June 13, 2013

<u>Economy continues to face fiscal and external challenges in Q3-FY13: SBP Quarterly Report</u>

State Bank of Pakistan released its Third Quarterly Report for FY13 on the State of Economy, today. The Report says that key challenges to macroeconomic management emanated from fiscal as well as external sectors. After a surplus during the first half of FY13, the current account position deteriorated to a deficit in the third quarter, creating some pressure on the country's foreign exchange reserves. On the domestic front, the growth in FBR tax revenues remained sluggish, while expenditures on power subsidies and debt servicing increased sharply. The government had to resort increasingly to borrowing from SBP to finance its fiscal deficit.

The Report also notes some positive developments including a significant decline in inflation and some signs of recovery in large-scale manufacturing. Revival in large scale manufacturing was supported by loans disbursed by banks to the private sector businesses, and higher production of sugar, POL, cement, fertilizer, and cotton yarn.

However, agriculture was adversely affected by heavy rains and localized floods during the *Kharif* season, and services sector also remained subdued. In overall terms, growth in real GDP is estimated at 3.6 percent in FY13 compared with 4.4 percent last year (this is at rebased GDP data).

The Report highlights that while inflation has continued to decline and registered a recent low, deterioration on the external front, or an increase in administered prices (to minimize subsidies and arrest the size of the circular debt required for fiscal consolidation), pose main risks to inflation in the medium term. In the absence of these risks, inflation is likely to remain subdued.

According to the Report, the fiscal situation has worsened because of subsidies and rising interest payments. The amount of subsidies paid during the first three quarters of FY13, significantly exceeded the full year target. Furthermore, debt servicing has surpassed development expenditures. These two heads (i.e., subsidies and debt servicing) together constitute around 40 percent of total current expenditures. On the revenue side, growth in FBR tax collection during Jul-Mar FY13 was the lowest since FY02.

However, the availability of US$ 1.8 billion of Coalition Support Fund (CSF) and surpluses generated by the provinces helped the government contain its 9-month deficit. Nevertheless, SBP projects the full year budget deficit in the range of 7 – 7.5 percent of GDP, due to continuing pressure of subsidies and interest payments, and sluggish revenue collection by FBR.

The Report also points out difficulties faced by the government in financing the fiscal deficit. As external financing dried up completely, the government continued to rely on the domestic banking system to finance its fiscal deficit. More worryingly, domestic borrowing was skewed towards short-term financing, which raises concerns about the sustainability of Pakistan's public debt, which has already reached Rs 13.9 trillion as of end-March 2013.

According to the FRDL Act (2005), the government must achieve a public debt-to-GDP ratio of 60 percent by end FY13. However, given the pace of recent increase in the fiscal deficit (and resulting rise in public debt), the government is unlikely to achieve this target. The Report states that SBP has been flagging this fact that the rise in the debt stock accompanied by debt servicing, directly adds to subsequent fiscal deficits – this shows the increased risk of entering a debt-deficit spiral.

In addition to the challenges on the fiscal front, the SBP Report also notes pressure on Pakistan's external account after the first half of FY13, with a current account deficit of US$ 1.3 billion in Q3-FY13 alone. Also for rest of FY13, the external outlook remains a source of concern with scheduled repayments to the IMF. These repayments caused Pakistan's liquid foreign exchange reserves to decline from US$15.3 billion (as of end-June 2012) to US$12.3 billion as of end-March 2013. Although the country's reserves are currently above international adequacy benchmarks (e.g., import and short-term debt coverage), the falling trend makes managing the FX market a bit challenging.

The Report underscores the need for decisive structural reforms to address the macroeconomic challenges, instead of just securing short-term financing. It is important that all provinces should be taken on board in this process of economic reforms (from formulation to implementation), as their role in the macro-economy has become significant after the introduction of fiscal devolution via the 18th Amendment.

The Report urges the government to commit to bold economic reforms in order to achieve sustainable and equitable economic growth. More specifically, the central bank identifies 7 key areas:

1. The size of the fiscal deficit and how it will be addressed;
2. Providing comfort to the FX market for FY14;
3. Institutional strengthening of tax authorities (federal as well as provincial) so they can increase the tax base and collection;
4. A balanced approach to energy reforms that supplements tariff rationalization with strict enforcement on theft, overdue bills, better management practices, and decisive steps to encourage the use of alternate fuel sources (e.g. coal);
5. A strictly commercial orientation towards PSE reforms (especially for Pakistan Railways; PIA; and Pakistan Steel Mills);
6. Increasing the risk-appetite of commercial banks; and
7. Immediate steps to increase power generation, which requires urgently addressing the circular debt problem. #####