PIDE Economy Watch

July-December 2015

Supported by historically low oil prices inflation has touched historic low levels and foreign reserves equivalent to four months of imports are available. Real economic activity, though posting some increase, has not picked up much despite the accommodative monetary policy being in vogue for over a year now and the decline in exports is worrying.

Responding primarily to lower inflation, the State Bank of Pakistan has been decreasing policy rate since November, 2014 - from 10 pc in September, 2014 to 6 pc in September, 2015. The latest monetary policy announced recently left the rate unchanged at 6 pc (Fig: 1).

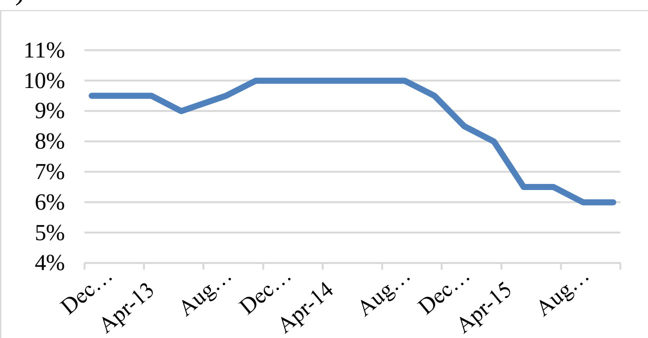


Figure 1: Discount Rate, Dec 2012-June 2015 (%)

Given the long term easy stance of monetary policy, the weighted average lending rates, on fresh bank loans at 7.8 pc in September 2015, are the lowest in 10 years. The interest rate spread too has been on the decline - the average interest rate spread was 5.45 pc during July-November, 2015 as compared to 5.8 pc in the corresponding period last year (Fig: 2).

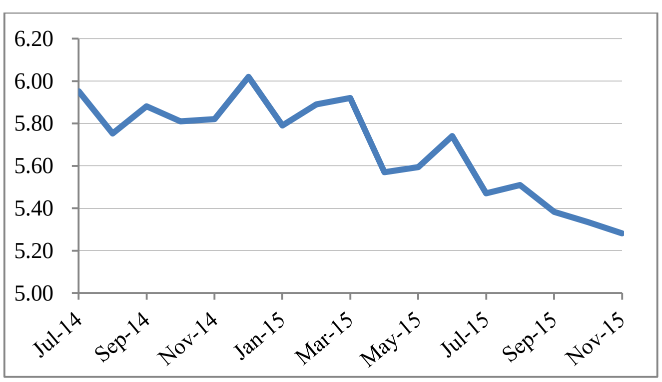


Figure 2: Interest Rate Spread, July 2014-Nov 2015 (%)

Despite the easy stance of monetary policy which seems to have been passed on to the lending rate as well, the credit to private sector – an indicator of the economic activity, has not picked up much as yet - year on year growth as of Nov 2015 is 5.5 pc (Fig: 3). Perhaps energy constraint and other structural issues continue to mar economic activity.

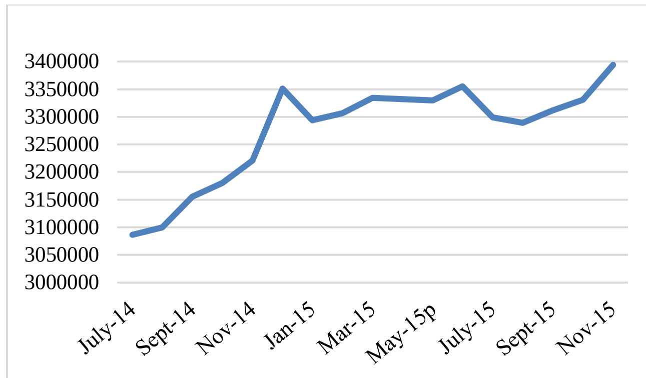


Figure 3: Loans to Private Sector (Million. Rs.)

After getting the GSP Plus status, the expectation was that the credit intake of the textile sector would register a significant increase. The expectation, however, has not materialized - since January, 2014 the net credit to the textile sector has registered a decline of 4.9 pc till November, 2015 (Fig: 4). Except for made up textile articles, knit-wear and finishing of textiles, all the sub sectors of textile also show decreased credit intake relative to what was outstanding against the sub-sectors as at of January 2014.

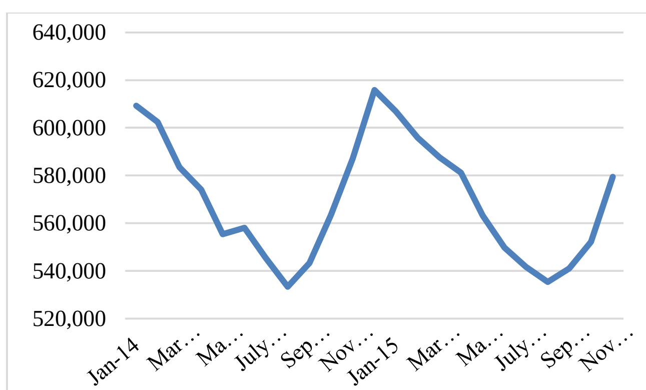


Figure 4: Loans to Textile Sector (Million. Rs)

Supported by lower oil prices, the average inflation dropped to 2.1 pc in the first six months of FY16 from 6.1 pc in corresponding period of last year.

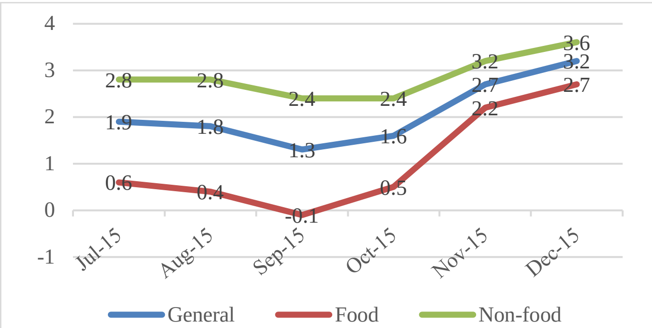


Figure 5: CPI Inflation YoY (%)

Focus on achieving sales tax revenue target had constrained the full pass-through of fall in international prices to end consumers (see Box: 1). Obviously, a larger pass-through would have meant a farther fall in inflation. In December 2015 the Consumer Price Index (CPI) was higher than the previous month's figure.

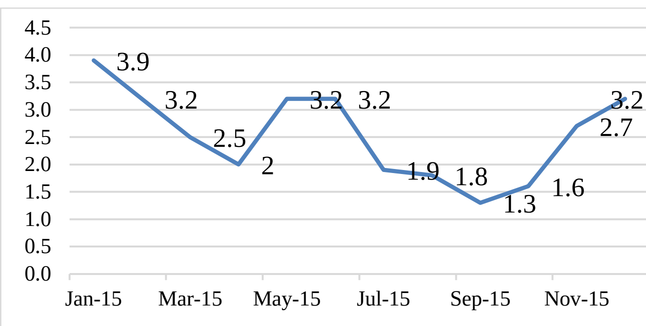


Figure 6: CPI Inflation 2015

This suggests that downward trajectory of the inflation might reverse in coming months however a substantial decline in state regulated oil prices may avert this. The tax revenue target set for the first half of FY 16 was almost fully achieved (Target: Rs.1390 billion, Actual collection: Rs.1385 billion). The revenue collected represents an increase of 19 pc over the actual of Rs. 1172 billion in the first half of previous fiscal year. The handsome collection is owed to the revenue generating measures like increase, during July to December, in sales tax rate on petroleum products and the regulatory duty imposed on import of 400 items with effect from December 1, 2015. The rates range between 5, 10, 12.5 and 15 percent. With all the increase coming through indirect taxes, the reliance on regressive taxation has increased further.

The level of fiscal deficit, on the back of handsome surpluses posted by the provinces, is around the target set for the first half of the fiscal year.

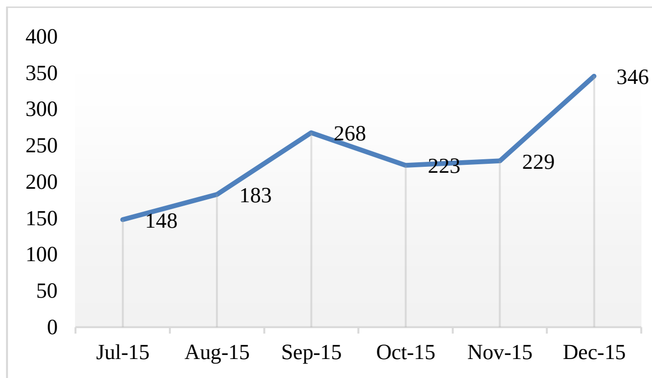


Figure 7: FBR Revenues (Rs. Billion)

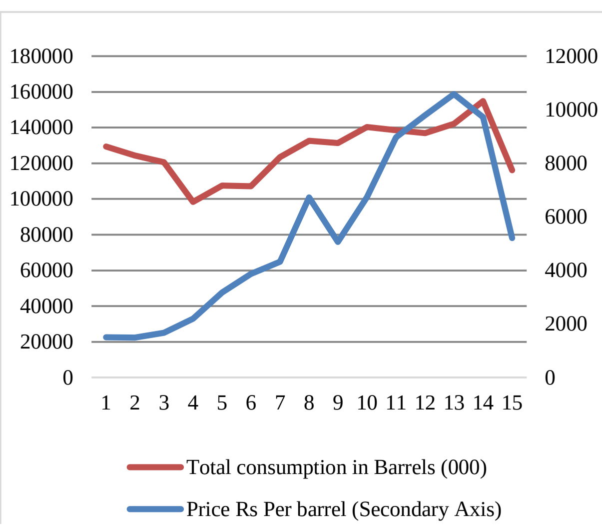


Figure 8: Price of Oil and Consumption

Box: 1

The sales tax on petroleum products constitutes a significant portion of the total revenue target. This tax being fixed in terms of percentage of sales price, any decrease in oil prices would hurt the tax revenues. To avoid a fall in tax revenue the government had been increasing the rate of sales tax with decrease in sales prices however the rate revisions were becoming difficult with large and frequent downward revision in oil prices. Recently the government has fixed the sales tax in terms quantity (liters) consumed. The demand for petroleum products being relatively inelastic (Figure 8 shows historical data on oil consumption at different prices - the quantity consumed does not change a lot with every downward revision in price.) This besides helping the government in stabilizing the collection from sales tax on petroleum products would also allow her to pass through a greater part of the fall in international oil prices to consumers. Thus fixation of sales tax on quantity consumed is welcome step. One wonders, why the government adopted this practice so late.

The question is how does posting budget surpluses augur for the development at the provincial level? Secondly, asking provinces to post surplus defeats the very purpose of higher transfers from the federal government under the 7th NFC Award.

Exports during the first half of FY16 have declined by 8.6 pc over the corresponding period of FY15.

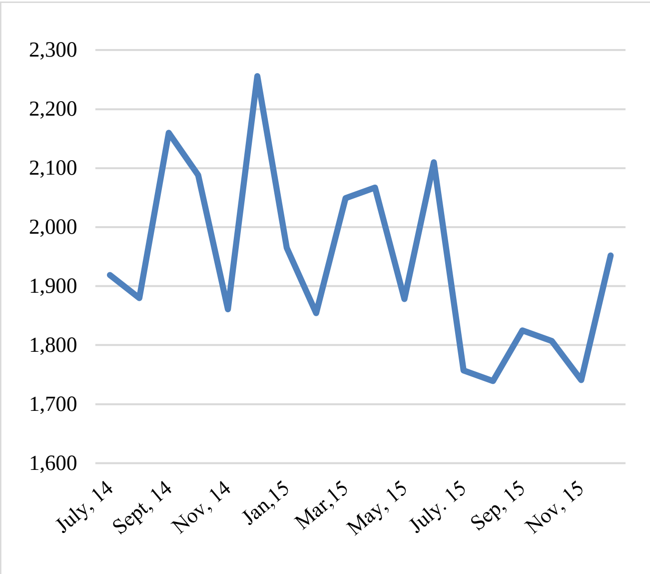


Figure 9: Pakistan's Exports ($ Million)

The exports have faced a consistent decline for over a year. Possible explanations include; energy crisis, over-valued exchange rate, economic slow-down in trading partner countries and structural issues at home. While all factors together might be at work, which factor is contributing how much, does not seem to have been rigorously examined.

To focus on alleviating the most severe constraints, knowledge of constraints and their relative contribution is essential. An ideal course would be to gather data, secondary as well as primary, on all sorts of constraints, and frame a policy of encouraging exports based on the evidence that emanates from the data gathered. A breakdown of the total exports data reveals that exports in all major commodity groups; textile, food, petroleum and manufacturing showed a decline in 2015 relative to last year with the largest decline in the value of petroleum exports of about 41 pc.

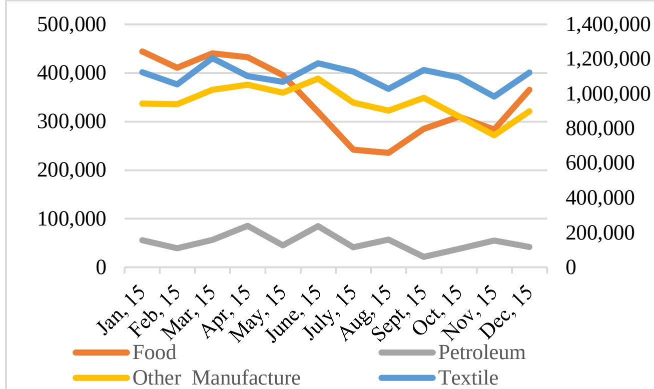


Figure 10: Pakistan's Exports ($ Thousand)

Imports however showed a mixed trend with import value of machinery, textiles and transport showing increase of 14.9, 12.7 and 9.6 pc respectively relative to imports in 2014. The import of food and petroleum products showed a decline of 3.4 pc and 38.3 pc in 2015 relative to previous year.

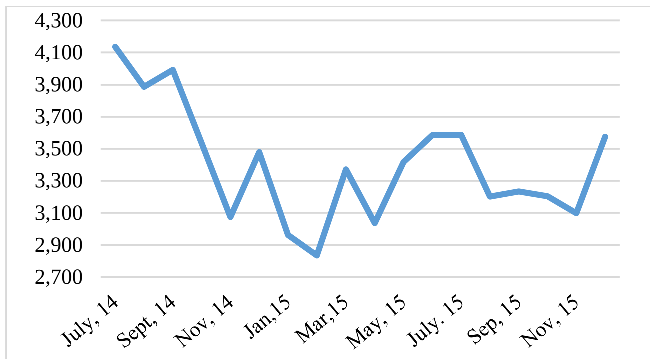


Figure 11: Pakistan's Aggregate Imports ($ Million)

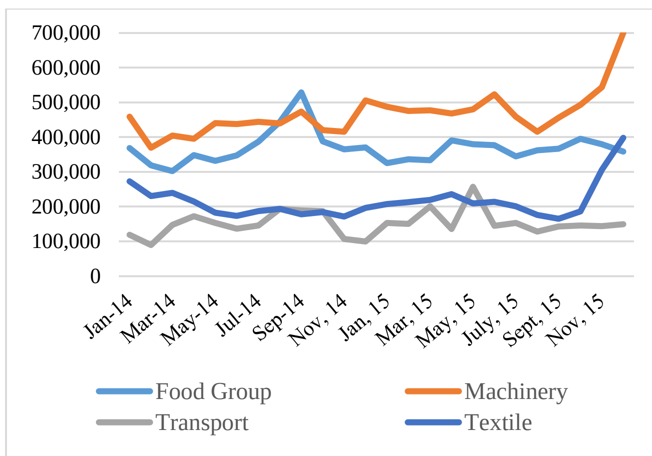


Figure 12: Pakistan's Imports ($ Thousand)

Thanks to the fall in international oil prices the trade deficit has declined despite the decrease in exports (Fig: 14).

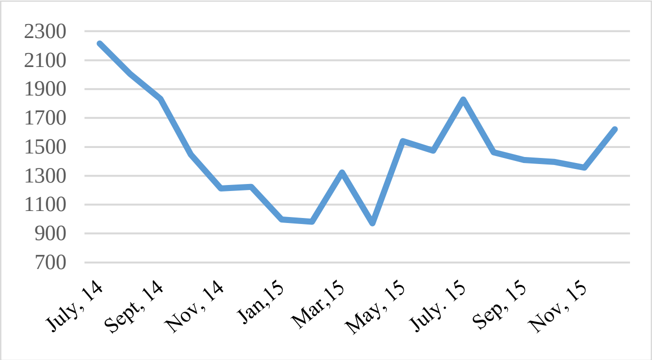


Figure 13: Trade Deficit ($ Million)

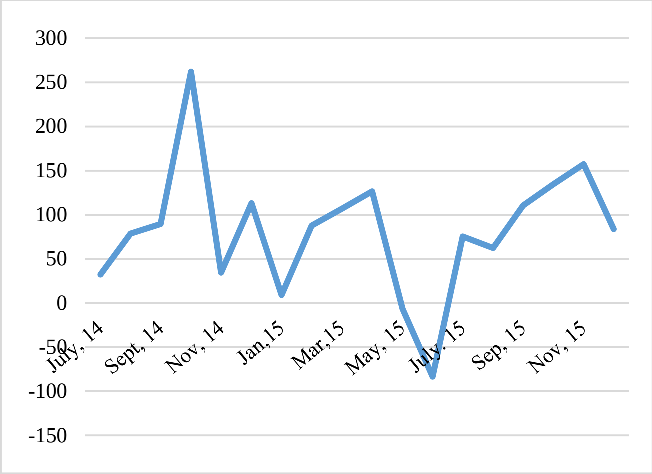


Figure 14: Net Foreign Direct Investment ($ Million)

Box 2:
Exchange Rate Valuation

A controversy has raged relevant sectors whether the Pak Rupee is overvalued and that whether it is hurting exports. One way to resolve the controversy could be that researchers based in universities and think tanks should periodically come with independent estimates of exchange rate misalignment, if any. Secondly the estimates based on desk studies need to be supplemented with situation on the ground. The researchers need to ask the exporters, importers and other informed stakeholders about whether the exchange rate is hurting competitiveness. If so, what is the evidence in this regard? For example to investigate whether the Pak Rupee has remained over valued in the last year or so, we need to find evidence whether some exporters have lost long time customers – at least some customers might have indicated why they are switching over to a source of supply in another country.

The Foreign Direct Investment scenario has not been good enough - investment of $865 million in 2015 relative $1833 million last year represents a decrease of almost 53 pc over the previous year.

A country wise look at the data shows an erratic trend with the exception of investment from China which has been positive and appears to show a rising trend – FDI from China in 2015 stood at $475 million.

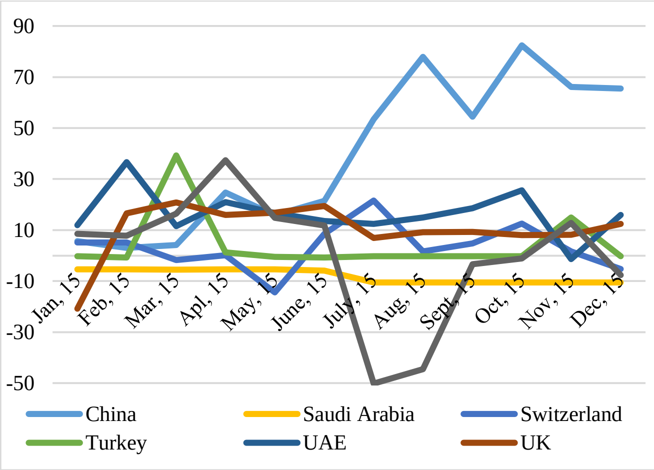


Figure 15: Country-wise FDI ($ Million)

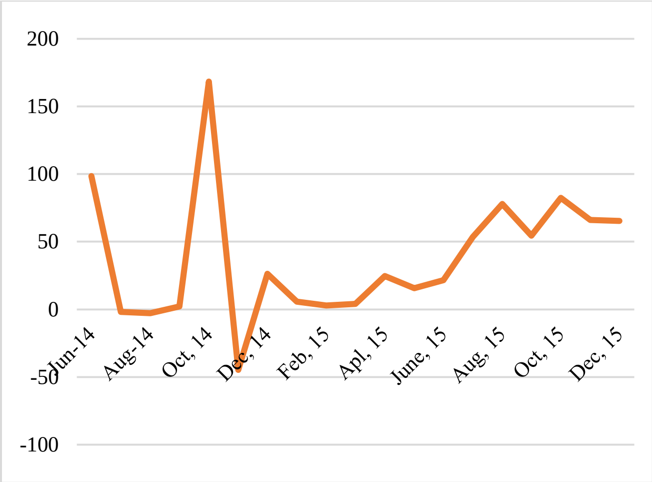


Figure 16: Foreign Direct Investment from China ($ Million)

The foreign exchange reserves at $15.9 billion with the state bank of Pakistan as on December 2015 were 51 pc higher than those available with the bank at the end of last year. The exchange rate has been gradually depreciating since July 2015. The depreciation of 3 percent has been recorded till end December 2015.

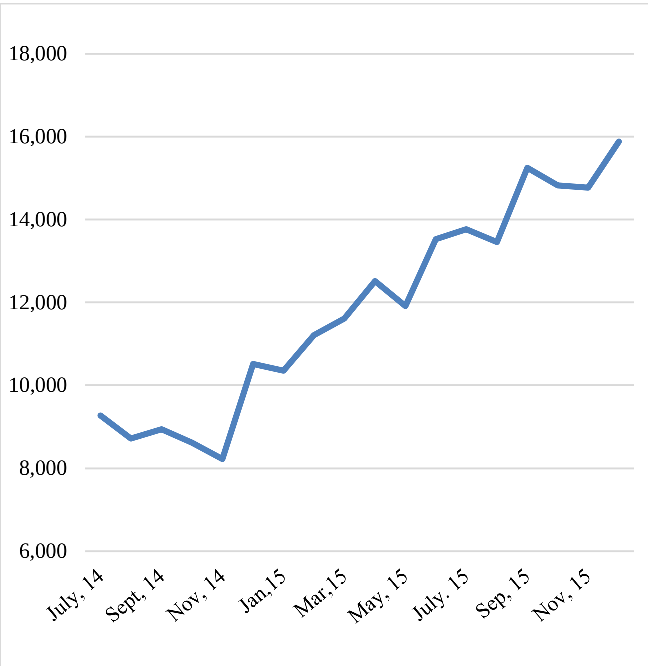
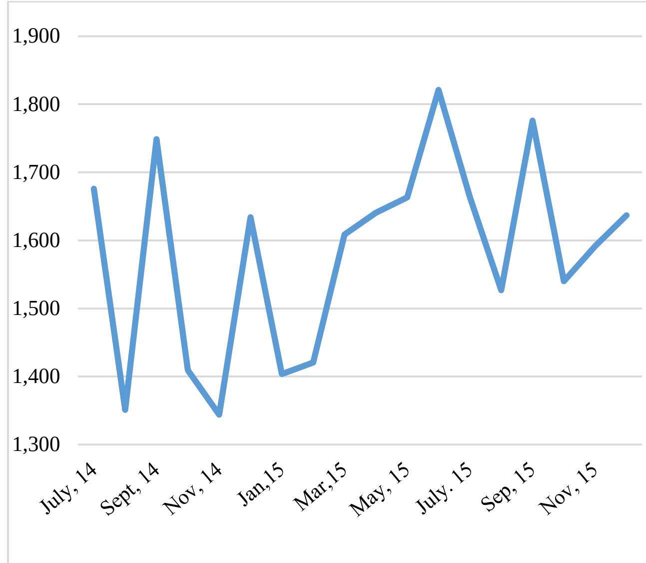


Figure 17: Foreign Exchange Reserves with the SBP ($ Million)

Remittances have maintained their upward growth trend for over 15 years – in 2015 these increased by 12.1 pc over the previous year's figure. A country wise break down of remittances received during the year reveals that those received from traditional sources; UAE, Saudi Arabia, the UK and the US showed a consistent increase trend, with total remittances from each 25.8, 13.5, 9.3, and 4.7 pc higher than what was received last year. However, remittances from EU countries registered a decrease of 13 pc during 2015. Thus the apprehension that, with the fall in prices the remittances from the gulf may slowdown has not materialized. The fall in remittances from EU countries could be due to slowdown in economic activity there and raises a cause of concern for Pakistan.



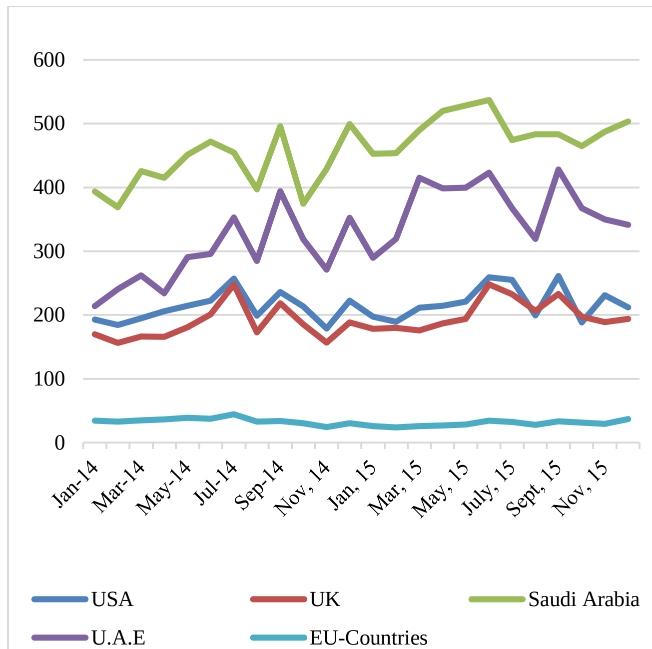


Figure 18: Remittances ($ Million)

Consumer financing showed an improvement of around 2 pc in November, 2015 over its value in June, 2015 – the major chunk of consumer financing goes to personal loans (41 pc) and Auto lease (33 pc). Housing enjoys a share of 15 pc, while credit cards have a share of 8 pc in the total outstanding consumer finance of Rs.287 billion.

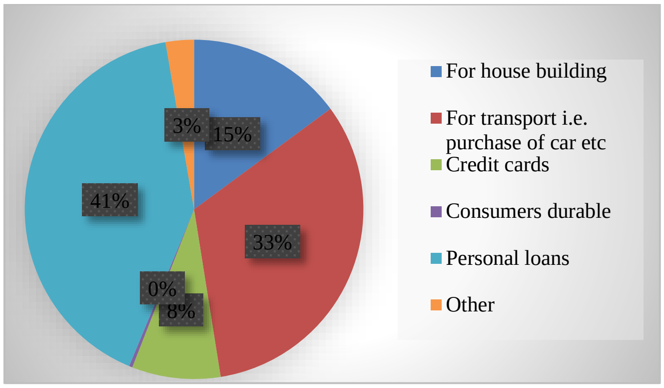


Figure 19: Consumer Financing

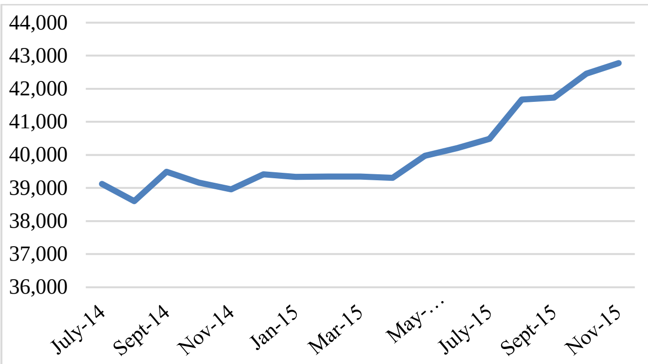


Figure 20: Loans for House Financing (Rs. Million)

One noteworthy development is that Islamic banks, despite their limited lending volume relative to private commercial banks, have moved slightly ahead of the conventional commercial banks in extension of housing finance. Out of the total housing finance of as of September 2015, 33 pc was contributed by Islamic banks while the conventional private banks with contribution of 32 pc lagged behind. This suggests that the Islamic view regarding prohibition of 'interest' might be one of the limiting the factor in expansion of housing finance so far. Besides, the better performance of Islamic banks, on extension of housing finance, might be owed to active pursuance of this landing avenue by the Islamic banks. However, the Islamic banks with their relatively limited outreach may not be able to fully tap the potential of housing finance market. If commercial banks were to open an Islamic window of housing finance and aggressively pursue this lending avenue, then this kind of finance has huge potential to expand.

VIEWPOINTS

Water in Agriculture

Water scarcity, one of the effects of climate change, has been made more acute by inefficient utilization of water, non-conservation and failure to build dams. The question is what should be the policy, given water scarcity. 90 percent of available fresh water in the country is used in agriculture and related activities; therefore any serious effort towards tackling Pakistan's water woes must address the water consumption in this sector. Water use includes the amount of water used or applied to crops through rainfall and/or irrigation.

Water stressed countries may achieve water security by importing water-intensive products instead of producing these domestically. Reversibly, water-rich countries could profit from water-abundance by producing water-intensive products for export. Trade of real water between water-rich and water-poor regions is generally impossible due to the large distances and associated costs, but trade in water-intensive products (virtual water trade) is realistic. Virtual water trade between nations and even continents could thus be used as an instrument to improve global water use efficiency and to achieve water security in water-poor regions of the world.

Sugarcane is amongst the most water intensive crops. A decade old report of World Wide Fund for Nature shows that sugarcane accounts for 9 percent of the total fresh water use in the country. With more area coming under sugarcane cultivation the share is likely to have increased. Rice is yet another thirsty crop and this should be a cause of worry for Pakistan in the face shift from cotton to rice, which some areas of the country have experienced in the last couple of years.

Given water scarcity, Pakistan needs to carefully evaluate the cost and benefits of continuing to grow water thirsty crops like sugarcane and rice. Alternates like using water-smart technologies, going for importing these commodities rather than producing domestically and producing only for domestic consumption need to be carefully weighed. For example, if we were to evaluate import of water thirsty crops against their domestic production, possible costs would include, some initial unemployment, the cost of labour switch over to other sectors and foreign exchange required for imports. The benefit of course would be higher level of water security. It is such costs and benefits that need to be weighed against each other and of course there is a huge element of political economy that has to be factored in.

Rethinking Resource Distribution

In Pakistan, fiscal resources are transferred from the centre to the provinces on the basis of the criteria developed by the National Finance Commission. Factors included in the resource distribution formula include; population (82 pc), backwardness (10.3 pc), inverse population density (2.7 pc) and revenue collection/generation (5 pc).

The broad principles, put forth in relevant literature, for the design of resource distribution criteria include; *simplicity* of distribution formula, *revenue adequacy* taking account of fiscal needs of provinces, *equity* in that the transfers decrease disparities between provinces, *incentives* that encourage provinces to create their own revenues, *autonomy* of provinces in spending the amount transferred to them, *predictability* of transfers to provinces that allows them to design their budgets accordingly, and *accountability* that makes all the stakeholders answerable for the usage of funds.

The NFC award, currently in vogue, seriously lacks on the *incentive* principle; provinces being ensured of a specific share in the divisible pool that seems enough to meet their needs, do not feel the need to mobilize revenue on their own. Moreover, most of the lucrative tax bases such as personal income tax and corporate tax, etc. are with the centre to collect. This does not leave much room for provinces to increase provincial revenue generation.

Regarding the equity and revenue adequacy principles, it is noteworthy that provincial population share is still enjoying rather large weight of 82 per cent. The three smaller provinces persistently complain that the resource distribution formula is not too fair. This feeling of deprivation is seemingly at the root of demand for creation of new provinces and other separatist movements. Number of countries like Canada and Germany, use distribution mechanisms that essentially transfer funds from Have provinces to Have-nots, to prevent the feelings of deprivation from raising their head for the worse. The resource distribution models of these countries may not be perfect; e.g. in Germany the Have-not *Landes* (provinces) lack incentives to generate revenue and are looked at as exploiting the richer provinces. Yet, the horizontal transfers combined with the incentives for own-source revenue generation is likely to yield a better distribution formula than the one we are currently following.

In light of the foregoing, we need to re-think the resource sharing mechanism. One option could be the sharing of more (if not all) tax bases between centre and provinces in a certain proportion. For example, a percentage of personal income tax may be given to the province from which it is collected while the rest should end up in the centre.

Moreover, in accordance with equity and revenue adequacy principles, centre may transfer more funds to poorer provinces than to the richer ones on the pattern of equalization or solidarity transfers practised in other countries. To avoid perverse incentives, such funds could be made conditional upon decent revenue generation effort over a period of time. Such changes in distribution mechanism, while encouraging own-source revenue generation in the provinces, will keep at bay the feeling of deprivation in the have-not provinces.

The transition to the new system, however, will not be easy as there would be winners as well as losers in the short run. To build consensus on adopting the new system, initially say for ten years, all provinces be guaranteed their existing shares in total resources and only the revenues collected beyond the existing levels be shared under the proposed distribution mechanism. Once the provinces have developed the capacity to raise revenue over time, the proposed mechanism can be put in place in its entireness.

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