NBP Fullerton Asset Management Ltd.
A Subsidiary of National Bank of Pakistan

Dr. Amjad Waheed, CFA
Chief Executive Officer

Pakistan Economy

Benefitting from tailwinds, but sustained pickup entails structural reforms

The worldwide slump in commodity prices, particularly energy, has provided a strong tailwind to Pakistan's economy. Headline inflation has hit low single digits; the current-account deficit is shrinking; rupee has been stable; fiscal deficit remains well-contained and GDP growth is picking up albeit from a low level due to lower input costs and higher household incomes. The economy seems to be on a sounder footing as the sharp decline in oil prices provides multiple benefits to a country that imports four-fifths of its oil and relies significantly on erstwhile expensive furnace oil to run its power plants along with outsized energy subsidies. Capital markets responded to the positive development on the economic front with interest rates touching multi-year low, and stock market reaching new heights.

However, Pakistan's economy has remained stuck in a boom-bust cycle for the last many decades. The high growth periods are often triggered by positive international developments and increase in foreign flows. Once this situation reverses, the economy experiences sharp downturn brought about by rising macroeconomic imbalances as manifested in rising and unsustainable fiscal and current account deficits. Consequentially, the country repeatedly has to enter into stabilization programs under IMF.

To achieve a sustained high growth path, the government must undertake the necessary reforms to address the following chronic structural issues besetting domestic economy.

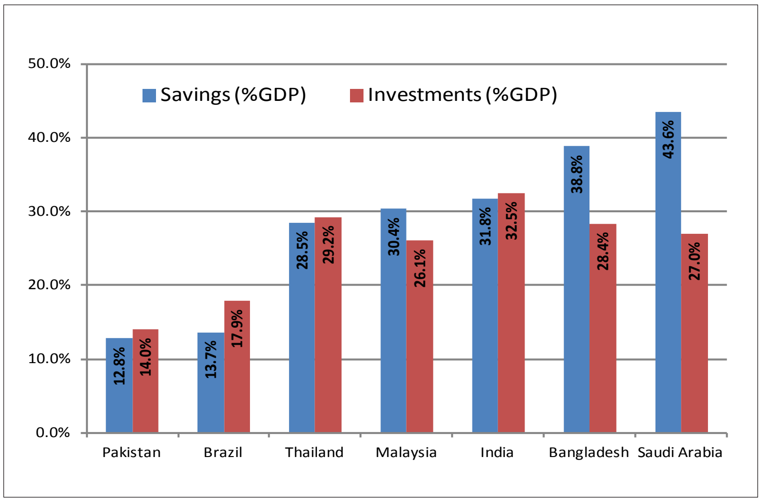
Fiscal account weakness: The root cause of Pakistan's macroeconomic woes is fiscal mismanagement by successive governments. The main issues are 1) Low tax collection as most of the economy remains undocumented/under-taxed. Resultantly, our tax-to-GDP ratio at 10.1% is one of the lowest in the world, and tax revenues are not enough to meet government's current expenditures. The existing tax collection system mainly targets the industrial sector and salaried class while agriculture, services and real estate sectors remain lightly taxed despite making up nearly 80% of GDP. 2) Public sector inefficiencies as depicted by heavy losses incurred by state enterprises. Financial condition of these PSEs has continuously deteriorated due to overstaffing, corruption, politicized unions and mismanagement. Government spends about Rs.500 billion every year to bail out these organizations. 3) Large and untargeted subsidies. The resultant large fiscal deficits with excessive reliance on the domestic banking system crowds out the private sector and suppresses public savings and investments.

Sectoral contribution in GDP and taxes

	Share in GDP	Share in taxes
Agriculture	23%	1%
Manufacturing	18%	62%
Construction	2%	3%
Electricity and gas distribution	4%	5%
Transport and communication	10%	4%
Wholesale and retail trade	19%	3%
Finance and Insurance	4%	4%
Public administration and defense	6%	5%
Social and community services	10%	8%
Others	4%	4%

Source: Fiscal Policy Statement, MOF

Savings / Investments as a % of GDP



Source: World Bank 2013, Pakistan Economic Survey

GDP composition is too lopsided: An aggregate demand-wise break-up of the economy reveals that GDP composition has become extremely lopsided over the last few years with an overwhelming share of consumption expenditures and very little contribution by investments and net exports. The share of consumption expenditures is far above, and investments significantly below than in comparable developing countries. Lack of public and private investment is reflected in poor infrastructure and narrow manufacturing base of the economy. Negative contribution of net exports is reflective of a weak current account position. To reverse this trend, Pakistan needs to pursue a more balanced growth (current GDP composition: Consumption 92.5%, Investments 14.0%, Net Exports -6.5%), with investments and exports rising at a faster pace than consumption expenditures.

Low savings: Another related issue is the abysmally low savings rate (12.8% of GDP) which is substantially below that in other developing countries. The government needs to substantially reduce its fiscal deficit to improve savings rate.

Competiveness and productivity: Weak external competitiveness, as manifested in a high structural trade deficit, due to low value addition and anemic productivity in the agriculture and industrial sectors remains another impediment facing local economy, threatening macroeconomic stability and impeding efforts to achieve sustained higher GDP growth. Chronic energy shortages forcing excessive reliance on expensive thermal power generation has further eroded the competitiveness of the local industry.

It is hoped that the government will seize the opportunity provided by the current favorable global macroeconomic environment to implement critical structural reforms needed to sustain the incipient economic recovery. Otherwise, the recent upturn may eventually fizzle out as a result of policy complacency.