OICCI Economic Update

NOVEMBER 2024

The First Port of Call for Foreign Investors

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After achieving economic stabilization, the quest to find a growth momentum continues. In the absence of structural reforms, the real challenge will be not only reviving growth but also sustaining growth once it is revived. The country needs significant investment in productive and efficiency-driven sectors, primarily from the private sector. However, weak investor sentiment remains a persistent concern.

On the fiscal front, deficit figures have shaped up well in the first quarter, largely due to one-time windfall profits from the State Bank of Pakistan (SBP). However, the challenge lies in meeting ambitious tax revenue targets.

Externally, the external accounts are in good shape. Demand compression has kept import growth in check, while remittances maintain their positive trend. Export orders, especially in textiles, show promise as demand picks up. However, uncertainty persists over the medium-term outlook.

The key challenge remains attracting both local and foreign investment in medium- to long-term projects, which is critical for achieving growth rates exceeding 3 percent. The IMF has revised international private credit inflows downward to more realistic levels, signaling lower economic growth ahead.

A sharp increase in foreign private inflows is critical for altering this trajectory. Existing foreign investors are well-positioned to invest, provided the environment is conducive. The focus should be on rebuilding their confidence. However, the handling of sovereign contracts, particularly those involving Independent Power Producers (IPPs), is reported to have eroded investor confidence. Furthermore, this may undermine the privatization program, with the delays in PIA's privatization having already caused significant damage and dented investor confidence. Similarly, the prospects for privatizing and corporatizing energy distribution companies, as well as opening the energy market, are becoming increasingly uncertain.

IMF program is on track

The IMF mission recently concluded its visit to Islamabad, serving as a stock-taking exercise. Unlike previous programs with quarterly reviews, reviews are now conducted biannually. All quantitative performance targets for the September-end quarter appear to have been comfortably achieved, particularly those related to SBP on the monetary and external fronts. These include the ceiling on Net Domestic Assets (NDA), the floor on Net Foreign Assets (NFA), and the floor on forward and swap liabilities. The primary fiscal target remains well within the expected range, and all December-end numbers are anticipated to stay on track.

Quantitative Performance Criteria

On track till Dec-24

	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25
Floor on net international reserves of the SBP (millions of U.S. dollars)	-12,349	-12,150	-12,050	-10,200	-8,650
Ceiling on net domestic assets of the SBP (stock billions of Pakistani rupees)	15,542	15,044	15,211	15,179	15,820
Ceiling on SBP's stock of net foreign currency swaps/forward position (negative, millions of U.S. dollars)	-3,450	-3,250	-3,000	-2,750	-2,500
Ceiling on the general government primary budget deficit (cumulative, excl. grants, billions of Pakistani rupees)	-401	-198	-2,877	-2,707	-2,435
Ceiling on the amount of government guarantees (stock billions of Pakistani rupees)	4,585	5,100	5,200	5,400	5,600
Cumulative floor on targeted cash transfers spending (BISP) (billions of Pakistani rupees)	472	101	235	415	599
Cumulative floor on the number of new tax returns from new filers (thousands)	142	75	225	300	450

Exhibit 1: IMF targets being met

The issue pertains to the indicative target for FBR tax revenues, where a shortfall of 1 percent in the 3-month rolling average collection could trigger contingency taxation measures. The IMF mission has reviewed this shortfall and is expected to present the matter to the board. A waiver is likely to be granted, as the revenue shortfall is being offset by lower expenditures.

Delays are also seen in the structural benchmark on privatization, particularly with the stalled PIA privatization process. On the energy side, the key issue is the commitment to end captive power generation by January 2025. The plan involves cutting gas supply to captive plants and redirecting it to more efficient users, while encouraging captive plants to switch to the grid.

However, the government did not fully account for the implications of this commitment to the IMF. Some captive users operate cogeneration facilities that are more efficient than certain independent power producers (IPPs). Furthermore, many factories lack grid access, and installing the necessary infrastructure could take 2–3 years and involve significant costs. Despite these challenges, the IMF continues to push for timely completion of the benchmark. As a result, many captive power generators are expected to transition to the grid by January 2025, with efforts for the remaining users to follow.

Inflation and interest rates outlook

Headline inflation increased slightly to 7.2% in October 2024, up from a 44-month low of 6.9% in September. The 4MFY25 average inflation stood at 8.7 percent versus 28.5 percent in the same period last year. The sharp fall in inflation is attributed to subdued domestic demand, stemming from last year's tightening measures, and reversal in the global commodity prices. The fiscal consolidation is helping to tame the inflation.

The downward trend is likely to continue, with projections ranging between 4-7 percent till April 25 before rising to 9-10 percent due to base effects. The FY25 average inflation is estimated at 6.5-7.5 percent and CY25 average is expected to range between 7.5-8.5 percent.

Inflation and interest rates outlook

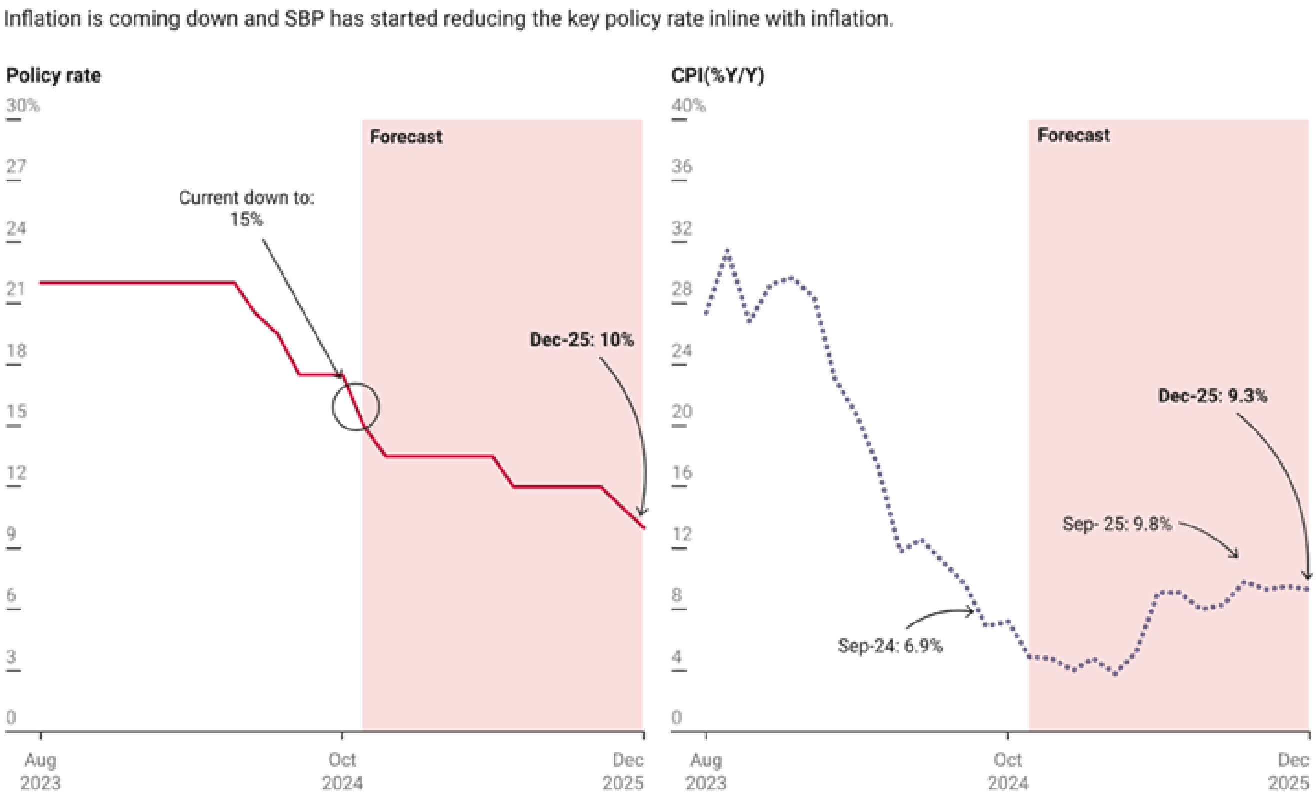

Exhibit 2: Policy rate and inflation

SBP is now pursuing an aggressive policy of cutting the interest rates, bringing them down to 15 percent from 22 percent in four policy reviews. The most recent cut of 250 bps had beaten the market expectations of 150-200 bps. Going forward, the quantum rate cuts to be lower and expected interest rates to be at 13-14 percent by December 2024 and 10-12 percent by December 2025.

No mini budget in offing

The FBR's revenue target of Rs 12.9 trillion for FY25 remains overly ambitious given the revenue measures outlined at the time of the budget. As anticipated, this target is proving difficult to meet. For the first five months of FY25, revenue collection stood at Rs 4,295 billion, falling Rs 344 billion short of the target. With inflation lower than expected, nominal GDP is projected to grow at just 11-12 percent, compared to the initial forecast of 18 percent. At the same tax-to-GDP ratio, the revenue target should be revised downward to Rs 12,150-12,200 billion.

The question now is whether the contingencies outlined in the IMF staff report need to be applied. It's likely that the IMF board will grant a waiver, as the overall primary fiscal numbers remain on track. Additionally, the sharp decline in interest rates is reducing interest expenditures, and the federal government has been cutting development spending. These measures should be sufficient to offset the shortfall in FBR revenues, making a mini-budget unlikely at this stage.

Consolidated Fiscal Operations

In PKR billion | 1QFY25

	1QFY24	2QFY24	3QFY24	4QFY24	1QFY25	Yoy	QoY
Total Fiscal Revenue	**2,686**	**4,168**	**2,926**	**3,489**	**5,827**	**117%**	**67%**
Total Tax Revenue	**2,217**	**2,617**	**2,428**	**2,823**	**2,776**	**25%**	**-2%**
Federal Tax Revenue	2,042	2,428	2,242	2,599	2,563	26%	-1%
Provincial Tax Revenue	175	190	186	223	213	21%	-5%
Total Non-Tax Revenue	**469**	**1,551**	**498**	**666**	**3,051**	**551%**	**358%**
Federal Non-Tax Revenue	435	1,506	419	602	2,997	589%	398%
Provincial Non-Tax Revenue	34	45	80	64	54	59%	-16%
Total Fiscal Expenditure	**3,666**	**5,596**	**4,421**	**6,793**	**3,931**	**7%**	**-42%**
Total Current Expenditure	**3,173**	**5,392**	**3,769**	**6,238**	**3,537**	**11%**	**-43%**
Debt Servicing	1,380	2,840	1,298	2,642	1,306	-5%	-51%
Defence Expenditure	343	415	465	636	410	20%	-36%
Other Current Expenditure	**1,450**	**2,137**	**2,006**	**2,959**	**1,821**	**26%**	**-38%**
Total Development Expenditure and Net Lending	**282**	**379**	**482**	**936**	**277**	**-2%**	**-70%**
Statistical Discrepancy	211	-175	171	-380	117		
Overall Fiscal Balance	**-980**	**-1,428**	**-1,495**	**-3,304**	**1,896**		
Primary Balance	**400**	**1,413**	**-197**	**-662**	**3,202**	**701%**	
Total Fiscal Financing	**980**	**1,428**	**1,495**	**3,304**	**-1,896**		
External Fiscal Financing	442	166	-115	-173	-157		
Domestic Fiscal Financing	538	1,262	1,609	3,478	-1,739		
GDP	105,741	105,741	105,741	105,741	124,150		
Budget deficit (to GDP)	-0.9%	-1.4%	-1.4%	-3.1%	1.5%		
Primary balance (to GDP)	0.4%	1.3%	-0.2%	-0.6%	2.6%		

Exhibit 3: Summary of fiscal operations in 1Q

External account shaping well

The external account is in a stable position, with expectations of achieving a current account surplus. Demand compression has helped keep import growth in check, while remittances continue to increase, driven by more workers going abroad, a surge in freelancers' earnings, and improved measures against money laundering. Export orders remain strong, particularly in textiles, as demand picks up in key importing countries, while competitors like Bangladesh face their own challenges. However, the potential risk of the Trump administration imposing duties on imports could affect Pakistan's exports to the US. The standout performer remains ICT exports, which continue to show impressive growth trajectory.

Slow sliding into surplus

FY25 may see a slight move into positive current account balance as international commodity prices decline and domestic demand lowers

USD mn	Current account	Imports (goods)	Exports (goods)	Trade balance (goods)	Services balance	Primary Income balance	Secondary Income balance	Remittances	CAD as % of GDP
FY23	-3,275	52,695	27,876	-22,089	-2,822	-8,996	28,351	27,333	-1.0%
FY24	-1,695	53,056	30,967	-22,065	-2,306	-8,623	32,212	30,250	-0.5%
FY25E	1,300	52,000	30,000	-22,000	-2,000	-7,500	32,800	31,500	0.3%

Each column has a different range. Red bars indicate negative values

Exhibit 4: Current Account summary

The current account continues to post a surplus, with October marking the third consecutive month at $349 million, contributing to a 4MFY25 surplus of $218 million, compared to last year's deficit of $1,528 million. Imports during this period reached $18.8 billion, a 13% increase from last year. However, the positive trend is that export and remittance growth is outpacing the rise in imports.

Demand has gradually picked up over the past few months, as reflected in the 12-month rolling import data, which increased from $50.1 billion in January 2024 to $55.8 billion. Exports, particularly in textiles, are performing well, with orders rising as business shifts from Bangladesh to Pakistan.

Balance of Payment

In $Million | 4M

	4mFy24	4mFy25	Yoy
Current Account Balance	**-1,528**	**218**	
Trade Balance	**-7,000**	**-8,324**	**19%**
Goods Exports (fob)	9,671	10,508	9%
Goods Imports (fob)	16,671	18,832	13%
Services Balance	**-1,101**	**-992**	**-10%**
Services Exports	2,409	2,601	8%
Services Imports	3,510	3,593	2%
Primary Income Balance	**-2,640**	**-2,884**	**9%**
Secondary Income Balance	**9,213**	**12,418**	**35%**
Workers' Remittances	*8,795*	*11,850*	*35%*
Capital Account Balance	**55**	**67**	**22%**
Financial Account Balance	**-3,775**	**-909**	
Direct Investment	-658	-885	34%
Portfolio Investment	-14	-198	1314%
Other Investments	-3,103	174	
Net Errors and Omissions	*-235*	*-267*	*14%*
Overall Balance	**-2,067**	**-927**	**-55%**
SBP reserves excluding CRR/SCRR	7,473	11,203	50%

Exhibit 5: Balance of Payment in 4M

ICT exports surged by 39 percent in October, reaching $330 million, with 4MFY25 proceeds rising by 35 percent. This marks the thirteenth consecutive month of growth in ICT exports. Since FY20, exports have doubled, and the positive momentum continues. Companies are expanding globally, with a particular focus on the GCC region. Relaxed policies on external outflows and increased retention limits have provided incentives for further expansion.

SBP reserves

The most significant indicator of economic stabilization is the growth in foreign exchange reserves, which have risen to $11.3 billion, up from a low of $3.5 billion last year. However, the SBP cannot prioritize high growth until reserves reach a more sustainable level of $15 billion.

Currency stability will continue

An improved supply of foreign currency will help maintain stability in the interbank market, while stricter controls on money laundering should help curb demand in the grey market. The USD is expected to continue weakening against other major currencies as the Federal Reserve is likely to begin cutting interest rates, narrowing growth differentials. Additionally, with falling inflation, the inflation differential between Pakistan and its trading partners is anticipated to shrink. This will contribute to maintaining the Real Effective Exchange Rate (REER) close to 100, despite declining interest rates and a stable nominal currency.

Economic growth to remain subdued

There has been a slight uptick in demand from the depressed levels of last year, as reflected in higher year-on-year growth figures. However, demand across nearly all sectors remains below the peak levels of FY22, with excess capacity still awaiting full utilization. The Large-Scale Manufacturing (LSM) sector contracted by 1.9 percent in September 2024, and growth for 1QFY25 has slowed by 0.8 percent.

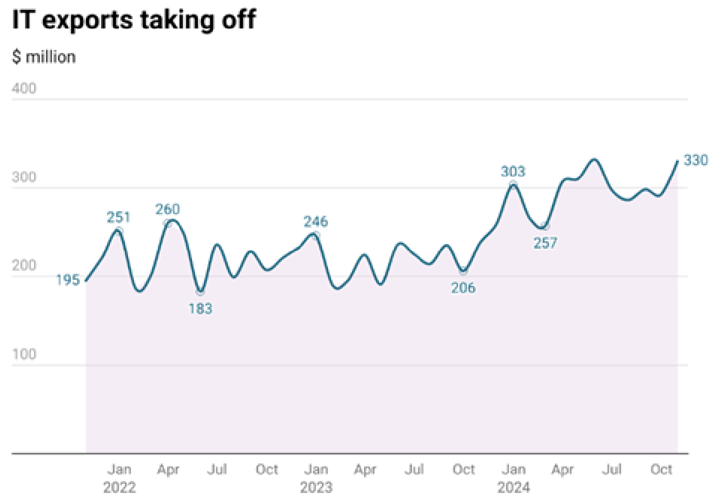

Exhibit 6: IT exports

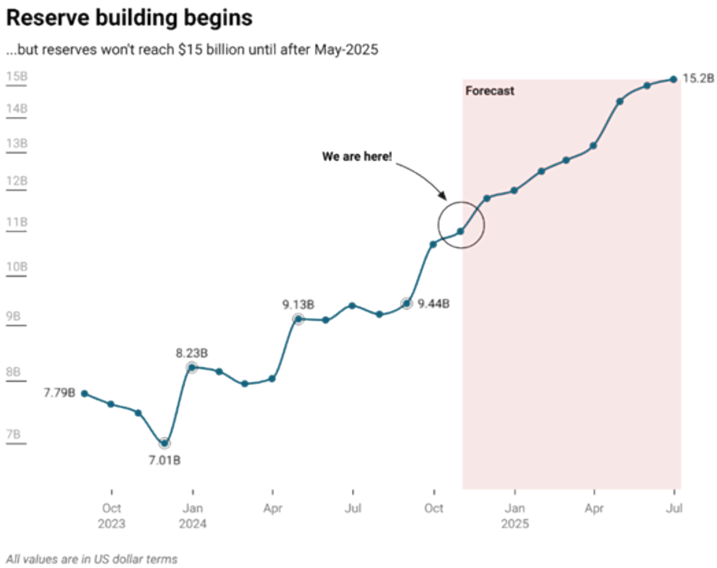

Exhibit 7: SBP Reserves forecast till FY25

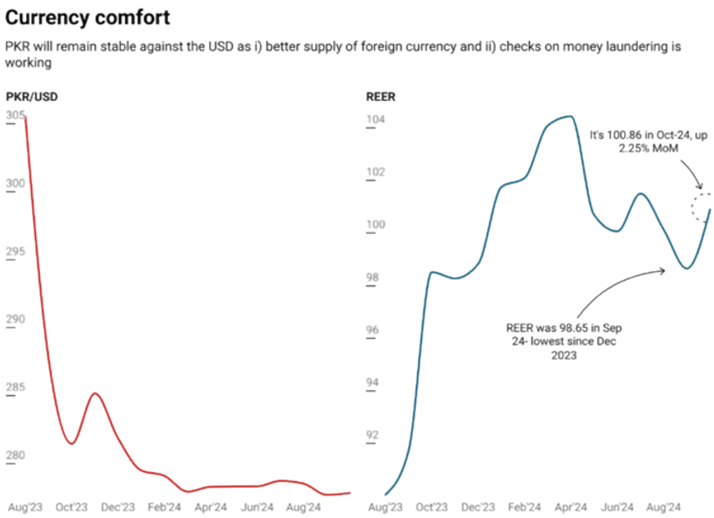

Exhibit 8: Currency and REER

Oil market

Petroleum product sales, particularly petrol and high-speed diesel, have shown a slight recovery from the multi-year lows experienced last year. Total energy sales in 4MFY25 increased by 2 percent to 5.2 million tons, partly due to improved control over smuggling from Iran, which had been widespread the previous year. However, sales are still at about two-thirds of the peak levels reached in FY22.

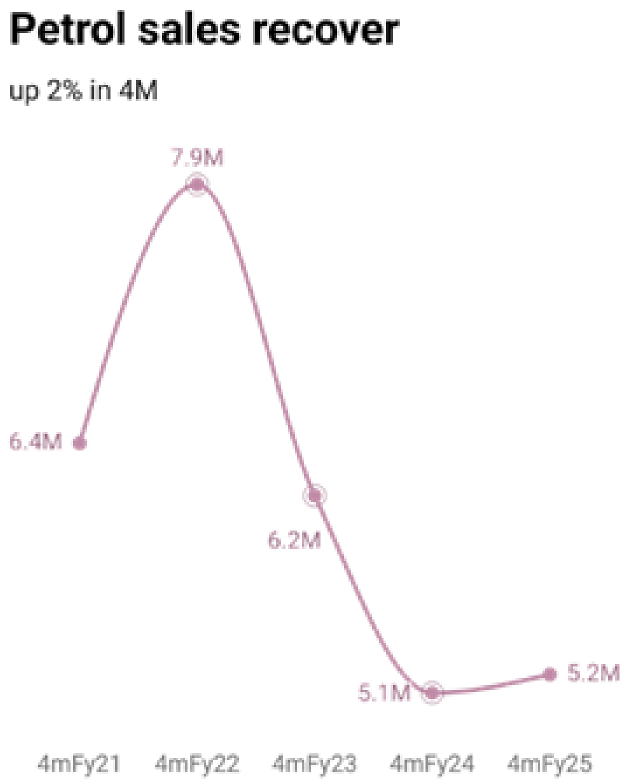

Exhibit 9: Petroleum product sales in 4M

Cement and construction challenges

The construction sector, especially the real estate market, continues to face a downturn, driven by stricter documentation requirements for buying and selling plots and files. This has indirectly impacted construction activities, exacerbated by the broader economic slowdown. Cement dispatches in 4MFY25 declined by 8 percent, totaling 14.6 million tons, which is still about three-fourths of the peak level recorded in FY21.

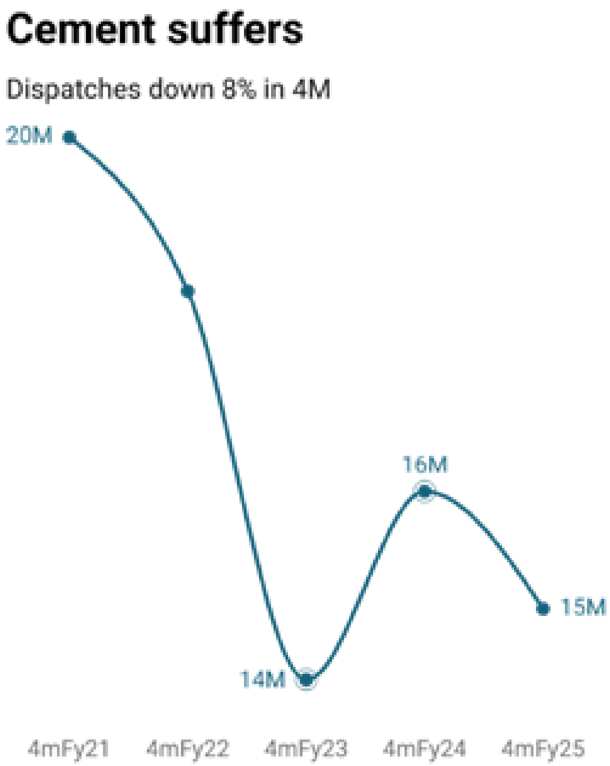

Exhibit 10: Cement sales in 4M

Power generation sector struggles

Reviving power demand on the grid remains a significant challenge for the government, with declining demand attributed to the economic slowdown, sharp increases in consumer tariffs, and a shift toward renewable energy, particularly solar. Power generation fell by 5 percent in 4MFY25 to 50,808 GWh, although there was a 7 percent year-on-year increase in October, largely due to prolonged summer conditions. Despite this, power generation remains at 89 percent of the peak levels seen in FY22.

The government is exploring several measures to address this issue, including lowering consumer tariffs and managing the growing capacity payments per unit. These efforts include negotiations with Independent Power Producers (IPPs) and plans to shift part of the power sector's legacy loans to the federal government, which could result in savings of Rs3.8 per unit. Additionally, a subsidy-neutral winter package is being considered, which would charge excess consumption at Rs26.1 per unit, with the aim of stimulating higher consumption during off-peak months.

FY25 growth outlook and sector challenges

The SBP forecasts GDP growth in FY25 to range between 2.5 percent and 3.5 percent, while the World Bank expects it to be around 2.8%. If the World Bank's forecast holds, it would bring the rolling three-year growth average down to just 1.7 percent, the lowest since 1953. The economy continues to struggle to sustain a healthy current account deficit of 1-2 percent of GDP, and under the current economic structure, growth remains challenging without increasing imports. Depressed domestic demand is pushing firms to explore export markets, though this shift will be gradual. While this shift could help transition toward a more sustainable economic structure, it will take time to materialize. Challenges persist, particularly in aligning fiscal policies and managing the energy sector. Moreover, rising taxes and energy prices are eroding the feasibility of export-led growth.

Agriculture growth in FY25 is projected at 1-1.25 percent, marking a significant decline from last year's 6.25 percent. The previous year's growth was driven by a recovery in major crops following floods, better soil conditions, and a one-time boost in rice exports due to India's export ban. However, this year's outlook for cotton and rice crops is weak, due to erratic weather patterns. Additionally, the lack of a wheat support price, as required by the IMF, will add further pressure on wheat production.

Manufacturing has faced considerable setbacks over the past two years, with import restrictions and reduced demand significantly impacting performance. Large-Scale Manufacturing (LSM) saw a decline of 10 percent in FY24 and stagnated in FY25. Some recovery is expected, but overall growth in manufacturing is anticipated to be limited to 1.75-2.25 percent in FY25. The services sector is expected to grow by 2.25-2.75 percent, up from last year's modest 1.2 percent growth, with improvements attributed to a more stable economic environment, though challenges remain in sustaining momentum across all sectors.

Going forward – Investment flows are imperative for growth

Attracting foreign investment is crucial for achieving growth beyond 3%, but it remains a significant hurdle. The IMF has revised its projections for international private credit inflows, lowering expectations to more realistic levels, signaling slower economic growth. Initially, the IMF projected a 5% growth rate by FY26, but now it expects growth to reach only 4.5% by FY28. This suggests that the growth slowdown will persist, and recovery will be gradual and difficult.

To reverse this trend, increasing foreign private investment is imperative. Existing foreign investors are well positioned to contribute and showcase Pakistan, but only if the environment is conducive to investment. The focus must remain on restoring and enhancing investor confidence.

While the Special Investment Facilitation Council (SIFC) aims to attract both foreign and large local investors, confidence among new investors continues to erode due to low returns on existing investments. Sharp currency fluctuations and frequent delays in profit repatriation are key drivers of this decline. Although guarantees and promises are being offered to new investors, the overall investment climate remains uncertain.

Furthermore, the renegotiation of past sovereign contracts, especially in the energy sector, is taking place in an unfavorable environment, sending mixed and confusing signals to potential investors.

The root issue lies in the inconsistency of the policy framework, which frequently changes. Adding more layers of bodies or councils will not resolve this issue. Instead, the existing Board of Investment needs to be strengthened, and long-term economic planning must be made independent of political leadership to ensure stability and restore investor confidence.

Finally, it is important to highlight that one of the critical operational constraints for existing foreign investors is the lack of coordination with key government bodies especially the FBR. This has been sending negative signals and creating uncertainty for large foreign investors. For instance, OICCI members, who contribute over one-third of the total tax revenue, have unresolved tax refunds amounting to over Rs. 100 billion for an extended period.

Moreover, negative initiatives, such as requiring affidavits from the CFOs of large taxpayers, are sending highly discouraging messages to both current and potential foreign investors, as well as their respective headquarters.

At the same time, the Government of Pakistan has not delivered on their commitment to broaden the tax base by effectively taxing the retail and wholesale trade sectors, among others. Key stakeholders expect the Government of Pakistan to take decisive actions to control expenditures, privatize state-owned enterprises (SOEs), streamline the economy, and engage meaningfully with economic stakeholders.