OVERVIEW

Budget Deficit for FY19 hit the highest level since 2001 of 8.9% of GDP, against a revised target of 7.2%, to Rs. 3,445 billion (FY18: Rs. 2,260 billion), an increase of 52% over the last year. Only in the June quarter FY19 alone the deficit was 3.9% of GDP, exceeding the first three quarters' average of 1.7%. The primary deficit which excludes cost of debt servicing was also significantly high at 3.45% of GDP.

The challenge is to restrict budget and primary deficits for the current year at 7.1% and 0.6% of the GDP respectively. These targets are budgeted to be achieved in FY20 by a 43% increase in tax revenues, 146% increase in non-tax revenues and restriction of current expenditures (other than cost of debt servicing, Benazir Income Support Program (BISP), and Ehsaas program) to an increase of 14%.

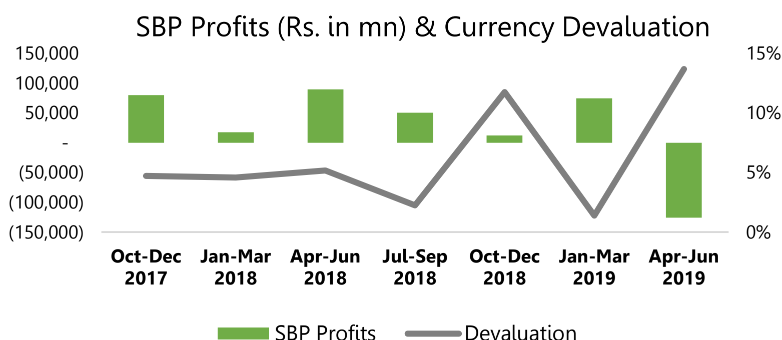
Apart from the Budget Deficit situation, the Current Account Deficit for FY19 declined by 32% to a deficit of $13,508 million, compared to last year (FY18: $19,897 million).

Two policy tools; interest rates and currency devaluation, were extensively used during the year to control the twin deficit situation; Pak Rupee was devalued by 32% starting the year FY19 at a price of Rs 121.50 per USD and ending at Rs 160.05 to a dollar; simultaneously, the policy rate was raised significantly from 6.5% at start of the year to 13.25% at the end of July 2019 after an increase of 104%.

Budget Deficit

The Budget Deficit for FY19 was primarily driven by a drop in Gross Revenue receipts of 5.5% from last year to Rs. 4,436 billion (FY18: Rs. 4,696 billion), and an increase in Current Expenditures by 26% to Rs. 4,804 billion (FY18: Rs. 3,814 billion).

Tax revenue growth was stagnant at 0.14% from the last year to Rs. 4,072 billion (FY18: Rs. 4,066 billion) amidst a slowdown in economic activities and lower imports. Despite the expected continuation of effects of policy of contraction in FY20, the total tax revenue is targeted to grow at 43% to Rs. 5,822 billion, and FBR's revenue is targeted at Rs. 5,555 billion (an increase of over 44%). During the first two months of FY20 Rs. 580 billion has been collected against a target of Rs. 644 billion, which translates into a shortfall of 11%. If same trend continues, we may end up with a tax collection deficit of over Rs 600 billion. To meet the target FBR needs to collect at least Rs. 500 billion in each of the remaining months which is substantially higher than an average collection of Rs 290 billion achieved in first two months.



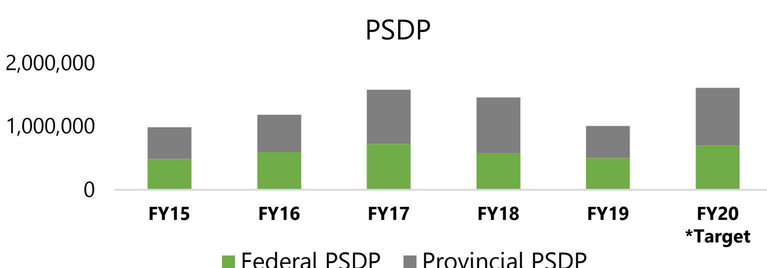
Non-tax revenue, which mainly comprises of surplus profits of SBP, fell by 95% in FY19 to just Rs. 12.5 billion (FY18: Rs. 233 billion) after SBP loss of Rs. 126 billion in the June quarter of FY19 as a result of exchange losses due to 14% currency devaluation in the quarter. The budget FY20 has targeted SBP Profits at Rs. 406 billion, which is quite a high target considering the central bank's topline has not crossed Rs. 322 billion mark in the past seven years. Despite the stabilization in PKR post IMF program, it will be a tough target for SBP to achieve.

As expected due to an upsurge in interest rates, the increase in cost of debt servicing was a major contributor for the increase in current expenditures. The cost increased by 39% to Rs. 2,091 billion (FY18: Rs. 1,500 billion). Domestic debt servicing cost was however slow to increase as compared with a sharp increase in policy rates.

The average cost of borrowing increased from 8.2% to 9.5%. The domestic debt servicing cost will continue rising to account for the increase in previous year and higher interest rate (13.25%) this year. The cost may rise to Rs. 2,534 billion which is almost in line with the budget allocation.

However, most surprisingly and despite the austerity claims, the Current Expenditures other than Debt Servicing, Defense affairs, BISP and Ehsaas programs, grew by 22% in FY19 to Rs 1,566 billion (FY18: Rs 1,284 billion) and are further budgeted to increase by another 14% in FY20.

Total Development Expenditure including spending on Public Sector Development Program (PSDP) declined by 25.6% to Rs. 1,178 billion (FY18: Rs. 1,584 billion), resulting in a shortfall of Rs. 406 billion. Spending under PSDP decreased by 31% from the last year to Rs. 1,008 billion (FY18: Rs. 1,456 billion), with a shortfall of Rs 448 billion. For FY 2020, an amount of Rs 1,613 billion is budgeted which is 60% higher than actual amount spent last year (FY19: Rs. 1,008 billion). The actual spending, however, depends on the progress of Government to meet exorbitant increases in tax and non-tax revenues. Similar to last year we expect that the shortfall in revenues and excess in current expenditures will limit the expenditure on development including PSDP.



Transfers to provinces in FY19 amounted to Rs. 2,397 billion, an increase of 8% (FY18: Rs. 2,217 billion), out of which provincial surplus was Rs. 139 billion (FY18: deficit Rs. 22 billion). Budgeted transfer to provinces for FY20 is Rs. 3,462 billion; out of which estimated provincial surplus is Rs. 423 billion. As per past record of provinces, it is highly unlikely that provinces save this huge amount of surplus for the federal government.

On the positive side, the government has planned another social protection program with an allocation of approximately Rs. 180 billion in addition to increasing the expenditure allocated to BISP by 52% to Rs. 180 billion (Revised Estimates FY19: 119 billion). These measures will help maintain demand and improve targeted subsidies, with the goal of protecting the most vulnerable segments of society.

- Current Account Deficit and Reserves

Subsequent to entering into the IMF program on July 3, 2019, PKR has proved stable against the USD in July and August 2019 staying in the range of 156-162 after touching its high of 164.05 on June 27, 2019. At these levels, PKR is undervalued with Real Effective Exchange Rate (REER) at its lowest since at least 2013. In addition, with the improvement demonstrated in current account deficit figures of July 2019 lead by a YoY reduction in imports of 22.75% and a growth in exports of 8.84%, the pressure on USD is expected to subside while current account deficit may remain within government's expectation of USD 6 billion.

Foreign borrowings of $20 billion are budgeted out of which we believe that an amount of $5 billion budgeted from friendly countries is already received in FY19 and it is only being reclassified to borrowings from deposits this year. The actual borrowing will therefore be $15 billion in FY20. Loan repayments of $9.7 billion is due this year. After accounting for all payments, the USD reserves are expected to be $6.3 billion by the end of June 2020, declining to an import cover position of approximately 1 and a half month.

Opening Reserves	Further Loans *	Loan Repayments	Current Account Deficit	Closing Reserves June 2020
$7.3 billion	$15.2 billion	$9.7 billion	$6.5 billion	$6.3 billion

*Gross loans as per budget of Rs 3,032 billion (valued at Rs 150/dollar).

Although the current account deficit figure of July 2019 is within the target for FY 2020, we look forward to further confirmation. In addition, loan disbursements depends on compliance status of Pakistan with targets set in IMF program. Any slippage on targets may cause an increase in USD on account of supply shortage.

- Interest rate

The Banks took heavy interest in the long tenure Pakistan Investment Bonds (PIBs) during the latest auction held by SBP August 21, 2019. This indicates that market is generally expecting that the policy rate has reached its peak at a high of 13.25%. Going forward, the policy rate is expected to be maintained and then to gradually start reducing provided the other budget targets discussed above are met. CPI inflation data for August 2019 also confirms a slow growth in inflation at 11.6% which is below IMF's expectation of an average of 13%. We, however, do not expect an immediate decline in policy rates in order to consolidate on the gains of policy measures.

OUTLOOK

The government's FY20 budget has targeted increase in total revenues by 52%, primarily through improvements in taxation regimes, and raising non-tax revenue. This, along with curtailment of current expenditures is necessary to keep the Budget Deficit under 7.1% and primary deficit under 0.6% of GDP.

Pakistan's economy has entered into a phase of structural adjustment after successfully negotiating Extended Fund Facility with IMF which entails a slower real GDP growth, improvement in tax-to-GDP ratio, and privatization. The gains of structural adjustment have started to manifest with revenue collection achieving 90% of the target in the first two months of FY20, Pak Rupee stabilization against the dollar, and reduction in current account deficit.

The Extended Fund Facility has also opened borrowing avenues from other international partners amounting to $38 billion during the program period. However, Government has to fulfill all the conditions, and any shortfall is to be met by stricter inflationary measures like raising indirect taxes in order to clear IMF's quarterly review of December 6th 2019.

We expect the stock exchange to remain highly volatile as the participants continue to look forward for further evidences on economic stability before entering into a bullish cycle. Stocks that were oversold earlier due to instability in PKR valuation and an exceptional increase in interest rates are now a primary buying target due to stability in PKR and a stable interest rates outlook. In addition, high dividend paying stocks will also benefit in case of interest rates reversal as they offer attractive dividend yield.

Further evidence in the coming months regarding revenue collection, and Current Account position will make it clearer if our economy is indeed on a steady path to recovery.