Pakistan

Macroeconomic and security challenges continue to weigh on the economy. Growth is expected to remain modest in FY2014, largely reflecting fiscal consolidation to deal with high deficits that have caused macroeconomic imbalances. The government has embarked upon a program of fiscal and structural reform, supported by an Extended Fund Facility Arrangement with the International Monetary Fund, to restore macroeconomic balance, relieve energy shortages, and guide the economy toward faster and more sustainable growth.

Economic performance

Moderate GDP growth in FY2013 reflected weak macroeconomic fundamentals in recent years. Investment remained low as energy shortages and security concerns continued to undermine investor confidence. Fiscal pressures kept the budget deficit very high for the second consecutive year. At the same time, however, inflation fell into single digits. Stable global commodity prices, Coalition Support Fund (CSF) inflows, and continued growth in worker remittances reined in the current account deficit.

GDP growth slowed to 3.6% in FY2013 (ended 30 June 2013) as weak expansion in the large service sector more than offset improved growth in manufacturing (Figure 3.20.1). Growth in agricultural production slowed slightly on weaker output of major crops, especially cotton and rice. Manufacturing expanded by 3.5%, reflecting a 4.4% pickup in large-scale manufacturing, though the sector remained hobbled by a continued power crisis and weak internal security. Textiles, food processing, and construction materials showed faster growth. Improved performance in construction was supported by flood rehabilitation, other public sector development projects, and their positive spillover effects to rest of the economy. Low growth in services was caused mainly by a slowdown in telecommunications. This counteracted improvement in finance and insurance that, however, reflected little more than commercial banks' profits from their high investment in government securities.

Investment continued its downward trend, with fixed investment falling from 13.3% of GDP in FY2012 to 12.6%. Private investment fell to 8.7% of GDP in large part because investment in manufacturing weakened, likely reflecting power shortages and low confidence in the country’s economic prospects, while investment in services also slipped (Figure 3.20.2). Consumption growth slowed to 4.6% in FY2013 from 6.0% in the previous year but still outpaced GDP growth. Private consumption eased as growth in remittance inflows slowed.
Government spending, on the other hand, continued to exhibit strong growth. Positive net exports reflected improved export volume and a decline in imports as investment fell. Headline inflation slowed from 11.0% in FY2012 to average 7.4% in FY2013, as food shortages eased (Figure 3.20.3). Gas tariff cuts and easing global commodity prices during the year moderated the rise of food and other prices. Greater exchange rate stability in FY2013—as compared with significant depreciation against the US dollar in the year before—also helped contain inflationary expectations. Inflation averaged 7.1% for food and 7.5% for non-food items.

The fiscal deficit stood at 8.0% of GDP in FY2013, lower than the 8.8% recorded in FY2012. It reflected low tax revenues and higher current expenditures on power subsidies, pensions, and interest on short-term domestic borrowing. The unbudgeted clearance of power sector debt amounted to 1.4% of GDP. Consolidated development expenditures in FY2013 were 6.3% lower than the target, on account of smaller provincial development outlays.

Federal tax revenues grew by a meager 3.2%, undermined by lower income tax and general sales tax collection and falling short of the FY2013 annual target. Federal Board of Revenue tax revenues grew by only 2.9% and, at PRs1.94 trillion, were below the revised target of PRs2.01 trillion. As such, they cover only about half of current consolidated budget expenditure, which is a pattern that has prevailed over the past 5 years (Figure 3.20.4). The shortfall in tax collection in FY2013 was partly compensated by higher nontax revenues, including the receipt of $1.8 billion under the CSF.

Monetary policy was accommodating. As inflation began to decelerate, the State Bank of Pakistan (SBP), the central bank, began in August 2012 to cut its policy rate gradually by a cumulative 300 basis points to 9.0% at the end of June 2013 (Figure 3.20.5). Government borrowing from the SBP and commercial banks remained high, as foreign financing was negligible. Budgetary borrowing from banks increased by 28%, or PRs1.5 trillion, in FY2013, including net borrowing of PRs536 billion from the SBP. To maintain market liquidity, the SBP injected, through open market operations, double the amount of funds injected in FY2012. However, credit to the private sector showed a slight net contraction in FY2013, as banks preferred to invest in government securities and economic activity remained weak. The heavy reliance on short-term borrowing has increased the government’s exposure to interest rate and rollover risks.

The current account deficit narrowed to $2.3 billion, or 1% of GDP, in FY2013 with improvement in the trade deficit, a lower service account deficit following receipts under the CSF, and continued inflows of worker remittances. Imports declined by 0.6% while export growth remained positive at 0.4%. A fall in external loan and non-debt financing, larger external debt repayment, and SBP interventions in the foreign exchange market to limit local currency depreciation drained foreign exchange reserves to a critically low $6.0 billion, enough to cover only 1.3 months of imports of goods and services by the end of June 2013. The Pakistani rupee depreciated against the dollar to Rs98.5, a decline of 4.5% over the year.
Economic prospects

GDP growth is projected at 3.4% for FY2014, marginally slower than in FY2013. Agriculture is expected to be weaker due to a drop in cotton output, which will partly offset improvement in the sugarcane and rice crops. Current rains may benefit the upcoming wheat crop, despite a reduction in the area sowed this year.

Weak agriculture will be partly compensated by the pickup in large-scale manufacturing, which grew by 6.7% during the first 6 months of FY2014, three times the rate during the same period a year earlier (Figure 3.20.6). Larger and more reliable power supply—partly reflecting better controls on unscheduled load shedding, as well as the increasing use of alternative fuels—is helping to revive the production of food, fertilizers, chemicals, electronics, and leather products, while petroleum refinery output continued its robust growth. Textiles are expected to recover from existing weak growth as they benefit from Generalized Scheme of Preferences Plus status granted by the European Union from January 2014. Improved manufacturing performance will spur retail and trade activity. Performance in transport and communication will continue to be affected by financial losses incurred by Pakistan Railways and Pakistan International Airlines.

On the demand side, private consumption will remain the main driver of economic growth, supported by the sustained inflow of remittances, low real interest rates, and better credit availability at banks. Government spending will be contained by fiscal consolidation to bring down the budget deficit, but accelerated credit flows to the private sector during the first 7 months of FY2014 indicate an uptick in private investment. Net exports are expected to be modestly negative as import growth quickens to support improved capacity utilization in manufacturing. GDP growth is expected to be higher in FY2015, at 3.9%, as the impact of fiscal consolidation eases somewhat, energy supplies improve, and the global economy strengthens.

In the first 8 months of FY2014, inflation averaged 8.6%, reflecting the increase in the general sales tax rate by 1 percentage point to 17%, increases in power tariffs in August and October 2013 for commercial and bulk residential and industrial users, and significant Pakistan rupee depreciation against the major currencies. Reflecting short supply of perishable items and higher wheat prices, food inflation rose to 13.0% in November 2013 before receding to 7.2% in January 2014 for an average of 9.3% over the 8 months (Figure 3.20.7). Core inflation was relatively stable and averaged 8.4% during the period. Further adjustments to electric and gas tariffs, as well as a levy to support gas infrastructure development, are expected to keep inflation elevated over the forecast period. Average consumer price inflation is projected at 9.0% in FY2014 and 9.2% in FY2015.

Monetary policy was tightened in response to a depreciating currency and rising inflation during the first half of the FY2014. The SBP raised the policy interest rate by 50 basis points in September 2013 and again in November, bringing it up to 10% from 9% in FY2013 (Figure 3.20.8). While inflation eased in January 2014, the SBP kept the policy rate unchanged in its monetary policy meeting that month.
Monetary management continues to be challenged by high government borrowing from the banking system in FY2014. As a result, the end-December International Monetary Fund (IMF) ceiling for government borrowing from SBP was breached. As foreign inflows remained negligible, and commercial banks lacked interest in government securities because short-term money market rates had risen more quickly than the policy rate, the burden of borrowing once again shifted from commercial banks to the SBP. From 1 July 2013 to 21 February 2014, government borrowing from the SBP increased to PRs890 billion, against net retirement to commercial banks of PRs184 billion. Credit to the private sector picked up to PRs280 billion during this period from PRs107 billion a year earlier, largely reflecting credit to private businesses for fixed investment and working capital as business activity in textiles, power, and trade improved, as well as for consumer credit. Weighted average bank lending rates have been relatively stable at just over 10%. Broad money growth slowed to 4.9% during this period from 7.5% in the previous year, as the marked contraction in the banking system’s net foreign assets reflected a deteriorating balance of payments.

The fiscal framework under the 3-year extended fund facility agreed in September 2013 with the IMF focuses on strengthening the revenue base, limiting power subsidies, ending the drain on the budget from loss-making state-owned enterprises, and compressing non-salary expenditure. With the framework, the budget deficit excluding grants is expected to be held to 5.8% of GDP in FY2014, which is somewhat lower than the original budget target of 6.3% (Figure 3.20.9). The fiscal deficit was contained at 2.1% of GDP during the first half of the FY2014, mainly by higher sales tax revenues, $322 million in CSF receipts, and restrained expenditure. The increase in tax revenues partly reflects measures already taken under the federal budget for FY2014, including raising the general sales tax rate and eliminating some tax exemptions. Tax collection of PRs1.031 trillion during first 6 months is broadly consistent with the fiscal framework target of PRs2.3 trillion for FY2014.

Consolidated expenditure for the first half of FY2014 was contained partly by reduced interest payments following the earlier clearance of accumulated power sector arrears—the circular debt. Interest payments are likely to be high in second half of FY2014 as domestic borrowing finances the deficit. In addition, the risk of a rebuild of circular debt in FY2014 remains high. Public sector development spending was subdued at PRs243 billion in the first 6 months of FY2014 and is likely to remain so to contain the budget deficit in light of high current expenditures. This will have negative implications for long-term investment and growth.

While the government’s commitment to severely limit energy subsidies is underscored by various initial measures, such efforts need to be more comprehensive. Apart from further price adjustments, substantial governance reform is needed to reduce theft and losses in transmission and distribution. Similarly, it will be necessary over the medium term to change the energy mix through very large investments in new generation capacity. While these energy measures will help contain expenditure overruns, efforts to widen the revenue base need to be accelerated.
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Fiscal devolution under the 18th constitutional amendment in 2011 has made consolidated budget outcomes more dependent on provincial fiscal performance. Expenditure containment envisaged under the federal budget for FY2014 called for a combined provincial budgetary cash surplus of PRs23.1 billion. Provincial fiscal operations for the first half of FY2014 indicate a consolidated cash surplus for the period, which needs to be sustained during the second half to meet the fiscal deficit target for FY2014. Unexpectedly slow progress toward the issuance of 3G spectrum licenses and issues around pending proceeds from telecom privatization raise concerns over whether these receipts will be realized during FY2014. Delays in receiving $878 million in CSF receipts could pose a challenge for the fiscal target.

To protect the poor from the adverse effects of fiscal adjustments and other negative shocks, the federal government is providing cash transfers through the Benazir Income Support Program to families identified through a poverty scorecard system. The number of program beneficiaries increased to 4.8 million in FY2013 (Figure 3.20.10). The federal government budget for FY2014 plans to nearly double the allocation for the program to PRs75 billion. The program has started piloting a number of additional initiatives for beneficiaries, including health insurance, skills training, loans to develop small businesses, and primary education co-responsibility cash transfers for children.

Deficits in the trade and services accounts worsened with revived imports and delays in CSF receipts, widening the current account deficit during the first 7 months of FY2014 to $2.1 billion (Figure 3.20.11). Imports grew by 4.2%, compared with negligible growth in the corresponding period a year earlier, as the textile and power industries bought machinery. Export growth also picked up to 3.3% in the first 7 months of the fiscal year, stimulated by 8% growth in textile exports, which offset the decline in exports of other manufacturers and slow growth in food exports. All exports are expected to grow further in the remainder of the fiscal year, as benefits from the Generalized Scheme of Preferences Plus are realized. With worker remittances showing a 10.1% increase in the first 7 months of FY2014, the current account deficit is projected at 1.4% of GDP. The current account deficit for FY2015 is forecast to be marginally lower at 1.3% of GDP, as lower global commodity prices partly compensate for higher imports needed to support the modest pickup in GDP growth.

Key risks emanate from low official foreign exchange reserves as weak official inflows and high debt repayments outweighed IMF disbursement during the first half of FY2014. Net foreign direct investment inflows, at $523 million during first 7 months of FY2014, were essentially unchanged from a year earlier, and net financial account inflows totaled only $251 million, though improved from a slight deficit in the earlier period (Figure 3.20.12). Gross official reserves—having plunged from $6.0 billion at the end of June 2013 to $3.1 billion in January 2014, equal to less than 1 month of imports—revived to $3.9 billion at the end of February, reflecting foreign inflows during this month (Figure 3.20.13). The Pakistani rupee appreciated to PRs100.3 to the dollar, following 6.5% depreciation during the first 7 months of FY2014.
Policy challenge—achieving fiscal sustainability

Achieving fiscal sustainability is a major recurring challenge for policy makers in Pakistan. Fiscal discipline has eroded in recent years with the persistent need to finance expanding energy sector subsidies, worsening losses incurred by state-owned enterprises, and high expenditures for security.

Tax collected by the Federal Board of Revenue stood at 8.5% of GDP in FY2013, one of the lowest collection ratios in the region that reflects structural and administrative issues. As a result, spending for badly needed infrastructure has relied largely on foreign inflows. Additional spending requirements have emanated from natural disasters in the past few years, as well from the need to establish social safety nets. Higher fiscal deficits and very limited foreign inflows during the past 2 years have significantly increased short-term domestic borrowing, causing interest payments to balloon. Moreover, high government borrowing from commercial banks contributes to low private sector credit.

The domestic portion of public debt increased sharply for the second year in a row, from 38.0% of GDP at the end of FY2012 to 41.5% in FY2013, to finance high fiscal deficits (Figure 3.20.14). Foreign debt fell by 4.6% of GDP in FY2013, mainly as IMF debt was repaid. Total public debt (including external liabilities) at the end of FY2013 amounted to 63.3% of GDP, exceeding the legal limit of 60% set under the Fiscal Responsibility Debt Limitation Act, 2005. Although a generally favorable negative differential between real interest rates and GDP growth has eroded the real value of government debt, growth in the primary deficit would endanger debt sustainability.

The federal government is implementing its fiscal framework under the IMF’s 3-year program. Immediate measures affecting the federal budget for FY2014 pertain to raising the general sales tax rate and certain power tariffs to contain subsidies. Structural reforms to widen the revenue base are, however, critical for restoring fiscal sustainability. These include improving tax administration, eliminating exemptions to certain sectors, and bringing all sectors including agriculture under the tax net. Efforts would be required from federal and provincial governments alike, as some taxes (notably on agriculture) fall under provincial administration and reforms would help enhance provincial revenues. Currently, over 90% of provincial revenues are transfers of federal shared taxes. As provinces have assumed a greater share of federal resources and spending responsibilities through devolution, their fiscal performance has become even more important toward achieving national fiscal outcomes. For instance, collecting sales tax on services is now a provincial government responsibility, and most social sector responsibilities have been transferred to provinces. Clearly, the allocation of 57.7% of the national shared tax base to provinces determined under the 2010 National Finance Commission award requires greater fiscal prudence and discipline on the part of the provinces. A mechanism to ensure provincial fiscal discipline is likely to be a crucial consideration in upcoming discussions for the 2015 award.