OICCI Economic Update

OCTOBER 2024

The First Port of Call for Foreign Investors

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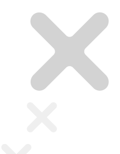


THE economy has stabilized. IMF's new program is in place. Inflation is down sharply due to domestic demand suppression and softening of global commodity prices. The fiscal policy is tight, and the current account is expected in marginal surplus as imports are curtailed and remittances have normalized. The supply in the forex market is healthy and the currency has no pressure of depreciation. Seeing all this, the State Bank of Pakistan (SBP) has started easing the monetary policy and market rates are adjusting at a faster pace; but the real rates are likely to remain well in positive to ensure the stabilization is cemented. However, the GDP growth will remain muted and economic slowdown will also continue.

The usual model of spurring growth through fiscal development spending and real estate bonanza is missing, and that brings the onus of growth to the private sector in the medium-term. The key is to introduce energy reforms- especially in the power sector. The work on lowering the tariffs is in process. The Energy Task Force is negotiating with the IPPs while the Ministry of Finance has requested the Chinese to reprofile the IPP debt (and there are some developments in it). Overall power tariff can be reduced by Rs3-5/unit. If that happens, the growth in the manufacturing sector may kick in.

IMF program starts on a positive note

The new IMF program is in, and there is no mini budget in offing, till the first six monthly review expected in Feb-March 2025. The Fund is apparently lenient as compared to the previous program. The gross financing requirements, after some deliberation with the bilateral partners are in place. The rollover of bilateral deposits and partial debt is ensured till the 37-month Fund's programme is in. Then the possible current account surplus to reduce the need of private inflows assumed by the IMF.

There are some elements of structural fiscal reforms – such as taxation on exporters, agriculture and retailers, and to improve governance of public officials. However, there are risks in implementation.

There is a great role of provincial coordination. All four provinces have ensured the IMF to show the budgeted surpluses. Three provinces have agreed to implement agriculture as a normal income tax from 1st January, 2025, while Sindh has conditioned it upon the provincial assembly's approval. Moreover, three provinces have agreed to share the fiscal burden of the Benazir Income Support Programme. However, Sindh is pressing it to remain a federal budget.

Inflation and interest rates outlook

Headline inflation is down to 44 months low of 6.9% in September 2024, which is down from 31.4% in the same period last year. The inflation is likely to remain low due to softening global commodity prices, high domestic base affect and normalization of energy prices.

The inflation is likely to be at 6.5-7% in October and it is to remain in the range of 4-6% till April '25 before slightly surging again to 9-10 in May and June due to the base effect. The FY25 average inflation is estimated 6.5-7.5% and CY25 average is expected at 7.5-8.5%.

The SBP has started reducing the key policy rate in line with the inflation and the policy rate is down from its peak of 22% to 17.5% in three policy reviews. The easing cycle is likely to continue with policy rate at 14-15% by December 2024 and 10-12% by December 2025. The 10-year paper is already trading at 12%, indicating further cuts in the next few months.

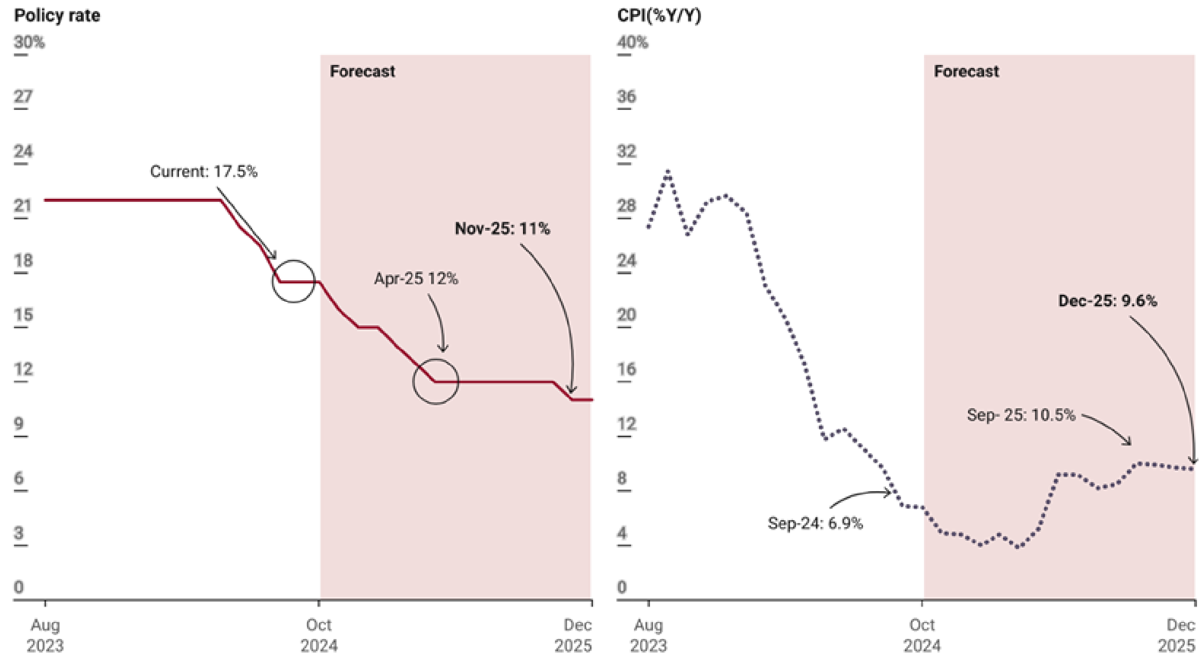


Exhibit 1: CPI and policy rate-present and forecast

International commodity prices are falling

The subdued international demand is causing the easing in the commodity prices. The Food and Agriculture Organization food index is down by 25% from its peak in 2022. Palm oil prices almost halved from the peak while the wheat prices are down by 60%. The Brent oil prices are down by 45% from the peak in 2022. All the indicators are showing that the commodity super cycle started in the aftermath of COVID amid Ukraine war are completing the full cycle. However, the risk of war in the Middle East (between Israel and Iran) can reverse the commodity prices cycle – especially of oil and its derivates.

This will give much needed breather to import dependant countries like Pakistan. That will help improve current account balance, lower inflation, jack up fiscal revenues (through imposition of higher taxes without increasing consumer prices) and all these indicate stable currency. The petroleum products realized imports prices are down to 3 year low while the HSD prices in PKR are at 20 months low.

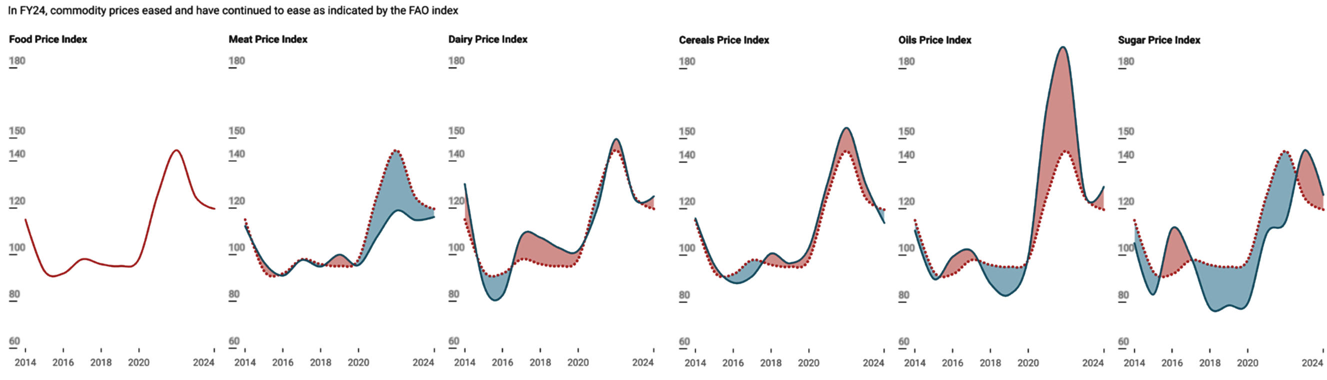


Exhibit 2: International commodity prices annual

External account pressure to remain muted

The current account is likely to be slightly in surplus in FY25 due to softening global commodity prices and lower domestic demand – both these factors will keep imports growth in check despite falling interest rates. The exports may continue to surge slightly as more and more firms are looking for export avenues to utilize idle capacity. The dividend and profit repatriation backlog is being cleared, and that will curtail the income account deficit. The home remittances may keep a momentum of $3 billion average inflow due to more people going abroad and reduced demand in the hundi/hawala system.

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	-24,819	-1,042	-5,765	28,351	27,333	-1.0%
FY24	-665	53,166	31,101	-22,065	-2,306	-8,623	32,329	30,250	-0.2%
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 3: Current Account position

- ### Imports

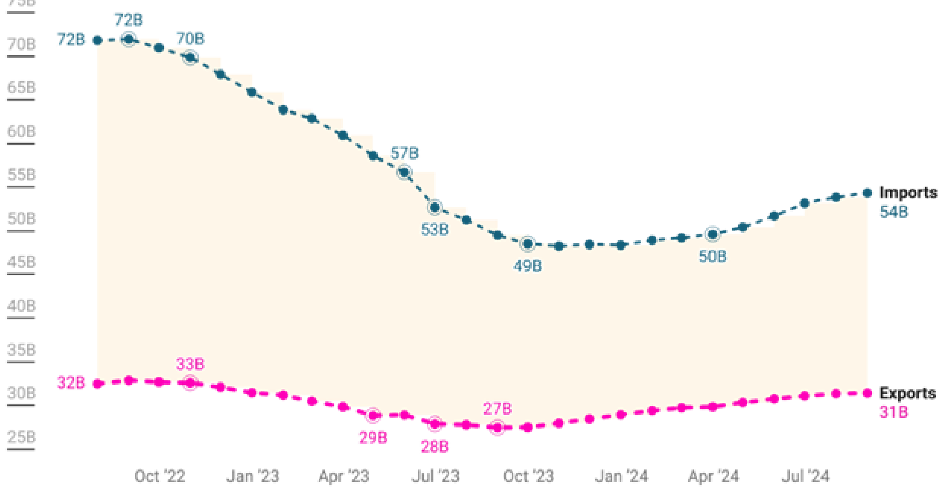
Imports are inching up from its low but its in the comfortable zone. The 12M moving average bottomed up in January 2024 and is back to the normalization path. Imports stood at $13.3 billion in 1QFY25 – up by 10% YoY. Falling interest rates are slowly reviving the import growth, which is partially being offset by the lower commodity prices. The SBP should keep an eye on imports and gradually ease the policy to stall imports growth.

- ### Exports

Exports of goods are going up on 12M moving average. However, it is yet to achieve its peak in 2022. The textile exports are showing resilience despite higher energy prices and imposition of normal income tax. This is perhaps due to already placed orders. Without lowering the energy prices, the exports growth will remain flat or fall marginally. Exports of goods stood at $7.9 billion in 1QFY25 – up by 14% YoY.

Imports and exports both slowly moving up

After bottoming out in Jan-24, imports are coming up again. The graph shows 12M rolling average of dollar imports/exports over the past two years



All values are in US dollar terms

Exhibit 4: Rolling average of imports and exports

- **Growing IT exports**

Pakistan's IT sector growth has been driven by a remarkable increase in exports over the last few years, particularly during and after the COVID-19 pandemic. This growth streak continued in FY24, with Pakistan's IT exports reaching $3.2 billion, marking a 24% YoY increase, and the positive trend is expected to persist in FY25. Several factors contribute to this growth, including increased activity in the GCC region, particularly in Saudi Arabia, where Pakistani IT companies have been expanding. Additionally, improved foreign exchange regulations—such as the SBP raising the permissible retention limit in Special Foreign Currency Accounts from 35% to 50%—have encouraged more exporters to repatriate their earnings. The stability of the PKR has also motivated IT exporters to bring a larger portion of their profits back to Pakistan. Looking ahead, the sector is expected to continue its upward trajectory, with a forecasted growth of 10-15% in FY25, potentially reaching $3.5-3.7 billion in IT exports.

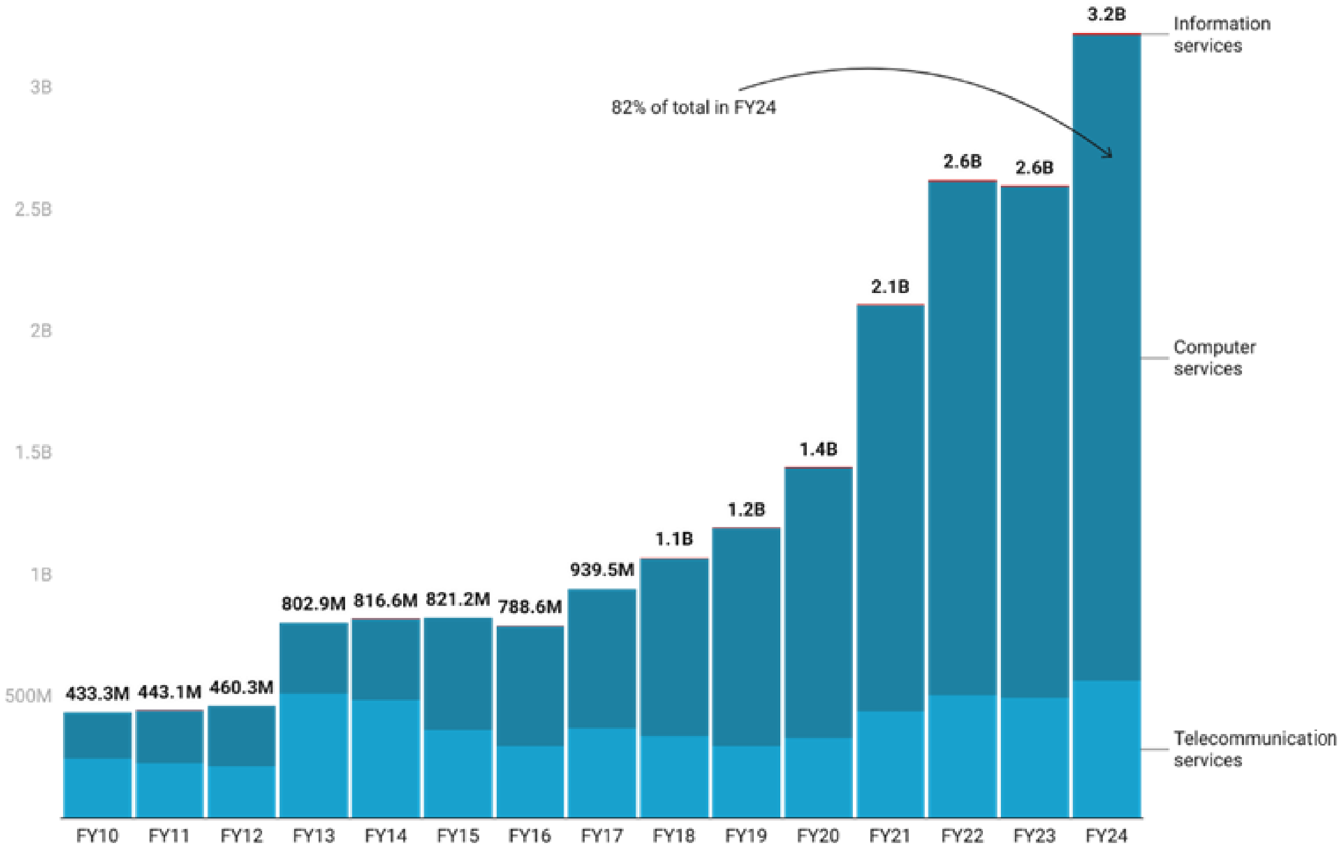


Exhibit 5: Breakdown of IT exports by segments

SBP reserves

The biggest sign of economic stabilization is in building forex reserves, which are up to $10.7 billion from the low of $3.5 billion last year. The SBP cannot think of high growth till the reserves are increased to $15 billion.

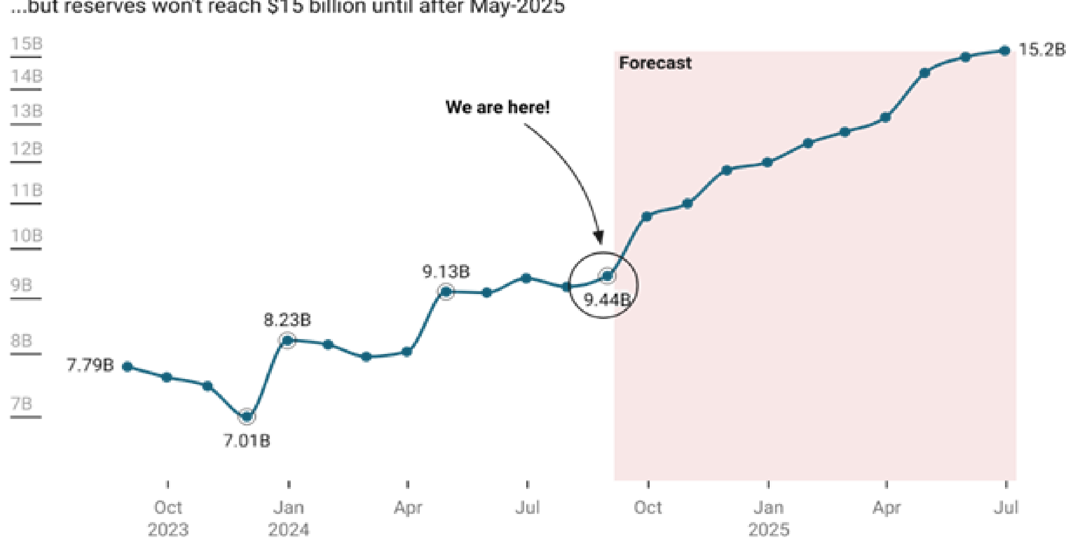


Exhibit 6: Forecast reserves till 2025

Currency stability to continue

A better supply of foreign currency will keep interbank market in a comfortable situation while the check on money laundering will keep the grey market demand in control.

The USD is expected to continue weakening against other major currencies because Fed is likely to cut the interest rates and that will narrow the growth differential. In addition, due to falling inflation, Pakistan inflation differential with the trading partners is likely to fall. This will keep REER close to 100 despite falling rates and stable nominal currency.

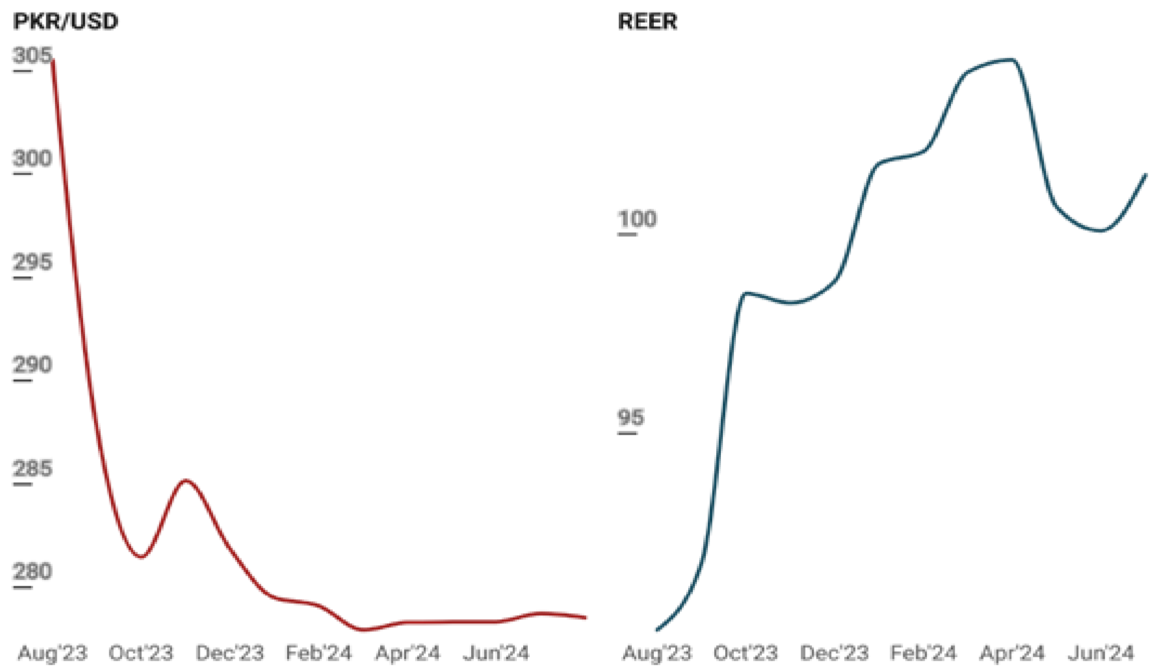


Exhibit 7: Currency and REER

Fiscal – more taxes are to be imposed

The targets for the Federal Board of Revenue (FBR) revenues are stiff. The FBR revenue gap is about Rs100 billion in the first quarter. Had the government not slowed down the refunds, the gap could have been of Rs200 billion. Nonetheless, SBP profits transfer is Rs200 billion higher than the budgeted Rs2,500 billion. The falling interest rates are likely to keep the fiscal deficit within budgeted levels. However, having a primary surplus of 2% will be a challenge.

The shortfall may increase in the coming quarters. This may trigger contingencies agreed with the IMF by imposing more taxes, including higher PL on petroleum in the second quarter and increase in WHT tax rates in fourth quarter. These will keep the wholesale and retail economic growth in check. These steps alone won't be enough to reach the primary surplus target of 2% of GDP in FY25, and the axe will fall on the development budget, which will dampen the economic growth.

Way off course

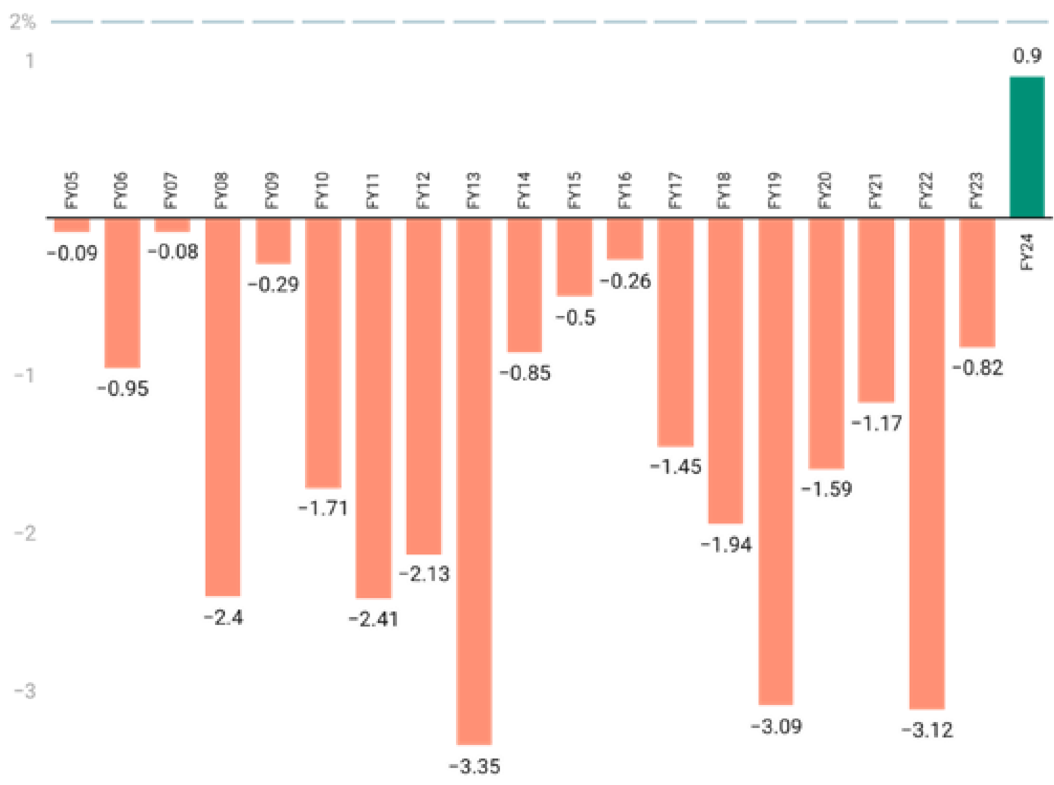


Exhibit 8: Primary Fiscal Balance % of GDP

Economic growth to remain subdued

The SBP expects the GDP to grow by 2.5-3.5% in FY25. The number is hard to achieve without continuing easing in the global commodity prices. The economy cannot afford to run a healthy current account deficit (1-2% of GDP), and in the current structure of the economy, the growth is hard to come by without increasing the imports bill.

The depressed domestic demand is incentivizing firms to move towards export markets. This shift is going to be slow but would help overall economic structure to have sustained growth. The challenge is to put the fiscal house and energy sectors in order, as higher taxes and growing energy prices are impeding the objective of having export led growth.

In FY25, agriculture growth will be at 1-1.25% versus 6.25% last year. The high growth in the last year was due to major crops bouncing back from the low base (owing to floods) and better

soil conditions. Then there was a one time bonanza of rice exports with India banning exports last year due to elections.

This year the reports on cotton and rice crops are weak due to erratic weather. Additionally, with the absence of wheat support price as per the IMF condition, the produce of wheat crop in FY25 would also be challenged.

In manufacturing, the last two years were a nightmare. Earlier, the import restrictions and later, the demand compression did incredible damage as LSM growth was negative 10% in FY24 and zero in FY24. It may bounce back a bit, but the growth would remain limited – overall manufacturing growth is likely to remain 1.75-2.25% in FY25.

Overall large-scale manufacturing (LSM) growth for FY24 closed at 0.92%, a slight improvement from the negative 10.3% growth recorded in FY23. July 2024 showed a more positive outlook, with a 2.23% year-on-year increase. Key sectors contributing to this revival include textiles, wearing apparel, automobiles, and tobacco, although the recovery is expected to be slow and heavily dependent on economic conditions such as interest rate stability and consumer purchasing power. The services sector is likely to grow to 2.25-2.75% from low growth of 1.2% last year due to better performance of manufacturing and retail/wholesale.

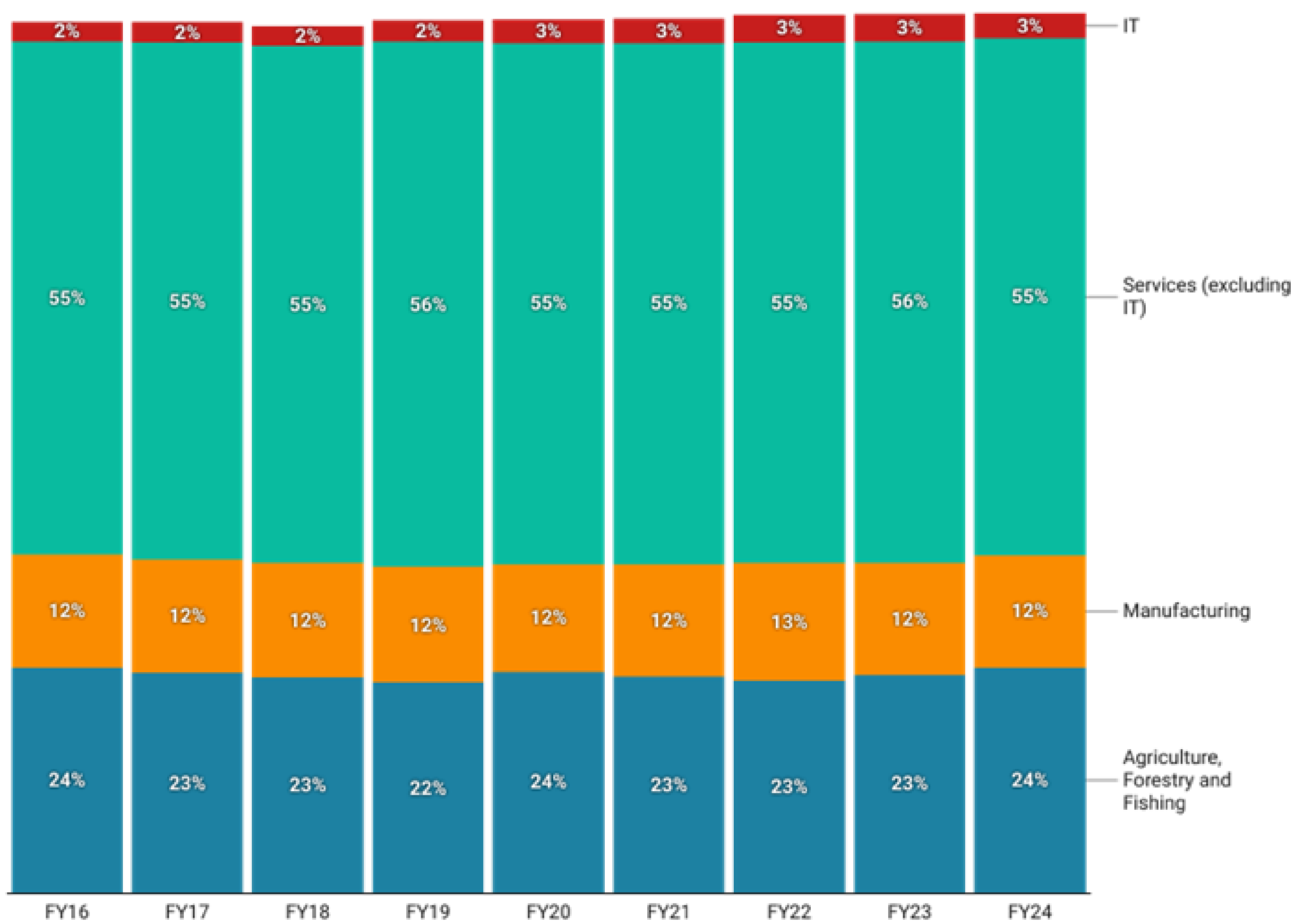


Exhibit 9: Sectoral distribution of GDP by year

Attracting FDI remains a challenge

Pakistan continues to face significant challenges in attracting foreign direct investment (FDI), a persistent weak point in its economic structure. The country's FDI levels are significantly lower than those of its regional peers, highlighting difficulties in fostering a competitive and stable investment climate.

In 2024, Pakistan's GDP growth of 2.3% lags behind other emerging markets like Bangladesh (5.7%), Vietnam (6%), and Indonesia (5%). This sluggish growth is attributed to ongoing economic challenges such as high inflation, political instability, and external debt pressures. While countries like Bangladesh, Vietnam, and Indonesia benefit from strong textile exports, robust manufacturing sectors, and strong domestic demand, respectively, Pakistan's economy remains more vulnerable, heavily reliant on agriculture and remittances.

FDI in Pakistan, at less than 1% of GDP, is significantly lower than in Vietnam (6%) and the Philippines (2.5%), underscoring the country's challenges in attracting foreign investment. Political instability, lack of policy continuity, and a difficult business environment have made Pakistan less competitive compared to its regional peers.

Pakistan v. peers

Other emerging markets are staying ahead of Pakistan in various ways

Country	GDP Growth (2024)	Inflation (2024)	FDI (% of GDP)	Key Growth Drivers
Pakistan	2.38%	23.40%	0.4%	Agriculture rebound, remittances, IMF support
Bangladesh	5.7%	8-10%	0.5%	Textile exports, remittances
Sri Lanka	1-2%	15-20%	1.2% (2022)	Recovery from financial crisis, IMF reforms
Vietnam	6%	3-4%	6%	Manufacturing exports (electronics, garments)
Indonesia	5%	5%	2%	Domestic consumption, commodity exports, infrastructure invt.
Philippines	5.5%	6-8%	2.5%	BPO sector, remittances, manufacturing

Exhibit 10: Peer country snapshot

Energy puzzle to solve to bring growth

Due to successive increases in the power tariff and overall suppression in demand, the power consumption is on secular decline. With the consumption lower than the reference target, high Quarterly Tariff Adjustment (QTA) will increase the effective tariff despite negative adjustment in the FPA (fuel price adjustment).

Power generation fell by 17% (YoY) in August 2024 to 13,179 GWH, which is 20% less than the reference generation. This is the lowest generation in seven years. In 2MFY25, the power generation is 12% less than the reference point. This will result in around Rs80-100 billion shortfall in revenues and this will be passed onto the consumers during the winter months.

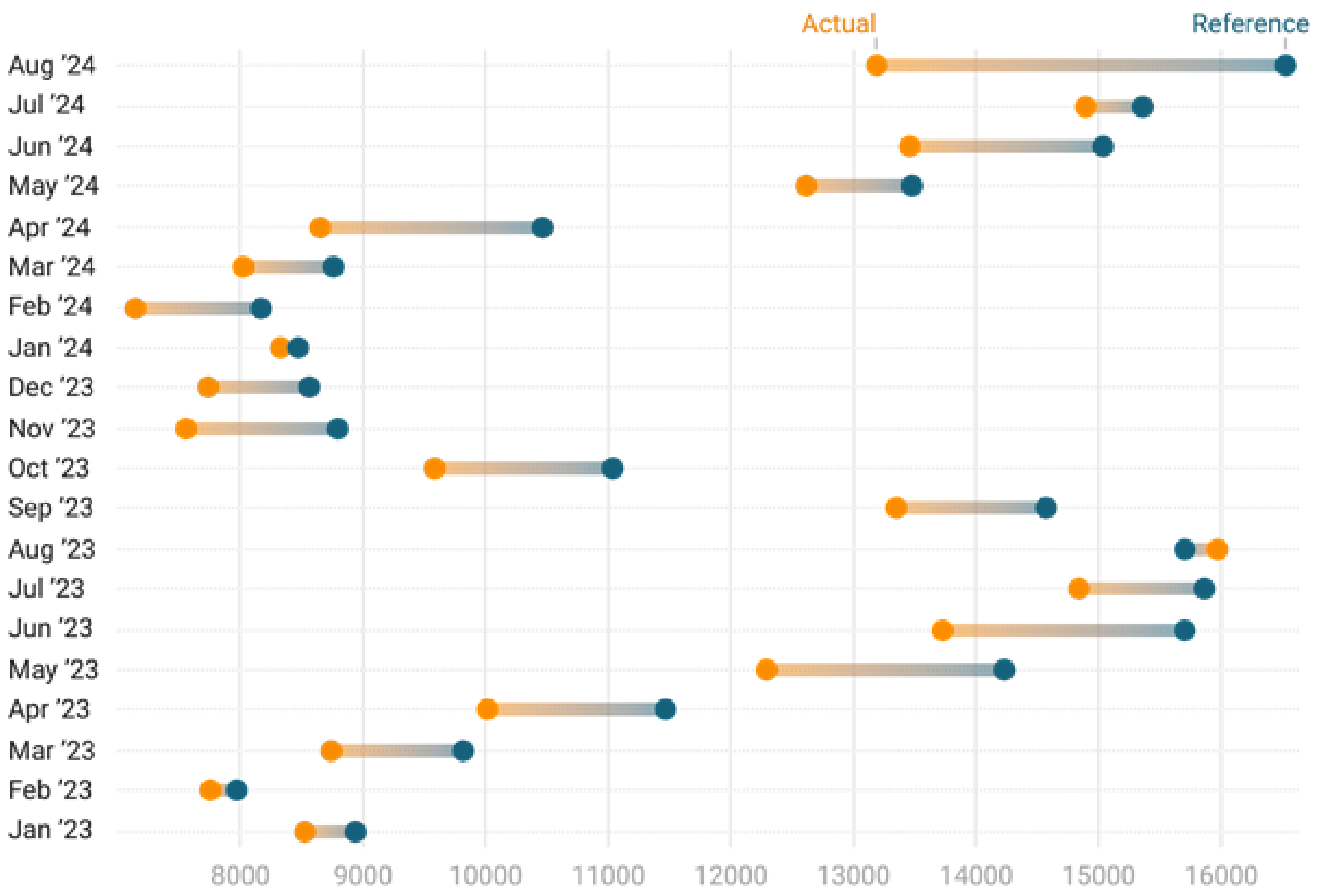


Exhibit 11: Electricity generation- actual vs. reference

This is a vicious cycle, and to break it, the power consumption ought to increase. And for the power consumption to increase, the power tariffs must be rationalized. To reach the objective, there is an ongoing negotiation with the IPPs happening. In the first step, energy task force is negotiating with 1994 and 2002 policy IPPs where some are being asked for termination and others are pressed to move towards 'take and pay', along with reduction in contractually agreed ROEs and OEMs. A matter of concern is that the finance minister has requested his Chinese counterpart to reprofile the Chinese debt on CPEC IPPs, and the process has initiated. In addition, Chinese lenders have already given principal payment moratorium on government owned nuclear power plants for two years which is yet to reflect in tariffs.

It's premature to say what positive results these steps will yield, but overall, this can reduce the power tariffs by Rs3-5 per unit. However, without addressing the inefficiencies in the value chain and overall energy sector, any gain would be short-lived. It's better to focus on cooperative alignments that enhance investor confidence and create a foundation for sustainable, long-term stability.

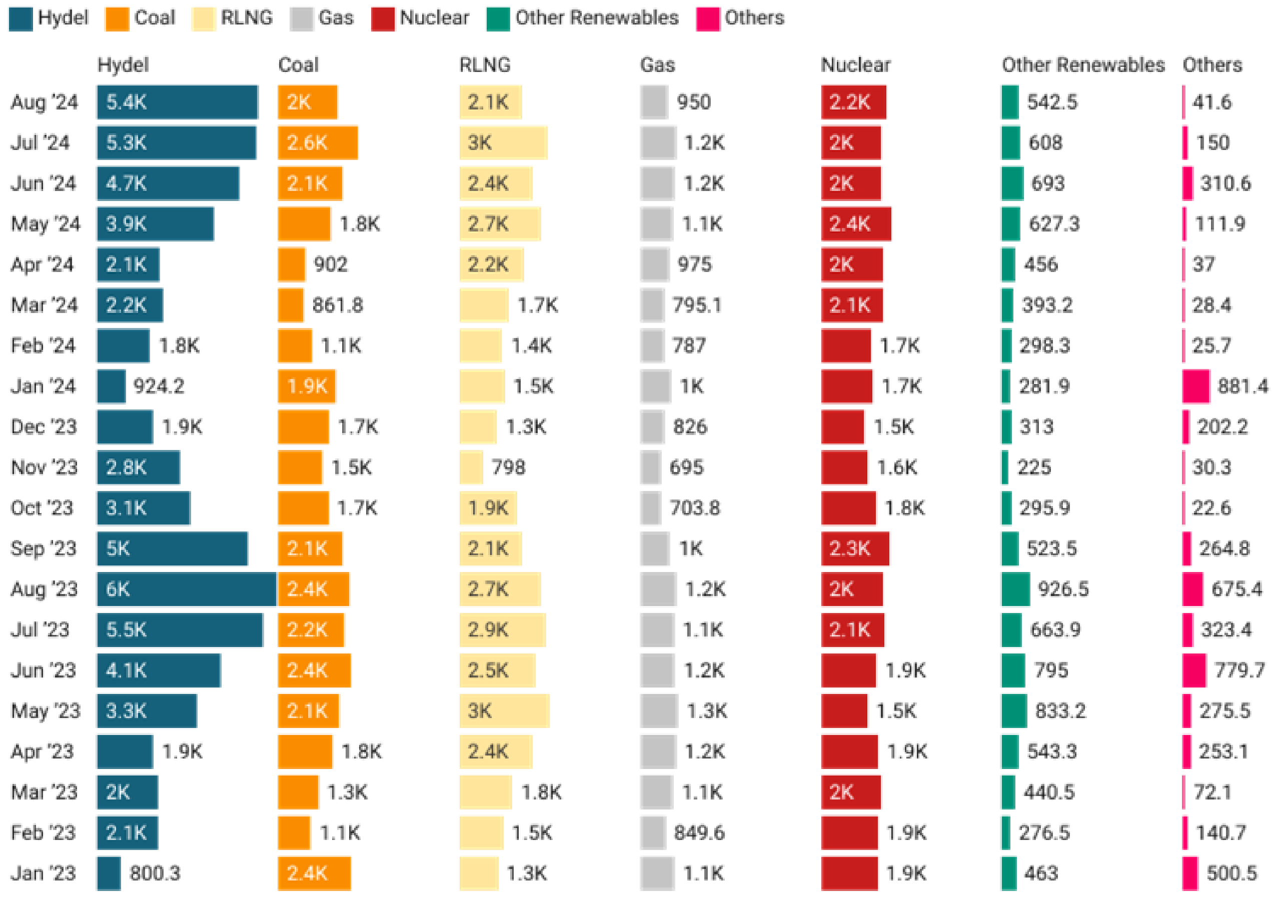


Exhibit 12: Power generation mix

Going forward –

The macro stability in terms of balance of payment and inflation have given a much-needed breather to think about the future reforms. However, without broadening taxation, rationalizing public expenditure and reducing energy inefficiencies, the stability is likely to remain short-lived. The government should not think of short-term growth and use this window to instill reforms to attract investment which is at multidecade low.