1 Overview

The analysis in this report is largely restricted to the first half of FY14 (July-December 2013), but will include an Outlook.

By the end of H1-FY14, there was a perceptible improvement in the country's macroeconomic indicators. Inflationary pressures have softened (post November); pressure on FX reserves and the PKR parity has eased in December 2013; LSM is showing improvement, which is supported by an increase in credit to the private sector; and as reported by the Ministry of Finance, the fiscal deficit as a percent of GDP declined in H1-FY14 (**Table 1.1**).

Table 1.1: Selected Economic Indicators during H1

	FY12	FY13	FY14	FY14[T]
Growth rate (percent)				
LSM	1.0	2.3	6.8	4.0
Tax revenue (FBR)	27.1	5.7	16.8	27.2
CPI (period average)	10.9	8.3	8.9	8.0
Private sector credit	6.2	3.1	9.6	NA
Money supply (M2)	5.7	8	6	NA
billion US dollars				
Total liquid reserves [1]	17	13.9	8.3	NA
Home remittances	6.3	7.1	7.8	15.1
Direct investment in Pakistan	0.5	0.6	0.4	NA
Current a/c balance	-2.4	-0.1	-1.6	-2.9
percent of GDP				
Fiscal deficit	2.7	2.7	2.1	6.3

[T] Target
[1] As of 31st December.
Source: State Bank of Pakistan, Ministry of Finance and Pakistan Bureau of Statistics

Improvement in the fiscal *and* external accounts in the second half of FY14 depends on the expected proceeds from the auction of 3G licenses and Coalition Support Fund (CSF) inflows.[1] However, if expected official external inflows (e.g., PTCL privatization proceeds, the OGDCL GDR, a new Euro Bond, and fresh inflows from multilateral creditors) are realized in H2-FY14, SBP's FX reserves are likely to exceed our initial projection for the full year. In a related development, there has been a significant change in sentiments in the FX market in March 2014; the PKR has appreciated significantly and SBP's FX reserves have exceeded in-house projections for Q3-FY14. This comfort on the external side can be traced to an unanticipated US$ 1.5 billion inflow into SBP's reserves, which may have triggered market expectations that Pakistan may receive a facility to defer oil payments in Q4-FY14. Along with

[1] The country expects to receive US$ 702 million CSF inflows during H2-FY14, out of which US$ 352 million have been realized in February 2014.

dampening inflationary expectations for the remaining part of FY14, this has changed the market's interest rate outlook. SBP projects average inflation in FY14 to be in the range of 8.5 to 9.5 percent.

1.1 Economic Review

The prospects of achieving the GDP growth target in FY14 could be undermined by less than expected performance of agriculture. This is due to a YoY decline in cotton production, which is likely to offset the gains in rice, sugarcane and wheat production.[2] On a positive note, LSM continues to post strong growth in H1-FY14, which bodes well for the country's overall economic growth; this is because LSM accounts for 10.2 percent of overall GDP, and has spill-over effects on services, particularly *wholesale and retail trade* and *transport* (**Chapter 2**). The rebound in LSM is supported by investments in alternate energy sources; improved power supply (after the resolution of the circular debt); capacity enhancement (in steel, paper, fertilizer, beverages, and rubber) in past few years; and increased lending to private sector businesses, especially in fixed investment loans.[3]

Lending to private sector businesses witnessed an increase of Rs 271.8 billion in H1-FY14, compared to Rs 146.5 billion in H1-FY13. This increase was channeled into the manufacturing sector (**Chapter 3**). More importantly, 18.9 percent of the entire increase in loans to private businesses, was fixed investment loans.

In addition to an increase in lending to the private sector, government borrowing from commercial banks also increased in Q2-FY14. In the first quarter, in anticipation of a rise in interest rates, commercial banks shied away from investing in long-term government paper. However, this pattern changed with the 50 bps increase in the policy rate announced in September 2013. As a result, the fiscal authority mobilized Rs 188.1 billion from commercial banks during Q2-FY14, against a net retirement of Rs 179.1 billion in the first quarter of the year. However, the government was not able to contain its borrowing from SBP within the limit agreed with the IMF; furthermore, as was the case in the first quarter, the zero quarterly borrowing limit as

[2] According to latest estimates, rice production is likely to be 6.4 million tons during FY14, compared to a target of 6.2 million tons. In contrast, sugarcane production of 63 million tons for FY14, fell short of the production target of 65 million tons.

[3] Fixed investment loans recorded 6.8 percent increase in H1-FY14 compared to 2.8 percent in the same period last year.

prescribed in the SBP Act, was also not met in this quarter.[4] Having said this, with the bilateral inflows in February and March 2014, and other external inflows expected in H2-FY14, these targets should be easier going forward.

Encouragingly, the narrowing fiscal deficit during H1-FY14, reduced the financing requirements of the government.[5] More specifically, the fiscal deficit during H1-FY14, narrowed to 2.1 percent of GDP, compared to 2.7 percent in the same period last year, as reported by the Ministry of Finance. The reduction in the fiscal deficit came from a slowdown in spending and an increase in revenues.[6]

As has happened in the past, the incidence of fiscal austerity fell on development spending both at the federal and the provincial level. This may be attributed to the lack of external funding. In our view, there is a need to rethink this avenue of fiscal consolidation within context of the long-term growth prospects of the economy. However the growth in current spending also fell during H1-FY14, due to lower subsidies in this period (excluding subsidies and interest payment, current expenditures recorded a 15.0 percent YoY increase - see **Chapter 4**). In an attempt to minimize the fiscal burden of the power sector, electricity tariffs for residential consumers were raised in October 2013. While the impact of this measure on collections has yet to materialize, payables of the power sector have once again accumulated in H1-FY14.[7] This raises some questions about sustainability of the improvement witnessed in the fiscal account in H1-FY14.

On the revenue side, FBR tax receipts grew strongly in H1-FY14, but the half-yearly target was missed by Rs 80 billion. This implies that tax collections need to grow by

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[4] The outstanding stock of net budgetary borrowing from the central bank stood at Rs 2,611.1 billion as of end-December 2013, compared to the IMF ceiling of Rs 2,560 billion.
[5] In absolute terms, fiscal deficit stood at Rs 540.1 billion in H1-FY14, compared to Rs 624.7 billion in H1-FY13.
[6] Fiscal spending recorded 6.6 percent YoY increase in H1-FY14, compared to 25.5 percent increase witnessed in the same period last year. Tax revenues posted 15.7 percent YoY increase in H1-FY14, compared to 12.0 percent increase in the same period last year.
[7] In response to a question in the National Assembly on March 7, 2014, the Minister of Water and Power informed the National Assembly that payables of the power sector stood at Rs 246.2 billion as of end-December 2013. A part of this amount may decline going forward, if the government decides to deduct the outstanding payables of the provinces to power sector at source.

36.6 percent in the second half of FY14 to meet the full year target, [8] which appears difficult, given the pattern of tax collection in the past several years and the actual impact of tax reforms undertaken so far. [9] Furthermore, non-tax revenues also witnessed a slowdown, due to lower CSF disbursements in H1-FY14, compared to the same period last year.[10]

The reduction in the budget deficit eased the pace of domestic debt accumulation during Q2-FY14. This, along with the lumpy US$ 1.2 billion repayment to the IMF and favourable exchange rate movement during Q2-FY14, allowed for a marginal decline in the public debt stock during this period.[11]

Notwithstanding this decline in public debt stock, we are concerned about Pakistan's debt profile, as its composition has witnessed a sharp shift towards the shortest tenor (i.e., 3m T-bills). To put things into perspective, on end-December 2013, the share of 3m T-bills rose to 19.5 percent of the domestic debt stock, compared to a mere 1.8 percent on end-June 2013.[12] As highlighted before, this exposes the government to increasing roll-over and interest-rate risks. In fact, the over-reliance on short-term debt has the potential to neutralize the government's fiscal consolidation efforts, if there is an adverse movement in interest rates.[13]

[8] According to SBP's internal estimates, the FBR tax collections stood at 92.8 percent of the half-yearly target in H1-FY14.

[9] During the past five years, on average, FBR revenues recorded 13.4 percent YoY growth in the second half.

[10] CSF inflows stood at Rs 34 billion in H1-FY14, compared to Rs 172 billion in the same period last year. Overall non-tax revenues could experience a one-off boost in H2-FY14, on account of the bilateral inflow in February-March 2014.

[11] Specifically, 6.8 percent depreciation of Japanese Yen against US Dollar during Q2-FY14, resulted in Rs 78.9 billion reduction in the Rupee value of the stock of public external debt in this period. Furthermore, an appreciation in PKR during Q2-FY14 (based on end-period exchange rate) resulted in a further Rs 16.2 billion decline in Rupee value of public external debt stock during this period.

[12] The share of short-term debt in domestic debt rose to 57.4 percent on end-December 2013 from 54.6 percent as of end-Jun 2013.

[13] One of the objectives of the ongoing fiscal consolidation is to put country's public debt on a declining path, to reach a sustainable level. However, the presence of a large share of short-term debt increases the vulnerability of debt stock to adverse movements in interest rate. This may in turn increase the servicing burden of domestic debt, leading to a further expansion of fiscal deficit, causing an increase in debt stock. For details, see IMF Country Report No. 14/1, January 2014.

While SBP retains its view to rebalance Pakistan's domestic debt towards long-term paper, there was an improving trend in Q2-FY14, which has been maintained in Q3. The government mobilized Rs 105.6 billion through PIBs during the quarter, which was the highest amount raised after four quarters. Furthermore, the auction held on 26th February 2014 was even more encouraging: in just one auction, the government raised Rs 240.7 billion of long-term funding. This change in market sentiments can be traced to falling projected inflation, which means that the market does not expect further interest rate hikes. The recent comfort on the external sector adds to this change in sentiments.

Headline inflation reached an average of 8.9 percent in H1-FY14, from 8.3 percent in H1-FY13.[14] The quarterly analysis indicates that the impact of the rise in wheat flour prices, the increase in GST rate and volatility in the prices of perishable food in Q1-FY14, was compounded by a rise in power tariffs during Q2-FY14. The latter is a one-off development, which is needed to resolve the structural problems in the energy sector. As a result, the combined share of inflation contributed by wheat flour, perishable food items, electricity prices and transport, rose to 39.3 percent in the second quarter, compared to 27.2 percent in Q1-FY14. This said, the situation improved in December 2013, with enhanced supply of perishable food items and PKR stability against the US Dollar. As a result, CPI inflation fell to 9.2 percent in December 2013, after entering double digits in November 2013; this downward trend is likely to persist.

On the external front, current account deficit deteriorated to US$ 1.6 billion in H1-FY14, compared to US$ 0.1 billion in H1-FY13. However, the entire increase was witnessed in Q1-FY14, whereas Q2-FY14 witnessed a YoY decline in the deficit. The improvement during Q2-FY14, was led by home remittances and a reduction in the trade deficit during the quarter, compared to the same period last year.[15] Nevertheless, the country's FX reserves remained under pressure till end-November 2013, due to the absence of financial inflows and lumpy repayments to the IMF. In fact by end-November 2013, SBP's liquid reserves reached US$ 3.0 billion, while the PKR posted a 1.5 percent depreciation in the month (**Chapter 5**). However, the situation improved in December 2013, after receipt of the second installment of US$

[14] Headline inflation continued to increase in Q2-FY14, reaching an average of 9.7 percent in the quarter, from 8.1 percent in Q1-FY14.
[15] The current account posted a deficit of US$ 385 million in Q2-FY14, compared to US$ 522 million in the corresponding quarter of FY13.

554 million Extended Fund Facility (EFF) from the IMF, and a current account surplus in this month. In fact, the PKR witnessed a 3.0 percent appreciation during December 2013, after shedding 8.2 percent of its value against US Dollar during Jul-Nov 2013. More importantly, SBP's adjusted Net International Reserves (NIR) target for end-December 2013 agreed with the IMF, was met.

Table 1.2: Projections for Major Economic Indicators

	Annual Target	IMF Forecast	SBP Forecast
Growth rate (percent)			
GDP	4.4	3.1	3.5 – 4.5
CPI inflation	8.0	7.9	8.5 – 9.5
Money supply (M2)	NA	13.8	13.0 – 14.0
billion US dollars			
Home remittances	15.1	14.7	14.5 – 15.5
Exports (fob-BoP)	26.6	26.9	26.0 – 26.5
Imports (fob-BoP)	43.3	43.4	42.0 – 43.0
Current account deficit	2.9	2.3	< 3.5
percent of GDP			
Fiscal deficit	6.3	5.5	6.0 – 7.0

NA: not applicable
Source: SBP, Planning Commission, and the IMF

1.2 Outlook

The outlook of the economy will be influenced by uncertainties in the fiscal account during the second half. On the external front however, the pressure on SBP's reserves has eased significantly in March 2014; not only has Pakistan met lumpy IMF repayments and expects substantial inflows from the IFIs before end-June 2014, the market has responded very positively to the unanticipated inflow of US$ 1.5 billion from a GCC country. Furthermore, the disbursement of CSF is on track; remittances are posting strong growth; and global commodity prices are likely to remain stable. If the government is able to realize the budgeted CSF and 3G inflows, the current account deficit is likely to be less than US$ 3.5 billion for the full year (**Table 1.2**).

As regards the fiscal account, higher development spending and an anticipated increase in the debt servicing will push up overall spending in the second half. Even accounting for the expected CSF and the proceeds from 3G licenses before July 2014,[16] the overall fiscal deficit is likely to remain in the range of 6.0 to 7.0 percent of GDP. The full year fiscal situation will depend on year-end subsidy payments; the possible need to pay off the circular debt in the power sector; the terms of payments for the 3G licenses opted by the cellular companies; and the performance of FBR. If

[16] Even if the 3G license auctions are held on time, the cellular companies have been given the option to spread the payment of 50 percent of the license fee over 5 years, which may impact Pakistan's fiscal account for FY14 (Source: Information Memorandum: The Award of 2100 Mhz, 800 Mhz, and 850 Mhz Spectrum: The Next Generation Mobile Services Award, PTA. http://www.pta.gov.pk/media/im_250214.pdf).

the February-March 2014 inflow is channeled into PSDP, this should ease the financing constraint.

In the real sector, GDP growth is likely to remain in the range of 3.5 to 4.5 percent. The main concern is a weaker than expected performance of agriculture. However, LSM is well positioned to achieve the growth target set in the Annual Plan for FY14, even if value addition by fertilizer and sugar are to subside in the remaining part of FY14. Furthermore, while hard data on services is not available, mixed signals are emerging from the performance of various sub-heads: *wholesale & retail trade* and *telecom* are likely to post an improvement over the previous year, whereas the performance of *finance & insurance* is likely to remain subdued during FY14.

Inflationary pressures have tapered since December 2013; headline CPI growth declined to 7.9 percent in Jan-Feb 2014, compared to 9.2 percent in December 2013. This can be traced to the stability in food inflation, the recent reduction in retail POL prices, and the stability and recent appreciation of the PKR parity. Furthermore, the latest 'SBP-IBA Consumer Confidence and Inflation Expectations Survey' of January 2014, suggests that inflationary expectations are easing. Based on these factors, we project inflation to remain in the range of 8.5 to 9.5 percent, unless the government announces an increase in household gas tariffs, which was due in January 2014.

While the macroeconomic picture is more encouraging, a sustainable improvement still requires deep-seated structural reforms. A tangible reduction in the fiscal deficit is crucial to alleviate financing pressure from the banking system, which is all the more important to support the recent increase in private sector credit off-take; this in turn is an important factor for the current improvement in LSM. More importantly, a sustained improvement in LSM can help achieve the long-run growth objectives of the country in terms of employment generation; economies of scale; technological progress; and spill-over effects to other sectors of the economy.

Having said this, measures to increase tax revenues have been guided by expediency rather than a focus on the structural problems in the fiscal system. There is also a need to ensure that fiscal consolidation has minimal fallout on the prospects for economic growth. In particular, taxation reforms should address the following issues: (i) widening the tax base by eliminating a broad range of tax exemptions; (ii) improvement in FBR's image and clamping down on leakages to minimize tax avoidance and evasion; and (iii) enhancing compliance and strengthening the tax administrative capacity. Similarly, broad based reforms in the energy sector and restructuring of loss-making PSEs, is required to contain the fiscal burden and to create space for undertaking development spending. In our view, the needed revival in public investment is likely to *crowd-in* the private sector by expanding opportunities for it. In addition to all these issues, internal security concerns continue to disrupt domestic economic activities. Without a solution to these challenges, it will be very difficult to revive domestic investment, which is required to put the country on a high growth path.