British Deputy
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PAKISTAN ECONOMIC UPDATE: JULY 2014

After a 'mostly positive' third review last month, Pakistan received the fourth (£325 million) instalment of its 3-year IMF loan. The recent improvement in external accounts – boosted by strong remittances growth – prompted an upgrade of the country's sovereign-bond rating by Moody's. The IMF also revised upwards GDP growth for last fiscal year to 3.3%; though this is still below the officially announced 4.1%. In line with agreements with the Fund, the Government pushed ahead with increases in a levy on gas consumption, despite business opposition. Meanwhile, the country's power crisis worsened, as summer temperatures rose, and the

Key Statistics[1]

- The IMF upgraded GDP growth for the outgoing year from 3.1% to 3.3% - this is below the Government's initial 4.1% figure that was seen by independent economists as too optimistic (see Chart 1).
- The current account deficit for FY14, at 1.2% of GDP, was almost unchanged on 1.1% last year.
- The country's total FX reserves, including those held by commercial banks, now stand at £8.5 billion – cover for around 14 weeks of goods imports.
- Overseas remittances for FY14 were up 13.7% on the previous year; those from the UK increased 12%.
- The Karachi Stock Exchange continues to sizzle: last week it hit a new record high, crossing 30,000 points.
- Industrial production grew 4.3% during 10M Jul-Apr over last year. This slight slowdown from earlier in the year points to energy shortages.
- The State Bank kept its main policy rate unchanged at 10% in its meeting last week.
- Inflation, at 8.2% in June, was almost unchanged from 8.3% in the previous month; a stronger rupee has helped contain price pressures.
- For FY15, the central bank expects average inflation of around 7.5 – 8.5%.

'circular debt' piled up again. Prime Minister Sharif has asked the public to scale back their expectations of quick-fixes to energy problems. In contrast to the hoped-for improvement in the investment climate, Pakistan slipped 4 spots in the World Bank's 'Ease of Doing Business' rankings to 110th place. Export growth has slowed, not least because of recent rupee strength. The Government plans to compensate exporters through subsidised trade finance. Separately, the privatisation programme kicked off; bankers are optimistic about upcoming sales.

1. **The 3rd IMF Quarterly Review concluded with the Fund describing performance as "mostly positive" and "generally satisfactory." It revised upwards Pakistan's FY14 growth rate from 3.1% to 3.3%; while Moody's, the US credit ratings agency, upgraded the country's sovereign-bond rating.** All key IMF programme targets were met other than a ceiling on Net Domestic Assets on the State Bank of Pakistan's (SBP) balance sheet. Although there were delays in meeting structural benchmarks (including the hiring of financial advisers for the privatisation programme), since the review, two transactions have been made on local capital markets (see point 3). The successful review saw disbursement of the fourth tranche (£325; $556 million) of Pakistan's 3-year Extended Fund Facility. An on-track IMF programme and improved external accounts prompted Moody's to upgrade Pakistan's sovereign-debt rating from 'negative' to 'stable'. The country's five largest banks, whose health is closely tied to the Government's risk profile, also received a ratings upgrade on their rupee deposit offerings.

2. **The country's external accounts have improved considerably since last year. Central bank foreign reserves are now £5.6 billion; and recent rupee strength is expected to continue with planned issues of Islamic bonds.** While much of this improvement was the result of a Saudi grant of £872 million earlier this year, inflows from the 3G/4G spectrum licence auction also helped (see Chart 2). In addition, the latest IMF disbursement and strong remittance growth helped build on these gains (see Chart 3). Over the course of the year, the Government plans to issue Islamic sovereign bonds, or *Sukuk*, on global capital markets. Analysts expect this to sustain the improved external position over the next few months.

3. **Further ahead, policymakers' hopes are pinned on privatisation transactions in generating additional FX inflows.** Two transactions of United Bank and Pakistan Petroleum went ahead on the Karachi Stock Exchange. Through these, the Government raised the rupee equivalent of £ 310 million. In the next phase, analysts expect sales such as the Oil & Gas Development Company on global markets, including the London Stock

Notes: [1] Figures have been converted to £'s at the prevailing market exchange rate at the end of the relevant period. [2] The country's fiscal year (FY) runs from 1st Jul to 30th Jun. [3] The analysis is based on data for 12M (Jul-Jun) unless otherwise indicated

Exchange, to generate additional FX inflows. Bankers, who have been part of ‘road shows’ for the Government’s privatisation plans, are optimistic about global investor appetite for stakes in the country’s well-run state-owned firms. Following the model of Karachi’s privatised power company, K-Electric, they say investors have expressed an interest in the Faisalabad Electric Supply Company in Punjab.

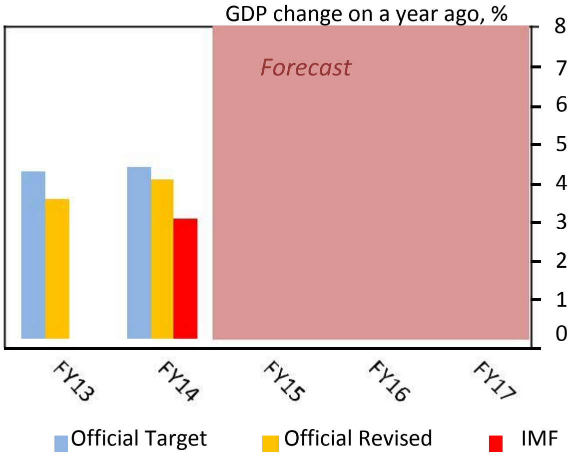
4. **Meanwhile, rising summer temperatures and a slow monsoon have seen the power crisis intensify. The Government has said there are no quick-fixes to the country’s energy problems. It is seeking Chinese investment in the sector.** Media reports suggest outages of 16-20 hours in rural areas, as some private power plants lie idle due to circular-debt related (unpaid bills in the energy supply chain) fuel shortages. To help increase the country’s generation capacity – and lower the cost of power generation - the Government hopes to attract Chinese investment in coal-fired power plants. Media reports suggest that a meeting of the Energy Working Group between the two countries is expected soon to finalise agreements. While, initially, it appeared that the plants were to be set up in Baluchistan and Sindh – to minimise the costs of transporting coal – it now appears that Punjab will get them too. Separately, the Government is also looking to restart investment in hydropower, with the support of the ADB, IFC and the World Bank.

5. **In line with agreements with the Fund, the Government has increased a levy on gas consumption.** The federal Government hopes to raise an amount nearly 3 times higher than last year’s budget target from the so-called Gas Infrastructure Development Cess (GIDC) (see Chart 4). This forms part of agreements with the IMF to rationalise gas usage in the country: the Government has committed to raise up to 0.4% of GDP from the GIDC. The funds raised are intended to address the growing gas shortfall in the country e.g. through the Iran-Pakistan and Turkmenistan-Afghanistan-Pakistan-India pipelines, or the setting up of LNG import infrastructure. Nevertheless, in doing so, it faces significant industrial opposition (see next point).

6. **Businessmen have criticised the Government’s move to increase the gas levy, and claim it will hurt the fertiliser sector and textile exports. The Government hopes to compensate exporters with other incentives.** High-value added textile exports, covered by GSP+, grew this year (see Chart 5). But exporters see the GIDC, and other increases in gas prices, as a contradiction of the ‘Textiles Package’ (incentives specifically targeted at textile exporters) announced in the Budget. Furthermore, they have voiced concern over power shortages that they claim - have crossed the ‘manageable’ 8-hour threshold - risk undermining GSP+ gains. They say that smaller textile mills, in particular, face serious challenges which could mean losses to local jobs. The Government, for its part, hopes to compensate exporters through measures such as the setting up of an Export Import Bank. Media reports suggest that it is pushing forward the legal framework necessary for its establishment. The Bank will provide subsidised export credit, thereby lowering finance costs. Critics argue, however, that such measures are unlikely to offset the wider loss to the country’s competitiveness due to the rupee’s recent strength.

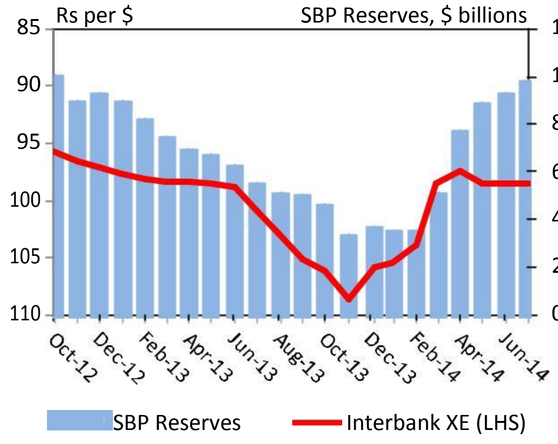
7. **With inflation for June at 8.2%, the central bank left its main policy rate on hold at 10%. Separately, in the interests of financial stability, the IMF has urged the State Bank to ensure all banks comply with minimum capital requirements by December. The central bank is also looking to set up a fund to insure depositors in the event of bank failures.** Presenting the Monetary Policy Committee’s decision to leave interest rates unchanged, the SBP said economic conditions were ‘certainly better’ than a year ago. However, local commentators have questioned the central bank’s decision to stick to positive real rates in the face of macroeconomic improvement (see Chart 6). Separately, the IMF has urged the SBP to ensure that four of the country’s commercial banks – accounting for around 6% of banking-sector assets – that fall short of the regulator’s 10% Capital Adequacy Ratio, meet this deadline by December 2014. This includes three private banks, and a public-sector bank. Analysts expect two of the private banks to receive an equity injection from foreign investors soon. Media reports suggest that the SBP is looking to set up a subsidiary, the Deposit Protection Fund (DPF), to insure bank deposits of up to £600. While details are unclear at this stage, it is expected that the DPF will build on its resources through periodic payments by banks covered by this scheme.

Chart 1: Economic growth



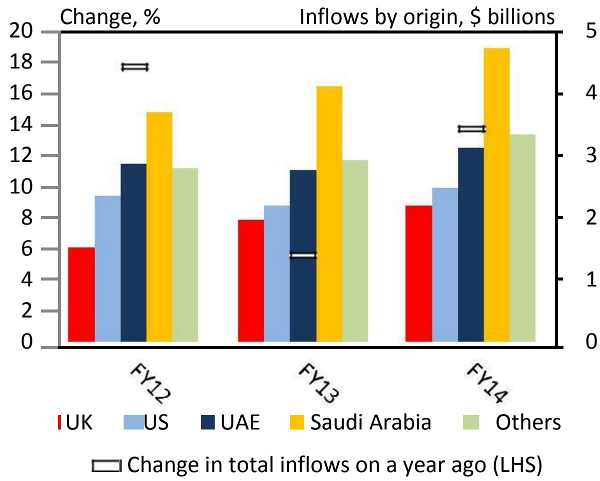
Source: Ministry of Finance; IMF

Chart 2: External position



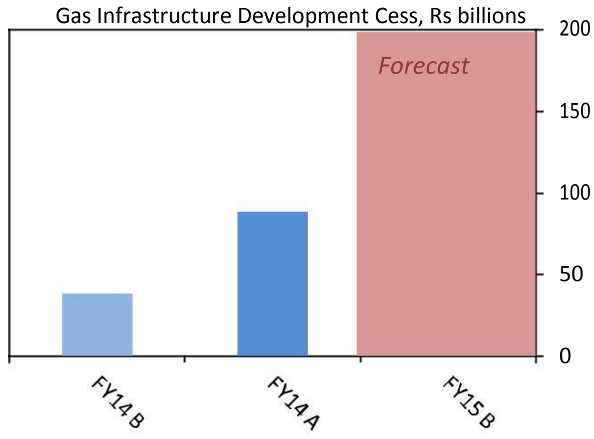
Source: State Bank of Pakistan; Analyst Estimates

Chart 3: Inward foreign remittances



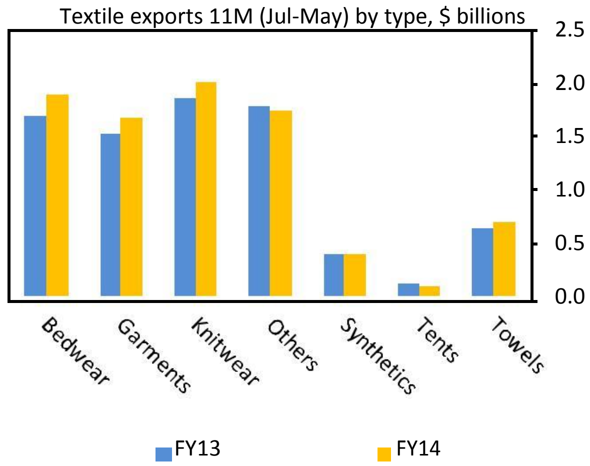
Source: State Bank of Pakistan

Chart 4: Revenues from gas levy



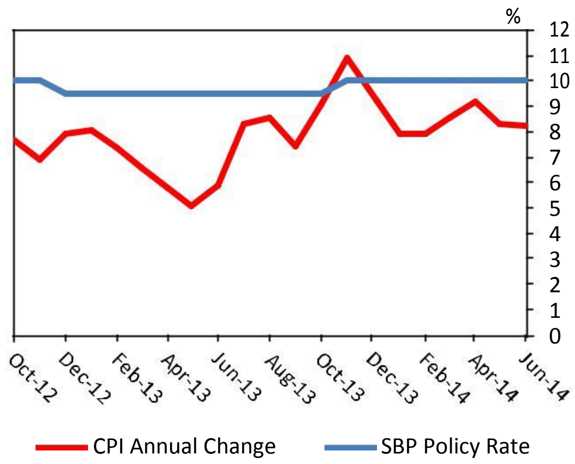
Source: Ministry of Finance; Analyst Estimates

Chart 5: Textile exports



Source: State Bank of Pakistan; Analyst Estimates

Chart 6: Inflation and monetary policy



Source: State Bank of Pakistan; Pakistan Bureau of Statistics