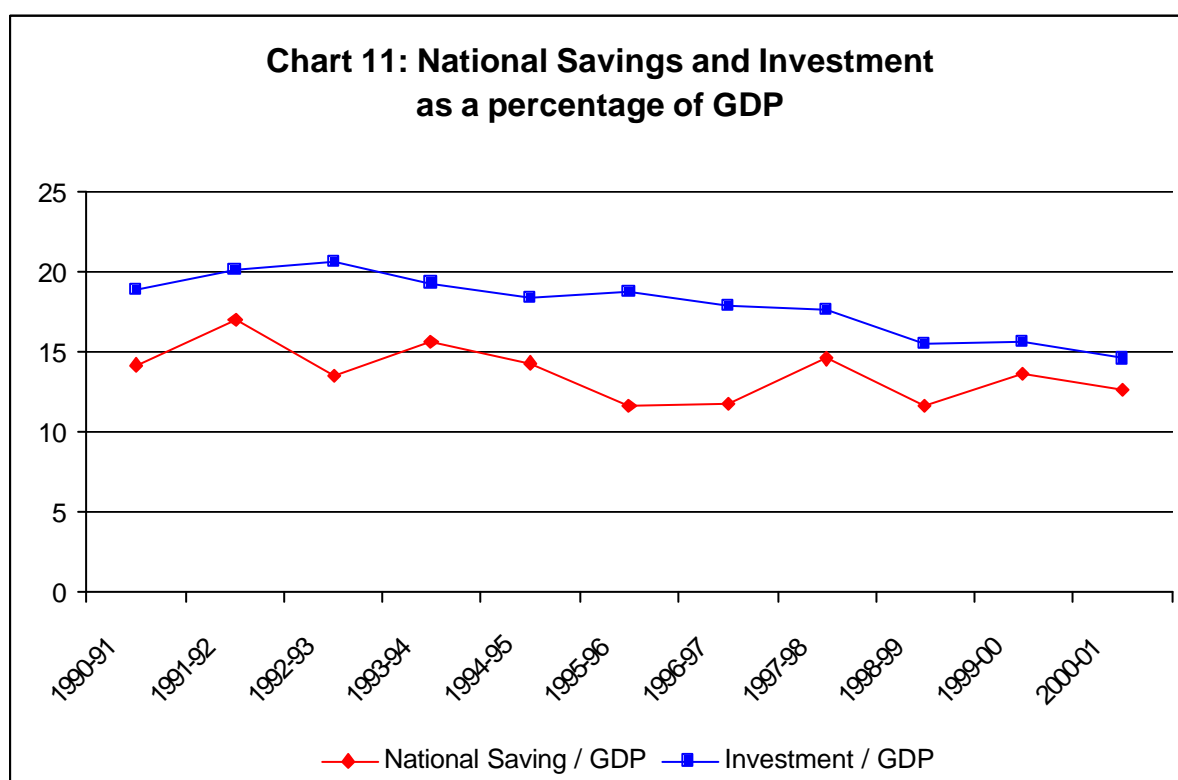




7 Conclusions and Recommendations

The thrust of economic policy since 1988, as reflected in the government policies, has been to pursue stabilization objectives at the cost of growth objectives. The mechanism for this policy has been a contractionary fiscal policy, including cuts in development expenditure. In our view, the policy has been counter-productive. It has dampened investment and curtailed purchasing power, leading to a recessionary situation. It has contributed directly to the increase in unemployment and poverty. That the policy continues to be pursued with greater vigour is unfortunate.

The paper also reveals that the stabilization targets have also been achieved in a way in which they should not be achieved. The budget deficit that should be achieved through increase in revenues or reduction in current expenditures have been achieved by reduction in development expenditure. This has adversely affected the GDP growth which in turn have increased poverty and unemployment. The current account deficit have been decreased significantly during this period but the current account deficit which should be reduced either by increasing in exports or reduction in imports of finished consumer goods have been reduced by reduction in imports of capital goods and imports of raw



materials especially for the production of machinery and the capital goods. This also reflect the recessionary conditions in the economy which is adversely affecting the growth and causing increase in the unemployment and poverty. During this period the gap between the saving and the investment have also declined in a negative way. This gap should be reduced by increasing the national saving but unfortunately during this period both saving and investment have declined but investment have declined faster because of the drastically reduction in the government investment.

This paper propose a fundamental shift in policy. The principal objective should be growth, with stabilization being a secondary objective. The contractionary fiscal policy regime needs to be relaxed, with a shift from revenue mobilization to current expenditure reduction. Development expenditure, however, needs to be enhanced even further, in order to create the crowd-in effect for investment, for the growth in employment, income, and purchasing power and for poverty to be reduced in absolute terms. The preoccupation with curtailing fiscal deficits needs to be reviewed. The fiscal deficits can be positively employed if the amounts thus generated are devoted to investment in productivity enhancing infrastructure and in employment generating projects.

The policy of opening up the economy more than what is required by WTO standards is inadvisable. In the past, domestic producers enjoyed unfair advantage relative to imports. A level playing field is perhaps in order. However, a new trade regime is now emerging, where imports are beginning to enjoy an unfair advantage relative to domestic producers. The cost of such a trade regime to the country's industry and economy and to the people in terms of unemployment and poverty is likely to be extremely high.

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**STABILIZATION POLICY
VS
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IMPLICATION FOR
THE PAKISTAN ECONOMY**

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