

Pakistan Business Forecast Report Q2 2014

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Abstracts

Core Views

Pakistan's long-overdue privatisation drive looks set to finally commence, with the partial sale of Pakistan International Airlines (PIA) likely the first target. Large-scale losses at PIA and other public sector enterprises is estimated to equate to roughly 15% of total fiscal revenues, and eliminating these losses would go a long way towards closing Pakistan's budget deficit.

With strong growth in the manufacturing and service sectors, Pakistan's economy posted impressive real GDP growth of 5.0% y-o-y in the July-September period. While we expect growth to slow over the remainder of the fiscal year, there are reasons for optimism as reforms are steadily undertaken and private sector crowding out is reduced, which should see growth accelerate to 4.0% in FY2014/15, from an expected 3.4% in FY2013/14.

Pakistan's foreign reserves are running critically low, at just 1.3 months of import cover, and negative in net terms. Rupee weakness is highly likely as the State Bank of Pakistan resorts to allowing gradual depreciation in order to support reserves. This, together with progress on structural reforms to narrow the current account deficit, should see reserves begin to rise over the coming quarters.

The Pakistani government's reliance on debt monetisation to cover its revenue shortfall continues to undermine private sector investment while keeping inflation elevated. With the support of the IMF, structural reforms aimed at broadening the tax base look set to go some way towards increasing tax revenues as a share of GDP, reducing the deficit, and reducing the fiscal burden on the private sector.

Major Forecast Changes

We have downgraded our FY2013/14 real and FY2014/15 exchange rate forecasts. We now expect to see more rapid depreciation as the central bank seeks to build up its perilous reserve position. We are forecasting the unit to end the current fiscal year at PKR107.8/ US\$, and the next fiscal year at PKR112.2/US\$. By the same token we have increased our FY2013/14 reverse repo rate forecast from 10.00% to 10.50% previously.

Key Risks To Outlook

Upside Risks To Fiscal Accounts: Should the government make further inroads into widening the country's tax base, we could see the fiscal deficit narrow at a more rapid pace than we currently project. While this could create some near-term drag on economic growth, it would also unlock productivity gains that would put upside pressure on the medium-term growth outlook.

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Long-Term Political Outlook

Instability To Prevail, But Outright Collapse Unlikely

Pakistan is at risk of experiencing years of instability and militant activity, but an outright collapse of the state is unlikely unless the core province of Punjab becomes ungovernable. Under such circumstances, we would not preclude a military coup. Meanwhile, due to its strategic importance, Pakistan's foreign allies will do everything they can to ensure its stability.

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The Pakistani government's reliance on debt monetisation to cover its revenue shortfall continues to undermine private sector investment while keeping inflation elevated. With the support of the IMF, structural reforms aimed at broadening the tax base look set to go some way towards increasing tax revenues as a share of GDP, reducing the deficit, and reducing the fiscal burden on the private sector.

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The State Bank of Pakistan's latest interest rate hike should help to cool inflationary pressure brought on by continued high money supply growth and currency weakness. While risks are to the upside, we believe that the bank will adopt a wait-and-see approach with real rates now firmly in positive territory. Together with efforts to address the fiscal deficit, higher policy rates should help to boost the economy's overall savings rate, paving the way for a pick-up in investment over the medium term.

Balance Of Payments

Reserve Collapse Suggests FX Weakness Ahead

Pakistan's foreign reserves are running critically low, at just 1.3 months of import cover, and negative in net terms. Rupee weakness is highly likely as the State Bank of Pakistan resorts to allowing gradual depreciation in order to support reserves. This, together with progress on structural reforms to narrow the current account deficit, should see reserves begin to rise over the coming quarters.

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