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Continuing challenges

With the close of February, eight months of the fiscal year have been completed. The emerging numbers for this period are not very encouraging. Inflation is rising and so is the fiscal deficit. Despite some positive signs last month, the external account remains precarious. Let us examine the new data.

After jumping to 6.8 percent in October, the year-over-year (YoY) consumer price inflation (CPI) had slowed down in the months of November and December to 6.2 percent, mainly due to decline in international oil prices and the government's decision not to recover applicable taxes on petroleum products. A new and intense surge in inflation is now seen. In January, it increased to 7.2p percent, and in February it further increased to 8.2 percent. This is the highest inflation in more than four years; the last such inflation was recorded in June 2014.

A closer look at the inflation tells us that this trend is most likely to persist for the foreseeable future. First, the inflation is driven by the non-food component of the consumer basket with a weight of 67 percent compared to the food component. The non-food component has few seasonalities and, once increased, it sticks. For the second consecutive month, non-food inflation was in the double digits, with such groups taking the lead as rents, education fee, fuels, electricity, health (drug prices) and transport.

Second, this measure of persisting inflation is further improved by excluding energy prices, being volatile, and is called core inflation. The core inflation was recorded at 8.8 percent and has been rising uninterruptedly for more than a year. This tells us that the inflation would not be easily reversed. Third, the average inflation during Jul-Feb was recorded at 6.46 percent, well above the 3.8 percent recorded for the same period last year and again highest in more than four years. Even more concerning is the double-digit inflation in the wholesale price index (WPI), which was recorded at 11 percent and has also been rising. This is an early warning indicator of future inflation in the CPI as it measures the rising cost of production.

It looks imminent that double-digit inflation may soon be around, and likely stay for some time. This assertion is based on several reasons. Oil prices have rebounded after touching a low of nearly $50 and have advanced to $65. Second, administrative prices continue to await their passage to consumers or recognition in the budget, further pushing the process of monetisation of fiscal deficit. Third, even though some lessening of SBP financing for budget has been witnessed last month, the level of Rs5.3 trillion in the government's borrowing from the SBP still remains very high and would mean continuing pressures on inflation.

The next data available is on revenue collection. The Jul-Feb collections amounted to Rs2337 billion, which was Rs78 billion higher than the collections of Rs2259 for the same period last year, showing an increase of a paltry 3.45 percent. The eight-month collections are only 53 percent of the target of Rs4398 billion for the year. Reportedly, there is already a shortfall of Rs228 billion relative to the level that should have been achieved during this period.

To achieve the full year target, the FBR has to collect Rs2061 billion in four months, or about Rs515 billion per month. This looks like an impossible target to achieve. If the next four months performance follows the pattern witnessed in the last eight months, the collections would barely come close to Rs4000. This would mean a whopping whole of Rs400 billion in revenue estimates, which were revised and set in the mini-budget announced by the present government in September-October last year.

The data for non-tax revenue is not published with the same frequency as tax revenues. The target for non-tax receipts was Rs772 billion in the original budget which was subsequently increased to Rs893 billion in the mini-budget. As against this, in the first six months Jul-Dec the non-tax receipts amounted to Rs224 billion, a mere 25 percent of the target. This is pointing to an even worse performance than in the case of tax revenues.

It appears that a shortfall of 1.5 percent of GDP looks looming from the revenues side. In the absence of any expenditures over-runs, this alone would take the fiscal deficit to 6.6 percent, which was estimated at 5.1 percent at the time of the mini-budget. The six-month fiscal deficit was recorded at 3.2 percent at the federal level. We feel that the provinces would not give any surplus as they are starving for funds under pressure of low revenue collection. On this basis also, the estimate of fiscal deficit for the year looks like 6.4 percent.

But there are huge over-runs on the expenditure side. There has been an increase of 400 bps (4 percent) in the policy rate during the current year. This will have a phenomenal impact on debt servicing cost, much larger than the Rs222 billion provided in the mini-budget. Then there is the rising defence expenditure, even prior to the recent tensions, which of course would further strain the expenditure needs. Then there are a number of unrecognised expenditures from the implicit subsidies entailed by not implementing prices as determined by the regulators. Taking all these together, it is estimated that a minimum of one percent over-run in expenditures looks reasonable to expect, taking the fiscal deficit in the range of 7.4-7.6 percent. This is an unsustainable level of deficit.

Under the circumstances, it is not surprising that the foreign exchange reserves remain dangerously low. In August 2018, reserves were $8.9 billion. After the friendly support, $4 billion were added, which would mean $12.9 billion. The reserves stood at $8 billion on February 22, 2019. Clearly, we are losing reserves by roughly a $1 billion monthly. Foreign debt is rising in the process. Nothing signifies the precarious nature of our economy than the phenomenon of loss of reserves.

An IMF programme is likely to start at the time of the next budget. However, we have allowed imbalances to grow by not doing so at the outset. The country should brace for painful adjustments which would inexorably follow a Fund programme at the time of the next budget. This would be the price of delayed adjustment.

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