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PAKISTAN ECONOMY UPDATE: JANUARY 2015

Medium-term economic challenges take a backseat as the Government turns to fire fighting a fuel crisis this month. There was a petrol shortage in the country, particularly in the Punjab. Limited fiscal room given IMF deficit targets means that short-term bailouts of the energy sector will be increasingly difficult to fund. Meanwhile, businesses facing energy and security challenges cheered the central bank's decision to cut interest rates 100 basis points to a 12-year low of 8.5%. While this has seen the Karachi Stock Exchange hit new all-time highs, sliding exports highlight the consequences of an overvalued rupee. So far, an on-track IMF programme has seen the central bank's foreign reserves improve; longer-term balance-of-payments sustainability will depend on an increase in export earnings.

1. **The country was hit by a petrol shortage this month, with fuel pumps, particularly in the Punjab, drying up. This caused panic buying that spread to other cities, including Karachi. Moody's has warned that the crisis could affect Pakistan's creditworthiness.** While power shortages in the country have become fairly standard; a shortage of petroleum products shocked the public. So far, despite initial fears of a knock-on effect on the power sector, due to a shortage of imported furnace oil, has been avoided. However, given that the level of fuel stocks available with power producers remains unclear, it is difficult to rule out a potential impact on electricity supply. Moody's, the ratings agency, has warned that the crisis has weighed on the country's creditworthiness, given the implications of the *circular debt* (unpaid bills in the energy sector) on the country's external and fiscal accounts. PM Sharif cancelled his trip to Davos to deal with the crisis. Reports suggest he has asked ministers to arrange funds for the state-owned oil company, Pakistan State Oil (PSO), to import sufficient fuel to avoid a repeat of last week's shortages.

2. **The shortage was the result of the *circular debt* cutting PSO off from bank credit to import POL.** But beyond unpaid bills, analysts highlight the role played by multiple ministries managing various parts of the energy sector in exacerbating the situation. On the one hand the Government slashed petrol prices by over a third to pass on the decline in global crude prices to consumers; on the other CNG supplies to pumps (a close substitute for petrol in the country) owing to natural-gas shortages. And while petrol demand expanded, supply did not keep up: the oil-sector regulator failed to ensure that oil companies maintained reserves for 20 days as required by their contracts. Against this backdrop, the minister for power has pushed back a self-imposed deadline to end power cuts to the summer of 2017.

Key Statistics[1]

- The State Bank of Pakistan expects GDP to grow between 4 to 5 % in the current fiscal year (see Chart 1).
- Annual inflation, measured by the Consumer Price Index, was 4.3% in December, up marginally from 4% the month before.
- Recent disinflation saw the central bank cut its policy rate 100 basis points, to a 12-year low of 8.5%.
- This propelled the Karachi Stock Exchange to a new all-time high – it crossed 34,500 points on news of the cut.
- The central bank's FX reserves increased to $10.5 billion by end-December up from $8.2 billion a month ago.
- But much of this increase reflects IMF disbursements and proceeds from a *Sukuk* bond issue late last year; the current account deficit widened to 0.9% of GDP from 0.8% last year.
- Mostly because the trade deficit worsened by over 11% as exports fell nearly 2%.
- The rupee's rise by 3.4% between Jul-Nov is seen as responsible. In real terms it has gained 1.8% over the same period (see Chart 6).

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 6M (Jul-Dec) unless otherwise indicated

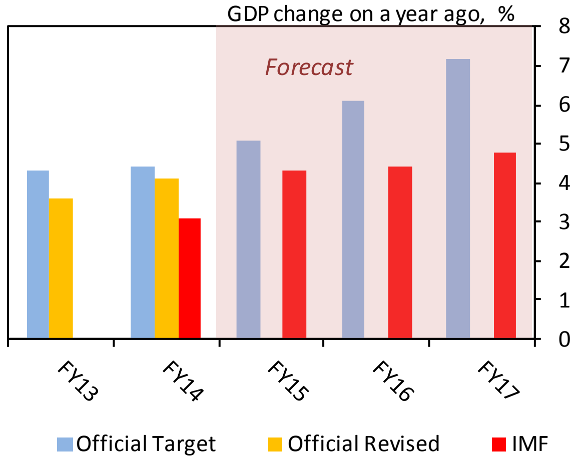
3. **Unaddressed, the circular debt is likely to continue jeopardising wider economic stability given the lack of fiscal room to strike anymore one-off bailouts of the power sector.** Although figures for the first quarter of the fiscal year show the fiscal deficit at 1.2% of GDP (within the IMF's 1.4% target); growth in overall revenues is lower than expected, mainly due to a legal impasse over collection of the Gas Infrastructure Development Cess (GIDC), a levy on gas consumption. It, therefore, remains to be seen how full-year fiscal targets will be achieved, especially as administered prices (e.g. energy) are revised downwards, hitting receipts of ad valorem taxes. For its part, to help meet a potential shortfall, the Government has imposed additional sales tax on petroleum products. Nevertheless, fiscal room to manoeuvre remains limited; making it much harder for the exchequer to bail the power sector out of its troubles. The crisis highlights these fiscal constraints on business-as-usual in the energy sector. Going forward, sans structural reform, the energy supply chain will continue to pose, what is perhaps, the biggest threat to the macroeconomic stability and prosperity in the country.

4. **The central bank responded to low inflation by cutting its benchmark interest rate by 100 basis points in a move widely expected by the markets.** The State Bank of Pakistan (SBP), citing an improvement in key macroeconomic indicators, cut interest rates to 8.5%, a 12-year low. Most analysts had expected a cut given that inflation stood at 4.3% in December (see Chart 2). Some of this reflects the global decline in crude oil prices, which the Government has passed on in large part to consumers. But the Bank noted that the decline was broad based, attributing the decline in food inflation to improved supply-side conditions. Looking ahead, the SBP emphasised "second-round" effects of lower energy prices on transport fares, saying that it expects average inflation for the full fiscal year to lie between 4.5% - 5.5%, well below the official 8.5% target. The central bank also appears concerned over a recent slowdown in growth of bank lending to the private sector. It sees this as the result of both supply and demand factors: a decline in commodity prices (making raw materials cheaper) and energy shortages. Central bankers hope that the decline in short-term interest rates will encourage banks to shift their focus away from investment in 'risk-free' government securities, towards private lending.

5. **The Karachi Stock Exchange hit a new all-time high following the move, as businesses cheered the Bank's decision as "growth supporting".** Unaffected by the fuel crisis – and general security situation in the country – the Karachi bourse's main 'KSE-100' index rose to just shy of 35,000 points on the news. Analysts expect the market (already one of the world's top performing with dollar returns of over 30% in 2014) to rise an additional 2-3% as investors switch portfolios from lower yielding government bonds to equities. Business groups have welcomed the move, although they had hoped for a larger 150 basis point cut. They believe lower financing costs would help them compete more effectively with regional producers in export markets where they have lost ground due to energy shortages. This is particularly true of the leveraged textile sector that has also been hurt by the overvalued rupee: profitability of the sector has suffered recently (see Chart 3). But while industrialists see the rate cut as good news, they remain critical of delays to the Government's 5-year Textile Policy – vital to medium-term investment plans – after the previous one expired in 2014.

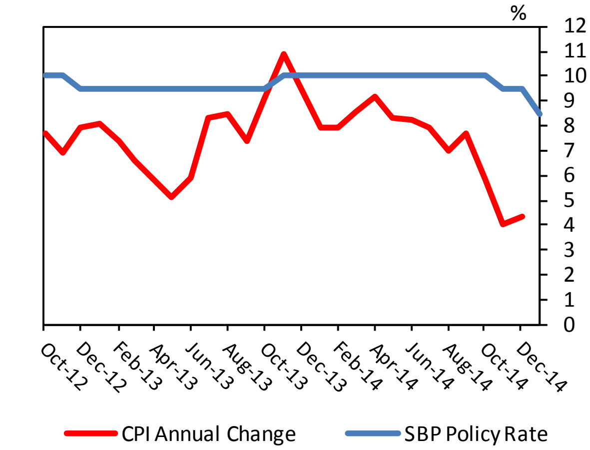
6. **While lower rates could provide some boost, a strong rupee has made it increasingly challenging for Pakistani exporters to compete in overseas markets.** The country's current account deficit is a fifth larger than the same period last year, largely due to a worsening trade balance. This means that much of the improvement in foreign reserves over last year is down to IMF disbursements; *Sukuk* issuance receipts; and growing remittances from overseas, including the UK (see Chart 4). Exports on the other hand, including textiles, have declined by around 2% over the same period last year; the notable exception is high-value added textile exports (e.g. clothing; see Chart 5). Analysts believe this reflects benefit to the industry from GSP+ status awarded to Pakistan by the EU last year. Nevertheless, business groups argue that the competitive edge from the preferential trading scheme is being eroded by the rupee's strength. The SBP itself noted in its latest monetary policy statement that the appreciation of the rupee in real terms is hurting the country's export competitiveness (see Chart 6). Looking ahead, analysts believe that the negative impact on textile margins of an overvalued rupee could worsen as a weaker euro - following monetary easing in the single-currency bloc (a key market for textile Pakistani exports) – makes Pakistan's dollar-priced exports costlier.

Chart 1: Economic growth



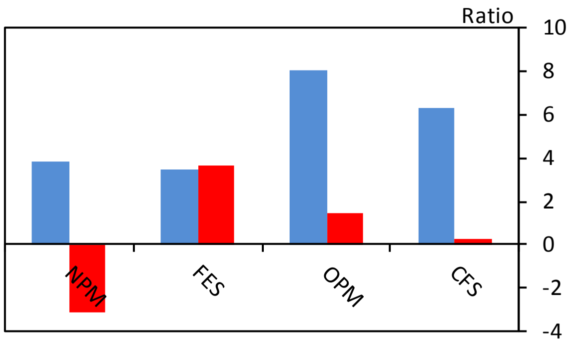
Source: Ministry of Finance; IMF

Chart 2: Inflation and monetary policy



Source: State Bank of Pakistan; Pakistan Bureau of Statistics

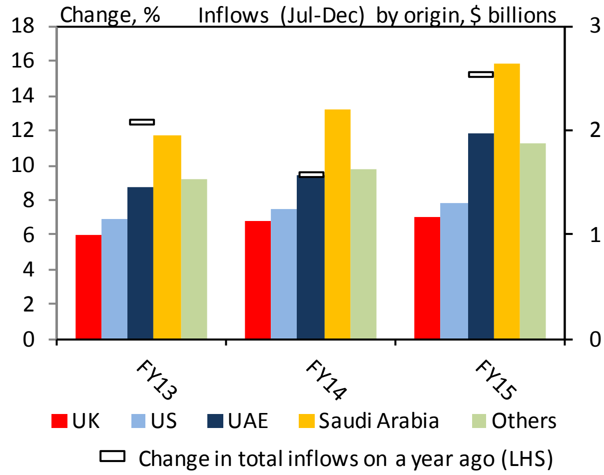
Chart 3: Textile sector profitability



NPM = Net Profit Margin; FES = Financial Expenses to Sales; OPM = Operating Margin; CFS = Cash Flow to Sales

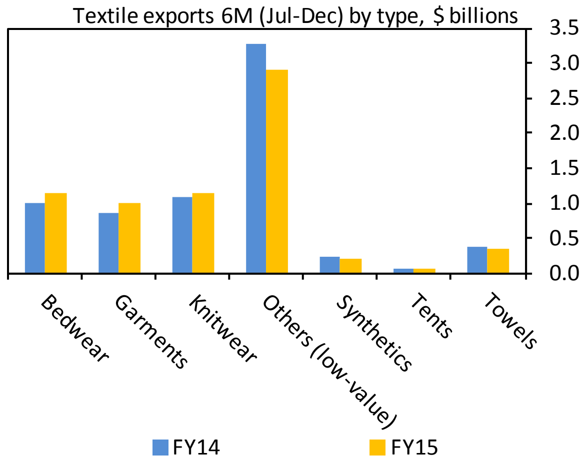
Source: State Bank of Pakistan

Chart 4: Overseas workers' remittances



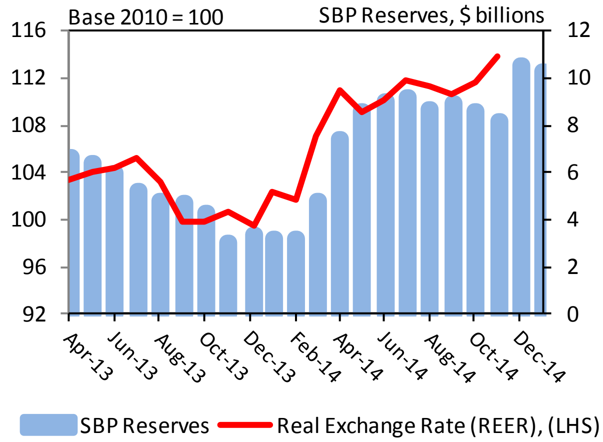
Source: State Bank of Pakistan; Analyst Estimates

Chart 5: Textile exports



Source: State Bank of Pakistan

Chart 6: Rupee rising



Source: State Bank of Pakistan

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