INSTITUTE FOR POLICY REFORMS

IPR FACT SHEET

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Pakistan Economic Survey 2015-16

About IPR

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State of the Economy

The economy performed much as expected. It met some of the targets. The rest we knew were too ambitious. Inflation and fiscal deficit seem in check and tax collection is on track. For the first time in many years, FBR tax collection will achieve target of Rs.3,104 Billion. But growth rate has fallen short, as economic stability remains the objective of choice. There is no visible step yet to place the economy on a sustained path of development. And, as of now, government has shared no plans about it. In the immediate context, three issues are of most concern. These include negative growth in agriculture, sluggish industry (though with revival in some areas) and a 15% drop in exports. They need deep analysis for appropriate short and long-term reforms. So far, policy makers seem to take these issues in their stride.

Annual Plan Targets Vs Achievements

Let us first look at the targets for 2015-16in the Annual Plan that were approved by the National Economic Council:

- The target for GDP growth for 2015-16 was 5.5%
- Fiscal deficit estimate was set at 4.3%
- The estimate for tax revenue was Rs. 3,729 Billion with Rs. 3,104 Billion by FBR
- Inflation was targeted at 6%
- Investment estimate was 17.7% of GDP of which private fixed investment was set at 12.2% and public at 4%
- The national saving estimate was 16.8%
- Foreign Exchange reserves of USD 19 Billion
- Exports were estimated to grow to USD 25,547 Million and inflow of foreign direct investment was to be USD 3,344. The current account deficit was set at USD 2,891 Million

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Targets Achieved

Of the above, the economy will possibly meet a number of targets.

- **Fiscal Development**

Tax Revenue

For the nine months July-March 2015-16, total federal revenue increased by over 9%. FBR revenue, for the same period, has increased by 18.5%. It appears certain that federal government will reach its tax revenue target of Rs. 3,104 Billion. This has improved the tax to GDP ratio. Non-tax revenue will fall short. A word of caution is necessary. GoP continues to rely on indirect taxes. It is no surprise that year on year growth for the nine months is 13% for direct taxes and 24% for indirect taxes. This has further skewed the distribution between direct and indirect taxes. Such high reliance in indirect tax is regressive. It also retards growth. There is news of further increase in indirect and withholding taxes. This could sap economic activity.

Fiscal Deficit

It is likely, though not certain, that fiscal deficit will remain within 4.3%. Government has done well to increase revenue and control expenditure. A caveat is on order. The budget deficit for July-March 2015-16 was 3.4% of GDP. The nine-month deficit has doubled from the fiscal deficit of 1.7% during July-December 2015-16. This is after a provincial surplus of Rs. 221 Billion. While still in check, it is no longer certain that the deficit will stay within the target of 4.3%. In any case, the deficit is understated as GoP has held back payment of power sector debt(about Rs. 350 Billion) and FBR refunds (Rs. 200 Billion).

- **Inflation**

Inflation is well under control. Despite recent increase, average inflation for fiscal 2015-16 will remain well within the target of 6%. Recent trends, however, suggest a pick up. Monthly inflation bottomed out middle of last year. Since September, inflation has grown every month. After a low of YoY growth of 1.3% in September 2015, CPI grew to 4.2% in April. Food and energy prices have increased, as have indirect taxes (regulatory duty on import, tariff increase, and GST). Also, the rupee declined by

2.8%. However, average CPI for July-April 2015-16 is still 2.8% and there is very little risk of inflation breaching the 6% target. For the next year, it is necessary to keep an eye on inflation. Currency in circulation grew 2.6 times in first half 2015-16. Both government and private borrowings grew in H1 2015-16, but have declined in the third quarter.

- **Foreign Exchange Reserves:**

  Foreign exchange stood at USD 21.6 Billion on 20 May 2016. This is indeed an unprecedented level. However, high foreign reserves have significant debt component and have increased the economy's risk profile. Some of it is commercial borrowing at high cost. During 2014-15, GoP borrowed USD 1.4 Billion from commercial sources at a cost that ranged between 4.74 and 5.2%. According to SBP, Pakistan has incurred short-term debt of USD 575 Million since the start of the fiscal year. Most of this debt is to pay back previous loans. The country is effectively in a debt trap.

Government can take justifiable credit for bringing stability to the macro framework. It is a necessary condition for growth. Inevitably, stability comes at the cost of growth. In addition, some measures have added risk to the economy, others perpetuate inequity, and some dampen growth. While forex reserves are healthy in the near term, a major portion consists of borrowings, some of it at high cost.

Without major reforms, the economy will continue to grow at moderate rates. There is no talk yet in policy circles on structural reforms. GoP must put in place structures to reduce cost of doing business. Economic policies reflect political choice. There is, so far, no effort to improve governance and address our grievous political economy.

Targets missed:

- **Growth and Investment**

Growth rate

The target growth rate of 5.5% comprised increase of 6.4% in industry, 3.9% in agriculture, and 5.7% in services. The PES estimates actual GDP growth in 2015-16 as 4.71%. While government has celebrated this growth rate, it is fueled by the services. The productive sectors of the economy, agriculture and industry, have been stagnant. As per the National Accounts, 1.4% contribution comes from industry, 3.35% from services, and a minus 0.04% from agriculture.

Agriculture: Decline in agriculture production is serious. While we hope this is temporary, it seems to be structural. Decline in production of three major crops, rice, wheat, and cotton, is the likely outcome of a mix of policy gaps. These include low investment in water resources and management. They include also no attention to a brewing crisis on seeds and virus coupled with price volatility. GoP's package for farmers' does not seem to have helped.

Manufacturing: GoP sees manufacturing performance as a sign of revival. However, manufacturing has seen mixed progress. It is particularly worrying to see textile stagnate. Year on year, textile production has grown by 0.6% during July-March 2016. It actually fell in March 2016 by 0.8%. Many other industries languish. These especially include engineering goods, electronics, and iron and steel. Autos, chemicals, and pharmaceuticals have done well. Manufacturing achieved double digit growth between 2000 and 2007.

There is news that government will announce incentives for revival of industry and agriculture. Clearly, its agriculture package announced last year did not work. While short-term measures are welcome, these sectors need long-term commitment to policies that enhance competitiveness and productivity. Sops and fiscal incentives alone will not work.

Methodology for growth estimate

IPR also recommends that GoP review the National Accounts methodology. This is especially apparent in estimates for economic growth. Some GoP assumptions may have tweaked up the growth rate. This year agriculture production has taken a major hit and industry has grown at less than the target growth rate. Power shortages continue unabated despite improvements on the margin. It is counterintuitive to see increase in overall growth rate from last year.

Let us first look at industry. While LSM has grown at 5%, below its target rate of 6%, growth in mining and power supply exceed targets. Also, for want of a better method, GOP approximates estimates for small scale and other industry. Their growth rates have not changed for years. Rates of 8.2% and 3.6% have no support in data. This is an endemic national accounting issue.

The growth rates for mining (6.8%), power supply (12.2%), and construction (13.1%) too seem high when compared with actual activity. According to the PES, mining index is at 179.9 in 2015-16 compared to 178.1 last year. Power supply grew by 10.6% (not 12.2%), but consumption of other energy was low. Oil consumption fell by 20% in 2015-16 and coal fell by 17%. Gas consumption grew by 6%.

The 5.7% growth in services too seems high. This is the part of national accounts whose accuracy is hard to ensure. Decline in agriculture production must translate to less activity in commerce and in transport. Estimates of 4.6% for wholesale and retail, and 4% for transport, therefore, seem high. Along with domestic production, export fell in value and volume. Though imports increased in volume, it is unlikely that this compensated for lower domestic production and exports. Finance and Insurance is estimated to grow by

7.8%. Total mark up and non-markup income of banks declined by 5% in the first quarter. Though they recovered in the second quarter, an era of low markups has squeezed profits. Also, while the Economic Survey shows over 11% growth in general government services, MoF shows a YoY growth of 6% in current expenditure. IPR recommends a review of accounting methods.

Investment

The target for total investment in fiscal 2015-16 was Rs. 5,438 Billion. This is about 17.7% of GDP. The Annual Plan 2015-16 set public fixed investment at Rs. 1,212 Billion, 4% of GDP and private fixed investment at Rs. 3,735 Billion, 12.2% of GDP. Actual investment to GDP ratio was 15.2% against 17.7%. The PES estimates private investment at 9.79% of GDP and public investment to be 3.82% of GDP. (There is discrepancy in the numbers).

Pakistan's historic investment to GDP ratio is 20%. For several years, this ratio has not reached 15%. In fact, it dropped to 12% in 2012. To revive the economy, it is critical to have policies that increase savings and investment.

Public investment is low. Total budgeted public investment of Rs. 1.5 Trillion for the country in 2015-16 was barely 5% of GDP. It was 16% of total federal budget. Actual spent up to March 2016 was Rs. 623 Billion. This scale is a travesty given the severe gaps in infrastructure and social indicators.

Private sector credit grew during H1 2015-16, but fell in the third quarter. H1 private credit was Rs. 353 Billion against Rs. 222 Billion for H1 2014-15. A number of industries benefited. These include textiles, fertilizer, retail trade, construction, and power. This scale must increase. Pakistan has one of the lowest private credit to GDP ratios. This ratio has been in decline. From a peak of over 25% between 2005 and 2009, it has fallen to about 7% in 2015. We will watch if this year's increase in private credit will reverse this trend. This is key as in recent years banks have profited simply by lending to government for budgetary support.

While banks prefer to lend to government, PSX remains under-developed. PSX does not yet perform the key role of supplier of capital to businesses. This need is especially felt as DFIs have phased out in Pakistan. Government, the SECP, and PSX must develop the capital market as a source of debt and equity for businesses.

As noted below, FDIs have stayed at very low levels, though there is marginal increase.

Balance of Payments

Current Account Deficit for July-April 2015-16 has improved when compared to previous year. For July-April 2015-16, CAD was USD -1,519 Million. The balance was USD -1,846 for the same period previous year. The reasons are not specially promising.

Exports of goods and services have declined, so CAD improvement comes from lower imports and rise in remittances. Exports have fallen consistently for about a year and a half. Pakistan has not adapted to the changes in world economy. Low growth in major economies called for measures to address competitiveness issues. In absence of such measures, exports have been adrift. There are concerns that export loss to Vietnam and Bangladesh would be hard to regain. This is a major concern with which GoP has not yet come to terms. In 2015-16, exports were 5.5% of GDP compared to 6.6% in 2014-15. Historically this ratio has been over 10%. It was 13.5% in 2002-03 and 10.3% in 2012-13. These are indicators of a serious secular decline. We have yet to see a policy response.

FDI is the other concern. It grew by 5% for July-April 2015-16 over the same period last year. Total FDI of USD 1,017 Million is still very low. GoP's FDI target for the year was USD 3,344. It will be hard pressed to reach half the target. Flows have more than doubled from China and have halved from the rest of the world. These are alarming figures and point to deep flaws in the economy's ability to attract FDIs. Pakistan must do something special to attract investment.

External Debt for July- March 2015-2016 has grown by over USD 3.9 Billion from March 2015. This does not include IMF financing and other liabilities. Increase in commercial foreign debt has grown by USD 1,400 Million since July 2015. Eurobonds and Sukuk have stayed at USD 4,550 Million. These are high cost debt. So even as Forex reserves have improved, Pakistan's foreign debt servicing grew by 19.5% for July March 2015-16.

Under-performance of energy sector

Energy shortage, especially uncertain power supply, has hampered industry and commerce. We would have expected government to take benefit from low energy prices and place the power sector on a sustained path. Overall, consumption of energy may have declined as seen by oil and coal use. Power supply has grown by 10.6%. In a surprising development, the PES shows decline in installed capacity from 23,212 MW in 2014-15 to 23,101 MW in 2015-16. This is contrary to government claims.

Social sector indicators

It was thought that social sector indicators would improve with greater autonomy and fiscal resources with the provinces. The reverse has happened. A number of key indicators in education, health, water, and sanitation worsened in 2014-15. Indicators declined in the following areas:

Education indicators: Key indicators that declined were net primary enrolment, net middle enrolment, and government primary enrolment. These indicators declined in Punjab and Sindh.

Health indicators: Full immunization of 12-23 months declined in Sindh and Balochistan. Post-natal consultation also declined for these two provinces

Indicator for housing units with two or more rooms declined.

Worsening social indicators reflect political preference and quality of governance. Social sector is best served by local governments. They respond to immediate needs of the people.

Pakistan's social deficit is a hurdle in the path of sustained growth. GoP's frequent claims that Pakistan will become an Asian Tiger does not seem to square up with realities on the ground.