INSTITUTE FOR POLICY REFORMS

IPR REPORT

August 2014

Economic Review of 2013-14 And Outlook For 2014-15

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IPR Economic Series

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ACRONYMS

BOP	Balance of Payments
CSF	Coalition Support Fund
CCI	Council of Common Interests
EU	European Union
EFF	Extended Fund Facility
FBR	Federal Board of Revenue
FATA	Federally Administered Tribal Areas
FDI	Foreign Direct Investment
FPI	Foreign Private Investment
GDP	Gross Domestic Product
IDPs	Internally Displaced Persons
IMF	International Monetary Fund
KSE	Karachi Stock Exchange
K-PK	Khyber Pakhtunkhawa
LTFF	Long term Financing Facility
MNCs	Multinational Companies
NEC	National Economic Council
PML(N)	Pakistan Muslim League (Nawaz)
PSO	Pakistan State Oil
PSDP	Public Sector Development Program
SPI	Sensitive Price Index
TDS	Tariff Differential Subsidy
WAPDA	Water and Power Development Authority

Executive Summary

This report by the Institute for Policy Reforms(IPR) undertakes a review of the performance of the economy in 2013-14 and presents the likely economic outlook for 2014-15.

The year, 2013-14, has ended with a mixed performance. On the positive side stability has been achieved in the foreign exchange market, with a major appreciation in the value of the rupee after March 2014.Foreign exchange reserves have increased by over 50%, due largely to one-off inflows. Remittances have shown buoyancy, but exports have stagnated, despite the granting of GSP plus status by the EU.

On the negative side, there is controversy about the Government's claims of a GDP growth rate of over 4% in 2013-14. IPR estimates that at the maximum it is 3.5%, while IMF believes that it is 3.3%. The latter estimates imply that the growth rate of the economy has been the lowest in the last four years.

Other targets that have been missed include a higher rate of inflation than anticipated; lower investment and savings rates; rising unemployment rate which has crossed 7% in 2013-14.

The Governments' claim that the fiscal deficit target of 5.8% of GDP has been met is based on substantial overstatement of the combined cash surplus of the Provincial Governments by almost Rs.150 billion. As such, the actual fiscal deficit is closer to 6.4% of the GDP.

Turning to the economic outlook for 2014-15, it needs to be recognized that this year is characterized by greater uncertainty than is normally the case. At the global level, the world economy is floundering once again and growth forecasts have been revised downwards. There are many more flashpoints of conflict in the Middle East and elsewhere. The oil price is showing greater volatility.

On the domestic front, the army is engaged in military operations (Zarb-e-Azab) and there is the possibility of a blow back. The political situation has become more tense and unpredictable, with parties both inside and outside the Parliament threatening marches to Islamabad.

In this environment of uncertainty, most Government targets appear very ambitious for 2014-15.The growth projection of over 5% is based on a bigger cotton crop and a surge in the large-scale manufacturing sector by 7%. The outcome will depend on the extent of improvement in the load shedding situation and performance of exports. IPR expects that the GDP growth rate will remain range bound at 3.5 to 4%, like the last six years.

The prospects for investment will be negatively impacted upon by the perceptions of risk. Also, the extent to which the development plans of the Federal and Provincial governments for 2014-15 are implemented will determine the rise in the investment rate.

The projected inflation rate could range from 7% to 10% depending on, first, whether oil prices rise, second, on the extent to which the Government raises power and gas tariffs and, third, on the degree of depreciation (if any) in the value of the rupee. The IMF projects this at over 8% in 2014-15.

A big reduction is proposed in the budget deficit to 4.9% of the GDP in 2014-15. This is based, first, on over 24% growth in tax revenues, second, on a massive provincial cash surplus of Rs.289 billion (almost 1% of the GDP).These optimistic projections are unlikely to materialize and either the PSDP will be cut once again or the consolidated deficit will approach 7% of the GDP.

On the balance of payments side, it is expected that foreign exchange reserves will rise from $9 billion to $13.5 billion by the end of 2014-15. This is premised based on, first, export and remittances growth of 4 and 9 percent respectively, second, doubling of foreign direct investment (excluding privatization receipts), third, a second round of flotation internationally of bonds of $1 billion and, fourth, privatization proceeds of $2 billion. No provision has been made for higher oil prices. IPR projections of the balance of payments are more conservative, with reserves staying at just below $10 billion.

Overall, IPR projections for 2014-15, as compared to those by either the Government or the IMF are given below:

	Government / IMF	**IPR**
GDP Growth Rate (%)	4.0-5.1	3.5-4.0
Rate of Investment (%)	16.1	15.0
Rate of Inflation (%)	8.0	7.0-10.0
Fiscal Deficit (% of GDP)	-4.9	-7.2
Current Account Deficit (% of GDP)	-1.1	-1.8
Foreign Exchange Reserves ($ billion)	13.5	9.8

ECONOMIC REVIEW OF 2013-14 AND OUTLOOK FOR 2014-15

The year 2013-14 has just come to an end. It was the first year of the PML (N) government. The year started with negotiations with the IMF on an Extended Fund Facility (EFF) in the presence of foreign exchange reserves of $6 billion and larger net financing needs in 2013-14. The agreement with the IMF was reached for funding of $6.6 billion, spread over three years in twelve equal quarterly installments. Five prior actions had to be implemented, including the presentation of a budget for 2013-14 with a sharp targeted reduction in the fiscal deficit (from 8% to 5.8% of the GDP) and a big increase in power tariffs.

The year has ended with a mixed performance. On the positive side, stability has been achieved in the foreign exchange market, with a major appreciation in the value of the rupee after March 2014. This is due primarily to the increase in foreign exchange reserves to over $9 billion by the end of the year, an increase of over 50%. However, the rise is due to one-off inflows, in the absence of which reserves would have fallen.

On the somewhat negative side, there is an on-going controversy on the growth rate of the GDP. Inflation has persisted at a high single digit rate. Private investment has fallen in real terms. The fiscal deficit target has not been met, despite Government's claims to the contrary.

The objectives of this report are twofold. First, we analyze in some depth the outcome in 2013-14. Second, the economic outlook for 2014-15 is derived under different scenarios.

2. ECONOMIC REVIEW 2013-14

The outcome of key macroeconomic variables is presented below:

2.1 Growth

The growth target with the IMF in September 2013, at the time of the signing of the agreement was 2.5%. This clearly implied that the process of stabilization would initially slow down the growth of the economy. This growth rate was raised by the IMF following each successive review, culminating in a growth rate projection of 3.3% in the third review conducted in May 2014.

As opposed to the target in the Fund program, the government set more ambitious targets in the Annual Plan for 2013-14, approved by the National Economic Council

(NEC). The GDP was expected to grow by 4.3% in this Plan, with 3.8% in agriculture, 4.8% in industry and 4.6% in services.

The Pakistan Economic Survey indicates that the GDP growth rate actually achieved is 4.1%, the highest in six years. The sectoral growth rates are 2.1% in agriculture, 5.8% in industry and 4.3% in services. Therefore, while agriculture has not done well, there has been an exceptional performance by the industrial sector.

The GDP growth rate of 4.1% is disputed by IPR. The growth rate of large-scale manufacturing of 5.3% is for the eight months period, July-Feb. In March, the growth rate is a negative 2.7%. Consequently, the nine–month growth rate for July-March has fallen to 4.3%. The normal practice is to base the provisional figures in the GDP on the the nine monthly growth rate.

As such, the growth rate of large-scale manufacturing has been overstated by 1%. This also has a consequential effect on the growth rate of the wholesale and retail trade sector. The reduction in the growth rate of the two sectors brings down the GDP growth rate by 0.2 percentage points.

Similarly, the growth rate of the construction sector of 11.3% appears too high, given that the consumption of the key input, cement, has increased by 4.2%. This reduces the GDP growth rate by another 0.2 percentage points.

88% of the value added banking and insurance sector is generated by commercial banks. Banks have shown a decline in profitability in real terms of over 15%. Therefore, the growth rate of this sector is unlikely to be 5.2% in 2013-14. It is probably negative. This reduces the GDP growth rate by another 0.2 percentage points at the minimum.

Overall, we estimate that the maximum growth rate of GDP in 2013-14 is close to 3.5%, and not 4.1%. This means that the GDP growth rate in 2013-14 is the lowest in the last four years.

Another indicator of the overstatement of GDP growth is the phenomenal increase of household final consumption expenditure by almost 6% in 2013-14. This is substantially higher than the growth rate last year of only 2.5%.

The explanation for the high growth rate is that household final consumption expenditure is estimated as a residual. If GDP obtained from the production side is overstated while investment, exports and imports are properly estimated than the residual tends to be overstated.

It is hardly likely that consumption standards of the people have gone up as much as 6% in 2013-14. If anything, sharply rising food prices have probably restrained consumption of basic food items, like atta, vegetables and pulses.

2.2 INVESTMENT

There was generally the expectation that following the induction of a business-friendly government of the PML (N), private investment would respond strongly. But there are some major retarding factors including a bad security situation, due to acts of terror; poor law and order conditions, especially in Karachi, and the shortage of electricity and gas.

Therefore, private investment has remained shy. It has fallen by 1.6% in real terms in 2013-14. A large fall of 27% has been observed in the large- scale manufacturing sector. Also, despite the signing of many agreements, investment in the power sector has declined by over 9%.

Public investment has shown some growth of over 7.3%. However, this may be overstated given the big cuts in the PSDP size by the Federal and Provincial governments during the year. Overall, the investment-to-GDP ratio has fallen from 14.6% in 2012-13 to 14.1% in 2013-14. This is possibly the lowest investment rate ever.

2.3 EMPLOYMENT

The labor force is estimated at 61.5 million in 2013-14, with an increase of 1.8 million during this year. With a GDP growth rate of 3.5% and an employment elasticity of 0.6% with respect to output, the number of new jobs created is 1.2 million. Therefore, the number of unemployed has increased by 600,000 in 2013-14, an increase of 15%. Consequently, the unemployment rate has risen significantly from 6.2% to 7%.

2.4 INFLATION

The government had targeted for a rate of inflation in the consumer price index of 8%. The actual average for the year is 8.6%, with the end- period inflation at 8.2%. Initially there was an upsurge in the rate of inflation **(see Table 1)** from 5.9% in June 2013 to 10.9% in November 2013. The year-to-year inflation in the Sensitive Price Index (SPI) in the latter month went up to as high as 13%. In fact, the rate of inflation in the SPI appears to be understated by almost 3 percentage points, due to the lack of incorporation of the rise in electricity tariffs for domestic consumers (except life-line consumers).

Table 1

INFLATION SNAPSHOT (2007-08 =100)

	CPI			SPI	Core Inflation	
	General	Food	Non-Food		NFNE	Trimmed
FY 10	10.1	12.9	8.3	13.4	7.6	9.5
FY 11	13.7	18	10.7	17.3	9.4	12.7
FY 12	11	11	11	8.9	10.6	11.5
FY 13	7.4	7.1	7.5	6.1	9.6	9
FY 14	8.6	9	8.3	10	8.3	8.5
Jun-14	5.9	7.9	4.4	4.6	7.8	6.8
Jul-14	8.3	9.2	7.6	9.1	8.2	7.8
Aug-14	8.5	10.3	7.3	9	8.5	7.9
Sep-14	7.4	7.9	7	7.9	8.7	7.6
Oct-14	9.1	9.8	8.6	10.9	8.4	9
Nov-14	10.9	13	9.4	14.6	8.5	9.2
Dec-14	9.2	9.3	9.1	12.1	8.2	8.7
Jan-15	7.9	7.2	8.4	9.5	8.1	8.2
Feb-15	7.9	7.6	8.2	9.3	7.8	8.1
Mar-15	8.5	9.3	8	10.5	7.6	8.1
Apr-15	9.2	9.9	8.7	10.3	8.5	9
May-15	8.3	7.4	9	9.3	8.7	8.3
Jun-15	8.2	7.4	8.9	8	8.7	7.9
FY 13						
Jul-Jun	7.4	7.1	7.5	6.1	9.6	9
FY 14						
Jul	8.3	9.2	7.6	9.1	8.2	7.8
Jul-Aug	8.4	9.7	7.4	9.1	8.4	7.9
Jul-Sep	8.1	9.1	7.3	8.7	8.5	7.8
Jul-Oct	8.3	9.3	7.6	9.2	8.4	7.9
Jul-Nov	8.8	10	8	10.3	8.5	8.2
Jul-Dec	8.9	9.9	8.2	10.6	8.4	8.3
Jul-Jan	8.8	9.5	8.2	10.5	8.4	8.4
Jul-Feb	8.6	9.3	8.2	10.3	8.3	8.4
Jul-Mar	8.6	9.3	8.2	10.3	8.2	8.4
Jul-Apr	8.7	9.3	8.2	10.3	8.2	8.5
Jul-May	8.7	9.2	8.3	10.2	8.3	8.5
Jul-Jun	8.6	9	8.3	10	8.3	8.5

Source: SBP

This jump in inflation is attributable, first, to a big escalation in industrial and commercial tariffs of over 35% on average in August 2013. Second, the rupee began to fall rapidly, depreciating by almost 8.6%. Third, there was a large amount of printing of money by borrowings from the Central Bank.

The rate of inflation has tended to moderate since November 2013, reaching a lower rate of 8.2% by June 2014. First, following receipt of a large grant from a friendly country the rupee has appreciated by 9.4%. This has brought down inflation especially in items like rice, vegetable ghee and petroleum products. Second, the procurement price of wheat was not changed for the 2014 crop. Third, following large external inflows, borrowings from the SBP have been brought down.

It is significant that the fall in the rate of inflation has been greater in food than non-food prices since November. However, a disturbing recent development is the rise in the rate of 'core' inflation. It has gone up from 7.6% in March 2014 to 8.7% in June 2014. This indicates the persistence of demand pressures in the economy.

2.5 PUBLIC FINANCES

The government has declared victory on the front of stabilization of the fiscal position of the country. The consolidated fiscal deficit had reached the high level of 8.5% in 2011-12 and 8% of the GDP in 2012-13. The Government claims to have brought down the fiscal deficit to 5.8% of the GDP and met the target agreed with the IMF for 2013-14, a reduction of over 2% of the GDP in one year.

But the quality of adjustment has not been of a high quality. There has been, in fact, a shortfall in revenues of FBR of Rs.200 billion in relation to the target. This has been compensated for by a massive reduction in the combined PSDP of the Federal and Provincial Governments of Rs.300 billion, equivalent to a cut back of 27%.

There is also one serious problem with regard to the magnitude of the surplus generated by the four provinces combined in 2013-14. The Federal Government claims that this is Rs.183 billion **(see Table 2).** But examination of the Provincial Budget Documents reveals, according to the revised estimates for 2013-14, that the combined surplus in much smaller at Rs.34 billion (see Statistical Appendix). Therefore, the consolidated fiscal deficit has been understated by Rs.149 billion. As such, the consolidated fiscal deficit in 2013-14 is 6.4% of the GDP, not 5.8% of the GDP.

Table 2

PUBLIC FINANCES IN 2013-14

(without Grants)

Head	IMF Projection (after Third Review)	Federal Government (Revised Estimates)	IPR (based on Federal and Provincial Revised Estimates)
FEDERAL			
Tax Revenue	2527	2514	2514
Non-Tax Revenue	841	879	879
Total Revenues	**3368**	**3393**	**3393**
Less Transfers to Provinces [a]	-1413	-1413	-1413
Net Revenue Receipts	**1955**	**1980**	**1980**
Current Expenditure [b]	**3124**	**3067**	**3067**
Development Expenditure and Net Lending	**372**	**569**	**569**
Federal Fiscal Deficit	**-1541**	**-1656**	**-1656**
PROVINCIAL			
Revenue Receipts [c]	**1658**	**-**	**1789**
Current Expenditure	**1200**	**-**	1276
Development Expenditure	**375**	**-**	**479**
Provincial Fiscal Surplus	**83**	**183**	**34**
Consolidated Fiscal Deficit	**-1459**	**-1473**	**-1622**
% of GDP	**5.7**	**5.8**	**6.4**

Source: IMF Staff Report, Third Review; MOF: Budget in Brief, PGs, ABS

2.6 BALANCE OF PAYMENTS

There has been considerable divergence in the actual balance of payments in 2013-14 as compared to the original projection made by the IMF at the time of commencement of the EFF **(see Table 3**). The big deviations are described below:

i. The current account is likely to be substantially worse by over $ 1.5 billion. This is due, first, to a poor performance of exports, with growth in the first eleven months of only 1.3%, as compared to the original projected growth rate of 11.1%. The GSP plus status was given by the EU in January 2014. But Pakistani

exporters have not been able to take advantage of this concession due to supply bottlenecks and an apparently overvalued exchange rate since March 2014 (the real effective exchange rate has gone up by 4.6% from June 2013 to June 2014). Second the Services account has suffered a larger deficit due to lower inflows of Coalition Support Fund (CSF) installments. Third, the net outflow on the income account has been larger, due to bigger repatriation of profits by multi-national companies.

a. Fortunately, the deterioration in the current account has been limited, first, by lower growth in imports and, second, by faster growth in remittances of 12.4%. However, it is a matter of concern that no major steps have been taken for improving the current account of the balance of payments.

ii. The inflow into the capital account has been substantially larger because of the 'gift' of $ 1.5 billion by a friendly country.

iii. The financial account is likely to perform somewhat better with expected net receipts of over $ 4.5 billion in 2013-14. But this is attributable largely to the successful flotation of $ 2 billion worth of Eurobonds, at high cost. As opposed to this, foreign direct investment (including privatization receipts) is almost 40% less than the original projection.

iv. The overall balance of payments surplus is likely to be about $ 3.5 billion in 2013-14, about $ 500 million larger than initially anticipated. But the surplus is entirely attributable to one-off flows of a 'gift' of $ 1.5 billion and Eurobonds of $ 2 billion.

v. After net repayment to the IMF, foreign exchange reserves are expected to cross $ 9 billion by the end of June 2014. On the 27th of June, reserves actually stood at $ 9.033 billion, equivalent to over two months import cover.

Overall, the balance of payments has stabilized largely with the help of one-off inflows and the rupee has appreciated consequently. But many of the other targets set by Government have not been achieved in 2013-14. This includes the GDP growth rate, rate of inflation, rate of investment, growth in exports and tax revenues. There is also the claim that the fiscal deficit target agreed with the IMF has been met. But this does not seem to be grounded in reality.

Table 3

BALANCE OF PAYMENTS IN 2013-14

($ Million)

	IMF Projection		Actual
	Original	After Third Review	(July 2013 to May 2014)
A. Current Account	**-1318**	**-3030**	**-2577**
Balance on Goods	**-14984**	**-16549**	**-14908**
Exports	27561	25695	22799
Imports	42545	42244	36907
Services (Net)	**-1143**	**-2111**	**-2070**
Income (Net)	**-3191**	**-3952**	**-3641**
Current Transfers (Net)	**18000**	**19581**	**18272**
Worker's Remittances	14191	15314	14333
B. Capital Account	**349**	**2018**	**1753**
C. Financial Account	**3938**	**4981**	**4364**
Foreign Direct Investment	**2327**	**1270**	**1362**
Portfolio Investment (Net)	**358**	**2248**	**2331**
General Government (Net)	**1305**	**796**	**976**
Disbursements	3509	4229	3672
Amortization	2203	3433	2915
Others	**-52**	**667**	**-305**
D. Errors and Omissions	**0**	**-220**	**-204**
E. Balance of Payments	**2969**	**3749**	**3336**
F. Net Repayment to IMF	**-911**	**-270**	**-469**
G. Change in FE Reserves	**2058**	**3479**	**2867**

Source: IMF Staff, Third Review SBP

3. ECONOMIC OUTLOOK FOR 2014-15

We first describe the setting, both globally and nationally which will influence the performance of the economy in 2014-15.

3.1 THE SETTING

3.1.1 Global

A few months ago there was a general feeling that the world economy was beginning to revive strongly. The April 2014 projections of the IMF **(see Table 4)** were upbeat.

Table 4

WORLD ECONOMY PROJECTIONS

(%)

	2012	2013	2014	2015
World Economy				
Growth Rate	3.22	3.01	3.59	3.88
Inflation	3.78	3.3	3.66	3.53
Growth in Volume of Trade	2.82	3.02	4.35	5.25
Advanced Economies				
Growth Rate	1.42	1.29	2.22	2.35
Inflation (%)	1.97	1.37	1.52	1.64
Growth in Volume of Trade (%)	1.1	1.39	3.52	4.47
Euro Area				
Growth Rate (%)	-0.68	-0.46	1.16	1.46
Inflation (%)	2.5	1.34	0.92	1.17
Growth in Volume of Trade (%)	-1.11	0.26	2.79	3.46

Source: IMF, **World Economic Outlook**, April 2014

The growth rate of the world economy was expected to rise to above 3.5% in 2014 and approach 4% in 2015. There was also an anticipation of more rapid growth in the volume of trade. But, more recently, the Managing Director of IMF has stated that 'global economic recovery remains fragile and laborious'. She says that the April projections will have to be revised downwards and has argued in favor of a fiscal stimulus by advanced economics.

There are also more flash points of conflict. The Middle East is in a general state of turmoil. There are problems of Ukraine with Russia. All these happenings have implications on energy prices.

In fact, international oil prices have shown a rising tendency since early June 2014. They reached a peak on 7th of June 2014 and have fallen somewhat since then. But forecasts of the outlook for oil prices in the latter part of 2014 is an increase of at least 5% in relation to the corresponding period of 2013.

Overall, the global setting is unlikely to be favorable. Pakistan could have difficulty in raising exports more rapidly and the import bill could rise significantly due to higher oil prices.

3.1.2 National

The domestic situation has also changed qualitatively. Pakistan has launched military operations (Zarb-e-Azb) against the militants in FATA. Almost one million IDPs have arrived in the settled areas of K-PK. They need all kinds of support.

There is danger of a blowback in the form of acts of terrorism. Fortunately, no major incident has taken place since the start of war operations. But risk perceptions are high, and are likely to affect adversely the pace of economic activity in the country.

Simultaneously, the political situation has become more volatile. The opposition, both within and outside the Parliament, is threatening to launch movements, culminating in a march to Islamabad.

In the close neighbourhood, in Afghanistan, contested election results have led to a severe political polarization. If a solution is not found for a peaceful transition of power, then the country runs the risk of a civil war or fragmentation. In either case, there could be an inflow of a large number of refugees into Pakistan, as happened earlier.

Overall, the global and national settings are both not conducive for a strong upsurge in the rate of growth in 2014-15. There is the possibility of a number of negative shocks. Already, the stock market in Karachi is beginning to reflect higher perceptions of risk. Recent performance of the KSE has been lackluster and trading volumes have declined by almost two-thirds.

3.2 THE TARGETS FOR 2014-15

We discuss below the macroeconomic targets for 2014-15 as contained in the Annual Plan approved by the National Economic Council (NEC). We also present the projections made by the IMF following the third review **(see Table 5)** for 2014-15.

Table 5

TARGETS / PROJECTIONS FOR 2014-15

(%)

	Annual Plan Target*	**IMF Projections (Third Review)**
GDP Growth	**5.1**	**4.0**
Agriculture	3.3	-
Industry	6.8	-
Services	5.2	-
Rate of Inflation	**8.0**	**8.1**
Rate of Investment (% of GDP)	**16.1**	**16.9**
Size of PSDP (Federal + Provincial) (Rs in Billion)	**1175**	**1011**

3.3 GROWTH

Based on the GDP growth rate of 4.1% in 2013-14, the Government expects to raise it to 5.1% in 2014-15. As opposed to this, with an estimated GDP growth rate of 3.3% in 2013-14, the IMF projects a growth rate of 4% in 2014-15. The important point is that the Government and the IMF both expect the growth rate of the economy to rise significantly.

But can higher growth be taken for granted as the likely outcome in 2014-15? This is not necessarily the case. Both the global and national settings are less conducive for higher growth, as highlighted earlier. Export growth is likely to be constrained by slow expansion in world trade. Private investment, both domestic and foreign, may be adversely affected by the on-going war on terror, worsening political conditions and a bad law and order situation.

The GDP growth rate can only pick up if a number of conditions are met. First, there has to be a quantum improvement in the power load shedding situation. Currently, during the summer, the incidence of power outrages has increased visibly. The demand – supply gap has exceeded 30% (see Box 1). Given the gestation period of new power projects and investments in transmission, it will take another two to three years for generation capacity to expand sizably. Meanwhile, the problem could worsen if the Government does not move decisively to solve the problem of over Rs.350 billion of circular debt in the power sector.

Box 1

STATE OF THE POWER SECTOR

- According to the PES in July-March 2013-14, the increase in installed capacity for electricity is only **197 MW**, not 1**700 MW** as reported by the Government.
-
- The T & D System Losses are as follows:

	July-March	
	2012-13	2013-14
Generation	66962	73435
Consumption	57754	62015
Loss (%)	13.75%	15.55%

- PEPCO billing losses have increased from 10% to 13% during the period, July to February 2013-14.
- Thermal power generation has increased by 4% in July-March, 2013-14. The supply of gas to the power sector has fallen by 8%.
- Reappearance of circular debt of Rs 350 billion after retirement of Rs 480 billion in late June 2013 and early July 2014.
- Power load shedding currently ranges from 8 to 12 hours in the urban areas and 12 to 16 hours in rural areas.
- The Minister of Water and Power has highlighted that the poor state of the transmission and distribution system is the principal constraint to increased supply of electricity to consumers. The demand-supply gap has exceeded 30%.

Second, the combined PSDP of the federal and provincial governments, as per the Annual Plan, of Rs.1175 billion will need to be fully executed. The fiscal multiplier of such expenditure to be large. Any shortfall will have a negative impact on the growth rate.

The leading sector in the growth process in 2014-15 is expected to be the industrial sector, with a growth rate approaching 7%. Such a high growth rate has not been achieved since the 'boom' years of the Musharraf era. Recent trends in the large-scale manufacturing sector have been, in fact, worrying. During the last three months, February to May 2014, for which data is available, the sector has shown a growth rate of only 2%. The cumulative growth rate, over the 10 month period, July 2013 to May 2014, is 4.1%.

Further, the growth in the large-scale manufacturing sector in 2013-14 has been concentrated in a few industries only, including fertilizers at 20%, beverages at 31% and sugar at 11%. The fertilizer industry is likely to suffer a big decline in output in 2014-15 because the preferential gas allocation policy to it has been withdrawn. Also the increase in sales tax/excise duty in the Federal Budget of 2014-15 on steel, cigarettes and cement is likely to negatively impact on these industries. Sugar output is likely to decline with a fall in the size of the sugarcane crop.

Overall, for all the reasons given above, we expect the GDP growth rate in 2014-15 to remain restricted in the range of 3.5 to 4%, as has largely been the case since 2007-08. Conditions are not yet favorable for getting on the path of relatively high growth of above 5%.

3.4 INVESTMENT

In comparison to the investment rate of just above 14% of the GDP in 2013-14, both the Annual Plan and the IMF expect the rate to jump up significantly to above 16% of the GDP. This will be the first time the rate of investment will have crossed 16%, since 2007-08, if it happens.

For this target to be achieved, public investment will need to rise by about 1% of the GDP. This will require not only that the combined PSDP reach 4% of the GDP but also that self-financing by corporations like WAPDA is substantially higher.

The outlook for private investment is not promising, given the heightened perception of risk. The government has tried to counter this by providing strong fiscal incentives in the Budget of 2014-15. The corporate tax rate for foreign direct investment has been brought down to 20% in comparison to the statutory rate of 33%. Exporters have been

given access to the LTFF of the SBP at a concessionary rate (two percentage points reduction). Hopefully, this will ensure that the rate of private investment will not fall below its present level.

Overall, given the risk perceptions, a good outcome will be if the economy reaches an investment rate of 15% of the GDP in 2014-15. As Chinese money starts pouring into infrastructure projects, the rate of investment should rise rapidly from 2015-16 onwards. However, these borrowings will put pressure on the fiscal deficit.

3.5 INFLATION

We have developed two scenarios on the rate of inflation in 2014-15. The key elements of each scenario are given in **Chart 1**

Chart 1

DIFFERENT INFLATION SCENARIOS

High Inflation Scenario	Low Inflation Scenario
• Significant increase in international oil prices of 5% or more	• No increase in international oil prices
• Big increase in gas price	• Small increase in gas price
• Increase in power tariffs	• No increase in power tariffs
• Higher fiscal deficit leading to large borrowings from SBP	• Fiscal deficit close to target and limited borrowings from SBP
• Significant depreciation of the rupee	• More or less, stability of the nominal exchange rate
• Failure of minor crops (vegetables, pulses, etc.)	• Growth in minor crops of over 3.5%
• Big increase in procurement price of wheat	• Small increase in procurement prices of wheat
Projected Rate of Inflation 10%	7%

The greatest uncertainty at this time is about the level of oil prices in 2014-15. Estimates are that a 5% increase in the domestic prices of petroleum products raises the rate of inflation by one percentage point. Other factors in a relatively high scenario of 10% inflation are increase in gas prices and power tariffs, as promised to the IMF. Also, the extent of borrowing from the SBP is higher in this scenario and food prices remain

vulnerable to supply shortages. Further, there is significant depreciation of the rupee in this scenario**(see Box 2).**

The forces operating on inflation impact with less intensity in the low inflation scenario. In this case, the rate of inflation in 2014-15 could fall from above 8% currently to about 7%.

3.6 PUBLIC FINANCES

The Government and the IMF have agreed to a fiscal deficit target of 4.9% of the GDP for the federal and provincial governments combined. This will represent a significant reduction in relation to 2013-14. If achieved, this will also be the first time since 2006-07 when the fiscal deficit falls below 5% of the GDP. But we have serious doubts about the feasibility of such a large deficit reduction for reasons given below.

3.6.1 Tax Revenues

We first take up the projection of FBR revenues at Rs.2810 billion for 2014-15 **(see Table 6)**. This is based on normal growth of Rs.305 billion from the level likely to be attained in 2013-14 of Rs.2275 billion and on a set of taxation proposals with the expected yield of almost Rs.230 billion.

The problem is, first, that the normal growth of tax revenues will be lower next year. The appreciation of rupee implies that the rupee value of imports will rise only modestly next year, thereby affecting the growth of almost 40% of FBR revenues.

Second, the taxation proposals may not yield as much as projected for the following reasons:

I. The sales tax SROs that have been withdrawn include many raw materials intermediate goods and capital goods. Revenues that accrue from these items at the import stage could be largely input tax invoiced away at the stage of domestic manufacturing.

II. Part of the increase in revenue from advance or withholding taxes may be reflected in lower tax payments with returns or in higher refunds.

III. Some of the new impositions of taxes will fall on very elastic tax bases like cigarettes (due to evasion) and bonus shares (companies will instead pay higher dividends or build reserves). Consequently, the additional revenue yield will be small.

We project that FBR revenues will reach about Rs.2660 billion, with a growth of 17%, like last year. The shortfall could be as large as Rs.150 billion, due to the above mentioned reasons. In addition, there will be a shortfall in GIDC revenues of almost Rs.60 billion.

3.6.2 Non-Tax Revenues

Turning to non-tax revenues, two sources are uncertain. The first is defense receipts of Rs.140 billion, consisting primarily of reimbursements from the Coalition Support Fund (CSF). These flows may decrease following a significant US withdrawal from Afghanistan.

Second, SBP profits may not reach the high level of Rs.270 billion. These profits will be reduced by the cost of export incentives provided in the Budget of cheaper export finance and the long term financing facility.

3.6.3 Expenditure

On the expenditure side interest payments have been projected at Rs.1325 billion, with growth of 11.6% over the estimate for 2013-14. This appears to be on the low side for the following reasons:

I. Since 2010-11, the annual growth rate in costs of debt servicing has been high, approaching 19%.
II. The composition of domestic debt in 2013-14 has shifted towards relatively high cost PIBs, away from treasury bills.
III. The interest cost on the Eurobonds alone will be about Rs.16 billion
IV. Interest costs were underestimated in the budget of 2013-14 by Rs.40 billion.

We expect that the interest payments in 2014-15 will be at least Rs.50 billion higher than budgeted.

The Federal Budget makes no provision for the retirement of circular debt in the power sector of almost Rs.350 billion. Maybe the government is proposing to adopt, at least partly, a quasi-fiscal route. This involves direct borrowing from the banking system of entities like Pakistan State Oil (PSO), the gas companies, etc., with guarantees from the government.

The proposal for reduction in the tariff differential subsidy (TDF) by Rs.124 billion is also of a tenuous nature. Given the high levels of load shedding, any significant increase in power tariffs at this time could lead to large-scale power riots.

3.6.4 Provincial Cash Surplus

Realizing the consolidated fiscal deficit target of 4.9% of the GDP requires the generation of a massive cash surplus of Rs.289 billion by the four provincial governments combined. This is well beyond the realm of possibilities.

Examination of the four Provincial Budgets for 2014-15 (see Statistical Appendix) reveals that all provinces have presented deficit budgets. The incentive to do so is that negotiations for the 8th NFC will be starting shortly and the provinces have strong incentives to spend more in order to establish higher benchmarks. However, some of the provinces may not be able to reach their ADP targets due to limits to institutional capacity.

Overall, our projections of public finances in 2014-15 are compared with the official projections in Table 6. The divergence is extremely large in the size of the consolidated deficit. As compared to the target deficit of 4.9% of the GDP, the actual deficit may exceed 7% of the GDP.

Our projection could be considered in the nature of the 'worst case scenario'. But it is clear that the government will have to work extremely hard to meet the fiscal targets agreed with the IMF. This will include redoubled efforts to convince the provincial governments in the CCI to generate larger surpluses. Further, given the nature of commitments to the IMF, the likelihood of mini budgets is high in 2014-15.

Table 6

PROJECTIONS OF PUBLIC FINANCES IN 2014-15

(Rs in Billion)

	Projection by Federal Government	**IPR Projection**
A. Federal Revenues	**3945**	**3645**
Tax Revenues	3129	2919
(FBR Revenues)	(2810)	(2660)
Non-Tax Revenues	816	726
B. Transfers to Provinces	**1720**	**1630**
C. Net Revenue Receipts	**2225**	**2015**
D. Current Expenditure	**3292**	**3442**
E. Development Expenditure and Net Lending	**645**	**745**
PSDP	525	525
Net Lending	120	220
F. Provincial Surplus	**289**	**100**
G. Consolidated Fiscal Deficit	**-1423**	**-2072**
H. GDP	**28832**	**28832**
I. Consolidated Fiscal Deficit as % of GDP	**4.9**	**7.2**

Source: MOF, Budget In Brief, 2014-15

3.7 Balance of Payments

The balance of payments projections for 2014-15 are also fraught with considerable uncertainty, due, first, to the prospect of a rise in international oil prices. Second, higher perceptions of risk due to the on-going war operations and a politically volatile situation, foreign investment into Pakistan may remain shy. Fortunately, Moody's has recently upgraded Pakistan's credit rating.

A comparison is made of our projections with those by the IMF, after the third review, in Table 7. The major differences are highlighted below.

a) Exports are projected by the IMF to increase by 3.5% in 2014-15, as compared to the growth of 1.3% only in the first eleven months of 2013-14. The higher growth rate is predicated on significant exchange rate depreciation. The Fund projects that the average value of rupee will be Rs.111.14 per dollar, implying a decline of over 8% **(See Box 2).** But given the strong commitment of the government to a stable nominal exchange rate, this is unlikely to happen. However, the government is trying to compensate for over valuation of the rupee by reducing the mark-up on export refinance by two percentage points and by offering duty drawback of up to 4% to exporters, with growth in exports above 10%.

b) Imports are projected to be $ 750 million higher, given a 5% increase in oil prices over the average level in 2013-14.
c) As mentioned earlier, there is likely to be a shortfall in inflows from the CSF of $ 700 million.
d) There is the possibility that repatriation of profits by MNCs will be somewhat higher, especially by transfer of reserves to safer locations.
e) On the positive side, grants could be higher for support to the IDPs in Kyber-Pakhtunkhwa, displaced by the war operations in FATA.
f) There may be some flight of portfolio funds from Pakistan in the face of greater concerns about security.
g) The biggest difference is likely to be in FDI. The IMF has optimistically projected a more than doubling in 2014-15. This is extremely unlikely.

Box 2

Exchange Rate Projections

The IMF does its best to hide its exchange rate projection. This is also the case for 2014-15 in the Third Review. But we have found a way to derive the exchange rate used by the IMF in its calculations.

The process of determination is as follows:

i. External debt (in million $) figures for 2013-14 and 2014-15 are given in Table 5 of the review.

ii. External debt as % of GDP is given in Table 10

iii. The GDP projection (in million $) can accordingly be derived

iv. The Projection of GDP in billion rupees is given in Table 6

v. The exchange rate projection can be derived as follows

GDP		Implied Average Exchange Rate (Rs / $)
in billion Rs	in million $	
25744	250416	102.8
28946	260454	111.14

Therefore, the IMF projects the average value of the rupee in 2014-15 of Rs 111.14 per US $. This implies a nominal depreciation of 8.1%. Has the Government agreed to this? We doubt it.

Table 7

PROJECTION OF BALANCE OF PAYMENTS
2014-15

($ Million)

	IMF 2014-15	IPR 2014-15
A. Current Account Deficit	**-3055**	**-4804**
A.1.Balance on Goods	**-17461**	**-18211**
Exports	26582	26582
Imports	44043	44793
A.2. Services (Net)	**-2839**	**-3539**
Credit	**5457**	**4757**
CSF	1400	700
Others	4057	4057
Debit	**8296**	**8296**
A.3. Income (Net)	**-4073**	**-4373**
Income Credit	**672**	**672**
Income Debit	**-4745**	**-5045**
Interest Payments	-1812	-1812
Income on Direct Investment	-2933	-3233
A.4. Current Transfers (Net)	**21318**	**21319**
Credit	**21477**	**21478**
Official	683	683
Remittances	16708	16708
Other Private Transfers	4087	4087
Debit	**-159**	**-159**
B. Capital Account	**464**	764
C. Financial Account	**5673**	**2903**
C.1 Direct Investment Abroad	**-15**	**-200**
C.2 Direct Investment in Pakistan	**4317**	**2500**
FDI	2567	1000
Privatization Receipts	1750	1500
C.3 Portfolio Investment (Net)	**1380**	**500**
C.4 General Government	**-3168**	**-2566**
Disbursements	2778	3390
Amortization	5956	5956
C.5 Others	**3159**	**3159**
D. Errors & Omissions	**0**	**0**

(Contd)

PROJECTION OF BALANCE OF PAYMENTS
2014-15

($ Million)

	IMF 2014-15	IPR 2014-15
E. BOP Surplus (+) / Deficit (-)	**3082**	**-137**
F. IMF (net)	**936**	**936**
G. Change in Reserves (Increase (+) / Decrease (-))	**4018**	**-799**
H. Reserves	**13505**	**9802**

Based on the above, we project that the current account deficit will be $ 4.8 billion in 2013, as compared to $ 3 billion projected by the IMF. The surplus on the capital and financial accounts is estimated by us at $ 4.7 billion, almost $ 1.8 billion less than that anticipated by the IMF. This implies that while the IMF expects a surplus in the BOP of $ 3 billion, we believe that the result may only be a small surplus. As such, while foreign exchange reserves could rise by $ 4 billion, according to IMF, they rise by $ 0.8 billion in our scenario. Hopefully, this is also the 'worst case' scenario and that reserves will rise further, especially if the government can conjure up more 'gifts' from friendly countries.

4. CONCLUSIONS

Given the adverse conditions in the global economy and within Pakistan, we have been constrained to adopt a less optimistic economic outlook for 2014-15 than is the case by the Government of Pakistan or IMF. A summary of the projections for 2014-15 is given below:

	Government / IMF	IPR
GDP Growth Rate (%)	4.0-5.1	3.5-4.0
Rate of Investment (%)	16.1	15.0
Rate of Inflation (%)	8.0	7.0-10.0
Fiscal Deficit (% of GDP)	-4.9	-7.2
Current Account Deficit (% of GDP)	-1.1	-1.8
Foreign Exchange Reserves ($ billion)	13.5	9.8

Given the somber nature of our projections, we will be the first to be pleased if we are proved to be wrong. Our primary intention is to remove any complacency arising due to optimistic projections and to urge the government to have contingency plans ready to manage any negative shocks in a year characterized by greater uncertainty than is normally the case.

STATISTICAL APPENDIX

Table S-1

MONTHLY IMPORT PRICES OF CRUDE OIL AND PRODUCTS
2013-14

	POL Products	per barrel $	Crude Oil	per barrel $
2013-14				
Average	**706**		**795**	
July 2013	723	100.1*	747	103.4
August	694	96.1	753	104.3
September	699	96.8	791	109.5
October	623	86.3	800	110.8
November	734	101.6	801	110.9
December	746	103.3	810	112.2
January 2014	699	96.8	792	109.7
February	605	83.8	793	109.8
March	705	97.6	904	125.2
April	719	99.6	777	107.6
May	830	115	774	107.2
2012-13				
Average	**775**		**777**	

Table S-2

KHYBER-PAKHTUNKWA BUDGETARY MAGNITUDES

(Rs in Billion)

	2013-14 Budget Estimate	2013-14 Revised Estimate	2014-15 Budget Estimate
General Revenue Receipts	298	294.7	357
less Current Expenditure	211	222	250
less Development Expenditure	118	104.9	139.8
Fiscal Deficit (-) / Surplus	**-31**	**-32.2**	**-32.7**

Source: Government of KPK, Annual Budget Statement, 2014-15

Table S-3

BALOCHISTAN BUDGETARY MAGNITUDES

(Rs in Billion)

	2013-14 Budget Estimate	2013-14 Revised Estimate	2014-15 Budget Estimate
General Revenue Receipts	161.4	160.7	176.8
less Current Expenditure	115.2	101.3	135.1
less Development Expenditure	39.9	35	48
Fiscal Deficit (-) / Surplus	**6.3**	**24.4**	**-6.3**

Source: Government of Balochistan, ABS, 2014-15

Table S-4

PUNJAB BUDGETARY MAGNITUDES

(Rs in Billion)

	2013-14 Budget Estimate	2013-14 Revised Estimate	2014-15 Budget Estimate
General Revenue Receipts	872	845.2	1033.1
less Current Expenditure	607.6	584.7	699.9
less Development Expenditure	290	224.1	345
Fiscal Deficit (-) / Surplus	**-25.6**	**36.4**	**-11.9**

Source: Government of Punjab, ABS, 2014-15

Table S-5

SINDH BUDGETARY MAGNITUDES

(Rs in Billion)

	2013-14 Budget Estimate	2013-14 Revised Estimate	2014-15 Budget Estimate
General Revenue Receipts	529.2	488.7	599.3
less Current Expenditure	356	368.4	436.1
less Development Expenditure	185	115	168
Fiscal Deficit (-) / Surplus	**-11.7**	**5.3**	**-4.8**

Source: Government of Sindh, ABS, 2014-15