1 Overview

Pakistan's economy appears to have turned a corner during the third quarter of FY14. After many years of low growth, sentiments about the economy seem to have improved. Manifestations can be seen in the rebound in real GDP growth; the rise in private sector credit; a contained fiscal deficit; the subdued inflation outlook; the sharp increase in FX reserves; and the appreciation and subsequent stability in the exchange rate.

While this change in sentiments can be traced to a one-off bilateral grant, a series of events (both before and after) appears to have consolidated this positive turn. For example, the government's resolve to address the energy shortage; a growing perception of business friendly policies; and external inflows that had been anticipated for many years, have recently been realized. More specifically, auction of 3G/4G licenses; a larger than projected inflow via Eurobonds; program loans from the IFIs; and SBP's efforts to support the FX reserves, have sharply improved the outlook of the country's external sector, and to some extent, its fiscal position.

Table 1.1: Selected Economic Indicators

		FY12	FY13	FY14
Growth rate (percent)				
Real GDP[1]	Jul-Jun	3.8	3.7	4.1
Agriculture	Jul-Jun	3.6	2.9	2.1
Industry	Jul-Jun	2.5	1.4	5.8
o/w LSM	Jul-Jun	1.1	4.1	5.3
Services	Jul-Jun	4.4	4.9	4.3
Exports	Jul-Mar	2.5	0.0	3.0
Imports	Jul-Mar	15.8	-0.6	3.3
Tax revenue (FBR)	Jul-Mar	25.1	4.9	17.9
CPI (period average)	Jul-Mar	10.8	8.0	8.6
Private sector credit	Jul-Mar	6.4	4.1	10.0
Money supply (M2)	Jul-Mar	8.2	9.0	5.9
billion US dollars				
Total liquid reserves	30th April	16.3	11.8	12.2
Home remittances	Jul-Apr	10.9	11.0	12.9
Net foreign investment	Jul-Apr	0.6	1.3	3.0
percent of GDP				
Fiscal deficit	Jul-Mar	4.5	4.7	3.2
Trade deficit	Jul-Apr	5.3	5.0	5.0
Current a/c deficit	Jul-Apr	1.4	0.5	0.9

Sources: Pakistan Bureau of Statistics (PBS), State Bank of Pakistan (SBP), and Federal Board of Revenue (FBR)

It must be said that these signs of improvements should not discount the challenges faced by the economy; and efforts for much needed structural reforms should continue. These positives developments provide a strong platform to move towards sustained economic growth in the medium term.

The revival of economic activity is a key development in FY14, with real GDP growth of 4.1 percent, which is the highest in the past five years. However, this growth was not broad-based, as it was driven primarily by construction and large-scale manufacturing (LSM). Even the LSM growth came largely from two items (sugar and fertilizer), which was realized in H1-FY14, and is not likely to be sustained in the second half.[1] As will be discussed later, this uneven growth can be traced to structural imbalances that need to be addressed.

Nevertheless, the second half of the year witnessed some important events that have improved business confidence:

- The receipt of a US$ 1.5 billion grant from a friendly country (in February and March, 2014), triggered a sharp appreciation of the PKR and changed sentiments in the FX market (see **Chapter 5** for details);[2]
- Against a target of US$ 500 million, the government was able to mobilize US$ 2 billion via the Eurobond issue; [3]
- The long-awaited auction of 3G/4G licenses was finally realized, fetching US$ 1.1 billion;
- The country received US$ 355 million in February 2014 and US$ 370 million in May 2014 under CSF; and
- By staying on track with the EFF, Pakistan witnessed the resumption of program loans from the Asian Development Bank and World Bank after many years. These loans should help push reforms in the power sector, education, social services and overall economic development.

As shown in **Figure 1.1**, these inflows have not only stabilized the exchange rate, but have sharply increased SBP's FX reserves. As of 30th May 2014, SBP's reserves were US$ 8.7 billion, compared to only US$ 3.5 billion as of end-December 2013. While the PKR's appreciation improved business sentiments and its subsequent stability has eased inflationary expectation, the sharp increase in the country's FX reserves provides some comfort for domestic and foreign investment. As will be discussed later, the sequence of events has also changed the market's interest rate outlook.

[1] As productions of sugar and fertilizer were concentrated in the first half of the year due to their seasonal nature; their impact on LSM growth dissipated in H2-FY14. Other factors affecting LSM growth during the second half included: increase in power tariffs, imposition of Gas Infrastructure Development Cess, and a sharp fluctuation of PKR.

[2] This grant was recorded in Capital Account of the Balance of Payments, and its rupee counterpart (Rs 157 billion) was placed in a special account of the government with SBP, under the name Pakistan Development Fund.

[3] Eurobonds were heavily oversubscribed with total bids amounting to US$ 7 billion (See MoF Press Release, PR No. 620, May 03, 2014).

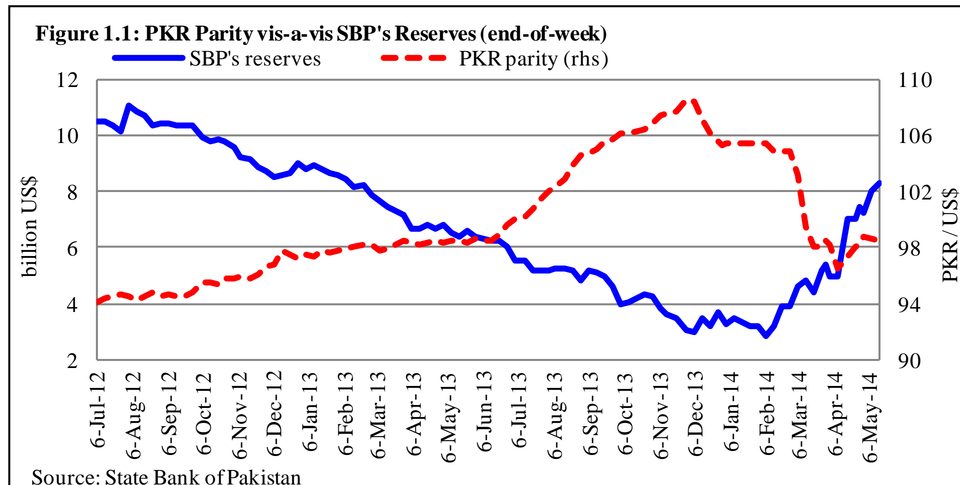


Figure 1.1: PKR Parity vis-a-vis SBP's Reserves (end-of-week)

Source: State Bank of Pakistan

The changed realities, regarding the availability of external resources with the government, have made the commercial banks to refocus on the private sector to deploy their funds. While this change may appear difficult from their perspective, one must realize that it would force them to focus on their core responsibility – financial intermediation to the private sector.

Real economic growth

After five years of sluggish economic activity, the economy has posted real GDP growth of 4.1 percent in FY14.[4] The momentum came from the industrial sector, which grew by 5.8 percent in FY14, compared with an average growth of only 1.3 percent since FY08. This industrial growth was also higher than the 4.8 percent target set in the Annual Plan for FY14. However, services and agriculture, which grew by 4.3 percent and 2.1 percent, respectively, could not achieve their target growth.

Agriculture was adversely impacted by the poor performance of minor crops (including fodder) and livestock. However, the five major crops (rice, cotton, sugarcane, wheat, and maize) together, posted growth of 3.7 percent, which was significantly higher than the 1.2 percent growth shown last year. Bumper crops of

[4] Average real GDP growth during the last five years was 2.8 percent, which was the lowest 5-year average in the past 60 years.

rice, sugarcane and wheat, more than compensated for the decline in cotton production.[5]

The services sector, which largely depends on the performance of commodity producing sectors, could not gain momentum in FY14. Although *wholesale & retail trade* and *transport, storage & communication* supported growth in services, the drag from *finance & insurance* and *general government services* kept this sector's performance weak. The lower growth in value addition by finance & insurance may be linked with slower growth in M2 than previously anticipated, while the slowdown in general government services corresponds to the fiscal austerity observed by the government.

Looking at the National Income Accounts for FY14[6], private consumption, which increased by 5.9 percent, was the driving force behind economic growth in FY14 – this was more than double what was realized in FY13. Nevertheless, real investment only grew by 1 percent during the year, with the result that the investment-to-GDP ratio continues to decline (it is 12.4 percent in FY14, compared with 13.0 percent last year). In our view, Pakistan's investment rate will only increase by addressing the law and order situation in the country; eliminating the energy shortage; and improving business sentiments. Other than sentiments, the government has partially tackled the circular debt issue in the initial phase of its tenure, and has announced ambitious plans to set up new power generation plants. However, we believe more is required to reduce losses due to theft and non-payments of bills, and to restructure Gencos and Discos.

Inflation and monetary policy

Average inflation during Jul-Mar FY14 was 8.6 percent, which was higher than the 8.0 percent realized during the same period last year. Encouragingly, YoY inflation started to decline after November (when it peaked at 10.9 percent), and is likely to end the fiscal year in the range of 8.0 to 9.0 percent. This may appear high, but one must realize that the impetus for rising prices can be linked to the reduction of subsidies in the early part of FY14, when administered prices were increased. Ignoring the seasonal and supply-driven volatility of food prices, the stability of PKR, stable international oil prices, and softer global commodity prices should contain inflationary expectations for the year ahead.

[5] This outcome of value addition by major crops was contrary to our earlier assessment, given in Second Quarterly Report FY14, which was based on partial information available at that time.
[6] One must realize that the annual data recently released by the National Income Accounts Committee, is based on 9-month data. The real sector data for FY14 will be revised in the latter part of FY15.

Monetary policy has been tight since September 2013 (there were two consecutive 50 bps increases in the policy rate in September and November), which has also helped cap inflation. SBP's policy rate has been kept unchanged since then, keeping in mind the stability of key macroeconomic variables, in particular the sustainability of recent improvements in the external sector.

Overall monetary expansion was only 5.9 percent during Jul-Mar, FY14, compared with 9.0 percent during the same period last year. It is encouraging to note that this slowdown came primarily from a decline in government borrowing, while private sector credit recorded a healthy growth of 10 percent during the period. This increase in credit was broad-based in the sense that it financed external trade activities; working capital; fixed investment and consumer financing.

Government borrowing from the banking system (cash basis) declined significantly to Rs 436.9 billion during Jul-Mar FY14, compared with Rs 856.7 billion during the same period last year. This decline was facilitated by the grant from a friendly country, which allowed the government to keep its borrowing from SBP within IMF limits.[7]

Table 1.2: Government Borrowing through Auctions viz-a-viz Retirement to SBP (FY14)

billion Rupees

	T-bill Auction	PIB auctions	Retirement to SBP (-)
19-Sep	305.7		-309.6
28-Nov	395		-403.3
23-Jan	146.9		-146.9
30-Jan		199.2	-195.5
27-Feb		245.0	-248.8
27-Mar		533.3	-540.2
24-Apr		429.1	-427.6
2-May	299.5		-267.1
22-May		248.2	
23-May			-287.6

Source: State Bank of Pakistan

During the first quarter of the year, the government relied heavily on SBP borrowing, as commercial banks were not interested in buying government securities as they anticipated an increase in interest rates. After the November 2013 increase in policy rate, the government was able to borrow much more from commercial banks. In fact, during the third quarter of FY14, the government borrowed more than its pre-announced targets for PIBs, and utilized the funds to immediately retire SBP borrowing (**Table 1.2**).

This change in commercial banks behavior in terms of their bid patterns, can be traced to the December YoY inflation number, which was made public in early January 2014. At 9.2 percent (against 10.9 percent YoY inflation in November), the market sensed that further monetary tightening was not on the cards. With

[7] While the government successfully met its end-March 2014 target, SBP' NDA target was missed with a small margin.

January's YoY inflation at 7.9 percent, this view became dominant, and by early February, banks started investing not just in longer term T-bills, but also participated enthusiastically in subsequent PIB auctions. Against a Q3 PIB target of Rs 180 billion, commercial banks offered Rs 1,030 billion during the quarter. This indicates that banks expected SBP to keep interest rates low for the short to medium term.

This aggressive bidding behavior, created a need for liquidity in the money market. Commercial banks that were earlier placing funds with SBP (before the November 2013 policy decision) were either dependent on OMOs for liquidity, or resorted to SBP's discount window. The overnight money market rate actually exceeded the policy rate on various occasions, as SBP tried to limit the liquidity it injected through OMOs. Interestingly, on many occasions, the OMO cut-off rate was also higher than the policy rate.

Despite market expectations of an interest rate cut, the central bank kept its policy rate unchanged during H2-FY14, as sudden external sector developments needed close monitoring; furthermore, the high inflation number for April required careful management.

Fiscal operations

In addition to the implications for the monetary sector, the grant from a friendly country also had a beneficial impact on the government's fiscal position. Its rupee counterpart reduced the government borrowing for budgetary support and hence lowered the fiscal deficit during Jul-Mar, FY14.[8] According to data released by the Ministry of Finance, the fiscal deficit during the first nine months of FY14 was only 3.2 percent of GDP, which is significantly lower than the average gap of 4.6 percent posted in the last five years. Even if we exclude the grant, the budget deficit is still only 3.8 percent of GDP, which is lower than the past trend.[9] Having said this, a positive outcome for the full year will be contingent on whether the government pays off the circular debt, as it has for the past three consecutive years.

[8] The grant amounting to Rs 157 billion has been kept separately in an account Pakistan Development Fund; and was shown as statistical discrepancy in fiscal data for Jul-Mar FY14. Excluding this, the statistical discrepancy would have been Rs 14 billion, which would imply a deficit of Rs 969 billion, i.e. approximately 3.8 percent of GDP, which is lower than the last year's deficit of 4.6 percent of GDP.

[9] Budget deficit during Jul-Mar FY14 was Rs 811.7 billion, compared with Rs 1,046.2 billion during the same period last year.

Although efforts towards fiscal consolidation can be seen on the expenditure side (e.g., interest payments, defence spending, pensions, etc., have all shown lower growth during Jul-Mar FY14, compared with the same period last year), tax mobilization still remains lackluster. FBR collected Rs 1,575 billion during this period, against a revised target of Rs 2,275 billion for the full year.[10]

FBR is still operating on a narrow tax base. To meet its target, FBR has mainly relied on raising tax rates (sales and income tax rates) rather than increasing the tax base. Beyond broadening the tax base, steps to plug leakages in collection and push towards the documentation of all financial transactions, are still to be taken. The government has, however, committed to reduce tax exemptions worth Rs 500 billion over the next three years. Although the government has contained expenditures growth (through lower subsidies and PSDP spending) and seems committed to austerity, meaningful fiscal consolidation cannot be achieved without increasing the tax-to-GDP ratio, which remains abysmally low (currently the ratio of overall federal and provincial taxes to GDP is less than 10 percent). [11]

In this regard, provincial governments have much potential in terms of resource mobilization, as they have the constitutional right to tax services and agricultural income. Although provinces have already imposed a GST on services, they need to increase efforts for the collection of agriculture income tax. Effective implementation of this tax will disallow the widespread tax leakage that currently takes place at the national level.

On the financing side, reduced government borrowing from the banking system has already been mentioned. Supporting this trend, is the fact that resource mobilization from non-bank sources increased sharply from Rs 193.7 billion in Jul-Mar FY13 to Rs 424.8 billion in the same period this year. This increase can be traced to rise in PIB holdings by non-banks, and the increase in NSS rates in October 2013 and January 2014.

Although external financing of the budget deficit during the period Jul-Mar FY14 was negative, this increased significantly in Q4-FY14 because of the issuance of Eurobonds, fresh loans from IFIs, and bilateral assistance. The resumption of external inflows is important for a resource constrained economy, but this will add

[10] FBR has revised downward its tax collection target twice from original target of Rs 2,475 billion to Rs 2,345 billion, and more recently to Rs 2,275 billion.
[11] Some measures have been proposed to control expenditures that include: reducing power sector subsidies by increasing electricity tariff; the National Power Policy will address line-losses, increase power generation, and restructure Gencos and Discos; the divesture of public sector entities (e.g., UBL, PPL and OGDCL); and restructuring PIA, Pakistan Steel, and Pakistan Railways.

to Pakistan's external indebtedness. It is important to highlight here that total public debt (external plus domestic) has already crossed the limit of 60 percent of GDP, as set by the Fiscal Responsibility and Debt Limitation Act (2005) for FY13 onward. Hence, any addition to the external debt should at least be matched with an equivalent reduction in the domestic debt outstanding.

Balance of payments

Before external funding started flowing in, Pakistan's external account was stressed by heavy repayments to the IMF, and oil payments. The country's FX reserves declined by US$ 2.8 billion during Jul-Nov 2013, and the PKR depreciated by 8.2 percent. However, pressures started to ease in December 2013 as bulky payments to the IMF subsided, and Pakistan received the second tranche of US$ 544 million as part of the EFF. This recovery gained momentum in Q3-FY14: the current account deficit declined with the strong growth in remittances and receipt of CSF money; the country received a US$ 1.5 billion grant from a friendly country; and fresh disbursements from the IMF more than offset SBA repayments. As a result, the country's FX reserves increased by US$ 1.8 billion during the quarter, and the PKR appreciated by 6.9 percent against the US Dollar.

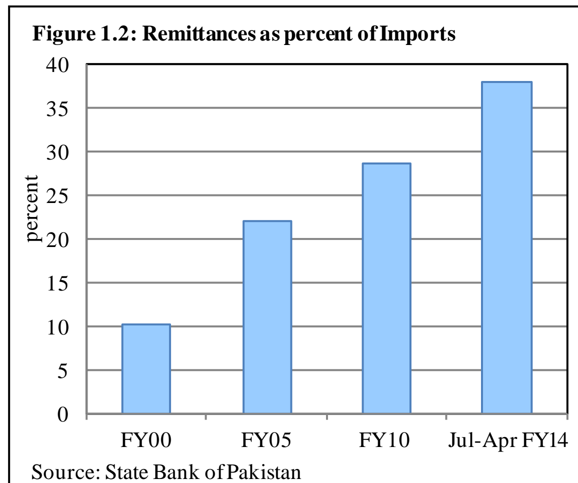
The performance of the external sector improved further after March 2014, when Pakistan re-entered the global capital market after 7 years, and comfortably mobilized US$ 2.0 billion via the Eurobond issue.[12] Furthermore, the ADB disbursed US$ 400 million in April, and IDA provided two single-tranche loans worth US$ 1 billion in May 2014. Pakistan also signed a Country Partnership Strategy (CPS) with the World Bank Group in May 2014, for US$ 11 billion to be disbursed over a period of 5 years (FY15-19). Furthermore, the auction of 3G/4G licenses in April 2014 (for US$ 1.1 billion, but with a portion in PKR) also improved the country's balance of payment outlook.

There are concerns about future repayments on recent external inflows, as the ratio of external debt servicing to FX earnings (exports and remittances) has been rising consistently since 9/11 (see **Chapter 4**). This makes it all the more important for Pakistan to reduce its current account deficit to ensure that future debt servicing does not drawdown the country's FX reserves. Support may come from home remittances.

[12] There are concerns that the government is paying too much for this money, but with Pakistan's sub-investment grade credit rating and its poor international image, the higher price of borrowing was expected. In fact, given the circumstances, the government's effort to raise higher external financing from the international market was significant.

Home remittances have been growing remarkably since 9/11. As a country with surplus labor, one should view manpower as a key export of Pakistan. Since a country's external sector sustainability is based on whether its exports can finance its imports, remittances should be added onto existing export revenues to gauge FX earnings. **Figure 1.2** shows that even with the country's rising import bill, remittances are financing a *growing share* of total imports. This critical source of comfort for the external sector cannot be under-stated: while remittances only financed 10 percent of total imports in FY00, it is currently financing almost 38 percent. Given that informal avenues to send remittances still exist, we expect the share of remittances (to total imports) to grow as the global financial infrastructure closely scrutinizes informal networks of fund transfers across countries.

Figure 1.2: Remittances as percent of Imports



Source: State Bank of Pakistan

Outlook

While we acknowledge the perceptible improvement in business sentiments, there is a need to be mindful of the structural problems that continue to plague Pakistan's economy. In this regard, some positive steps have been taken in the power sector, and we hope this momentum carries forward into the fiscal arena – especially in terms of mobilizing tax revenues.

Beyond the need to stop the hemorrhaging in the power sector, and forcing economically active (vibrant) sectors to pay their share of federal and provincial taxes, the government must focus on *inclusive* growth, which is more likely to make it sustainable. In our view, policymakers need to formulate an Industrial Policy that prioritizes production efficiency and job creation. Such an initiative should focus on: efforts to promote competitiveness, instead of a culture that creates and rewards inefficiencies; restructure loss-making PSEs (especially in the power and transportation sectors) to make them more dynamic and profitable; and create a skilled labor force that meets the current (and potential) needs of the manufacturing sector.

While the government has listed a number of public sector entities (including PIA and Pakistan Steel) for strategic private sector participation, it should be fast-tracked to avoid a further fiscal drain from these loss making enterprises. Similarly, the plan to restructure Pakistan Railways, Gencos and Discos, needs to be firmed up so that these institutions can play a more positive role in the Pakistan economy.

Furthermore, there is no getting away from the fact that Pakistan has no choice but to increase its tax-to-GDP ratio. However difficult, there is an urgent need to eliminate tax exemptions; clampdown on corruption and leakages in the tax collection machinery; expand the tax base to include all productive sectors of the economy; and enhance the independence and professional capacity of provincial tax authorities.

So far it seems that the task of keeping a stressed economy moving forward, has dominated policy thinking and formulation. The recent positive developments and improvement in sentiments provide a strong base for future growth. Policymakers should, therefore, stay the course towards inclusive growth while taking the harder steps to create a larger and more equitable tax base; to fix the energy sector; to create an environment that will absorb the growing number of job-seekers; and to project Pakistan more competitively in the international markets.