INSTITUTE FOR POLICY REFORMS

Six Monthly Economic Review 2014-15

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IPR Economic Series

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ACRONYMS

BoP	Balance of Payments
CPI	Consumer Price Index
CSF	Coalition Support Fund
EFF	Extended Fund Facility
EU	European Union
FBR	Federal Board of Revenue
FCA	Fuel Charges Adjustment
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
FTA	Free Trade Agreement
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GSP+	Generalized Scheme of Preferences Plus
GST	General Sales Tax
Gwh	Gigawatt
HEC	Higher Education Commission
IDPs	Internally Displaced Persons
IMF	International Monetary Fund
IPR	Institute of Policy Reforms
Kwh	Kilowatt
LSM	Large Scale Manufacturing
MW	Mega Watt
NEPRA	National Electric Power Regulatory Authority
NHA	National Highways Authority
PAEC	Pakistan Atomic Energy Commission
PBS	Pakistan Bureau of Statistics
POL	Pakistan Oilfields Limited
PSDP	Public Sector Development Program
PSM	Pakistan Steel Mill
SBP	State Bank of Pakistan
SROs	Statutory Regulatory Orders
UAE	United Arab Emirates
WAPDA	Water and Power Development Authority
WPI	Wholesale Price Index

EXECUTIVE SUMMARY

The assessment of the first six months performance of the economy in 2014-15 is generally positive by the Finance Minister. He has indicated that the economy is on track to achieve the high GDP growth rate of 5.1%; reserves have risen to above $15 billion; average inflation is down to 6%; FDI is on the increase; home remittances have been buoyant with a growth rate of over 15%; Government borrowing from SBP has decreased by Rs 425 billion and the fiscal deficit has been contained at 2.4% of the GDP.

This six monthly IPR report analyses whether the optimism is justified and if the targets for 2014-15 will be met. On the GDP growth rate, it appears unlikely that it will reach 5%. There has been a visible slowdown in the large-scale manufacturing sector with the growth rate down to 2.5% in the first five months, as compared to the target of 7%. Agriculture has been hit by the floods, albeit less than originally anticipated. Exports are showing a decline and investment trends are not so positive. Overall, IPR projects a growth rate of 3.8 to 4.3% in 2014-15.

Turning to inflation, there has been a precipitous drop in oil prices internationally and this is reflected mostly in domestic prices. On a year-to-year basis, the inflation rate has come down from 7.9% in July to 4.3% in December. However, there are reasons to believe that the rate of inflation is understated. It does not reflect the rise in the price of electricity, inclusive of the fuel charges adjustment and the higher rate of inflation in the larger cities. Also, oil prices are likely to have bottomed out and may start rising again. Further, the procurement/support prices of wheat and sugarcane have been increased. IPR expects that the average rate of inflation will range from 5 to 5.5% in 2014-15.

There is evidence that expenditures at the Federal level have been artificially controlled to achieve the six monthly deficit target agreed with the IMF. Releases for the PSDP show a growth of only 6% and are equivalent to only 24% of the annual target. There is also negative growth in expenditure on debt servicing. This explains the curtailment of the fiscal deficit to 2.4% of the GDP.

The performance of FBR revenues has been disappointing with a growth rate of about 13%, compared to the target growth rate of over 24%. While direct tax revenues have been somewhat buoyant, the growth in GST revenues is only 7%. The domestic component of this tax has shown growth of less than 2%. This reflects, in particular, the lack of dynamism of the manufacturing sector and the negative impact of the fall in POL prices.

On the financing side, while borrowings from SBP are negative, there has been an extraordinarily high level of borrowing from the scheduled banks, non-banking sector and households of almost Rs 955 billion. In addition, the flotation internationally of Ijara-Sukuk bonds of $1 billion has been a significant source of financing. However, the high level of borrowing from the banks has led to a 'crowding out' of the private sector with credit to it falling by 38%.

Over the next six months, expenditures are likely to rise rapidly due to the pending debt servicing obligations, expenditures on security arising from implementation of the National Action Plan and rehabitation of IDPs, retirement of circular debt of the power sector and so on. Coupled with the slow growth in tax revenues, IPR expects the fiscal deficit to approach 6% of the GDP as compared to the target of 4.9% of the GDP.

The balance of payments position has improved in the latter part of the period. This is attributable to the release of $1.1 billion from the IMF and $ 1 billion from the flotation of Ijara-Sukuk bonds. Overall, net external borrowing has been $2.4 billion, while the increase in foreign exchange reserves is $1.4 billion, in relation to the end-June level.
The rise in reserves, due to borrowings, hides the deterioration in the balance of trade. Exports have declined by 2% while imports have risen by 4%. This has been partially compensated for the buoyancy in home remittances. Overall, the current account deficit has risen by 18%, in relation to the corresponding period of last year.

IPR is particularly concerned about the large appreciation in the value of the rupee, especially with respect to the Euro. It appears that among 11 major Asian currencies, the only currency which has nominally appreciated with respect to the US$ is the Pakistani rupee. This explains the fast growth in the volume of imports and the lack of competitiveness of Pakistan's exports. Fortunately, with lower oil prices, the current account deficit for the year is likely to remain restricted at 1.4% of the GDP.

In summary, the year 2014-15 may not see the kind of strong revival and greater stabilization of the economy as anticipated by the government at the start of the year in the Annual Plan. The growth rate of the economy may show little improvement, private investment will remain shy, the fiscal deficit could rise sharply and the balance of payments position will improve, but not as much as anticipated. The silver lining will be a sharp fall in the rate of inflation.

SIX MONTHLY ECONOMIC REVIEW

OVERVIEW

The first six months, July to December, of 2014-15 did not start too well. The province of Punjab was hit by floods which led to some losses of output in Kharif crops. There was a hiatus in the IMF program and the Fourth Review was not completed. The trade deficit widened and foreign exchange reserves started falling once again. The process of slow down of industrial growth continued. Political agitation reached a peak and the sense of insecurity in making investments by the private sector increased.

Towards the end of the period, however, there was a spate of good news. The fourth and five reviews were completed and the IMF Board approved the release of the pending installments of $1.1 billion. Pakistan was able to float successfully in the international capital market $1 billion worth of Ijara Sukuk Bonds, albeit at a somewhat high cost. Agreement was reached with China on investment of $42 billion in the power sector and infrastructure. Due to falling international prices, the rate of inflation came down sharply to 4.3 percent by December 2014.

The Finance Minister has given in a press conference a performance review of the first six months, with the following salient points:

- Pakistan to achieve GDP Target of 5.1 percent this year
- As of December 31, the country's foreign exchange reserves had crossed US $15 billion
- FBR revenue collection was Rs 1162.4 billion as compared to Rs 1031.4 billion during the July-December period. This was higher by 12.7 percent, despite fall in oil prices
- 5 percent hike in GST on POL products will generate an additional Rs 17.5 billion this year.
- Budget deficit in the first six months at 2.4 percent, as compared to the target of 4.9 percent for the full year

- LSM growth of only 2 percent from July to October, due to delay in sugar crushing and low production by PSM
- Settlement of IDPs, flood affected people and anti-terrorism moves will add to expenditure
- Home remittances increased by 15.4 percent
- Exports in the first six months decreased by 4.3 percent, whereas imports increased by 11.7 percent
- FDI increased from $354.8 million to $422.8 million, an increase of 19.3 percent
- Inflation has come down to an average 6 percent compared to 8.9 percent last year in July to November
- Stock Market has increased by 12 percent from June 30, 2014 to Jan 8, 2015, as it went up from 29600 to 33000 points
- Government borrowing from SBP decreased by Rs 425 billion.

This IPR review evaluates the feasibility of attainment of the targets mentioned above, especially with regard to the GDP growth rate and the fiscal deficit. We also assess the likelihood of continuation of some of the favorable trends like the lowering of the rate of inflation, rise in the level of foreign exchange reserves, etc.

1. GROWTH

We first evaluate the prospects for achievement of a GDP growth of above 5 percent in 2014-15, the first time in seven years.

1.1. Agriculture

It has now been assessed that the flood damage to Kharif crops was not as extensive as was initially anticipated. It is likely that cotton and sugarcane have shown some growth, while the output of rice may have fallen somewhat. During the on-going Rabi season a bumper crop of wheat of over 26 million tons is expected due to the increase in procurement price by 8.3 percent[3] and greater availability of water in the aftermath of the floods.

Overall, the major crop sector could grow by 2.5 percent in 2014-2015 as compared to 3.7 percent last year. The good news is likely to come from minor crops, which collectively suffered a decline of 3.5 percent last year. During the current year, the prices of potatoes, onion and tomatoes has fallen sharply by 3.2 percent, 50.5 percent and 16.7 percent respectively. Clearly, this must be on the back of a big enhancement in output. Therefore, a growth rate of over 5 percent in minor crops may be achieved.

The livestock sector is likely to show normal growth of about 3.5 percent. Given the projections of sub-sectoral growth rates, a forecast of the overall growth of the agricultural sector in 2014-15 is 3.3 percent. This implies a significant improvement over the growth rate of 2.1 percent achieved last year.

1.2. Industry

The data on production in the large-scale manufacturing sector comes with a time lag of almost three months from the PBS. Currently, information is available for the first five months, July to November, of 2014-15. The growth rate of individual industries is presented in Table1.

The manufacturing sector continues to show a lack of dynamism. The growth rate recorded up to November is below 2.5 percent, as compared to almost 6 percent achieved in the corresponding period of the last year. Out of the sixteen industries on which the data is available, the majority (eleven) have seen declines in the growth rates of production.

Table 1 Growth of Industrial Production (%) *July to November 2014*			
	Weight	Growth Rate	
		2014-15	2013-14
Textiles	**29.74**	**0.7**	**1.9**
Yarn	18.43	0.8	2.4
Cloth	10.22	0.89	-0.04
Food, Beverages &Tobacco	**17.59**	**0.6**	**9.9**
Sugar	5.04	-80.90	53.2
Cigarettes	3.02	-7.4	-1.4
Cooking Oil	3.17	-4.2	8.2
Vegetable Ghee	1.63	0.0	6.8
Wheat Milling	1.44	2.9	4.8
Petroleum Products	**7.84**	**4.1**	**8.8**
Pharmaceuticals	**5.15**	**3.3**	**0.4**
Chemicals	**2.44**	**7.0**	**4.7**
Automobiles	**6.56**	**13.5**	**-2.5**
Jeeps, Cars	4.01	16.7	-0.3
Iron & Steel Products	**7.67**	**24.6**	**4.4**
Fertilizers	**6.31**	**-2.5**	**32.8**
Electronics	**2.79**	**8.6**	**23.7**
Leather Products	**1.22**	**6.4**	**8.7**
Paper &Paper Board	**3.29**	**-1.0**	**16.9**
Non-Metallic Min Prod	**7.63**	**3.5**	**0.0**
Cement	7.53	3.6	0.0
OVERALL GROWTH	**100.00**	**2.5**	**5.6**
Source: PBS			

There are number of reasons why the manufacturing sector is not performing well. The Finance Minister, as highlighted earlier, attributes this to the delay in sugarcane crushing and low production by the Pakistan Steel Mill (PSM). The crushing season of sugarcane starts in November. In the first month, sugar output has fallen by 80 percent. One of the few industries which have shown high growth of 16.7 percent is iron and steel. There are, in fact, indications that here has been some revival of production in PSM. Also, the automobile industry has shown a strong recovery.

There are also other reasons for the slowdown in the large-scale manufacturing sector. First, there is the common problem for most industries of continuing high levels of power load shedding and gas shortages. Second, the fall in exports has fundamentally affected the textile sector. Third, there are industry-specific reasons. The cigarette industry has seen a big increase in the incidence of taxes. The fertilizer industry is showing a fall in production because of a reduction in the supply of gas as a feedstock. Some industries like pharmaceuticals, paper and paper board are facing the onslaught of cheaper imports.

There is an overstatement of the growth rate of the large-scale manufacturing sector at 4.9 percent in November. The big fall in sugar output of over 80 percent actually pushes down the growth rate to near zero. As such, the cumulative growth rate of the sector in the first five months is only 1.5 percent.

Other sub-sectors of the industrial sector are also showing low growth. Although PES continues to assume a high growth rate of 8.4 percent in the small-scale manufacturing sector, the reality is very different. Exports of carpets have fallen by 2.9 percent, tanned leather by 1.3 percent, leather goods by 4.1 percent, auto parts by 4.5 percent, jewellery by 98 percent and so on. The crisis in the small-scale sector is highlighted by the fact that banks face a loan default rate of over 33 percent in this sector. Consequently, the flow of credit has declined.

The construction sector is showing some growth, as revealed by the growth in cement consumption of less than 5 percent. Electricity generation is also showing a low rate of growth (see section 1.3).

Overall, on the basis of current trends, the industrial sector’s performance in 2014-15 is unlikely to match the growth rate of 4 percent achieved in 2013-14. This will imply a big shortfall in relation to the growth target of 7 percent in the Annual Plan of the current year.

1.3. The Power Sector

There continues to be a decline in the performance of the power sector. The year, 2013-14, ended with an increase in power generation of only 5 percent. Transmission and distribution losses have remained high at 17.5 percent, while the extent of underecovery of billing has increased from 6 percent to 10 percent.

The data available from NEPRA reveals that during the period, July to November 2014 is only 5 percent above the level attained two years ago (see Table 2). However, the good news is that the recent fall internationally in oil prices, has led to a reduction in fuel cost per Kwh by 33.3 percent by November, in relation to the cost in July.

Table 2
Total Electricity sent out and Fuel Cost

	Electricity Sent Out (Gwh)	Fuel Cost (Million Rs)	Fuel Cost Per Kwh (Rs)	Generation by Furnace Oil
2012-13				
July	9364	66687	7.12	35.0
August	9422	60450	6.42	30.6
September	8338	52896	6.34	28.8
October	7907	53606	6.78	30.4
November	6914	48350	6.99	38.7
Cumulative	**41945**	**281989**	**6.72**	**32.7**
2014-15				
July	10232 (9.3)*	76724	7.50	33.3
August	10234 (8.6)	69404	6.78 (5.6)	31.3
September	8934 (7.1)	60638	6.79 (7.1)	31.1
October	8123 (2.7)	57634	7.10 (4.7)	33.6
November	6534 (-5.5)	29401	5.00 (-28.5)	21.5
Cumulative	**44057 (5.0)**	**293801**	**6.67 (-0.8)**	**30.2**

Source: NEPRA
*Growth rate

2. INVESTMENT

The Annual Plan has set ambitious targets for investment in 2014-15. Total investment is projected to increase by 16 percent, with a jump in private investment of 21 percent. The trend in various indicators of investment is given below.

2.1. Imports of Machinery

Total imports of machinery in the first half of 2014-15 is estimated at $2.7 billion, as shown in Table 3. The growth rate is 6 percent.

Table 3
Imports of Machinery
July to December ***($ Million)***

	2013-14	2014-15	Growth Rate (%)
Power Generating Machinery	326	343	5.2
Textile Machinery	317	233	-26.5
Electrical Machinery and Apparatus	380	409	7.6
Telecom Machinery *(including mobile phones)*	662	638	-3.6
Agricultural Machinery	55	47	-14.5
Other Machinery	806	1028	27.5
TOTAL	**2546**	**2698**	**6.0**

Source: SBP

The imports of power generating machinery remain low at $343 million, enough to generate only about 300MW. Clearly, the peak in investment in the power sector is yet to come. Imports of textile machinery have shown a big drop of 26 percent. In the presence of substantial excess capacity of over 30 percent and problems of energy shortage, the private sector is not investing in a big way in the sector, despite the granting of GSP+ status by the EU.

There is a decline also in imports of telecom equipment and apparatus include mobile phones, despite the granting of 3G licences to companies in the sector. The only type of machinery which has shown fast growth of 27.5 percent is mechanical machinery for a wide range of sectors.

2.2. PSDP Releases

As of end December, the releases for PSDP projects at the federal level is Rs 148.8 billion, equivalent to 28.2 percent of the annual PSDP allocation in the Budget (see Table 4). By now, releases should have reached 40 percent of the annual allocation. Therefore, the shortfall is close to 12 percent or Rs 61 billion. This shortfall is likely to persist as the Government is likely to scale back the PSDP to meet the fiscal target agreed with the IMF.

Table 4
Status of PSDP Releases
July to December

(Rs in Billion)

	2013-14	2014-15	Growth Rate (%)
Total Releases	**120.6**	**148.8** (28%)	**23.4** (15.4)*
Percentage of Releases	**Budget**	**Actual**	**Percentage**
HEC	20.0	7.8	39
Health Services	27.0	20.4	76
PAEC	51.5	23.7	46
Railways	39.6	18.3	46
Water & Power (Water)	43.5	14.9	34
NHA	111.6	21.7	19
WAPDA (Power)	63.6	10.2	16

Source: Planning Commission

It is indeed surprising that the lowest rate of releases of 16 percent only is observed in the case of WAPDA (Power). In fact, this sector should have the highest priority. Sectors which have already received a large part of their annual allocation are health services (76 percent); PAEC (46 percent) and Railways (46 percent).

2.3. Bank Credit

The bank credit in the first six months of 2014-15 is presented in Table 5. There has been a massive increase in government borrowing from scheduled banks of Rs 745.6

billion. Inevitably, this has led to 'crowding out' of the private sector, which has led to fall in credit by 37.6 percent. Also, the commodity financing is declining at a much slower rate, due to the inability to rundown of stocks, especially of wheat.

Table 5
Flow of Bank Credit
1st July to 26th December 2014
(Rs in Billion)

	2013	2014	Difference
Credit/Investment in Government Sector	-86.2	659.4	
Credit to Private Sector	263.1	164.0	-00.1
Credit to PSEs	40.2	30.2	-10.0
Commodity Financing	-94.8	-27.0	67.8
TOTAL OF ABOVE	**122.3**	**826.6**	**704.3**
Increase in Bank Deposits	191.0	111.4	-79.6
Source: SBP			

Further, OMO injections by the SBP have had to be substantially larger due to borrowings from banks being much greater than the increase in deposits.

3. INFLATION

3.1. Rate of Inflation

The major development in the second quarter is the precipitous fall in the rate of inflation. As shown in Table 6, it was 7.7 percent in September on a year-to-year basis. Since then, the rate of inflation has fallen to 4.3 percent. The average for the first six months is down to 6.1 percent, as compared to 8.9 percent in the corresponding period of the previous year. However, the 'core' rate of inflation has shown a smaller decline, from 8.0 percent to 6.7 percent. This indicates that demand pressures persist in the economy.

Table 6
Rate of Inflation

(%)

	CPI			WPI			SPI**	Core Inflation @	
	General	Food	Non-Food	General	Food	Non-Food		NFNE*	Trimmed
Year-on Year									
Dec-13	9.2	9.3	9.1	8.9	7.6	9.7	12.1	8.2	8.7
Jan-14	7.9	7.2	8.4	8.1	5.6	9.8	9.5	8.1	8.2
Feb-14	7.9	7.6	8.2	7.6	5.8	8.7	9.3	7.8	8.1
Mar-14	8.5	9.3	8.0	7.7	8.6	7.1	10.5	7.6	8.1
Apr-14	9.2	9.9	8.7	7.0	8.9	5.7	10.3	8.5	9.0
May-14	8.3	7.4	9.0	7.3	7.4	7.3	9.3	8.7	8.3
Jun-14	8.2	7.4	8.9	7.7	8.0	7.5	8.0	8.7	7.9
Jul-14	7.9	7.0	8.5	6.6	7.7	5.8	7.6	8.3	7.6
Aug-14	7.0	5.6	8.1	3.3	7.5	0.6	6.8	7.8	7.1
Sep-14	7.7	7.2	8.0	2.7	8.1	-0.7	6.9	8.0	7.1
Oct-14	5.8	5.2	6.2	1.3	7.4	-2.7	4.3	7.8	6.0
Nov-14	4.0	2.1	5.4	0.0	5.3	-3.4	-0.1	6.9	5.3
Dec-14	4.3	3.4	4.9	-0.9	6.3	-5.4	0.5	6.7	5.2
FY15									
Jul	7.9	7.0	8.5	6.6	7.7	5.8	7.6	8.3	7.6
Jul-Aug	7.4	6.3	8.3	4.9	7.6	3.1	7.2	8.1	7.4
Jul-Sep	7.5	6.6	8.2	4.2	7.8	1.8	7.1	8.0	7.3
Jul-Oct	7.1	6.2	7.7	3.4	7.7	0.7	6.4	8.0	6.9
Jul-Nov	6.4	5.4	7.2	2.7	7.2	-0.2	5.0	7.8	6.6
Jul-Dec	6.1	5.1	6.8	2.1	7.0	-1.1	4.3	7.6	6.3

Source: PBS

Another positive development is that the decline in food prices has been even greater, from 7.2 percent to 3.4 percent. However, groups of items which have exhibited a relatively higher rate of inflation, as shown in Table 7, are beverages and tobacco (20.7 percent), clothing and footwear (8.8 percent) and education (14.3 percent).

Table 7
Rate of Inflation by Groups

No.	Group	Group Weight (%)	Indices			% Change December 2014 Over	
			Dec-14	Nov-14	Dec-13	Nov-14	Dec-13
	General	**100.00**	**196.79**	**198.79**	**188.68**	**-1.01**	**4.30**
1.	Food & Non-alcoholic Bev.	34.83	215.18	220.25	209.87	-2.30	2.53
	• Non-perishable Food Items	29.84	217.02	216.69	211.33	0.15	2.69
	• Perishable Food Items	4.99	204.22	241.56	201.17	-15.46	1.52
2.	Alcoholic Bev. & Tobacco	1.41	266.63	266.65	220.96	-0.01	20.67
3.	Clothing & Footwear	7.57	213.88	213.01	196.57	0.41	8.81
4.	Housing, Water, Electricity, Gas &Fuels	29.41	174.04	174.01	164.44	0.02	5.84
5.	Furnishing & Household Equipment Maintenance	4.21	208.80	208.26	195.84	0.26	6.62
6.	Health	2.19	176.31	175.37	166.84	0.54	5.68
7.	Transport	7.20	185.18	190.59	197.03	-2.84	-6.02
8.	Communication	3.22	130.13	129.99	129.79	0.11	0.26
9.	Recreation & Culture	2.02	189.60	189.55	183.14	0.03	3.53
10.	Education	3.94	192.41	192.41	168.34	0.00	14.30
11.	Restaurants & Hotels	1.23	244.59	242.78	228.16	0.75	7.20
12.	Miscellaneous	2.76	220.73	220.35	210.34	0.17	4.94

Source: PBS

Table 8 presents the rate of inflation in individual commodities and services. Relatively high rates of inflation are observed in the case of fresh fruits (17.9 percent), pulses (12 percent), cigarettes (20.9 percent), cotton cloth (13.6 percent) and education (14.3 percent).

Table 8
Rate of Inflation in Major Commodities and Services, Dec 2014
(Year-on-Year)

Item	Weight (%)	Rate of Inflation (%)
FOOD	**34.8**	**2.5**
Wheat Flour	4.16	-4.6
Other Cereals	1.73	-1.7
Meat	2.43	6.3
Chicken	1.35	4.8
Milk (Fresh)	6.68	7.3
Cooking Oil	1.75	-1.9
Vegetable Ghee	2.07	-2.8
Fresh Fruits	1.86	17.9
Pulses	1.11	12.0
Vegetables	2.66	-1.6
Sugar	1.04	0.4
Tea	0.84	-12.9
Cigarettes	1.39	20.9
CLOTHING & FOOTWEAR	**7.6**	**8.8**
Cotton Cloth	1.73	13.6
Readymade Garments	0.97	8.8
Tailoring	0.88	11.0
HOUSING, ELECTRICITY, GAS, ETC	**29.4**	**5.8**
House Rent	21.8	7.6
Electricity	4.4	1.8
Gas	1.6	0.0
HEALTH	**2.2**	**5.7**
Drugs & Medicines	1.3	3.8
Doctors (Fees)	0.6	8.8
TRANSPORT	**7.2**	**-6.0**
Motor Fuel	3.0	-15.5
Transport Services	2.7	-1.7
COMMUNICATION	**3.2**	**0.1**
RECREATION & CULTURE	**2.0**	**3.5**
EDUCATION	**3.9**	**14.3**
RESTAURANTS & HOTELS	**1.2**	**7.2**
MISC. GOODS &SERVICES	**2.8**	**4.9**

Source: PBS

Price declines have occurred in the case of wheat flour (-4.6 percent), other cereals (-1.7 percent), cooking oil (-1.9 percent), vegetable ghee (-2.8 percent), vegetables (-1.6 percent), tea (-12.9 percent), motor fuel (-15.5 percent) and transport services (-1.7 percent). The monthly price trends in major items are given in the Statistical Appendix.

3.2. Why has Inflation Fallen?

The question arises as to how in a period of three months the rate of inflation in the CPI has fallen by as much as 3.4 percentage points. The primary explanation for this is the sharp fall in international prices of commodities in recent months.

Table 9 shows that the biggest fall in international commodity prices has occurred between September to December of almost 23 percent. This is also the period when the rate of inflation declined in Pakistan. The biggest decline of over 44 percent is observed in the case of crude oil.

Clearly, the transmission from international to domestic prices is the greatest in the case of tradable items (either exported or imported). This explains the fall in prices of items like wheat flour, rice, vegetable ghee, tea, motor fuel, etc.

Table 9
The Fall in International Commodity Prices

(%)

	June to December 2013	December to June 2014	June to September 2014	September to December 2014	June to December 2014
All Commodities	**2.8**	**0.5**	**-9.1**	**-22.6**	**-29.6**
Food	-6.8	1.9	-10.2	0.0	-10.2
Beverages	5.9	19.0	3.1	-5.1	-2.2
Agricultural Raw Materials	0.9	-1.3	-2.8	-3.7	-6.4
Metals	4.0	-9.6	-0.4	-7.9	-8.2
Fuel	5.1	1.5	-10.9	-32.5	-39.9
Crude Oil	5.9	2.6	-11.5	-36.9	-44.1

Source: IMF

However, there appears to have been only limited response to the fall in international prices. The Government has proceeded to levy large regulatory duties in the case of important consumer items like wheat and sugar.

Further, the General Sales Tax has been raised from 17 percent to 22 percent in the case of petroleum products. If the fall in international prices had been fully reflected in domestic prices, the consumer welfare gain would have been higher by Rs 440 billion in the case of food items and Rs 70 billion in the case of petroleum products. This would also have implied an even lower rate of inflation.

The overall macroeconomic impact of falling commodity prices are discussed in the second special note, attached to this quarterly review.

The persistence of high aggregate demand pressure in the economy is indicated by the relatively high rate of inflation in non-tradable services. For example, construction wage rates have gone up by 7.2 percent, wage of household servant by 11 percent, doctor's fees by 8.8 percent and education costs by 14.3 percent.

3.3. Downward Bias in Measuring Inflation

The largest item in the CPI is house rent, with a weight of 21.8 percent. The PBS does not have a way of determining the level of housing rents on a monthly basis. Instead, it relies on a quarterly survey. Consequently, the housing rent index remained unchanged in December. It will show some change in January 2015, at the start of a new quarter. This practice may have understated the rate of inflation in December. Given the importance of the change in housing rents in determining the rate of inflation, PBS will have to invest more in monitoring housing rents in different parts of the country.

Further, there has been relatively high inflation in some construction materials like sanitary fittings at 27 percent, glass sheets at 9 percent and timber at 13.5 percent. As compared to this, the inflation in housing rents is 7.6 percent. With a rising backlog in housing, it is likely that the inflation rate may be higher.

The other item in which the rate of inflation is understated is the domestic price of electricity. According to PBS, this has increased by only 1.8 percent between June and December 2014. The basic problem is that PBS does not include the Fuel Charges Adjustment (FCA) in the price of electricity. The median domestic consumer in Pakistan consumes between 200 to 300 Kwh per month. Inclusive of FCA, the price of electricity has increased from Rs 8.22 per Kwh in June to Rs 10.68 per Kwh in December, a rise of 29.9 percent. Therefore, the rate of inflation in the electricity price is understated by as much as 28.1 percent. If the correct inflation rate in price of electricity is included in the calculation of the rise in CPI, then the overall rate of inflation rises from 4.3 percent to 5.5 percent. The PBS must make efforts to remove such discrepancies. Overall, it is likely that the headline rate of inflation in Pakistan is still close to 6 percent.

4. PUBLIC FINANCES

The Finance Minister has indicated that the fiscal deficit in the first half of 2014-15 is 2.4 percent of the GDP, as compared to the annual deficit target of 4.9 percent of the GDP. However, the details of fiscal operations upto December have not been released yet by the Ministry of Finance.

We first highlight the projections of public finance projections for 2014-15 agreed with the IMF following the successful completion of the fourth and fifth review.

4.1. Projections for 2014-15

The projections contained in the latest IMF Staff Report are presented in Table 10. There are significant deviations from the Budget for 2014-15 presented by the Federal and Provincial governments, as follows:

i. The target for FBR has been reduced from Rs 2810 billion to Rs 2756 billion, a reduction of Rs 54 billion. This has been done in view of the relatively low growth rate of 15.2 percent in the first quarter. In addition, a short fall is expected of Rs 80 billion from the GIDC.

ii. The target of non-tax revenues of the Federal government has been set at Rs 902 billion, in relation to the budget estimate of Rs 816 billion. It is not clear how the additional amount will be mobilized.

iii. Current expenditure of the Federal government is projected at Rs 3292 billion. This is very close to the budget estimate of Rs 3294 billion.

iv. There is a big cut in the size of PSDP. The Federal PSDP has been reduced by Rs 48 billion (cut of 9 percent) and the combined Provincial PSDPs by Rs 210 billion (cut of 32 percent).

Table 10
Summary of Public Finances
(IMF Projections)

(Rs in Billion)

	2013-14	2014-15	Growth Rate (%)	IPR Projections
A. REVENUE & GRANTS	**3831**	**4288**	**12**	**4081**
Revenue	3625	4191	16	3983
A.1. Tax Revenue	**2635**	**3209**	**22**	**3053**
Federal	2445	2995	22	2839
FBR Revenue	2266	2756[a]	22	2600
Provincial	190	214	13	214
A.2. Non-Tax Revenue	**990**	**982**	**-1**	**930**
Federal	941	902[b]	-4	850
Provincial	49	80	67	80
A.3. Grants	**206**	**98**	**-52**	**98**
B. EXPENDITURE	**5027**	**5577**	**11**	**5839**
B.1. Current Expenditure	**4123**	**4637**	**12**	**4862**
Federal	**2950**	**3292**	**12**	**3487**
Interest Payments	1148	1344[c]	17	1400
Defence	623	711[d]	14	750
Subsidies	336	254[e]	-24	204
Grants	372	463[f]	24	513
Others	471	520	10	620
Provincial	**1173**	**1345**	**15**	**1375**
B.2. Development Exp & Net Lending	**966**	**925**	**-4**	**985**
PSDP	**865**	**917**	**6**	**977**
Federal	435	477[g]	10	477
Provincial	431	440[h]	2	500
Net Lending	**101**	**8[i]**	**-92**	**8**
C. STATISTICAL DISCREPANCY	**-62**	**0**	**-∞**	**0**
D. OVERALL BALANCE				
Excluding Grants	-1402	-1386		-1856
Including Grants	-1196	-1288		-1758
E. FISCAL DEFICIT AS % OF GDP				
Excluding Grants	-5.5	-4.8		-6.4
Including Grants	-4.7	-4.5		-6.1
F. FINANCING	**1196**	**1289**	**8**	**1758**
External	**320**	**297**	**-7**	**297**
Domestic	**876**	**992**	**13**	**1461**
Bank	322	412	28	881
Non-Bank	553	580	5	580

Source: IMF Staff Review Report
IPR estimate

Like last year, IMF expects a significant shortfall in tax revenues. This is to be compensated for by a large cut in the national PSDP of Rs 258 billion (overall cut of 22 percent). This will have some negative consequences on the growth rate of the economy.

IPR has made estimates of the budgetary outcome in 2014-15. These are at variance with the IMF projections in the following areas:

i. FBR revenues have shown a moderate growth rate of 14 percent in the first six month. This is likely to continue and revenues in 2014-15 are unlikely to cross Rs 2600 billion, implying a shortfall of Rs 210 billion

ii. The non-tax revenue target is likely to have a shortfall of Rs 50 billion due, first, to lower dividends of approximately Rs 20 billion from OGDC and PPL. This is the consequence of falling oil prices. Second, SBP profits are likely to fall by Rs 30 billion in relation to the peak level attained in 2013-14.

iii. Interest payments could be higher by Rs 56 billion. A growth rate of 17 percent looks low, given that these payments increased by 31.2 percent in the first quarter

iv. Defence expenditure could be higher by about Rs 40 billion due to the on-going **Zarb-e Azab** operations and bigger involvement of the military in counter terrorism operations in the country

v. Subsidies, especially to the power sector, could be lower by almost Rs 50 billion due to the fall in oil prices

vi. Grants will need to be higher by about Rs 50 billion due to the costs of flood relief and rehabilitation of IDPs

vii. Other expenditure is likely to be higher by Rs 100 billion as the liquidity position of PSO is improved to avert another petrol crisis

viii. Current expenditure of the Provincial Governments may be higher by Rs 30 billion in order to strengthen law and order and justice functions as part of the National Action Plan against terrorism

ix. A 32 percent cut in Provincial PSDPs is unlikely, as required in the IMF projections. Instead, the outlay may be higher by Rs 60 billion, implying a lower cut of 17 percent.

Overall, the IPR projection of the likely size of the consolidated fiscal deficit in 2014-15 is Rs 1758 billion, inclusive of grants. As such, the fiscal deficit may approach 6.1 percent of the projected GDP in 2014-15.

The IMF projection indicates that the largest source of financing the deficit will be non-bank borrowing, with a share of 45 percent. But if the deficit increases in absolute terms by Rs 470 billion, then much of the incremental financing will have to come from bank borrowing. This will effectively more than double the level of such borrowing. Consequently, money supply could expand at a faster rate, with some adverse implication on the rate of inflation.

4.2. Six Month Fiscal Deficit

We have adopted the 'below the line' approach to estimating the fiscal deficit in the absence of up-to-data on fiscal operations. The results are presented in Table 11.

Table 11
Estimated Fiscal Deficit
July to December 2014-15

(Rs in Billion)

	Amount
Borrowings from:	
SBP	-315.4
Scheduled Banks and Corporate Entities	759.4
National Savings Schemes	195.6
External Donors (Net)	25.4
Ijara-Sukuk Bond	**102.0**
TOTAL	**767.0**
Provincial Surplus	-82.4
FISCAL DEFICIT	**684.6**
% of GDP	**2.4**

Source: SBP

The estimated magnitude of the deficit is Rs 685 billion, equivalent to 2.4 percent of the GDP. This tallies with the figure mentioned by the Finance Minister. It needs to be recognized that the deficit in the first half of the year is 40 percent of the annual deficit on average. As such, the indication is that the annual fiscal deficit may approach 6 percent in 2014-15. This is consistent with the projection above. The Finance Minister has also hinted that the deficit may be higher in 2014-15, due to costs of anti-terrorism operations, flood relief and rehabilitation of IDPs.

4.3. FBR Revenues

The performance of FBR is a key factor in determining the degree of success in the management of public finances. During the first six months, FBR revenues have shown a growth rate of 13.5 percent, as opposed to the annual growth target in the Federal Budget of 24 percent. In effect, there has already been a shortfall of Rs 108 billion. This is worrying as the Budget contained taxation proposals of almost Rs 230 billion, including the withdrawal of a large number of SROs.

Table 12
FBR Tax Collections
July to December 2014-15

	2013-14	2014-15	Growth Rate (%)
Direct Taxes	282	459	20.2
GST (Total)**	481	513	6.7
Federal Excise Duty	58	63	8.6
Custom Duty	110	135	22.7
TOTAL	**1031**	**1170**	**13.5**

Source: Business Recorder, 14th January 2015
*After paying refunds of Rs 30 billion

	2013-14	2014-15	Growth Rate (%)
GST (Total)	**481**	**513**	**6.7**
GST (Domestic)	235	238	1.3
GST (Imports)	246	275	11.8

Direct taxes have performed well, with a growth rate above 20 percent. The problem is with the GST. It has shown a growth rate of below 7 percent, with the domestic component of the tax showing hardly any increase. The question is why this debacle taken place. One likely explanation is the fall in prices in petroleum products. Another reason is the low growth in the manufacturing sector and fall in the overall rate of inflation.

5. BALANCE OF PAYMENTS

5.1. Balance of Payments

The balance of payments of Pakistan deteriorated in the first quarter of 2014-15. Exports fell by 5 percent and imports increased by 11.8 percent. Consequently, the trade deficit is widened by as much as 36.3 percent. Fortunately, home remittances showed rapid growth of 19.6 percent. Also, exports of services were higher, due to receipt from the Coalition Support Fund (CSF). Overall, the quarter closed with a small fall in foreign exchange reserves.

This trend continued till November 2014. In December, there were two major debt-creating capital inflows; $1 billion from the flotation of the Ijara-Sukuk bond and $1.1 billion from the IMF following the successful completion of the Fourth and Fifth Review.

Table 13 gives the details of the outcome in the balance of payments in the first six months of 2014-15. The decline in exports has moderated to 2 percent while the upsurge in imports is lower at 4.2 percent. Overall, the current account deficit stands at $2.4 billion, 18 percent higher than the level in the corresponding period of 2013-14.

Table 13
Balance of Payments
July to December

($ Million)

	2013-14	2014-15	Difference
A. Current Account Balance	**-2001**	**-2362**	**-361** (18.0)*
Trade Balance	**-8642**	**-9773**	**-1131** (13.1)
Exports	12467	12221	-246 (-2.0)
Imports	21109	21994	-885 (4.2)
Services Balance	**-1507**	**-1195**	**312**
Primary Income Balance	**-2006**	**-2312**	**-306**
Secondary Income Balance	**10154**	**10918**	**764**
Remittances	7792	8982	1190 (15.3)
B. Capital Account Balance	**163**	**252**	**89**
C. Financial Account Balance	**245**	**2402**	**2157**
FDI (Net)	384	479	95 (24.7)
FPI (Net)	103	1183**	1080
Net Foreign Assistance	-30	252	282
Others	-212	488	700
D. Errors & Omissions	**-303**	**193**	**496**
E. Overall Balance of Payments	**-1896**	**485**	**2381**
F. Use of Fund Credit	**-472**	**1131**	**1603**
G. Change of Reserves	**-2368**	**1616**	**3984**
H. Level of Reserves	**3631**	**10592**	**6961**

*Growth Rate
**Flotation of Ijara-Sukuk Bonds of $1 billion
Source: SBP

The net inflow into the financial account is substantially larger than the previous year, due to the two inflows mentioned above. But both FDI and net foreign assistance remain low. The overall outcome up to December is that foreign exchange reserves have crossed \$10.5 billion, almost \$1.5 billion above the level attained in end-June 2014.

However, it needs to be emphasized that the buildup of reserves is due to borrowings. In the first six months, the net external borrowing is estimated at 2.4 billion. As opposed to this, reserves have gone up by \$1.5 billion. In fact, almost \$0.9 billion of borrowings have been used to finance the deficit in the BOP. The strategy of building reserves through borrowing is a risky strategy and raises serious doubts about future external debt sustainability.

The IMF projections of the balance of payments for 2014-15 are given in Table 14. Exports are expected to show some positive growth for the year as whole. This seems unlikely, given the negative growth in the first six months. Imports are projected to continue growing at 5 percent. This does not factor in the precipitous fall in oil prices in recent months. This should reduce the oil import bill by almost \$2 billion between January and June 2015. Therefore, the trade deficit and the current account deficit should be smaller than the magnitude anticipated by the IMF.

The real question mark relates to the projection of net inflow into the financial account of \$6.5 billion. This hinges on privatization receipts of over \$1 billion later this year. Also, the magnitude of foreign portfolio investment expected at \$2.7 billion is very much on the optimistic side. If security conditions deteriorate, there could even be some repatriation of capital.

Overall, the IMF's projection of foreign exchange reserves at over \$14 billion by end-June 2015 is on the high side. A more likely outcome is the level of reserves at \$12 to \$12.5 billion.

Table 14
Summary of the Balance of Payments Projections by IMF 2014-15
($ Million)

	2013-14 Actual	2014-15 Annual	Change
1. Current Account	**-2971**	**-4006**	**-1035**
of which:			
Exports	25151	25381	230 (1%)
Imports	41786	44043	2257 (5%)
Remittances	15832	17340	1508 (10%)
2. Capital Account	**1833**	**678**	**-1155**
3. Financial Account	**5235**	**6469**	**1234**
FDI	1483	1712	229
(Privatization Receipts)	(831)	(1040)	(209)
FPI	2766	2710	-56
Net Foreign Assistance	1223	791	-432
Others	-237	1256	1493
4. Net Omissions& Errors	**-254**	**240**	**494**
5. BOP deficit/surplus	**3843**	**3381**	**-462**
6. Use of Fund Credit	**-572**	**1720**	**1148**
7. Change in FE Reserves	**3271**	**5101**	**1830**

Source: IMF Staff Review Report

5.2. Exports

The trend in exports is given in Table 15. The product group which has shown a decline of 1.1 percent is textiles. Within this group the exports of cotton yarn and cotton cloth have fallen sharply by 22.5 percent and 10.4 percent respectively. However, exports of value-added products like knitwear, bedwear and readymade garments have demonstrated significant growth, especially to the EU due to the granting of GSP+ status.

Table 15
Trend of Exports by Item
July to December 2014

($ Million)

	2013-14	2014-15	Growth Rate (%)
Food Group	**1841**	**1955**	**6.2**
Rice	892	942	5.6
Fish	179	187	4.4
Fruits	129	170	31.8
Meat	113	126	11.5
Textile Group	**6878**	**6799**	**-1.1**
Raw Cotton	118	109	-7.6
Cotton Yarn	1126	873	-22.5
Cotton Cloth	1412	1265	-10.4
Knitwear	1086	1157	6.5
Bedwear	1010	1137	12.6
Towels	362	350	-3.3
Readymade Garments	869	995	14.4
Art & Silk Textile	220	190	-13.6
Make Up Articles	248	319	28.6
Petroleum Group	**436**	**553**	**26.8**
Other Manufactures	**2186**	**2427**	**11.0**
Sports Goods	268	293	9.3
Leather Tanned	291	271	-6.9
Leather Manufactures	238	284	19.3
Surgical Instruments	189	202	6.9
Chemical & Pharmaceuticals	531	626	17.9
Cement	255	228	-10.6
Others	**1126**	**487**	**-56.7**
TOTAL	**12467**	**12221**	**-2.0**

Source: SBP

Rice exports have also shown growth of 5.6 percent. Other manufactured goods like sports goods, leather manufactures, surgical instruments and leather manufactures have also increased. The biggest decline is observed in other exports of 56.7 percent.

Table 16 gives the breakup of the change in exports of individual products between the change in quantity and the change in price respectively. In the case of 18 out of the 22 items covered there is an increase in export price. This is surprising in light of the fall internationally in commodity prices. However, the rise in price has been accompanied by a fall in quantities exported of 16 items. This highlights that in the presence of an overvalued exchange rate and the implied lack of competitiveness Pakistani exporters has faced difficulty in pursuing a more aggressive pricing strategy so as to achieve increases in the volume of exports.

Table 16
Change in Export Quantity and Price of Major Items
July to December 2014

	% Change in		
	Quantity	Price	Value (in $)
Food Group			
Rice	4.2	-0.7	3.5
Basmati	-3.3	5.9	2.6
Others	5.6	-1.8	3.8
Fish and Fish Preparations	-2.7	1.0	-1.7
Fruits	-26.2	22.9	-3.3
Vegetables	-31.4	6.2	-25.2
Sugar	-1.8	2.3	0.5
Meat and Meat Preparations	-17.6	7.6	-10.0
Textile Group			
Raw Cotton	-6.6	-11.3	-17.9
Cotton Yarn	-0.1	-9.3	-9.4
Cotton Cloth	-33.0	20.0	-13.0
Knitwear	7.5	2.6	10.1
Bedwear	0.6	-1.5	-0.9
Towels	0.4	2.4	2.8
Readymade Garments	8.9	0.5	9.4
Art & Silk Textile	-23.9	32.1	8.2
Other Group	**436**	**553**	**26.8**
Petroleum (Naptha)	-59.5	6.1	-53.4
Carpets	-19.4	16.6	-2.8
Sports Goods (Footballs)	0.0	4.2	4.2
Leather Tanned	-14.6	13.3	-1.3
Plastic Materials	-23.2	-1.6	-24.8
Cement	4.0	0.0	4.0
TOTAL	**-4.3**		

*with respect to the corresponding period of 2013-14
Source: PBS

Turning to the destination of exports, Table 17 highlights the relatively high growth of exports to EU countries of 13 percent to the UK, 23.3 percent to Italy, 29.3 percent to Spain, 20.6 percent to Belgium, 6.2 percent to France and 8.9 percent to Germany. However, exports to other major destinations have fallen sharply by 2.2 percent to the USA, 21.2 percent to China and 29 percent to the UAE. China is Pakistan's second largest export market and the two countries have a FTA. The decline in exports is a matter of some concern.

Table 17
Exports by Destination
July to December 2014

($ Million)

	2013-14	2014-15	Growth Rate (%)
USA	2008	1965	-2.2
UK	737	833	13.0
Italy	313	386	23.3
Spain	293	379	29.3
Belgium	209	252	20.6
France	259	275	6.2
Germany	549	598	8.9
China	1433	1129	-21.2
Hong Kong	257	217	-15.6
Afghanistan	502	774	54.2
Bangladesh	378	342	-9.5
Singapore	203	306	50.7
Saudi Arabia	225	237	5.3
UAE	859	641	-29.0
TOTAL	**12467**	**12221**	**-2.0**

*with respect to the corresponding period of 2013-14
Source: SBP

5.3. Imports

Despite the fall in commodity prices, imports have shown a positive growth of over 4 percent in the first six months, as shown in Table 18. Fast growing imports include other food items (41.4 percent), synthetic fiber and yarn (15.6 percent), plastic materials (12.9 percent), medicinal products and transport vehicles (9.3 percent). Despite the big fall recently in oil prices, imports of crude oil and petroleum products declined by only 2.2 percent.

Table 18
Trend of Imports **($ Million)**
July to December

	2013-14	2014-15	Growth Rate (%)
Food Group	**2129**	**2482**	**16.6**
Palm Oil	979	938	-4.2
Tea	141	158	12.1
Pulses	130	143	10.0
Other	879	1243	41.4
Machinery Group[a]	**2546**	**2698**	**6.0**
Transport Group	**843**	**921**	**9.3**
Petroleum Group	**1762**	**7588**	**-2.2**
Textile Group	**978**	**1111**	**13.6**
Raw Cotton	154	146	-5.2
Synthetic Fiber& Yarn	527	609	15.6
Others			
Agricultural & Other Chemical	**3456**	**3457**	**0.0**
Fertilizer	428	370	-13.6
Plastic Materials	805	909	12.9
Medicinal Products	245	292	19.2
Others			
Metal Group	**1307**	**1605**	**22.8**
Miscellaneous Group	**441**	**462**	**4.8**
Others			
TOTAL	**21109**	**21994**	**4.2**

Source: SBP

The major reason for the continued increase in imports, despite fall in prices, is the phenomenal rise in quantities imported, as shown in Table 19. The growth of volume of imports is 86.7 percent in wheat, 33.6 percent in tea, 43.4 percent in pulses, 54 percent in synthetic fiber, 42.8 percent in synthetic and silk yarn, 15.7 percent in insecticides, 27.5 percent in plastic materials, 43.9 percent in iron and steel scrap, 42.3 percent in paper and paper board.

Table 19 Change in Import in Quantity and Price of Major Items *July to December 2014**			
Item	**% Change in**		
	Quantity	**Price**	**Growth Rate (%)**
Food Group			
Wheat	86.7	-16.1	70.6
Wheat	86.7	-16.1	70.6
Tea	33.6	-12.4	21.2
Palm oil	7.9	-2.8	5.1
Pulses	43.4	-4.1	39.3
PETROLEUM			
Petroleum Products	-2.1	-6.9	-9.0
Petroleum Crude	-3.3	-2.5	-5.8
TEXTILE			
Raw Cotton	-33.0	-0.6	-33.6
Synthetic Fiber	54.0	-10.7	43.3
Synthetic & Silk Yarn	42.8	-24.4	18.4
Worn Clothing	0.0	-31.4	-31.4
AGRICULTURAL & CHEMICAL			
Fertilizer	-2.6	19.8	17.2
Insecticides	15.7	26.1	41.8
Plastic Materials	23.5	-1.7	21.8
Medicinal Products	7.8	27.7	35.5
METAL			
Iron & Steel Scrap	43.9	-0.7	43.2
Iron & Steel	42.3	12.1	54.4
MISCELLANEOUS			
Rubber Tyres& Tubes	14.5	15.6	30.1
Paper & Paper Board	37.4	-2.3	35.1
Source: SBP			

The exceptional increase in import quantities can be attributed to, first, substitution of domestic production and, second, because of some ‘trade creation’ due to the fall in prices. The decline in the growth of the manufacturing sector reflects the big jump in imports.

5.4. Home Remittances

Home remittances have shown remarkable buoyancy in the first half of 2014-15, with a growth rate of 15.3 percent. As shown in Table 20, the big increase is from Middle East countries like Saudi Arabia, UAE and other GCC countries. Remittances from the USA and the UK have shown only modest growth, while these from EU countries have declined. This is a reflection of the depressed demand for labor in these countries due to the recessionary conditions.

Table 20
Home Remittances by Source
July to December 2014 ($ million)

	2013-14	2014-15	Growth Rate (%)
USA	1249	1306	4.6
UK	1140	1170	2.6
Saudi Arabia	2204	2650	20.2
UAE	1572	1974	25.6
Other GCC Countries	898	1037	15.5
EU Countries	216	196	-9.3
Others			
TOTAL	**7792**	**8982**	**15.3**

Source: SBP

5.5. Exchange Rate

One of the reasons why exports continue to fall while imports rise is because of overvalued exchange rate of Pakistan. The real effective exchange rate has risen by 4 percent in the last six months.

As shown in Table 21, out of 11 major Asian countries Pakistan is the only which has seen nominal appreciation of its currency with respect to the US dollar. Also, the rupee has risen the most in value with respect to the US dollar. Also, the rupee has risen the most in value with respect to the Euro.

A key policy issue is the need to adjust the value of the rupee so that exports are incentivized and imports discouraged.

Table 21
Movement of the Exchange Rate of Selected Asian Countries

(Units)

Countries	Per $ as of 31st December			Per Euro as of 31st December		
	2013	2014	% Change	2013	2014	% Change
India	61.86	63.19	2.15	85.22	76.52	-10.21
Bangladesh	77.29	77.87	0.75	106.47	94.31	-11.42
China	6.05	6.21	2.48	8.84	7.52	-9.83
Thailand	32.71	32.91	0.61	45.07	39.85	-11.58
Malaysia	3.28	3.50	6.71	4.52	4.24	-6.19
Indonesia	12162	12422	2.14	16754	15043	-10.21
Philippines	44.40	44.78	0.85	61.17	54.23	-11.35
Vietnam	21079	21386	1.46	29039	25899	-10.81
Sri Lanka	130.80	131.21	0.31	180.19	158.90	-11.82
Turkey	2.15	2.33	8.37	2.96	2.82	-4.73
Pakistan	105.50	100.53	-4.71	145.33	121.74	-16.23

Source: www.xe.com

6. ECONOMIC OUTLOOK

The world economy has been experiencing a slowdown for a number of years now. IMF has produced recently its forecasts for different global indicators up to 2016. The growth rate in 2015 of world output has been revised downwards by 0.3 percentage points to 3.5 percent. The decline is expected in the Euro Area and Japan, while the projection for USA has been revised upwards. It is indeed surprising that IMF has revised downward its global growth forecast in the presence of substantially lower oil prices.

Similarly, the projected growth of world trade has also been brought down by 1.1 percentage points to 5.3 percent in 2015. Imports by advanced economies are expected to grow by a modest 4.8 percent in 2015. Oil prices are expected to remain lower by 41.1 percent in 2015, with some recovery by 12.6 percent in 2016. Other commodity prices are also projected to be lower by 9.3 percent in 2015, followed by some stabilization in 2016.

The implications for Pakistan is that given the state of the world economy, prospects for exports, remittances, FDI and foreign aid are not very favorable. However, Pakistan will continue to enjoy the benefits of much lower oil prices.

The IMF's fourth and fifth review of the EFF with Pakistan also contains projections of the economic outcome in 2014-15. As demonstrated below, the projections are optimistic in nature and do not adequately reflect the conditions both in the global and the domestic economy. Clearly the Fund has an interest in showing positive developments to demonstrate that the program is working successfully.

The GDP growth rate is projected at 4.3 percent in 2014-15, as compared to 4.1 percent in 2013-14. The Fund does recognize that the latter growth rate has been significantly overstated. Is there a basis for assuming that the economy will grow faster in 2014-15?

First, as highlighted above, the large scale manufacturing (LSM) sector is in the grip of a slowdown. In the first four months, July to October, the growth rate was very low, at close to 1 percent. This is a reflection of the fall in exports, pervasive gas shortage and power load shedding. To get back to the growth rate last year of 4 percent, the sector will have to grow at a faster rate of 6 percent for the remainder of the year.

Second, the agricultural sector has been impacted by the floods, albeit less than what was thought to be case initially. It is estimated that there is a modest increase in the output of the cotton and sugarcane crops. However, rice production has declined significantly. The expectations are that there will be a significant jump in the output of wheat crop of about 4 percent. Overall, the major crop sector is likely to show a somewhat higher growth rate of about 2 percent, as compared to only 1 percent achieved last year. With the primary and secondary sectors showing slow growth it is unlikely that the tertiary sector of services will be buoyant. Overall, 2014-15 is likely to close with a growth rate of GDP between 3.75 percent to 4.25 percent. The upper end of this range is close to the IMF projection

6.1. Investment

The IMF projects a major revival of investment in the economy with a growth rate of 16 percent in 2014-15. Private sector investment, in particular, is expected to be very dynamic, with a growth rate of over 21 percent. Unfortunately, these are very optimistic projections. In the first five months, as highlighted above, imports of machinery have increased by 6 percent. Bank credit to the private sector is down by as much as 37.67 percent. Further, releases for the federal PSDP show little growth over the level attained last year. Foreign investment has shown some growth, but is down to less than 5 percent of the total investment in the economy. If security conditions deteriorate then the private investment may become more shy. Therefore, the investment rate is unlikely to rise significantly in 2014-15.

6.2. Inflation

One area in which the IMF appears to be unduly cautious is in the projection of the rate of inflation, at just under 8 percent in 2014-15. Already, it has fallen to 4.3 percent in December 2014. Part of this is, of course, due to the 'high base' effect, with inflation at the peak rate of almost 11 percent in November 2013. There is no doubt, however, that sharply falling commodity prices internationally are exerting a strong downward pressure on the domestic price level. The Government has appropriately brought down the prices of petroleum products and has indicated that it will do the same with electricity tariffs (via a negative fuel charge adjustment).

However, there are reasons why the rate of inflation may start rising somewhat from 4 percent once again. The procurement/support prices of wheat and sugarcane have been raised. The GIDC in gas has been imposed by an ordinance. Also as indicated above, the level of deficit financing from the SBP may rise sharply in the second half of 2014-15. The rapid expansion in money supply will put pressure on prices. Over all, the IMF expectation of average inflation in 2014-15 of almost 8 percent is on the high side. It is more likely to be in the range of 5 to 5.5 percent.

6.3. Public Finances

Turning to the projected size of the fiscal deficit, both the government and the IMF are expecting a low deficit of 4.8 percent of the GDP in 2014-15. The actual deficit may be substantially larger for a number of reasons indicated in the section above on public finances. First, FBR revenues are already falling short of the target significantly. Second, there may be no option, following the recent petrol crisis, but to retire part of the circular debt of almost Rs 300 billion. After allowing for a cutback of over 15 percent in the national PSDP, the consolidated deficit of the federal and provincial governments may approach 6 percent of the GDP.

6.4. Balance of Payments

The trend in the balance of payments is of crucial importance. The IMF is very positive about the build-up of foreign exchange reserves to $14 billion by the end of 2014-15. This will represent an increase of $5 billion over the last year’s level. The current account deficit is expected to rise to $4 billion, from just under $3 billion in 2013-14. This will be compensated for by a jump in capital inflows, especially due to an increase in the net inflow from the IMF under the EFF.

In line with the fall in commodity prices, the Fund expects exports to rise by only 1 percent in 2014-15. However, exports have actually fallen by 2 percent in the first six months. They are unlikely to show a big positive growth rate in coming months. Imports are projected to grow by 5 percent in 2014-15, as compared to 6 percent from July to November. The growth rate may be lower as the country benefits from lower prices. Overall, the Fund projection of a current account deficit of $4 billion looks reasonable.

The big question relates to capital inflows into the Financial Account of the balance of payments. The IMF projects that these will aggregate to $6.5 billion in 2014-15. In the first six months, the net capital inflow is $2.4 billion, including $1 billion from the flotation of Ijara-Sukuk Bonds. Therefore, there may be a significant shortfall in capital inflows. Consequently, reserves may not reach the level of $14 billion by end-June 2015.

In summary, the year 2014-15 may not see the kind of strong revival and greater stabilization of the economy as anticipated by the government at the start of the year in the Annual Plan. The growth rate of the economy may show little improvement, private investment will remain shy, the fiscal deficit could rise sharply and the balance of payments position may not improve as much as anticipated. The silver lining could be a sharp fall in the rate of inflation.

In summary, the projections for 2014-15 are as follows:

	Annual Plan/ Budget	IMF	IPR
GDP Growth Rate (%)	5.1	4.3	3.8-4.3
Rate of Inflation (%)	8.0	8.0	5.0–5.5
Fiscal Deficit (% of GDP)	4.9	4.8	6.1
Current Account deficit (% of GDP)	1.1	1.4	1.4

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