<u>Why should we avoid populist economic policies</u>?[1]

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As the leader of an opposition party, President-elect Lula of Brazil was consistent in his attack on President Cardoso's efforts at fiscal reforms, demanding more spending regardless of affordability. Now when he has been elected by a vast majority of the population he has struck a note of economic realism. He has warned that 'there is no miraculous solution for such a huge social debt' and Brazil's dire straits demand 'austerity in the use of public money'.

Fortunately, none of the major political parties in Pakistan has made current economic policies an issue. But some economists, commentators and columnists without adequate understanding of the country's economic problems and the growth process, have been advocating some potentially dangerous but populist economic policies for the country. They feel that this period of transition in the governance of the country provides an opportunity for them to sell what in my view are some outdated but failed policy prescriptions. Although debates and discussion on alternative solutions and economic policies should be welcomed but we should remember the old adage:

and apply the same to these

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Let us first examine the track record of these commentators during the past three years? Three years ago these same pundits were predicting that the country was about to default and nobody was coming to rescue this government. When this proved wrong they were vocal in asserting that the agreed targets were not going to be achieved and the program would soon derail. When the program remained on track and the economy began to show signs of resuscitation their explanation was this was all artificial due to infusion of financing from outside and unproductive purchases of foreign exchange from open market and will prove short lived. When the reserves began to accumulating even more rapidly, exchange rate became stable, remittances started rising, inflation remained muted, debt stock was reduced there was a new round of shouting that all these gains were due to the windfall of September 11 and real economy indicators were not moving. Since last six months real economy indicators such as exports and tax revenues are showing a double digit growth, large scale manufacturing is up by 5 percent, machinery imports have risen by 25 percent, non-oil non-food imports have expanded by 11 percent, now the popular mantra is that what do these statistics mean when the common man is not witnessing any improvement in his life, poverty is on rise and unemployment ranks are swelling. While it is true and nobody can deny that this criticism is largely true but it should be realized that when economy was in intensive care unit it had to be brought to a stable condition before it could start growing. All the intermediate steps outlined above that are pre-requisites for the path towards higher growth, poverty reduction and increased employment and will thus eventually benefit the common man are totally ignored and completely dismissed. The height of cynicism is that all the difficult exogenous shocks that the country had to go through during this period – an unending sequence of adverse geo-political and internal security shocks, a synchronized world recession and uninterrupted drought for three years – are dismissed as an excuse and cover up for the failure of government policy. The question then arises: with this kind of track record and logic should their new advocacy that the continuity of present policies only implies one thing – pursuit of macroeconomic stabilization be given due credence. They argue for adoption of a set of alternative set of and discarding of the present policies.

It is common sense that macroeconomic stability is the foundation upon which the superstructure of economic growth is built. Nowhere in the world macroeconomic stabilization policies are pursued as an end in themselves. They are the means through which economies get revived from their ailing state and this is exactly what the three year period has achieved. The new government can safely use this foundation to pursue prudent growth generating policies but not fall in the trap of believing that the populist policies being advocated are required at this stage. Before delving into the reasons for discarding populist policies let us address the question: what is the link between macroeconomic stability and revival of growth?

Growth can take place either through new investment by the private and public sector, better utilization of existing capacity or improved productivity and efficiency of resource use. What has macroeconomic stability been able to achieve? It allows businessmen, investors and exporters to plan their decisions knowing that the prices of output and inputs will remain stable and not fluctuate widely. Their cost and income streams will be secure from the onslaught of currency depreciation and interest rate fluctuations. Domestic savers will no longer be tempted to transfer their holdings into foreign currencies as the latter are no longer hold the charm as store of value. Foreign investors will be certain that the value of their assets will no longer keep falling. They will also be confident that they can transfer their profits and remittances without any fear of non availability or inadequacy of foreign reserves. Domestic businesses will have satisfaction that they can access credit at competitive rates as the banks have ample liquidity. The real purchasing power of consumers and particularly the poor will remain intact and not get eroded due to high and accelerating inflation rates. Higher public expenditures on infrastructure and social services can now be accommodated due to the fiscal space created by debt reprofiling, lower interest rates and appreciating exchange rate.

Good economic governance has plugged in a lot of the leakages and wastages in the utilization of public resources but not all. This should give rise to improved efficiency of resource use and push the incremental capital output ratios back to their historical averages i.e. create higher output without the proportionate change in the level of inputs.

Thus the time is ripe for the new government to translate the pains incurred by the society during the last three years of tough adjustment and austerity measures (which were absolutely essential to lay this foundation) into gains and take the credit for this turnaround.

What are the key populist policies which are being advocated for apparent benefits to the "common man" and for alleviating poverty in this country.

(a) the Government should pursue expansionary fiscal policy by increasing its public expenditure

(b) the ever-increasing prices of petroleum products and utilities such as electricity and gas should either be frozen or reduced

(c) public sector organizations should be restrained from retrenching their employees and instead asked to hire new employees

(d) interest rates on national savings schemes such as Defence Certificates should not be cut any more and actually increased to their previous levels.

(e) Exchange rate should be allowed to appreciate without any intervention so as to reach a level between Rs 50 – 55 per dollar

(f) Export refinance rate should be reduced from the present level of 8 percent to 2 percent to help the exporters and other forms of subsidies be provided to exporters and investors.

These policies, if implemented, will no doubt make the leaders and economic managers of the new government extremely popular in the short term but set the stage for the destruction of the economy in the medium to long term. Let me analyse each of the above six policy propositions and demonstrate the pernicious effects of each one of them.

If we expand the level of public expenditures beyond the current level the objective of bringing down fiscal deficit over the next three years will never be achieved and we will have to go for higher fiscal deficit. This deficit can either be financed by external borrowing, internal borrowing or by printing money. Higher external borrowing will lead us once again to rely on the whims and fancies of the international financial institutions and to follow their conditionalities. This will move us further away from our stated goal that the current on-going program would be the last program with the IMF and after 2004 we won't approach them for financial assistance. Higher domestic borrowing by the government will invariably result in an increase in the level of lending interest rates which have been brought down with considerable difficulty from 20 percent to 11 percent. Reversion to such high interest rates will render a number of our firms, enterprises and businesses bankrupt and defaulters as they will be unable to meet their higher debt servicing obligations. Banking system will also suffer as a large proportion of its loans turn into non-performing assets.

If we follow the easy money policy of printing currency the country will be soon faced with double digit inflation rates and there will be a hue and cry from all over the country on this escalation in general prices level of essential commodities. The poor will be particularly hurt by high inflation as they don't have assets such as dollar accounts, real estate or jewelry which can insulate them from price hike. The only feasible way out of this problem is to reform the CBR and mobilize additional revenues by widening the tax net and curtailing the discretionary powers of tax collectors.

Let us move to the next proposition i.e. freeze or reduce the prices of petroleum products and utility prices. There is no doubt that this is area of serious concern both for consumers as well as businesses in Pakistan. The middle class families in this country find it difficult to manage and balance their household budgets because of the price rise in transport costs and utility bill payments. Similarly, the competitiveness of our industry is also under severe strain because of this cost escalation. No doubt, something has to be done to bring this situation under control. The Government of Pakistan has already poured in billions of rupees into KESC for meeting their losses accumulated over last several years. This has been one of the reasons for larger than desirable fiscal deficit. The prescription of subsidizing utility prices and oil products is workable only in the short term and cannot be sustained over time due to inadequacy of resources. Reducing petroleum surcharges in absence of equivalent additional taxation will only widen fiscal deficit or require further cuts in the already low level of development expenditure. The real need is for WAPDA and KESC to reduce their line losses, improve their recoveries and invest in renewal and replacement of distribution systems. Public sector management of these companies has so far failed to achieve these objectives and thus privatization of these utilities under a regulatory framework appears at present as the only viable solution. But no private operator will be interested if it is not allowed full cost recovery and the utilities are subsidized. So this is a catch-22 situation. Consumers are suffering for a variety of poor or postponed decisions taken in the past, for the inefficiencies of the companies themselves, for external shocks such as hike in world oil prices but the situation cannot be rectified unless the private investor takes over the operations and improve their efficiency. But private sector will not take them over unless they are allowed full cost recovery. Here lies the real dilemma as far as utility prices are concerned. Subsidies or reduction in surcharges will only allow the structural deficiencies and weaknesses to be covered temporarily but huge losses will continue to occur to national exchequer. As debt servicing burden is eased over the next two to three years it should be possible to reduce the surcharges on petroleum products and provide relief to the consumers but immediate action is not advisable.

The policy of restructuring public sector corporations and banks under which thousands of employees have been laid off has attracted criticism from political parties and the media. But this restructuring has already started to pay off as the annual budgetary outlay of Rs 100 billion borne by the government for meeting the losses of these enterprises has been reduced to Rs 35 billion. Pakistan Steel Mills, PIA, Nationalized Commercial banks (NCBs), oil and gas companies, Pakistan Railways have already started generating profits or reducing their losses significantly. This turnaround could have been possible only by eliminating surplus employees and aligning their manpower to international industry norms and practices. It is a travesty of justice that to keep about 100,000 people employed in these corporations we ask the whole nation to pay almost Rs 100 billion every year and bear the losses of the Corporations employing these individuals. The productivity of each of these enterprises which has gone through restructuring has improved, their cost of production has gone down, their product pricing has become more realistic and it is quite feasible that they can become competitive over time. The economy as a whole has gained and will further gain as these public enterprises either become efficient or are privatized. They will then be in a position to reduce their prices and upgrade their services to the consumers. While I do have a great deal of sympathy with those individuals who have been retrenched and their families the State Bank of Pakistan had insisted that the NCBs for example should provide generous golden hand shake packages to those employees who have chosen to leave the service of the banks. The average package was Rs 2 million per employee and this amount should provide them some financial wherewithal. The only sustainable way of generating employment in the economy is through private sector investment and expansion of existing businesses particularly in agriculture, small and medium enterprises and services sector and not through artificial inflation of ranks in the government departments and public corporations.

The fixed income groups, pensioners, small savers and widows are quite justified when they protest against the policy of gradual reduction in the interest rates paid by the Government on National Savings Schemes (NSS). Money illusion prevails whereby nominal returns of 15 percent annually in an inflationary environment of 12 percent appear quite attractive compared to the nominal returns of 11 percent when inflation is down to 4 or 5 percent. Higher real returns do not enter into their calculations and they resent the fact that they are today receiving only Rs 11,000 per year on an investment of Rs 100,000/- as against Rs 15,000 which they used to receive three years ago. In the meanwhile the prices of all the commodities they consume have moved up and thus their purchasing power has been eroded considerably. They find it extremely difficult to meet their both ends meet. There is a lot of merit in the above arguments and I do fully recognize that the welfare of this particular class of our population has been lowered. But the flip side of maintaining higher rates of return on these schemes is that the Government's borrowing cost and debt servicing bill keeps going up and up. One of the factors for debt servicing accounting for such a high proportion of Government expenditure is the above-market interest rates being paid to those buying Defence Certificates, Monthly Income Certificates etc. If these rates are kept at the same level as in the past the debt servicing costs will, at one stage, consume all the tax revenues leaving nothing for other expenditures including running of government, defence and development. Is this a desirable outcome for the nation? While the small savers will definitely benefit the Government budget will be in a state of perpetual crisis. I am not sure if any patriotic Pakistani will like Pakistan's public finances to plunge into this state of disarray.

The other problem with higher interest rates on national savings schemes is that the banks start losing their deposits as there is a powerful incentive to divert these deposits into NSS instruments and earn higher returns. The banks therefore lose their source of financing for businesses, investment, consumers and agriculture. This is exactly what was happening in the mid 1990s when the rates on NSS were so attractive that the rupee deposit mobilization by the banks was negative. Thus the risk to the health of the financial system will become heightened once again if the differential between the NSS rates and bank deposit rates is allowed to widen. We have to design a scheme which will restore the balance between the returns on the savings of the small savers, pensioners, widows etc. and their purchasing power.

A popular demand since the rupee has strengthened vis a vis US dollar is that the SBP should adopt a hands-off approach in the foreign exchange market and allow the rupee to find its natural level. This argument is quite valid since the SBP is committed to a policy of free floating exchange rate and did not actively intervene when the rupee depreciated about 18 percent in the year 2000-01. The Central banks all over the world are both a market participant and a regulator of foreign exchange markets. In case of Pakistan, the purchases and sales of foreign currency by the SBP have been deliberately misinterpreted and the opponents of the present regime have invented all kinds of disingenuous arguments to discredit the reserve accumulation goals achieved through this policy. In the competitive environment of global economy the space earned by Pakistani exports has to be maintained and widened. Exchange rate policy is one of the tools employed by the central banks to help maintain the competitiveness of the country's exports. Because once the market share is lost due to short-term expediency it becomes extremely difficult to recapture this share. Pakistani currency had overshot in the aftermath of free float primarily because the central bank did not have adequate reserves to quell the speculative attack. But once the economic circumstances changed and economic fundamentals got strengthened the central bank is able to intervene to protect the longer term interest of maximizing the country's exports.

The cost structure of Pakistan's infrastructure services and low productivity of Pakistan's labor services already puts the country's exports at a comparative disadvantage. If some of the gains arising from a stable and remunerative exchange rate are also destroyed to help the imports of goods and services from overseas sellers in the short term the permanent shock to the economy will be both substantial and irreversible. We have to guard against the possibility, however remote, that the external account improvements could taper off in future; if this development emerges, it could have significant negative repercussions, not least the re-emergence of devaluation expectations and a jump in domestic interest rates. Thus gradual adjustment of monetary and exchange rate policies despite a substantial improvement in the current account is called for. An abrupt shift in the exchange rate is not to be desired in any case, as an inadequate adjustment period for exporters could lead to the loss of hard-to-recapture export markets and a consequent fall in economic activity and higher unemployment. The exporters have to be protected from abrupt and large negative decline in their profitability and the only way to do is to continue the present policy of gradual adjustment. Cheaper imports will not only raise the demand for foreign exchange but also make some of the domestic production particularly in new and emerging fields unprofitable. Marginal Exports that can penetrate the world markets at the prevailing exchange rate will also disappear reducing the supply of foreign exchange to the country. The country will have rising trade and payments imbalances which can be filled in by external borrowing. Is this a wise policy to squeeze our foreign exchange earning capacity and facilitate the growth of sales of foreign goods through imports and land the country into higher indebtedness to external creditors? The economic managers bear some responsibility for ensuring that the cost of production of exporters is kept under control by providing to them public utilities and services at a competitive price structure.

Finally, there is a strong lobby of exporters who have been insisting for a subsidized interest rate for export finance. There is no empirical evidence in Pakistan to support the argument that an increase in volume of export finance leads to higher volume of exports. The periods of low and subsidized rates have led to an expansion in the demand for export refinance but a reduction in the volume of exports. Subsidized rates, in the past, have given rise to a lot of misuse and misallocation of resources. The arbitrage between the subsidized rate and the market rate has created distortions in the financial system in terms of artificial deposits, spurious collaterals and bad loans taken on the strength of those collaterals. Market based rates have, on the other hand, engendered discipline and prudence in the use of these resources. Subsidies have to be paid for by the other users of the financial system i.e. depositors and borrowers outside the export finance scheme. Their returns and costs are affected adversely and the process of financial intermediation is stunted. In the open trading system of WTO these kinds of subsidies invoke retaliatory action by the importing countries who impose anti-dumping duties against Pakistani exports thus shutting us out of their markets. It is thus very important that we do not encourage such deviant behavior which will eventually hurt our export interests. The SBP has opened up avenues of dollar financing of exporters which, in the wake of stability of exchange rate, is quite attractive. The shift to dollar export financing from rupee financing has thus addressed this concern of low cost credit to exporters to a large extent.

The above analysis of the six 'populist' measures advocated strongly by these half-baked economists shows that while these are indeed palliatives and band-aids and will be received very warmly by the general public and the media their consequences for the health of the economic system are certainly dangerous. The Military government has taken some very unpopular and tough decisions during the last three years to restructure the economy. The pains caused by these measures have already been felt by everyone but particularly by the middle class and fixed income earning groups. The grievances of these groups are legitimate but the remedy is not to abandon this course of action and adopt populist measures. The new government should follow, improve and strengthen the measures already taken so as to maximize and spread their benefits gradually over next few years.

The new Government should give priority attention to a few issues. First, they have to bring about a shift in the sentiments of private investors – both domestic and foreign. They have to convince them that there will be political stability, law and order and security situation would be kept under control, macroeconomic framework will remain intact and there will be continuity and consistency in economic policies and governance. Second, the level of public sector development expenditure should be raised in consonance with the medium term expenditure plan. But unlike in the past that whenever revenue shortfalls occurred during the course of the year the axe always fell on development expenditure. The new Government should ensure that any such shortfalls are met by taking additional revenues mobilization measures or curtailing non-development expenditure and not by reducing public sector development program. Third, they should accelerate the process of restructuring and revamping public sector institutions such as WAPDA, KESC etc. so that they can improve their efficiency and reduce their operational costs. The benefits of these improvements should be passed on to consumers rather than captured by the Government. Fourth, the CBR reforms should be given full support so that tax administration and resource mobilization efforts produce dividends for the economy and extend fiscal space for increasing public sector investment. Higher revenues will also enable achieve debt sustainability sooner than later. Fifth, a special scheme should be designed for protecting the savings of pensioners, widows and other small savers. The country already has very low domestic savings rate and this class can be induced to raise their savings in a way that the budgetary discipline is not impaired.

As the impact of external shocks of Sept. 11, drought, tension with India, political uncertainty of elections, and global slow down has begun to recede several key domestic economic indicators during the last six months such as growth, investment, exports, taxes, water availability for agriculture and manufacturing output are showing healthy signs of recovery. These indicators are going to make the difference to the life of the common man and the middle class in the country. As the rays of sunlight are just beginning to appear out of the long darkness let us not deliberately eclipse them by politically expedient but economically disastrous populist policies. Let us prove the critics of democracy wrong and explode the myth that the democratically elected leaders cannot be trusted with responsible and prudent economic management.