1 Overview*

As the economy entered the second half of the current fiscal year, the key challenges to macroeconomic management emanated from the fiscal side and also the external sector. After a surplus during the first half of FY13, the current account position deteriorated to a deficit in Q3-FY13, resulting in 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. Finally, the government had to resort increasingly to borrowing from SBP to finance its fiscal deficit. On a positive note, however, inflation fell significantly in Q3-FY13, and large-scale manufacturing showed some signs of recovery.

Table 1.1: Selected Economic Indicators

		FY11	FY12	FY13
Growth rate (percent)				
Real GDP[1]	Jul-Jun	3.7	4.4	3.6
Agriculture	Jul-Jun	2.0	3.5	3.3
Industry	Jul-Jun	4.7	2.7	3.5
o/w LSM	Jul-Jun	1.7	1.2	2.8
Services	Jul-Jun	3.9	5.3	3.7
Exports (fob-PBS)	Jul-Mar	26.0	-3.6	5.4
Imports (cif-PBS)	Jul-Mar	15.6	14.7	-1.6
Tax revenue (FBR)	Jul-Mar	12.2	25.5	5.0
CPI (period average)	Jul-Mar	14.0	10.8	8.0
Private sector credit	Jul-Mar	7.6	6.4	4.1
Money supply (M2)	Jul-Mar	9.4	8.1	9.0
billion US dollars				
Total liquid reserves[2]	31st Mar	17.6	16.6	12.2
Home remittances	Jul-Mar	8.0	9.7	10.3
Net foreign investment	Jul-Mar	1.3	0.4	0.6
percent of GDP[3]				
Fiscal deficit	Jul-Mar	4.3	4.5[4]	4.6
Trade deficit	Jul-Mar	3.8	5.2	4.7
Current a/c deficit	Jul-Mar	0.0	1.3	0.4

1. As per new base of FY06.
2. With SBP & commercial banks
3. Full-year GDP (at new base) in denominator
4. Fiscal deficit rises to 6.4 percent of GDP in Jul-Mar FY12, after one-off circular debt settlement.

Sources: PBS, SBP, FBR

While the growth in industrial sector increased with the support of broad-based recovery in *large scale manufacturing, construction* and *mining & quarrying,* agriculture growth was adversely affected by heavy rains and localized floods during Kharif season.[1] Services sector also remained subdued due to decline in growth rates of transport, storage and communication

* The analysis in this report is confined to the period July-March FY13.

[1] See **Chapter 2** for further discussion.

(on the back of weakening profits in the telecom and transport), general government services and other private services. Consequently, growth in overall real GDP (at new base of FY06 released recently by Pakistan Bureau of Statistics) declined from 4.4 percent in FY12 to 3.6 percent in FY13 despite recovery in LSM (**Table 1.1**).

Revival in large scale manufacturing was also supported by increase in loan disbursement by banks to the private sector during Jul-Mar FY13 along with a number of other industry-specific factors as discussed in **Chapter 2**. Loans to private businesses have increased from Rs 42.9 billion in Jul-Mar FY12, to Rs 165.1 billion in the same period this year; within this, fixed investment loans to the industrial sector have increased considerably.[2]

A part of this increase is the result of SBP's monetary easing over the last two-and-a-half years. As receding inflationary pressures provided room to cut interest rates, SBP reduced its policy rate to stimulate investment and growth.[3] Encouragingly, inflation has continued its declining trend and registered a 45-month low of 6.6 percent (YoY) in March 2013. However, any deterioration on the external front, or an increase in administered prices to minimize subsidies and arrest the size of the circular debt (as necessary steps for fiscal consolidation), pose the greatest risks to inflation in the medium term. In the absence of these risks, inflation is likely to continue the declining trend in the short-term.

These subsidies, along with rising interest payments on domestic debt, have worsened the fiscal situation. The amount of subsidies paid during the first three quarters of FY13, exceeded the full year target by a distressing 29.4 percent;[4] while debt servicing payments have increased by 23.6 percent during this period, compared with the same period last year. Debt servicing during Jul-Mar FY13 has surpassed development expenditures, whereas, subsidies and debt servicing together constitute around 40 percent of total current expenditures (**Figure 1.1**).

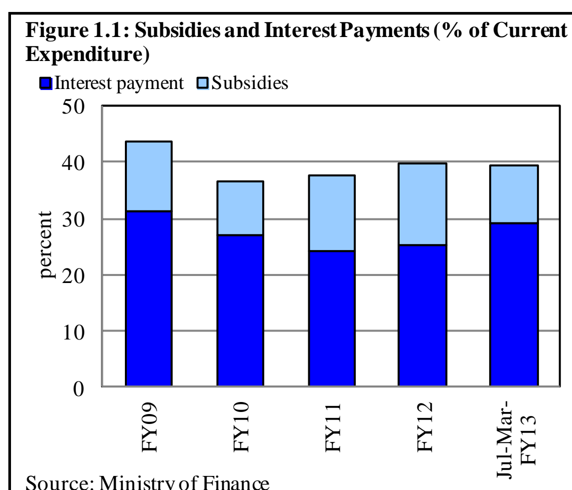
On the revenue side, FBR taxes increased by only 5.0 percent in Jul-Mar FY13 – the lowest increase since FY02. While a part of this sluggishness may be the result of low level of economic activity and anemic investment due to energy

[2] While anecdotal evidence suggests increased demand for private sector credit; supply of loanable funds for private sector also increased during Jul-Mar FY13 with the government shifting its borrowing away from the commercial banks. However, from macroeconomic management point of view, it was not a desirable outcome as the government resorted to SBP borrowing instead of non-bank or external sources of financing.
[3] The policy rate has been lowered by a cumulative 250 basis points since August 2012.
[4] Almost the entire amount of subsidies was disbursed to the power sector during Jul-Mar 2013.

constraints and law and order issues; the lack of tax reforms; a range of tax exemptions; and leakages; remain the major factors behind this slowdown. However, the availability of US$ 1.8 billion of Coalition Support Funds (CSF) helped the government keep its deficit close to the last year's level during Jul-Mar FY13 – i.e., 4.6 percent of GDP, compared with 4.5 percent in same period last year. Moreover, provincial surpluses also supported the overall fiscal position during the first nine months of FY13. However, according to SBP projections, the continuing pressure of subsidies and interest payments, are likely to push the budget deficit to 7 – 7.5 percent of GDP (in FY13), compared to the target of 4.7 percent.

The government continued to rely on the domestic banking system to finance its deficit as external financing dried up completely. More worryingly, domestic borrowing remained skewed towards short-term financing, which raises concerns about the sustainability of Pakistan's public debt.[5,6] During the first nine months of the year, the public debt stock increased by Rs 940.6 billion – which is 44.6 percent higher than the increase in debt over the first nine months of FY12 (after adjusting for the one-off settlement of circular debt last year). More importantly, 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 the increase in the fiscal deficit (and resulting rise in public debt) during the first three quarters of FY13, there is a high likelihood that the government will not be able to achieve this target. In our earlier reports, we have repeatedly highlighted that the rise in the debt stock

Figure 1.1: Subsidies and Interest Payments (% of Current Expenditure)



Source: Ministry of Finance

[5] The short-term borrowing increased the stock of floating debt by Rs 910.3 billion during FY12, resulting in a hefty Rs 294.0 billion addition to debt servicing in Jul-Mar FY13. Similarly, the Rs 633.1 billion increase in floating debt during the first nine months of FY13 is likely to increase interest payments by Rs 179.9 billion during the next fiscal year.

[6] According to in-house estimations, the cumulative 250 bps reduction in the policy rate during H1-FY13, brought down interest payments on the auction of T-Bills by around Rs 21.8 billion for the full year FY13. This understates the savings to the Federal government, as we have limited the impact only to FY13.

accompanied by debt servicing, directly adds to subsequent fiscal deficits – this shows the increased risk of entering a debt-deficit spiral for the country.[7]

This situation underscores the need for initiating fiscal reforms on an urgent basis. Meaningful fiscal consolidation would require retrenchments in spending and efforts to increase tax revenues. We believe a significant reduction in spending can be achieved by rationalizing power tariffs and restructuring loss-making public sector enterprises (PSEs). As a strategy to reduce the domestic debt-servicing burden, the government should move away from bank borrowing, which is short-term and costly. The alternatives include domestic non-bank sources, which usually have a longer maturity, and external borrowing, which is usually cheaper. On the revenues side, the tax net needs to be widened along with removal of tax exemptions, and leakages in the tax collection need to be plugged. Moreover, provincial taxation authorities should be strengthened to mobilize revenues from both agriculture and services – in our view, the provincial governments have very promising sources of revenues in their hands.

In addition to the challenges on the fiscal front, Pakistan's external account also came under pressure after the first half of FY13. A current account surplus of US$ 187 million during H1-FY13, driven primarily by the inflows under the Coalition Support Fund (CSF), strong remittances, and a lower trade deficit; quickly turned in to a deficit of US$ 1.3 billion in Q3-FY13 because of the absence of CSF flows and a 5.1 percent YoY decline in remittances – the latter appears to be a one-off event.

Although the cumulative current account deficit of US$ 1.1 billion for Jul-Mar FY13 was much lower than the same period last year, the external outlook remains challenging, with scheduled repayments to the IMF in the rest of FY13. As shown in **Figure 1.2**, on-going repayments of external debt (mostly to the IMF) 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, which is the lowest level since July 2009.[8] Most of the decline was concentrated in Q3-FY13 (US$1.6 billion) and primarily impacted SBP's FX reserves. However, compared to the extent of pressures on reserves, Pak Rupee remained relatively stable in Q3-FY13.

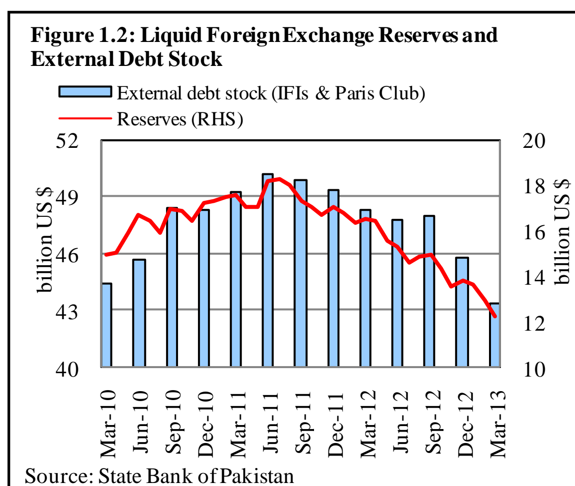
Although the country's reserves are currently above international adequacy benchmarks (e.g., import and short-term debt coverage), they have been

[7] Our assessment is that the primary deficit and Rupee depreciation are two main drivers of the increase in government debt during the past five years (**Box 4.2**).
[8] The external debt owed to multilateral institutions, the IMF and Paris Club, constituted 71.2 percent of Pakistan's stock of total external debt & liabilities as of end-March 2013.

consistently falling since the beginning of FY13.[9] If this trend continues, the challenges in managing the FX market will persist.

These underlying macroeconomic challenges should be addressed through decisive structural reforms, instead of just securing short-term financing.[10] 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 economy has become significant after the introduction of fiscal devolution through the 18th amendment.[11] Particularly, success of *fiscal* reforms will hinge on the performance of the provincial governments, as their share in overall revenues (as well as in expenditures) has increased.[12] Moreover, provinces now have an exclusive role in the development of the social sector (health and education) and in broader economic development.

Figure 1.2: Liquid Foreign Exchange Reserves and External Debt Stock



Source: State Bank of Pakistan

To summarize the immediate risks facing the country, we would list the following: (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

[9] Liquid foreign exchange reserves as of end-March 2013 were equivalent to 4 months of imports – higher than the rule-of-thumb of 3 months of imports. When the previous IMF SBA was signed, Pakistan's liquid FX reserves were US$9.0 billion which were equivalent to 12.2 weeks of imports.

[10] Given Pakistan's past history with multilateral lenders like the IMF (**Table 1.2**), a credible reform agenda is also essential to negotiate with the IFIs.

[11] One way to take provinces on board is to include provincial finance ministers in negotiations with IMF.

[12] During FY12, the first complete year after devolution, total expenditures of provinces were higher than federal expenditure excluding debt servicing and defense expenses.

commercial banks; and (7) immediate steps to increase power generation, which may require fresh liquidity to secure fuel supplies.

To achieve sustainable and equitable economic growth, the government will have to firmly commit to bold economic reforms.

Table 1.2: IMF Programs since 2000 *

IMF Program	Start Date and Changes	Amount (in millions)		Status
		Sanctioned	**Drawn**	
Emergency Natural Disaster Assistance (ENDA)[13] to help the country manage the aftermath of massive floods	September 15, 2010	SDR 296.98 (or US$ 451)	SDR 296.98 (or US$ 451)	Immediate disbursement of full amount.
Stand-by Arrangement (SBA)	November 2008 The program was originally for 23 months (to October 2010). It was extended to end December 2010 after the second review; and further to end-September 2011 to enable Pakistan to complete GST reform, consolidate fiscal policy, and amend the legislative framework for the financial sector.	SDR 7,235.9 (or US$ 11,327) Originally SDR 5,169 million (or US$ 7.6 billion) was approved. It was enhanced to SDR 7,236 million (or US$ 11.3 billion) after the second review in August 2009.	SDR 4,936.0 (or US$ 7,477)	**1st** tranche of US$3.1 billion in December 2008; **2nd** tranche of US$847 million in March 2009; **3rd** tranche of US$1.2 billion in August 2009; **4th** tranche of US$1.2 billion in December 2009; **5th** tranche of US$1.13 billion in May 2010. Remaining amount not released due to non-implementation of agreed measures.
Poverty Reduction and Growth Facility (PRGF)[14]	December 2001 (3 years)	SDR 1,034 (or US$ 1,322)	SDR 861.42 (or US$ 1,186)	**1st** tranche of US$ 109.6 million in December 2001; **2nd** tranche of US$ 107

[13] The ENDA, which provides rapid and flexible financial assistance for countries affected by natural disasters with an urgent balance of payments need, is not linked to any program-based conditionality or review. Pakistan's financing under the ENDA carried the IMF's basic rate of charge, had a three-year and three month grace period, and to be repaid in eight equal installments with a final maturity of 5 years.

[14] The IMF's concessional facility for low-income countries, the Enhanced Structural Adjustment Facility (ESAF), was renamed in November 1999 the Poverty Reduction and Growth Facility. PRGF loans carry an interest rate of 0.5 percent a year, and are repayable over 10 years with a 5½-year grace period on principal payments.

				million in March 2002; **3rd** tranche of US$ 114 million in July 2002; **4th** tranche of US$ 114 million in November 2002; **5th** tranche of US$ 118 million in February 2003; **6th** tranche of US$ 123 million in June 2003; **7th** tranche of US$ 247.54 million in October 2003; **8th** tranche of US$ 252.60 million in June 2004. The final tranche was approved in Dec 2004, but Pakistan did not draw this tranche.
Stand-by Arrangement (SBA)	November 2000 (10 months)	SDR465 (or US$ 596)	SDR465 (or US$ 591)	**1st** tranche of US$ 192 million in November 2000; **2nd** tranche of US$ 133 million in March 2001; **3rd** tranche of US$131 million in July 2001; Last tranche of US$135 million in September 2001. This program was completed successfully.

* See SBP Annual Report, 1999-00, Chapter 8 for IMF programs of 1980s and 1990s.
Source: Various documents available at IMF website.