1 Global and Domestic Macro-financial Environment

The global economic growth after remaining subdued in CY16 is expected to recover in CY17. Growth prospects in the emerging market economies are upbeat, while the economic activity is strengthening in the advanced economies. Financial markets, especially the world equity markets, having experienced bouts of volatility during CY16, are on an upward trajectory. Nonetheless, normalization of monetary policy in the US may tighten financial conditions in the emerging and developing economies, prompting financial stability concerns. The global trade activity remains subdued as well. At the same time, the growing political uncertainties and protectionist tendencies in some advanced economies pose further downside risks to both the trade and the global economic growth. The domestic economy, however, is well on its growth path. The financial conditions remain accommodative with banking sector sound and resilient. Asset prices are, however, rising as stock market is at historic highs. Similarly, recent pressures on external front, resurgence of inflation and rising commodity prices needs close monitoring for promptly addressing any financial stability concerns.

1.1 Global Developments

The global economy to tread on slow growth trajectory…

The global economy recorded a growth of 3.11 percent in 2016, down from 3.35 percent in 2015, primarily due to slowdown in Advanced Economies (AEs) (**Table 1.1**). The growth outlook in AEs remains subdued given uncertainties post-Brexit vote, moribund growth prospects both in EU and Japan and the fact that most of the AEs are operating below potential. The real growth in AEs slowed down to 1.69 percent in 2016 from 2.15 percent in 2015. However, with recovery and pick up in major AEs, the growth is likely to convalesce to 2.01 percent in 2017.

Some of the risks to global growth associated with Emerging Markets and Developing Economies (EMDEs), though, have abated: the concerns about China's hard landing have subsided; the commodity markets have rebounded; and, with Brazil and Russia expected to come out of recession, the EMDEs have grown by 4.13 percent in 2016. The growth prospects in India and Saudi Arabia are more restrained, due to former's experience with currency note withdrawal and latter's concurrence with other oil producing countries to shed oil production. The EMDEs are, however, estimated to lead global growth with a healthy growth of 4.49 percent in 2017. As a result, the world output is projected to recover to 3.46 percent in 2017.[22]

Table 1.1
Global Economy: Real GDP growth (percent)

	CY14	CY15	CY16	CY17*
World	**3.50**	**3.35**	**3.11**	**3.46**
Advanced Economies	1.90	2.15	1.69	2.01
Euro Area	1.10	2.05	1.73	1.68
Emerg. and Dev. Econ.	4.65	4.25	4.13	4.49
Emerg. and Dev. Asia	6.75	6.74	6.38	6.43
MENAP	2.79	2.70	3.89	2.58
China	7.30	6.90	6.70	6.58
Japan	0.34	1.20	1.00	1.25
Saudi Arabia	3.68	4.11	1.40	0.37
United Kingdom	3.07	2.19	1.81	2.05
United States of America	2.40	2.60	1.60	2.30

* Forecast
Source: World Economic Outlook, IMF, April 2017.

In 2016, the financial markets experienced bouts of volatility, generally of transient nature, due to various political and macro-financial shocks. The negative shocks came from uncertainties

[22] International Monetary Fund (2017), World Economic Outlook: Gaining Momentum?, *April.*

surrounding China's hard landing earlier in the year; the slump of oil prices to a decade low; the adoption of negative interest rates by Bank of Japan and the unexpected outcome of UK's referendum. However, the election results in the US, though unexpected as well, only briefly unsettled the markets. Anticipating fiscal stimulus and reversal of regulatory restrictions by the incoming US administration, the US stock markets strongly rallied, with global markets following suit.

The ultra low interest rates during most of the year 2016 adversely affected the profitability of the banking sector in major banking markets, particularly, EU and Japan. However, the second dose of policy normalization in the US in December 2016 followed by another one in early 2017, led to increased yields in the US with spillovers to other advanced markets. This will potentially ease some pressures on the profitability of some of the global players in the banking sector. However, in the Euro area and Japan, the pressures still remain. The financial institutions in Japan, especially, face negative interest rates and low credit demand and have accumulated exposure in foreign bonds and investments trusts. These heightened risk taking activities can impair financial system stability.

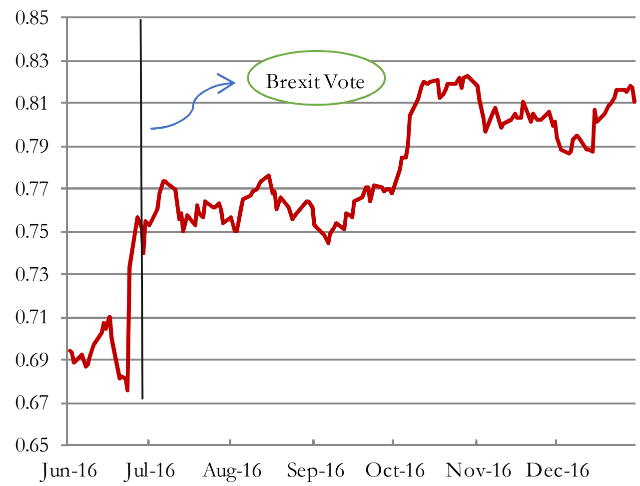
In general, various factors may influence the dynamics of global growth and stability of financial markets. These could include, for example, a growing wave of protectionist tendencies that may strengthen inward-looking policy prescriptions; the divergent policy stances in AEs; expected tightening of financial conditions in EMDEs in the wake of normalization of the US monetary policy stance; slowdown of global trade, both in the AEs and EMDEs; the tightening fiscal conditions in oil producing countries, especially the Gulf Cooperation Council (GCC), and, finally, the ongoing rebalancing of Chinese economy.

Protectionist sentiments are on the rise…

The year 2016 witnessed a rise of populist politics and protectionist sentiments around the globe. Mid-way through the year, Britons shocked the world by voting to opt out of the EU (Brexit) and the year culminated with the surprise election results in the US. Brexit briefly unsettled the global financial markets, and was a particularly watershed event for the pound sterling (**Figure 1.1**).[23]

Figure 1.1
Brexit vote sends pound tumbling

Trajectory of British pound (Daily)
(GBP per USD)



Source: Federal Reserve Economic Data (FRED), St. Louis.

Bank of England (BoE), however, intervened early on to reassure the markets, cutting interest rates to historic lows, increasing the stimulus and promising to stand ready to step in when needed.[24] On macroprudential front, the Financial Policy Committee (FPC) reduced counter-cyclical capital

[23] The British pound traded at a 31-year low of USD 1.3224 on June 24, 2016, a day after the Brexit vote. Between June 23, 2016 and Dec 30, 2016, the Sterling lost around 17 percent to the US dollar.
[24] Bank of England, Monetary Policy Summary and Minutes of Monetary Policy Committee meeting, July 2016. (http://www.bankofengland.co.uk/publications/Pages/news/2016/007.aspx)

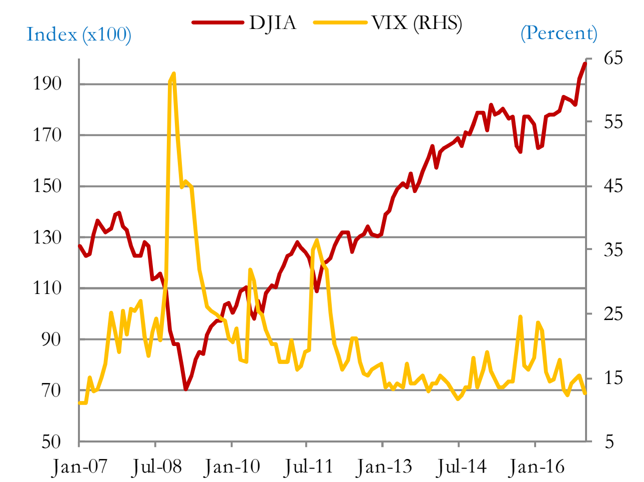
buffers from 0.5 percent to zero percent.[25] The UK economy has so far shown resilience: the official data and the major business surveys continue to indicate a steady pace of expansion in real activity.[26]

However, full ramifications of Brexit decision are contingent on the outcome of UK's divorce negotiations under Article 50 of the Lisbon Treaty and possible renegotiation of trade treaties with other countries and trading blocks. Nonetheless, the events unfolding around the exit negotiations will have financial stability implications not only for the UK's domestic economy but also for the global financial markets.

Figure 1.2

Post US elections, global risk perceptions remain muted

Monthly Global Risk Perceptions (VIX) and the US Stock Market (DJIA)



Source: Federal Reserve Economic Data (FRED), St. Louis.

Financial markets shrug off the US election surprise…

The impact of the US election surprise on financial markets, however, proved to be short lived as the markets factored in the benefits of promised fiscal stimulus, tax cuts and easing of regulations under the new US administration. This prompted a bullish rally on the US stock markets with the benchmark indexes heading for a steep rise and the bourses around the world following suit. The rally was further fueled by the strengthening of energy prices as OPEC and other oil producing countries agreed to slash oil production.[27] The global risk, as gauged by VIX,[28] largely remains muted as well (**Figure 1.2**).

…But, easing of regulations may have financial stability consequences…

It is no surprise that internationally coordinated efforts to strengthen financial regulations in the wake of GFC has, generally, led to macro-financial stability. The global banking sector, for example, has substantially beefed up its capital and liquidity buffers and remains in a better position to withstand any potential shocks. Nonetheless, the agenda remains unfinished and much needs to be achieved.[29] The expected easing of financial regulations under new US administration, for instance, may trigger reciprocatory responses from other jurisdictions as well. The competitive regulatory easing may eventually encourage risk taking and may lead to build up of vulnerabilities in the global financial system.

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[25] Financial Policy Committee, Countercyclical capital buffers. (http://www.bankofengland.co.uk/financialstability/Pages/fpc/ccbrates.aspx).

[26] Bank of England, Monetary Policy Summary and Minutes of Monetary Policy Committee meeting, March 2017.

[27] OPEC agreed on November 30, 2016 to slash oil production by around 1.2 million barrels per day. On December 10, 2016, other oil producing countries also agreed to join OPEC in the cut. (Source: OPEC Bulletin, December 2016).

[28] VIX, CBOE's Volatility Index, is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. It is also known as 'fear gauge'. (Source: Chicago Board of Options Exchange (CBOE)).

[29] International Monetary Fund. (2017). Global Financial Stability Report: Getting the Policy Mix right. *April.* (henceforth IMF GFSR 2017)

…and the pace of tightening in the US critical for EMDEs…

Now that the US has started normalizing its monetary policy stance,[30] the implications for the EMDEs are enormous. The US dollar has already started to strengthen, potentially introducing exchange rate pressures, putting fiscal positions under stress and creating financial stability concerns in such EMDEs that carry higher dollar-denominated debts.[31] At the same time, any potential capital flight in response to attractive interest rates in the US may also adversely affect EMDEs external positions and their capacity to tap global capital markets. The financial conditions for the EMDEs, therefore, are expected to remain tight in the near term. The upshot could be that the economic recovery in the US reignites the export engines of the EMDEs, if protectionist sentiments do not take hold in the form of policy actions.

Table 1.2

Euro area and Japan Macroeconomic Performance

	Euro area		Japan	
	CY16	CY17*	CY16	CY17*
	Percent			
Real GDP Growth	1.7	1.6	0.9	1.0
Inflation	0.2	1.7	-0.1	0.4
Unemployment rate	10	9.6	3.1	3.1
Current Account (percent of GDP)	3.6	3.2	3.9	4.1
Fiscal Balance (percent of GDP)	-1.7	-1.4	-3.7	-4.0

Source: European Commission

* Forecast

[30] After bringing the policy rate to historic lows in December 2008, the Federal Reserve's Open Market Committee (FOMC) started policy normalization in December 2015. The second and third rate hike came in December 2016 and March 2017, respectively. With a quarter point increment each time, the current range of federal funds rate is 0.75-1.00 percent from its lowest 0.0-0.25 percent. (Source: The Borad of Governors, Federal Reserve System, USA).

[31] As of end 2014, the corporate debt in emerging markets (local and foreign currency) stands at $ 18 trillion (Alter and Elekdag, 2016).

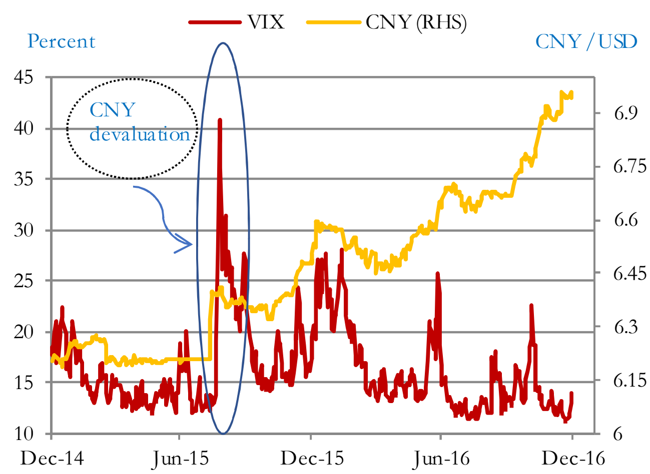
The policy stance in the EU and Japan remains ultra-easy…

The economic activity in the Euroarea and Japan remained sluggish and inflation rates stayed well below the official targets (**Table 1.2**). This prompted the central banks (ECB & BOJ) to pursue ultra-accommodative policy stance by resorting to unconventional monetary policy tools. The main refinance rate in the Euroarea, for instance, is at *zero*-percent while the interest rate on deposit facility stands at *negative* 0.40 percent. Further, the ECB's governing council decided in March 2017 to extend its asset purchase program until end 2017, and beyond, if necessary.[32]

Figure 1.3

Devaluation of Chinese Yuan (CNY) sends global risk perceptions high

Daily trend of VIX and Chinese currency



Source: Federal Reserve Economic Data (FRED), St. Louis., USA.

The stimulus seems to be working in the Euro area (EA). From the beginning of 2015, the real growth has picked up; unemployment is lowest since May 2009; the lending rates are on a downward trajectory; credit to both the households and business is picking up; and, most importantly, the

[32] Governing Council, European Central Bank (https://www.ecb.europa.eu/press/pr/date/2017/html/pr170309.en.html)

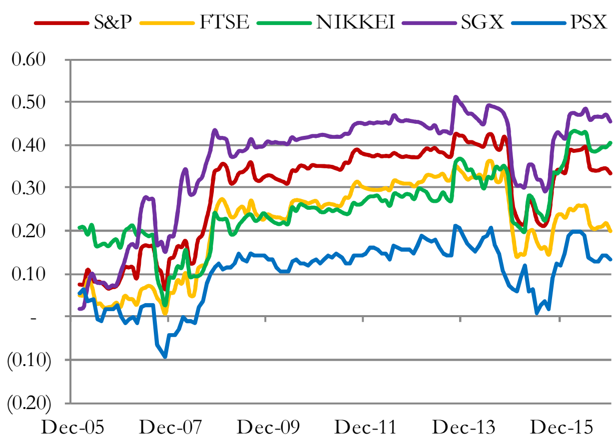
inflation is heading up.[33] Being a major trading partner, the strengthening of economic activity in EA bodes well for the export sector of Pakistan.

However, the legacy issues with the balance sheets of the banking sector, including elevated stock of NPLs in some EA member states, cost inefficiencies (i.e., low assets per employee ratios) prevailing in several markets, and limited degree of income diversification are principal factors creating uncertain outlook for the EA banking sector and its stability.[34]

Figure 1.4

Synchronization of Chinese stock market with world markets is istrengthening

Rolling window (6 years) correlations of Shanghai Stock Exchange Returns with...



Source: Federal Reserve Economic Data, St. Louis; and Haver Analytics

In Japan, the negative benchmark rates and low credit demand have hurt the profitability of financial institutions, prompting them to venture into foreign bonds, such as the US government securities. Besides, the Japanese banks have also heavily channeled funds to offshore centers through investment fund special purpose vehicles.[35] These cross-border exposures increase the financial stability concerns.

Besides the US, now China's economy matters too…

Ranked as the second largest economy in the world, China's role and influence on the global economy and markets has been increasing over the years. For instance, towards the end of 2015, the uncertainties surrounding its economic slowdown (hard landing) sent tremors throughout the global financial markets. The IMF in its Global Financial Stability Report (GFSR) of April 2016[36] has noted that the impact of shocks to the economic fundamentals in China on the equity returns in both EMDEs and AEs has been rising. Indeed, the slowdown in China in the aftermath of GFC led to the commodity price deflation,[37] affecting the resource rich and commodity exporting countries in, e.g., Middle East and Latin America. Moreover, the shock to the real output in China has been one of the major causes of global trade slowdown.[38]

…as spillovers from China are strengthening

As regards the spillovers of shocks from the Chinese financial markets, especially the equity markets, to the rest of the world, the correlation seems to be higher but it remains less strong (IMF, GFSR 2016). Nevertheless, global risk perceptions remained elevated after devaluation of Chinese Yuan in August 2015 (see **Figure 1.3**). The co-movement between major world equity markets and the Chinese stock market is also strengthening, especially after GFC (see **Figure 1.4**). Therefore, the news emanating from Chinese markets will have

[33] Benoit Coeure, 'Outlook for monetary policy in the euroarea'. Speech at Association d'Economie Financiere, Paris, 2017.

[34] European Commission. (2017). European Economic Forecast. Institutional Paper No. 048. Luxembourg, *February*.

[35] Inoue M., Yoshizaki Y., Sasamoto K. and Shiotani K. (2017). Enhancements to the BIS international banking statistics and highlights of the results of the statistics in Japan. *Bank of Japan Review*, March.

[36] International Monetary Fund. (2016). Global Financial Stability Report: Fostering Stability in Low-Growth, Low-Rate Era .*October*. (henceforth IMF GFSR 2016)

[37] Financial Times. (2015). Explainer: Why commodities have crashed. *August 24, 2015*.

[38] The World Bank. (2017). Global Economic Perspectives: Weak Investments in Uncertain Times, Washington, D.C., *January*.

quite a bearing on the global financial markets including that of Pakistan.

…and the Chinese economy remains highly leveraged.

In the wake of GFC, the Chinese government encouraged investments which resulted in a credit boom. The credit-to-GDP ratio has crossed 200 percent, while its deviation from long-term trend – the so-called credit overhang and a leading indicator of financial crisis[39] - has exceeded 25 percent. Besides bank credit, corporate bonds and other shadow products are also rapidly increasing, shrouding the financial system in opacity.[40] On the other hand, many financial institutions rely on short term wholesale funding, creating large maturity mismatches.[41] At the same time, investment efficiency has fallen and the financial performance of the corporates has steadily deteriorated, potentially affecting the asset quality of financial institutions.[42] Together, these developments point to tighter conditions and financial stability concerns. Given its importance and inter-linkages with the global economic and financial system including Pakistan, the implications could be enormous. However, the Chinese authorities have embarked on regulatory initiatives to rein in leverage and increase transparency in the financial system.[43]

Finally, as noted in GFSR 2016, the uncertainties surrounding the transition of the Chinese economy from an investment-led growth model to a more sustainable consumption-based model with a relatively open market-based financial system have abated, as the government continues to pursue multi-faceted reforms agenda. Nonetheless, the new normal for the Chinese economy is a slower but sustained growth path.

Low growth in AEs spurs global mergers and acquisitions…

A low growth in advanced economies coupled with low interest rates has been a driving force behind continued higher activity in mergers and acquisitions (M&A). The activity has been recorded at USD 3.9 trillion in CY16 compared with last year's USD 4.7 trillion.[44] The multinationals responded to investors' demand for high returns by exploring and acquiring cross border stakes to enhance outreach, market access and exploit know-how. Moreover, a substantial thrust came from Chinese investors. If the trend continues, EMDEs are expected to benefit from continuous M&A activity.

Table 1.3

GCC - Genral Government Overall Budget Balances

	CY14	CY15	CY16	CY17*
	(Percent of GDP)			
Kuwait	27.1	1.2	-3.6	3.60
Qatar	15.3	5.6	-4.1	-3.10
Saudi Arabia	-3.4	-15.8	-16.9	-9.80
United Arab Emirates	5.0	-2.1	-3.9	-2.60

Source: Fiscal Monitor, IMF, April 2017.

* Forecast

GCC economies battered by oil price slide….

The slide of oil prices that started in mid-2014, has adversely affected the fiscal position of oil exporting countries. The economies of the GCC are no exception. As a result, the countries of the region which depend heavily on oil revenues are experiencing overall negative budget balances (**Table 1.3**). Saudi Arabia, world's top oil producer, for instance, suffered heavily as it drew down on its

[39] Borio, C and P. Lowe, 2002, Assessing the Risk of Banking Crises, *BIS Quarterly Review*, December, pp 43–54

[40] Shadow products – credit products composed of trust and other structured products – surged by 50 percent (YoY) in 2015 compared with 13 percent and 20 percent growth of loans and bonds, respectively (GFSR October 2016).

[41] IMF GFSR 2017.

[42] International Monetary Fund. (2016). Resolving China's Debt Problem. Working Paper No. 16/203.

[43] IMF GFSR 2017.

[44] J. P. Morgan. (2017). 2017 M&A Global Outlook: Finding Opportunities in a Dynamic Market. *January*.

international reserves to finance its fiscal needs.[45] Further, the currencies of the region are pegged with the US dollar. Therefore, besides supporting the fiscal position, maintenance of the parity to the US dollar also required them to intervene in the forex market, leading to further depletion of their reserves.

…and are pushed to pursue ambitious reforms agenda

The situation has led to a general reform process in the GCC countries whereby the expenditures on subsidies and infrastructure projects are being scaled down. Most notably, Saudi Arabia, the largest economy in the region, has rolled out an ambitious reforms plan, *Vision 2030*, which seeks, inter alia, to pivot the economy away from its reliance on oil revenues; envisions educational reforms, development of SME sector, setting up of special economic zones, boosting tourism and encouraging home ownership.[46]

…including labor reforms….

The GCC economies are also implementing labor market reforms whereby businesses would be required to hire nationals (locals) to meet human resources needs. This move will have far reaching effect on many developing economies which export human capital that forms a major chunk of the labor force in these resource-rich countries. The resulting retardation of the remittances outflows from these oil exporting countries will have repercussions for the current accounts of the recipient countries. The receding flows of remittances are likely to affect negatively the funding source of the receiver countries' banks.

…and are tapping international financial markets

Apart from domestic fiscal consolidation measures, many GCC countries have tapped international capital markets during 2016, raising a record amount of USD 66 billion through fixed income securities. Most notable is Saudi Arabia's debut bid to raise USD 10 billion from international bond issuance. The issue was over-subscribed and the Kingdom ended up accepting USD17.6 billion.[47] The country is also contemplating, under *Vision 2030*, an initial public offering of the state oil company, Aramco, which is being dubbed in the financial markets as historically the biggest IPO. Separately, Kuwait is also mulling over its first ever dollar-denominated bond issue in early 2017.[48]

Reforms in GCC countries carry promise for developing countries

Despite initial disruptions due to reforms, their successful implementation may have some silver lining for developing countries. Conditional on the pace of the reforms and resulting rebound in economic growth, the countries may require additional human resources while the eventual strengthening of aggregate demand may support the export engines of the developing and even developed countries.

Global trade exhibits moribund growth…

The global trade witnessed another troubled year in terms of growth (**Figure 1.5**). Worryingly, being the worst since 2010, the deceleration in trade growth was experienced simultaneously by the AEs and EMDEs. While the AEs principally contributed in global merchandise imports, supporting the export

[45] Between Jun 2014 and Dec 2016, the depletion of reserves is to the tune of USD 206.6 billion. (Source: Saudi Monetary Authority)
[46] Vision 2030 (http://vision2030.gov.sa/en)

[47] Against the bid amount of USD10 billion, the government received offers to the tune of USD67 billion of which it accepted a higher amount of 17.6 billion in 5, 10 and 30 year bonds offering yields of, respectively, 2.60 percent, 3.41 percent and 4.63 percent (Financial Times and Thomson Reuters).
[48] Financial Times. (2017). Kuwait closer to first sale of dollar debt. *January 17.*

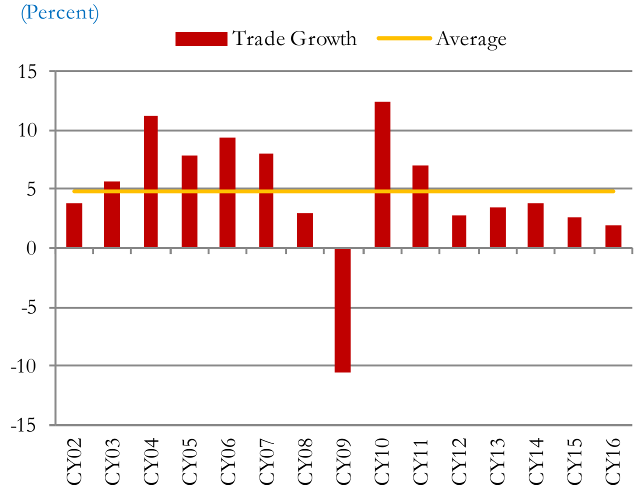
engines of EMDEs, however, low imports by EMs reflect weak investments on their part[49] (**Figure 1.6**).

Figure 1.5

Global trade growth remains muted

Global trade growth

(Percent)



Source: The World Bank

The reasons for such profoundly weak global trade growth in 2016 are many. A recent World Bank study finds that a one percent increase in economic policy uncertainty (EPU) in major AEs and some EMDEs lead to 0.02 percent reduction in trade volume of goods and services. By that count, three fourth of the slowdown in global trade in 2016 could be accounted for by EPU.[50]

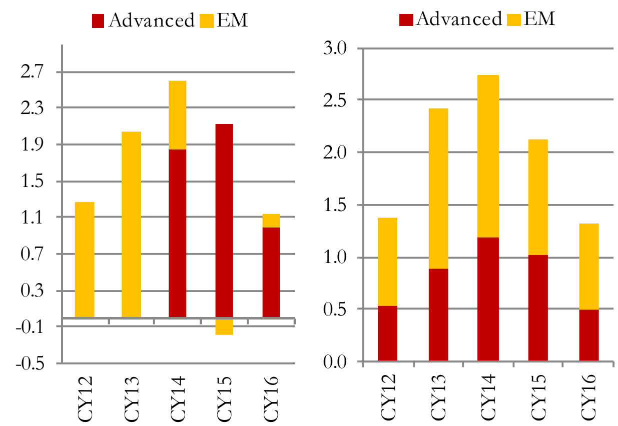
Besides policy uncertainty, maturing global value chains, slow global economic activity, slower pace of trade liberalization, downfall in commodity prices and the structural shifts in China could be some of the other factors that have contributed to the slowdown in world trade.

Figure 1.6

Low imports by EMs reflect weak investments

Contribution to Growth in Merchandise Trade (Volume Index)

(a) Imports (b) Exports



Source: CPB Netherlands Bureau of Economic Policy Analysis

It is worth noting that the trade policy uncertainty, which is a component of EPU, may have played some role in undermining global trade during 2016. However, average trade restrictive measures during 2016 appear in line with the past eight years' average.[51] Nonetheless, such policies do affect the trade dynamics and, given the rise of nationalist sentiments globally, the prospects for the already fragile growth of world trade are depressing. A growing policy uncertainty will lead firms to hold back on their investment and export decisions, which will further feed negatively into the real growth in both AEs and EMDEs, with adverse consequences for everyone involved.

49 World Bank. (2017). Global Economic Prospects. *Washington, January.*

50 The EPU increased by 30 percent between Nov. 2015 and Oct. 2016, which translates into a 0.6 percent (30*0.02) decline in trade due to EPU in 2016. The latest IMF estimates put the decline in global trade between 2015 and 2016 to 0.8 percent. Therefore, around 75 percent of YoY decline in trade is accounted for by EPU. (Global Trade Watch, 2016)

51 Constantinescue, C., Matto, A. and Ruta, M., 2017. Trade Developments in 2016: Policy uncertainty weighs on world trade. *Global Trade Watch*, Washington D. C., World Bank Group.

1.2 Domestic Developments

Domestic economy is gaining momentum…

The economy of Pakistan is on a higher real growth trajectory, increasing in size by 4.51 percent and 5.28 percent during FY16 and FY17, respectively, compared with 4.06 percent in FY15. The industrial activity is also rebounding, with large-scale manufacturing (LSM) recording a year-on-year growth of 7.04 percent in CY16 compared with last year's 1.99 percent. With a rebound in the commodity prices, the inflation has also bottomed out, but the end of year figure at 3.76 percent remains considerably lower than the official target of 6.0 percent (**Table 1.4**). The exchange rate has remained stable on the back of adequate forex reserves. Moreover, the outlook has been portrayed as *stable* by various international rating agencies.[52]

A number of other developments on the ground also point to an increasing aggregate demand, going forward. These include an enabling policy and operating environment; for example, decades-low interest rates, upsurge in credit uptake (especially for fixed investments), lower corporate taxes[53], government's commitment towards development spending (mainly infrastructure), availability of energy, improving law and order conditions, and an accelerated pace of progress on the projects under China-Pakistan Economic Corridor (CPEC). With impetus from these developments, the economy is poised to head towards a higher target growth of 6.0 percent in FY18.[54]

…amid rising headwinds…

Nonetheless, some domestic and global economic developments are likely to act as headwinds. For instance, an increasing trend of imports with stagnating exports implies higher trade deficit; the recent recovery of oil prices and the government's policy decision to import high quality (92 RON) petrol means even higher import bill; the deceleration of global trade and rising protectionist sentiments coupled with subdued economic activity in major markets like GCC, EU and Japan further bodes ill for the exports; the budgetary pressures and structural reforms in GCC countries may lead to lower remittances inflows for Pakistan.

Table 1.4

Pakistan: Key Economic Indicators

	CY13	CY14	CY15	CY16
	Percent			
Real Sector				
Real GDP Growth (on ***FY*** basis)	3.65	4.05	4.06	4.51
LSM Growth (YoY)	12.90	0.86	1.99	7.04
Inflation (12-month Average)	7.69	7.19	2.54	3.76
Banking Sector				
WALR	11.73	11.58	9.10	8.45
WADR	7.23	7.19	5.19	4.64
	USD billion			
External Sector				
SBP Reserves (End-of-Period)	4.7	11.9	17.2	19.5
Current Account Balance	(4.4)	(3.6)	(2.1)	(4.9)
Exports	25.1	24.8	22.7	21.7
Imports	41.2	42.7	39.3	41.6
Trade Balance	(16.1)	(17.9)	(16.6)	(19.8)
Remittances	14.6	17.2	19.2	19.7
PKR/USD Rate (Average)	101.5	101.0	102.7	104.7

Note: WALR and WADR (Outstanding, Excluding zero mark-up but including interbak)

Sources: Ministry of Finance, Pakistan Bureau of Statistics and State Bank of Pakistan

On the domestic front, the increase in inflation, though currently contained; the lower tax-to-GDP ratio and receding pace of government's revenue collection which implies widening fiscal deficit, and

52 The sovereign ratings by various international rating agencies are: Moody's, B3 (stable); S&P, B (stable); Fitch, B (stable).

53 Corporate tax rate has been reduced from 35 percent in FY13 to 32 percent in FY16.

54 Ministry of Finance. (2017). Economic Survey 2016-17.

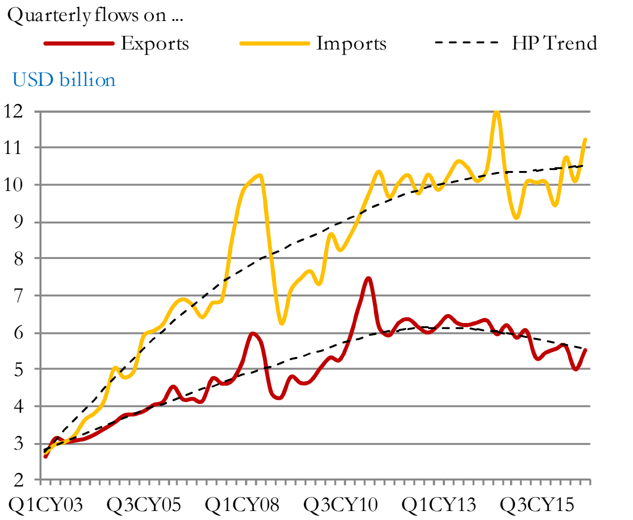
the public debt standing at 66.5 percent of GDP[55] present some challenges as well.

Rising machinery imports point to capital formation…

The imports are on a rising trajectory, ticking above the trend recently (**Figure 1.7**). However, the good news is that the bulk of the imports comprise of higher purchases of fuel and capital equipments, which implies capital formation and strengthening of economic activity going forward.[56] Specifically, the imports of power generation, electrical, textiles and construction related machinery and that of heavy vehicles (buses, trucks, etc.) are rising and will support the projects under CPEC (**Figure 1.8**). This is a welcome sign for the sustainable growth of industrial activity, which is already inching up.

Figure 1.7

Pakistan: The trend of exports and imports points to widening trade deficit

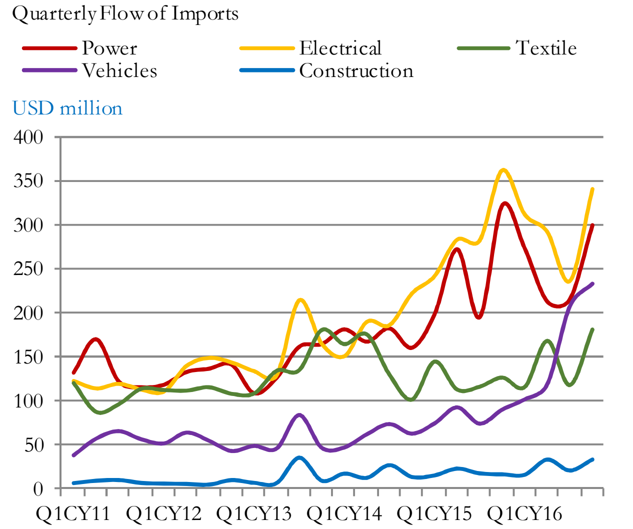


Source: State Bank of Pakistan

Moreover, the announcement of PKR 180 billion five-year package for the uplift of exports would benefit industry, particularly the textile sector, and may provide the needed support to reverse the trend of exports.

Figure 1.8

Pakistan: The uptick in imports of machinary and heavy vehicles is encouraging



Source: State Bank of Pakistan

…and easy monetary policy induces credit uptake

In the meantime, the monetary policy stance remained accommodative throughout the year 2016. Starting from November 2014, the policy rate was successively cut from 10 percent to the four-decade's low of 5.75 percent in May 2016. The easy policy stance became possible due to improving macroeconomic conditions, mainly the easing of inflationary pressures and comfort on external front with historic high reserves coupled with manageable trade and current account balances.

Resultantly, the domestic private sector availed a hefty PKR 645.86 billion of advances in CY16, growing by 13.16 percent over the past year (See **Figure 1.9**). The intake was broad-based as all major industrial sectors including Textile, Auto and transport, Cement and Energy utilized credit. Encouragingly, the private businesses kept strengthening their capital investments by resorting to fixed term loans (see also **Chapter 3**). With

[55] The Fiscal Responsibility and Debt Limitation Act (FRDLA) places a cap of 60 percent on public Debt-to-GDP ratio

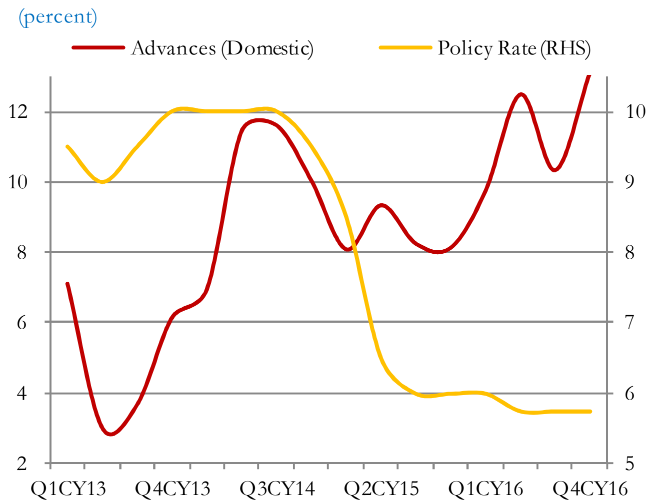
[56] State Bank of Pakistan. (2017). The State of Pakistan's Economy, Second Quarterly, FY17, Chapter 5. [henceforth SBP 2017]

CPEC related projects gaining traction and the demand conditions improving further, advances are expected to maintain their growth momentum.

Figure 1.9

Easy monetary policy spurs credit growth

Year-on-year growth of Advances (Domestic)



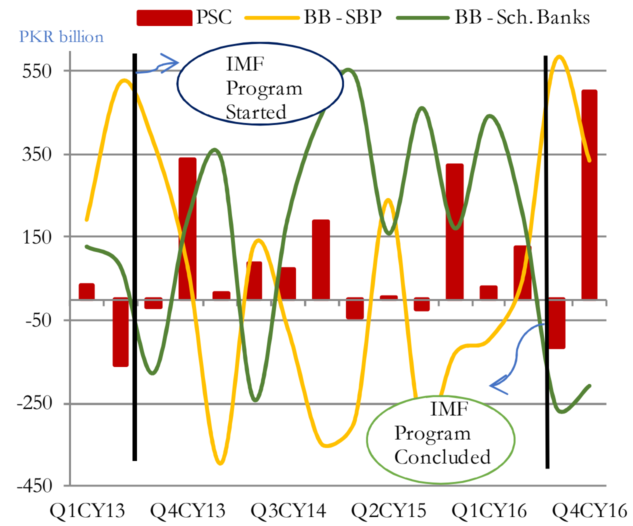
Source: SBP

The uptick of advances may get additional support from the shift in government's budgetary borrowing away from the banking sector to the central bank. As the reliance of Government on the banking sector reduces the funds available for the private sector,[57] a subsiding trend of government borrowing may help banks channel funds to the private sector (**Figure 1.10**).

A shift in asset mix of banks is already visible as shown in **Figure 1.11**. Investments (net) as a proportion of deposits are declining while the share of advances (net) is inching up. This implies that the banking sector is engaging more in its core business of lending.

Figure 1.10

Flows of Private Sector Credit (PSC) and government's Budgetary Borrowing (BB)

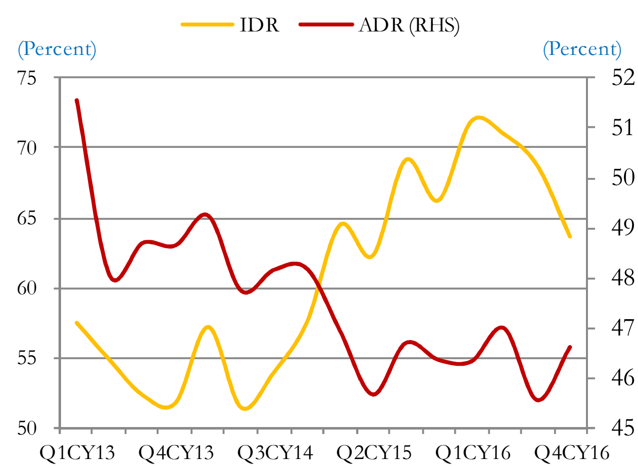


Source: Monetary Survey, SBP.

Figure 1.11

Asset mix of banks shifts from investments towards adavnces

Asset mix as a proportion of deposits



Source: SBP

However, the pace of revenue collection is receding[58] which might make the government tap funds from the banking system. As the central bank borrowing tends to be inflationary, an extended use of such a facility warrants caution. Given that the

[57] During CY16, the federal government borrowed PKR 1042 billion for budgetary support. Out of this, PKR 865 billion were raised from the Central Bank while PKR 177 billion were borrowed from scheduled banks (Source: SBP's Monetary Survey). Incidentally, the shift in borrowing pattern coincides with the completion of IMF's 3-year Extended Fund Facility (EFF) in September 2016.

[58] State Bank of Pakistan. (2017). The State of Pakistan's Economy, Second Quarterly, FY17, Chapter 4.

inflationary pressures are already building up in the economy, it poses a downside risk for the nascent growth of private sector credit.[59]

Funding base remains robust to challenges….

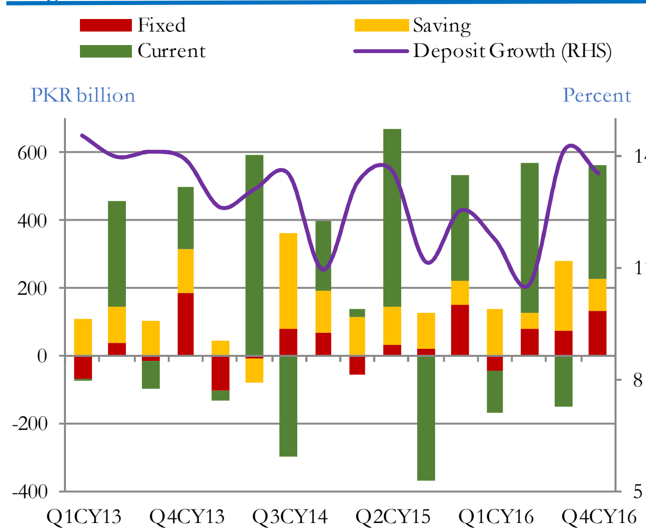
While easy monetary policy boosted the advances growth, low interest rates presented a challenge for the deposit mobilization. Also, the increase in withholding tax on cash withdrawals from banks exceeding PKR 50,000 since July 2015 has been another constraining factor for the supply of deposits. At the same time, tying of minimum return on savings deposits to 50 bps below the floor of policy rate has also had an impact on the spreads of the banking sector. Whereas the impact of each factor cannot be disentangled, the first two were particularly challenging.

After imposition of tax, the year-on-year growth of deposits has decelerated from 13.64 percent in June 2015 to 10.57 percent in June 2016, before recovering to 13.56 percent in December 2016. Simultaneously, the cash holding, proxied by currency-to-deposit ratio (CDR), has also gone up from 28.43 percent in December 2014 to 32.48 in December 2015 and further nudged to 33.86 percent in December 2016.[60] Given that the inflationary pressures remained subdued during this period, build-up of currency for transactional purposes can be less of a motive.

The recovery of deposits in CY16 coincides with the multiplier effect of credit growth and can be discerned from healthy flows in the category of current deposits, majority of which belongs to private businesses. The savings segment, which is mostly deposits of personnel, witnessed lower but continuous inflows. However, higher flows into current deposits, which are pre-dominantly non-remunerative, may also reflect conscious efforts on part of the banks to mobilize low cost deposits in order to maintain their spreads (See **Figure 1.12**).

Figure 1.12

Deposit growth picks up with current deposits witnessing higher inflows



Source: State Bank of Pakistan

The upturn in deposit growth is a welcome sign and will support the anticipated growth in loans and advances. Besides, the decline and subsequent reversal of deposits also indicates that the banking system remains the preferred avenue for the customer savings despite costs. As shown in **Figure 1.13**, with the decline in benchmark rate, the year-on-year growth of NSS flows has sharply decelerated while the deposits have maintained their growth momentum.

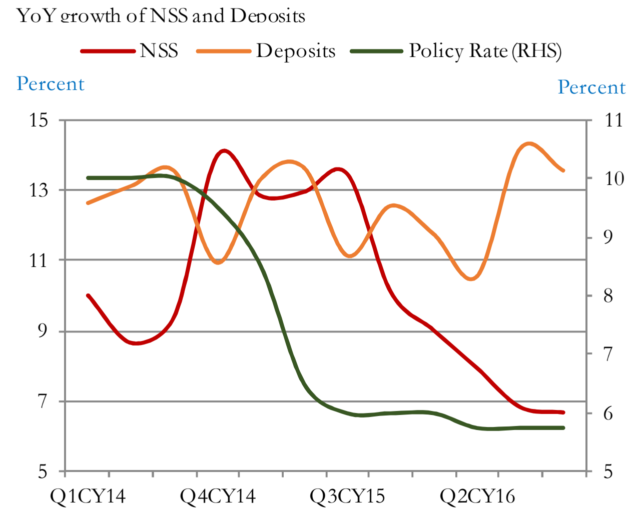
… and the banking sector remains resilient

The risk weighted CAR at 16.2 percent in CY16 remains substantially higher than the regulatory benchmark of 10.65 percent and international requirement of 9.25 percent. Banking sector has also earned reasonable profits, however, due to higher growth in assets and low interest rate environment, the before-tax return on assets (ROA) has declined to 2.10 percent in CY16 from 2.51 percent in CY15.

[59] Ahmed, J. (2016). Credit Conditions in Pakistan: Supply Constraints or Demand Deficiencies? *The Developing Economies,* 54(2), 139-61.
[60] State Bank of Pakistan, Monetary Survey, December 2016.

Figure 1.13

Banking sector remains preferred avenue for placement of savings



Source: State Bank of Pakistan

Nevertheless, the sector needs to be watchful given: the moderation in profitability; anticipated increase in regulatory capital requirements; and an uptick in advances, which may lead to increase in credit risk weighted assets.

Financial markets also remain stable and upbeat...

The other components of financial sector, especially the exchange, money and equity markets, have generally remained stable. For instance, the volatility in exchange market stayed contained, with PKR parity against major currencies remaining stable. However, the premium between Rupee's parity with US dollar in the interbank and Kerb markets widened lately, reflecting some speculative sentiments which can be attributed to a host of factors including appreciation of USD before and after the second dose of rate hike by the FED, growing current account deficit, decelerating remittances and net outflows of equity investments. The trend is, however, reversing and the gap has reduced (**see Chapter 2**).

In money market as well, due to existence of interest rate corridor and the commitment of the central bank to stabilize overnight rate around the policy rate has largely brought stability. Except for occasional off-shoots, the volatility in the market remained subdued. Given that the State Bank stands ready to intervene in the event of any probable liquidity disruptions, the market does not pose any immediate risk to the stability of the financial system.

Bulls ride the stock market but equities witnessed outflows

There were equity outflow in Foreign Portfolio Investments (FPI) despite the fact that during CY16, domestic stock market continued its bullish trend and staggering performance, fetching stellar returns of 45.7 percent during the period (**Figure 1.15**). At the same time, from June 2017, the PSX would be shifted from MSCI's Frontier Market Index (FMI) to Emerging Market Index (EMI).

That would signal confidence of international institutions and is expected to boost FPI in Pakistan. However, as pointed out in SBP's second quarterly report of FY17, the reclassification may entail some portfolio outflows as the funds tracking the FMI could rebalance. Nonetheless, positive or stable outlook reflected in the sovereign ratings by international agencies is a confidence booster for the investors. Moreover, besides rating upgrade, the upward real growth trajectory—implying better corporate performance—suggests that the FPI inflows would outweigh the outflows resulting from portfolio rebalancing, and may further strengthen if the general bullish sentiments continue.

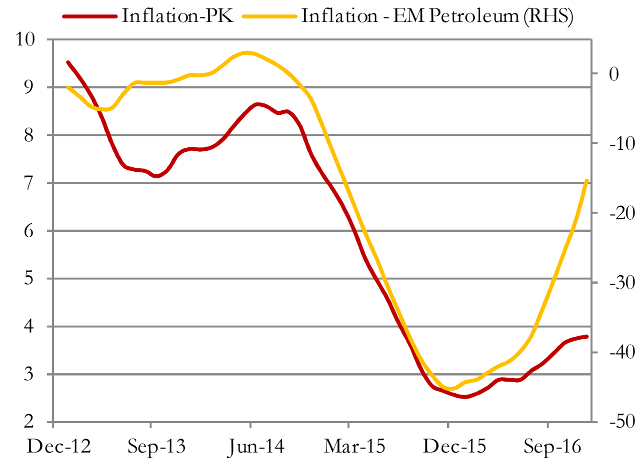
Some macro-financial risks are building up: inflation heading up …

After a slump that started in mid-2014, the commodity prices have rebounded. With recovery of demand for commodities in China and OPEC's decision to cut oil production, the World Bank's energy price index has bottomed out. The domestic prices are also following the pattern and the price levels are heading up (**Figure 1.14**).

Figure 1.14

With petroleum prices, the domestic prices bottomed out as well

Year-on-year 12-month moving average growth of Petroleum (EM) and Consumer Price Indexes (PK)



Source: The World Bank and Pakistan Bureau of Statistics

Besides global factors, the strengthening domestic demand, some disruptions in the supplies of certain food items due to dry weather in CY16, recovery in prices of some edible commodities (rice, sugar, cooking oil etc.) and imposition of taxes on some items in the budget of FY17 led to generally higher price levels.[61] With strengthening of aggregate demand and recovery of energy prices, the pass-through to domestic prices is expected and the trajectory of the inflation is likely to remain upward sloping.

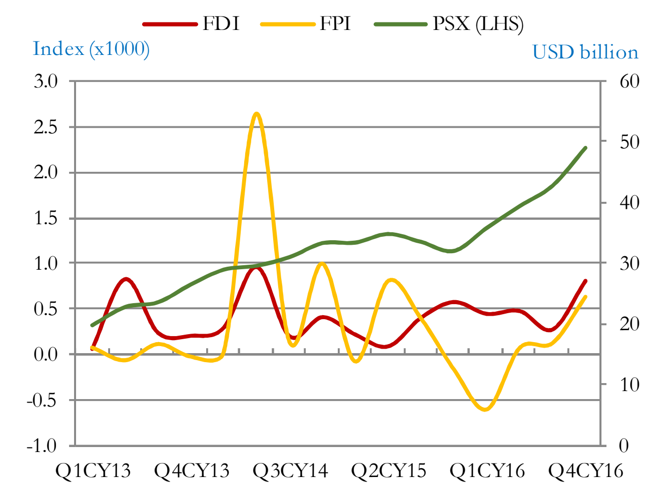
…external account is under pressure…

The current account balance is widening. Risks are stemming from rising imports, stagnant exports, gradually declining official reserves, decelerating remittances and monetary policy normalization in the US. While the foreign direct and portfolio investments (respectively, the FDI and FPI) witnessed upswing lately; the FPI flows were mainly driven by public sector's debt inflows. The equity investments, however, witnessed net outflows, mainly driven by monetary policy normalization of the US. Besides, the bulls on the US equity markets in the wake of US presidential elections in November 2016 also sparked outflows from EMs (**Figure 1.15**). These developments might pose challenges for the external account management.

Figure 1.15

Pakistan: Bulls ride the stock market while FDI and FPI flows recover

PSX Index and Quarterly Flows on FDI and FPI



Source: Bloomberg and State Bank of Pakistan

…fiscal balance may slip…

Although fiscal deficit has decreased to 4.6 percent in FY16 from 5.3 percent in FY15, higher expected development expenditures and possible deceleration in revenues could lead to more budgetary borrowings and rising interest expense. Therefore, to keep fiscal balance in check some additional revenue generation measures may be needed.

…but banking sector is expected to remain stable

[61] State Bank of Pakistan. (2017). The State of Pakistan's Economy, Second Quarterly, FY17, Chapter 3.

Despite these rising macrofinancial risks, banking sector, with improving asset quality and ample liquidity, is expected to perform steadily. In fact, under stress tests, in the *baseline scenario* that assumes normal business conditions, banking sector's soundness more or less remains the same or even improves in the coming three years. However, in extremely adverse scenario (*hypothetical*) banks' earnings and, therefore, resilience could come under pressure (**See Chapter 4**).