# PIDE Economy Watch

July – December 2014

## ECONOMIC PERFORMANCE

The short-term macroeconomic scenario looks apparently fine. Driven by low oil prices, inflation is at all times low and the current account deficit is in check despite the blip in exports. With current level of oil prices, foreign reserves seem enough to cover 3 month of imports and the exchange rate is stable. The fiscal deficit is also low and within the limit prescribed by the IMF.

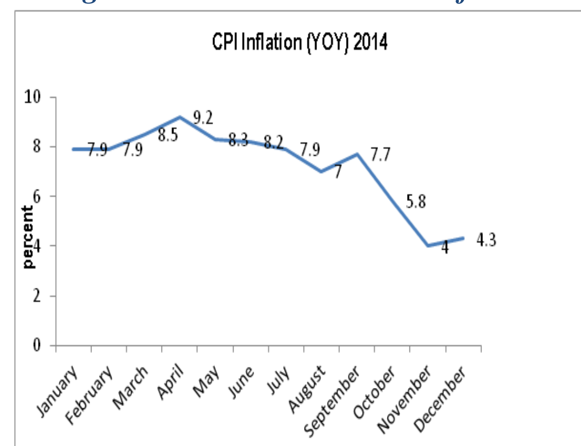
The country just weathered the severe oil crisis with pumps failing to meet demand. While one can pick up causes like increase in demand, non-availability of CNG, liquidity issues of PSO and problems with the supply chain, but only a thorough study can pin-point the exact cause(s) of the crises and inform us what factors contributed to the crisis. However the fact that PSO defaulted on her L/Cs makes it clear that poor liquidity of PSO had played some role in precipitating the crisis. PSO's poor liquidity, increment in circular debt, focus on keeping fiscal deficit low and IMF's conditions for release of loan tranches under the standby agreement, all seem related.

The fine macroeconomic numbers notwithstanding, contained fiscal deficit comes on the back of increment in circular debt and privatisation receipts. Tax revenues and exports receipts, that should ideally keep the twin deficits in check, remain under pressure due to structural reasons.

Independent estimates suggest that the raise in GST on oil will more than compensate for loss of revenue due to oil price decline. The more than required raise in GST on oil will help comply with the IMF demand that compensatory revenue measures be instituted if the imposition of Gas Infrastructure Development Cess (GIDC) remains held up due to judicial review.

Inflation at 6.1 percent was recorded during the first six months of FY15 with CPI registering growth rate of mere 4.3 percent in December 2014. The inflation rate has been on the decline since the beginning of FY15 even when the oil prices had not registered a decrease in Pakistan. In August 2014, inflation rate touched the lowest level of 7 percent in 14 months rising slightly to 7.7 percent in September but then the oil driven price plunge began contributing to the steep decline in inflation.

***Figure 1: Year on Year CPI Inflation***

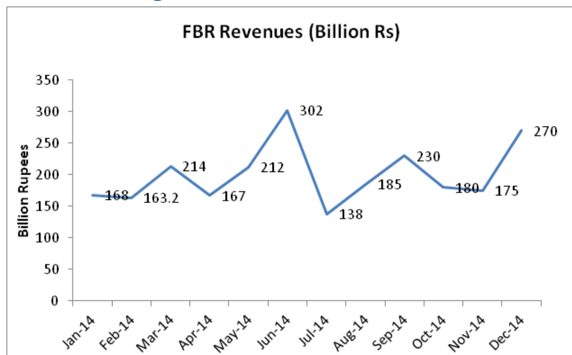


On the back of consistent decrease in inflation, the SBP has reduced the policy rate (Discount rate) by 150 basis points in two episodes; first the SBP came with a 50 basis points reduction in November 2014 and then with a 100 basis point cut in January 2015.

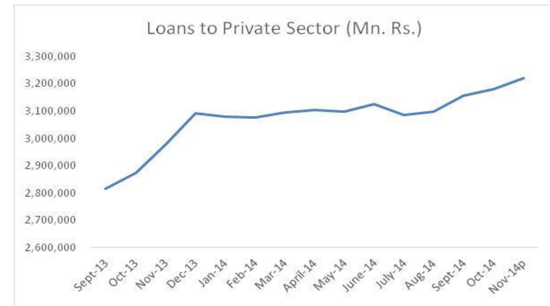
The sharp decline in inflation in a relatively short period on the back of low oil prices lends support to the hypothesis that inflation is more of supply-side phenomenon in Pakistan. This puts to debate the frequent use of monetary policy to contain inflation, when it is on rise.

During the first six months of FY15 FBR collected the taxes of Rs. 1172 billion, which represents an increase of 14 percent over Rs.1032 collected during the same period of last year. With this tax collection performance, the achievement of targeted 25 percent growth in tax revenues for full year remains elusive. As per past practice the target for tax revenues is likely to be revised downward. With the decrease in sale price of oil, to compensate for the loss of sales tax revenue from this source, the government has increased the GST on oil from 17 percent to 27 percent in two episodes.

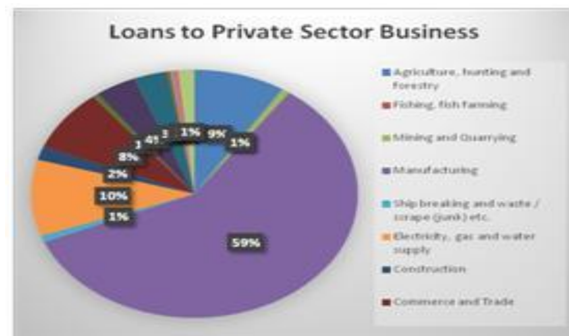
***Figure 2: FBR Revenues***




Credit to private sector, including the credit to the textile sector, has gradually risen since the initial months of FY15. With a significant fall in the discount rate theoretically the credit demand should pick up further. However the lending canvass of the financial sector is rather narrow—a major part of the lending pie (59 percent) goes to manufacturing sector.



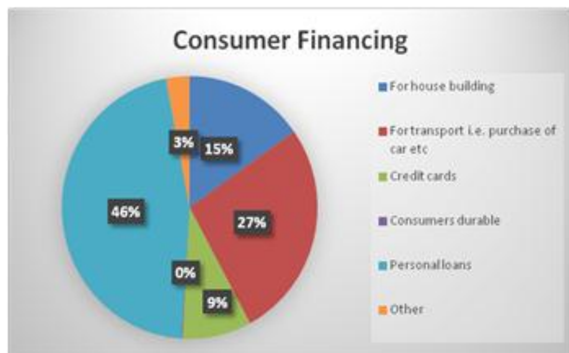

This limits the potential of expansion in credit to the private sector — an increase in the lending volume primarily depends upon the willingness of the manufacturing sector to borrow. The sector's willingness to borrow is contingent upon the sector's ability to produce and sell more. While the ability to produce more is constrained by access to energy, the ability to sell more, also to an extent is held back by the country's security profile and the all too known structural impediments to exporting more.




Consumer financing carries potential, has shown some increase over the immediate past and may register further increase as well on the back of decrease in discount rate.

However housing finance, which is typically a major component of consumer finance elsewhere, enjoys only a small share here and structural impediments, like weak foreclosure law, keeps its growth stunted.

*Figure 4: Consumer Financing*

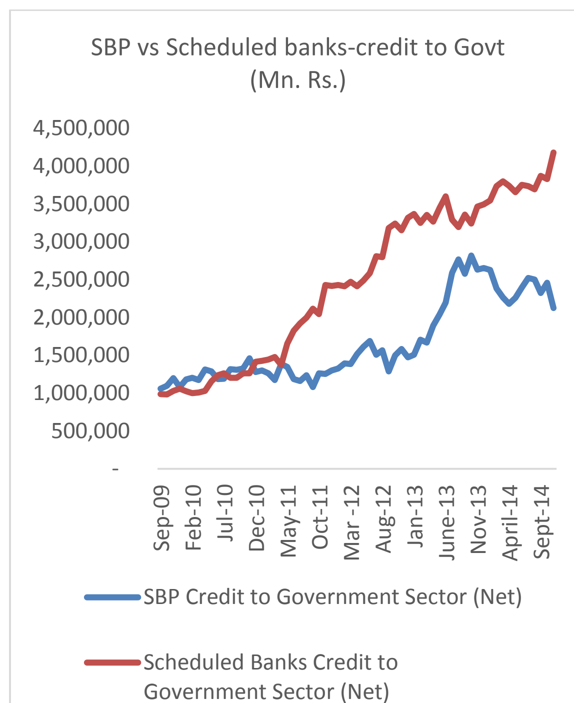



Car leasing has grown over the past decade due to the water-tight collateral attached to it – the bank being a joint owner, can drive away the car without much legal hassle, upon default. This is not true for housing finance – if the legal framework for housing finance could be improved sufficiently to assure repayment to the banks, it has the promise to grow significantly.

The interest spread of the banks declined from 6.4 percent in June 2014 to 5.8 percent by December 2014. Both the decrease in lending rate and the increase in deposit rate have contributed more or less equally to the decrease in spread.

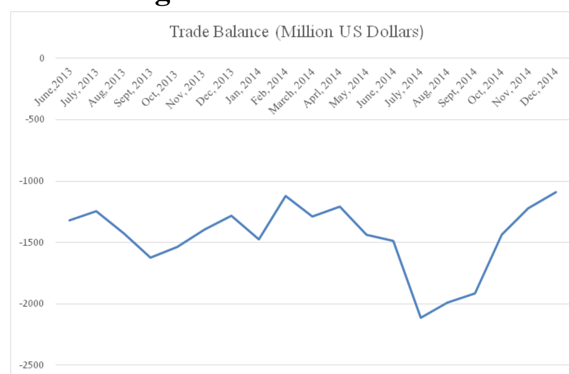
To comply with IMF's performance criteria, the government's borrowing from the State Bank decreased significantly over the past couple of months, however this seems to have been offset by the increased borrowing from commercial banks. Reportedly, huge government borrowing from commercial banks comes at the back of corresponding amounts being injected into the market by the SBP.

*Figure 5: Government Borrowing: SBP vs Banks*




Trade deficit at $9.7 billion for the first half of FY15 represents an increase of 14.7 percent over the trade deficit in corresponding period of last year.

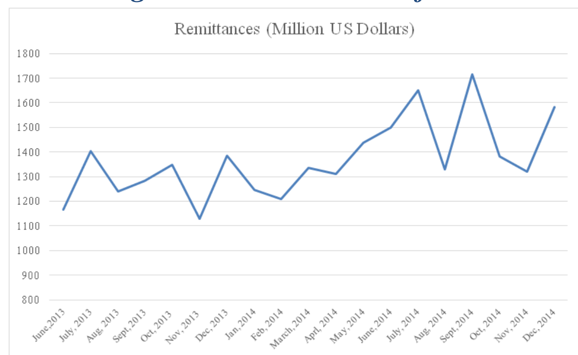
**Figure 6: Trade Balance**




Exports, during July-December 2014 declined by 2.5 percent, while the imports despite the plunge in oil prices, rose by 4.5 percent over last year's corresponding figure. The trade deficit, which was $6 billion in the first quarter of FY15, dipped to $3.75 for the second quarter. Remittances at

$8.9 billion during 6 months of FY 15 were 15 percent greater than inflows in the corresponding period of last year.

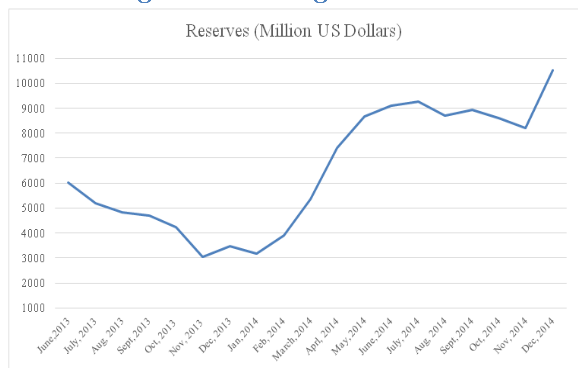
***Figure 7: Remittance inflows***




Current Account deficit of $2.16 billion was recorded during July-December 2014 – the deficit stood at $1.6 billion during July-September but dropped to $0.56 billion only due to fall in oil prices.

Foreign Reserves, as of end December 2014, stood at $10.5 billion. A major increase of $2.29 billion in reserves was recorded in December 2014. This is owed to placement of Sakuk bonds in international market to the tune of $1 billion and disbursement of $1.1 by IMF against two loan tranches.

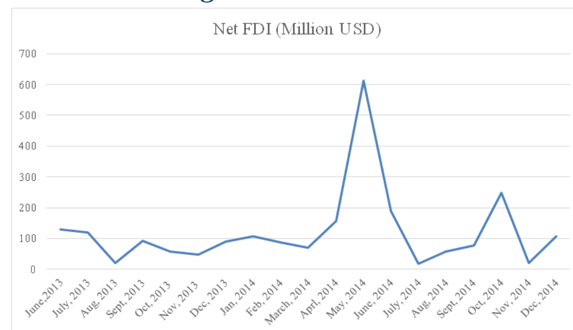
***Figure 8: Foreign Reserves***




Moreover the central bank netted in $795 million through spot purchases in the local market during July-November 2014. Assuming average monthly imports of $3.5 billion, the reserves are enough to cover 3 months of imports.

The foreign direct investment during October-December 2014 amounted to $376 million as compared to $153 million during the period July-Sept. The spikes in FDI in the current fiscal year are owed to investments from China.

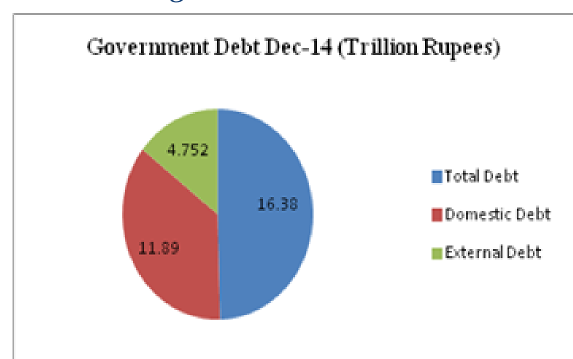
***Figure 9: Net FDI***




The exchange rate fluctuated a bit during July-December 2014, was Rs.100.08 to $1 in August 2014, spiked upward to Rs. 102.75 by end of October and receded back to Rs. 100.08 by end of December.

The total public debt as of December 2014 was Rs.16.4 trillion representing an increase of 8.5 percent over the debt outstanding a year ago.

***Figure 10: Public Debt***




During the year domestic debt increased by 13 percent while the external debt declined by 0.12 percent. There is a

slight change in the maturity profile with the long term debt declining and the short term debt showing some increment.

***Figure 11: Domestic Debt***

Large scale manufacturing shows sluggish growth rate of 2.65 percent during July-December 2014. High growth sectors include Iron & Steel (66.0pc), leather (30.2pc) paper and board (18.8pc), electronics (17.5pc), automobiles (11.1pc) and pharmaceuticals (9.4pc). Sectors, which registered slow growth include; fertilisers (3.6 pc), non-metallic minerals (3.6pc), chemicals (1.5pc), rubber products (0.56pc) and textiles (0.24 pc). The sectors, which registered negative growth include wood products (60.3pc), engineering goods (15.2pc), food & beverages (5.8pc) and petroleum products (4.8pc).

***Figure 12: Large Scale Manufacturing Growth***

VIEWPOINTS

**Falling Global Oil Prices**

The oil glut in the international markets has led to an unprecedented decrease in the price of crude oil in the international market. For much of the last decade the oil price, spurred by demand in China and conflict in Iraq remained rather high. The higher oil prices encouraged the search for cheaper alternatives and the result was oil from the shale formations in United States and Canada. Since 2008 United States alone has added 4 million barrels per day to the total global output of around 75 million barrels per day (5.3 percent of global output). On the other hand demand started falling due to weakening economies in Europe, Asia and U.S. By late 2014, oil supply was rising faster than demand.

***Figure 13: Global Oil Prices***

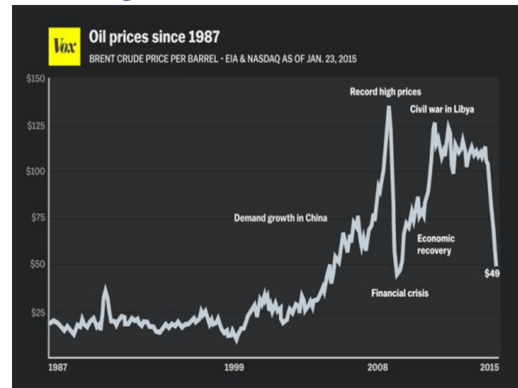
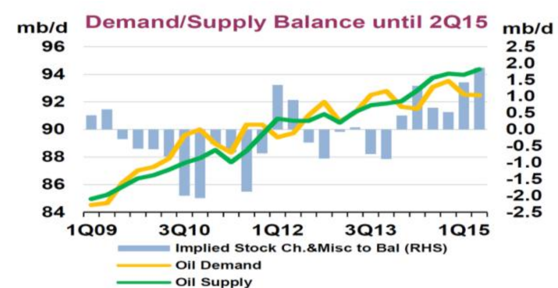



***Figure 14: Global oil Demand and Supply***




The major factors, which contributed to the decline can be summarised as; 1) lower demand mainly due to forecasts of dawdling economic activity, 2) increased

output of oil from the USA and most importantly from OPEC, 3) use of efficient technology, and use of alternate fuel sources and 4) the consistent oil supplies from conflict hit countries such as Iraq and Libya.

However the superfluity and the subsequent decline in oil prices is not explained by simple demand-supply analysis but transcends into the political economy domain. The OPEC, led by Saudi Arabia, which currently has around 40 percent of global market share of oil decided, not to cut supply in the wake of decrease in demand and increase in supply from North America. Extraction of oil from the fields in Kuwait and Saudi Arabia being much cheaper than extraction from Shale formations in Texas and North Dakota, the OPEC's decision not to cut supply could have two-fold objective; One, to throw out of business the American fracking companies producing oil from Shale formations and two, to adversely hit arch rivals like Russia, Iran and Venezuela.

## Electricity Distribution Companies: Privatise or Provincialise?

Privatisation of certain electricity distribution companies (DISCOs) is on the anvil. Economists, who might otherwise be all for privatisation of state owned enterprises would think twice before recommending privatisation of the Discos. The reason is simple! Discos are monopolies, which face an altogether different environment than the firms operating in a competitive environment face - a privatised Disco will have all the opportunity to exploit her consumers, in terms of price as well as service. Price fixation by the state owned regulator (Nepra) may not help curb exploitation - Discos would have every incentive to lobby the regulator, to fix a higher than the fairly determined price, with Disco and the regulator sharing the premium owed to lobbying. With the level of rent seeking that we typically experience, collusion between the regulator and the privatised Discos cannot be ruled out.

For monopolies to function in private sector without adverse influence on public welfare the regulator must be very strong ─ unfortunately, a strong Nepra is not in sight right now. Nepra's performance to-date does not allow us to hope that she would be free of the influence of private sector and the government. Even if it is possible to make Nepra strong, still let us not put the cart before the horse—let us first make Nepra independent and strong and then privatise Discos.

If the control of the Discos is transferred from the federal to provincial governments this is likely to improve the efficiency of Discos, especially by way of curbing power theft, which comprises a significant part of the power loss ─ the police, which can curb power theft is under provincial control.

Suppose that provinces enjoy control over Discos and power tariffs are determined by the regulator, accounting for cost and efficiency of the Discos. Also assume that consumers are charged whatever tariff NEPRA determines—that is, subsidy on electricity is disallowed by law. This implies that consumers served by less efficient Discos will pay more and therefore uniform tariffs will not prevail across provinces. Non-uniform tariffs will make provinces compete for offering lower tariffs to the ultimateconsumers.

How a province or a Disco may offer lower tariffs to its consumers? By improving the efficiency of the distribution system! If at the provincial level, the efficiency of the

Disco is primarily influenced by the level of power theft, this would induce the provinces to curb it. The province would have both the Discos and the police at their disposal to do this. The tariff differential among provinces, influenced primarily by the level of power theft, can become an election issue. Therefore, those ruling in the provinces will try their utmost to curb power theft.

It's worth mentioning here that in a number of countries, electricity distribution is a local affair. Moreover the fact that the privatisation of the then KESC (now K-Electric), after a passage of more than a decade, has not yielded the expected dividends and that the company is still dependent on WAPDA for electricity suggests that idea of privatisation of Discos needs more debate.

Once we attempt to provincialise the distribution of electricity, a numerous issues will crop up. A province may demand the up-gradation of the transmission network before the transfer while another may ask for control over generation as well. What the stakeholders need to understand is that provincialisation is possible only in a win-win scenario for all. With debate on the subject such scenario can emerge.

### Population Census

The population census is long overdue and still holding the census does not seem to be in sight. The population census of Pakistan, besides telling the head count, provides a range of information including age, gender, population density, literacy rate, enrolment ratio, dependency ratio, economically active population, labour force participation rate, unemployment rate, rural/urban proportions and the percentage of disabled population. The census report provides most of this information at the tehsil level and almost all the information is available at the district level. Imagine how useful this information could be to plan and govern.

Anything that goes by the name of planning makes use of the population census in one or the other way. Be it providing for energy, transport, education or health needs, we need accurate head count, age mapping and information on gender. The same holds true for devising labour market and social protection policies. The knowledge of density and the urbanisation trends help us provide for civic amenities and ponder over zoning regulations.

The list is obviously illustrative and not exhaustive. Estimates on some aspects of population are available but these are only estimates. It is only the population census that provides accurate numbers. What if the estimates prove to be wrong? What if the growth rate of the population turns out to be 2.05 instead of the estimated 2 percent? This can seriously affect all sorts of plans. What if the underestimation happens often? Numerous constitutional rights and responsibilities, including the distribution of financial resources under the NFC award, provincial share of seats in National Assembly and provincial quota in jobs at the federal level are pegged to population count of a province/jurisdiction. We might be doing all these things wrong if the population mix among provinces has changed significantly since the last census held in 1998.

The population census is becoming a difficult issue to tackle with different stakeholders, wary of the new numbers for one or the other reason. Though there may be few supporters of the cause of holding the census, the need of holding the census

cannot be over emphasised. One way of managing to hold the census is to reduce the stakes in the population numbers by delinking whatever is possible from population numbers. For example the distribution under the NFC award can easily be delinked from provincial population shares - very few countries around the world use population share as a basis to distribute national resources among provinces/states and the ones that do, typically accord very low weightage to it. Secondly the stakes in the NFC itself can be reduced by sharing tax bases between the province and the center rather than pooling in all the funds at the center and then distributing under a formula that supposedly constrains the holding of the census. Sharing tax bases may adversely influence provinces where economic activity is rather low. Practices around the world allow the 'have' provinces to transfer financial resources to 'have-not' provinces either directly or through the federal government. We can take lead from such practices to rethink our resource distribution policy.

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