ECONOMIC IMPACT OF THE CORONAVIRUS AND THE RELIEF PACKAGE

By

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The Coronavirus has already spread to 186 countries. The worst hit countries have been the EU countries, USA and China. The consequences are that normal economic activity, both in the domestic economy of these countries and their external economic relations, has been severely disrupted. Meanwhile, we are also witnessing the signs of a possible exponential growth of Coronavirus cases in Pakistan.

The magnitude of the negative impact globally is so large that some writers have suggested that it will be even worse than the Great Depression. The Moody's rating agency has forecast that instead of an over 3 percent growth of the global economy in 2020, it will now see negative growth. Conditions accordingly are unlikely to improve till 2021. The EIU has projected that the growth rate in 2020 will fall, for example, in China from 6 to -1.5 percent, in India from 6 to 1 percent and in Turkey from 4 to -5 percent.

The fundamental question, therefore, is what will be the impact of the Coronavirus on the Pakistan economy? The problem is that there was already a slowing down of the growth momentum. The growth rate for 2019-20 was expected generally to be significantly lower than in 2018-19 and to come down to perhaps even below the target of 2.4 percent. In fact, the large-scale manufacturing sector has been exhibiting negative growth. Some of the major crops, especially cotton, are likely to see significant output declines and various service activities like domestic trade and transport are in a state of recession.

Therefore, the economy is inherently unable to face the major shock of negative global growth caused by the Coronavirus. There is the risk of a further massive decline in domestic economic activity, especially in industry which makes the more dominant contribution to GDP growth. The stock market continues to be under pressure, partly because of the withdrawal of portfolio funds by foreign investors. There is an outpouring of news of closures of a host of large and small industries The conditions in developed country markets are already exerting a negative impact on our exports. and commercial enterprises in a wide range of sectors and the resulting heightening of risk perceptions. The large-scale continuing outflow of 'hot money', invested in Government short-term treasury bills, has already contributed significantly to a perceptible decline in foreign exchange reserves and an almost 7 percent depreciation in the value of the Rupee.

Given the big uncertainties about the future outlook on the economy for the last quarter of 2019-20 and thereafter we decided to use the 43 equation Macroeconomic Model of the Beaconhouse Center for Policy Research (BCPR) to simulate the impact of different scenarios. This Model was used earlier to project the performance of the economy during the tenure of the IMF Program from 2019-20 to 2021-22. These projections were published earlier in this newspaper.

The Model has been used to quantify the combined impact of different shocks. The first is the likely fall in the volume of global trade in the next few months. The size of the shock has been varied from 10 to 20 percent. The consequential impact on the unit dollar value of exports has been taken in the same range. Further, the assumption made is that with the precipitate more than halving of the oil prices there will be a somewhat bigger fall in the unit value of imports by Pakistan of 20 to 30 percent.

The shocks to the domestic economy due to the Coronavirus and measures taken thereof, in particular the lockdown, to avoid its spread have both supply and demand related manifestations. These include, first, some shortages in supplies of domestic goods due to transport and other bottlenecks of possibly 5 to 10 percent. Second, the restrictions imposed on imports by the countries like EU, USA, UK and China or cancellation/postponement of export orders for Pakistani goods are expected to lead to a decline in the volume of exports of 20 to 30 percent in relation to the desired level.

Similarly, there is likely to be a decline in the physical inflow of imports into Pakistan of 5 to 10 percent also in relation to the desired level. Third, given the impaired liquidity position of potential investors and heightened risk perceptions, there is likely to be a big fall in private investment in coming months when faced with industrial closures and the obvious reluctance of banks to take on greater risk following the likely growth of non-performing loans.

Meanwhile, the Government is expected to maintain a real growth in current expenditure of 8 to 12 percent and in development spending of 10 to 15 percent, contributing to a higher fiscal deficit given the erosion of the tax base. The SBP has reduced the policy rate by 225 basis points and the rate of expansion in the money supply is assumed to be 10 percent. The level of tax revenues and the exchange rate are endogenous variables and will emerge from the model simulations.

The magnitudes of the shocks to key variables in two possible scenarios are given in Table 1. Scenario-I builds in the impact of a less severe decline in key magnitudes, while Scenario-II captures the effect of more severe shocks. The objective is to simulate through the Model the variation in the size of the negative impact of the Coronavirus on Pakistan's economy.

Table 1
Likely Magnitude of the Shocks

(%)

	Scenario-I	Scenario-II

EXTERNAL		
Volume of World Trade	-10	-20
Unit $ Value of Exports	-10	-20
Unit $ Value of Imports	-30	-20
FDI in Pakistan	-40	-60
Remittances	-10	-20
DOMESTIC		
Availability of Domestically Produced Goods	-5	-10
Export Orders	-20	-40
Availability of Imported Goods	-10	-15

The key results of the simulation of the model in the two Scenarios respectively are highlighted below:

(i) **The GDP could fall by 4.6 percent in Scenario- I and by as much as 9.5 percent in Scenario- II in the fourth quarter of 2019-20.**

(ii) **The rate of inflation is likely to remain relatively low in Scenario- I at 9.6 percent. However, it could be as high as 16.1 percent in Scenario- II.**

(iii) **The possible increase in number of unemployed workers is 3.1 million in Scenario- I and almost 5 million in Scenario- II. This is the unemployment caused by the likely slowdown of the economy and is of a more lasting nature. The temporary unemployment resulting from a lockdown / curfew could be of as much as 10.5 million workers, including daily wage and contract/casual workers in establishments.**

(iv) **The number of people who could fall below the poverty line ranges from 9 to 15 million.**

The projections of macroeconomic variables in the two Scenarios are presented in Table 2. It may be observed that there could be a significant fall in private consumption expenditure of 4 to 8 percent. This will have negative implications on the nutritional status of the bottom 40 percent of the population during the next three months.

Table 2
Projected Magnitude of Macro Economic Variables in the two Scenarios

Growth Rate (%)

	Scenario-I	Scenario-II
(at constant prices)		
Private Consumption Expenditure	-4.4	-8.2

Public Consumption Expenditure	12.0	8.0
Private Investment	-11.7	-27.0
Public Investment	15.0	10.0
Exports of Goods and Services	-6.8	-15.1
Imports of Goods and Services	5.2	-2.6
Net Taxes	-5.0	-9.5
GDP at factor cost	**-4.6**	**-9.5**
Rate of Inflation	**9.6**	**16.1**

The volume of exports of goods and services could fall by almost 7 to 15 percent. Imports of goods and services are likely to increase by over 5 percent in Scenario-I due to the big fall in imports prices but decline by almost 3 percent in Scenario-II.

There is also a need to work out the implications on the current account of the balance of payments. This is done in Table 3 for the last quarter of 2019-20.

Table 3
Projection of the Current Account, 4^{th} Quarter, 2019-20

($ million)

	2018-19	2019-20	
		Scenario-I	Scenario-II
Exports of Goods & Services	7462	6208	4842
Imports of Goods & Services	-15282	-11492	-11828
Remittances	5740	5166	4592
Others	-1081	-1189	-1298
Current Account	**-3161**	**-1337**	**-3692**

There is a positive outcome in Scenario-I. The current account deficit could decline by $1824 million. However, in Scenario-II it may worsen by $531 million.

The financial account of the balance of payments is likely to come under stress because of the big anticipated decline in foreign direct investment and continuing exit of portfolio funds. This could be partially mitigated by an increase in the inflow of borrowing from the IMF, World Bank and the ADB, although because of their internal institutional processing mechanisms they are more likely to become available in June or early next financial year. However, debt service payments will peak in the fourth quarter and consequently the surplus in the financial account may not be large enough to fully finance the current account deficit. Consequently, there could be some pressure on the foreign exchange reserves. Already, this process has begun, due initially to the exit of ‘hot money’. The IMF program will need to be focused more on preventing the economy from going into a deeper recession.

Table 4
Projected Growth Rates of Sectors
(Fourth Quarter, 2019-2020)

(%)

	Scenario-I	Scenario-II
Agriculture	1.5	1.0
Industry	-8.2	-14.2
Services	-5.3	-11.1
GDP	-4.6	-9.5

The next question relates to the prospects for different sectors of the economy. The sectoral growth rate projections in the two Scenarios are presented in Table 4. The fourth quarter represents a seasonal peak in economic activity in the country.

The simulations in the two Scenarios reveal that the big fall is going to be in the industrial sector of the economy. In Scenario-II it could fall by as much as 14 percent, due to a decline in the volume of exports and fall in domestic consumer demand. The services sector could also see a big contraction of over 11 percent. This will be the case especially in wholesale and retail trade, transport and financial services.

The estimated GDP loss in the fourth quarter of 2019-20 is potentially large. It has been calculated at Rs 891 billion in Scenario-I and Rs 1602 billion in Scenario-II at current prices. The tax revenue loss could range from Rs 150 billion to Rs 290 billion. However, this will be partially compensated for by a decline in the cost of debt servicing of Rs 90 billion over the next three months. Also, as the decline in the oil price gets reflected in imports the Petroleum Levy could yield additional revenues of Rs 100 billion by end-June 2020.

There is need to appreciate that the economy could remain in a state of recession beyond June 2020 depending on the duration of the Coronavirus incidence and inevitably the economy could take some time to recover. The first quarter of 2020-21 may continue to see a persistence of negative growth in the economy.

Turning to the relief package, with the primary purpose of staying on the right side of its benefactors at the IMF, the Government has employed somewhat a sleight of hand in claiming that it has tabled a massive diversified economic relief and stimulus package of more almost Rs. 1.2 trillion. Several of the proclaimed incentives do not in any significant way burden the Federal budget, e.g.:

a) Tax refunds to exporters (this is money which belongs to them anyway).

b) Support to beneficiaries of BISP and Ehsaas programs (already budgeted) and there being little, if any, additional liability due to earlier underutilization.

c) Deferment of bills of low-end consumers of utilities (they would still have to eventually discharge their liability), an action already rejected by K-Electric.

d) Deferment of loans, the cost to be picked up by the banks, assuming there is no compounding of interest charges on the delayed servicing of the debt.

e) Procurement of wheat, the cost of the bulk of the built-in subsidy to the farmer will be picked up by the provincial governments.

Again, although the SBP has cut the policy rate by 225 basis points, considering the nature of the crisis we are confronted with, the decision falls short of the scale of reduction needed to keep the economy running at a more decent pace to check the probability of a more rapid growth in the rate of unemployment.

SBP has also proposed a raft of measures focusing on the availability of new refinancing to support credit flows for much needed liquidity and on the relaxation of regulatory requirements for a short time period. Are these relief measures adequate? Given the voracious appetite of the Federal Government for borrowing to finance its expenditure obligations, the question is why the banks would take the risk of increasing their exposure to the likes of SMEs. They would have little empathy for them, irrespective of the extent of relaxation of prudential regulations by the SBP. Their proclivity to rush to 'assist' would be greater, the larger the size of the loan, even without any SBP supported relaxations. Hence, it is not quite obvious if the underlying objectives would be achieved from these relief measures announced by the SBP.

And if the recession is as large as highlighted above then much more will need to be done. Our proposals are summarized below:

a) The industries operating essentially in the domestic market will need to be focused more on, by permitting delays in the deposits of their tax liabilities, reduction in tax rates (especially through the halving of the minimum turnover tax). This includes cement, iron and steel, fertilizer, chemicals, paper and board, etc.

b) The profitability and liquidity of export industries will need to be enhanced by the restoration of the zero-rating facility, at least until the end of June 2020; to be replaced next year by a cash incentive of 10 percent which would be payable automatically to the exporter by SBP on receipt of export proceeds in lieu of other incentives. Our estimates suggest that this measure, while improving the timely availability of liquidity to the exporter will also be revenue neutral.

c) Reduce energy tariff to reflect the reduction made by the government in the domestic prices of oil and the decline in the import price of coal.

d) The proposed credit flows to SMEs and large enterprises in the formal sectors of the economy would be needed by them to finance wages, rental costs and debt servicing obligations. This assistance can be for a period of say 6 months to be repaid over a 3-5-year period. The portion pertaining to wages should be paid directly into the bank accounts of individual members of their labor force (using personal CNIC and EOBI data). Contractual agreements with these firms would have in-built penalties in case money is not targeted properly. This measure could serve as an attractive incentive for SMEs to opt for a more acceptable degree of documentation.

e) Since the above referred additional World Bank, ADB and IMF support is not likely to be available until June or early next financial year, we propose the deferral of remittances of all categories of dividends, reserves, technical and royalty fees (including any payments connected with take or pay contracts) using the good offices of the SBP to persuade the enterprises to postpone the associated outflows for the remainder of this year and the first quarter of next year.

f) The construction industry will also have to be activated by a strong package of incentives and tax breaks as promised. This will require early finalization of foreclosure laws, housing loans at low interest rates below 7 percent and reduction in taxes on building inputs.

g) There is also need to appreciate that the rise in unemployment will be structural and more persistent in nature. As such, the social protection and anti-poverty initiatives will have to be significantly larger and longer lasting in nature. More effective targeting mechanisms will need to be developed to reach new families falling below the poverty line and the large number of displaced daily income and casual workers. The subvention per family will have to be increased from Rs 3000 to at least Rs 7000 per month, with the floor for family income eligibility of Rs.16000 being raised to Rs.25000 (to cover the impact of inflation and the likely loss of most other sources of family income).

h) The tax credit on charitable donations to recognized NGOs and to the Government's proposed Special Fund may be raised to 40 percent as per Section 61 of the Income Tax Ordinance. .

i) Full restoration of the initial depreciation allowance and tax credit for balancing, modernization and replacement in income tax.

The above proposals will involve some additional expenditure or foregone revenues. Fortunately, agreement has been reached with the IMF that the costs of the relief and incentive package will not be included in the calculation of the budget deficit. As such, deficit financing from the SBP can be resorted to up to 1.5 percent of the GDP. This will ensure that inflationary pressures remain low.

In conclusion, for once we hope that our projection of the depth of the likely recession is on the high side and that the people of Pakistan will show greater resilience. We pray that the economy will come out faster from the crisis and that there will be less loss of lives and suffering by the people of our country.

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*The authors are former Federal Minister and Governor of the State Bank of Pakistan respectively. The research support by Dr.Amanullah and Sitara Gill is acknowledged.