REPORT

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WILL ECONOMIC REVIVAL LAST ? PAKISTAN ECONOMIC SURVEY FY 21

June 2021

Will economic revival last? Pakistan Economic Survey FY 21

Exceeding everyone's expectation, GDP for FY 21 will grow by about 4%. That is cause for relief and satisfaction. Celebration though may be premature. It is more important to analyze what caused the unexpected growth and how can it be increased and sustained over a long period. Merely focusing on one indicator is to reduce the complexity of the processes that create economic growth.

If we look behind the growth figures, not all signs are equally sanguine. The economy is still mired in fundamental issues. Without addressing those, economic revival in Pakistan will be short lived. These issues include unsustainable debt levels with debt servicing needs that strain both the fiscal and the current accounts. With high debt servicing, the present current account surplus is expected to last as long as the economy is in slow to moderate growth. If economic revival continues, imports for investment and consumption could change the current account balance. As would a tapering off in growth of remittances, which is a major source of a positive current account.

A special concern for the economy is low savings rate, which has led to insufficient investment. Without enough investment exports suffer and growth becomes transitory, caused by one time spending. The Survey bears this out. Also, there are serious infrastructure shortage caused by insufficient investment and policy shortcomings. An obvious example is the power sector that is both costly and marred by frequent breakdowns. All governments have resolved to exit from the conundrum of circular debt. So far, their efforts have not borne fruit.

Despite the best face put on the economy's performance, the Pakistan Economic Survey brings home to us once again a fact that is now an annual norm. Each year there is a stark divergence between the macro framework and budget estimates shared by GoP at the start of the fiscal year and the actuals that we see at the end. It shows that economic policy predicates more on hope than expectation. This has gone on for decades. This year though some indictors have held up, perhaps surprising policy makers themselves.

Yet, government revenue, a major fiscal indicator will likely fall short of its target. For the first three quarters until March 2021, FBR tax revenue grew by 11.5 % over the same period in FY 20, a little more than increase in CPI. GoP's target growth rate for FY 21 is 24% to Rs. 4,963 Billion. To achieve that number, FBR revenue must grow by 64% in the last quarter over the same quarter last year. They must collect Rs. 1,568 Billion in the last quarter. This seems ambitious. FBR tax collection may fall short by about Rs. 350- 400 Billion. Non-tax revenue

which was to decline by 10% as fallen by 9% so far, lending some cushion to the government.

With respect to expenditures, both the federal and provincial governments have contained spending up to March 2021, and are close to target. Budget 2021 set a target of 4.5% growth in expenditure over FY 20, a decline in real terms. So far, the growth rate is 4.9% marginally above target. Reflecting government priority, PSDP spending is down by 15% over last year. At Rs. 2,104 Billion up to March 2021, debt servicing is 82% of net federal receipts and 45% of its total expenditure, leaving little for government to meet other essential expenditure. This is despite the extension in moratorium on G 20 debt servicing.

As GoP wants to borrow more in FY 21 to meet debt servicing, PSDP and Ehsaas needs, this expenditure will continue to grow. Policy makers must balance between the vital need for providing relief to citizens and the sustainability of debt. Past borrowing that went to consumption, not investment, is a major reason for the present economic woes.

Overall fiscal deficit for the three quarters is 3.6% of GDP. Federal deficit was 4.5% of GDP. It came down because of provincial surplus of Rs. 412.7 Billion. Before we estimate if GoP will stay within its fiscal deficit target of 7% of GDP in FY 21, there are a few imponderables to consider. First, we have to see the result of GoP's especial efforts to raise revenue. Second, if GoP and the provinces continue to limit spending and the latter will contribute with a surplus. As revenue collection has picked up to cross Rs. 4 Trillion, government could stay within the 7% deficit target.

Yet, the real value of the Economic Survey is to inform about the quality of growth, its components and some indication about GoP's medium term strategy to pursue GDP growth, increase productivity, and create jobs.

This fiscal's GDP estimated growth rate of 3.94% is based on healthy growth in the productive sectors, agriculture and manufacturing. LSM grew by 9.3% and important crops, with revival in wheat production, grew by 2.8%. Growth in construction was 8.3% and finance sector by 7.8%.

Despite claims about a revival, it seems that growth is the result of fiscal incentives and concessional credit for investment to the private sector and creation of demand through social protection payments. It likely did not come from investment. Fiscal 22 growth rate will increase if such largesse continues. That depends on ongoing talks with the IMF, as Pakistan pins its hopes on US political support.

But it is time that policy makers recognize that such feel good growth does more harm than good. Borrowings have to be paid back with interest. Pakistan must invest the borrowing into infrastructure that boosts exports. The Economic

Survey shows that incentives and concessional credit have not caused private sector to invest more.

Estimated gross capital formation for FY 21 is estimated to be 15.2% of GDP, slightly below FY 20's 15.3% of GDP. In real terms, private sector capital formation declined in FY 21 from the previous fiscal. This is especially notable in two key sectors of manufacturing and construction. Construction was offered major incentives and concessions last year. This is serious. Government's express goal of sustained growth will come about from greater private investment. Until profits don't get reinvested, growth will not be enduring. It must look at policies to correct this issue.

Production in some areas have taken a hit. Power generation and distribution fell by 23%. This suggests that while production is down because of transmission and distribution constraints and low demand, consumers and taxpayers must still pay for capacity guarantees.

Another sector that is in decline is mining. Despite 25% fall in crude prices and 29% fall in petroleum products, our energy import will be above $ 10.5 Billion this year, or 20% of total imports. Pakistan has known reserves of conventional and shale oil and gas as well as lignite. We must upgrade policies to increase exploration and production of oil and gas. For shale production, government may consider risk sharing with state owned exploration companies. This would bring a big reduction in forex needed for their imports.

The justified celebration of a thin current account surplus is also under pressure. Eleven months imports have grown by 22.5%, with the trade deficit worsening by 30.5%. Similarly, external debt servicing is estimated to touch $ 14 Billion for FY 21. Actuals for nine months is $ 10.6 Billion. Effect on the current account from increasing trade deficit and debt servicing is mitigated so far by a 29% growth in workers' remittances.

Inflation is up again. Year on year by May 2021, CPI grew by almost 11% over May 2020. The sensitive price index was higher by 19.7% and wholesale prices were up by 19.4%. Food inflation too was in double digits. For the period July-May FY 21, CPI grew by 8.8%, sensitive price index by 13. 5% and wholesale prices by 8.4%.

For years, the economy has been bound in a vicious circle of weak fundamentals, weak growth, leading further to weak fundamentals. Added to this is continued issues of the political economy. The longer Pakistan postpones economic reforms while parliament avoids its role of political oversight on economic decision making, the worse would be the effect on the economy.

This Institute has said so for years. Without revisiting our paradigm for policy making, Pakistan should not expect an improved economy. There are three areas that hinder economic progress:

- No political oversight of economic policy. Concessions to IPPs have stayed as taxpayers must meet circular debt payment. Loss making state owned enterprises in which politics prevails over judicious decision making. PIA, Railways, DISCOs and many more with captive markets survive on taxpayer subsidy. Political influence must yield to well thought policy making or else thee economy will stay mired in deep challenges and the people will suffer.
- Continued transfer of resources to sectors that earn surplus profits because of guarantees and concessions.
- Inability to fix tax policy and tax administration.

In the case of tax collection, despite economic growth, there is no real growth in tax revenue, which so far has kept pace with inflation. Also, contrary to how widely it was advertised two years ago, there was no reform of tax administration.

The ambitious FBR revenue level of Rs. 4,963 Billion (less ambitious than the year before) was based on tax reforms. That has not happened. Direct taxes have grown by 8.7% in the three quarters, less than inflation. FBR should have done better, in a year where corporate profits are said to have grown. Indirect taxes grew by 13%, just above inflation.

Below is a recap of the economy's performance during FY 21. How the economy performed should not be a surprise. Sustained economic growth will come with reorienting spending priorities, ensuring economic inclusion, and by investing in and empowering the people of Pakistan. Disregard of this fundamental truth about nation building is what keeps the economy sub-optimal and dependent on foreign funds for survival.

Inflation in Pakistan is only partly a function of monetary policy. It has occurred because of frequent jacking up of tariffs on power, gas, and petrol. In fact, all administrative prices increased. This happened even when the IMF programme was in abeyance. That such policy making defies logic does not reduce the pain that it has caused citizens. If Covid did not occur last year the government would have to invent it as an excuse for poor policy.

Economic Performance FY 20

Below are economic indicators with targets approved by the National Economic Council and parliament for FY 21. While growth rate is above estimate, those indicators that show whether the economy is sufficiently invested for future growth have not picked up or have done so marginally. Rate of savings that has been in long term decline was 15%, with domestic savings a paltry 5.8% of GDP. Same with investment. Gross capital formation has dropped from last year. Credit to private sector flow declined further. Table below:

FY 21 actuals against GoP targets

	Target FY 21 %	Actual FY 21 %
GDP growth	**2.1%**	**3.94**
Industry	**0.1**	**3.57**
• Manufacturing	-0.7	8.71
• LSM	-2.5	9.29
Agriculture	**2.8**	**2.77**
Commodity producing (Industry + Agriculture)	**1.5**	**3.17**
Services	**2.6**	**4.4**
Current account balance/GDP	-1.4	0.3
Inflation	6.5	8.8
FDI. Growth	25	-32
Fiscal balance/GDP	7	6
Federal expenditure, growth	4.5	5
Federal Revenue, growth	24	13
Total investment	15.5	15.2
Savings	13.8	13.6

Source: For growth, Targets Annual Plan 2019-20, Actual PES/National Accounts FY 20, for other indicators, target from Budget speech, Budget in Brief FY 21and Annual Plan FY 20, actual from MoF Economic Survey FY 21, and SBP data

While economic growth has revived, tax collection has been weak.

Revenue Collection				Rs. Billion
	Target FY 21	Revenue FY 20 July March	Revenue FY 21 July March	% Growth
Total Revenue Fed and provincial		4,689.9	4,992.5	6.5
Tax Revenue	5,822	3,594.3	3,765. 0	4.7
Federal Revenue	6,717	4,289.0	4,540.3	5.8
FBR Tax Revenue	4,963	3,273.1	3,394.9	3.7
Direct Taxes	2,043	1,146.1	1,246.4	8.7
Indirect Taxes	2,920	1,898.2	2,148.5	13.2
• **Customs**	640	474.1	541.0	14.1
• **Sales tax**	1,919	1,242.3	1,415.8	13.9
• **Fed Excise**	361	181.8	191.7	5.4
Other Taxes + Non-Tax Revenue	1,610.2	1,262.7	1,165.6	-9.2

Source: Budget from Budget in Brief FY 21, Revenue actuals from respective Fiscal Operations

Fiscal Deficit:

In the budget speech, the target fiscal deficit was target to be 7 %. The July-March actual is 3.6 %. Last year too the deficit for July-March was 3.8% which grew to 8.1% by the end of the year.

In any case, government's main target now is the primary and not the fiscal deficit. Primary balance was 1% surplus. As GoP mainly spends money on debt servicing, the primary deficit is easy to control. Fiscal deficit minus debt servicing, is primary deficit. This time IMF's focus is the primary deficit. MoF is thus more interested in managing the primary balance.

Balance of Payment:

The improved current account balance shows a surplus of $ 773 Million for the ten month period up to April 2021. This is against a deficit of $ 4.4 Billion last fiscal. GoP will go beyond its target of containing current account deficit by having a surplus. Trade deficit for July-May FY 21 worsened by 30.5%. The current account has been buoyed by a sudden 29% increase in remittances. Net FDI, targeted to grow by 25%, in fact fell by 32%. Net Forex Reserves with the SBP stood at USD 15.6 B on 30 April 2021.

Despite a major devaluation, exports have grown slowly and in the traditional textile and apparel sectors. Exports will grow with increase in competitiveness and production of higher value goods. It does not respond to Rs. Value alone. There is not enough discussion about increasing productivity and competitiveness.

The Balance of Payment was hit also by fall in FDI and exit of portfolio investment. As we have said before, the policy to attract private debt with high interest was unwise. The money left quickly.

Government has expressed its interest to give fiscal incentives to boost exports in FY 22. Not sure why governments prefer export growth by using this unsustainable but easy option instead of enhancing capacity to boost export and move into new product areas. For FY 21, GoP targeted goods exports to be USD 22.7 Billion. By April 2021, thee economy achieved that target for the year. Workers remittance during FY 21 will be more than $ 28 Billion by year end.

Balance of Payment
Major Indicators

	FY 20	July-April FY21	July-April FY20	Change +/-
	Million USD			%
Current Account Balance	-4,449	773	-4,657	--
Trade Deficit FOB (incl. Services)	-24,425	-22,736	-20,599	-10.4
Workers' Remittance	23,131	24,246	18,793	29
FDI	2,598	1,554	2,302	-32.5

Trade Flows July-April FY 20
Million USD

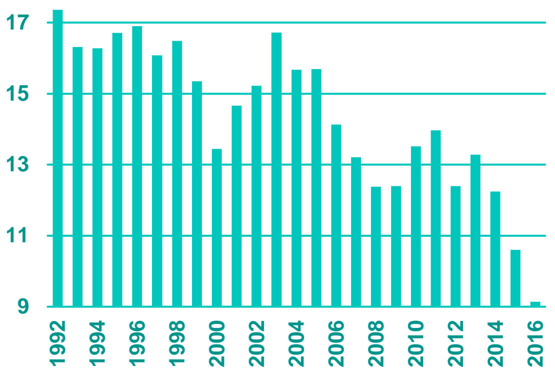
	July-April FY 20	July-April FY 21	% +/-
Exports	19,785	22,560	14
Imports	40,849	50,048	22.5
Trade Deficit	-21,064	-27,488	-30.5

Low savings and investment:

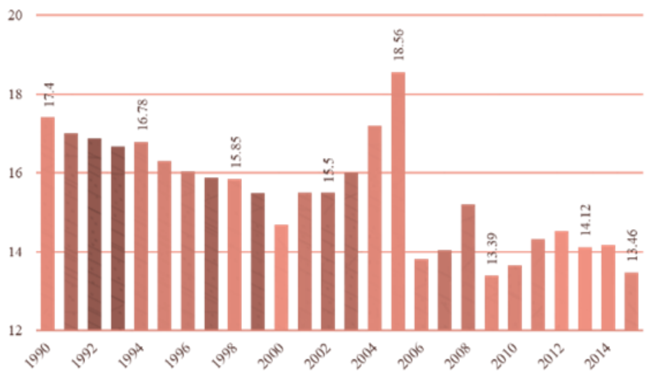
Low savings and Investment affect growth. Along with low technology content in our production base, this is the most enduring predicament of our economy. As per the Economic Survey, investment was 15.2 % of GDP against a target of 15.5 % of GDP. Last year, total investment was 15.3%. Until ten years ago, Pakistan's historical Investment/GDP ratio was 20%. With an Incremental Capital Output Ratio of 4 or more, 20% investment is needed to generate 5% GDP growth.

National savings is 15.3% of GDP in the current fiscal against a low target of 13.9%. Domestic savings was a paltry 5.8 % of GDP. Over the years, domestic savings have progressively fallen. This is grave cause for concern and yet not mentioned in GoP's policy discussion. There is a direct relationship between savings, investment, manufacturing and export. See Charts below:

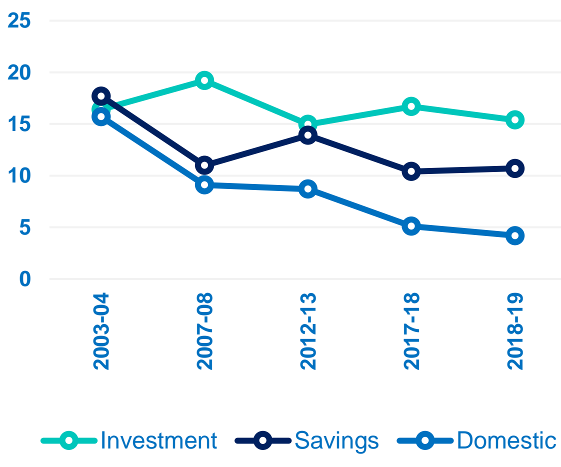
Exports/GDP 1992-2017



Manufacturing/GDP 1990-2015



Falling Savings and Investment as % GDP



Inflation: July-May FY 21 and YoY May 21				%
	Average July-May		YoY May 2020	
	FY 20	FY 21	May 2020	May 2021
CPI	10.94	8.83	8.22	10.87
SPI	13.95	13.49	10.99	19.72
WPI	11.13	8.41	1.50	19.39

Inflation was in check until 2018, based on an artificial Rupee value. The combination of correction of exchange rate, perhaps more than needed, brought import driven inflation. This was aggravated by continuous increase in administered prices of utilities and essentials. Despite correction in Rupee value, inflation is high, though moderately down from last year. Average July-May CPI grew by 8.83 % while sensitive price grew by 13.95%. The target for CPI was 6.5%. In recent months, there seems to be an uptick as YoY for May 2021 increased by 10.87%. The sharp growth in wholesale prices and SPI do not augur well for the CPI trend.

Fiscal Operations:

Overall, despite GoP's claims, economic fundamentals remain weak. GoP's focus on current account balance and primary balance has dampened demand and government revenue. Total debt servicing is on the rise as new loans service old ones. Today, federal government's debt servicing cost is 82% of federal net receipts. In FY 20, GoP paid Rs. 2,619.7 Billion in mark-up, while net revenue was Rs. 3,278 Billion. Net revenue is gross receipts of the federal government minus transfer to provinces. It is the same in FY 21.This leaves very little space for government to spend on other priorities. This is questionable public finance management.

Similarly, for the current account. GoP's external financing needs are on the rise and without growth in exports it must rely on more debt to balance its external account. This year an unexpected boon came in the shape of workers' remittances.

Public debt including external debt has increased, inflation has been stubborn, and forex reserves is precarious, not knowing how long it will last. Public debt has not grown simply because of change in Rupee value. Between June 2018 and March 2021, GoP has borrowed USD 14.9 Billion in external public debt alone. Its commercial finance stock and its short term debt have also increased. It is not known where those large sums of debt goes as there is no visible project built. Apart from short-term growth, borrowing has not worked in the past and will not work for sustained growth.

In the last two decades there were two occasions when Pakistan had large fiscal space to build its production base and revive the economy for sustained GDP and export growth. On both occasions, we missed the opportunity. The first was after 9/11, when Pakistan received massive aid and foreign funds from the US and other bilateral and multilateral donors. Along with rescheduling of USD 28 Billion of Paris Club debt for fifteen years, estimates of the total space available to Pakistan was about USD 60 Billion. The second was during 2015-2018 when along with IMF's Extended Fund Facility, Pakistan received massive Chinese assistance for CPEC. Both times Pakistan did nothing to build competitiveness and exports. On the second occasion we at least built infrastructure, albeit on a lavish scale. During 2001-2007, when most flows were either grant or Coalition Support Fund and concessional multilateral funds, we did not even do that. The energy shortage and the circular debt are products of that decade. Over many governments, we have repeated the same mistakes. That is why the macro-economic indices forever stay weak.

While under an IMF arrangement, we exercise discipline to stay in the programme. Even then more often than not the programmes do not go beyond the first couple of tranche. Space provided by IMF should be used to institute deep structural reform. During the programme, we test IMF's patience. Once the programme is over, we go back to our ways. In the past, we should have contained spending, chosen infrastructure development carefully to boost exports, and invested in our technical capacity. Reforms of revenue and spending policy (public finance) would have corrected major inequities. That was needed to build competitiveness.

We neither stabilized nor built competitiveness. There could not have been a worse use of IMF space and other assistance such as US aid and CPEC finance. Since then, tight monetary policy and adjustments in Rupee value and in utility tariffs have spurred inflation and have dampened investment plans.

Inevitably, growth has been up and down and uncertain. The discipline imposed by IMF is much needed. The test lies in what the government does once the arrangement ends and whether it has the foresight and the willingness to correct the economy's structural flaws. We have to move from a crony and elite economy to an efficient dispensation. The future of the economy rests on that decision.

GoP has been unable to reduce revenue leakage in the power sector. If successfully done, this will mitigate the circular debt to an extent. With considerable tariff increase in power and gas sectors, GoP hopes to recover fully their cost and restore financial order to the sector. However, this has not happened. It merely encourages leakage. Meanwhile, circular debt continues to grow. PSDP spending received a large cut in the last two years. Actual expenditure booked up to March 21 was Rs. 353 Billion, 15% below Rs. 417 Billion in FY 20 for the same period.

Summarized Fiscal Operations					in Billions PKR
	July-March FY 20	July-March FY 21	% +/-	July-June FY 20	% Share in total expenditure
Total Exp	**4,422**	**4,639**	**5%**	**6,819**	**100**
Current	**3,946**	**4,223**	**7%**	**6,092**	**89.3**
Defence	802	784	-2%	1,213	17.8
Debt servicing	1,880	2,104	12%	2,619.7	38.4
Pensions, grants, subsidies	1,011	1,090	7.8%	1,375*	20
Sub-Total of above 3	3,693	3,977.5	7.7%	5,207.7	76.3
Balance for civil government	253	245	-3%	923	13.5
PSDP	**476**	**413**	**-13%**	**688**	**10.0**
Fiscal Deficit	-3.80%	-3.6%		8.90%	

* Pension 447 M in FY 20

With FBR taxes barely growing, in real terms, fiscal deficit has been controlled so far by expenditure management. July-March FY 21 fiscal deficit was 3.6% of GDP, compared to 3.8% same period last year. Total expenditure increased by 5% (current by 7%). July March growth of 11.5% in FBR taxes, is barely above inflation. Indirect taxes grew by 13.5%.

As in past years, government this year too has not addressed the issue of PSE losses. Each year, this is a major drain on GoP resources. While taxpayers are rightly being asked to fulfill their responsibilities as citizens and pay the taxes due, government has

yet to show strong urgency in creating expenditure efficiencies. Unrestrained PSE losses is money that could go to development, security, or to improve service provision to the people. Plans for strong action have been have afoot, but so far, there is nothing on ground. Subsidy for PSEs are a particular concern. Despite claims to contrary, government has done very little, if at all, to restructure and turn around PSEs or to privatize them.

Pakistan Total Debt and Liabilities

Billion Rs.

	Jun-07	Jun-13	June 20	March 2021	Growth March 2021/June 20
Total Debt and Liabilities	**5,024**	**16,228**	**44,591**	**45,470**	**2** **+879B**
Domestic Debt	**2,597**	**9,833**	**24,773**	**27,020**	**9%** **2,247 B**
Government	2,597	9,521	23,283	25,552	9.7% 2,270
PSEs	--	312	1,490	1,468	-1.5 - 22
External Debt	**2,341**	**5,698**	**16,614**	**16,653**	**2.3%** **39**
Government	2,135	4,311	11,824	11,289	-5%
IMF	85	435	1,292	1,165	-10%
PSEs & Private incl intercompany	121	952	3,498	3,972	13 %
Total Debt	**4,935**	**15,531**	**41,387**	**43,673**	**5.5 %** **2,286**
Liabilities	**89**	**697**	**3,441**	**2,025**	**-40%**
Domestic	--	470	813.4	700.9	
External	89	227	2,628	1,324	

Accumulated PSEs losses are routinely estimated to be between Rs. 1.2 to 1.4 Trillion. This includes revenue loss by DISCO, which government must control but has been unable to do so. Government does not clearly disclose PSE losses.

After meeting debt servicing and subsidies, not much of government spending is left for stimulating growth or for public welfare. During July-March FY 21, PSDP spending was a paltry 7.6% of total expenditure, falling from 11% in FY 20. Debt servicing and defence had a share of 56% in total expenditure. Add to it grants, subsidy, and pensions and their combined share is 76 % of total. The pace of growth of debt servicing is formidable and a cause of concern. We cannot have a prudent fiscal policy at this scale.

Public Debt:

High fiscal deficit over many years means that government has continued to incur debt. Total debt and liabilities stood at over Rs. 45 Trillion or 100 % of GDP. Debt and liabilities have grown by Rs. 2.3 Trillion from the debt stock on 30 June 2020. In June 2018, total debt and liabilities was 29.8 Trillion, so we have added Rs. 15.6 Trillion to the total. Since June 2020, domestic has grown by 9% and external debt by 2.3% (this also includes the effect of a revalued Rupee).

External debt and liabilities alone is now 44% of GDP. Measured in dollars, external debt has grown in double digits. Public debt has grown from USD 75.5 Billion in June 2018 to USD 90.3 Billion in March 2020. Total debt and liabilities stood at USD 116 Billion end March 2021, compared to USD 95.1 Billion in June 2018, up over 22 %.

We have also seen more commercial debt, a growth of 13.5%. The increase in market-based debt with limited tenure and high cost is a great factor in causing fragility in the economy.

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