1 Overview

The analysis in this report is confined to the end of the first quarter, and mainly covers the period July-September 2013 and the outlook.

1.1 Economic Review

FY13 ended on a positive note for Pakistan's economy: political transition remained smooth in June 2013, and the new government spelled out its policy focus on energy issues, which had suppressed growth in the previous few years.[1] In addition, several other factors had positioned the economy to post a recovery in Q1-FY14, including: adoption of alternate fuel sources by industrial sector in past few years; initiation of talks for the new IMF program; single-digit headline inflation throughout FY13; and a 300 bps reduction in discount rate during FY13, which triggered some pick-up in manufacturing loans – in addition to reducing the government's debt servicing burden.[2,3] However, as FY14 proceeded, structural weaknesses in the economy started taking a toll, and concerns started to emerge about the sustainability of economic recovery.

Since macroeconomic indicators were favorable at the start of the year, the increase in real GDP growth in FY14 was discernible. Estimates for first quarter growth exceeded expectations: GDP grew by 5.0 percent during Q1-FY14, compared to only 2.9 percent in Q1-FY13, and a target of 4.4 percent for the full year (**Table 1.1**). As anticipated, industry and services were the major drivers of growth, as agriculture performed below-target.[4]

Agriculture under-performed due to water shortages at sowing time, and soft agri prices globally (mainly cotton), which reduced the area under cultivation. In addition, pest attacks and heavy rains before the harvest season, also damaged the standing crops (**Chapter 2**). While nothing significant can be inferred about

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[1] This focus was manifested in a partial settlement of circular debt during June 2013, along with a commitment of full settlement within 60 days.
[2] Interest payments during Q4-FY13 were reduced to Rs 218.8 billion, compared to Rs 264.5 billion in Q4-FY12. The decline in interest rates was expected to mitigate some pressure on interest payments during FY14 arising from the sharp increase in public debt stock.
[3] Loans to manufacturing sector were increased by Rs 58.9 billion in FY13, compared to only Rs 4.5 billion in the preceding year.
[4] Pakistan Bureau of Statistics has released only the growth numbers of quarterly GDP so far, and the volumes of nominal and real GDP are not yet released.

the services, till the detailed information is available, improved energy supplies and higher capacity utilization were mainly responsible for a broad-based improvement in the industrial sector. The rebound in the fertilizer sector, which alone contributed 35 percent of LSM growth in Q1-FY14, can be traced to better gas availability; in the case of steel, higher capacities and alternate fuel arrangements weighed in (**Chapter 2**). Furthermore, lower palm oil prices in the international market helped the domestic edible oil sector.

Table 1.1: Selected Economic Indicators

	Q1-FY13[E]	FY14[T]	Q1-FY14[E]
Growth rate (percent)			
Real GDP	2.9	4.4	5.0
LSM	0.5	4.0	6.3
CPI (period average)[1]	9.1	8.0	8.1
Private sector credit	-2.5	NA	-0.5
Money supply (M2)	0.7	NA	0.2
billion US dollars			
Tax revenue (FBR)	411.0	2,475.0	481.0[3]
Total liquid reserves	14.9	NA	9.8
Worker remittances	3.6	15.1	3.9
Direct investment in Pakistan	0.1	2.1	0.2
Current account balance	0.4	-2.9	-1.2
percent of GDP[2]			
Fiscal balance	-1.2	-6.3	-1.1

[E] Estimate; [T] Targets set by the government in the Annual Plan for 2013-14;
[1] YoY growth in the average of CPI index for the quarter;
[2] Based on the full-year GDP estimates stated in the Annual Plan for 2013-14; NA: not applicable;
[3] This is the revised number, reported in the FBR's Quarterly Review for Jul-Sep 2013. The Ministry of Finance has reported provisional number (Rs 468.5 billion) for FBR tax collection, in its fiscal operations data for the period.
Source: State Bank of Pakistan, Federal Board of Revenue and Pakistan Bureau of Statistics

As the industrial sector revived, import pressures reappeared, especially for capital goods and raw materials. The import of petroleum, machinery, and metal, was particularly strong, which increased the trade deficit by US$ 0.6 billion during Q1-FY14 over Q1-FY13. Additional stress on the current account came from delayed inflows of coalition support fund (CSF) in Q1-FY14; in Q1-FY13, payments under CSF had turned a current account deficit into a surplus.[5] As a result, the current account posted a deficit of US$ 1.2 billion in Q1-FY14, against a surplus of US$ 0.4 billion in Q1-FY13. Putting this in perspective, this deficit used up to 10.9 percent of the country's liquid FX reserves, available at the start of the quarter (**Table 1.2**). Although worker remittances posted an impressive 9.1 percent growth, this was not enough to cover the FX gap in other heads (**Chapter 5**).

Financial flows did not help either. Repayments on external debt continued to exceed fresh disbursements; and foreign investments still remain shy. This caused a strain on the country's FX reserves, which posted a decline of US$ 1.2 billion during the quarter. Meanwhile, the government was already in negotiations with

[5] Current account had posted a surplus of US$ 0.4 billion in Q1-FY13, however, excluding coalition support fund, this account turned into a deficit of US$ 0.7 billion.

the IMF for an extended fund facility (EFF), which had become necessary in the face of lumpy IMF-SBA repayments; and almost non-existent FDI. As a prior action for this program, SBP purchased US$ 125 million from the interbank market during July and August 2013, to shore up its reserves. SBP's net international reserves (NIR) were US$ -3.2 billion at the end of the quarter, which was lower than the adjusted target of US$ -2.9 billion agreed with the IMF.[6,7]

Table 1.2: External Payments as % of Liquid FX Reserves*

percent

	Q1-FY12	Q1-FY13	Q1-FY14
Trade balance	-22.8	-23.7	-38.5
Current account balance	-7.3	2.9	-10.9
IMF debt servicing	0.6	3.1	7.9
Total external debt servicing	4.7	7.3	16.3

*calculated as imbalances during the quarter, as percent of total liquid FX reserves of the country at the start of the quarter.

Source: State Bank of Pakistan

The PKR depreciated by 6.0 percent against the US Dollar during Q1-FY14, compared to only 0.3 percent in the first quarter of the previous year. In addition to a larger external deficit and SBP's FX purchases from the interbank market, pressures on PKR also came from adverse market sentiments. More specifically, when the IMF released the detailed *letter of intent* in September 2013, the market focused on future FX purchases by SBP to meet subsequent NIR targets. This even caused the interbank rate to touch a record-high of 110.5 on 26th September 2013, before closing at 105.35 on the same day (**Chapter 5**). This unprecedented movement in a single day was triggered by the settlement of a large oil payment, which caused some misperception in the FX market. When this settlement was made later in the day, the interbank market returned to normal. The fact that the interbank rate settled so quickly, reflects how adverse market sentiments can trigger exaggerated movements in the PKR.

This level of PKR depreciation was partially responsible for the increase in inflationary pressures in the country (**Chapter 3**). More specifically, weaker Rupee not only triggered inflation expectations, but also pushed up prices of imported items like petroleum products. The impact on headline inflation was

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[6] The IMF defines net international reserves (stock) of the (SBP) as the US Dollar value of the difference between usable gross international reserve assets and reserve-related liabilities, evaluated at the program exchange rates.

[7] Two factors explain this deviation in end-September 2013. First, the target was based on optimistic balance of payment projections; and second, the target and adjustor were derived using a definition that was inconsistent with reserve accounting practices. In Q1-FY14, the overall external balance was a deficit of US$ 1.2 billion against a deficit of US$ 0.2 billion projected by the IMF. In the first review of the EFF program in December 2013, the IMF significantly revised its balance of payment projections for the second and third quarters of FY14; rationalized the NIR target for end-December 2013; and rectified the definition of NIR and it adjustor.

exacerbated by liberal export of onions; lower wheat stocks;[8] and the collusive behavior of traders and distributors, which pushed food inflation into double-digits (**Chapter 3**).[9] Headline CPI inflation increased to 8.1 percent in Q1-FY14, compared to only 5.6 percent in the preceding quarter.[10] Under these circumstances, if nominal interest rates were left unchanged, it would have undermined SBP's efforts to rein in the second-round effect of food inflation and curb inflation expectations. The revision in monetary policy was also required to counter market sentiments following the volatile PKR.

Therefore, SBP increased its policy rate by 50 bps to 9.5 percent in the monetary policy decision announced in September 2013 (**Chapter 3**). This policy tightening was required despite the fact that monetary growth was already subdued; the growth in broad money supply (M2) during Q1-FY14 was only 0.2 percent, compared to 0.7 percent in the corresponding quarter last year.[11] This trend can primarily be traced to a rise in the external deficit, which reduced the NFA of the banking system by 64.4 percent during the period.[12]

NDA, on the other hand, posted an increase of 2.3 percent during the quarter, mainly on the back of high budgetary borrowing from the banking system, and lower net retirement of private sector credit. The latter is partially explained by the re-emergence of circular debt in the energy sector from August 2013 onwards, which increased borrowings by petroleum refineries and IPPs. This, coupled with higher credit demand from fast moving consumer goods (FMCGs) and the textile sector, offset most of the seasonal retirement. A positive development was the higher credit off-take for fixed investment purposes; energy, food, cement and paper industries borrowed long-term loans from banks to finance capital expenditures. As far as budgetary borrowing from the banking system is concerned, this was higher than the previous year due to a decline in financing

[8] For instance, wheat stocks available with Punjab Food Department were only 491.5 thousand MT at end April 2013, compared to 3500 thousand MT available with the authority at end April 2012.
[9] Prices of fresh vegetables remained particularly strong in Q1-FY14. For instance, onions prices posted an inflation of 50.7 percent YoY in Q1-FY14. Its price increased from Rs 31.2 per kg on average in Q1-FY13, to Rs 47.0 per kg in Q1-FY14. Similarly, price of tomatoes increased from an average of Rs 46.0 per kg in Q1-FY13, to Rs 83.0 per kg in Q1-FY14. Potato was also expensive this year, as its price increased from an average of Rs 29.1 per kg in Q1-FY13, to Rs 32.8 per kg in Q1-FY14.
[10] After increasing to 10.9 percent in November 2013, CPI inflation tapered to 9.2 percent and 7.9 percent in December 2013 and January 2014, respectively.
[11] Since SBP monetary policy is forward looking, the decisions on interest rates are not based on the previous data, but on the forecast of key macroeconomic variables.
[12] In absolute terms, the NFA of the banking system declined by Rs 173.2 billion in Q1-FY14, compared to an increase of Rs 11.8 billion in Q1-FY13.

from domestic non-bank (especially NSS) and external sources – the size of the fiscal deficit during the quarter was fairly modest compared to the same period last year (**Figure 1.1**).

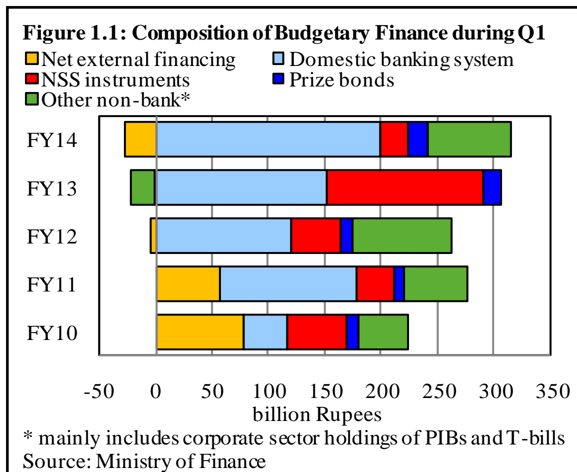


Figure 1.1: Composition of Budgetary Finance during Q1

* mainly includes corporate sector holdings of PIBs and T-bills
Source: Ministry of Finance

Within the banking system, government borrowing from the central bank was more pronounced, as commercial banks did not participate actively in T-bill auctions held during the quarter. This apparent disinterest was actually the outcome of prevailing uncertainty ahead of the new IMF program, regarding the future course of interest rates. 6-month and 12-month T-bills were perceived to be unattractive instruments, because expectations of a rise in interest rates (as part of the IMF program) were strong.[13,14] Therefore, banks offered much less in these auctions compared to the target volumes, and on-going maturities (**Chapter 3**). In effect, the roll-over risk and interest rate risk facing the government, which we have highlighted in our previous reports, were partially realized during the quarter. As banks were not willing to reinvest their maturing T-bills, the government had to rely on central bank financing through most of the quarter.

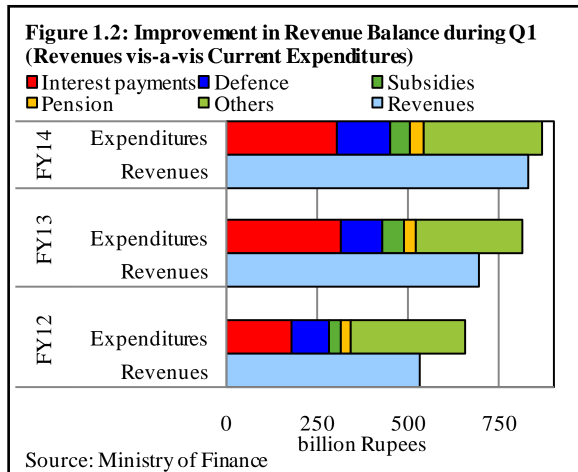
As a result, the government could not meet the limit of zero quarterly borrowing from SBP, though its borrowings were well below the limit agreed with the IMF.[15] However, as discussed later, this reliance on central bank fell after the increase in interest rates in mid-September 2013.

The fiscal deficit fell to 1.1 percent of GDP in Q1-FY14, from 1.2 percent in the corresponding quarter last year.[16] This improvement occurred on both the revenue and expenditure sides. Tax revenues grew by an impressive 19.0 percent YoY in

[13] In the auction held on 5th September, not a single bid was offered for 6-m and 12-m T-bills.
[14] Interbank market was anticipating an increase in interest rates also because of prevailing inflation expectations.
[15] The *stock* of budgetary borrowings from SBP at end-September 2013 was Rs 2,521 billion, against the ceiling of Rs 2,690 billion.
[16] In absolute terms, fiscal deficit posted a marginal increase from Rs 283.8 billion in Q1-FY13, to Rs 286.9 billion in Q1-FY14.

Q1-FY14, compared to only 10.3 percent in corresponding quarter last year. Non-tax revenues also posted healthy growth of 21.5 percent over the first quarter of the previous year, despite the absence of CSF inflows. On the expenditure side, interest expenses posted a *reduction* of 3.7 percent YoY, which was the single-most stressful item in the previous year. In overall terms, the primary balance posted a surplus of 0.1 percent of GDP, whereas the revenue deficit was brought down by 0.4 percentage points (**Figure 1.2**).

Figure 1.2: Improvement in Revenue Balance during Q1 (Revenues vis-a-vis Current Expenditures)



Source: Ministry of Finance

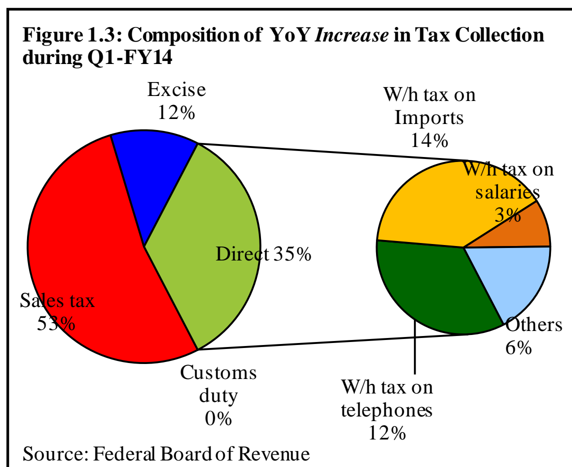
This improvement in the fiscal accounts primarily represents revenue measures announced in the 2013-14 Annual Budget (**Chapter 4**). In addition to these measures, the government has formulated a medium-term strategy for implementing fiscal reforms in the economy, ranging from improving tax administration, to privatizing loss-making PSEs. However, the policy mix which delivered the better fiscal outcome in Q1-FY14, may not be sustainable in the medium-to-long term; tougher decisions on energy prices and institutional reforms are yet to be taken, and legal complications related to higher prices, add to the challenges facing the government (e.g., the partial reversal of the August 2013 increase in power tariffs, and suspension of gas infrastructure development cess in July 2013 till December 2014).[17]

On the revenue side, it was the increase in tax rates and *not* the base, which is responsible for higher collections during the quarter. Specifically, more than half of the increase in tax revenues came from sales tax collection, which followed the 1 percentage point increase in the standard GST rate stated in the Annual Budget 2013-14 (**Figure 1.3**). The improvement in direct tax collection, can also be traced to higher withholding tax rates. For instance, the increase in collections from mobile phone subscribers, which contributed 34.0 percent to the *increase* in direct tax collections, came from a 5 percentage point rise in the withholding tax

[17] The cess was later revived in January 2014.

rates during the quarter.[18] Similarly, the contribution of tariff rationalization to the increase in withholding tax on imports, was fairly significant.[19] Furthermore, a rise in tax collection from salaries and corporate dividends *also* came from rate increases, and a revision in salary slabs (for details on revenue measures, see **Box 4.1**).[20]

Figure 1.3: Composition of YoY *Increase* in Tax Collection during Q1-FY14



Source: Federal Board of Revenue

A similar trend was also visible in non-tax revenues; the gas development surcharge increased from only Rs 3.9 billion in Q1-FY13, to Rs 20.8 billion in Q1-FY14 due to a rise in the surcharge rate. However, the swing factor in non-tax collections was the mobilization of certain one-off revenues, which turned the YoY decline in these collections into an increase (**Table 1.3**). These one-off revenues included the dividend/mark-up received while settling the circular debt; and a transfer of Rs 67.6 billion in Universal Service Fund (USF) and Research & Development Fund

Table 1.3: Impact of One-off Non-tax Revenues during Q1

billion Rupees

	FY13	FY14
I. Development surcharge on gas	3.9	20.8
II. Other collections from energy sector	31.2	29.9
III. SBP profit	50.0	80.0
IV. Interest and dividends	16.0	60.6
of which: circular debt related (a)	0.0	56.7
V. Defence	107.3	1.9
VI. Universal service fund (b)	0.0	67.6
VII. Others	32.4	31.8
Total non-tax revenues (I to VII)	**240.8**	**292.7**
of which: **one-off revenues** (a + b)	**0.0**	**124.3**
Non-tax revenues excluding one-offs	**240.8**	**168.4**

Source: Ministry of Finance

[18] Withholding tax rates on mobile phone subscribers both prepaid and postpaid have been increased from 10 percent to 15 percent in the 2013-14 Annual Budget.

[19] For details, please see FBR Quarterly Review for Jul-Sep 2013-14.

[20] The government relies heavily on withholding tax because these are easily collected at source. However, since withholding taxes must be refunded if the amount deducted is above the total tax liability of the individual and businesses, this is only possible if the tax payer files his/her income tax form. Since many tax payers in Pakistan do not file their income tax returns, this reduces the volume of withholding taxes that the government must refund.

(RDF), from the Ministry of Information Technology to the federal consolidated fund.[21]

The impact of USF and RDF alone was 0.3 percent of GDP; excluding these one-off inflows, budget deficit would have increased to 1.4 percent of GDP during Q1-FY14. It is important to mention here that USF and RDF were mobilized with an objective to finance expansion of the IT and cellular infrastructure in the country; utilization of these funds for other budgetary purposes may defeat this objective.

Similarly, on the expenditure side, a major positive was the reduction in interest payments, following the interest rate cuts in FY13. Since debt servicing has been driving current expenditures in last couple of years, this factor alone was able to deflect the momentum created by excessive government borrowing.[22] Having said this, the burden of interest payments would increase in the second half of FY14, when payments on 6 & 12-month T-bills, issued in Apr-Jun 2013, would fall due.[23] Half-yearly payments on PIBs issued in Apr-Jun 2013 (for circular debt settlement) would also add to the debt burden. This implies that concerns about the debt-trap situation that we highlighted in the Annual Report 2012-13, may materialize later in the year.

The reduction in interest expense during Q1-FY14 was partially offset by a large increase in defence related expenditures. While a part of this increase represents salary and pension increments for defence employees, the rest can be traced to the cost of logistics borne by our armed forces for supporting NATO's engagements in Afghanistan. The other big item – subsidies, remained stubbornly at the previous year's level, despite a partial increase in power tariffs in August 2013.

As far as public debt is concerned, it posted a record increase of Rs 1.0 trillion during the quarter. This increase, however, does not represent the fiscal imbalances alone, which recorded only a modest increase. Instead, this increase can primarily be traced to large revaluation losses associated with the external

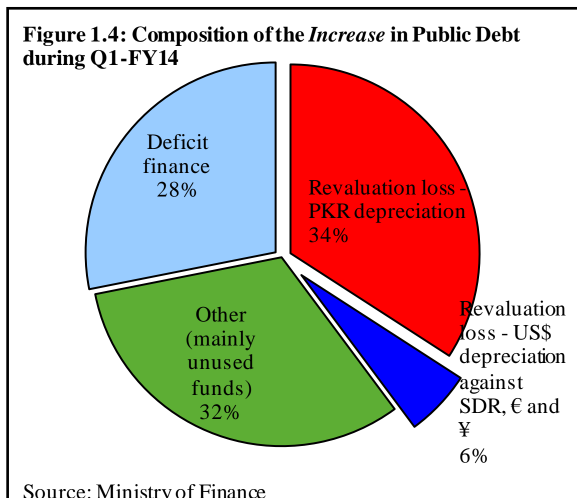
[21] Universal Service Fund was created in 2006, and became operational in 2007, as a public-private partnership. The major objective of the USF was to expand the telecom footprint to un-served and underserved areas of Pakistan. USF account, which is maintained by the Ministry of IT, gets funds from licensed telecom operators, who have been contributing 1.5 percent of their adjusted revenues to USF; and also from long-distance and international operators (LDIs), who have been contributing a part of their proceeds to the fund.

[22] Despite a sharp rise in outstanding debt stock last year, interest payments – that increased by 76.5 percent YoY in Q1-FY13, actually declined by 3.7 percent in Q1-FY14 (**Chapter 4**).

[23] More specifically, around 38 percent of the total increase in the government's domestic debt during FY13, was mobilized in the fourth quarter (Rs 720.4 billion). Since banks were anticipating a fall in interest rates at that time, they were locking in their funds in 6 & 12-month T-bills.

debt stock due to adverse exchange rate movements during the period (**Figure 1.4**).[24] As far as the government's domestic debt is concerned, it increased by Rs 634.0 billion in Q1-FY14 – a large amount compared to the Rs 286.9 billion fiscal deficit during the quarter. The additional borrowing *over and above* the budgetary requirements, was kept unused in the government's deposits with SBP at end-September 2013 (**Chapter 4**).[25]

Figure 1.4: Composition of the *Increase* in Public Debt during Q1-FY14



Source: Ministry of Finance

Notwithstanding the contained spending by the government, we are still concerned about the increase in the public domestic debt. More specifically, the increase in domestic debt would have been significantly larger, if the government was not able to realize certain one-off revenues during the quarter. Furthermore, the government cannot increase tax rates *indefinitely,* to secure higher revenues, as such measures will start choking economic growth, which reduces the revenue generation capacity of the country. More worryingly, interest payments are likely to increase in the second half of the year. If the government is not able to mobilize funds from abroad, then pressures on domestic debt could increase significantly. Therefore, there should be no compromise on initiating broad-based fiscal reforms, to bring the public debt-to-GDP ratio on a declining trajectory.

In addition to fiscal reforms, there is a corresponding need to rebalance the maturity profile of Pakistan's domestic debt. The growing prominence of 3-month

[24] There were two adverse effects of exchange rate on external debt stock during Q1-FY14. First was the depreciation of US Dollar against Japanese Yen, Euro and SDRs, which increased the US Dollar value of external debt. And secondly, depreciation of PKR against the US Dollar, which increased the Rupee value of external debt.

[25] In fact, the government was able to mobilize these funds from active participation of commercial banks in T-bill auction held on 19th September – when uncertainty in the interbank market regarding interest rates, was finally over after the announcement of monetary policy, in which, SBP raised the policy rate by 50bps. On aggregate, Rs 515.9 billion was mobilized by the government in this auction, which is the highest ever amount raised in a single T-bill auction. Government deposited most of these funds with central bank, and later, retired SBP debt using these deposits.

instruments in the outstanding volume of T-bills requires attention.[26] As discussed in previous reports, this exposes the financial system to *interest rate* and *roll-over* risks. The latter is particularly challenging as Pakistan has agreed to quarterly performance targets that seek to limit government borrowing from SBP; if banks do not roll-over their debt in any one primary auction, the remaining amount is automatically borrowed from the central bank.[27] Hence, there is an urgent need to lengthen and spread out debt service payments by the government.

1.2 Assessment and Outlook

The EFF program with the IMF is on track, and Pakistan has been able to meet all the agreed targets, except SBP's NIR for end-September 2013, which was missed by a margin (**Table 1.4**).[28] Since the government is expecting significant volume of financial flows from abroad for the rest of the year, we expect an increase in the SBP NFA. However, this increase would largely substitute for the budgetary borrowings from SBP, which are already capped under the IMF program. As a result, we expect a moderate growth in reserve money, albeit with a significant change in its composition.

Tale 1.4: Pakistan: Quantitative Performance Criteria and Indicative Targets for FY14

	Q1		Targets	
Performance criteria	**Target**	**Actual**	**Q2***	**Q3**
Floor on net international reserves of SBP (million US$)	-2,850	-3,154	-4,130	-2,750
Ceiling on NDA of SBP (stock, billion Rupees)	2,877	2,595	2,901	2,627
Ceiling on overall budget deficit (excl grants, billions Rs)	419	297	882	1,209
Ceiling on SBP's stock of net foreign currency swaps/forward position (millions US$)	2,255	1,775	2,255	2,255
Ceiling on net government borrowing from SBP (including provincial governments, stock, billions Rupees)	2,690	2,521	2,560	2,390

*Second quarter targets and actual will be discussed in detail in the Second Quarterly Report for FY14.
Source: IMF

A more balanced composition of reserve money should help contain inflation expectations in the economy, which may also get some support from the relative stability in the PKR parity in Q2-FY14. Unchanged petrol prices during the last 3 months, and the recent decline in prices of perishable food items has brought back headline inflation to a single-digit. Nonetheless, some upside pressures still persist from the external deficit; a further increase in energy tariffs that are also

[26] The share of 3-m T-bills in total outstanding T-bills held by commercial banks has increased from only 5.9 percent at end-June 2013, to 40.0 percent at end-September 2013; and further to 64.2 percent at end-December 2013. Furthermore, the share of floating debt in the total domestic debt has increased from 54.6 percent at end-June 2013, to 57.2 percent at end-September 2013.
[27] As mentioned before, the roll-over risk was partially realized in Q1-FY14, as banks offered much less than on-going maturities in T-bill auctions, through most of the quarter.
[28] The SBP's NIR target for December 2013 was duly met.

required as part of the IMF program; and the recent surge in global commodity prices. Having said this, after the December CPI data was published, SBP has reduced its forecast for headline inflation to a range of 10.0 – 11.0 percent for the year, which is still higher than the target of 8.0 percent set by the government (**Table 1.5**).

Table 1.5: Projections for Major Economic Indicators

	Annual Target	IMF Forecast	SBP Forecast
percent growth			
GDP	4.4	2.8	3.0 – 4.0
CPI inflation	8.0	7.9	10.0 – 11.0
Money supply (M2)	NA	13.8	13.0 – 14.0
billion US$			
Worker remittances	15.1	14.7	14.0 – 15.0
Exports (fob-BoP)	26.6	26.9	26.0 – 26.5
Imports (fob-BoP)	43.3	43.4	43.0 – 44.0
Current account deficit	2.9	2.3	2.5 – 4.5
percent of GDP			
Fiscal deficit	6.3	5.5	6.0 – 7.0

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

In the external sector, the receipt of CSF inflows in October 2013, February 2014, and expected inflows of US$ 1.2 billion for the full-year, should ease some of the pressures on FX reserves. Moreover, proceeds from the 3G auction are also likely to add US$ 1.2 billion in the country's FX reserves in H2-FY14. Worker remittances have gathered pace in the second quarter, and may even meet the government's target of US$ 15.1 billion by end-FY14. In overall terms, the current account deficit is likely to remain in the range of 1.0 to 1.8 percent of GDP.

Pressures from inadequate financial flows are likely to ease going forward, as Pakistan has already made bulky repayments to the IMF, and scheduled repayments in the second half of FY14 will largely be compensated by disbursements under EFF (**Chapter 5**). More specifically, a net inflow of US$ 4.0 million is expected from the IMF in Q3-FY14, whereas in Q4-FY14, net repayment to the Fund will be limited to only US$ 75.0 million.[29] In addition, the government is expecting financing of around US$ 3.3 billion in the second half of FY14, through various sources including a new Euro Bond; disinvestments through the stock market; privatization proceeds from Etisalat; and structured transactions.

In the fiscal sector, while the uptrend in tax collection is expected to continue in the second half, a major positive would be the inflows under CSF and 3G auction, as mentioned above. On the expenditure side, however, interest payments are

[29] In the first and second quarter of FY14, net repayments to the IMF were US$ 311.0 and US$ 585.9 million, respectively.

likely to increase in the second half of this fiscal year. In overall terms, SBP's forecast for the full-year fiscal deficit is in the range of 6 – 7 percent of GDP.

In our view, economic growth is likely to remain in the range of 3 – 4 percent, despite optimistic estimates for Q1-FY14. In fact, the IMF is even more skeptical, and envisages a growth of only 2.8 percent. We believe the industrial sector will continue its impressive performance for the rest of the year, but agriculture would remain subdued due to a decline in cotton production, and below-target sugarcane production.[30] Within the services sector, some improvement is visible in *telecommunications* due to the better financial position of PTCL this year; and some increase in value-addition by *wholesale and retail trade*, following the rise in industrial production. As far as *finance and insurance* is concerned, commercial bank profitability has declined in Q1-FY14, but the full-year performance will become clear once the banks finalize their year-end audited accounts, and provide conclusive figures for provisioning and recoveries.

In order to maintain the current growth momentum, and to take the economy to a higher growth trajectory, the government should speed up structural reforms in the fiscal and energy sectors. By focusing on these sectors, the government has signaled that its priorities are correct; however, the policies should aim to *sustainably* manage long-standing issues, instead of implementing makeshift arrangements. In the external sector, the government is making all efforts to mobilize financial inflows by engaging with the IFIs, and the international market. Although these inflows will be important to shore-up the country's FX reserves, more substantive measures are required in the real sector, to narrow the imbalance in the current account.

The IMF staff mission has recently concluded its meetings with Pakistan's fiscal and monetary authorities. Broadly speaking, the mission has found the macro stabilization process in the energy and fiscal sectors to be on track. Furthermore, the government is following through with Budget measures to increase tax rates and withdraw some tax exemptions. Similarly, the government is also implementing the National Energy Policy, which entails reducing end-user subsidies and improving bill collections. Although it is too early to make any impact analysis on these efforts, we believe the continuation of this reform process is critical for the long-term success of fiscal consolidation efforts.

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[30] Here, it is important to highlight that since PBS has not made public the methodology of quarterly national accounts, it is not possible to clearly identify seasonal factors for growth estimation. In our view, for instance, the impact of lower cotton production, and below-target sugarcane growth, will be evident in growth numbers from second quarter onwards, as the harvest for these crops come in full swing during Oct-Dec.