British Deputy
High Commission
Karachi

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PAKISTAN ECONOMIC UPDATE: JUNE 2014

Presenting the Government's second budget, Finance Minister Dar said that, as a result of the PML-N's economic policies, Pakistan is more "strong, healthy and prosperous" compared with a year ago. This is seen as the result of improvement on a wide range of economic indicators from growth, inflation and industrial activity to fiscal and external accounts. The new budget for FY15 looks to build on the Government's attempts to restore fiscal sustainability by bringing the deficit down to 4.9% of GDP, mainly through better tax collection. But there are risks. Firstly, while efforts to bring the undocumented economy into the tax net are welcome, the Government's revenue collection targets are seen by analysts as ambitious. Secondly, the deficit target relies on even larger Provincial surpluses than last year.

1. **Despite a pick-up due to improved energy availability, GDP growth for the outgoing fiscal year fell short of the Government's target. For FY15, the growth target has been set at 5.1%.** As with the last year, the Budget is based on a Medium-Term Macroeconomic Framework that sees the economy expanding at over 7% annually in 3 years time (see Chart 1). Although FY14 growth, at 4.1%, fell short of the Government's 4.4% target at the start of the year, this is still seen as an achievement compared with 3.6% before the PML-N took office. The Finance Minister argues this performance is particularly impressive given that it was achieved while the Government undertook austerity measures to lower the fiscal deficit.

2. **In his Budget speech, Minister Dar highlighted the Government's success in stabilising the economy, particularly the budget deficit.** He said the Government has successfully reduced the country's fiscal deficit from 8.2% of GDP last year, to 5.8% during its first year in office. Over half of this was the result of a decision last year to include settlement of power-sector unpaid bills (circular debt) in the FY13 Budget (see Chart 2). Nevertheless, analysts believe the country's power sector could continue to pose risks to the Government's efforts to restore fiscal sustainability; especially if it needs to repeat some form of circular-debt payment this year.

3. **Budgeted federal transfers to the Provinces have increased, but so has the reliance of national deficit targets on Provincial surpluses.** Actual Provincial surpluses for FY14 were 8 times larger than planned in last year's Budget. And this reliance on Provincial surpluses to meet national deficit targets appears to be growing. While the new Budget for FY15 envisages a 20% nominal rise in transfers to Provinces as their share of taxes, the surpluses they are expected to generate are nearly 60% higher than those budgeted last year (see Chart 3). At this stage it is unclear if and how this will be achieved, particularly given frequent revisions to Federal tax-collection targets during the year that impact provincial spending decisions. Perhaps this explains why provincial governments have called for more fiscal decentralisation, including the collection of the General Sales Tax on goods, in addition to the tax on services that they currently manage.

Key Statistics[1]

- GDP grew 4.1% in FY14, lower than the Government's 4.4% target; the target for FY15 is 5.1%
- The fiscal deficit for FY14 is projected at 5.8% of GDP; the FY15 target is 4.9%.
- The new Budget envisages a 23% nominal increase in Federal tax revenues; last year they rose 16%
- The current account deficit for 10 months (Jul-Apr) was 1% of GDP compared with 0.8% last year.
- The goods-trade deficit for same period widened 3% to £ 7.8 ($ 13.3) billion, as imports outpaced growth in exports.
- FX reserves increased to £ 7.9 ($13.5) billion (around 4 months imports) by 6th Jun
- Of these, SBP reserves stood at £ 5 ($8.6) billion; the rest with commercial banks.
- Industrial production grew 4.3% in 9M (Jul-Mar) compared with 3.5% last year.
- So far, despite the security situation, buoyed by the Government's listing of its stock in local bank, UBL, the Karachi Stock Exchange trades near all-time highs.
- Inflation in May declined to 8.3% from 9.2% in April.

Notes: [1] Figures have been converted to £'s at current market exchange rates. [2] The country's fiscal year (FY) runs from 1st Jul to 30th Jun. [3] The analysis is based on data for Jul-Jun unless otherwise indicated.

4. **Last year, in its first budget, the PML-N Government had unveiled a sharp increase in development spending, at both Federal and Provincial levels. However, much of this, particularly at the Provincial level did not materialise.** Last year's budget announced a 35% increase in the Government's flagship development spending plan, the Public Sector Development Programme (PSDP)**.** However, some of the Federal Government's developments spending plans were scaled back during the year to meet IMF deficit targets. Provincial development spending was a third lower than planned (see Chart 4). Media reports suggest this was due to the provinces accepting cuts to Annual Development Plan to facilitate the Centre in pursuit of its deficit targets. But it also reflects delays in setting spending priorities at the provincial level.

5. **The Budget for FY15 appears to be the Government's opportunity to press ahead with large-scale infrastructure projects. Allocation for development spending has again been scaled up considerably. In addition, inflows from Saudi Arabia of £880 million, received earlier in the year, may also be used to finance such projects.** At the national level, the PSDP is expected to rise by 44% compared with actual spending last year. The Finance Minister has said the programme will focus on the construction of large and small dams and other energy projects. In addition, the Government's priorities also appear to be large-scale roads and railway projects: budgetary allocation for the National Highway Authority has been increased nearly 30%.

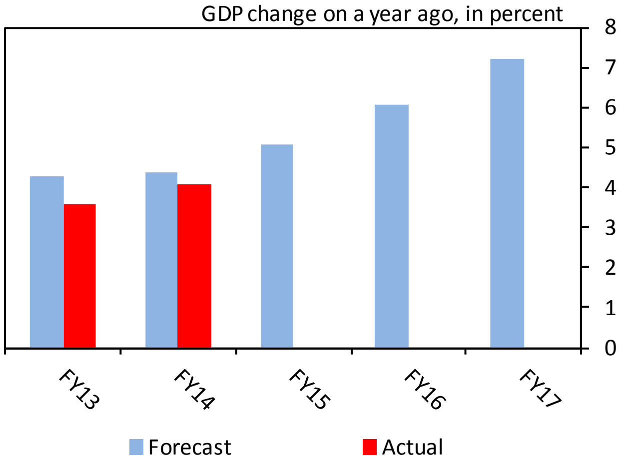
6. **In line with agreements with the IMF on gradual elimination of power subsidies, the Government continues to reduce allocations in the Budget. However, it missed last year's targets by a considerable margin.** Although power tariffs were increased during the year in a bid to contain expenditure on subsidies, actual expenditure during FY14 was 60% higher than budgeted (see Chart 5). The bulk of this was on Tariff-Differential Subsidies intended to ensure uniform consumer tariffs across the country. For FY15, the target for such subsidies has been set 40% lower than last year. Analysts believe meeting this target would require further tariff hikes during the year.

7. **Measures to broaden the tax net are welcome. However, targets for tax revenue collection are widely seen by analysts as optimistic.** Federal tax collection increased around 16% in nominal terms compared with actual collection last year. However, adjusting for inflation and GDP growth, the increase is 3% in real terms. Even this, critics claim, is due to delayed or withheld tax refunds by the Federal Board of Revenue (FBR). Nevertheless, in the FY15 Budget the Government has set a target that is 23% higher than actual collection in FY14 (see Chart 6). Adjusting for projected inflation and growth this means a 10+% increase. The Government hopes to achieve this through measures designed to bring undocumented retailers into the tax net through advance indirect taxes on electricity bills; and wealthy "non filers" through taxes on premium airline tickets and the sale of property. Nevertheless, given the complexities of collecting such taxes – particularly on retailers – most analysts expect that actual growth in tax revenue during the year will be half the Government's Budget targets.

8. **While privatisation proceeds budgeted for FY14 did not materialise, the auction of 3G/4G licences is seen as a success. The privatisation programme is expected to kick-off in earnest this year, along with additional spectrum licences.** For FY15, privatisation proceeds are nearly 3 times higher than those budgeted last year. In the first stage divestments will include capital market transactions for profitable banks (such as the recent divestment of a stake in UBL) as well as oil & gas firms by December 2014. In addition, the Finance Minister has said that two additional spectrum licences – that remain unsold from the previous auction – will be sold in the new fiscal year.

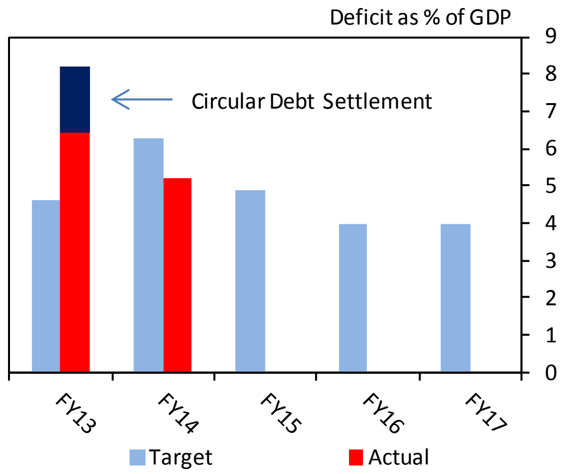
9. **The Government has also announced incentives to boost the country's flagging exports, including the setting up of an Export-Import Bank. The measures appear to be specifically targeted at textile exporters to benefit from GSP+ market access.** This is welcome news to the country's textile industry who suffered losses due to the Rupee's sharp appreciation earlier in the year**.** Other measures, designed to provide cheaper financing to exporters, include a reduction in the refinancing rate available through the State Bank of Pakistan. In addition, a "Textiles Package" has been announced for exporters that includes a 2-year extension for duty-free import of machinery; and promises of speedier tax refunds for exporters.

Chart 1: Growth Forecasts



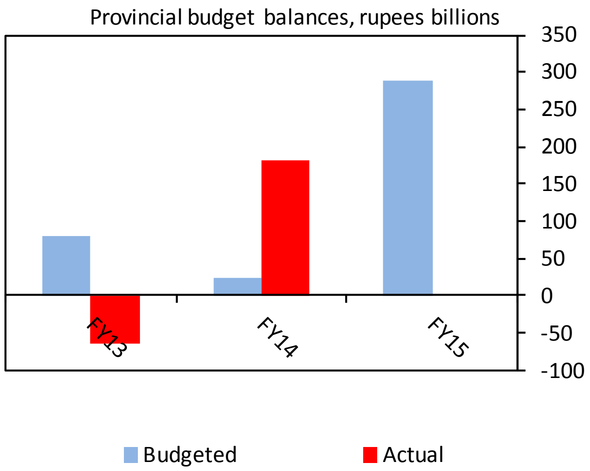
Source: Ministry of Finance

Chart 2: Fiscal Consolidation



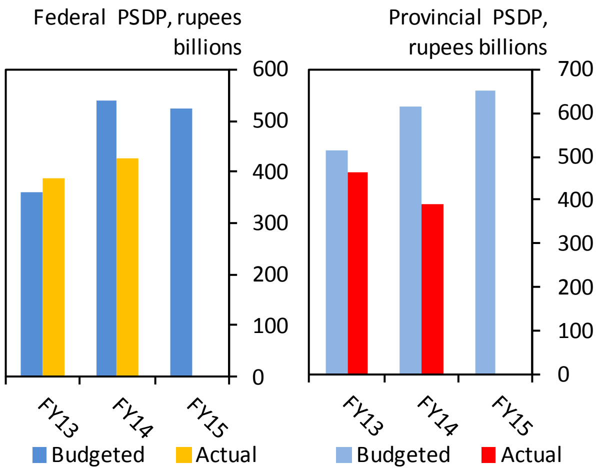
Source: Ministry of Finance

Chart 3: Provincial Surpluses



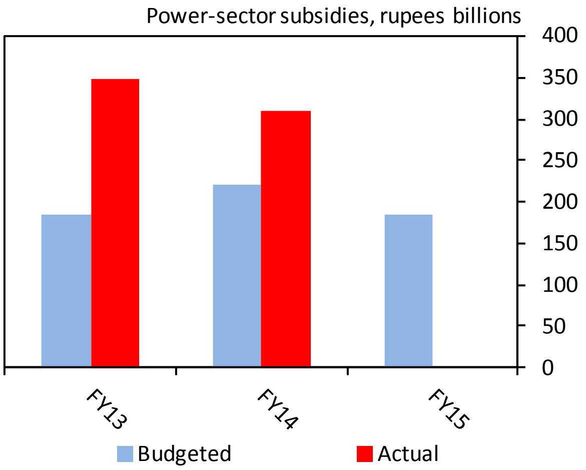
Source: Ministry of Finance

Chart 4: Public Sector Development Programme



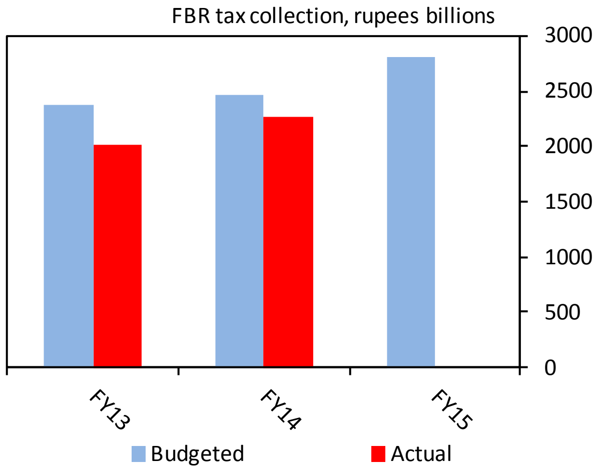
Source: Ministry of Finance; Analyst Estimates

Chart 5: Spending on Power Subsidies



Source: Ministry of Finance

Chart 6: Federal Tax Collection



Source: Ministry of Finance