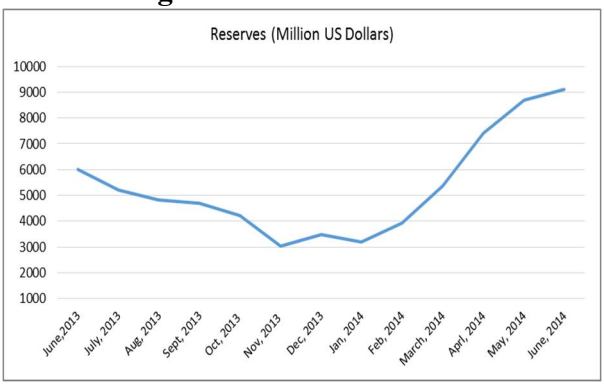
# PIDE Economy Watch

*July 2013 – June 2014*

## ECONOMIC PERFORMANCE

The incumbent regime had faced an unstable macroeconomic environment upon assumption of office in June 2013. Economic challenges faced then included; improving the precarious balance of payments position, bringing down fiscal deficit, avoiding debt trap, keeping inflation in check and yet grow. After the passage of more than a year the economic environment is relatively stable. Fiscal deficit is down, exchange rate, after a steep decline is back at the level prevailing in June 2013 and foreign reserves are 51 percent more than reserves held then. In FY 14 the economy posted an encouraging growth rate of 4.1 percent, especially when seen in the context of average growth rate of 3.2 percent during 2008-13.

**Fig. 1. Reserves with SBP**




Major contribution to the increase in foreign reserves and the stabilisation of exchange rate came from one-off debt creating inflows like the disbursement of 3 tranches of $550 million each against the IMF standby facility of $6.7 billion, floatation of Eurobonds of $2.0 billion and $1.5 billion from Saudi Arabia. Structural and institutional issues facing exports would have to be addressed to increase recurrent inflows. Risks to foreign inflows, in medium to long run include; tapering off of the foreign inflows, on account of support to coalition forces in Afghanistan and under-performance on the Conditionality agreed with the IMF. Media reports already suggest that the release of the 4th tranche of $550 million has been withheld by the IMF due to insufficient increase in electricity tariffs and slow progress on commitments like privatisation of PIA and independence of central bank.

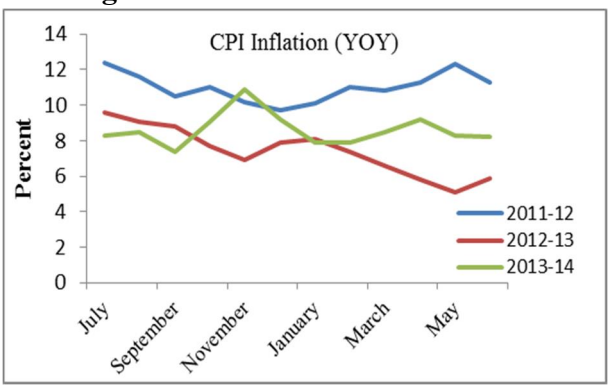
If the one-off debt creating foreign inflows are not supplemented by significant increase in exports on a continual basis, the external account position and hence the macroeconomic instability would remain vulnerable to the slightest of unforeseen shocks, like the increase in oil prices. Debt-creating foreign inflows to developing countries are often susceptible to change in geo-political environment. Heavy reliance on such inflows has the potential to cause macroeconomic instability, if geo-political environment undergoes a change.

Though there can be no two opinions that the saving rate needs to be increased yet equally important is to put the existing savings, especially the householdsô savings, to better use. Anecdotal evidence suggests that a

large part of household savings are invested in unconstructed residential plots and remain invested there for a long time, though huge capital gain is often made on frequent trading. Investment in unconstructed plots, for a long time, is one of the least productive kinds of investments. However as this provides an excellent hedge against inflation, this is considered the most preferred kind of investment by the households. While on one hand institutional reforms, like prohibitive non-use charges, are required to discourage investment in unconstructed residential plots for long, on the other hand, it is only a reasonable positive real interest rate and availability of sound investment avenues to the households which can encourage savings.

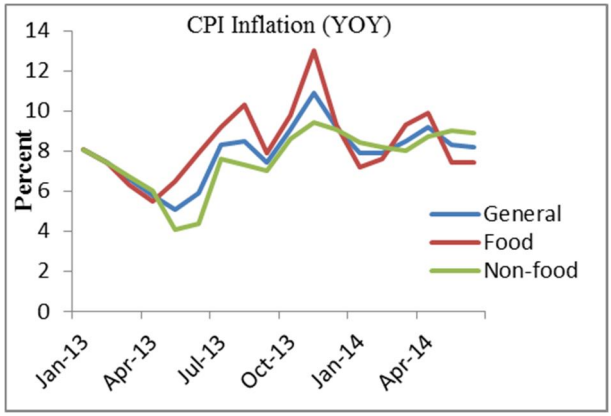
During FY 14 Inflation rate of 8.6 percent was recorded, on annual basis, as against 7.4 percent in FY 13.

**Fig. 2.Year on Year CPI Inflation**




Through-out the year, except for the last couple of months, food inflation remained greater than non-food inflation. November, December and April were the peak inflationary months during FY14.Volatile food prices, massive electricity shortages, rise in international oil prices, cut in subsidies and governmentôs borrowings from the central bank were some of the key contributors to inflation in FY 14.

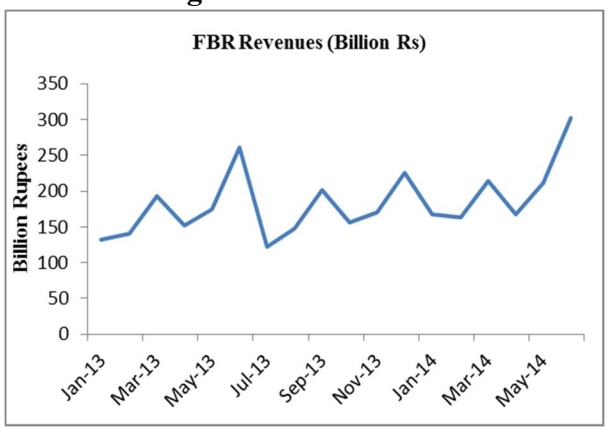
**Fig. 3.Food and Non-food CPI Inflation**




Improvement in the fiscal deficit, build-up of foreign reserves and appreciation of Rupee helped restrain inflation to the level observed. The targeted inflation for FY 15 is 8 percent. Given the agreement with IMF, the planned increase in utility prices and cut in subsidies would pose a serious challenge to the governmentôs effort to keep inflation at the targeted level.

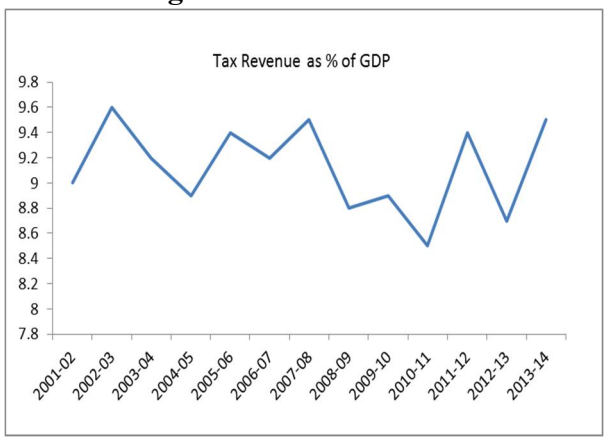
Tax revenue target of Rs. 2475 billion was fixed for the FY 14. During the year, the target was revised downward twice, once in February and then in May. Finally the actual collection (Rs. 2260 billion) fell short of even the revised target by 9.5 percent. In nominal terms, the revenue collection represents an increase of Rs. 320 billion over the previous yearôs figure.

**Fig. 4. FBR Revenues**



The tax to GDP ratio which has hovered in the range of 8-9 during the past decade remains low and the target of 15 percent by 2018 will remain elusive without structural changes to plug leakages and broaden the tax base.

**Fig. 5.Tax to GDP Ratio**



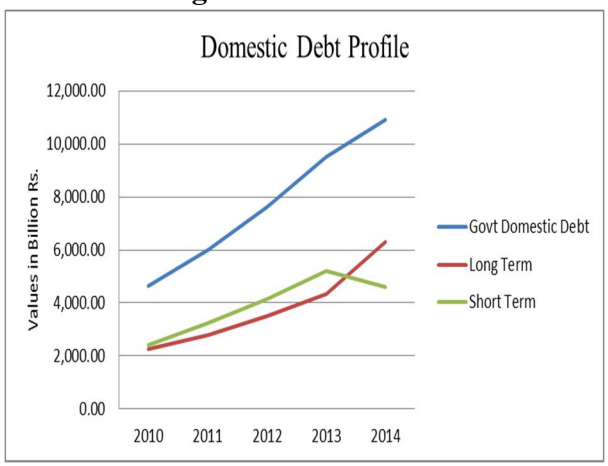

Upon the regime change in June 2013 the SBPôs discount rate was slashed by 50 basis points to bring it down to the level of 9 percent. Later on, after the negotiation of standby facility with the IMF in July 2013, the discount rate was increased by 100 basis points in two episodes of 50 basis points each, in September and November 2013. The discount rate has since been held static at 10 percent, though the year on year inflation has fallen from 10.9 percent in November, 2013 to 7.9 percent in July, 2014.

The total debt registered growth of 11.9 percent (Rs. 1.8 trillion) during FY 14, reaching Rs. 17.4 trillion as of June 2014, which is 68.6 percent of GDP- 8.6 percentage point higher than the limit imposed by the Fiscal Responsibility Debt Limitation (FRDL) Act. The continuous increase in debt volume will pose a serious challenge for debt servicing in the years to come.

During FY 14 the domestic and external debt increased by 14.4 and 7.4 percent. Major part of the increase (Rs. 1.1 trillion) in total debt was observed in the first quarter of FY 14. Increase in domestic as well as external debt contributed to the first-quarter increase. While the settlement of circular debt to the tune of Rs.480 billion in the first quarter largely explains the huge increase in domestic debt, the increment in external debt came from the release of the first tranche of $ 550 million against the $6.7 billion standby facility agreed with IMF in June 2014.

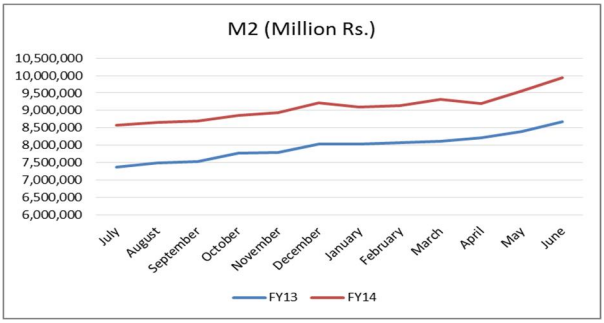
During the second quarter of FY 14 there has been some re-profiling of domestic debt with slight shift in favour of the medium to long term debtð the share of medium term debt increased from 5.8 percent in June 2013 to 10.4 percent in March 2014 while the short term debt fell from 57.6 to 52.6 percent. Banks seem to be exhibiting more interest in the medium term Pakistan Investment bonds. This shift augurs well for the monetary management in particular and the economy in general.

**Fig.6. Domestic Debt**




The money supply expanded by 12.5 percent during FY 14 as compared to 15.9 percent in FY 13. The decrease in deposit money and currency in circulation primarily contributed to lower growth in M2.

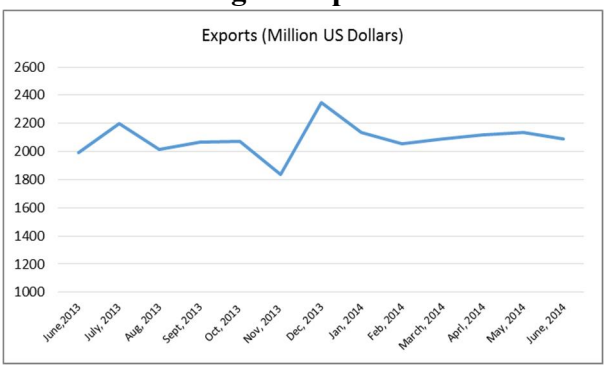
**Fig. 7. Money Supply (M2)**




The net government borrowing during FY 14 stood at Rs. 443 billion compared to Rs. 1559 billion in the corresponding period of last year. The borrowing for budgetary support showed a decline of around 79 percent over last yearôs figure. Out of the total borrowings for budgetary support Rs.197billion (65 percent) were borrowed from SBP while Rs.106 billion (35 percent) were borrowed from commercial banks during FY 14.

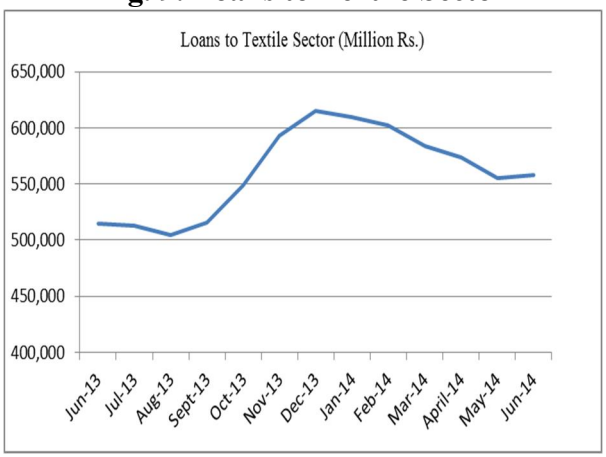
The GSP plus status granted to Pakistan by the European Union became effective on January 01, 2014. The GSP was expected to boost exports significantly however the expectations have not materialised at least during the first 6 months of the GSP. The exports at $25 billion during FY 14 have registered an increase of mere 1.41 percent over the export volume achieved in FY 13, though textile exports registered a growth of 6 percent during the same period and only by 4.8 during January-June 2014, (the period after the award of GSP Plus).

**Fig. 8. Exports**




Loans to textile sector, which are correlated with the level of production, have increased only slightly since the grant GSP Plus status in January 2014. One possible reason could be that production remains constrained by access to energy and other institutional factors ī it is worth mentioning, however, that for two months (January and February 2014) gas was diverted from power producers to textile sector.

**Fig. 9. Loans to Textile Sector**




The Large Scale Manufacturing Industry (LSMI) registered a growth of 4.28 percent during July-May, 2013-14 as compared to 4.13 percent during the corresponding period of last year. The monthly data shows that LSMI performed better during the first half FY 14 relative to the second half, though the first-half data has been marked by certain controversy as to reliability of the figures released then. Reasons for improvement in the first half of FY 14 could be the improved power supply, credit availability, capacity enhancement in some sectors, export demand, early sugarcane crushing, and gas diversion to one of the urea manufacturers.

**Fig. 10. LSMI Growth**

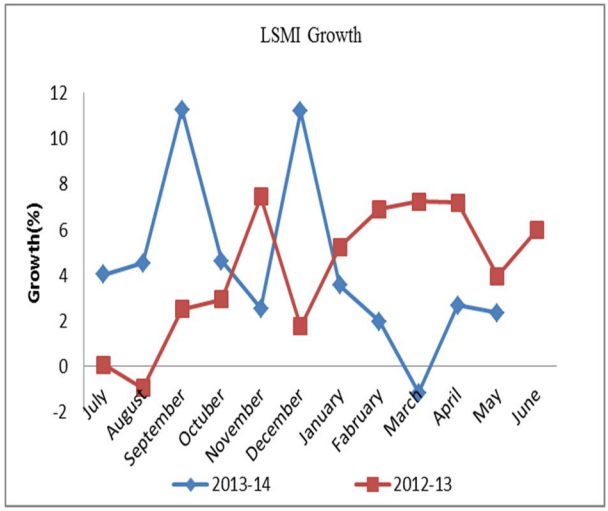
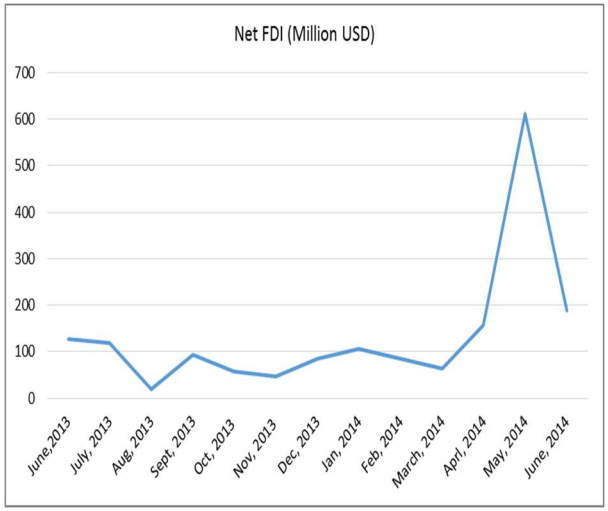



**Fig.11. Foreign Direct Investment**




During July-May 2013-14, the products which registered significant growth were switch gears (58 percent) diesel oil (53 percent), deep freezers (43 percent), trucks (40 percent), billets/ingots (32 percent), galenicals (30percent), paints and varnishes (30 percent) and soft drinks (29 percent). Other products with good growth performance were Light Commercial Vehicles, electric motors, air conditioners, cycle tiers, woollen and carpet yarn, fertiliser, petroleum products and sugar etc. On the flip side, during July-May 2013-14 the production of coke - Pakistan Steel (83 percent), pig iron (57 percent), sewing machines (43 percent) and tractors (30 percent) registered significant decline during the 11 months of FY 14.

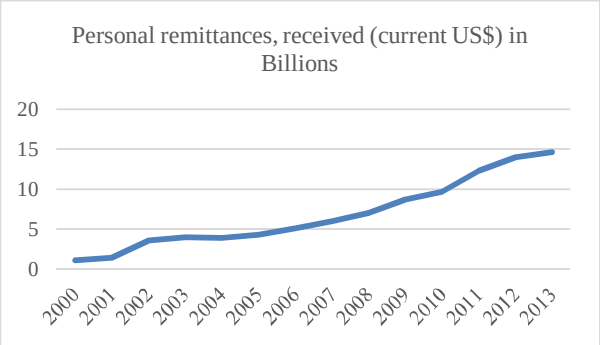
The FDI increased by 12 percent in the FY14, the increase primarily was observed in May 2014. The spike observed in May is owed to inflows in telecommunications, oil and gas exploration and the power sector. The net inflow of FDI during May 2014 in the telecom sector was from China - $547.2 million. This could be partly due to investment for 4G license from Zong, a mobile phone network based in China.

Remittances from overseas Pakistanis have registered an impressive growth of 13 percent during FY 14 with remittances from Saudi Arabia and UAE showing a persistent increasing trend. Typically 60 percent of the remittances originate from the Middle East while the balance is from the West. The remittances have been registering a handsome increase annually for more than a decade. It appears that the potential for increase is yet to be exhausted. Research into the dynamics of remittances from different countries and the Pakistan Remittance Initiative (PRI) ъ the institutional mechanism in place to encourage remittances, may yield potential avenues of bringing in even greater remittances.

Policymakers need to look into, how the remittances are used. If these are invested in real estate the prices in the real estate market rises which has contagion effect on inflation. The use of remittances to consume luxury goods has its own kind of ill effects. The challenge then is how to

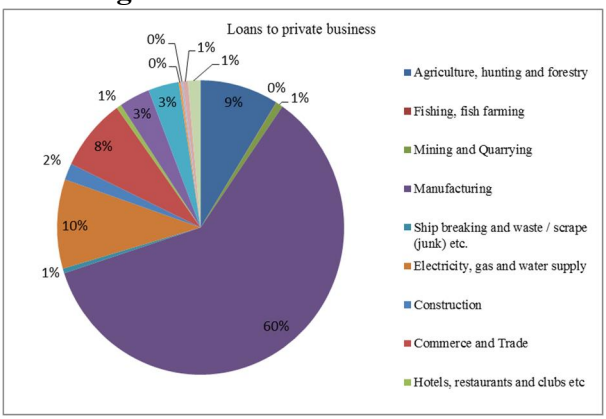
channel remittances into productive investment avenues.

**Fig. 12. Remittances**



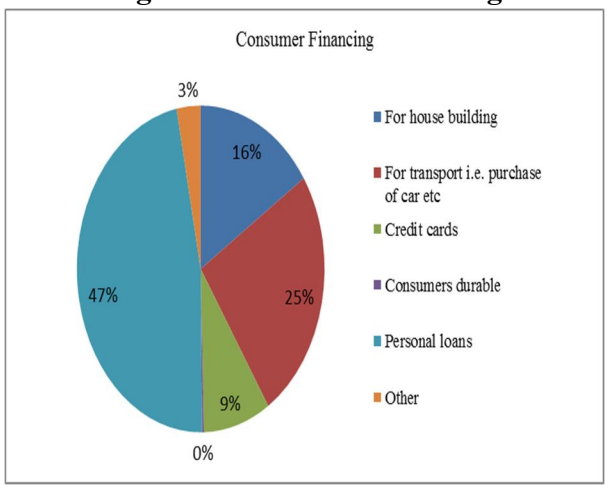

During FY 14, the banks extended loans to the tune of Rs.1636 billion to the private sector registering an increase of 13 percent over the loans extended in FY 13. The largest portion of such loans went to manufacturing sector, followed by loans for electricity, gas and water supply. The service sector, especially the pro-poor retail is almost absent from the list of beneficiaries of bank loans. Variety of institutional factors seems to inhibit the demand and supply of bank loans to the small scale entrepreneurs including the retail sector.

**Fig. 13. Loans to Private Sector**




Consumer financing showed an improvement of around 14percentby June, 2014 (standing at Rs. 251 billion) over its value in June, 2013.Personal loans and car financing continue to dominate consumer financing.

**Fig. 14. Consumer Financing**




The volume of housing financing, which contributes a lot to economic growth in the developed world, remains low in Pakistan. To increase the demand and supply of housing finance, institutional issues, like legal framework and land titling need to be addressed.

## Viewpoint on Budget 2014-15*

The targets envisaged in the budget are often not met - in some cases there is a significant shortfall while in others the actual amounts realised are way above the budget estimates. Lack of sophistication in developing estimates and the political economy of showing rosier estimates are seemingly the major reason for divergence between estimates and actual figures.

Provincial budget surpluses are estimated at Rs.183 billion for FY 13. Rather than being out of choice, the surpluses may reflect the lack of capacity in the wake of devolution at the provincial level. For FY 14 Rs.289 billion has been budgeted as the budget surplus of the four provinces put together. As the FY 14 is second year of provincial governments after the elections of 2013, the provinces might now be in a better position to spend. This makes the realisation of provincial surpluses budgeted for FY 15, challenging. The non-realisation of the envisaged provincial budget surpluses can disturb the estimates of overall national fiscal deficit. Moreover it is not clear whether or not the estimate of surpluses has been arrived at in consultation with the provinces.

Out of the total current expenditures of Rs.3130 billion (excluding repayment of foreign loans) 42 percent comprise interest payments, 22 percent Defence (27.5 percent if military pension of Rs.163 billion are included under Defence).

Federal Public Sector Development Programme (PSDP) is budgeted at Rs525 billion. In accordance with priorities of the government a major part of this is budgeted for infrastructure. Development expenditures, outside the PSDP, of Rs. 162 billion primarily includes expenditures to be incurred under the National Income Rural Support Program (BISP: 97 billion, Prime Ministerôs schemes: 21 billion and subsidy to TCP: 25 billion, Pakistan Poverty Alleviation Fund: 7. 6 billion)

Tax collection target of Rs.2810 billion for FY 15 is too ambitious. This represents an increase of 24.3 percent over the actual collection during FY 13. Historically, the highest growth in tax collection that Pakistan has ever achieved is 22 percent. One problem with setting ambitious tax collection target is that the estimates of transfers under the NFC to provinces are based on tax collection budgeted at the federal level. The non-realisation of the federal governmentôs revenue target by a wide margin disturbs the provincial budgets.

Moreover under the 7th NFC award it is stipulated that Baluchistan will receive its provincial share on the basis of budgetary projections instead of actual collection of the FBR. Shortfall if any due to lesser collection by the FBR is to be borne by the federal government. An additional amount of Rs.39 billion has been transferred to Baluchistan from 2010-11 to 2013-14 on account of shortfall in collections of the FBR, with reference to the collection budgeted at the time of framing the budgets.

In FY13, PSDP of Rs.2 billion were allocated to Cabinet Division but the division spent as much as Rs. 21 billion. This year again a budget Rs.2 billion has been allocated for the cabinet division. This clearly suggests that more sophistication is required in developing the budget estimates.

Capital gain tax, corporate tax rate, excise duty on telecom sector and customs duty have been rationalised in the budget. The Flat rate capital gain tax on trading in securities has been replaced with a cascading structure, with those holding the securities for a longer period paying less. This would encourage investors to hold rather than indulge in speculative trading. Whether or not this would help curb speculation in stock market would depend upon the margins involved in speculation relative to tax concessions on holding securities longer. To encourage FDI, corporate tax at the concessional rate of 20 percent shall be levied if the foreign equity in the project is at least 50 percent. Salaries of government employees, pensions and minimum wage of labourers have been increased marginally.

The budget envisages various incentives for the textile industry, though the expected impact of GSP plus on the industry is yet to materialise. The poor state of energy supply must be constraining production, therefore fresh incentives to textile industry, will partly add to the margins of the existing producers, if the energy situation remains more or less unchanged during FY 15.

Collection of sales tax due from small retailers through electricity bills though commendable, has implementation challenges. This would require correct identification of the retailers. For example problems would emerge where electric connection is not in the name of retailer operating the business.

Note:
Besides the Economy Watch team, Mahmood Khalid and Ali Kemal, have actively contributed to this section.

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