

Analyst Beep- CPEC oriented economic improvement recognizable but what about fiscal anomalies...?**Capitalizing on Positives**

Pakistan's economy is thriving manifested in key statistics (domestic indicators: controlled inflation and stable interest rate, nearing 5.5% GDP growth and growing LSM productivity owing to improved energy supply)- there is no doubt to that- couple with recent developments of brighter prospects as duly recognized/ acknowledged in principle by local and international stakeholders, rating agencies etc. It certainly is priding and boastful since, a lot of damage to the socio-economic demographics in the form of undue criticism has been done for political or other interests; however, this analysis sheds light on the ultimate financial woes that have been put on radar by various economists/ policymakers for conceiving sustainable economic growth plan going forward.

A report prepared by PricewaterhouseCoopers (PwC), a multinational professional services network headquartered in London and considered among the `Big Four` auditors viewed Pakistan to become the 16th largest by 2050 based on its gross domestic product (GDP) at purchasing power parity (PPP).

This means the country would overtake Italy and Canada, which currently rank at 12th and 17th places, respectively.

The report, titled `The Long View How Will the Global Economic Order Change by 2050` released earlier this month, projected a number of new emerging markets taking the center stage. Emerging economies such as Indonesia, Brazil and Mexico are likely to be larger than the UK and France.

A table appended to the report indicated that on the basis of PPP, Pakistan would climb from its current 24th place (with GDP at PPP amounting to \$988bn) to 20th place (\$1.87tr) by 2030 and to 16th place (\$4.2tr) by 2050.

In terms of GDP at real market exchange rate (MER), Pakistan's economy is projected to rise from 28th place (\$284bn) at present to 27th by 2030 (\$776bn) and to 19th (\$2.8tr) by 2050.

GDP at PPP adjusts for price level differences across countries and provides a better measure of the volume of goods and services produced in an economy. In contrast, GDP at MER provides a better measure of the value of goods and services produced in an economy and converts a country's GDP in national currencies to the US dollar based on current market exchange rates.

China has already overtaken the United States to become the world's largest economy in PPP terms, said the report. India currently stands in third place and is projected to overtake the US by 2050.

France will no longer be among the world's 10 largest economies on this basis, with the UK falling to 10th place, while Indonesia could rise to 4th place. Key findings of the report projected that the world economy could more than double in size by 2050. By 2050, six of the seven largest economies in the world could be today's emerging economies in PPP terms according to our projections, the report highlighted.

Assuming broadly growth friendly policies, emerging markets would continue to be the growth engine of the global economy.

Fitch Ratings applauded and reaffirmation of Pakistan's credit rating, terming it an acknowledgment of government's economic policies. Fitch upheld the rating at 'B' with a 'Stable' outlook confirming the progress achieved by the present government under its economic reform agenda.

Fitch recognized the country's foreign exchange reserves have strengthened, fiscal deficit has reduced, and significant progress has been made on structural reforms. Fitch further acknowledged the country's economic outlook has brightened and looked promising in the current fiscal year supported by agricultural recovery and an influx of investments into China-Pakistan Economic Corridor (CPEC) project. The international credit rating company has also forecast continued as well as strong domestic demand with private consumption and faster credit growth.

Fitch appreciated performance of banking sector and with improvements shown across IMF's Financial Soundness indicators wherein the percentage of nonperforming loans has also fallen considerably and also foresees the debt-to-GDP ratio to gradually fall in the medium-term if Pakistan can sustain its progress with fiscal consolidation.

Citing the report, the budget deficit has been projected to continue narrowing gradually if the economy performs in line with Fitch's baseline scenario and the government remains committed to the policy plans set out during the IMF programme.

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Fitch does not expect Pakistan to face external liquidity difficulties, but increasing gross external financing needs could increase the country's vulnerability to shifts in investor sentiment.

Fitch Ratings has affirmed Pakistan's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'B' with stable outlooks. The issue ratings on Pakistan's senior unsecured foreign- and local-currency bonds, country ceiling as well as the Short-Term Local- and Foreign-Currency IDRs are also affirmed at 'B'.

The issue ratings on the third Pakistan International Sukuk Company Limited's foreign-currency global certificates have also been affirmed at 'B'. The company was incorporated primarily for the purpose of facilitating sukuk transactions and is wholly owned by Pakistan.

Pakistan's ratings balance broad gains have been achieved over the International Monetary Fund (IMF) programme against a high public debt/GDP ratio, low scores on the World Bank governance indicators and heightened security risks.

Pakistan completed a three-year IMF Extended Fund Facility (EFF) in September 2016. The country has entered 12 IMF programmes since 1988.

Under the programme, reserves were strengthened, the fiscal deficit reduced and significant progress was made on structural reform. Pressure related to the 2018 elections could test the government's commitment to maintaining the policy framework set out by the IMF.

The country's economic outlook has brightened since the start of the programme, with annual GDP growth rising to 4.7% in the financial year ending June-2016 (FY16), from 3.7% in FY13, above the 'B' median of 3.6%.

Fitch expects growth to strengthen to 5.3% in FY17, lifted by a recovery in agricultural output following poor weather conditions in the previous season and an influx of investment linked to the China-Pakistan Economic Corridor (CPEC).

Analyst forecasts continued strong domestic demand, with private consumption aided by faster credit growth. Remittances have moderated, as over half come from Gulf economies that are adjusting to lower energy prices, but a sharper slowdown is a downside risk. A sharp slowdown in remittances is a downside risk, as over half come from Gulf economies that are still adjusting to lower energy prices.

Inflation slowed to 2.9% in FY16, a positive development for a country that has experienced higher and more volatile inflation than the 'B' median. Fitch expects inflation to increase to 4.5% in FY17 and 4.8% in FY18, as commodity prices slowly recover. Inflation is then forecast to remain stable in the medium term.

Central bank financing of the fiscal deficit is an upside risk to inflation; government borrowing is shifting back towards the State Bank of Pakistan after moving towards private banks under the IMF programme. The banking sector has performed well, with improvements shown across IMF's Financial Soundness indicators.

Non-performing loans remained high at 11.1% of total loans at FYE16, though this is down from a peak of 14.8% at end-June 2013. Pakistan's public debt/GDP ratio of 64.8% at end-FY16 was higher than the 'B' median of 56.7%, but Fitch expects the ratio to gradually fall in the medium-term if the country can sustain its progress with fiscal consolidation.

The general government budget deficit fell to 4.6% of GDP in FY16, from 5.3% in FY15, with revenues boosted by structural reforms, including the lowering of the number of tax concessions. Fitch projects the budget deficit to continue narrowing gradually if the economy performs in line with our baseline scenario and the government remains committed to the policy plans set out during the IMF programme.

The accumulation of losses in public sector enterprises (PSE), particularly electricity distribution companies, has in the past led to injections of funds from the federal government budget to clear debt. Efficiency improvements, higher tariffs and lower energy prices have helped cut PSE losses.

However, plans to sustain long-term efficiency gains through privatization have been delayed due to objections from workers and political opposition. PSE losses could rise considerably if Pakistan suffers an economic shock or there is a sharp rise in energy prices, ultimately feeding through to the government balance sheet.

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They do not expect Pakistan to face external liquidity difficulties in baseline scenario, but increasing gross external financing needs could increase the country's vulnerability to shifts in investor sentiment.

External debt service costs are likely to increase in the medium-term, with \$2.75 billion of international bonds maturing between FY17 and FY20. The country will also start paying back the \$6.4 billion IMF facility and \$11.7 billion of rescheduled Paris Club debt in FY18 and FY17, respectively, albeit over an extended timeframe.

Fitch also expects the current account deficit to widen as energy prices start to recover and capital imports increase with higher infrastructure investment, although such investments will be heavily funded by Chinese entities as part of the CPEC.

Pakistan demonstrated market access in October 2016 by issuing a \$1 billion Sukuk at a historically low yield of 5.5%. Geopolitical tension and security threats could negatively affect the economic outlook and investor sentiment.

Pakistan has had a series of disagreements with India in 2016 over violent incidents along the shared border, marking a turn in relations that had shown tentative signs of improvement in the previous two years.

Domestic terrorist incidents remain frequent, particularly in Baluchistan province and along the Afghanistan border, although the number of attacks fell in 2016 compared with the previous year and annual civilian casualties from terrorist activities are at the lowest point since 2006.

Furthermore, Bloomberg, an internationally renowned financial data watcher company which delivers business and markets news from all over the world, has stated that the economic developments in Pakistan, over the time, have remained fairly positive. Terming "Pakistan's Economy Is a Pleasant Surprise" it further mentioned that Pakistan's economy is the most underrated market of the world, which instead has appeared to be a pleasant surprise to the global market-critics and investors.

The writer Tyler Cowen, who himself is a market veteran and a professor at George Mason University, US, wrote that although due to bad reputation Pakistan may appear to be a sick country, it definitely is one of the most promising markets of the world. Not many experts were optimistic about Pakistan's economic development just 17 years from now, in 2001. It is clear that Pakistan has defied the odds, and has shown promising prospects lately.

Of the many significant economic improvements that have happened last year, Bloomberg mentioned the quite recent developments in the Pakistani stock market which are quite notable. The unified Pakistani bourse, the Pakistan Stock Exchange, had spiked by as much as 46% during the past year. Our capital market PSX could easily be termed one of the best performers in the Asian Stock Market since 2013. During the recent past specifically, Pakistan's economy has been conquering some landmark achievements. Pakistan was given 'Emerging Market' status just a few months back and just after the attribution the Pakistan Stock Exchange made to Asia's best performer. Recently, it reached to its all-time high when it crossed the 50,000 mark. Right now, several companies from countries like China, Italy, and Middle East are also actively investing in Pakistan.

With a fast-improving security, a dynamic Pakistan has the potential to become a global turnaround success story as the country's GDP growth accelerated to almost 5%, from an average of about 3% in the last five years. That's not going to rival recent Chinese performance, but it is enough to put the economy on a fairly positive path. Since 2002, the rate of poverty has fallen by half, and over the past three years the rate of terrorist deaths has declined by two-thirds. It's now the case that 47% of Pakistani households own a washing machine, up from 13% in 1991, and retail is booming more generally. The rate of poverty was cut by as much as half that too within past 15 years. Just during the past three year, the deaths caused by terrorist attacks have diminished by a two-third factor.

On February 7, 2017, Business Insider ranked world's top 32 economies in 2030 and ranked Pakistan in top 20 world economies in next 13 years. Similarly, the Bloomberg in its report published on October 3, 2016 stated that even with limited progress on reforms, Pakistan's gross domestic product growth accelerated to almost 5%, from an average of about 3% in the five years through 2013, supported by buoyant construction activity, strengthened private sector credit growth and Chinese-led investment, according to the IMF. The rupee and Pakistan's stocks have been among Asia's best performers since 2013, boosted by the IMF program and MSCI Inc.'s June announcement it would include the nation's equities in its emerging-markets index.

On February 10, 2016 World Bank President visited Pakistan and during his stay he held meeting with the leadership of Pakistan including the prime minister. The World Bank president said that Pakistan is now on the path

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of increased economic growth and prosperity. He applauded the prudent economic policies of Pakistan government, saying that the country's economic outlook had become stable which was the result of the efforts of its financial team. He said Pakistan had an opportunity to become more ambitious in reforming its economy and reducing poverty in the country. Similarly, the 'Economist' in May 2015 reported that Pakistan's economy was doing even better than the economies of Canada and the USA. It also said there was no corruption scandal at all in Nawaz Sharif's current tenure and that transparency was being ensured.

"Forbes.com," a renowned business magazine website in an article published on August 3, 2015 stressed that American policymakers and business leaders should be looking at Pakistan beyond the security lens.

According to the article published in Forbes, "The Pakistan of today is similar to that of Colombia in the late 1990s. Back then, words like "drugs, gangs, and failed state" were freely associated with the Andean country. Today, Colombia has a free trade agreement with the United States, a stable 3.5% annual GDP growth, and security is vastly improved. Similarly, Western headlines on Pakistan gloss over the progress on the security front, the increased political stability, and incremental progress on the economic front. In spite of this potential for Pakistan, it continues to suffer from a terrible country brand that has not caught up with realities on the ground.

'Bloomberg,' in its report published on June 30, 2015 said that the construction boom had marked the nation's emergence as a leading market after successful aversion of Balance-of-Payment crisis with help from the International Monetary Fund, boosting infrastructure spending as the \$232 billion economy expands at the fastest pace since 2008 amid the cheapest borrowing costs in 42 years. Shrugging off sectarian violence, bombings, killings and kidnappings, the benchmark PSX-100 stock index has advanced about 46% in the past 12 months, featuring among the world's top 10 performers.

Meanwhile, in one of its earlier reports of June 12, 2015, 'Bloomberg' revealed that Moody's Investors Service upgraded Pakistan's sovereign credit ratings for the first time since 2008, making a strong mention of the soaring Forex reserves and the state's economic overhauling under an IMF programme.

The reputed London-based 'Economist,' in its May 2, 2015 edition wrote that Pakistan's economy was doing even better than economies of Canada and America. The 'Economist' contended: "Pakistan's economy is growing at over 4 percent when the whole Europe and Canada are below 3%. Terrorism incidents have dramatically gone down in the last year. Operations in Fata and Karachi and throughout Pakistan are producing fruit and the economic policies have put the economy back on track and economists and IMF are predicting that Pakistan's economy would grow 4.7% next year."

According to the 'Economist,' the key economic indicators in Pakistan's economy include \$17.7 billion Forex reserves, raised electricity tariffs and collection of some unpaid bills that have helped ease the cash burden on hard-pressed distribution companies, increase in tax receipts to broaden the base and cut exemptions, dispatch of over 150,000 tax notices to nonpayers, roping in more retailers into the indirect-tax net, bringing the budget deficit below 4% of GDP in 2015-16 from a peak of over 8%, an under-control inflation, creation of jobs in services sector, increase in sale of cement, lowering of interest rates twice this year only, a 22% upward trend in car sales, a projected saving a total of \$12 billion in the next three years due to low oil prices and doubling of Pakistan's stock market in dollar terms since the start of 2012 etc.

On December 20, 2016, 'Wall Street Journal' published a story that how Pakistan is planning to overcome the energy crisis. According to this report, Pakistan's economic growth has risen to almost 5% annually setting a 7% target for the years ahead. That, his government hopes, will boost the moribund private sector, reduce unemployment and provide youth with more alternatives to extremism.

Monetary anomalies growing- warranting caution

Hard currency in circulation – cash in hands – rose 18.12% to PKR 3.402 trillion as of December 2016 over the preceding year as people were giving preferences to nonbanking transactions. The State Bank of Pakistan, in its latest report, showed that currency in circulation (CiC) amounted to PKR 2.880 trillion as of December 2015. Currency in circulation jumped to PKR 3.34 trillion in the mid of last year.

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Rising currency use, in our view, reflects the falling opportunity cost of holding cash. This is due to a combination of falling returns on deposits as a means of saving – due to monetary easing – as well as the incidence of tax on the use of the banking system for certain transactions.

Last year, the government extended the scope of withholding tax on banking transactions by non-filers of returns.

The volume of currency in circulation and its rapidly-rising trend vis-à-vis both the monetary base as well as deposits in the banking system are indeed worrying signs.

This trend goes against the norms of a documented economy and a banking system that is playing an effective role of financial intermediation and inclusion. Prima facie it appears that the government's taxation policy is a major cause for the shift from bank deposits to CiC.

Pakistan's informal economy is almost as big as the formal one, perhaps larger. It's a source for concern for the government as it doesn't generate revenue to national exchequer.

The level of CiC can be taken as a broad proxy for the degree of informalization of the economy and its trend.

Economists are surprised why CiC is surging amid falling inflation and relatively low transactions into the real estate sector after the upward revision in the property valuation and subsequent changes in the tax rules.

Though a demand in urban consumption is picking up, yet inflation remains at the lower side. We can't rule out that some currency may be used for all kind of illegitimate activities. Currency in circulation, as percent of M2 and currency-to-deposit ratio, has also been increasing over the last few years.

Though banking deposits grew 20% in 2016, yet stakeholders need to render more efforts to increase the penetration of formal banking services into the economy in line with the national financial inclusion strategy. Bank deposits rose to PKR 11.2 trillion in December 2016 from PKR 9.3 trillion in December 2015.

The country's domestic debt increased 10% to PKR 14.192 trillion during the past one year, as the government is still reliant on internal money sources amid dried-up foreign funds to reduce budget deficit.

The State Bank of Pakistan (SBP) data showed that total domestic debts amounted to PKR 14.192 trillion as of December 2016 as against PKR 12.879 trillion by the end of 2015. Analysts said the government is dependent on domestic sources, mostly, banks in the shape of treasury bills and bonds to finance its fiscal deficit.

Treasury bills are still elephant in the bond market supported by the government's strategy to meet budget-related expenditures via short-term securities. Unlike the previous trend, the ministry of finance has increased yields on treasury papers and bonds, reflecting that it would meet its borrowing requirements through these two instruments in the absence of external funding, especially, the US-backed coalition support fund.

The central bank's data showed that the outstanding amount of the SBP's holding of market treasury bills (MTBs) stood at PKR 2.835 trillion at the December-end 2016 as against PKR 2.161 trillion in December 2015. The permanent, or a long-term, debt inched up to PKR 5.215 trillion from PKR 5.197. It includes borrowing from banks through Pakistan Investments Bonds (PIBs) and Ijara Sukuk. Unfunded debt rose to PKR 2.579 trillion from PKR 2.494 trillion.

The stock of floating debt — a main contributor to the rise in domestic debt — was recorded at PKR 6.237 trillion as of December 31, 2016 from PKR 5.03 billion a year ago. Within floating or short-term borrowing, market treasury bills were main source of bank financing for budget deficit. The government borrowed an amount of PKR 3.402 trillion from banks via T-bills in December, compared with PKR 2.655 trillion in the same month of last year.

The government projected the fiscal deficit at 3.8% of GDP in the current fiscal year of 2016/17. The budget deficit was recorded at 4.6% of GDP in the last fiscal year. Achieving the annual fiscal deficit target of 3.8% of GDP would be difficult on account of revenue shortfalls reported during the first quarter of FY17. It will require additional fiscal consolidation efforts on the part of the government. The country's total public debt of more than PKR 18 trillion – 64.8% the country's GDP – is still manageable. In the past four years, the incumbent government managed to address the fiscal malfunctions by bringing up the tax-to-GDP ratio to 12.4% from less than 10%.

The fall in non-tax revenues and lower-than-expected tax collections by the Federal Board of Revenue, however, widened the fiscal deficit to 1.3% of GDP in July-September 2016/17.

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The recent PIBs and MTBs auctions showed that banks continued to lock in their funds in risk-free government securities. However, the bid pattern tilted more towards three-month and six-month papers as market was not expecting the interest rates to fall further.

The government restored to the central bank's borrowing, after exit from the International Monetary Fund's loan program last year to finance deficit and settle maturing amount of PIBs.

Broad Money (M2)		PKR Mn	
		From Jul 01 to	
		13-Jan-17	15-Jan-16
A)	Currency in Circulation	200,750	441,239
B)	Other Deposits with SBP	(51)	797
C)	Total Demand & Time	249,962	(129,957)
Total		450,661	312,079
<i>Growth</i>		<i>3.51%</i>	<i>2.77%</i>
Factors Affecting Broad Money (M2)			
A)	NFA of Banking System	(50,418)	103,914
B)	NDA of Banking System (1+2+3)	501,079	208,165
Total		450,661	312,079
<i>Growth</i>		<i>4.24%</i>	<i>1.99%</i>
1	Net Govt. Sector Borrowings (a+b+c)	361,172	190,212
a	Borrowings for Budgetary Support	470,382	248,585
	(i) From SBP	847,364	(410,598)
	(ii) From Scheduled banks	(376,982)	659,183
b	Commodity Operations	(109,374)	(56,255)
c	Others	164	(2,118)
2	Credit to Non-Govt. Sector (a+b+c+d)	342,377	232,750
a	Credit to Private Sector	296,371	231,068
b	Credit to PSEs	43,024	2,018
c	PSEs Special Account	-	(169)
d	Other Financial Institutions	2,982	(167)
3	Other Items (net)	(202,470)	(214,797)

Source: SBP

Food for thought- Summing it all up

Consequently, credible global financial institutions and reputed foreign media houses are in unison that Pakistan's economy is continuously performing well and is the most underappreciated in the world's emerging economies in terms of finance, investment, industry and marketing issues with the major factors of the economic boom and growth in Pakistan are the construction activity, strengthened private sector credit growth and Chinese-led investment in the name of China Pakistan Economic Corridor (CPEC).

As Pakistan continues its march from being a frontier economy to becoming an emerging market, 2017 may be the best year in the country's 70-year-long history. From increase in foreign investment, creation of Export-Import Bank to likely changes in the auto industry, here's what we predict will happen to Pakistan's economy this year.

GDP growth: Although gross domestic product (GDP) growth forecasts by International Monetary Fund, World Bank and federal budget vary, Pakistan's GDP is likely to grow by 4.7% this year. The annual GDP may increase from \$270 billion to around \$300 billion and for the first time, the Purchasing Power Parity may cross the \$1trillion mark. Pakistan is currently 40th largest economy in the world and our ranking may improve by a point or two.

Debt: National debt, currently at \$73 billion, will continue to grow.

Debt-to-GDP ratio: Currently at 64.8%, it may decline slightly.

Foreign exchange: Reserves will continue to be in the region of \$23-24 billion.

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Stock market: Pakistan will enter MSCI's Emerging Markets category in May, meaning larger amounts will inflow. MSCI is a leading provider of international investment decision support tools. In 2016, Pakistan Stock Exchange (PSX) provided 46% returns. PSX-100 benchmark index is also likely to cross 55,000 – 60,000 points from current nearly 50,000 points. 40% stakes in PSX will go to Chinese consortium and this is likely to bring large institutional investors from other countries.

Retail: More large shopping malls will be built or become operational across major urban centers. Superstore chains will open new stores in unprecedented three-digit numbers.

Tax filers: Number of active tax payers/filers may reach 1.2 million.

Exports: Although IT exports are picking up, Pakistani exports will continue its declining trend, mostly because of poor cotton production, our low global competitiveness and travel advisories.

Export-Import Bank: The bank may be functional before June to facilitate exporters and importers after State Bank of Pakistan licenses it.

Foreign Direct Investment: FDI this year may cross the \$1-billion mark.

Remittances: After a drop in 2016, remittances may pick up to reach \$20billion mark.

Inflation: It may remain between 4-5% as low oil prices are expected to stay stable.

Agriculture: Agriculture sector will continue to remain affected because of declining cotton production.

Finance: The sector will increase focus on financial inclusion, generating opportunities for micro-finance and commercial banks.

Banking: Smart banking, mobile banking and branchless banking will increase.

Ease of doing business index: Pakistan, at 144 out of 190 countries, was among top 10 global improvers in World Bank's 2017 Doing Business rankings. In the 2018 ranking, it will improve further.

Auto industry: Pakistan may need additional 100,000 trucks to meet the CPEC-related material and freight transport needs and it is unlikely that this demand is planned and met in time. Demand for locally manufactured new and imported used cars will continue to rise. Although there's interest from Volkswagen, Kia, Renault and Nissan for manufacturing plants in Pakistan, the production will not start this year which also means prices of cars will not come down as current producers – Toyota, Honda and Suzuki – remain in monopolistic situation.

Construction and industrial activities: Key drivers for demand are likely to be CPEC projects and higher public spending by the government ahead of the General Elections.