1 Economic Outlook

1.1 Introduction

Following several years of low economic growth and poorly implemented structural reforms, FY14 was a better year for the macro-economy (see **Table 1.1**). The most notable developments were the IMF's Extended Fund Facility (EFF) that was formalized in September 2013; the tangible improvement in the country's FX reserves that started in February; the unprecedented appreciation of the PKR in early-March; the reduction in the fiscal deficit; the lower than expected inflation rate;[1] the improvement in private sector credit; and the relatively contained current account deficit.

Table 1.1: Macroeconomic Indicators

	FY13	FY14 Target	FY14
growth in percent			
Real GDP[1]	3.7	4.4	4.1
Agriculture	2.9	3.8	2.1
Industry	1.4	4.8	5.8
Services	4.9	4.6	4.3
CPI inflation[1]	7.4	8.0	8.6
as percent of GDP			
Current account balance[2]	-1.1	-1.1	-1.2
Fiscal balance[3]	-8.2	-6.5	-5.5
Public debt[2]	64.8	--	64.3

Source:
[1] Pakistan Bureau of Statistics;
[2] State Bank of Pakistan;
[3] Ministry of Finance (this includes payments made in FY13 to settle circular debt in the power sector).

On the other hand, though the government took several initiatives to address key bottlenecks in the energy sector (see **Box 3.1**), the results remained short of expectations, and the sector continued to struggle as it has in the past several years. Furthermore, despite policy intentions, public sector enterprises (PSEs) continued to be a fiscal burden on the federal government, as little in the way of internal restructuring was possible in power-related PSEs; PIA; Pakistan Railways; and Pakistan Steel.

Having said this, the fiscal burden at 5.5 percent of GDP was significantly lower when compared to trends in the past three years.[2] In our view, there was a concerted effort on the part of the government to contain expenditures and generate additional revenues. However, the ambitious tax revenue target set in the Budget, had to be adjusted downwards twice, during the course of the fiscal year. In effect, efforts to document the economy and widen the tax net, did not deliver the desired results.

Against a fiscal deficit target of 6.5 percent announced in the FY14 Federal Budget, the government was able to contain the gap to 5.5 percent, which is a significant achievement. However, one should be mindful of one-off factors like the inflow into the Pakistan Development Fund (PDF), and the fact that the government did not pay off the circular debt in FY14. One must also highlight the role of provincial governments, which have vastly exceeded their commitment to book (and provide) surpluses to the federal government. This is perhaps not the intended goal, as these governments require timely disbursements and expertise to undertake development spending (fiscal devolution – see **Chapter 5**).

With the start of a new IMF program, external inflows from other international financial institutions (IFIs) also began after a gap of almost three years. This helped stem the gradual depletion of SBP's FX reserves, which had come to dominate policymaking in the first quarter of FY14. More importantly however, the US$ 1.5 billion inflow into PDF (which also released pent up inflows) in

[1] Although the average headline CPI inflation for FY14 (at 8.6 percent) was higher than a year before (7.4 percent), it was considerably less than SBP's initial projections of 11-12 percent for the year.
[2] Fiscal deficits ranged between 6.5 to 8.2 percent of GDP (after incorporating circular debt settlement) during the past three years.

February/March 2014, was unanticipated by the FX market, and triggered an unprecedented appreciation of the PKR. The positive sentiments this generated, also instilled a view that the government was finally gearing up for a growth phase.

This external grant and subsequent positive developments in the external sector, helped increase SBP's FX reserves well above the end-quarterly targets the government had agreed with the IMF. The successful auction of the long-awaited 3G/4G telecom licenses in April 2014; the US$ 2 billion mobilized via the Eurobond in April; and the divesture of UBL shares to foreign investors in June, pushed SBP's FX reserves to $ 9.1 billion at the end of FY14 (a $ 3.1 billion increase during the year). In terms of unencumbered FX reserves (also called *net international reserves*), SBP was able to increase its *actual* FX holdings by $ 5.1 billion during the year.

The external sector also gained comfort from exogenous and one-off factors. Soft international commodity prices (especially oil and palm oil) allowed the import bill to grow by only 3.8 percent, which combined with the 1.5 percent growth in exports, increased the trade deficit by $ 1.2 billion in FY14. Despite an increase in the *services* deficit ($ 1.0 billion, because of a shortfall in CSF) and a larger *income account* deficit (by $ 251 million); the current account deficit only increased by $ 475 million during the year. At the margin, the critical source of comfort was the $ 1.9 billion increase in worker remittances, which is fast becoming as important as Pakistan's export revenues. This should not be surprising; we have stated in previous publications that Pakistan's main FX earning is not from the export of textiles, but from worker remittances.

1.2 Assessment of FY14

Real Sector

Real GDP growth in FY14 was 4.1 percent compared to 3.7 percent in FY13 (Pakistan Bureau of Statistics). As shown in **Table 1.1**, this was below target, but higher and better balanced than FY13. Industrial growth was above target, and the impetus for LSM growth can be traced to beverages, the sugar sector and fertilizer.

The agriculture sector grew by 2.1 percent, which was below the 3.8 percent target. This was primarily because of the fall in minor crops, and below target growth in livestock sector. With the exception of cotton, major crops did well due to increased area under cultivation, and attractive market prices of wheat and rice. In the case of cotton, the 12.8 million bales realized, were both below target and also less than FY13 – again area under cultivation was low. Feedback from market experts suggests that lower margins; water shortages during the sowing period; rising input prices, and a shift to sugarcane, were the primary reasons for this below-target performance. Looking at Pakistan's agri performance in the past several years, reveal that production is far too dependent on cultivated area and/or adverse weather. The only way to escape this physical constraint is to adopt better farming practices to increase crop yields.

Minor crops declined by 3.5 percent in FY14, compared to growth of 6.1 percent in the previous year. As in the case of cotton, area under cultivation for gram, potatoes, sunflower, chilies, rapeseed and mustard, was lower than in FY13. More problematic, was the performance of the livestock sector. In terms of perspective, livestock accounts for over 11 percent of Pakistan's GDP (higher than LSM), and in terms of live animals, Pakistan figures prominently in the world (see **Chapter 2**). However, a meaningful analysis of this critical sector is constrained by limited data, which is only available once a year.

LSM growth in FY14 was 3.9 percent, which is almost the same as in the previous year – this should be qualified, as LSM growth was 5.3 percent in the first three quarters of FY14. The reason for the downward adjustment, can be traced to a strong base-effect from Q4-FY13, and the lackluster performance of cement, steel and cigarette production in Q4-FY14. The bulk of LSM growth this year, came from three sub-sectors (fertilizer, sugar and beverages), while other areas of Pakistan's industrial base (textiles, cement, automobiles, cooking oil, steel, POL, paper and glass), either witnessed a slowdown in growth, or a fall in production compared to the previous year.

In terms of growth drivers, the improved availability of gas to fertilizer; a strong sugarcane crop; and domestic demand for beverages, gave LSM a boost. In terms of the downward momentum, lower textile production; the fall in cement exports to Afghanistan; demand compression for autos[3]; the base-effect in edible oil production; and the temporary closure of Pakistan Steel Mills, all factor into the equation. A final point is how manufacturing firms have adapted to the shortage of power in Pakistan. Large factories have the resources to invest in alternate energy sources, but the more numerous small/medium sized units, have had to curtail operations, as the cost of shifting to other sources of energy, is not affordable (e.g. glass, paper and textile weaving). Having said this, the outlook for manufacturing growth in FY15 is positive.[4]

Services grew by 4.3 percent in FY14, against 4.9 percent in the previous year. This can primarily be traced to lower value addition by *finance & insurance*, and a sharp fall in *general government services* (see **Chapter 2**). Although profitability of commercial banks (which dominate *finance & insurance*) increased during FY14, their value addition followed the trend in overall assets, which grew by just 3.8 percent in real terms, compared with 7.2 percent in FY13. Government services that posted growth of 11.3 percent in FY13, only managed 2.2 percent during the period under review. Broadly speaking, this sharp reduction could be explained by slower growth in government salaries compared to the year before.

In gauging the overall performance of the real sector, one must remain mindful of the coverage of official data, and growth assumptions used for those sectors that are difficult to monitor and document. In our view, most of the vibrancy witnessed in agriculture, manufacturing and services, is not adequately reflected in PBS data (see **Chapter 2**).[5,6] This reinforces the perception, that a large part of the more vibrant economic activities in the country, are not reflected in official data. To support this point, one cannot ignore commercial businesses that intentionally avoid documentation – these firms are obviously absent in official coverage. These stylized facts support the commonly held view that Pakistan's informal economy is more the engine of economic growth, compared to established businesses captured by official data.

Energy Sector

Despite being the single most important reason that Pakistan has posted record high fiscal deficits in the past three years, the energy sector continues to burden the economy (both directly and indirectly), and the country. Although FY14 witnessed fewer days when the demand-supply gap exceeded 4,000

[3] A Special Section on Pakistan's auto sector shows that largely speaking, Pakistani consumers are not as well off (in a welfare sense) compared to Indian consumers, as producers in Pakistan's auto sector have significant market power and are also protected from international competition.

[4] We expect demand for automobiles to recover with the reduction in GST on tractors announced in the FY15 Budget; the launch of the new model for Toyota Corolla; and the announcement of a yellow cab scheme by the government of Punjab. Furthermore, domestic demand for cement is likely to pick up, if development projects announced in the FY15 Budget are implemented. In addition, production activities in Pakistan Steel Mills (PSM) have also resumed following the bailout package.

[5] For example: (1) in agriculture, growth in the livestock sector (which accounts for 56 percent of agri) is softly estimated on past censuses; (2) in LSM, the fast-moving consumer goods (FMCGs) sector that includes the likes of Engro Foods; P&G; Unilever; Nestle; etc., are not even covered by PBS surveys; and (3) in services, most new IT-based startups, fast-food chains and fusion restaurants; shopping malls, and specialized retail outlets that have been sprouting up, are simply not covered.

[6] Although PBS follows international standards for compiling national accounts, the construction of the LSM index is based on the Census of Manufacturing Industries (CMI), which was last conducted in 2005-06. We expect a new CMI census for 2010-11, which is currently being compiled, will allow PBS to publish a more inclusive picture of LSM.

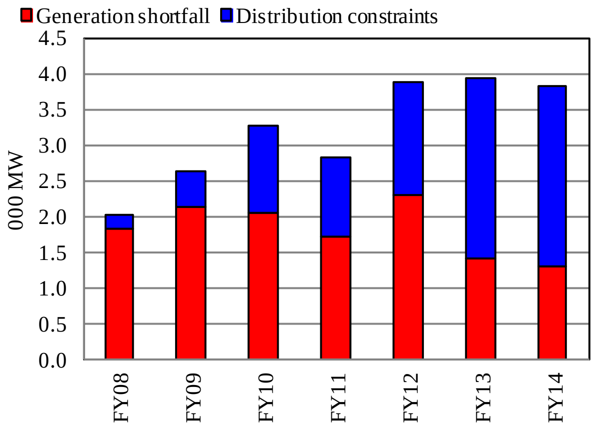
MW compared to the previous year, a comparison with the period before FY12 shows a marked deterioration (see **Chapter 3**). Having said this, power subsidies have fallen in FY14, but inadequate planning and development of the energy infrastructure, and lack of reforms in Gencos and Discos, continue to impede Pakistan's economy.

One must also acknowledge that the Government of Pakistan (GoP) did not pay-off the circular debt in FY14, which helped contain its fiscal deficit during the year under review. This does not, however, imply that the circular debt problem has been solved. In our view, the circular debt, which has grown again in recent months, will be paid this fiscal year, or it could risk undermining the supply chain of power, which the country can ill afford.

Even with the policy emphasis to increase generation capacity, the results have been mixed. The units that have been commissioned are gas-based (but with an option for FO use), which means that once these units are completed, they will either depend on inadequate gas supplies, or add to the country's oil import bill and simultaneously increase the cost of thermal generation. The latter is likely to stoke the circular debt problem.

As discussed in **Chapter 3**, the more binding bottleneck in the energy sector is not generation (which should be clear, as most generation units are working well below capacity), but distribution (see **Figure 1.1**). In effect, even if generating units are geared up to increase capacity utilization, the country simply does not have the capacity to distribute this power to where it is needed (i.e., from the main-grid to actual users). Hence, to reduce the demand-supply gap, greater policy focus is required on distribution, which means higher federal/provincial government expenditures to improve the distribution network (to reduce theft & leakages) and avoid overwhelming the distribution grid; it will also require restructuring and privatizing the Discos.

Figure 1.1: Break up of Load Management



Source: NTDC

In terms of the natural gas sector, the growing public campaign by industrial, commercial and CNG associations, urging the authorities to supply them with gas, is a clear indication that the shortage of gas has regressed to publically lobbying policymakers. As we have stated in the *Annual Report FY13*, the priority of gas users must be reworked to focus on more productive users (power[7], then industrial and commercial users) and tariffs should be increased to eliminate subsidies and also to reflect the growing excess demand. The revenue loss from abnormally high unaccounted-for-gas (UFG, which is basically organized theft); the overuse of subsidized gas by households; and the current CNG policy, must be addressed. Furthermore, gas exploration and production, should be stepped up to ensure the existing supply of gas is not allowed to fall.

On a final note, not enough has been done to exploit Pakistan's ample coal reserves in Sindh. Although coal-fired generation units would require significant investment,[8] given the permanence of this fuel source, the use of domestic coal needs urgent policy action.[9] We feel that unless credible

[7] See **Special Section 3.1**, for an assessment of the FX savings if gas is shifted from fertilizer to the power sector.
[8] This entails investment in infrastructure for storage and transportation of coal, and to transmit this power from the source of generation to the main grid.
[9] See **Special Section 3.2**, which shows that the use of coal for thermal generation of power is far cheaper than the current use of furnace oil.

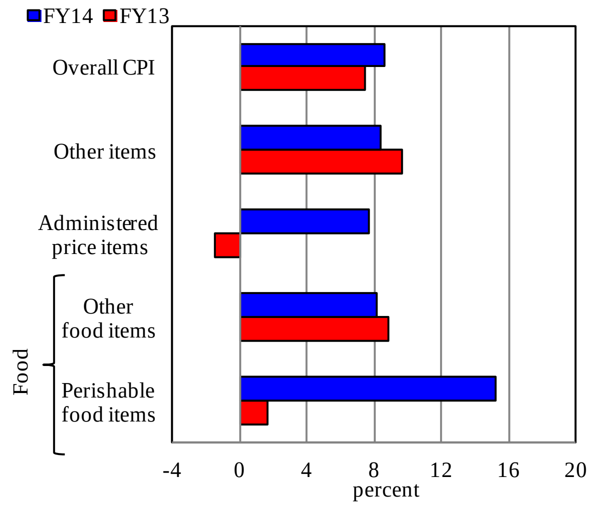
steps are taken to resolve the various challenges facing the energy sector, Pakistan's macro-economic foundations will not be able to sustain the growth rates needed.

Inflation

On the face of it, inflation increased in FY14, compared to the year before (see **Table 1.1**). However, the experience during the course of the year was that inflation was milder than initially expected. SBP had initially projected inflation to fall in the range of 11 to 12 percent (see **Chapter 4**), on the basis of two primary concerns. First, the on-going negotiations with the IMF in early FY14, had flagged the urgent need to reduce the fiscal burden created by power subsides, which meant tariff rates would have to be increased significantly to cover the rising cost of power generation. Second, with a stabilization program on the cards, SBP had factored in a weaker PKR, which would not only increase imported inflation, but also stoke inflationary expectations.

During the course of the year however, several factors came into play that could not have been anticipated. First, global oil prices softened much more than expected. Second, although the weakness of the PKR in the first quarter had been anticipated, the subsequent appreciation and stabilization after March 2014, meant the overall weakness of the currency was much lower than projected.[10] Third, the above target mobilization from the Eurobond and the successful divesture of UBL shares, coupled with a smaller underlying fiscal gap, sharply reduced government borrowing from the banking system (especially SBP). Fourth, the increase in electricity and gas tariff were smaller than initially expected. And finally, the primary source of inflation in Q1-FY14 (perishable food items), had subsided by December 2013. As shown in **Figure 1.2**, the real drivers behind inflation in FY14, were perishable food items and administered prices.

Figure 1.2: Breakdown of Average CPI Inflation



Source: State Bank of Pakistan & Pakistan Bureau of Statistics

In early 2014, the market had changed its inflation outlook. Although SBP subsequently adjusted its projections downward during the course of the year, the market's view was that inflation would be even lower. As discussed in **Chapter 6**, this change in the inflation outlook was instrumental in the sudden shift in commercial bank appetite for longer-term government securities (PIBs). This was also reflected in the market's view (around January 2014, which was reinforced in March) that interest rates would be cut.

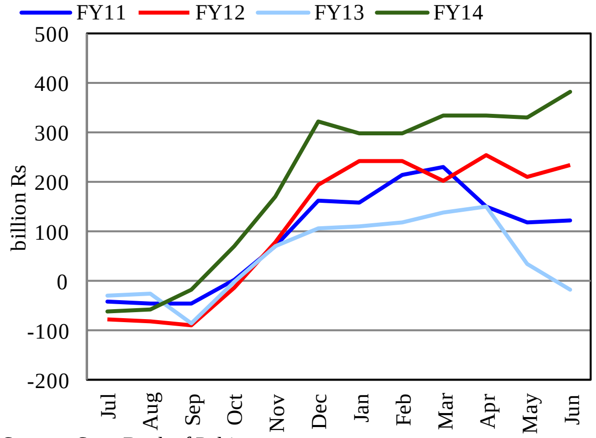
Monetary Policy

As part of the stabilization program to reduce the twin deficits (fiscal and external), the easing monetary policy stance that started in mid-2011, was changed in September 2013. After two consecutive 50 bps increases, SBP held its benchmark rate for the remaining part of FY14. As mentioned earlier, although the market's inflation outlook had eased significantly by early 2014, SBP opted to pursue a cautious monetary policy driven by concerns about the external sector, and possible pressure on the PKR.

[10] This was supported by unexpected foreign inflows and other proceeds that could not be counted upon (e.g., 3G/4G proceeds).

This policy stance appears to be vindicated, as it managed to curb M2 growth to 12.5 percent (against 15.9 percent growth in FY13) and yet was able to support a significant increase in private sector credit growth last seen in FY08. From the supply side, lower government borrowing from the banking system and healthy growth in deposits, created the space for commercial banks to lend productively; from the demand side, the optimism after the general elections in May 2013, created a conducive environment to borrow (see **Figure 1.3**). Credit uptake was however concentrated in the textile sector (in preparation of GSP Plus); telecoms (gearing up for enhanced 3G/4G services); the sugar sector (bumper crop and liquidity problems); beverages (strong demand and capacity enhancement); and the power sector (a perpetual borrower). From discussions with the market, there is a view that many corporates (e.g. cement and automobiles – see **Box 2.3** & **Special Section 2.1**) were so cash rich in FY14 that they opted against borrowing for their day-to-day operations.

Figure 1.3: Private Sector Credit- Cumulative Flows



Source: State Bank of Pakistan

Fiscal Policy

As shown in **Table 1.1**, there was a significant improvement in the fiscal deficit in FY14, compared to the year before. The 5.5 percent deficit realized, was even lower than the 6.5 percent target set at the beginning of the year (a first since FY06). There was strong growth in both total revenues (spearheaded by non-tax revenues) and development expenditures. More specifically, PSDP spending by the federal government increased by 34.4 percent in FY14, compared to a rise of 11.8 percent last year. In addition to PSDP, the government also provided cash grants of Rs 63.9 billion under the Benazir Income Support Program (BISP) for poverty alleviation and women empowerment in FY14, compared with Rs 58.0 billion in the previous year.[11] In overall terms, the sharp reduction in the primary deficit (expenditures less debt servicing, minus total revenues) in FY14, was a welcome change compared to the past five years.

It is important to note that the bulk of the fiscal improvement was attributed to factors, which are one-off in nature. First, the government did not settle the circular debt of about Rs 235 billion in FY14, which it had consistently done every year since FY11 (see **Chapter 5**). Second, the government treated a one-off grant of Rs 157 billion as a statistical discrepancy, which reduced the overall deficit by the same amount. In effect, just these two factors account for a 1.5 percentage point reduction in the fiscal deficit. If we add to this the recovery of Rs 56.0 billion from PSEs (as markup on loans extended earlier) following the settlement of circular debt in July 2013, and the one-off utilization of Rs 67.7 billion from the Universal Service Fund (USF), the fiscal gap increases to 7.5 percent of GDP, which is still lower than the 8.2 percent deficit realized in FY13 (see **Table 5.2**).

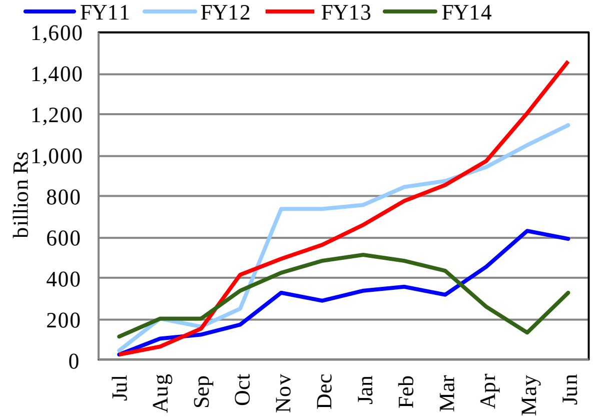
Some key developments on the fiscal front in FY14, should be highlighted: (1) the government geared up its focus on withholding taxes, which increased by 32.6 percent over the previous year (this reflects the difficulty in actually getting people to pay their taxes voluntarily); (2) federal subsidies

[11] Interestingly, BISP supplements SBP efforts to promote financial inclusion, as banking facilities are utilized for disbursements. More broadly, SBP has been actively promoting the provision of financial services to underserved segment of society. Key steps in this direction include: (a) the introduction of Basic Banking Accounts, aimed at the provision of basic banking facilities for low income people; (b) the implementation of Annual Branch Licensing policy, which requires banks to open at least 20 percent of new branches in unbanked areas; and (c) efforts to create an enabling environment for the provision of branchless banking and sustainable microfinance.

were lower than last year, but still over 27 percent higher than target; (3) efforts to increase the tax net did succeed (in terms of notices sent to new tax payers), but this did not generate much in the way of actual revenues; and (4) as in FY13, non-tax revenues posted very sharp growth driven by SBP profits; receipts from the 3G/4G licenses; the use of USF money; and oil & gas related charges accruing to the government (see **Table 5.7**). As stated earlier, non-tax revenues helped cover the tax revenue shortfall, but this does not bode well for the structural changes needed in the country's tax structure.

The most positive development in the fiscal side, was the smaller deficit and the onset of external financing. This sharply reduced financing pressure on the banking system (see **Figure 1.4**). External funding and higher non-bank investment in PIBs, added to the sense of comfort. While SBP was able to reduce its lending to the government during the course of the year, commercial banks also had the space to finance the private sector (see **Chapter 4**).

Figure 1.4: Net Budgetary Borrowing from Banking System - Cumulative Flows



Source: State Bank of Pakistan

Lastly, the accumulated surplus of the provincial governments was Rs 149.5 billion, against a target of only Rs 23 billion. From the data, it would appear that the shortfall in PSDP spending could be linked to the limited spending capacity of provincial governments, which thereby pushed the surpluses well above target. Furthermore, we believe that after releasing the *divisible pool* to provincial governments, and earmarking allocations for debt servicing and defence; the federal government has also communicated that provincial governments should help create a smaller *consolidated* fiscal deficit. This direction is reinforced by unpredictable inflows at the end of the fiscal year, which coupled with hard limits on SBP financing to provincial governments, creates a degree of conservatism in spending patterns.

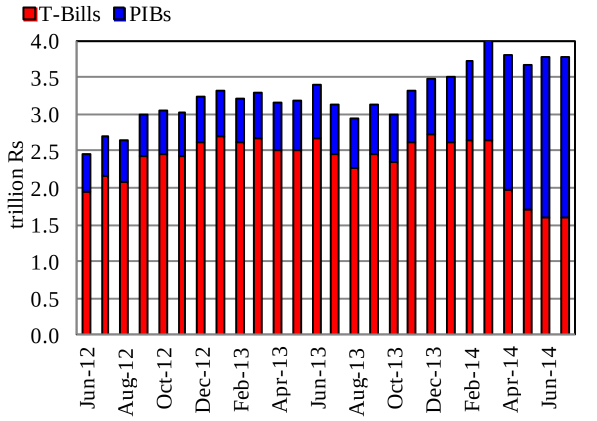
Having said this, the differing spending priorities of provincial governments, is a positive sign as it signals that provincial governments are determining their spending patterns by the needs of the province. In our view, capacity constraints in the provincial government machinery need to be addressed, and greater responsibility for collecting taxes should be given to the provinces. With greater control on revenue flows, provincial governments are likely to better manage their respective budgets.

Debt & Liquidity Management

Changing dynamics in the debt market made liquidity management more challenging, but in overall terms, the outcome at the end of FY14 was positive. The onset of the stabilization program had geared up SBP to shift government borrowing away from the central bank. This meant ensuring that banks had sufficient liquidity to finance the government via T-bills. However, as discussed in more detail in **Chapter 6**, with inflation rising in the early part of the year (and the period also coinciding with the start of the IMF program), the market expected more pronounced monetary tightening in September 2013. As a result, the money market during the period July to November 2013, was largely liquid, after which things changed significantly.

As discussed in **Chapter 4**, the shift in the market's inflation outlook was clear by January 2014, which could explain the sudden change in banks' appetite for PIBs. As shown in **Figure 1.5**, outstanding holdings of government securities (by commercial banks) continued to build during the course of the year, but there was a very rapid change in composition from January 2014. Although this change in sentiments has had a profound impact on improving the average maturity of outstanding government debt, there are growing concerns about the scale of this shift.

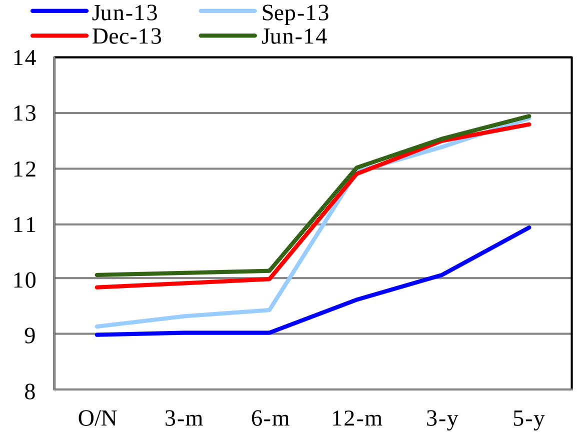
Figure 1.5: Banks' holding of T-bills and PIBs



Source: State Bank of Pakistan

By mid-May 2014, commercial bank holdings of PIBs were higher than T-bill holdings for the first time since PIBs were launched in December 2000. This trend of holding PIBs on their books, still persists. The magnitude of this change can be gauged by how aggressively banks had been investing in T-bills in the past several years. Since PIBs lock up liquidity for longer tenors, the degree of crowding out the private sector is that much more serious.

Figure 1.6: Secondary Market Yields (in percent)



Source: State Bank of Pakistan

Not coincidentally, the yield curve also experienced a significant change between July and September 2013. As shown in **Figure 1.6**, a significant gap has been created between T-bill rates and those carried by PIBs. Furthermore, from November till the end of the fiscal year, the T-bill section of the yield curve became flatter, while the PIB part retained the same upward slope (this is to be expected given the prolonged holdings reflected by 5 and 10-year PIBs). With this apparent disconnect in the yield curve, the attractiveness of PIBs increased compared to T-bills, which explains the sharp reversal in bank holdings of long-term government paper.

Focusing on the money market, FY14 could be divided into two periods: pre-November and post-November. As stated earlier, the period from July to November could be characterized as a *wait-and-see* period, as banks remained liquid and SBP's interventions were primarily to absorb liquidity via OMOs. This was the period when overnight rates stayed in the middle of the interest rate corridor, and on many occasions, banks placed excess cash with SBP.[12] During this period, investment in government securities was primarily in 3-month T-bills, with many auctions not able to attract any bids in longer tenors (6 or 12-months).

The status quo changed abruptly after November 2013. Banks started to worry that interest rates had peaked, as inflation was trending down much more than anticipated. Other than over-bidding in the first T-bill auction in December 2013, banks also focused on PIBs (see **Chapter 6**). With this pattern of over-bidding (in T-bills and PIBs), SBP had to inject cash into the money market, but did so with

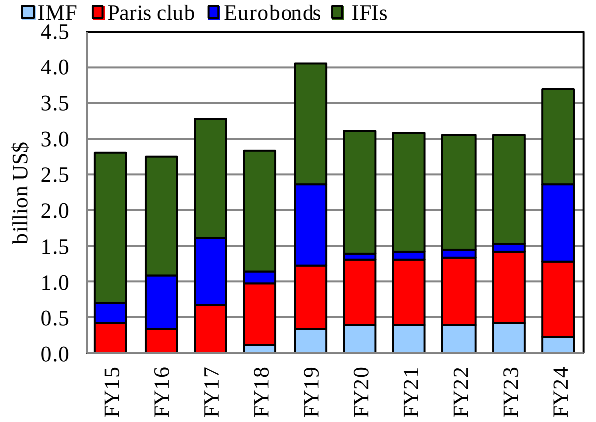
[12] It is important to make a distinction between "liquidity" and "cash". Cash refers to available cash holdings of a bank, while liquidity refers to bank holdings of government securities that can be converted to available cash.

some reservations, as this directly impacted the growth of its net domestic assets (NDA), which could threaten the quarterly targets agreed upon with the IMF.

In terms of Pakistan's external debt, FY14 was the first time in two years that its outstanding external indebtedness did not fall. The $ 4.6 billion increase in outstanding debt is clearly explained by the start of the IMF program. Having said this, Pakistan's indebtedness to the IMF *itself* actually fell by $ 1.4 billion during the course of FY14, which shows that the Extended Fund Facility (EFF) was not front-loaded. In effect, Pakistan was repaying more to the IMF during FY14, compared to fresh loans it received from this IFI. The real reason for the increase in Pakistan's external debt, was the successful launch of the Eurobond and fresh funding from the World Bank, ADB and some bilateral inflows.

Although these external inflows helped build SBP's reserves and calmed the FX market, certain debt sustainability indicators witnessed erosion in FY14. More specifically, external debt servicing as a fraction of export earnings and/or foreign exchange earnings (i.e. exports and remittances) both increased, as did the stock of external debt as a percentage of GDP. This should be viewed as a warning that Pakistan must increase its hard currency *earnings* in the future, and not take on expensive debt to finance its external deficit (see **Figure 1.7**).

Figure 1.7 : Projected Repayments



Source: EAD & IMF website

External Sector

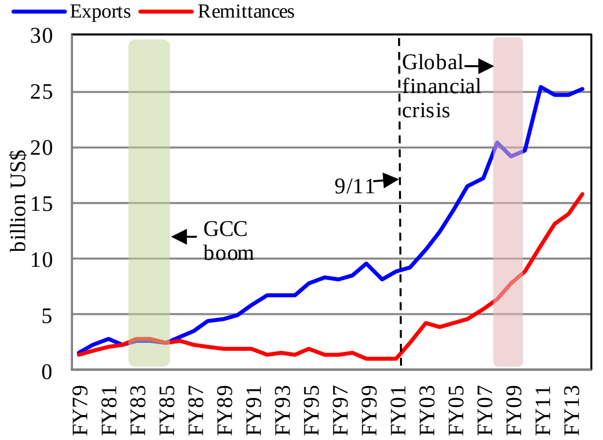
The key message in the external sector is that while the overall size of the external gap was manageable in FY14, financing it was quite challenging. At the start of the fiscal year, SBP's FX reserves were consistently falling, not just because of the monthly current account deficits in the first quarter, but also because of lumpy IMF repayments that persisted till November 2013. Although these payments did not directly impact the interbank market, the resulting drop in SBP's FX reserves did sour sentiments in the FX market. As discussed in **Chapter 7**, the PKR lost quite a bit of its value vis-à-vis the US$ in the first quarter of FY14.

Although sentiments in the FX market did improve with the start of the IMF program, the real improvement was realized in H2-FY14. News of a current account surplus in December (which was made public in January), and a subsequent surplus in February, coincided with the market's softening inflation outlook and the start of exports to the EU (GSP Plus). Furthermore, the grant of US$ 1.5 billion in February/March 2014, Eurobond and 3G/4G proceeds in April, and the divesture of UBL share in June, pushed up SBP's FX reserves at a rapid pace.

The resulting appreciation of the PKR generated positive sentiments, as the public perceived this as the start of a growth phase the government would spearhead. The subsequent stabilization of the PKR in the range of 98-99 per US$, may not have been appreciated by exporters, but it was viewed positively by others who felt that earlier government promises to bring the PKR to this level, were overly optimistic. This stability in the Rupee persisted till the end of FY14.

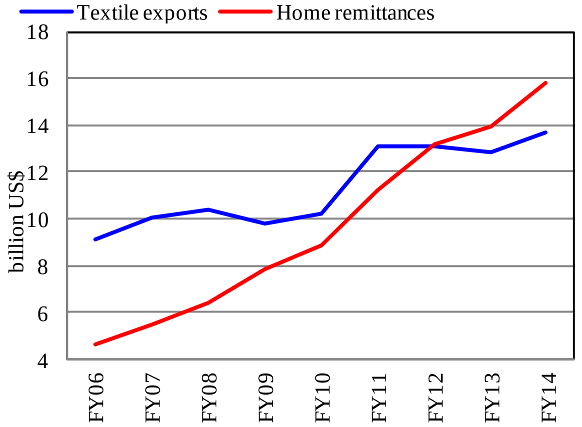
In the bigger picture, the stand out performer in the external sector were expatriate Pakistanis. Despite changing sentiments in the FX market during the course of the year, worker remittances increased by US$ 1.9 billion, which is a 13.8 percent increase in *dollar terms*. In fact, as shown in **Figure 1.8**, remittances have posted remarkable growth since 9/11. What is more interesting however, is the fact that while Pakistan's export revenues have remained almost stagnant since FY10 (linked to adverse international conditions and domestic issues like energy and security), remittances have continued to grow strongly. Although remittances were not expected to play as pivotal a role as our traditional exports, the track record shows that Pakistan is not just fortunate in realizing robust remittances, but the latter has become an underlying strength of this economy.[13]

Figure 1.8: Pakistan's Major FX Earnings



Source: State Bank of Pakistan

Figure 1.9: Home Remittances Surpassed Textile Exports



Source: State Bank of Pakistan

As stated in earlier publications, it is becoming increasingly clear that Pakistan's main FX earnings, is not from textile exports, but worker remittances. In economic terms, manpower has as much of a 'comparative advantage' as traditional textile exports (see **Figure 1.9**). The key is to ensure that export receipts (from manpower) are channeled through the banking system. In our view, the shift towards official remittances is what has kept inflows growing, despite the slowdown in the GCC and the global economy after 2008. Furthermore, there is an element of counter-cyclicality in these inflows: when the domestic economy is not faring well, expatriate Pakistanis are likely to increase remittances to help their families here; also, if domestic employment opportunities do not look promising, or Pakistanis opt to emigrate because of security concerns, the flow of remittances is also likely to increase. This is not the case with traditional exports, which are dependent on a smoothly functioning domestic economy, or the in-roads that have been created in the international market.

Although analysts have expressed concerns that the indigenization of the labor force in the GCC could hurt the volume of remittances into Pakistan, we believe the *actual* inflow of worker remittances is much larger than what is currently being realized via official channels. Just as 9/11 forced expatriate Pakistanis to use official channels to send money back home, there is sufficient anecdotal evidence that a significant flow is still being handled by the parallel FX market.[14] With global concerns about terrorist financing and the growing regulatory norm to *know your customer*, we expect more remittances to be channeled via banks and Exchange Companies. Hence, SBP remains confident that remittances will continue to grow strongly.

[13] Having said this, actively promoting manpower exports comes at a price for the domestic manufacturing and service sectors. However, we feel that once Pakistan's economy is able to generate the jobs that Pakistanis are able to find overseas, the net migration from the country will stop, and perhaps reverse itself.
[14] This avenue of money transfer is currently financing domestic capital flight, and the cash import of high-end consumer products.

1.3 Outlook

The outlook on Pakistan's economy has been tainted by the floods in early FY15, but the damage appears to be less severe than in previous years. As shown in **Table 1.2**, with the exception of the fiscal deficit target that comes from the Federal Budget, the government's other targets for FY15 are formulated by the Planning Commission – SBP's macro projections (which have been updated to incorporate the impact of flooding) are shown for comparison. [15] The main points of departure are the larger fiscal gap, the bigger current account deficit, and the slightly lower growth estimate. Having said this, SBP's projected fiscal deficit range of 5 to 6 percent, does not include the likely settlement of the circular debt.

Another key development is the political uncertainty created by the public protests that started in mid-August, and have since receded (see IBA-SBP Consumer Confidence Index for September 2014). The economic cost of this political impasse is difficult to quantify, but it is clear this uncertainty has delayed investment plans. For businesses that need to interface with the federal government, delays have become commonplace.

The IMF program too was becoming a source of concern for the market, as the Fund has deferred its tranche due to a delay in the 4th Review. There are three issues the IMF would like to see progress on before taking Pakistan's case to the Board: (1) tariff increase in the power sector; (2) government should realize the budgeted Gas Infrastructure Development Cess (GIDC) of Rs 145 billion; and (3) the successful launch of the Islamic Sukuk. However, in the recently concluded Bank-Fund Annual Meetings in Washington DC, there are promising signs that the fourth and fifth tranches would be combined and disbursed by December 2014, contingent on certain actions to be taken by the Government of Pakistan.

Table 1.2: Key Macroeconomic Targets and Projections

		FY15	
	FY14[1,3]	**Target[2]**	**SBP Projection[1]**
		percent growth	
Real GDP	4.1	5.1	4.0 – 5.0
CPI (average)	8.6	8.0	6.5 – 7.5
M2	12.5	-	11.5 - 12.5
		billion US$	
Remittances	15.8	16.7	16.5 – 17.5
Exports (fob)	25.2	27.0	25.4 – 25.9
Imports (fob)	41.8	44.2	43.9 – 44.7
		percent of GDP	
Fiscal deficit	5.5	4.9	5.0 – 6.0
Current a/c deficit	1.2	1.1	1.0 – 2.0

Source:
[1.] State Bank of Pakistan;
[2.] Planning Commission;
[3.] Ministry of Finance.

On the external side, the delay in the IMF tranche coincided with a larger current account deficit in the first quarter of FY15, which has started to chip away at Pakistan's FX reserves. There are valid concerns that Pakistan's export performance has been hurt by the appreciation of the PKR in March 2014, but available data does not allow for a conclusive answer. In addition, import payments for petroleum, iron & steel; plastics; and fertilizers, remained high. Despite this pressure on the external side in Q1-FY15, SBP feels the current account deficit will remain manageable at 1 to 2 percent of GDP.

Earlier concerns about the August 2014 floods have dissipated, as the outlook on inflation for FY15 has improved. SBP's initial range for average inflation was 7.5 to 8.5 percent (broadly what it was in FY14), but this could not predict the sharp fall in international oil prices. In effect, the reduction in retail oil prices in November 2014, and the soft outlook on international oil prices, implies that the projected inflation rate for FY15 has been lowered to a range of 6.5 to 7.5 percent. However, a further cut in power subsidies and the realization of the GIDC, do pose upside risks.

[15] Annual Plan targets were formalized in April-May 2014, whereas SBP made its projections in November 2014.

Of greater concern to SBP is commercial banks' continued interest in holding PIBs on their balance sheets. The bid patterns in Q1-FY15 are alarming, as it appears that banks have lost appetite for T-bills and are more than willing to lock up their funds in long-term PIBs.[16] With the difference in T-bill and PIB rates at record levels, the behavior of banks is understandable; however, with money locked away in PIBs, the crowding out of the private sector will *persist* that much longer. There is also growing concern that PIB rates are now so attractive (especially with the subdued inflation outlook) that commercial banks are even avoiding corporate lending, preferring instead to invest in PIBs.

Finally, there is the issue of structural reforms in PSEs. As discussed in **Chapter 5**, there was little progress in this area in FY14, which means this agenda would have to be fast-tracked. Since the poor implementation of structural reforms can be boiled down to the reluctance (or inability) to change the self-serving behavior of management and staff, moving ahead with the restructuring of loss-making PSEs is likely to be resisted. The challenge going forward is whether energy-related PSEs, PIA and Pakistan Railways, will be immune to the growing public frustration regarding their poor performance.

[16] Although the first quarter is traditionally a period of retirement by firms, we believe banks have realized that PIBs *asset dominate* private sector lending.