INSTITUTE FOR POLICY REFORMS

IPR FACT SHEET

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State of the Economy in 2014-15

The Pakistan Economic Survey (PES) for 2014-15 was released on the 4th of June 2015. The state of the economy as revealed by the PES and other sources is described below.

Mixed Performance in Achieving Targets

Out of the 15 targets in the Annual Plan for 2014-15, four are likely to be achieved. These include the rate of inflation, current account in the balance of payments, growth of imports and net foreign assistance. The precipitous fall in global oil and other commodity prices is the primary explanation for achievement of these targets.

The eleven targets which will be missed include the GDP and sectoral growth rates, private and public investment, export growth and the level of foreign direct investment.

The GDP Growth Rate is Overstated

The growth rate of GDP in 2013-14 has been brought down marginally from 4.1% to 4%, primarily due to a lower growth rate of the large-scale manufacturing sector. This has been compensated for by a big upward revision in the growth rate of the important crops sector from 3.7% to 8%. Analysis by IPR reveals that the growth rate of this sector is 5.9%, not 8%. Consequently, the growth rate of the GDP in 2013-14 is 3.9%, not 4%.

The pattern of growth in 2014-15 appears to be fundamentally different from that observed in 2013-14. The growth rate of the important crops sector has plummeted to 0.3% only and the growth rate of the large-scale manufacturing sector has fallen to 2.4%. Despite this, PBS estimates a higher GDP growth rate in 2014-15 of 4.2%

In-depth analysis by IPR indicates that the growth rate has been significantly overstated in a number of sectors including important crops, livestock, forestry, fishing, construction and general government services. This brings down the GDP growth rate from 4.2% to 3.6%.

Over the last five decades, the economy has grown by less than 4% in a

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year when the industrial sector achieves a growth rate of less than 4%, as in 2014-15.

The low growth rate of the important crops sector is attributable to a 1.1% drop in wheat, fall of 5% in maize and 7.1% decline in sugarcane output. Due to adverse weather conditions, the reduction in wheat output may be even larger. Fortunately, the big jump in cotton output of 9.5% has compensated for the fall in other crops. Despite the floods in Punjab, it is reassuring to note that the output of rice has still shown a growth rate of 3%. However, the exports of basmati rice , in particular, have fallen by as much 22.5%.

The large-scale manufacturing sector remains sluggish. It has grown on average in the last six years by less than 1% annually. This year the growth rate is estimated at 2.5%, compared to 4% last year. The textile sector has shown little growth in the first nine months of 2014-15. Food , beverages and tobacco industries are showing a decline. The growth rate of the cement and fertilizer industry is below 3%. The only industries which have shown high rates of growth are automobiles and iron and steel products. Overall, out of the 98 items covered by the Quantum Index of Manufacturing (QIM) of PBS, 41 items show a negative growth rate, while 11 items have a growth of less than 2%.

The services sector has performed well in 2014-15, with a growth rate approaching 5%, as compared to 4.4% last year. The dynamic sectors have been finance and insurance (6.2%), general government services (9.4%) and private services (5.9%). However, as highlighted above, we believe that the growth rate in some services is overstated.

Private Investment Continues to Fall

Private investment has continued to fall to one of its lowest levels ever of 9.7% of the GDP. Factors contributing to the fall are acts of terror, law and order situation in Karachi, high levels of power load shedding, shortage of gas and 'crowding out' of the private sector from bank credit.

Private investment in large-scale manufacturing is down to only 1.2% of the GDP. Also, at less than 0.1% of the GDP, the private sector has virtually stopped investing in the power sector, due primarily to the high level of receivables with IPPs.

Public investment is also overstated. It is likely to be 3.4% and not 3.9% of the GDP. Consequently, the total investment-to-GDP ratio will fall from 15% of the GDP in 2013-14 to 14.7%. One of the weakest spots of the economy continues to be the lack of revival of investment. This is yet another indicator that the economy has not been able to get out of the 'low growth trap'.

Labor Market Conditions have Deteriorated

The Labor Force Survey (LFS) of 2013-14 has just been released by PBS. The numbers in the LFS are not consistent with the findings of the PES.

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Worrying developments in 2013-14 include a fall in the labor force participation rate, probably due to a ' discouraged worker' effect, especially among youth. Consequently, the total labor force in 2013-14 has increased by only 360,000, as compared to an annual average increase of 1,690,000 in the previous six years.

The economy has created only 510,000 new jobs in 2013-14. This is one third of the job creation rate in the previous six years. Bulk of the jobs have been created in the informal sector, which is characterised by a large number of working poor.

Inclusion of discouraged workers raises the unemployment rate to 6.4%. The unemployment rate is very high among youth of almost 11%. Also, real wages of unskilled workers have fallen by almost 5% in 2013-14. The poor labor market conditions are likely to have persisted in 2014-15.

The Rate of Inflation has fallen sharply

One of the major positive developments in 2014-15 is the unprecedented fall in the rate of inflation from 7.7% in July 2014 to 2.1% only in April 2015. It has risen somewhat last month to 3.2%.

The fall in the rate of inflation is due primarily to the fall in international commodity prices, especially of oil, by over 40%. Consequently, domestic food and fuel prices have registered significant declines, although the Government has limited the transmission effect by imposition of large regulatory duties on basic food items like wheat and sugar.

The `core` rate of inflation stands currently at 4.9%. Therefore, some demand pressures continue to persist in the economy. The international price of oil has started to rise once again. Also, prices of food items like livestock products, pulses, onion and tomato have experienced big increases in 2014-15.

The Balance of Payments Position has Improved

The main factor contributing to the improvement is the virtual halving of the current account deficit. In fact, it has turned positive in recent months as imports have fallen due to the containment of the oil import bill, and continued buoyancy in home remittances.

The soft spots are smaller capital and financial account surpluses. However, net credit inflow from IMF is larger at almost $2 billion. Foreign exchange reserves have risen by $2.8 billion as of 29th May in 2014-15. However, this increase is due entirely to external borrowings and privatization receipts.

The fall in exports of over 3% is due more to fall in quantities. Export prices have actually gone up by 0.5%, according to PES. This indicates more the presence of supply-side constraints, like the power shortage.

Import quantities have shown big increases in items like tea, pulses, synthetic fiber and yarn, iron and paper and paper board. The fall in prices has constituted a threat to domestic import substituting industry.

The big increase in remittances of over 16% is due primarily to larger inflows from Saudi Arabia and UAE. The latter accounts for 20% of remittances but for 42% for the increase. This raises the possibility of reverse capital inflow into Pakistan (for whitening of black money)

The nominal value of the rupee has remained, more or less, stable in recent months. According to SBP, the real effective exchange rate has appreciated by over 18 per cent. Overvaluation of the rupee has adversely impacted on competiveness of exports and artificially raised import demand.

In a tight and competitive environment of world trade, many countries have significantly depreciated their currencies, by 6% in the case of India, Turkey by 22%, Indonesia by 12%, Thailand by 4%, Egypt by 7%, Argentina by 11% and Brazil by 43%. Pakistan may also have to do so, sooner or later.

Focus of Fiscal Policy is on Stabilization, not on Growth

FBR tax revenues have increased by 12.7% only in the first ten months as compared to the budgeted growth rate of 24% in 2014-15. Even the lowered target of Rs 2691 billion is unlikely to be met. The initially negative impact of the fall in oil prices has been countered by increases in the GST (for example, from 17% to 32% in the case of HSD oil) and by imposition of regulatory duties on POL products (like 7% on furnace oil).

Current expenditure has shown moderate growth at the Federal level of 10% in the first nine months. Costs of debt servicing have risen by 7%, less than anticipated due to the fall in interest rates. Despite the costs of Zarb-e-Azb, defence expenditure has gone up by 7.5%, again below the projected growth rate.

The short fall in revenues has already led to a cut back in PSDP releases. As of 22nd May an amount of Rs 385 billion has been allocated, equivalent to 73% of the annual targeted PSDP.

The federal fiscal deficit is estimated in the first nine months at Rs 1227 billion, equivalent to 4.5% as compared to 4.2% of the GDP last year. The annual target is 5.9% of the GDP. Therefore, there is the likelihood that the deficit will exceed the target.

Provincial own tax revenues have grown by only 6.6%, while expenditures have risen at a much faster rate, current expenditure at 14.6% and development spending by 45.5%. The Provinces appear to be establishing higher expenditure benchmarks for the 9th NFC Award. It is unlikely that the combined Provincial cash surplus will reach the targeted level of Rs. 289 billion.

The federal fiscal deficit is being financed disproportionately by the scheduled banks in 2014-15. Borrowings from these banks are financing almost 75% of the deficit. This has enabled the Government to bring down its borrowings from SBP by over 360 billion as of 22nd of May.

The Power Sector continues to Underperform

According to the PES, there is an increase of only 792MW in electricity generation capacity in the first nine months of 2014-15. The actual generation has fallen by 2.3%. This explains the continued high levels of power load shedding. Further, the fall in generation raises serious questions about how the economy can grow at over 4% with less power.

The use of thermal power in electricity generation has also fallen by 2.8%, despite the over 17% increase in the consumption of furnace oil. Fortunately, there has been a modest increase of 1.3% in the consumption of electricity, despite the fall in generation. This implies some reduction in transmission and distribution losses.

Industrial consumption of electricity has increased by about 2%. This is consistent with the growth rate of the large-scale manufacturing sector of just above 2%. Agricultural and government consumption of electricity have declined.

NEPRA has reflected the reduction in fuel costs in the form of negative Fuel Charges Adjustment monthly. This has implied an effective reduction in the price of electricity of up to Rs. 3/kwh. The adhoc surcharges imposed by the government have been struck down recently by the Lahore High Court. This will provide more relief to consumers.

Social Development Indicators have started Falling

The unthinkable has happened. The findings of the latest Pakistan Living Standards and Social Measurement Survey 2013-14 by the PBS has revealed, perhaps for the first time, that some of the key social development indicators have started falling.

In 2013-14, the literacy rate fell by two percentage points(from 60% to 58%); full immunization coverage declined by six percentage points (from 82% to 76%); the percentage of households with improved water source decreased by four percentage points (from 30% to 26%) while the net primary enrolment rate remained unchanged.

The 7th NFC Award led to a big increase in transfers of over Rs 200 billion annually to the Provincial Governments. The fall in the indicators highlights both that not enough priority has been given to the provision of basic social services to the people and that there has virtually been a breakdown of governance in the delivery of services.

Overall, the year 2014-15 has been a mixed year. On the positive side, the rate of inflation has fallen sharply, the balance of payments position has improved, with a significant increase in foreign exchange reserves. The fiscal deficit will be contained to an acceptable level and some of the services sectors have performed well.

On the negative side, the important crops and large-scale manufacturing sectors have shown low growth and have contributed to keeping Pakistan in the `low growth trap`. Labor market conditions have deteriorated and tax revenues have shown only moderate growth, despite a heavy dose of taxation proposals. The PSDP has been cut back. The power sector continues to underperform and, perhaps for the first time, social development indicators have started falling. We hope that these soft spots will be largely removed in 2015-16.