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Social impact of the global recession on Pakistan

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Introduction

The direct impact of the global financial crisis on developing countries, including Pakistan, has been limited due to nonintegration of the domestic financial sector with the global financial sector (IMF 2009a). However, the crisis has set in motion a global recession that has not spared low-income countries. Global economic growth is expected to fall to a mere 1.0% after averaging around 4.0% during 2003–07 (Martin 2009).

How the recession affects an economy depends, among other things, on the state of the economic fundamentals of the country when the recession sets in. Economies with sound macroeconomic indicators will be able to face the recession heads on with the Keynesian prescription—the public sector spends more to compensate for the lack of demand in the private sector. The Keynesian recipe, when followed, of course causes macroeconomic indicators such as the fiscal deficit to deteriorate and foreign reserves to fall. Countries with precrisis sound fundamentals can afford this kind of luxury. However, countries with poor macroeconomic indicators at the onset of the recession can follow the Keynesian prescription only at the cost triggering a crisis of greater proportions.

The enormous wealth of literature on the impact of the global financial crisis and the consequent global recession has identified various channels through which the recession may influence economies. These include remittances and migration, international trade, foreign direct investment (FDI), the exchange rate, interest rate, and foreign aid. This paper seeks to examine which of these channels have actually been at work in the case of Pakistan.

Before we examine the channels through which the global recession influenced Pakistan's economy, an examination of the health of the economy at onset of recession is essential to put things in the right perspective. This examination will not only allow us to figure out how the channels worked but will also serve to determine Pakistan's preparedness for coping with the recession, especially the authorities' ability to design an appropriate fiscal stimulus package. The response is particularly crucial, since it will ultimately determine the net social impact of the recession on the economy.

State of the economy at the onset of recession

The ongoing global recession, as we know, was preceded by a steep surge in commodity prices the world over. Pakistan, being a large importer of fuel oil and other commodities such as vegetable oil and at times wheat, ended up importing inflation. Commodity prices, especially those of fuel oil, went through the roof in 2007. However, the year being an election year in Pakistan, the then government, in accord with political cycle theory, chose not to pass on the oil price hike to consumers. Electricity in Pakistan is primarily distributed by a public sector entity, the Water and Power Development Authority (WAPDA), while the price is determined by the government. A substantial part of the electricity consumed is generated using furnace oil. With the increase in oil prices the cost of production of electricity had also increased but the government again refrained from passing on the increase to consumers. The decision not to pass on the increase in cost of fuel and electricity to the ultimate consumers obviously worsened the fiscal deficit.

The impetus to demand from the high fiscal deficit and surge in international commodity prices had caused the external current account, which was already in deficit, to further deteriorate. The impact of the sharp increase in the external current deficit was accentuated further by the decline in the capital account surplus. Pakistan's current account deficit was large even before the financial crisis unfolded, but a host of factors had allowed the country to finance the deficit through inflows on the capital account.

International as well domestic environment was congenial to capital inflows and the current account deficit was comfortably financed from grants and foreign aid on soft terms from bilateral and multilateral institutions, sovereign debt issues in international financial markets, and proceeds from privatization of profitable public sector enterprises. However as the financial crisis led to a liquidity crunch, it became difficult to float debt issues in the international financial markets at affordable terms or find buyers for planned privatization deals. Aid flows also slowed for a while for geostrategic reasons. These factors had an adverse impact on the external account. Moreover, with the increase in international commodity prices, the trade deficit deteriorated sharply.

The state of the balance of payments suggested that the exchange rate, if left completely to market forces, would depreciate. However the intervention of the monetary authority in the foreign exchange market averted a significant fall in the value of domestic currency. The intervention mechanism primarily used, which had been in vogue since November 2004, was to provide foreign currency to the oil companies for the import of oil. Therefore, as oil prices increased, the intervention increased as well. A sharp depreciation of the domestic currency was avoided in FY2006/07 (the fiscal year begins on 1 July), but at the cost of depletion of foreign reserves to dangerously low levels.

We now turn to Pakistan's key macroeconomic indicators immediately before and after the rise in international commodity prices, i.e., FY2006/07 and FY2007/08, and then after going through recession for a year (FY2008/09).

Table 1: Key macroeconomic indicators (%)

	2006/07	**2007/08**	**2008/09**
Inflation (average)	7.8	12.0	20.8
GDP growth	6.8	4.1	2.0
Large-scale manufacturing growth	8.6	4.8	-8.2
Tax revenue (% of GDP)	10.2	10.6	9.2
Fiscal deficit (% of GDP)	4.3	7.6	5.2
External account deficit (% of GDP)	5.1	8.5	5.3

Source: *Pakistan Economic Survey 2008-09*, National Accounts Committee (MoF website).

It is clear from Table 1 that Pakistan's macroeconomic indicators had worsened even before the onset of global recession. While on one hand inflation and the fiscal deficit had increased during 2007/08, on the other hand GDP growth had declined. Growth in large-scale manufacturing, which had declined significantly in FY2007/08, became negative in FY2008/09. The country was faced with a severe energy shortfall and factories had to cope with frequent power shutdowns, which restrained production units from operating at optimal production capacity. However, the energy shortfall is also, at least, partially due to an increase in the price of crude oil. As the cost of producing thermal energy increased, WAPDA, in its poor financial position, failed to procure all the electricity that private sector power projects could produce.

The account of the economy given above serves to show that at the onset of recession, the economic fundamentals of the country were poor. Given this scenario, the country was in no position to offer a fiscal stimulus package—the typical Keynesian recipe adopted by developed countries to cope with recession. Rather, to stay afloat the country had to seek funds from IMF. IMF's "conditionalities" demanded that the country go into a fiscal tightening mode, whereas coping with the recession called for a fiscal expansion. Thus, the country simply did not have the instruments at hand with which to protect the public from the adverse economic and social consequences of the global recession. This scenario makes it easier to understand the economic and social impact of the recession.

Global recession and social impact: Channels of influence

With the scenario painted just now in mind, one can now consider the impact of the global recession on Pakistan's economy. In this section we examine the impact of global recession upon the economy with specific focus upon changes in migration patterns and remittance levels, public spending, social outcomes, export performance, balance of payments and exchange rate, and the impact of these on national poverty levels.

Migration and remittances

Remittances from overseas workers constitute one channel that has been the most discussed in the context of impact of the global recession on developing countries. It is widely feared that the layoffs in labor-importing countries will affect migrant workers as well—with the host countries being naturally more concerned about their own citizens—since the migrant workers are likely to be among the first ones to be laid off. The layoffs would not only cause remittance levels to decline, but may well induce the return of the migrant worker to his or her home country, thereby increasing home-country unemployment.

The decrease in remittances would adversely influence aggregate consumption and investment in the labor-exporting countries. Moreover, remittances are an important source of foreign exchange for labor-exporting countries and any decline in their amount would cause an adverse impact on foreign exchange reserves and hence the value of the country's currency vis-à-vis other countries. This in turn has the potential to affect other macroeconomic variables such as inflation, the fiscal deficit, and even output. Given the wide-ranging consequences of the fall in remittances, the trend of remittances is being closely monitored in remittance-exporting countries.

Data from most countries that are host to remittances—see, for example, Ruhunage (2009) and Skider (2009)—suggest that despite the almost daily reports of shutdowns and layoffs since October 2007, the effect on migrant workers is still not clear because, so far, a significant drop in remittances from overseas workers has not been observed.

There are at least four possible reasons why remittance levels have not declined so far. The first line of reasoning is in accord with the notion of the life-cycle hypothesis put forward by Modigliani way back in

1950s (Modigliani and Brumberg 1954). Under this hypothesis, economic agents tend to smooth their consumption pattern over their lifetime and therefore when they earn unusually high income they save a part of that income and when their income is not enough to meet certain minimum level of expenditure, they consume out of their savings to maintain a certain stable consumption pattern. Thus one reason for the continuing trend in remittances could be that the workers are remitting money out of their savings, to allow their dependents to maintain a stable consumption pattern while weathering the storm.

The second reason could be that that laid-off workers are returning with their hard earned savings. Such one-off remittances have compensated for the decline in periodic earnings that were being remitted earlier, if this argument holds the field than the one-off increase in remittances could be the precursor to a decline in the future.

A third view is that, given the high inflation that preceded the recession, the impact of which is yet to dissipate fully, workers were remitting greater amounts to their relatives back home to make ends meet.

A fourth possibility put forth by Abella and Ducanes (2009) is that migrant workers are either in occupations that have been rejected by domestic workers or are in occupations that continue to be in strong demand despite the economic downturn.

We examine next, which one of these four possibilities is relevant in the context of Pakistan.

During FY2009, Pakistan received remittances from overseas Pakistanis to the tune of $7.8 billion. United States (US), United Arab Emirates (UAE), Saudi Arabia, and United Kingdom are the four major remitter countries to Pakistan. It is clear from Table 2 that not only, the remittances from Pakistan's overseas workers have not registered a decline so far, against fears to the contrary, but have rather maintained a healthy growth trend. This trend is contrary to expectation and warrants further investigation.

Table 2: Remittances from workers overseas

Countries	Share in FY2009 (%)	$(billion)		Growth from FY2009 (%)
		FY2008	FY2009	
United States	22.2	1,762	1,736	-1.5
UAE	21.6	1,090	1,689	54.8
Saudi Arabia	20.0	1,251	1,560	24.6
United Kingdom	7.8	458	606	31.9
Others GCC Countries	15.4	983	1,203	22.3
Others	13.0	905	1,017	12.4
Total	100.0	6,449	7,811	21.1

Source: State Bank of Pakistan, Economic Data website; www.sbp.org.pk.

Roughly 70% of Pakistan's remittances come from the four above countries (Table 2). It is clear that, except for a marginal decline in remittances from the US, inflows from other countries have not been affected so far; rather some have exhibited an increase in 2009 compared to previous years. For example, in 2009, remittances from the UAE showed a growth of 54% as against a growth of 26% in 2008. The main driver of this growth was a staggering 124% increase in remittances from Abu Dhabi.

These unusual growth rates of remittances come at a time when these were in fact expected to decline; giving credence to the hypothesis that workers from these countries are returning and they are bringing back their hard earned savings in bulk. If this is indeed the case, the unusual increase would be a one-off phenomenon and remittances would decline in the future due to the return of the migrant workers. However, given the non-availability of data on returning migrants, we cannot test the hypothesis beyond this point.

The unusual increase in remittances also lends some credence to the view that overseas workers are sending more money home to allow their dependents to make ends meet in the face of rather high inflation. Yet another reason for no decline being observable in remittances could be that these may respond, with a lag, to decline in income as the worker for sometime can draw upon savings (Modigliani's view).

The point made by Abella and Ducanes (2009) that migrant workers are either in occupations that have been rejected by domestic workers or are in occupations that continue to have strong demand in spite of economic downturn, cannot be ignored altogether. This could be especially true of migrants to developed countries such as the US and United Kingdom.

Thus it is a combination of the reasons discussed above, rather than just one reason, that has so far prevented the decline in remittances.

Given the trend of remittances to Pakistan, it is not difficult to conclude that, to date, the global recession has not had any significant adverse economic and social impact on Pakistan, but as far as the future is concerned, one should remain wary.

Hence, will Pakistan be able to sustain the growth trend in remittances or at least manage to avoid a decline? To answer this question, let us look at the GDP growth projections for our major remitter countries, which, however, are rather dismal for the next two years (Table 3).

Table 3: Growth rate of real GDP

	Actual		**Projected**	
Year	**2007**	**2008**	**2009**	**2010**
Country				
SA	3.5	4.6	-0.9	2.9
UAE	6.3	7.4	-0.6	1.9
US	2.0	1.1	-2.8	0.0
UK	3.0	0.7	-4.1	0.4

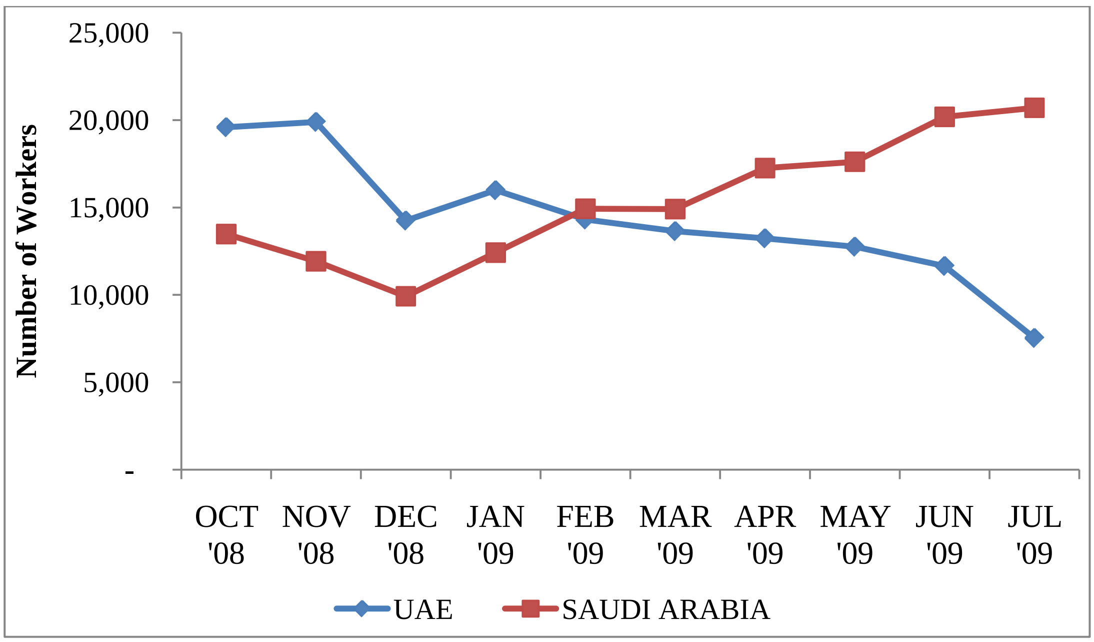
SA = Saudi Arabia, UAE = United Arab Emirates, US = United States, UK = United Kingdom.
Source: IMF. 2009. *World Economic Outlook: Crisis and Recovery*.

How can one expect that no worker from Pakistan will be laid off when firms by the dozen are shutting down daily, with daily layoffs of employees in hundreds if not thousands. The gloomy growth prospects of the major remitter countries restrain us from rejoicing over the healthy growth of remittance in FY2009. To gauge accurately whether or not remittances will decline in times to come, what is required is to conduct a household survey to inquire whether workers have returned and, if yes, what amount they were remitting periodically.

A rough prediction about the growth trend of remittances in the future can be made by examining the outflow of labor since the onset of recession. If the outflow has decreased in recent months, this would imply that remittances may decline in future. Fortunately, we have data for labor migration through formal channels, for at least two of the four major remitter countries to Pakistan, namely Saudi Arabia and the UAE.

Each of these two countries contributed 22% to total remittances to Pakistan in FY2008/09. Figure 1 shows that labor flows to the UAE have unambiguously declined sharply (October 2008: 19,592 workers, July 2009: 7,354 workers) in the 10-month period covering October 2008–July 2009 while labor flows to Saudi Arabia increased for the same time period. The decrease in labor flows to the UAE is understandably due to recession, but the increase in flows to Saudi Arabia is surprising.

One reason perhaps could be the decision of the Saudi authorities to undertake mega infrastructure projects including the development of five new urban centers (Abella and Ducanes 2009). Given the trend of labor flows to the two countries, there is a strong possibility of decline in remittances from the UAE. The UAE's share in total remittances of $7.8 billion for FY2008/09 was as high as 22%. Thus the unusual increase in remittances from the UAE during FY2008/09 may herald a decline. The decline may, however, be offset at the aggregate level by the increase in remittances from Saudi Arabia.



Source: Ministry of Labour and Manpower, Government of Pakistan.

As far as remittances from these two countries are concerned, the impact may not be felt at the aggregate level, though families depending on remittances from the UAE are likely to face difficult times.

The data available with Pakistan's Ministry of Labour and Manpower, suggest that out of the total migrant labor force from Pakistan to all countries put together, around half the migrant workforce is unskilled. These unskilled workers are likely to belong to the poorest rung of the society. With such a large proportion of workers belonging to the poorest segment of the society, therefore, any layoffs and the consequent decrease in remittances are expected to increase the poverty headcount in the country. We do not have enough data to predict the trend of remittances from the US and United Kingdom, though the marginal decrease in remittances from the US in FY2008/09 provides a cause of concern.

Public spending and its social consequences

When the current regime came to power in February 2008, government finances were in poor shape and by the end of the fiscal year in June 2008 the fiscal deficit was projected to be around 9.0% of GDP, or almost 5 percentage points higher than the previous year's figure. To restore fiscal discipline, the Government had to cut down expenditure on various development projects.

Similarly for FY2008/09, a Public Sector Development Plan (PSDP) of Rs. 330 billion was budgeted, but the plan had to be revised downward by a staggering 41% to PRs192 billion due the shortfall in expected government revenues and projected capital flows. This shortfall in turn is mainly due to the global recession. With the cut in the PSDP, a number of development projects planned to be undertaken had to be suspended (Table 4 lists the sectors that received major cuts in their original allocation under the PSDP for FY2008/09).

Table 4: Cuts to Public Sector Development Plan due to financing shortfall

	Budgeted allocation (PRs billion)		Decrease from original allocation (%)
	Original	Revised	
Education	24	17	29
Health and nutrition	20	15	25
Special programs	58	24	58
Water	73	38	48
Power	46	7	85
Others	109	91	17
Total	**330**	**192**	**41**

Source: Data provided by Planning and Development Division, Government of Pakistan.

Power, water, education, and health projects all received major cuts in their PSDP allocation for FY2008/09, which was to have a ripple effect on the economy. In the first place, such cuts would adversely influence immediate earnings of those who would have been involved in the projects planned, as employees, contractors, or suppliers. Thus, efforts to reduce poverty received a dent to the extent that low-paid jobs, which were to be created by these projects, were not created.

The cuts would have other, far-reaching, consequences. Resolution of a power crisis that has already taken a heavy toll on the domestic economy would be delayed to the extent that these projects were expected to contribute to meeting the electric power shortage in the country. The same holds true for water projects.

The cut of 29% for education has affected the Higher Education Commission (HEC) the most. Hundreds of scholars who were awarded scholarships by the HEC for higher studies abroad could not actually undertake their study programs due to lack of funds. This will undoubtedly have some impact on the state of human capital in Pakistan in the near future.

Thus, the cut in PSDP, which was primarily forced on the Government by the global recession, will have adverse social consequences for Pakistan.

Exports

The global recession, which has decreased demand for goods and services worldwide, has had a particularly severe impact on demand levels in developed countries, the markets for the majority of Pakistan's exports. The net decrease in Pakistan's exports for FY2008/09 relative to the previous year has been 6% ($1.2 billion).

Regardless of the net impact upon the economy, a number of industries have suffered adversely, which has had undesirable social consequences. The textile industry, which typically contributes over 50% of export earnings, has lost over 5% of its earnings ($578 million) in FY2008/09, with readymade garments the hardest hit (18%, or $221 million) (Table 5). Other industries affected include tanned leather, carpet and rugs, and football manufacture. Workers have suffered and employer earnings have dwindled in the industries that have lost export earnings. The decrease in earnings of the workers will, without doubt, serve to increase poverty levels in the country.

Table 5: Export performance among industries with significant declines in export earnings, FY2008/09

	Share in total exports	Decrease over previous year	
		Amount ($ billion)	Decrease (%)
Textiles	**50**	**578**	**5.6**
Readymade garments	6	221	18.3
Cotton yarn	6	179	15.3
Other textile products	3	111	18.8
Knitwear	10	80	3.7
Cotton carded	1	75	35.6
Cotton cloth	10	66	12.9
Manufactures (excl. textiles)	**23**	**236**	**5.0**
Petroleum products	4	95	13.2
Solid fuel	3	252	41.5
Leather tanned	3	80	15.4
Carpets and rugs	1	70	29.3
Footballs	1	55	25.3
Molasses	0.3	49	93.6
Total exports	**-**	**20.4**	**5.9**

Source: State Bank of Pakistan, Economic Data website; www.sbp.org.pk.

A decline in export earnings for certain industries implies factories being shut down and employees being laid off, with the daily wage worker being the first one to feel the brunt. Thus the adverse impact of reduced export earnings on poverty on account of the global recession is not hard to imagine.

Balance of payments and exchange rate

Depreciation of the exchange rate can result in an increase in cost of inputs and consumables for countries that import industrial inputs and different consumer goods. The countries dependent on oil imports for energy needs could be especially hard hit if demand for the product is less elastic. For 3 years, from October 2004 to October 2007, the Pakistan rupee had maintained remarkable stability against the dollar, with depreciation of the currency being a mere 1%. However, since the global financial crisis, the domestic currency has depreciated by a whopping 36% in under 2 years (October 2007–August 2009). During the period of the stable exchange rate, the current account balance was almost always negative (Table 6).

Table 6: External current account balance (% of GDP)

2004/05	2005/06	2006/07	2007/08	2008/09
-1.6	-4.4	-5.1	-8.5	-5.3[a]

a. Due to IMF package.
Source: *Pakistan Economic Survey: 2007-08*, National Accounts Committee (Pakistan Ministry of Finance website)

Receipts on the capital account were not only used to finance the deficit on the current account but also contributed to incremental increases in foreign reserves as well. These included foreign direct investment inflows as well as portfolio investment, proceeds from privatization of public sector entities, sovereign debt issues in international financial markets, and multilateral as well as bilateral aid.

On top of all this, the State Bank of Pakistan had been providing the bulk of foreign exchange required for the purchase of oil since November 2004. This was an implicit intervention in the foreign exchange market that has now been phased out as a condition of financing arrangements agreed with IMF in December 2008. The extent of implicit intervention and its impact on the exchange rate can be gauged from examining the share of petroleum products in total imports (Table 7).

Table 7: Share of import of petroleum products in total imports (%)

FY	2004/05	2005/06	2006/07	2007/08	2008/09
Import of petroleum products	19	24	27	30	32

Source: State Bank of Pakistan, Economic Data website; www.sbp.org.pk.

The implicit intervention in the foreign exchange market—and a host of other congenial factors that had allowed the surplus on capital account to finance the deficit on the current account—were not effective for much of FY2008/09. With the onset of recession, the capital flows dwindled—FDI has declined significantly while portfolio investment for the first time in many years has seen net outflows.

Due to the liquidity crunch, the country has neither been able to issue sovereign debt in the international market nor has it been able to secure receipts from sale of its public sector entities. All these factors have contributed to deterioration of the balance of payments, drawdown of foreign reserves, and steep depreciation in the domestic currency vis-à-vis its foreign counterparts.

Possibly, phasing out the intervention in the foreign exchange market, forced upon the authorities by IMF, is responsible for the depreciation of the domestic currency. While this may be partially true, one needs to keep in mind the fact that for intervention in the foreign exchange market to avert deprecation of the exchange rate, the country requires foreign reserves in sufficient quantity. Also, the foreign reserves of Pakistan have been falling since mid-2007 at a fast pace due to reduction in capital flows, which is in turn is owed to recession. As such, given the level of foreign reserves, even without IMF-imposed restraints, the country would not have been able to engage in interventions in the foreign exchange market in 2009. Lastly, the country had to go to IMF in the first place due to the financial crunch caused by the financial crisis and global recession. Thus, in essence it is the recession that has contributed to the depreciation of the Pakistan rupee.

In conclusion, as far as the external account is concerned, the adverse social impact is being channeled through the exchange rate. With depreciation, either the prices of some commodities have increased or have not declined to the extent that they would have in a recession, had there been no depreciation. This inflation in turn has contributed to an increase in the poverty head count.

Impact on poverty

Accurate estimates of the changes in the poverty head count ratio are not readily available; however, preliminary estimates by different agencies point to a significant increase in poverty levels (around 6 percentage points in FY2008/09) during the last 2 years (Government of Pakistan 2009). Four channels (discussed above) have contributed to the increase in poverty.

The first trickle-down effect is from the reduction in GDP growth. Large-scale manufacturing contracted in FY2008/09, implying that numerous firms had shut down and workers had been laid off. Typically, the first ones to be laid off are daily wage earners, who are among the poorest segments of the society. Thus the increase in poverty is understandable.

Second, the expected reduction in remittances from the UAE will also contribute to a further rise in poverty levels since almost 50% of the registered overseas workers are unskilled. These unskilled workers are likely to be from the poorest rung of the society. The return of a part of this workforce will contribute to an increase in the poverty head count.

Third, the cuts in public sector spending mean fewer jobs for the poor, poorer health facilities, and fewer opportunities of free education for the poor.

Fourth, depreciation of the exchange rate, induced by global recession, has contributed to inflation, which has robbed the poor of their purchasing power, thereby contributing to a rise in the poverty head count.

Despite the fiscal constraints, the Government has introduced a new social safety net, the Benazir Income Support Programme (BISP), to augment the income of the poorest of the poor, who have been severely hit by the global recession. The budgeted allocation (in FY2008/09) for the program was PRs70 billion ($875 million). This is the third-largest allocation in the total budget and is over 0.3% of GDP for FY2008/09. Under the program the poor, who fulfill certain criteria, will be given monthly cash support of PRs1,000 (approximately $12). This monthly grant will increase the income of a family earning PR5,000 a month (around $60) by 20%. The program aims to cover around 15% of the entire population, which constitutes 40% of the population below the poverty line.

Conclusion

Theory, empirical evidence, and the current response of developed countries to the global recession, all advocate a strong fiscal stimulus to cope with the recession. However, the surge in commodity prices that preceded the recession, and the increase in the fiscal deficit for FY2008/09, precluded the use of a comparable stimulus package. The standard Keynesian recipe of fiscal stimulus was simply not available. Given these fiscal constraints, planned public spending in FY2008/09 was curtailed.

Fiscal tightening, in addition to exchange rate depreciation and poor export performance, has contributed to the increase in the poverty head count. And, despite the maintenance of a healthy growth trend of remittances so far, it is too early to celebrate for a number of reasons: remittances from the US have registered a marginal decline while the outflow of workers to the UAE has fallen significantly. Remittances from these two countries, especially from the UAE, may therefore decline in the future. If this turns out to be the case, there is more bad news for the poverty head count.

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