State of the Economy

ANALYTICAL BRIEF

June 2016

Key Issues in the State of Economy 2015-16

Social Policy and Development Centre

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This analytical brief on the state of Pakistan's economy has been prepared by SPDC in the light of Economic Survey 2015-16 and the latest available data from the Ministry of Finance (Pakistan Fiscal Operations) and the State Bank of Pakistan. This brief analysis will be followed by a detailed research report on the state of economy and evaluation of federal budget 2016-17.

GDP growth rate is 3.1% not 4.7%

Social Policy and Development Centre (SPDC) has estimated that the GDP growth rate in 2015-16 is likely to be 3.1%. This is substantially less than the GDP growth rate of 4.7% reported by the Pakistan Bureau of Statistics (PBS).

This is the third year running that PBS has exaggerated the GDP growth rate. Further, in June 2014, PBS brought down the relatively high growth rate achieved in 2011-12 from 4.4% to 3.8%. This was done to demonstrate that the GDP growth rate of 4% in 2013-14 was the highest in last six years.

According to the SPDC estimates, the growth rate in 2015-16 has been overstated in ten out of the eighteen sectors in the national economy. Almost 60% of the overstatement is in the services sector.

The alternative estimated growth rate for agriculture is negative 2%; for industry, 5.5% and for services, 4.1%, implying a GDP growth rate in 2015-16 of 3.1%[1]. This is consistent with the finding over last four decades that in a year when the agricultural sector declines, the GDP growth rate never exceeds 4%.

Agriculture is important for Pakistan not only because it accounts directly for 21% of the GDP but also 60% of the manufacturing is agro-based and over 40% of trading and transport is of agricultural products.
It may be that electricity generation increased by only 2%. This is unlikely to support a relatively high GDP growth rate.

Private investment fell despite an improvement in the security situation, extraordinarily low interest rates and greater access to credit

Government has missed the target of investment set for 2015-16. The level of total fixed investment remained 13.6% of GDP against the target of 16.1%. Private investment has emerged as a major concern in this regard. Despite extraordinarily low interest rates and access to more credit, private investment has fallen from 10.2% of GDP in 2014-15 to 9.8% in 2015-16. In absolute terms, growth in private investment (at constant prices) declined to 3.3% as compared to 10.1% in fiscal year 2014-15.

The decline in private investment may be attributed to lower rate of investment both in agriculture and industry. During 2015-16, growth in investment in agriculture sector declined to only 0.2% as compared to 6.4% in 2014-15. This is in response to the sharply falling profitability of different crops, especially cotton. The negative growth in agriculture is also reflected in the sale of tractors which has declined by 39% and the fall in imports of agricultural machinery of 37%.

Growth rate in private investment in large scale manufacturing has also declined from 11.2% to 2.2% during the same period. One explanation for this is the decline in the rate of existing capacity utilization due to the quantitative decline in exports. Another reason is the lack of expansion in the supply of electricity and gas.

There appears to be an inconsistency in that the growth in construction sector is reported at over 13% but the growth in investment in housing in only 4%.

Decline in exports is mainly due to negative quantity effect as opposed to government's claim of negative price effect

The government is vociferously claiming that due to low international prices of major export items, the exports of Pakistani goods have dropped by 10%. The analysis of exports reveals that quantity effect is predominant rather than price effect in FY 2016.

Major decline in export quantity is observed in sugar (47%), cotton yarn (32%), leather tanned

[1] Detailed calculations sector-wise are available from SPDC on request.

(26%) and cement (24%). Basmati rice and fruits have shown modest falls in quantity of 9% and 6% respectively. However, some increase in quantity exported is observed in cotton cloth (4%) knitwear (10%) and readymade garments (4%).

Exports of SMEs have shown a significant decline in carpets (24%), leather gloves (31%) and fans (21%). This indicates that there has been a significant loss of employment in SMEs.

Significant decline in export prices is observed in basmati rice (19%), other rice (15%), cotton cloth (14%), knitwear (12%), bed wear (5%) and cement (4%).

Chinese investment is substituting for FDI from other countries instead of complementing it

The net flow of foreign direct investment (FDI) remained at only $1 billion during first 10 months of 2015-15 against the target of $3.3 billion. Major sectors attracting FDI include power, oil and gas exploration and telecommunications. China has been the main contributor of FDI during this period with a share of 54% as compared to 23% last year.

The country-wise analysis of FDI reveals that Chinese investment is substituting for the FDI from other countries such as USA, UK and UAE. The combined contribution to FDI from these countries has declined from about 43% to 14%.

Some portfolio money has left Pakistan indicating some capital flight despite a relatively buoyant stock market

The stock markets in Pakistan, particularly Karachi Stock Exchange, have performed relatively well in 2015-16. The KSE Index has gone up by 8% in 2015-16, more than most other markets in the region. However, despite the increase, almost $400 million of foreign portfolio money has left Pakistan. This indicates that external perceptions of Pakistan are not favorable. Last year, $837 million of portfolio money had entered the stock markets in the country.

Rise in foreign exchange reserves since June 2013 is due primarily to external borrowing

Net foreign exchange reserves of the State Bank of Pakistan (SBP) have increased from $ 6,008 million on June 30, 2013 to $ 16,808 million on May 27, 2016, showing an increase of $ 10,800 million.

During the same period, cumulative net external borrowing is $11,102 million. The break up is of multilateral/bilateral assistance ($5,310 million), Euro/Ijara Sukuk Bond flotation ($ 2,908 million) and the IMF's Extended Fund Facility ($ 2884 million).

Therefore, reserves have increased entirely due to external borrowing. In fact, $302 million have been used to finance the consumption of imported goods and services. There are serious concerns about future external debt sustainability.

There is risk of depletion of foreign exchange reserves by almost 54 % in the next two years

The government seems to be comfortable with the current level of foreign exchange reserves. However, keeping in view the external financing needs for the next couple of years, the external resource position is potentially vulnerable. The budget estimates for repayment of foreign loans and interest payment are about $6.6 billion in 2016-17.

According to SPDC estimates, current account deficit (CAD) for next year could rise to $5.5 billion. There are several factors which will increase the CAD from the present level of $ 2 billion. Oil prices and LNG import are expected to add $2 billion and $ 1 billion to the import bill respectively.

If expected negative impact of reduction in Coalition Support Fund ($ 1.5 billion) and positive impact of increase in exports due to restoration of cotton crop ($ 1 billion) is incorporated, estimated CAD may approach $ 5.5 billion. Thus, including external payments and CAD, external financing needs would be above $12 billion.

However, the potential financing position is not encouraging. China Safe Deposits did not materialize last year and government has excluded this item from the resource picture. It is aiming to obtain about $ 1 billion net from external flotation of bonds, which may not be feasible in the absence of an IMF cover.

Gross external inflow of borrowing and grants is estimated to be about $ 6 billion. Along with FDI, total inflow may reach $7.5 billion. This implies a shortfall of $ 4.5 billion, which will have to be financed through the existing foreign exchange reserves. As such, foreign exchange reserves face the risk of depletion of 27% next year and up to 54% in the next two years.

Federal non-tax revenues have declined precipitously by 25%

The federal non-tax revenues have collapsed from Rs 592 billion during first nine months of 2014-15 to Rs 445 billion during the same period of 2015-16, implying a decline of Rs 147 billion. The fall is due to a Rs 74 billion reduction in the inflow from Coalition Support Fund (CSF), Rs 45 billion due to lower profits of SBP because of decline in mark up rates, and the remaining Rs 27 billion from other sources.

The consequence is that despite the fast growth in federal tax revenues of almost 20%, overall revenues of the federal government have increased by only 10%. Next year, the short fall in CSF inflow could be as much as Rs 150 billion.

Defense expenditure has fallen in the first nine months of 2015-16 despite Zarb-e-Azb operations

The data on federal government current expenditures reveal that expenditure on defense affairs and services has, in fact, declined during July-March 2015-16 compared to same time period during last year. It was Rs 483 billion in the first nine months of 2015-16, compared to Rs486 billion in the same months of 2014-15. The budgeted growth rate of defense expenditure in 2015-16 is 8%.

This decline is hard to explain as it happens at time when the Zarb-i-Azb operation is at its full and final stage. Has the army suddenly become more cost effective or is this the consequence of delayed releases to limit the fiscal deficit up to end- March 2016?

Cost of debt servicing has increased by Rs 105 billion due to the' lock-in' effect of a bigger stock of PIBs acquired at higher mark up rates

The government borrows from commercial banks and the capital market through auctioning of Market Treasury Bills (MTBs) and Pakistan Investment Bonds (PIBs). At the end of March 2016, the magnitude of medium- and long term PIBs stood at Rs 4.7 trillion after registering a growth of 261% since end of June 2013.

A significant feature of this borrowing is that it was made at time when interest rates were much higher than the existing rates. This is termed as the lock-in effect as government is committed to service the outstanding debt at a higher interest rate. As a result the interest payments has reached Rs 1 trillion in the first nine months of 2015-16, reflecting an increase of Rs 105 billion or over 10%, compared to the similar period a year ago. The budgeted estimates of 2015-16 assume no increase in the cost of debt servicing.

Development expenditures have shown improvement, particularly in the provinces of Balochistan and Punjab

There has been a commendable increase in consolidated (federal and provincial) development expenditure by 20% in the first nine months of 2015-16 against the same period in 2014-15. The break-up shows that federal government increased its development spending by 14%.

Among provinces, Balochistan and Punjab have done well where these expenditures increased by 27% (from Rs 22 billion to Rs 28 billion) and 48% (from Rs 148 billion to Rs222 billion) respectively. In Khyber Pakhtunkhwa also the development expenditures increased by 24% (from Rs 45 billion to Rs 56 billion). However, Sindh showed dismal performance where development expenditure declined by 12% (from Rs 75 billion to Rs 66 billion).

Over 18 percent increase in tax revenues of FBR reflects success in mobilization of revenues, but is due mostly to increase in indirect taxes, especially on the energy sector

Tax revenue collected by FBR shows high growth of over 18% during first nine months of 2015-16, facilitated mostly by the enhancement of tax rates and holding back of refunds.

However, this increase is largely on account of growth in indirect taxes that constitute 62% of FBR taxes. While direct taxes grew at a rate of 13%, the indirect taxes went up by 22% during this period.

It is important to note that the energy sector contributed almost 50% to the total revenue from indirect taxes. In particular, this has contributed to a loss of export competitiveness.

Reduction in government borrowing from scheduled banks has facilitated access of the private sector

There has been a significant reduction in government's reliance on scheduled banks for budgetary support during 2015-16. Net government borrowing from scheduled banks (July 2015 to May 2016) stood at Rs 703 billion as compared to Rs 1,093 billion during the same period in 2014-15, exhibiting a decrease of over 35%.

Reduction in government borrowings from scheduled banks has crowded in more credit to the private sector which expanded from Rs 171 billion to Rs 312 billion..

Withholding tax on all banking transactions by non-filers has led to a big decline in the increase in bank deposits and a big rise in currency in circulation

In order to raise the tax-to-GDP ratio by increasing the number of tax payers, the government levied withholding tax at a rate of 0.6% on all transactions (of Rs 50,000 or above) through banking channels by non-filers of income tax. However, in response to dissension faced from the business community, tax rate was reduced it to 0.3% in July 2015 but subsequently was raised to 0.4% in March 2016.

This move of the government has discouraged banking transactions and promoted a culture of cash transactions, which eventually will have harmful consequences for the economy.

According the SBP data, the increase in total deposits with banks was only Rs 140 billion during Jul-May 2015-16 as compared to Rs 452 billion during Jul-May 2014-15 (less by Rs 312 billion). Simultaneously, the amount of currency in circulation increased by Rs 611 billion during Jul-May 2015-16 against Rs 336 billion during same period last year (up by Rs 275 billion).

Budget deficit up to March 2016 is understated by Rs 200 billion

The budget deficit is equal to the total borrowings, domestic and external. Domestic borrowing is derived as the change in domestic debt.

During the period, July 2015 to March 2016, Ministry of Finance reports the increase in domestic debt of Rs 1,007 billion. As opposed to this, SBP estimates the rise in domestic debt at Rs 1,209 billion. Therefore, the Ministry has understated the deficit of the federal government by over Rs 200 billion.

As such, the federal deficit has reached 4.8% of the GDP by March 2016. During the last quarter of a year during the last five years, the average deficit is almost 2% of the GDP. Consequently, the federal deficit may exceed 6.5% of the GDP by end June 2016, somewhat above the level of last year.

Public debt as percent of GDP has increased in the first nine months of 2015-16 to 66 %

Pakistan's debt-to-GDP ratio was 63.2 percent at the end of 2014-15, which has increased to 66 percent at the end of March 2015-16, according to the SBP. Almost three percentage point increase in the debt-to-GDP ratio is an alarming development.

The trend of debt servicing as percentage of net federal revenue receipts during last few years reveals that the public debt is mounting to unsustainable level. This ratio increased from 53% in 2007-8 to 62% in 2014-15 and then to 73% in the first nine months of 2015-16, which indicates that only 27% of the net federal revenue (NFR) is left for all other expenditures.

The situation becomes even worse if defense expenditures are added. The combined expenditure on debt servicing and defense as percentage of NFR was 82% in 2007-8 and 94% in 2014-15. It has now risen to 105%. It implies that government has to borrow money even to pay salaries, subsidies and so on.

Ideally, a government should only borrow for development. Federal development expenditure as percentage of its fiscal deficit is an indicator that reflects the extent of borrowing utilized for financing the development spending. This ratio was 41% in 2013-14 and has now declined to only 26% in 2015-16 (first nine months) implying that 78% of the borrowing is being used for consumption purposes instead of investment in development projects.

This again raises serious concerns about the debt servicing capacity of the government in future.

Poverty is increasing not falling

The Finance Minister in his Press Conference on June 2, 2016 claimed that incidence of poverty is declining in Pakistan.

The estimates given in Economic Survey 2015-16 also indicate that poverty has fallen drastically from 44% in 2007-08 to 29.5% in 2013-14.

However, performance of several indicators that affect poverty incidence does not support this claim. These include deterioration in housing conditions, increase in unemployment, fall in real wages, relative increase in food prices, and decline in food consumption leading to higher levels of malnutrition.

For instance, the proportion of housing units with one room increased from 23% to 26% and further went up to 28% in 2014-15, reflecting deterioration in housing conditions. Also, the proportion of housing units with piped water facility declined from 31% 2008-09 to 30% in 2012-13 and to 27% in 2014-15. Further, during 2011-12 to 2013-14, growth in housing rents was 26% against 17% growth in the overall CPI. This indicates that housing rents in this period increased in real terms.

According to Pakistan Labor Force Survey the unemployment rate increased from 5.2% in 2007-08 to 6.2% in 2012-13 and then declined to 5.9% in 2014-15. However, after incorporating the effect of 'discouraged workers', the estimated unemployment rate increases to 10% currently.

Food inflation during 2007-08 and 2012-13 and during 2013-14 and 2015-16 remained higher than overall inflation. This gap increased substantially during 2014-16 with food inflation at 14%, and overall CPI at 7 %.

Another worrisome indicator is that per capita consumption of some important basic food items by the population in two lower quintiles has declined. Between 2007-08 and 2013-14, per capita consumption of atta and milk has fallen.

These fundamental indicators are among the crucial determinants of poverty and deterioration in their performance certainly contributes in increasing the incidence of poverty. As such, SPDC is of the view that poverty is rising not falling.

Social Policy and Development Centre (SPDC) is a policy research think. Since its establishment in 1995 as a private non-profit company, SPDC has made significant intellectual contribution in placing issues of pro-poor growth and social development on Pakistan's policy-making agenda. With a focus on issues related to poverty and inequality, governance, social service delivery, gender, and pro-poor macro-economic policy, it contributes to the national goal of social development through research, policy advice, and advocacy. Being an independent and non-partisan research organization, the centre collaborates and cooperates with organizations working on issues relevant to its mandate both at home and abroad. It determines its own agenda and has successfully maintained its independence and balance between responsive and proactive social sector research.

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