1 Economic Outlook

1.1 Introduction

1. While economic activity remained subdued for yet another year in Pakistan, headline inflation fell to single-digits for the first time since FY07. Soft global commodity prices, downward revision in key energy prices (e.g., tariffs on household gas and CNG), and a relatively stable exchange rate, allowed the average inflation rate to fall to 7.4 percent in FY13 (from 11.0 percent in FY12), which was much lower than the 9.5 percent target for the year. The fall in inflation let the State Bank of Pakistan (SBP) cut its policy rate by 300 bps since August 2012 to 9.0 percent, which was last seen in FY07.

2. Robust growth in construction activity and capacity enhancement in a few sub-sectors, supported the industrial sector during FY13, but this growth was slightly below target (**Table 1.1**). Global prices helped contain Pakistan's import bill, and there was some improvement in exports. Furthermore, higher than anticipated Coalition Support Fund (CSF) inflows, and modest growth in worker remittances, reduced the current account deficit to 1.0 percent of GDP in FY13, from 2.4 percent in the previous year.

3. Despite these favorable developments, growing security concerns and persistent structural weaknesses continue to hamper economic growth. While CSF is essentially a reimbursement for services provided to NATO countries in Afghanistan (by our armed forces), the actual economic cost of this war on Pakistan is significantly higher than CSF inflows. In addition to the loss of human lives, this war has further deteriorated law & order in the country, which in turn has adversely impacted the investment climate; caused production losses due to frequent interruption in economic activities; diverted resources to enhance security; encouraged manpower and some businesses to migrate out of the country; and adversely impacted revenue collection by the fiscal authorities.

4. At the same time, challenges in managing public sector enterprises; the need to expand the tax net to untaxed or under-taxed areas; to contain untargeted subsidies; to tackle theft and leakages in the energy sector; to revitalize the private sector; and to increase documentation, were largely unaddressed during FY13. As a result, the country's fiscal performance did not improve during the year.

5. In a repeat from the previous year, the budget deficit exceeded the target for FY13 by a wide margin, as the realized deficit was 8.0 percent of GDP, against a target of 4.7 percent. The resulting pressure to secure financing, dominated policymaking throughout the year. As in previous years, poor tax collection and overruns in discretionary spending featured prominently. For the third consecutive year, the authorities had to bailout the energy sector by paying off the circular debt, which pushed the fiscal deficits way above the respective targets for these years (**Figure 5.1** in **Chapter 5**).

6. With inadequate external funding, the onus of financing the fiscal deficit fell entirely on domestic sources – specifically the banking system. During the course of the year, the government borrowed Rs 939.6 billion from commercial banks, and an additional Rs 506.9 billion from SBP. In effect, Pakistan's domestic debt increased by Rs 1.9 trillion, a 24.6 percent increase from the end of FY12.

7. The lack of external inflows also created challenges in financing the relatively small current account deficit. More specifically, the financial account (which is the primary source of funding the current account in Pakistan) recorded a net inflow of only US$ 0.3 billion during the year, compared to US$ 1.3 billion last year, and US$ 5.1 billion in FY10 – see **Table 1.3**. This, along with significant

repayments to the IMF, pulled down SBP's liquid FX reserves to a 55-month low of US$ 6.0 billion by end-June 2013. Not surprisingly, the Pak Rupee faced some pressure in June 2013.

1.2 Assessment of FY13

Real Sector

8. Real GDP growth was 3.6 percent, compared with 4.4 percent in FY12. This was disappointing, given the accommodating monetary policy and the expansionary impact of fiscal spending during the year. While all three sectors contributed to economic growth, the improvement in the industrial sector was more than offset by the slowdown in agriculture and services (**Table 1.1**). Agriculture, which accounts for more than one-fifth of GDP, posted below-target growth of 3.3 percent in FY13. The sharp recovery in minor crops and consistent growth in livestock was overshadowed by the marked slowdown in major crops (**Chapter 2**).

Table 1.1: Macroeconomic Indicators

	FY12	FY13 Target	FY13
growth in percent			
Real GDP	4.4	4.3	3.6
Agriculture	3.5	4.0	3.3
Industry	2.7	3.8	3.5
Services	5.3	4.6	3.7
Consumption	6.0	-	4.6
Investment	1.7	-	1.3
CPI inflation	11.0	9.5	7.4
as percent of GDP			
Current account balance	-2.1	-1.9	-1.0
Fiscal balance[1]	-8.5	-4.7	-8.0
Public debt	64.3	-	63.3

[1]: This includes one-off payments made in FY12 and FY13 to settle circular debt in the power sector.
Source: State Bank of Pakistan and Pakistan Bureau of Statistics

9. With the exception of sugarcane, all other major crops (wheat, rice and cotton) fell short of their annual targets – in fact, rice and cotton posted a YoY decline. It is important to highlight that the agriculture sector in Pakistan is facing multiple challenges: (1) increasingly uncertain weather patterns (as evident from recurrent flooding) are damaging staple crops; (2) average yields are either stagnant or declining; (3) Pakistan has been identified as a water scarce country, yet little has been done to enhance storage and improve the effective distribution (and use) of canal water fed by the River Indus; (4) the increasing cost of inputs has reduced the farmer's ability to use optimal levels of fertilizer; and (5) agricultural practices remain too traditional, as farmers have not adopted modern soil preparation and sowing techniques or mechanization.

10. Within the industrial sector, the most notable development was the pickup in manufacturing, which grew at 4.4 percent in FY13 – the highest rate in the past five years. The revival in manufacturing was broad-based as a large number of industries contributed to this recovery (**Chapter 2**). Capacity enhancement in *iron & steel*, *rubber & plastic*, and *paper & paperboard* was refreshing, while better margins due to lower prices of imported raw material (palm oil, rubber, coal, etc.) and the investment in alternate energy (especially by large-scale manufacturing), also contributed to this growth.

11. This sector also gained from the strong spillovers from a vibrant construction sector. In its role as the backstop to the economy, a portion of worker remittances continue to support construction activities, while the rest adds to disposable income.

12. The service sector did not perform too well, primarily because of the telecom sector. Strong competition amongst service providers, the increasing use of grey channels, and regulatory issues like the interruption of mobile services, the drive to regularize SIM cards, and additional taxes, reduced value addition by an otherwise vibrant telecom sector (**Chapter 2**). While *finance & insurance* posted higher growth compared to the previous year, this mainly reflects government borrowing from commercial banks. The momentum of this growth would be interrupted if government borrowing were to be contained during FY14.

13. Despite the improvement in manufacturing, overall investment remained sluggish. The investment-to-GDP ratio was 14.2 percent in FY13, which is lower than the 14.9 percent realized in FY12. More importantly, private investment fell to 8.7 percent of GDP in FY13, which is far below the level required to meet the country's needs. With a young population that is still growing at 2.0 percent per annum, job creation in the private sector must be prioritized to absorb the number of people who are entering the workplace every year. Given the need to generate private sector jobs to absorb this growth in the working population, sustained economic growth of 7 percent is required to improve social indicators and reduce poverty levels.[1]

14. The sharp reduction in the investment rate in recent years can be attributed to a familiar set of factors: energy shortages; heightened security concerns; weak contract enforcement; and persistent fiscal slippages. Not surprisingly, in a recent report about the *Ease of Doing Business*, Pakistan was ranked 107 among 185 countries, which is three notches below its ranking in 2012. In terms of 'getting electricity', Pakistan's ranking slipped 5 notches to 171.[2]

Energy Sector

15. The energy shortage appears to be the government's policy priority. This is required, since around Rs 1.0 trillion has been utilized to pay-off power sector circular debts and untargeted power subsidies in the last two years (FY12 & FY13); nevertheless, a few policy measures have been taken to reduce the hemorrhaging in power-related PSEs. As discussed in **Chapter 3**, reforms in the energy sector had stalled: limited headway was made to restructure power-related PSEs; to tackle line-losses in distribution and overcome inefficiencies at the generation level; or rationalize end-user tariffs. In fact, despite the ill-advised shifting of natural gas away from power to less productive uses (e.g., CNG), the resulting increase in thermal generation costs was not passed onto end-users. In effect, all household users of electricity (especially the heavier, more affluent users) have been subsidized by the government. This unproductive use of power (compared to industrial and commercial users) has hampered GDP growth, specifically impacting small and medium size manufacturing units that sustain the bulk of employment in the industrial sector.[3]

16. As promised, the new government took immediate steps to pay off the circular debt at the end of June 2013, and has committed to reduce power subsidies to most end-users in a phased manner. This step to rationalize tariffs must be commended, as opposed to the criticism that has been leveled at the government. Having said this, judicial proceedings temporarily interrupted the tariff increase on households, while the actual restructuring of power-related PSEs was also delayed. Since the power regulator (Nepra) has stated that power shortages in Pakistan are likely to persist till mid-2018 (**Chapter 3**), we think more proactive steps are required not just in terms of the inefficiencies of state-owned Gencos and Discos, but also to redirect energy (i.e., electricity, gas, and oil) to more productive users.

17. In our view, the misallocation of natural gas must be urgently addressed. This is likely to be facilitated by a single *Ministry of Energy*, instead of the Ministry of Petroleum and Natural Resources

[1] The Economic Growth Framework prepared by the Planning Commission points out that Pakistan must growth by 7 percent GDP growth to absorb the growing population.

[2] For details, please visit http://www.doingbusiness.org/data/exploreeconomies/pakistan/

[3] In an effort to quantify the productivity of power usage, we can divide GDP by power used during the year. Crudely, this quantifies how effectively power usage 'creates' economic activity. **Figure 3.4** in the Chapter on Energy shows that while Pakistan's productivity of power usage has plateaued, its neighbors in South Asia have recently become much more efficient in how they use power.

(which allocates gas) and the Ministry of Water & Power (which has shifted power generation to furnace oil, as it was unable to secure adequate gas allocations).[4]

Inflation

18. As discussed earlier, there were positive developments on the inflationary front. Single-digit inflation in FY13 was well below expectations at the beginning of the year. Declining administered prices and soft global commodity prices were primarily responsible for this positive outcome, which in turn helped ease inflationary expectations. As discussed in **Chapter 4**, surveys done by SBP show that while households anchor their inflationary outlook to retail fuel prices, commercial enterprises also focus on the current and expected value of the Pak Rupee. Since both POL and the PKR were relatively stable during FY13, inflationary expectations remained soft during the year. This has been verified by SBP's *Consumer Confidence Survey*, conducted after every two months, which shows that softening inflationary expectations were seen right across the country. Having said this, the recent increase in POL prices and the weakness in the PKR, has impacted the September 2013 CCS, which shows a reversal in inflationary expectations for the current year (**Outlook for FY14**).

Fiscal Policy

19. With declining private investment, the government did not have the fiscal space to boost public investment to *crowd-in* private investment. In our view, the growing fiscal weakness continues to exacerbate Pakistan's structural problems. The policy focus on financing the increasing fiscal gap, leaves little time (and resources) to address problems in the energy sector; build and maintain the country's physical infrastructure; implement a focused debt management strategy; enhance substandard social services; improve law enforcement; curb corruption; and remove other impediments to long-term private investment.

20. The fiscal consolidation envisaged at the beginning of the year, was undermined by the shortfall in revenues and expenditure overruns. As stated earlier, the budget deficit for FY13 was 8.0 percent of GDP, against a target of 4.7 percent. This includes an impressive performance by provinces as they posted a combined *surplus* of Rs 52.7 billion in FY13 (compared to a Rs 39.1 billion *deficit* in FY12).

21. Revenues were initially projected to grow at 31.7 percent in FY13 compared with an average increase of 14.9 percent in the preceding five years (FY08-12 – **Chapter 5**). During the course of the year, the government could only realize 88.3 percent of the projected revenue, with revenues growing at only 16.2 percent. This shortfall was entirely due to lower growth in tax collection, as non-tax revenues surpassed the annual target because of CSF inflows (**Table 1.2**).

Table 1.2: Fiscal Performance

billion Rs

		FY13		
	FY12	Initial Target	Actual	Excess/ Shortfall
Total revenue	2,566.5	3,376.0	2,982.4	-393.6
Tax revenue	2,052.9	2,626.0	2,199.2	-426.8
CBR Tax	1,881.5	2,381.0	1,936.1	-444.9
Non tax revenue	513.6	750.0	783.2	33.2
Total expenditure	3,936.2	4,480.0	4,816.3	336.3
Current expend.	3,122.5	3,430.0	3,660.4	230.4
Interest payments	889	925.8	991.0	65.2
Subsidies	512.3	208.6	367.5	158.9
Defence	507.2	545.4	540.6	-4.8
PSDP	664.8	873.0	695.1	-177.9
Net lending	12.0	0	362.8[1]	362.8

1. This includes the cash impact of circular debt settlement made in June 2013.

Source: Ministry of Finance

22. Tax revenues could not gain momentum as the government was unable to implement tax measures proposed in the FY13 budget. Furthermore,

4 The recommendation to have a unified Ministry of Energy was put forward by the Prime Minister's Task Force for Energy in 2008, and subsequently endorsed by the ADB in 2013. It is also part of the Manifesto of the PML-N.

frequent changes in FBR management along with the perennial issue of leakages, impaired the efficiency of the organization. Although weak economic activity could also be blamed, the fall in tax-to-GDP ratio from 10.2 percent in FY12, to 9.6 percent in FY13, suggests this is not the case – in effect, tax revenue collection could not even keep pace with the subdued growth in nominal GDP. In our view, the stagnant tax-to-GDP ratio (one of the lowest in the world) is the biggest impediment to a stable macro economy, which is required to deliver higher economic growth. Without the political will to increase tax collection in a more equitable manner, fiscal consolidation is likely to remain elusive, as was the case in FY13.

23. Like revenues, slippages on the expenditure side are challenging the fiscal authorities. Total expenditures (including the one-off payment to settle the circular debt in June 2013) grew by 22.4 percent during the year, against the targeted increase of 13.8 percent. Over 2/3rd of this deviation was due to higher current expenditures (e.g., debt servicing and energy subsidies), which overshadowed the restrained administrative costs posted by many government ministries.

24. With a revenue squeeze and overruns in current expenditures, there was no fiscal space to support weak economic activity. As a result, the share of development expenditures in total spending declined to 16.1 percent in FY13, compared to 18.6 percent in the previous year (**Chapter 5**).

25. While expenditure rigidities in interest payments, defense, and civil administration should be acknowledged, overruns in discretionary spending like untargeted subsidies and net lending to PSEs, are somewhat disappointing.[5] In fact, loss-making PSEs and untargeted subsidies have become such a major drain on fiscal resources, that the recently signed Extended Fund Facility (EFF) with the IMF has prioritized urgent reforms in these interlinked sectors. To put this issue into perspective, the revenue deficit (the gap between total revenues and current expenditures) reached 3.0 percent of GDP in FY13, which implies that the federal government is not only borrowing to finance all its development expenditures, but is also borrowing to finance 10.4 percent of its current expenditures.

Debt management

26. As mentioned earlier, financing the growing fiscal gap and balancing competing expenditure needs, has dominated policymaking in the country. Government borrowing from domestic sources in FY13, was *actually* higher than the overall fiscal deficit in the year, as net external debt payments had to be paid despite insufficient fresh external inflows (**Chapter 6**). Other than the drain on domestic resources, this resulted in a sharp fall in SBP's FX reserves during the year.

27. More specifically, the stock of external debt & liabilities (EDL) recorded a decline of US$ 5.7 billion during FY13, reaching US$ 59.8 billion as of end-Jun 2013. This was the sharpest drop in a single year, driven primarily by the US$ 2.9 billion servicing of IMF debt, and a US$ 2.7 billion valuation gain with a depreciating Japanese Yen.[6]

28. Looking at domestic debt, the government relied heavily on short-term borrowing from the banking system, despite the doubling in net mobilization via national saving schemes (the predominant source of non-bank financing). This issue, and the following bullet-points, complicated the government's debt management; the conduct of monetary policy; and increased commercial bank exposure to the dominant borrower (i.e., GoP):

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[5] The tariff differential subsidy on power, being a part of overall subsidy, comes under current spending, whereas government compensation against transmission losses are categorized as net lending.

[6] As of end-June 2013, around 25 percent of the country's public & publicly guaranteed external debt was denominated in Japanese Yen. During FY13, the Yen depreciated by 19.8 percent vis-à-vis US$, which reduced the country's external debt stock by US$ 2.7 billion.

- The country's public debt, which is an accumulation of past budget deficits, reached Rs 14.5 trillion by end FY13. In terms of GDP, it stood at 63.3 percent against the statuary limit of 60 percent under the Fiscal Responsibility and Debt Limitation Act of 2005 (**Chapter 6**). Moreover, the government was unable to meet the quarterly commitment of zero net budgetary borrowing from SBP, in three of the four quarters of the year. In addition to breaching these limits, the real challenge is the sustainability of this debt. Although the public debt-to-GDP ratio has fallen by 100 bps during the year, the ratio of public debt-to-tax-revenue (which gauges the government's ability to repay its debt) has weakened to 659 percent by end FY13, compared with 630 percent last year. A similar assessment of the burden of interest payments is included in **Special Section 6.1** (Debt Trap – GDP Growth is the Way Out).

- The heavy reliance on short-term bank borrowing has increased the government's exposure to *interest rate* and *rollover* risks. The outstanding volume of floating debt (T-Bills) reached Rs 5.2 trillion by end FY13, which now accounts for 35.8 percent of total public debt – by end-FY08, this ratio was only 26.3 percent. Given the short-term nature of T-bills (maximum maturity of up to one year), the government is required to rollover this debt at least once a year. Hence, any disruption in short-term liquidity or a change in commercial bank lending patterns, could force the government to rely on central bank financing, which could complicate the existing IMF program. As seen in the 4th quarter of FY13, this rollover risk did materialize as the government was unable to rollover its maturing T-bills with commercial banks; this meant it had to borrow the difference from SBP. Along with the settlement of the circular debt, government borrowing from SBP increased by Rs 530.7 billion during the 4th quarter. In this setting, the need to rebalance the maturity profile of Pakistan's domestic public debt can hardly be over emphasized.

- The government's reliance on short term borrowing is also impairing the yield curve in terms of pricing long term private sector borrowing. More specifically, the yield curve serves as a benchmark for pricing project and infrastructure financing. A steep increase in short term debt (less than one year maturity) coupled with a thin market for PIB trading, has weakened the information content of the long end of the yield curve.

- The quantum of government borrowing from commercial banks has significantly impacted their balance sheets. More specifically, commercial bank investment in federal government securities reached Rs 3.7 trillion by end-FY13, compared to Rs 2.0 trillion (outstanding) as of end-FY11 – an increase of 84.5 percent in just two years. Over the same period, outstanding bank loans increased by only 10.1 percent to Rs 3.6 trillion (**Chapter 4**).[7] The resulting change in the composition of commercial bank balance sheets, implies that at an aggregate level, government securities now account for 37.2 percent of their total assets, compared to only 26.5 percent at the end of FY11. Although this increase in banks' exposure to government securities has allowed them to improve their financial health (government securities carry zero risk of default), this has not only marginalized the private sector, but also entails systemic risks to financial stability, albeit with a low probability.[8]

Monetary policy

29. As mentioned earlier, the sharp fall in headline inflation allowed SBP to cut the policy rate to support investment and growth during FY13. In terms of monetary aggregates, government borrowing remained dominant, with central bank financing driving the 15.8 percent increase in

[7] This includes all private sector lending; commodity financing; lending to NBFIs; and loans to PSEs. This data is taken from the aggregate balance sheets of commercial banks, and may not match with data from the Monetary Survey.

[8] For example, in the event that the country realizes heavy external inflows (e.g. bilateral, multilateral or foreign investment) that sharply reduce the government's need for commercial bank borrowing, this would not only reduce market interest rates, but could push banks into aggressive lending to the private sector, as seen in 2003-04.

reserve money (this happened despite a 66.3 percent contraction in the central bank's net foreign assets). As a result, 87.3 percent of reserve money is now backed by treasury bills, compared with 77.9 percent at the end of FY12. Following this trend, the growth in broad money supply (M2) was also dominated by the government, with government borrowing increasing by Rs 1.5 *trillion* during the year; this may be compared to an increase of only Rs 11.7 billion in credit to the non-government sector. These developments in the banking sector, kept market liquidity under pressure throughout the year. SBP's efforts to ensure the smooth functioning of both the FX and the money markets (and to facilitate the transmission of monetary policy decisions to retail interest rates), required large injections of liquidity through open market operations. As a result, the average volume of OMOs more than doubled in FY13, compared to the previous year (**Chapter 4**).

30. Despite an accommodating monetary policy and SBP efforts to ensure adequate market liquidity, credit to the private sector witnessed a net contraction of Rs 19.0 billion in FY13, which was in sharp contrast to the net expansion of Rs 235.2 billion in FY12. However, a larger part of this sharp reversal can be traced to the change in tax incentives on mutual fund investments, and the settlement of the circular debt in June 2013. Looking specifically at credit to private businesses, loans to the manufacturing sector increased by Rs 58.9 billion during the year, compared to Rs 4.5 billion in FY12. Furthermore, trade financing also picked up during the year, concurrent with the rise in exports.

External Sector

31. Pakistan's exports grew by 3.5 percent in FY13 (based on PBS data), compared to negative growth of 4.8 percent last year (**Chapter 7**). In our view, this was largely because of duty free access of certain items (mainly textiles) to the EU market; and the increased demand for cotton yarn and fabric from both China and Hong Kong. This, along with an almost stagnant import bill, helped narrow the trade deficit. The services account also posted a notable improvement on account of CSF inflows (worth US$ 1.8 billion) during the year. However, the real positive in the country's BoP was worker remittances, which has become the most critical source of foreign exchange *receipts*. In absolute terms, worker remittances reached US$ 13.9 billion in FY13, which effectively financed one-third of the country's import bill. Both the realization of CSF and increase in remittances narrowed the current account deficit to US$ 2.5 billion in FY13, against a US$ 4.7 billion deficit in the previous year (**Table 1.3**).

Table 1.3: Summary Balance of Payments
billion US$

	FY09	FY10	FY11	FY12	FY13
Current account balance	-9.3	-3.9	0.2	-4.7	-2.5
Capital account (net)	0.5	0.2	0.2	0.2	0.3
Financial account (net)	5.6	5.1	2.1	1.3	0.3
Overall balance	-3.1	1.3	2.5	-3.3	-2.0

Source: State Bank of Pakistan

32. Despite this improvement in the external sector, financing the smaller current account deficit proved to be a major challenge due to dwindling financial inflows. Although foreign direct investment (FDI) increased to US$ 1.3 billion in FY13 (compared with US$ 0.7 billion last year), it could not compensate for the sharp fall in other financial inflows during the year. The declining trend in net financial inflows seen in the past three years has increased the vulnerability of the external sector. As a direct result, SBP has been drawing down its FX reserves not just to finance the current account deficit, but also to meet lumpy repayments to the IFIs (especially the IMF). This pushed the country's foreign exchange reserves down to cover 14.3 weeks of imports by end-June 2013, which is still adequate by international standards.

1.3 Outlook for FY14

33. The Annual Plan for FY14 sets a GDP growth target of 4.4 percent. Broadly speaking, this outlook is based on the assumption that energy supplies would improve; that weather conditions would not impact the agriculture sector; and the positive sentiments created by the smooth political transition in May 2013, would continue into FY14. While the payment of the circular debt appears to

have improved energy availability this year (FY14), we believe GDP growth will remain below target (**Table 1.4**).

34. On the supply side, the factors that supported the recovery in large scale manufacturing should continue to sustain industrial growth in FY14. In addition, the expected launch of 3G services is likely to boost value addition in telecom services. However, growth in agriculture is likely to remain below its target of 3.8 percent, as recent rains have damaged the upcoming rice and cotton crop in Punjab; furthermore, we do not expect minor crops to repeat the strong 6.7 percent growth seen in FY13. In overall terms, SBP projects GDP growth in the range of 3.0 - 4.0 percent for FY14, which is higher than the IMF's growth forecast of 2.5 - 3.0 percent.

35. In our view, the degree of fiscal contraction via the phasing out of energy subsidies and the rise in tax collection that underpins the IMF program, could explain the differing growth projections for the year. The FY14 budget envisages a fiscal deficit at 6.3 percent of GDP, which assumes: (1) a Rs 120 billion inflow under 3G licenses; (2) a 27.8 percent growth in FBR tax revenues; (3) a Rs 127.1 billion reduction in subsidies (to Rs 240.4 billion against Rs 367.5 billion incurred in FY13); and (4) a combined provincial surplus of Rs 23.1 billion. While the government appears determined to cut power subsidies quite aggressively, the FBR revenue target seems less credible. The task ahead for FBR is likely to be more challenging with subdued growth and a slowdown in imports. Furthermore, the prospect of achieving provincial surpluses is also a little suspect, as only Balochistan has shown a budget surplus for the current fiscal year in its budget documents. This suggests the need to improve coordination between the federal government and the provinces, especially during the budget making process.

36. Staying with the fiscal side, we also expect some pressure from interest payments this year, owing to the steep increase in short-term domestic debt incurred during FY13. According to in-house estimates, repayments on T-bills and PIBs issued in FY13 *alone*, would increase interest payments by Rs 277.5 billion in FY14, which is almost a third of the entire interest expense on domestic debt during FY13.

Table 1.4: Key Macroeconomic Targets and Projections

		FY14	
	FY13	Target	SBP projection
	percent growth		
Real GDP	3.6	4.4	3.0 – 4.0
CPI	7.4	8.0	10.5 – 11.5
M2	15.9	-	13.0 – 14.0
	billion US$		
Remittances	13.9	15.1	14.0 - 15.0
Exports (fob)	24.8	26.6	26.0 - 26.5
Imports (fob)	40.2	43.3	43.0 – 44.0
	percent of GDP		
Fiscal deficit	8.0	6.3	6.0 - 7.0
Current account deficit	1.0	1.1	1.0 – 1.8

Source: State Bank of Pakistan

37. In terms of inflation, encouraged by the steep decline in headline CPI growth in FY13, the government has set an inflation target of 8.0 percent for FY14. However, we believe a more realistic inflation outlook would be in the range of 10.5 - 11.5 percent due to the following factors: (1) the recent sharp increase in power tariffs (and likely increase in gas tariffs in January 2014); (2) the weakening of the Pak Rupee and resulting increase in POL prices; (3) the upward revision in the GST rate from 16 to 17 percent; (4) below target production of cotton this season; and (5) lower wheat stocks in the country.

38. As discussed in **Chapter 4**, weakness in the PKR and the increase in retail POL prices, will strongly impact inflation expectations, which will be reflected in price-setting behavior at the retail level. Hence, the developments in the first quarter of FY14 do not bode well for inflationary expectations, and what is likely to be realized during the year.

39. In terms of the external sector, the approval of a 3-year (US$ 6.64 billion) Extended Fund Facility from the IMF, and expected financial support from other IFIs, should bring stability to the domestic

FX market in FY14.[9] However, the detailed Letter of Intent (LoI) temporarily unhinged the FX market in late September 2013, and resulted in some speculative pressures on the PKR. Furthermore, the market is focusing on several risk factors like: (1) the current account deficit in the first quarter of FY14, is not consistent with the annual target; (2) international oil prices (Brent) have risen by 4.8 percent by end-November 2013; (3) exports may not perform well because of the continuing global slowdown and energy shortages at home; (4) remittances may suffer if the country experiences future bouts of PKR volatility; (5) CSF inflows may not be as high as in FY13; and (6) the quarterly targets to build unencumbered FX reserves in the second half of FY14, appear to be challenging.

40. However, we believe this outlook is misplaced, as it does not account for the following factors: (a) inflows from other IFIs (WB & ADB) come with a short lag, and the resulting structural reforms could solicit foreign investment; (b) a sovereign bond issue is quite likely during the course of the year; (c) although there is some market fatigue concerning the inflows from the 3G licenses and Etisalaat, these inflows will significantly narrow the external gap; (d) subsequent quarterly targets could be revised as the IMF program plays out; (e) the government has prepared a detailed disinvestment and privatization list; and (f) CSF inflows during the drawdown of NATO troops from Afghanistan in 2014, could be stronger than expected.

41. While managing expectations in the external sector will remain a pressing challenge for policymakers, the government must push ahead with fiscal reforms. More specifically, a concerted effort must be made to increase revenue collection in a more equitable manner, and to restructure loss-making PSEs to reduce the subsidy burden on the federal government. Only then will domestic investors secure a sounder footing to put the country on a much needed growth trajectory.

[9] Pakistan has already received US$ 1.1 billion from the Fund as of end-December 2013.

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