PIDE Economy Watch

Quarterly January-March 2014

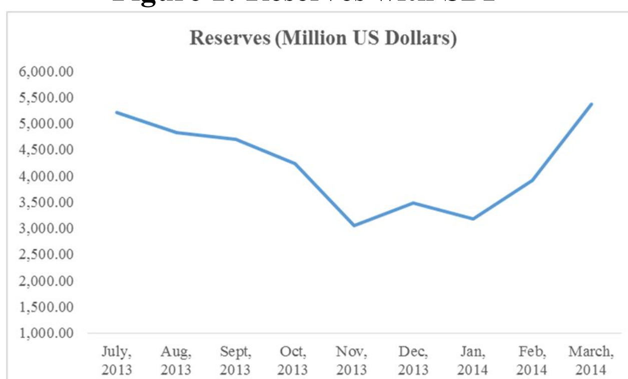
ECONOMIC PERFORMANCE

The panic that prevailed in the forex market and on external account for months has given way to "comfort", inflation has receded, fiscal deficit is even lower than envisaged, perceived business confidence has shored up, large scale manufacturing coupled with credit to private sector has picked up too. The revenue collection is somewhat behind target and the low fiscal deficit comes at the back of re-emerging circular debt and less than budgeted public sector development expenditure. The Pakistan Bureau of Statistics, using an under trial methodology, has released a heartening GDP growth figure of 4.1 percent for the first six months of 2013-14, with the largest increase coming from industrial activity. For full year the SBP has projected GDP growth of 3.5-4.5 percent, inflation of 8.5-9.5 percent and fiscal deficit to GDP of 6-7 percent.

The exchange rate witnessed considerable volatility since June 2013. The depreciation registered during the initial months of the incumbent regime was fully offset by the wave of appreciation observed in March 2014. The appreciation was triggered by management of the forex market and strengthened by the receipt of $1.5 billion from Saudi Arabia. Floatation of Euro Bonds of $2 billion has curbed the fears that the appreciation is temporary. The volatility observed in the forex market speaks of the need to keep a stronger watch and devise rules for greater transparency in the forex market transaction (see policy viewpoint on managing the forex market).

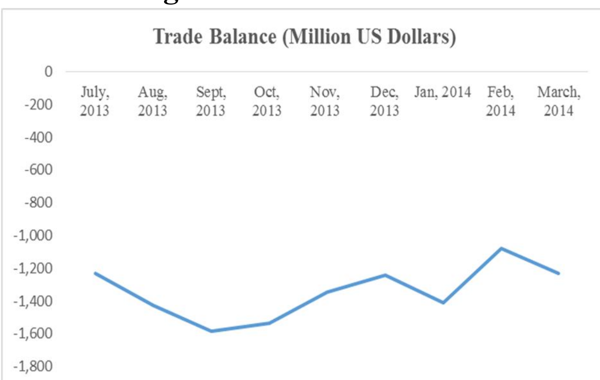
After the inflows on account of 3rd tranche from IMF, $1.5 billion from Saudi Arabia and $2 billion on account of Euro bonds the foreign exchange reserves of the SBP stood at $5.36 billion as at end of March. Media reports suggest that only one winner of the 4G license will pay the license fee in dollars while the rest of the winners of 3G/4G licenses will pay in Rupee. Thus the boost to foreign reserves expected on account of sale of these licenses may not be much. However the ability to intervene in the forex market that the SBP has gained with the surge in reserves due to various inflows is enough to keep the speculators at bay.

Figure 1: Reserves with SBP



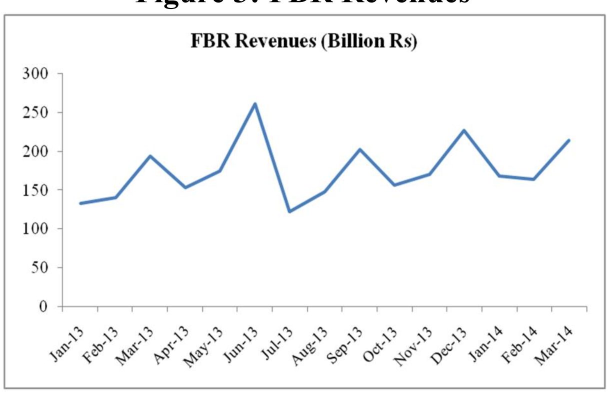
At the close of first nine months of the fiscal year the trade deficit stood at $1,230 million, while the deficit was $1,216 million in the corresponding period of last year. Exports and imports showed growth of 3.1percent and 3.6 percent respectively during the period. The current account deficit in quarter three of the current fiscal year stands at $416 billion as compared to $1172 billion in the corresponding period of last year showing an improvement of 64 percent.

Figure 2: Trade Balance



The revenue target of Rs.2475 billion envisaged in the budget has been revised downwards to Rs. 2345 billion. A total of Rs. 1575 billion has been collected during the 9 months of this year.

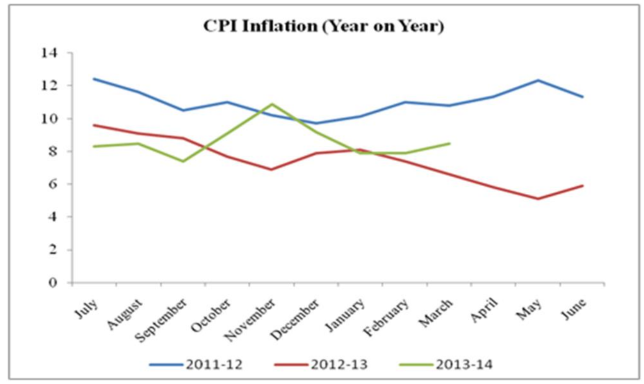
Figure 3: FBR Revenues



This leaves Rs. 770 billion to be collected during the last quarter of the current fiscal year to meet the revised revenue target. Even after accounting for the typically larger collection in the last quarter of the fiscal year a target of Rs.256 billion per month is ambitious given that on average Rs.170 billion have been collected during the nine months.

Inflation is down to 8.5 percent as at end of March from 9.2 percent three months earlier.

Figure 4: Year on Year CPI Inflation

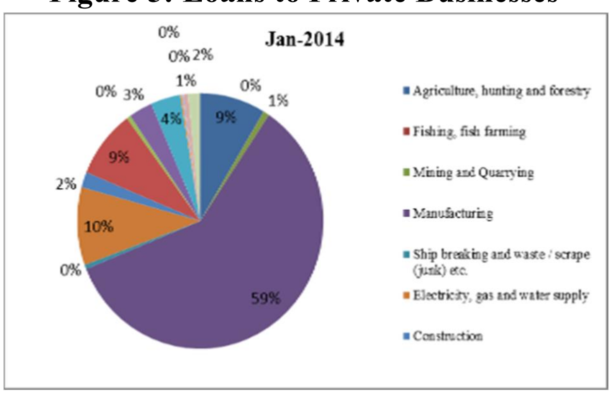


The respite in inflation is owed to factors like stable food and oil prices and improvement in the fiscal deficit. (2.2 percent in the first six months against the 3.5 percent envisaged in the IMF program).The improvement in the fiscal deficit has to be considered in the backdrop of significantly less than budgeted releases against the Public Sector Development Program (PSDP) and the rising circular debt. Out of the full year PSDP of Rs.363 billion Rs.145 billion had been released by April 18, 2014 which accounts for only 40 percent of the budgeted PSDP. Going by the procedure for release till now 70-75 percent of the funds budgeted in the PSDP should have been released. Had this been the case the fiscal deficit and inflation figures could have been higher than what we observe today. The re-emergence of circular debt raises question about the sustainability of the rather low fiscal deficit. Unfortunately both the typical avenues available for the settlement of circular debt - cut in subsidy and money printing, are inflationary.

The large scale manufacturing grew by 5.16 percent during the 8 months of the current fiscal year as against 3.32 percent in the corresponding period of last year. At the disaggregate level exceptional increase was observed in the production of switchgears (126%), deep-freezers (107%), and air conditioners (88%).

Credit to the private sector has unambiguously picked up during July-March 2014-131 percent increase over corresponding period of last year, though a slight decline in the extension of credit to the private has been observed in the January and February 2014. The jump in extension of credit to the private sector reflects an increase in economic activity.

Figure 5: Loans to Private Businesses



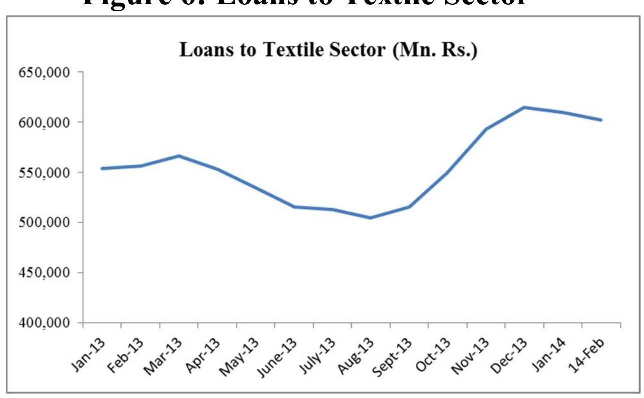
The IBA-SBP business confidence survey also suggests that the confidence in the economy is picking up.

The discount rate was kept unaltered at 9 percent in the monetary policy announced on March 15 2014. The tamed inflation suggests that it is possible to slash the discount rate and the signals emanating from SBP also suggest that the rate in fact might be slashed in the next monetary policy to be announced in mid-May.

A major chunk of the credit to private sector has historically been availed by the manufacturing sector. Other major beneficiaries of private sector credit include suppliers of electricity, gas & water, fishing, and agriculture. Other than electricity, gas & water, the services sector which contributes over 50 percent to the GDP is almost missing from the list of beneficiaries of the credit to the private sector. Conspicuous by its absence is the pro-poor retail and wholesale, which contributes significantly to the GDP. The rapidly growing branchless banking has provided the banks a mean address the supply constraints in accessing finance by reaching out the entrepreneurs with mobile phones. (See policy viewpoint on branchless banking).

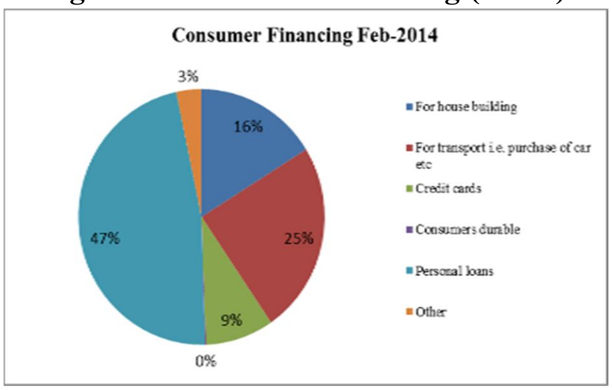
Credit to the textile sector has not increased significantly after the GSP Plus status became effective from January, 2014 though some increase was observed in December 2013. This perhaps reflects the credit availed to produce more by the time GSP becomes effective. However the credit to textile sector has shown a decline of around 2 percent in February 2014 over its value in December 2013.

Figure 6: Loans to Textile Sector



Consumer financing grew marginally during the quarter (0.54 percent). A large part of the consumer financing comprises personal loans followed by car financing. The housing finance which typically comprises perhaps the largest part of consumer financing in developed countries is rather low in Pakistan. One needs to investigate the demand and supply constraints to the growth of housing finance.

Figure 7: Consumer Financing (Stock)

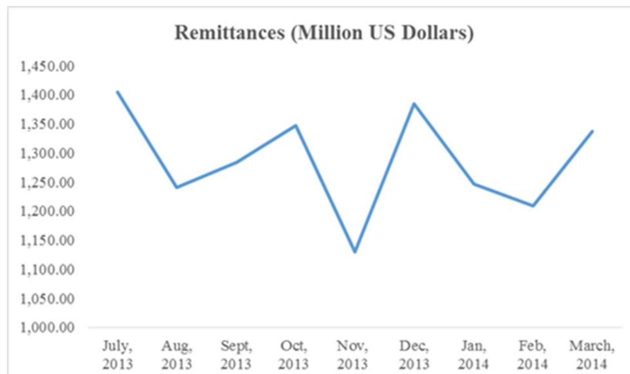


The FDI increased by 31.9 percent over the last quarter, the increase primarily was observed in January 2014. The spike observed in January is owed to inflows in power, food, construction and financial sector.

Figure 8: Net FDI

Remittances from overseas Pakistanis have registered an impressive growth of 12 percent during the nine months. Outliers include 25 percent growth in remittances from Dubai during the nine months. Typically 60 percent of the remittances originate from the Middle East while the balance is from the West. Research into the dynamics of remittances from different countries and the Pakistan Remittance Initiative (PRI) ï the institutional mechanism in place to encourage remittances, may yield potential avenues of bringing in even greater remittances.

Figure 9: Remittances



POLICY VIEWPOINT

Managing Forex Market

One element in the latest episode of the Rupee appreciation, observed in March 2014, was the positive statements, like ómarket is flooded with dollarsô coming from the president of the Forex Association of Pakistan. Should the government be relying on support of individuals to manage the market or more specifically to inform the public about the demand and supply in the market or do we need an institutional mechanism to keep the public abreast of the market conditions? What if an informed individual, like the office bearer of some forex association comes up with a statement conveying scarcity of the green bag? Clearly an institutional mechanism is preferable. The exchange companies/money changers report daily the particulars of their transactions to the SBP or some authority. If the information about foreign currency bought and sold on a particular day is made public this would give the stakeholders an idea about demand and supply in the market and also about the sudden spikes, if any. All this will help curb speculation in the forex market.

Does the KSE 100 Index predict Pak Economy?

Since the end of June 2013 to April 28, 2014 the KSE index has risen by 37 percent. The rise and fall of stock market indices, notwithstanding the prevalence of herd behavior, are perceived to respectively predict the upcoming boom and bust in an economy. Why the stock market indices are used as predictor of upcoming boom-bust in an economy? Can the KSE index be used to predict the boom-busts in Pakistan? We argue that under-representation of the agriculture and services in the KSE index, larger influence of the bigger firms on the changes in index value, and smallness as well as volatility of the KSE makes it difficult to rely on the KSE index as the predictor of Pakistanôs economy.

Generally the stock market indices are constructed in a manner to represent the movement in prices of shares quoted in that specific market. A rise in the price of share X theoretically implies that the profit of the firm is expected to increase in future. At times, rumors are also at work. If profits of most of the firms in an economy are expected to increase this would mean that a booming economy is likely in the times ahead. It is worth emphasizing that a trend-change stock market index predicts the expected long term trend of the economy rather than the current state of the economy or the state in the near future.

Now can the KSE index be used to predict the boom or recession in Pakistanôs economy? To answer this we need to answer; One, is the KSE index broad enough to represent all sectors of the economy ï industry, agriculture and services, preferably in proportion to their contribution to the GDP and two, does the KSE index represent on aggregate the expected profitability changes in the KSE itself. The matter of fact is that other than some agro based industries, the agriculture sector is completely missing from the KSE, though at times the changes in the in the index value bear some correlation with cotton prices and the weather changes that may affect agriculture one way or the other.. The services sector though represented at the KSE is dominated by financial services, energy and telecom. Retail, wholesale and number of other services for example the services of professionals, which contribute significantly to the GDP are not represented on the KSE. The KSE index cannot predict much about the sectors of the economy which are not represented in the KSE market.

Moreover by construction the weight that the share of a company enjoys in the index is determined by the size of the firm ï the larger the firm higher the weight. The KSE index being a weighted index, firms with greater weight influence the index relatively more. Out of 100 scrips included in the KSE index, 20 enjoy a combined weight of around 65 percent and thus the index is more sensitive to changes in the share prices of these 20 companies. Out of these 20 scrips, 6 are energy firms, (with a combined weight of 30), 4 are banking firms (combined weight: 15.5), 3 are fertilizer firms (combined weight 9.5) and 5 others (combined weight 11). All this is not to say that index is wrongly constructed. In fact by construction the KSE index resembles some of the popular stock market indices around the world. The problem lies with the market structure - some firms quoted on the KSE are too large relative to the rest. There is not much that can be done about this at the moment, except to wait for the other firms to grow big. However, the tilt of the index towards large firms makes the KSE index an inefficient predictor of the movement of aggregate stock prices even within the KSE market. An index that does not adequately represent the very market for which it is constructed will have difficulty in predicting the state of countryôs economy.

Finally given the small capitalization of the KSE relative to other stock markets and huge amount of investable funds available with local and foreign investors, the KSE is very volatile. This also makes the KSE index not so suitable a predictor of the long-term trend of the economy.

Branchless Banking: To Bank the Unbanked

Thanks to cell phones, branchless banking is doing wonders in developing and less developed countries like Pakistan, India, Bangladesh, Kenya and South Africa. Under the system the network agents, mostly operating in retail markets, use mobile phones to pay utility bills and transfer money for individuals from one place to another and even to and from bank accounts. The branchless banking has made headway in Pakistan and outlets can be found in a number of retail markets, around Pakistan. The activity is regulated by the SBP. The most pro-growth plus pro-poor activity that the branchless banking can do right now in Pakistan is to bring the unbanked into the banking fold. This would not only increase financial deepening in the economy but is also likely to increase the access of the credit constrained micro and small entrepreneurs to formal finance, which may contribute to the private sector led growth of the economy.

A study reports that at the aggregate level only 14 percent of the Pakistanis enjoy any kind of interface with the formal financial system, as against 32, 48 and 59 percent respectively in Bangladesh, India and Sri Lanka. More than half the population of Pakistan saves but only 8 percent entrust their saving to formal financial institutions. One third of the population borrows but only 3 percent borrow from the formal financial system. Clearly the financial inclusion is very low in Pakistan. A PSSP funded study being undertaken at PIDE finds that 38 percent of the micro and small entrepreneurs in the populous city of Rawalpindi do not have a bank account i.e. they do not even have the most preliminary nature of interface with a bank, let alone borrowing from a bank.

Possible reasons for remaining unbanked include but are not limited to; inconvenience or inability of the entrepreneurs to visit a bank during banking hours and low literacy level of the entrepreneurs.

How branchless banking can be used by the banks to reach to such unbanked entrepreneurs who cannot make it to the bank branches to deposit cash. The small entrepreneurs can use the branchless banking network agents present in their market, may be just a few shops away, to deposit money into their bank accounts. If the banks reach out to the unbanked entrepreneurs more aggressively, they can even manage to send the network agent to entrepreneurôs outlet. Thus the entrepreneur will be saved of the trouble and time to visit the network agent. The banker having observed the daily inflows from an entrepreneur X can also offer him/her a loan on the strength of regular inflows.

In all likelihood the entrepreneurs will not be willing to bear any charges for the transfer of money to their bank accounts. Whatôs the solution? The increase in scale of business that the banks would experience shall allow them to bear the charges. The banks will also experience decrease in cost, in terms of cut in staff strength and lesser branches, with the decreased need to have face-to-face interaction with customers.

Should Wheat Support Price Continue?

The government intervenes in the wheat market with the price support system. The objectives are to guide the farmersô production decisions, stabilize price and take care of both small farmers and urban consumers in the face of poorly integrated and volatile markets. This rationale of the wheat support price and wheat procurement by the government has lost ground. The main argument against the wheat support price is based on informed assessment of some individuals who may err on either side ï fix too high or too low a price relative to the market price. For example SBPôs 2^{nd} quarterly report quoting Pakistan Bureau of Statistics informs that the market price of wheat was Rs.1600 per 40 kg in November 2013. With the support price fixed at Rs.1200 how the government can expect to meet her procurement target.

Other arguments against wheat price support include; the subsidy mostly benefits the large farmers and wheat millers, despite the increase in support price in 2007-8 to 2011-12 the total area under wheat crop has decreased, price volatility in international markets is not too common, the price support mechanism creates inefficiencies if the coverage is limited and that the Asian economies with liberal regimes are outperforming interventionists. Under the support price mechanism the government has to procure wheat which involves huge financing from the banks at concessional rate under the commodity operations. Estimates suggest that amount of untargeted subsidy on account wheat price support is quite large and lending for commodity operations crowds out other productive sectors. Some studies take the view that the economy stands to benefit if the support price is gradually replaced with subsidies on input and targeted cash transfers in short run and gradual liberalization in long run.

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