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Review of the Economy: July-September 2016

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About IPR

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Executive Summary

Review of first quarter 2016-17 performance of the economy shows a mixed trend, with respect to both fiscal consolidation as well as growth objectives. A caveat is in order. One quarter is only an initial indicator of the whole year's performance:

- The commodity producing sectors of industry and agriculture show moderate growth. LSM grew by 2.3% during the first quarter. The target for growth in manufactures during 2016-17 is 5.9%. Manufacturing sector saw a decline in textile, petroleum products, and in food. Production of major agriculture crops increased, after a significant decline in 2015-16. Cotton production is 18% higher. Rice production also grew. Production of wheat and sugarcane are expected to improve, though marginally. It is early to say if the economy will achieve the target rate of 5.7% growth. For this LSM growth must improve and the power sector must perform better. IPR also recommends review of National Accounts methodology.
- Fiscal deficit and current account deficit seem to have worsened from the previous year. Inflation remains under control. There is unpaid fiscal liability of an estimated Rs. 650 Billion circular debt. Accounting for this large liability, increases the fiscal deficit.
- GoP has set ambitious target for revenue collection this year above the high growth achieved in fiscal 2016-17. Last year, was the first in many, when FBR achieved and exceeded revenue target for the fiscal year. FBR's revenue for fiscal 2015-16 increased by 20% over the previous year. This year targets a further increase of about 17% in FBR taxes and 16% in federal revenue. For the first quarter, FBR and total federal revenues have grown by 4% and 3% respectively.
- Collection of other taxes and non-tax revenue declined substantially, by 9.5% and 51% respectively.

Government's current expenditure for the first quarter remains within proportional budget. Development expenditure for the first quarter is

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9% below the same period last year. PSDP releases up to 16 December 2016 was 35% of total for the year. Debt servicing stayed within budget.

- Markup rates have been stable, yet private credit has declined during the quarter after substantial increase in 2015-16.
- Balance of Payment is a major concern. All three forex sources have declined. Year on year, exports fell by a further 9.5%, FDI has lagged, and remittances declined by 4%. During the period, imports grew by 10% and fiscal deficit has increased by 29%.

The prospects for the economy to see rapid and sustained growth depend on important policy changes to address structural issues. There are fundamental issues that prevent the economy from achieving sustained economic growth.

- The economy has yet to strengthen long term fundamentals. Nor is there yet a basis for higher level of productivity. (The undergoing infrastructure investment, especially under CPEC, will help with productivity).
- Because of higher imports and debt servicing needs, and with declining exports, slow FDI (so far), and lower remittances, IMF estimates increase in the need of external resources from USD 7.3 Billion in 2015-16 to USD 14 Billion by 2020.
- Of the factors that increase productivity, infrastructure will improve in coming years. However, there is no indication yet of upgrading of skills, improved R&D, and improvement in governance. So far, we have not seen a major policy initiative to empower economic players.
- Import of power generation machinery has increased greatly. In 2015-16, Pakistan imported power generation machinery worth USD 1.8 Billion. This equals additional capacity of about 1700 to 1800 MW. Since then, additional USD 795 Million worth of machinery imported during the first quarter, suggests an increase in generation capacity by 750 to 800 MW. Pakistan should near its target of increasing power generation by about 13,000 MW by 2018 to 2020, including 10,700 MW under CPEC. Increase in import of other machinery show the possibility of overall revival in industry.
- There is no sign yet of a surge in savings and investment. Last year, their ratio to GDP were well below target level. In fact, private investment fell from 10.2% of GDP in 2014-15 to 9.8% in 2015-16. While targets for the current fiscal year too are the same, there is no new of policy to achieve them. Government must lead a concerted effort to reduce its negative savings.

- While development budget has increased from the previous year, questions remain about project selection, transparent procurement, and effective project management. These issues reduce the returns to the economy from PSDP spending. Allocation for some key sectors, such as higher education, health, and especially the water sector, have declined in recent years. Overall, public investment in infrastructure and people remain well below needs
- To support growth, economic policy must review the political economy. It shows most obviously in tax policy, but equally in expenditure priorities.

The economy needs an urgent and effective response to the constraining structural issues.

Review of the Economy
First Quarter, July-September 2016

1. Targets

Budget 2016-17 and the government's annual plan 2016-17 set the following targets for the economy for fiscal year 2016-17:

- GDP growth: A target of 5.7% has been set for GDP growth for fiscal 2016-17, with agriculture growth of 3.5%, industry 7.7%, and services 5.7%. Within Industry, large scale manufacturing is set to grow by 5.9%. The targets are ambitious. Growth estimate for GDP and its components are substantially above those achieved in 2015-16. Official estimate of GDP growth for 2015-16 is 4.7%, with agriculture growth at negative 0.19 %, industry and LSM at 6.1% and 3.1% respectively, and services at 5.7%[1].

- Fiscal deficit: Despite projection of a high GDP growth rate, government rightly still considers fiscal consolidation an objective, to maintain strong fundamentals. The 2016-17 fiscal deficit target is 3.8% compared to an actual of 4.3% for 2015-16[2]. This will be achieved through 15.7% increase in total revenue (with 16.7% increase in FBR taxes) and by limiting increase in current expenditure to 6.8%[3]. An important component of the federal budget is a provincial surplus of Rs. 339 Billion[4]. The 2015-16 estimate was Rs. 297 Billion, but the actual surplus was Rs. 207 Billion[5].

- Savings and Investment: GoP plans higher investment in the economy based on growth in savings and FDI. This will lead to growth in GDP. Fiscal year 2016-17 targets for savings and investments are 16.2% and 17.7% respectively. The corresponding actuals for 2015-16 were 14.6 and 15.2%[6]. IMF's preliminary actuals for the two indicators for 2015-16 are 14.2% and 15.2%[7] (the latter is gross capital formation a slightly different measure than investment to GDP ratio).

- Inflation: The target for inflation in 2016-17 is 6% compared to an increase of 3.19 in CPI for 2015-16[8]. Increase in SPI and wholesale prices was much lower while core inflation rose by 4.6%.
- External Account: GoP has set a target of 10.8% growth in exports in 2016-17, (to USD 24.8 Billion, fob). In 2015-16, exports declined by 12%. With expected increase in

[1] Planning Commission GOP, Annual Plan 2016-17, Pages 1 through 9
[2] MOF, Budget Speech by Finance Minister, June 2016, Page 5
[3] MOF, Budget in Brief Table 8
[4] MoF, Budget in Brief Page 51
[5] SBP, State of the Economy, Annual Report 2015-16
[6] Planning Commission, Annual Plan 2016-17, Page 10 Annex II
[7] IMF Twelfth Review under the Extended Arrangement, Table 4, Page 33
[8] IPR, Annual Review of the Economy 2015-16, Page 13

imports the trade balance is targeted to be USD 20.5 Billion in 2016-17[9], it was USD 18.4 Billion in 2015-16[10] (both fob). Pakistan Bureau of Statistics reports a trade deficit on goods of USD 21.2 Billion for 2015-16. The Annual Plan estimates current account deficit of 1.5% of GDP against actual of 0.9% in 2015-16[11]. FDI for 2016-17 is targeted at USD 4.5 Billion compared to USD 1.3 Billion in 2015-16[12].

- In addition to macroeconomic stability, GoP has predicated increase in growth on a number of drivers. These include growth in commodity producing sectors as well as services. The stimulus is expected to come from higher debt and equity flows from China (CPEC investments) and higher savings and investments from within the economy. An easy monetary policy with low capital cost will increase private credit and investment. The government estimates that increase in power production, telecom connectivity, and upgraded water infrastructure for agriculture will stimulate GDP growth sufficiently.

This is the first financial year for the current government to proceed largely without IMF's mandatory review. However, the two parties have agreed on a medium-term macroeconomic framework. It is most likely though that from here on election politics would guide policy.

2. Economic Performance

GDP Growth: Let us look at the key determinants of growth, which include industry, especially LSM growth, as well as performance of agriculture and services. As government prepares national accounts annually, we will look at proxy indicators to gauge performance for the first quarter 2016-17.

Industry: In 2015-16, Industry contributed about 20% to total GDP. LSM has a share of about 11% of GDP[13] . The share of manufacturing in total is about 14%. The Annual Plan 2016-17 estimates that industry will grow by 7.7% with 5.9% increase in LSM[14]. Against this target, year on year growth in LSM was 2.2% during July-September 2016-17, falling to 2% for the period July-October[15]. A number of LSM industries with major weight in the indicator declined during the quarter. These include textiles, food, beverages, and tobacco, petroleum products, and chemicals. On the other hand, pharmaceuticals, iron and steel, non-metallic minerals, autos, and fertilizers grew (see Table 1). There were industries

[9] Planning Commission, Annual Plan Page 102
[10] SBP Export receipts, Import payments, and Balance of Trade
[11] Ibid Page 105
[12] Board of Investment, Pakistan, Foreign Investment inflows in Pakistan($Millions), FDI target from Annual Plan Page 105
[13] MoF, Pakistan Economic Survey, Statistical Appendix Table 1.1
[14] Planning Commission, Annual Plan 2016-17 Page 9
[15] Pakistan Bureau of Statistics, Quantum Index of Large Scale Manufacturing, July-September and July-October 2016-17 compared to the same corresponding period for 2015-16.

within groups that showed a different trend. While production in the food group declined, beverages increased. Within autos, production of cars and LCVs declined by 3.4% and 33% respectively, while tractor production fell by 1%. On the other hand, production of buses, trucks, and motor cycles grew rapidly.

Government expects revival in manufacturing, but this seems work in progress. When it comes, the revival will be based on a combination of factors. Chinese public and private investment will stimulate when it reaches critical mass. Thus far, Chinese have invested in infrastructure projects not in manufacturing. Infrastructure projects may have already increased demand for goods and services (cement is an example).

Improved macro fundamentals, at least in the short-term, has helped lower interest rate as have fall in international commodity prices. Reduction in interest rate should help private credit. It grew last fiscal, but has taken a correction this year. Low commodity prices helped with the balance of payment also. Discussing fiscal 2015-16, SBP says, "businesses have reverted to bank borrowing; the import of capital goods has firmed up; and large-scale manufacturers have resumed BMR development"[16].

Table 1
Change in Quantum Index of Manufacturing
July-September 2016-17 over 2015-16

Manufacturing Items	Weight	% Change	YoY Growth Impact
		Jul-Sep	Cumulative
Textile	20.915	-0.06	-0.02
Food, Beverages, & Tobacco	12.370	-0.89	-0.13
Coke & Petroleum Products	5.514	-3.4	-0.24
Pharmaceuticals	3.620	7.95	0.69
Chemicals	1.717	-3.60	-0.10
Non-Metallic Mineral Products	5.364	9.2	0.97
Automobiles	4.613	3.8	0.26
Fertilizer	4.441	6.5	0.43
Leather Products	0.859	-19.1	-0.36
Rubber Products	0.262	0.27	0.00
Iron & Steel Products	5.392	12.9	0.45
Electronics	1.963	12.3	0.2
Paper & Board	2.314	6.1	0.2
Engineering Products	0.400	- 17.8	-0.34
Wood Products	0.588	- 97.8	- 0.11

Source: Adapted from PBS QIM for September 2016

[16] SBP Annual Review of the Economy 2015-16, Page 31

- **Agriculture growth:** The six-month period saw a mixed trend in agriculture production, with some revival from the declines seen in fiscal 2015-16. Cotton production fell by 30% in 2015-16. This year cotton production grew by 17.98%. Total production was 10.6 Million bales in 2014-15. It fell to 7 Million bales in 2015-16 and is 8.25 Million this year. Rice production, which declined slightly last year, has regained. Pakistan produced 6.9 Million tons of rice this year, which equals production in 2014-15 and is 3% above 2015-16[17]. Sugarcane production too is estimated to come close to the target of 67.3 Million Tons. Production estimates vary between 65 and 67 Million tons[18]. The US Department of Agriculture estimates a growth of over 8% over last year[19]. Projection about wheat production shows that it will equal or may slightly exceed last year's production of 25.1 Million tons[20].
  The aggregate of cotton, rice, and sugarcane has a share of 52% in total agriculture production. The above increase will reflect in GDP growth rate. Continued increase in fertilizer production, though more modest than last year, suggest stable off take, especially as imports have not declined from last year[21].

- Production of oilseeds is projected to increase by 19%. Rapeseed will grow by 56% in production and cottonseed by 20%. Their overall production volume and contribution to agriculture is limited.

- Fiscal 2014-15 saw a general, and at times substantial, decline in production of major and minor crops. There is overall recovery this fiscal year. The recovery is not sufficient to reach the 2014-15 production level, yet increase will stimulate overall GDP growth.

- Volatility is endemic to the agriculture sector. Production remains contingent on international prices, weather conditions, and virus affecting production. Without investment in water infrastructure, improvement in water use and service delivery, and appropriate research and policy interventions, growth of farm produce remains uncertain. Adequate research does not exist. There isn't even clarity why production levels vary year to year. It is also hard to confirm, either way, if government's agriculture package of last year has helped.

The power sector: Power supply was again a constraint on economic activity. For the period July-October 2016, total power supply was 40,691 GWh[22]. This was 4.1% higher than the power supply for the same period in 2015. Updated numbers for DISCO billing and recoveries are not available. Informal discussion with officials do not suggest

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[17] All data from US Department of Agriculture, Food and Agriculture Service
[18] http://par.com.pk/news/country-expects-around-5mn-tons-sugar-production-in-coming-season
[19] http://www.indexmundi.com/agriculture/?country=pk&commodity=centrifugal-sugar&graph=cane-sugar-production
[20] USDA, Food and Agriculture Service
[21] Ministry of Commerce, GOP, Comparative Imports of Selected Commodities
[22] Central Power Purchase Agency Guarantee Ltd. (CPPA), settlement and billing statements for October 2016 compared with October 2015.

improvement in overall DISCO governance. In the last few years, there have been minor incremental increase in power generation. The 4% increase in power supply is below the rate of increase in GDP. Experts estimate an elasticity of over one for demand of power for each percentage point growth in GDP.

In addition, a number of headwinds stall growth. These have encumbered Pakistan's economy for some years. Despite strong resolve shown by the state, security in Pakistan remains a challenge. It would likely be so for the near future. Social tensions, regional instability, and displaced persons (though reduced in number) continue to thwart economic activity.

For the medium-term, it is important to remember that sustained growth needs strong macro fundamentals, enhancement in productivity through investment in human resource, and improved infrastructure. These factors crowd in private investment. Most social indicators show Pakistan well behind other emerging economies. Public investment in infrastructure must be based on judicious selection of projects with high economic returns. This is, at best, work in progress. Despite government's good work on fiscal consolidation, IPR fears that macro fundamentals would remain vulnerable as continued borrowing (especially external) for investment would increase indebtedness. Improvement in gross national savings is necessary to increase investment to contain indebtedness. Traditionally, external debt, other than IMF support, funded projects while government met current expenditure from tax and non-tax revenues, and from domestic borrowings. Presently, part of the external debt also finances current expenditure. This adds to the economy's vulnerability. This will likely continue in the future. IMF estimates savings to be 14.2% of GDP for fiscal 2016-17 to reach 15.1% by 2019-20[23]. To meet government's plan for increase in investment to 20% of GDP, the economy must rely on external savings by almost 5% of GDP. At current GDP value, this means additional about USD 12 Billion per year. Pakistan must very significantly increase FDI as incurring further debt is unsustainable.

2A Investment

The Annual Plan sets a target of 17.7% of GDP for total investment in fiscal year 2016-17. This target is unchanged from the target set for the last fiscal year. The Annual Plan estimates that this increase will come from private investment as well as from public and private CPEC projects. It is important to review the indicators for this increase:

[23] IMF Twelfth Review

2B Import of Machinery

In an encouraging development, Pakistan imported machinery worth USD 2,735 Million during July September 2016, an increase of 60% over the previous year. Machinery import increased in a range of sectors including power generation, textiles, construction and mining, and electrical machinery:

Table 2
Machinery Imports
July-September 2016-17

USD Million

	2015-16	2016-17	Growth %
Power Generation Machinery	316	795	152
Office Machinery	66	148	125
Textile Machinery	109	116	6
Construction & Mining	102	116	14
Electrical Machinery	339	449	33
Telecom	313	278	-11
Agriculture Machinery	21	24	15
Other Machinery	440	810	84
Total	1,705	2,735	60

Source: Trade Statistics Ministry of Commerce based on PBS data

Since 2015-16, import of power generation machinery has gained momentum. In 2015-16, Pakistan imported power generation machinery worth USD 1.8 Billion. That equals additional capacity of about 1700 to 1800 MW. Since then, additional USD 795 Million worth of machinery imported during the quarter under review, suggests an increase in generation capacity by 750 to 800 MW. Pakistan should get close to its target of increasing power generation by 13,000 MW by 2020 (10,700 MW under CPEC and 2,400 MW LNG). Much of this will be on stream by 2018. Increase in import of all other machineries is a positive sign and perhaps reflects broad based manufacturing revival. Electrical machinery import increased by 33% in fiscal 2015-16. Construction machinery has increased by 14%.

2C PSDP Releases

Rupee releases up to 16 December 2016, five and a half months into the fiscal year, are 34%. Total release, including foreign assistance, was 35%. Though releases up to 16 December 2016 should have been close to 50%, the 34% is not too far behind given that work in the new fiscal year is slow to take off, though the release mix is moot. Selected sectoral releases are in Table 3:

Table 3 PSDP Releases 2015-16 Rs. Billion				
	Budget Full Year		Releases 2016-17 Up to 16.12 2016	% Released
	2016-17	2015-16		
HEC	21.4	20.5	2.6	12
Health	24.9	20.7	7.6	31
PAEC	27.7	30.4	9.0	32
Railways	41.0	41.0	13.9	34
Water Sector	31.7	30.1	6.8	21
NHA	188.0	159.6	79.1	42
Power	130.0	113.9	41.2	32
Total	**800.0**	**700.0**	**279.1**	**35**
Source: Planning Commission, Status of Releases as on 16. 12. 2016				

Release of funds for most sectors are low, except for roads and motorways. This is a stated priority of the government. Roads also are a major part of CPEC's public investment and have merited top-level supervision.

Releases do not necessarily mean that money has been spent. Economic growth and further progress of project depend on actual expenditure. The Table gives release figures until 16 December 2016. Figures of releases up to 30 September 2016 are not available. Compared to the Rs. 279 Billion released by December, the amount booked by Finance Ministry for the first quarter was Rs. 64 Billion. There is an inherent lag in amount released and spent.

Public investment is important to increase economic productivity and to crowd in private investment. While it is encouraging to see a 14% increase in total federal PSDP budget this year (from Rs. 700 Billion in 2015-16 to Rs. 800 Billion in 2016-17, Table 3), IPR is concerned at some of government's priorities. Higher education and national health services have reduced budgets when compared with fiscal 2014-15. The water sector is one third lower than its budget for 2014-15. These three sectors are important determinants of growth and productivity. More importantly, they could defuse the time bomb posed by the youth bulge. In the coming years, water scarcity could pose a greater challenge to the country than power does at present. It has begun to affect seriously our agriculture. It could likely lead to friction among provinces as well as with neighbouring countries. Each year, highways receive a disproportionate increase in allocation. The economic return on grand highways projects is yet to be proven in Pakistan. IPR welcomes increase in allocation for the power sector. It is concerned though that the exclusive focus of the increase is on two LNG power projects[24]. The medium term economic viability is yet unproven. Many questions remain unanswered about LNG power projects.

[24] PC, PSDP 2016-17, Items 756 and 757

For it to be an engine of growth, public investment needs well considered project selection as well as quality governance. Public investment increases output and jobs as well as help efficiency all around. However, public projects at inflated costs, with further cost and time overruns, and the presence of prestige projects in the portfolio, reduce economic impact. Increased spending levels, however, will have immediate gains for short-term economic growth.

As stated before, government's macro-economic framework sets a target of 17.7% as the investment to GDP ratio. The target for total fixed investment is 16.1%. Of this, public investment is 3.9% and private is 12.2%. The actual for 2015-16 was 15.2% total and 13.6% fixed investment[25]. With respect to public sector investment, GoP's budgeted public sector development programme (not the same as public investment[26]) is Rs. 1,675 Billion. Against this amount, IMF projects a PSDP of Rs. 1,255 Billion (Table 7). Last year, combined PSDP spending amounted to Rs. 1,186 against the budget of Rs. 1,514 Billion (these figures do not include other development expenditure).

The fixed investment target of 16.1%, depends on private investment of 12.2%. Last year, private investment was 9.8% of GDP. Machinery imports suggest higher overall investments and likely private investment (Table 2 above). SBP data so far does not show increase in credit to the private sector (discussed in later paragraphs). Overall, there is yet no major uptrend in FDI[27]. It is not clear if private investment will achieve the target of about 12.2% of GDP.

2D Bank Credit

A look at net assets of the banking system shows increase in borrowing by government. During fiscal 2015-16, government borrowing was Rs. 223 Billion up to 11 December 2016. Comparable net government borrowing in the current fiscal year is Rs. 452 Billion up to 9 December 2016, an increase of more than 100%. During the same period, credit to private sector has decreased from Rs. 84 Billion in 2015 to Rs. 79 Billion. This is not an encouraging sign and is contrary to GoP expectation[28]. Decrease in private credit may dampen the investment impetus.

OMO injections by the State Bank of Pakistan continue to be very high, as banks have borrowed far more than growth in their deposits[29].

[25] Planning Commission Annual Plan 2016-17 Macroeconomic Framework, Chapter 1, Page 10

[26] Public investment estimates are derived by PBS from MOF and PC data about actual development/investment component in current and development expenditures. PBS estimate for 2015-16 is Rs. 1,212 Billion (against Rs. 1,514 Billion). This amount is 4.2% of estimated GDP

[27] BOI Country wise FDI flows in Millions http://boi.gov.pk/foreigninvestmentinpakistan.aspx

[28] State Bank of Pakistan, Provisional Data on Monetary Aggregates as on 09 December 2016, http://sbp.org.pk/ecodata/BroadMoney_M2.pdf

[29] SBP Open Market Operations, Reverse Repo (Injection), http://sbp.org.pk/ecodata/OMO-Inject-Hist.pdf

2E Inflation

GOP's Annual Plan for 2016-17 targets a 6% inflation rate[30]. Based on government's fiscal consolidation measures and fall in international commodity prices, inflation has been well under control for two years. However, all inflation measures show an uptick compared to the last year. For the period July 2016 to September 2016, year on year CPI was 3.86% compared to 1.66% for the corresponding period in the previous year. For the same period, Sensitive Price Index increased to 1.89% from -1.09, and WPI has turned around from -3.1 to 3.29. In September 2016, core inflation that includes items other than food and energy was 4.8% compared to 3.4% in September 2015. Also, core inflation (non-food non-energy) is higher than CPI, SPI, and WPI[31]. This may suggest a revival in overall demand in the economy.

Food inflation has grown at a rate below overall CPI. In September 2016, year on year food inflation was 3.14%, though rate increase of perishable items was higher at 4.7%. Food items whose prices increased included onion (12.73%), eggs (5.39%), fresh vegetables (3.4%), and honey (1.38%). Decrease was seen in tomatoes (4.91%), chicken (3.99%), pulse mash (3.91%), besan (3.61%), dry fruits (1.55%), pulse moong (1.54%), pulse masoor (1.07%) and beans (1.04%)[32].

Table 4
July-September 2106-17 Inflation and YoY Changes

Percentage

	Averages Changes %			**September on September Changes %**		
	2016-17	**2015-16**	**2014-15**	**2016**	**2015**	**2014**
CPI	3.86	1.66	7.52	3.88	1.32	7.68
SPI	1.89	-1.09	5.48	1.81	-1.29	5.37
WPI	3.29	-3.14	4.17	3.38	-3.47	2.74

Source: Reproduced Table from PBS Monthly Review of Price Indices September 2016

As fall in inflation is worldwide, it helps to place in context price changes in Pakistan. Table 5 compares Pakistan's CPI with selected countries:

[30] Planning Commission, Annual Plan 2016-16, Page 10 (Annexure II)
[31] Pakistan Bureau of Statistics, Monthly Review of Price Indices, September 2016, Table 1 and Table 1.1
[32] Pakistan Bureau of Statistics, Monthly Review of Price Indices, September 2016,Notes to Table 2 and Annexure A

Table 5
Inflation Country Comparison

%

Country or Region	CPI 2015	CPI 2014	GDP growth 2015
Pakistan	2.5	7.2	4.7*
China PRC	1.4	2.0	6.9
India	5.9	6.4	7.6
Vietnam	0.6	4.1	6.7
Bangladesh	6.2	7.0	6.6
USA	0.1	1.6	2.4

Source: The Global Economy Data
*Pakistan GDP growth for 2015-16 as per National Accounts

The CPI for 2015 is universally lower than for 2014. Pakistan's CPI has taken a more precipitous fall than of other countries, perhaps reflecting our fiscal consolidation preference. Inflation in India and Bangladesh is higher than in other countries. This is perhaps because they have pursued aggressive growth policy, including correction in the value of their currencies. Regardless, fall in commodity prices was a world phenomenon that began in 2014 and impacted prices fully in 2015. World economy also has grown at a slow rate since 2008 and demand worldwide seemed to have plateaued. Inflation and growth rates in China and Vietnam suggest a lack of correlation between the two indicators in these countries. Clearly, their growth comes from higher productivity increases rather than fiscal policy.

IPR has some observations on computation of inflation indices. In its report for July-December 2014, IPR discussed the dampening effect on inflation for procedural and methodological reasons. These pertain to jerks in housing rent assessment that may lead to effect on monthly and quarterly CPI calculation. Inflation is underestimated also as PBS does not include fuel charge adjustments and the many surcharges in power tariff. This understates electricity prices. The fall in inflation may have been limited by frequent increase in indirect taxes. Also, PKR lost value by a few percentage points in recent months.

Table 6
Inflation in Major Food Items, Commodities, and Services, January 2016
YoY

	Weight in CPI	**Inflation %**
General CPI	**100.00**	**3.88**
Food Group	**34.80**	**3.14**
Wheat flour	4.16	0.25
Rice	1.58	-5.9
Meat	2.43	3.6
Chicken	1.36	-4.0
Milk (fresh)	6.68	3.8
Cooking oil	1.75	-3.1
Vegetable ghee	2.07	-0.22
Fresh fruits	1.86	-0.1
Pulses	*1.11	25.4
Vegetables	**3.13	3.7
Sugar	1.04	10.2
Tea	0.84	-2.5
Cigarettes	1.39	17.5
Clothing and Footwear	**7.57**	**4.4**
Cotton cloth	1.73	4.6
Readymade garments	0.97	4.7
Tailoring	0.88	8.4
Housing, Electricity, Gas	**29.41**	**4.3**
House rent	21.81	5.8
Electricity	4.39	0.0
Gas	1.57	0.0
Health	**2.19**	**6.9**
Drugs and Medicines	1.27	6.7
Doctors' fee	0.59	8.1
Transport	**7.20**	**3.0**
Motor Fuel	3.02	-7.6
Transport Services	2.70	-2.0
Communication	**3.21**	**0.4**
Recreation & Culture	**2.02**	**1.4**
Education	**3.94**	**10.2**
Restaurants and Hotels	**1.23**	**5.9**
Misc. Goods and Services	**2.75**	**5.5**

Source: PBS, Monthly Review of Prices, Annexure A, September 2016

*** Pulses include whole grams, ** Vegetables include fresh vegetables, tomatoes and onions**

3. Public Finance

Details of fiscal operations released by Finance Ministry show positive signs:

- Budget deficit for the first quarter was 1.3% of GDP[33]. This seems high when compared with the target deficit of 3.8% for the fiscal year[34]. It is too soon to comment on the year's performance based on first quarter result, but the pace of the fiscal deficit suggests that it may likely exceed target. Usually, revenue and expenditure are slow to take off in the initial months of the fiscal year.

- By September 2016, total federal tax revenue of Rs. 686 Billion was 17% of target for the year. It was Rs. 300 Billion short of the one quarter mark[35]. This is not much different from last year's revenue collection trend. Total federal taxes collected last year was 19% of the 2015-16 target[36]. Tax collection for July-September 2016 was 3.3% above the same period last year. Budget estimate of Rs, 3,956 Billion for federal taxes for fiscal 2016-17 is 17% above last fiscal's actual collection of Rs.3,377 Billion[37].

- FBR tax collection follows this trend. Year on year increase for July-September 2016 is 4% above last year's revenue for the same period. The collection was also 17% against full year target of Rs. 3,621 Billion. This target is 16% above last fiscal's actuals. This follows last year's unprecedented increase of over 20% in FBR's collection. Budget estimate 2016-17 for Other Taxes is 26% above last year's actual. However, actual collection for the quarter July September 2016 was 9.5% below the corresponding period last year[38].

- Federal government's non-tax revenues are a concern as July-September 2016-17 collections are 51% below the same period last year. Government may have to watch this head, as its budget estimate for the year is a high (perhaps unrealistic) 36% above last year's collection. Collection in all non-tax heads have declined[39]. Dividend and profits from oil companies have fallen with low oil prices. Also, profits from the State Bank of Pakistan have fallen. Pakistan would likely miss the target of Rs. 959 Billion by a large margin, even if markup and energy prices rebound.

- With respect to expenditures, total current and development expenditure are within proportional budget. Development expenditure for July-September 2016 at 9% below the same period last year seems to be a concern. Federal development budget for fiscal 2016-17 (including Other Development expenditure), is 33% over actual for 2015-16.

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[33] Ministry of Finance, Summary of Consolidated Federal and Provincial Budgetary Operations, July-September 2016-17, Table 1
[34] MOF, Budget Speech by Finance Minister, June 2016, Page 5
[35] MoF Fiscal Operations, July-September 2016, Table 4
[36] MoF, Budget in Brief and Fiscal Operations
[37] Ibid
[38] Op.Cit 29
[39] ibid

As is the norm, development expenditure should pick up in the second half of fiscal year. Close top-level monitoring of CPEC projects would ensure rapid execution.

- The budget deficit for July-September is Rs. 438 Billion (1.3%). As indicated before, proportionately, this exceeds the annual estimate of 3.8%. That target itself is contingent on provincial surplus of Rs. 339 Billion[40]. So far, the provincial surplus is Rs. 110 Billion[41]. Net fiscal deficit of 1.1% of GDP also exceeds the proportionate target. Last year, provinces generated a surplus of Rs. 207 Billion against a target of Rs. 297 Billion[42]. It appears that the combination of likely revenue shortfall (especially from non-tax revenue) and lower than estimated provincial surplus will lead the economy to exceed the fiscal deficit target.

- Interest payment too is on track. First quarter's payment is equal to the corresponding period last year. While servicing of domestic debt is slightly below first quarter last year, it is marginally higher for foreign debt. It is to be seen if this will continue as GoP has taken substantial amount of high interest external debt in recent years. In October 2016, GoP again floated a bond for USD 1 Billion[43]. The budget for the year, however, is 7.6% above last year's actual. Expenditure in this head is likely to remain within budget, as markup on domestic debt has decreased[44].

- Subsidy for the power sector would likely remain within budget because of continued low oil prices (despite recent increase) and surcharges imposed in the last years. After withdrawal of NEPRA's independence (along with of other regulators), GoP will be free to increase tariff to do away with subsidy. However, there is Rs. 650 to 700 Billion in accumulated circular debt payments. These must be liquidated at some point and will affect fiscal deficit. Subsidy for other PSEs will remain.

- A number of other expenditures are likely to weigh on the budget. These include continued expenditure on the pressing need for border and internal security and on settlement of IDPs.

- These needs may exact a cut on development expenditure. Last fiscal, actual federal PSDP expenditure was 86% of budget, less by about Rs. 100 Billion. It is not clear if that was because of fiscal constraints or inability to achieve physical targets. IMF has forecasted annual development expenditure (federal and provincial) of Rs, 1,255 Billion, Rs. 420 Billion and 25 % below government's target. This will reduce public investment by up to 1.3% of GDP and may dampen economic growth.

- Of the Rs. 437 Billion deficit financing needs for the quarter, government has sourced Rs. 69 Billion externally. Of the balance Rs. 369 Billion from internal sources, GoP

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[40] Budget in Brief, Page 51
[41] Mof Fiscal operations Table 10
[42] MOF, Fiscal operations 2015-16
[43] Reuters UPDATE, Pakistan says to issue $1 billion sukuk bond within hours
[44] All expenditure numbers from MoF's Fiscal Operations statement, budget number from Budget in Brief 2016-17

has financed Rs. 69 Billion from non-banking sources and Rs. 300 Billion from banks[45]. For the quarter, however, financing from banks is 66% of the total for the year, while non-banking sources have provided less than 12%. External financing equal 29% of the budgeted amount for the year.

3A IMF projections:

Table 7 compares budget estimates for 2016-17, with fiscal operations for the first quarter, and IMF's projections:

- GoP and IMF have similar federal tax and non-tax revenue estimates. IMF's projection of direct taxes is Rs. 100 Billion below GoP. Both may have overestimated non-tax revenue, though IMF's estimate is Rs. 85 Billion below GoP.
- IMF's estimate of federal government current expenditure is higher by Rs. 154 Billion. IMF estimates higher subsidies and grants payments.
- The budgeted Federal PSDP is Rs. 800 Billion. Provincial budgeted amount is Rs. 875 Billion to total Rs. 1,675 Billion. IMF's corresponding projections are Rs. 620 Billion (22.5% below budget), Rs. 635 Billion (27.5% below budget) and Rs. 1,255 Billion (25% below budget)[46].
- Government estimate for 2016-17 fiscal deficit is Rs. 1,276 Billion. IMF projects a lower number of Rs. 1,250 Billion[47].

[45] MOF, Fiscal operations, Table 10
[46] For PSDP, Planning Commission, PSDP 2016-17, for IMF projection Twelfth Review,
[47] For GoP estimate, Budget in Brief 2016-17, Page 51, for IMF projection Twelfth Review, Table 6a, Page 35

Table 7
Summary of Public Finance
Budget 2016-17, IMF Projections, Fiscal Operations

Rs. Billion

	Budget 2016-17	IMF Projections 2016-17	Actual Fiscal Operations July-Sep 2016	July-Sep % of Budget
A. Revenue		**5,248**	862	16
A.1Tax Revenue	**4,267**	**4,265**	**739**	**17**
Federal	3,956	3,921	686	17
FBR	3,621	3,621	625	17
Direct	(1,558)	(1,461)	(232)	15
Indirect	(2,063)	(2,160)	(393)	19
Other taxes	335	300	61	18
Provincial	311	344	53	17
A.2 Non-Tax Revenue	**--**	**983**	**123**	**13**
Federal	959	874	99	11
Provincial	N/A	110	24	22
B. Expenditure	**N/A**	**6,498**	**1,262**	**19**
B.1 Current Expenditure	**N/A**	**5,248**	**1,071**	**20**
Federal	**3,400**	**3.554**	**763**	**22**
Interest Payments	1,360	1,362	414	30
Defence	860	860	151	18
Subsidies	141	154	NA	--
Grants	442	581	48	11
Others	597	597	150	25
Provincial	N/A	1,694	313	18
B.2 Development Exp & Net Lending				
PSDP	**1,926**	**1,255**	**378**	**20**
Federal	800	620	64	8
Provincial	875	635	103	12
Other Development	157		24	15
Lending and grants	94	-5		
E. Fiscal Deficit % GDP	**3.8**	**3.8**	**1.3**	**34**
F. Financing Net (after provincial surplus of Rs. 297 Billion)	**1,276**	**1,250**	**438**	**34**
External	234	424	69	29
Domestic	1,042	782	369	35
Bank	453	547	299	66
Non-Bank	589	234	69	12
Grant		45	--	--
Memorandum Item				
Nominal GDP		**33,130**	**33,509**	**--**

Source:
1. Pakistan revenue and expenditure from MoF Fiscal operations
2. Federal revenue and expenditure estimates from MoF, Budget in Brief
3. IMF Projects from Twelfth Review, Staff Report, Page 35
4. Actuals from MoF Fiscal Operations, various tables
5. In federal non-tax revenue, discrepancy of Rs. 100 Billion between SBP and MoF The latter source adopted

3B Public Debt

Federal government debt has increased rapidly. Figures are available for October 2016. In four months, GoP has incurred additional debt of Rs. 603 Billion. Of this amount, Rs. 141 Billion is from external sources. Within domestic debt increase of Rs. 463 Billion, GoP has borrowed heavily short term (mostly MTBs). Short term debt has grown by Rs. 1,166 Billion, while long term debt has decreased by Rs. 703 Billion.

Table 8
Federal Government Debt

Billion Rs.

	June 2016	**October 2016**	**Borrowing July-October 2016**
Total Domestic Debt	**13,626**	**14,089**	**463**
Long-term	**8,624**	**7,921**	**-703**
Market Loans	3	3	0
Federal Government Bonds	5,287	4,506	-781
PIBs	(4,921)	(4,140)	(-781)
Prize Bonds	646	688	42
Unfunded Debt	2,684	2,720	36
NSS	(2,527)	(2,564)	(36)
Foreign Currency Loans	5	5	0
Short Term	**5,002**	**6,168**	**1,166**
Market Treasury Bills	(4,789)	(5,955)	(488)
External Debt	**5,417**	**5,558**	**141**
Long term	5,240	5,381	(141)
Short Term	177	177	(0)
Total Federal Government Debt	**19,044**	**19,647**	**603**

SBP: Central Government Debt[48]

[48] SBP: http://www.sbp.org.pk/ecodata/cengovdebt.pdf

4. Balance of Payment

Exports have been in free fall for over two years. In 2014-15, they declined 8% from the previous fiscal year. In 2015-16, they fell by a further 12.4% and have taken another hit of 9% for the first quarter 2016-17[49]. This is an unsustainable fall. What is surprising is a lack of serious analysis about the reasons. A proactive and concerted effort is needed, especially in a period of slow growth in world trade. Bluster cannot take place of serious policy. The decline was across the board in a wide range of products.

Looking at the latest available data for July-November 2016-17, the picture is not different. Detailed look shows that export of two of Pakistan's major items, knitwear and bed linen, have grown in quantity. This is encouraging, as at least Pakistan has not lost market share here.

Impact on the current account deficit is significant, as imports have increased by 10% while exports have declined. The trade deficit of over USD 7 Billion for July-September 2016 has worsened by 29% against the same period last year (Table 9). Declining exports, lower remittances, and FDI, and increase in import of capital equipment, means that Pakistan's BoP is financed by external debt. Debt sustainability will be a major concern in coming years.

Declining export seems a structural issue at two levels. First, structural economic issues are important. It would help to revisit how to improve international competitiveness of our export products. Our exports rely heavily on textiles and apparels. More so, it pursues a price competitive strategy. Uncertainty about export could reduce through product differentiation.

Pakistan may review too the current value of the Rupee against US Dollar. Exporters have lost out from Rupee value: a. from the appreciation of US Dollar against most other currencies, and b. because of adverse REER (many other developing economies have sharply reduced the value of their currencies). Second, for some years, world trade has fallen. Moderate GDP growth rates in China may not revive soon. These will affect medium term demand. Lower oil prices may have begun to affect home remittances (discussion below). If one quarter results is the precursor of a trend, this is a troubling development.

Once in operation, increased import of LNG and coal for power plants may burden future trade flows of the country, even with low energy prices. Import of machinery is also likely to increase. Yet these are productive imports (apart from the environmental issues related to coal). Sustainability depends on how efficiently our economy uses these imports to create high returns and increase payback ability.

[49] All figures based on PBS and MoC data.

Table 9
Trend in Trade
July September 2016-17 compared with 2015-16

Exports

Million USD, %

Commodity	**July-September 2015-16**	**Share in total export %**	**July-September 2016-17**	**Share in total export %**	**Change %**
Food Group	794	15	635	14	-20
Textiles	3,221	63	3,029	65	-6
Petroleum & Coal	53	1	36	1	-33
Other Manufactures	844	16	754	16	-11
Chemicals and Pharmaceuticals	241	5	205	4	-15
Engineering Goods	43	1	44	1	2
Others	231	5	222	5	-4
Total	5,143	100	4,676	100	-9

Imports

Million USD, %

Commodity	**July-September 2015-16**	**Share in total export %**	**July September 2016-17**	**Share in total export %**	**Change %**
Food	1,240	12	1,360	12	10
Machinery	1,705	16	2,735	23	60
Transport	641	6	692	6	8
Petroleum	2,476	23	2,356	10	-5
Textile	629	6	688	6	9
Chemicals	1,781	17	1,764	15	-1
Metal	896	8	929	8	4
Miscellaneous	279	3	283	2	1
Others	964	9	917	8	-5
Total	10,611	100	11,725	100	10
Trade Deficit	**(5,468)**		**(7,049)**		**(29)**

Source: Ministry of Commerce Statistics, based on PBS data

The Annual Plan sets a target of 1.5% of GDP for the Current Account deficit[50]. SBP data shows a current account deficit of 1.1% for the period July-October 2016[51]. Home remittance is an important external financing source for Pakistan, which limits the current account deficit. As feared in past IPR economic reviews, workers' remittance appears to have eased this fiscal year. GoP has targeted an increase in remittances by 5% in 2016-17 over last year's home remittance[52]. Last year's actual was USD 19,241 Million[53]. For the four months period July-October 2016-17, home remittances to Pakistan totaled USD 6,258 Billion. This is a drop of 4% from the same period last fiscal when workers' remittance was USD 6,507 Billion[54]. As noted in previous IPR reports, a significant part of remittances to Pakistan is from oil exporting economies. This may be the effect of declining oil prices. Whether increase in price reverses this trend is yet to be seen.

Table 10
Increase in External Debt and Liabilities
July-September 2016

Million USD

Head	**Amount**		
	30.6.2016	**30.9.2016**	**Increase**
A. Public External Debt	**61,357**	**62,399**	**1,042**
1. Government	51,714	52,676	962
Long term	50,026	50,938	912
Short term	1,688	1,738	50
2. From IMF	6,043	6,132	89
3. Forex Liabilities	3,600	3,592	-8
B. Public Sector Enterprises	**2,806**	**2,759**	**-47**
C. Banks	**2,696**	**2,956**	**260**
Borrowing	1,618	1,916	298
Deposits	1,078	1,040	-38
D. Private Sector	**3,348**	**3,568**	**220**
E. Debt liabilities to investors	**2,857**	**2,957**	**100**
Total External Debt & Liabilities **% GDP**	**73,063** **25.9**	**74,638** **23.3**	**1,575** **0.5**
Public Debt including PSEs + Bank Public **% GDP**	**64,252** **22.7**	**65,287** **20.4**	**1,035** **0.4**
Source: SBP[55]			

[50] PC Annual Plan Page 105
[51] SBP Summary Balance of Payments as per BPM6 - October 2016, Page 2
[52] PC, Annual Plan Page 105
[53] SBP Summary Balance of Payments as per BPM6 - October 2016.
[54] Ibid
[55] SBP Pakistan's External Debt and Liabilities-Outstanding http://www.sbp.org.pk/ecodata/pakdebt.pdf

In addition to decline in exports and remittances, another weakness in the Balance of Payment comes from low FDIs. The Annual Plan targets USD 4,550 Million as FDI for 2016-17. This is over three and a half times above the actual for 2015-16 of USD 1,281 Million[56]. FDI received for five months, July-November 2016-17 is USD 489 Million[57]. This is nowhere close to the target. SBP gives figures for July-October of F17 and shows inflows of USD 316 Million only. This is 48% below the corresponding period the previous year[58]. Apparently, increase in imports are financed by debt. Although private flows are hard to predict, especially with CPEC investment due, FDIs in 2016-17 would likely be short by over USD 2 Billion. Portfolio investment has also dropped.

Largely, external debt has sustained the BOP. During July–October 2016, public debt increased by over one billion USD. Government debt grew by USD 962 Million. Of this, USD 701 Million came from commercial loans and credits[59]. Table 10 gives increase in external debt and liabilities for the four-month period July-October, 2016.

On 16 December 2016, official reserves stood at USD 23,132 Million about equal to the reserves of 30 June 2016 reserves of 23,099 Million. Net foreign currency reserves were USD 18,190 and 18,142 Million respectively. As seen above, with declining exports and remittances, FE management has come from borrowings. At about six month's imports, current official reserves are well placed.

Though there are a number of structural and competitiveness factors that have led to decline in Pakistan's exports, exchange rate is certainly one of them. While the Rupee value has declined in 2015, but at a rate less than of its competitors. So, despite loss in value, the Pak Rupee has gained value since December 2103 against currencies of countries that it competes with for export. Consequently, its real effective exchange rate does not help our exporters. If exports do not increase quickly, Pakistan may have to continue to borrow to finance imports. This will become a particular concern if energy prices also increase at this time. We hope that these imports would soon stimulate the economy and increase exports. For the present, Pakistan's debt sustainability remains a concern.

[56] BOI Foreign Investment inflows in Pakistan($Millions), the Annual Plan estimates this amount to be a little less at USD 1,202 Million.
[57] Ibid
[58] SBP Summary Balance of Payments as per BPM6 - October 2016.
[59] Ibid