1 Global and Domestic Macro-financial Environment

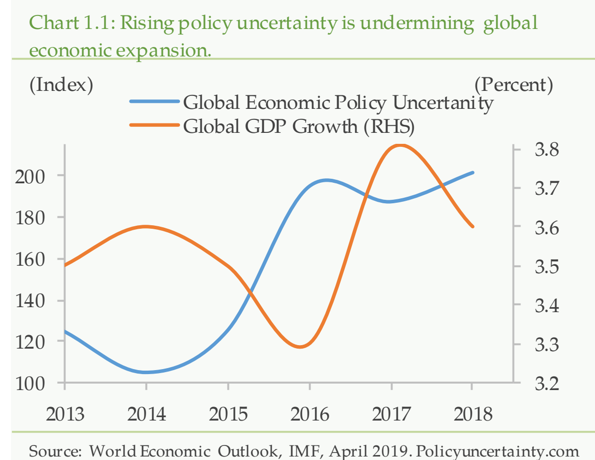
The global economic cycle has trended downwards during 2018 amid rising trade tensions and tightening financial conditions. Short-term risks to global financial stability have risen modestly, while the medium-term risks remain elevated. Financial vulnerabilities in the global financial system continue to build-up in the form of elevated leverage and stretched asset prices. Likewise, the domestic economy has decelerated owing to rising twin deficits, elevated inflationary pressures and the stabilization measures taken to contain the macroeconomic imbalances. A combination of monetary tightening and fading economic activity may undermine the repayment capacity of the borrowers. The pace of economic expansion is expected to remain weak in the short-term.

Global Developments

Pace of global economic expansion has moderated during 2018…

In 2018, the global growth momentum has softened to 3.60 percent after peaking at 3.80 percent in 2017. Increased policy uncertainty—driven by trade tensions—and tighter financial conditions, particularly in the emerging markets and developing economies (EMDEs), have primarily undermined the pace of global expansion **(Chart 1.1)**.[58]

Chart 1.1: Rising policy uncertainty is undermining global economic expansion.



Source: World Economic Outlook, IMF, April 2019. Policyuncertainty.com

Among the advanced economies (AEs), weak economic activity in the euro area, United Kingdom and Japan along with rising vulnerabilities in certain EMDEs (i.e. Turkey and Argentina) have resisted the world economy to maintain its growth momentum.

Contrary to the global economic slowdown, the growth in the US has accelerated (2.90 percent in 2018 versus 2.20 percent in 2017), which has helped moderate the global downturn. **(Table 1.1)**.

Table 1.1: Global economy: Real GDP growth (percent)

	2017	2018	2019*	2020*
World	3.80	3.60	3.30	3.60
Advanced Economies	2.40	2.20	1.80	1.70
EMDEs	4.80	4.50	4.40	4.80
EMDEs - Asia	6.60	6.40	6.30	6.30
MENAP	2.20	1.80	1.50	3.20
USA	2.20	2.90	2.30	1.90
Euro Area	2.40	1.80	1.30	1.50
U.K	1.80	1.40	1.20	1.40
Japan	1.90	0.80	1.00	0.50
Argentina	2.70	-2.50	-1.20	2.20
China	6.80	6.60	6.30	6.10
Turkey	7.40	2.60	-2.50	2.50
India	7.20	7.10	7.30	7.50
Russia	1.60	2.30	1.60	1.70
Saudi Arabia	-0.70	2.20	1.80	2.10
United Arab Emirates	0.80	1.70	2.80	3.30
Pakistan	5.22	5.53	2.90	2.80

*IMF-Projections
Source: World Economic Outlook, IMF, April 2019

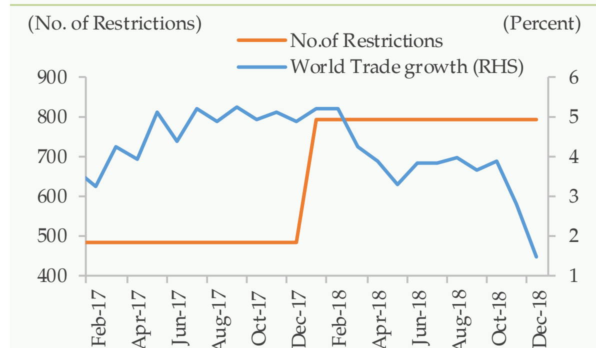
The mounting trade tensions have weakened the business confidence and resultantly global trade has observed weaker growth of 3.27 percent in 2018 against 4.68 percent in 2017 **(Chart 1.2)**.[59] The trade restrictions, in turn, are hindering the overall growth

[58] International Monetary Fund. (2019). World Economic Outlook. Washington, April.

[59] In the wake of trade restrictions imposed since the start of 2018, the import of goods in the US and Chinese economies has declined by about 12 percent and 6.5 percent, respectively. World Bank. (2019). Global Economic Prospects. Washington, January.

and investment.[60] The downward trend in global economy is, thus, likely to continue if the trade tensions among major economies, particularly, the US and China are not resolved.

Chart 1.2: Rising trade restrictions are weakening trade growth

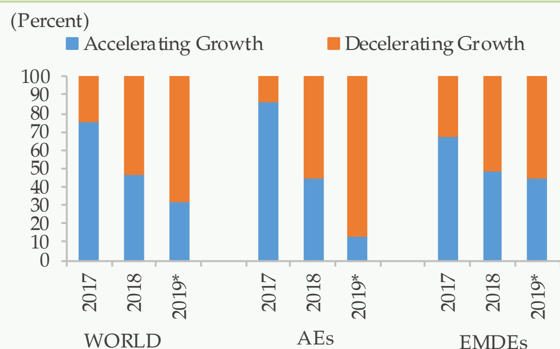


Source: CPB Netherlands Bureau for Policy Analysis and Global Trade Alert
Note: Number of trade restrictions represents annual data

…along with receding growth synchronization

Besides moderating, the global economic growth has remained less synchronized during 2018. In 2017, 58 percent of the world's economies (representing 75 percent of global GDP) had experienced upturn in growth. However, in the reviewed year, the expansion has been contained to 52 percent of the economies (representing 47 of global GDP), indicating a possible tilt of the business cycle towards a trough (Chart 1.3).[61]

Chart 1.3: Increasing share of economies (in global GDP) with weak economic expansion



Source: International Monetary Fund
*2019 IMF Forecast

A number of factors have constrained euro area growth…

Euro area has struggled to grow as it recorded 1.80 percent growth in 2018—down from 2.40 percent in the year 2017. The notable slowdown in the economic activity has come from: (i) waning consumer and business confidence, (ii) weak industrial output in Germany and France due to revision of auto emission standards and the street protests (yellow vests movement), respectively, (iii) fiscal policy uncertainty; and (iv) dent in the external demand for exports owing to appreciation of Euro.[62] Moreover, the growth outlook may further deteriorate to 1.30 percent in 2019, if the uncertainties arising from trade tensions and a no deal-Brexit continue.

EMDEs including China have followed slow growth trajectory…

The EMDEs have delivered 4.50 percent growth in the year 2018—down from 4.80 percent achieved in the previous year. Corrective policy measures in response to growing idiosyncratic vulnerabilities (i.e. macroeconomic imbalances, external leverage etc.), coupled with capital outflows in the backdrop of rise

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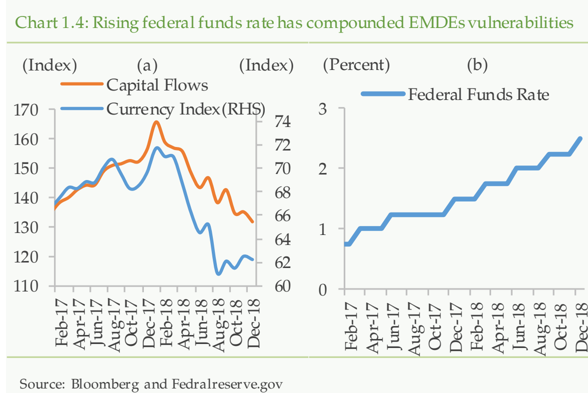
[60] Organization for Economic Co-operation and Development (2019). Interim Economic Outlook. France, March.

[61] International Monetary Fund. (2018). World Economic Outlook. Washington, October.

[62] International Monetary Fund. (2019). World Economic Outlook. Washington, April.
World Bank. (2019). Global Economic Prospects. Washington, January.

in federal funds rate and escalating trade tensions, have constrained their economic activity and triggered risk aversion (**Chart 1.4**). [63,64] However, jittery sentiments in such markets have not spread to other EMDEs because the country-specific factors seem to be instrumental in investors' decisions.[65]

Chart 1.4: Rising federal funds rate has compounded EMDEs vulnerabilities



Source: Bloomberg and Fedralreserve.gov

Among the EMDEs, Chinese economy has slightly moderated to 6.60 percent in 2018 as compared to 6.80 percent in the previous year. This deceleration has largely resulted from regulatory measures taken during 2017 to limit high indebtedness[66], partly brought about by growing shadow banking intermediation, and softening of export demand due to on-going trade conflict with the US.

Anticipating further deceleration in economic activity, the People's Bank of China has provided liquidity support and reduced reserve requirements in early 2019. Moreover, there has been targeted fiscal policy loosening as well.[67]

The uncertainties surrounding trade tensions with the US are likely to critically determine future economic course of the Chinese economy. Unless the aforementioned dynamics play out positively,[68] the growth is expected to further moderate to 6.18 percent in CY19.

While GCC economies have performed well…

The pattern of economic activity in the Gulf Cooperation Council (GCC) economies is tied to the oil price dynamics. In 2017, as the oil prices dropped so did their growth (0.40 percent). With increase in oil prices, GCC economies are expected to bounce back with 2.40 percent growth in 2018 (**Table 1.2**). The economic recovery has allowed some fiscal space to UAE, Qatar and Kuwait to invest in public projects.

Table 1.2: Gulf Cooperation Council (GCC) macroeconomic performance

	2016	2017	2018*	2019*
GDP (Annual change, percent)	2.9	0.4	2.4	3.0
Current Account Balance (Percent of GDP)	-5.6	-0.2	4.3	5.2
Fiscal Balance (Percent of GDP)	-10.4	-5.5	0.0	2.5
Average Oil Price (US$ per barrel)**	42	54	70.5	60
CPI (year avg - percent)	2.3	1.0	2.5	3.1

Source: Regional Economic Outlook, Middle East and Central Asia, IMF (Nov-2018); Bloomberg and calculations

*Projections

**Oil prices represent the Average price of UK Brent, Dubai Fateh and West Texas intermediate crude Oil, Oil prices for 2018 is actual data and Oil prices for 2019 is IMF Projections

The growth outlook though encouraging, remains uncertain as it is mainly contingent upon the future path of oil prices. Rising trade concerns, geo-political tensions in the gulf region, as well as global growth slowdown could dampen the demand for oil. This may jeopardize GCC economies growth prospects.

…and so has the US economy…

The US economy—given its considerable weight in the global output—has uniquely performed by

[63] Yield on EMDEs sovereign bonds has risen by 140 bps in 2018.

[64] International Monetary Fund. (2019). World Economic Outlook. Washington, April.

[65] IMF. (2018). Global Financial Stability Report. Washington, October.

[66] Debt levels have reached to its historically highest level of USD 34 trillion (over 253.40 percent of GDP) as of Q1CY18, compared to USD 6 trillion (145.80 percent of GDP) in Q1CY08 (Source: BIS. https://stats.bis.org/statx/srs/table/f1.2)

[67] Reserve Bank of Australia. (2018). Financial Stability Review. October.

[68] For example, the positive market expectation surrounding the trade talks between China and the US.

growing at 2.90 percent in 2018, higher than 2.20 percent observed in the previous year. The continued growth momentum—despite Fed's monetary tightening during 2018—is due to strong labor market conditions and robust consumption spending.

In the near term, nonetheless, the restrictions on bilateral trade may dent exports and investments. Therefore, the economic activity is expected to slow down to 2.30 percent in 2019.[69] The growth momentum may further stall as the fiscal expansion fades down. More recently, the term-premium[70] in the US has dipped into negative territory indicating increased risk perceptions of the investors about US growth outlook (Chart 1.5).

Chart 1.5: Term premium has dipped into a negative territory

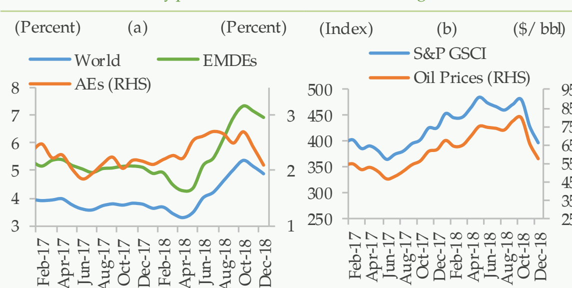
Source: Federal Reserve Bank of St. Louis

Note: Term premium is difference between 10 Year US treasury constant maturity and 3 month treasury constant maturity

Inflationary concerns, due to softening global growth, remains benign…

Globally, inflationary pressures have remained moderate during CY18 **(Chart 1.6a)**. In AEs, inflation has hovered around 2.0 percent level during 2018—up from 1.70 percent in CY17.[71] In EMDEs, it has inched-up to 4.80 percent compared to 4.30 percent in 2017. Marginal uptick in the headline inflation is due to rising oil prices[72] **(Chart 1.6b)** and the pass through impact of currency depreciation in EMDEs. It is important to note that the core inflation across AEs and EMDEs has remained subdued reflecting softening of economic momentum.

Chart 1.6: Inflationary pressures remain moderate during CY18



Source: Haver Analytics, IMF; Bloomberg.

Note. Standard and Poor Goldman Sachs Commodity Index (S&P GSCI)

Risks to global financial stability have somewhat risen…

Near-term risks to global financial stability have risen modestly during CY18 amid tightening in financial conditions. Short-term risks to global financial stability could sharply elevate in response to sudden tightening of financial conditions,

[69] World Bank. (2019). Global Economic Prospects. Washington, January.

[70] Kopp, E. & Williams, P. D. (2018). A Macroeconomic Approach to Term Premium, Working Paper No. 18/140, International Monetary Fund.

[71] According to OECD database: Consumer price indices (CPIs) of OECD reached to 3.1 percent level in October 2018 and sharply reversed back to 2.1 in January 2019- on the back of lower energy prices.

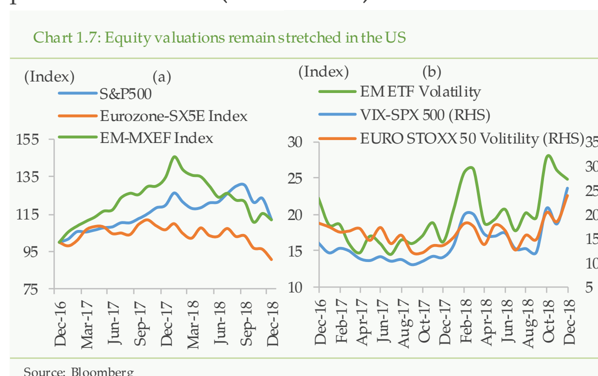
[72] In October 2018, average oil price jumped to USD 80 per barrel, achieving its peak since November 2014. The prices increased due to supply side factors, including a decrease in supply from Iran following the US sanctions and a fall in Venezuela's production. However, in recent months, oil prices have declined sharply and have settled around USD 58 a barrel. The decision by Organization of Petroleum Exporting Countries (OPEC) and Non-OPEC exporters not to cut production and the waiver given by the US from sanctions to eight countries to continue importing Iranian oil has led to this development.

unexpected growth slowdown, further increase in trade tensions, and geopolitical risks.

…and the financial vulnerabilities continue to build-up

A prolonged period of easy financial conditions has been feeding vulnerabilities into the global financial system; hence, the medium-term risks to global financial stability remain elevated. The stretched equity valuations in the US along with lower volatility[73] , amid accommodative monetary policy, represent vulnerabilities in the form of possible asset price corrections.[74] **(Chart 1.7a-b)**

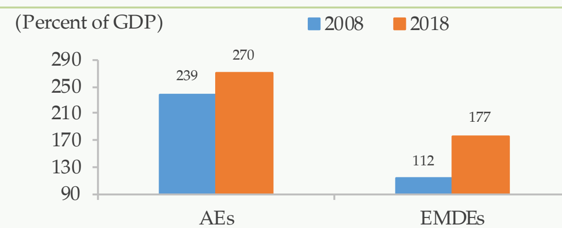
Chart 1.7: Equity valuations remain stretched in the US



Source: Bloomberg

Besides, low interest rates in AEs are triggering leverage. Total non-financial sector debt stands at USD 183 trillion (217.80 percent of world GDP)—up from USD 119 trillion (178.90 percent of world GDP) a decade earlier.[75] Most of the global debt pertains to AEs (69.41 percent share in the global debt). However, EMDEs have increased accumulation of the global non-financial debt as a percentage of GDP during the last decade **(Chart 1.8)**.

Chart 1.8: Global non-financial sector debt has risen mostly in EMDEs



Source: Bank for International Settlements
AEs comprise Australia, Canada, Denmark, the euro area, Japan, New Zealand, Norway, Sweden, Switzerland, the United Kingdom and the United States
EMDEs comprise Argentina, Brazil, Chile, China, Colombia, the Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

It deserves emphasis that in AEs, financial risk taking has increased and resultantly the stock of lower-rated investment grade bonds (BBB) has quadrupled since the global financial crisis.[76] A reversal in financial conditions or negative growth shock could hamper repayment capacity of the weaker firms and may trigger defaults.

EMDEs near-term outlook is less than encouraging…

The growth in EMDEs is likely to dip to 4.4 percent in the year 2019—slightly down from 4.5 percent in 2018. Slowing pace of economic activity reflects the impact of deceleration in China's growth, recession in Turkey, the lagged impact of weaker activity in 2018, and downturn in Iran.

Moreover, the interplay between the idiosyncratic challenges and the external environment marked by softening growth momentum in AEs and elevated trade concerns would continue to determine the near-term prospects for the EMDEs.[77]

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[73] In 2018, escalating trade tensions, concerns about possible rise in inflation due to strong wage growth in the US and hike in federal funds rate resulted in bouts of volatility across the globe in the early (February and March) and later (October to December) part of the year.

[74] Standard valuation metrics suggest that equity prices in the USA are hovering at levels significantly above its historical norm. (Source: ECB. (2018) Financial Stability Review. November)

[75] Source: BIS Database (About two-third of the total debt is held by private sector and the rest is public debt)

[76] For instance, the average exposure of European insurers to BBB-rated corporate and sovereign bonds increased from about 5 percent to more than 20 percent from 2008 to 2017 (Source: Global Financial Stability Report (April-2019).

[77] International Monetary Fund. (2019). World Economic Outlook. Washington, April.

Domestic Developments

After robust economic expansion during FY18, economic prospects are fading…

The domestic economy has managed to grow by 5.53 percent during FY18—up from the 5.22 percent in FY17. The momentum was backed by robust consumption and relatively low inflationary environment.[78] However, in FY19, economic prospects are fading[79] amid rising twin deficits, elevated inflationary pressures, and corrective policy measures taken by the authorities to rein in macroeconomic imbalances **(Table 1.3)**

Table 1.3: Key economic indicators of Pakistan

	FY16	FY17	H1FY18	FY18	H1 FY19
Real Sector			(Percent)		
Real GDP Growth	4.56	5.22		5.53	
LSM Growth (YoY)	2.98	5.64	6.58	5.12	(1.82)
Inflation (YoY Average)	2.86	4.16	3.75	3.92	6.05
External Sector			(USD Billion)		
Trade Balance	(19.3)	(26.7)	(15.2)	(31.8)	(16.0)
Exports (Goods)	22.0	22.0	11.8	24.8	11.9
Imports (Goods)	41.3	48.7	27.0	56.6	27.8
Remittances	19.9	19.4	9.9	19.9	11.0
Current Account Balance	(4.9)	(12.6)	(9.0)	(19.9)	(8.3)
SBP Reserves (End-of-Period)	18.1	16.1	14.1	9.8	7.2
PKR/USD Rate (Year Average)	104.4	104.8	106.0	110.0	129.7
Fiscal Sector			(Percent)		
Fiscal Deficit (as % of GDP)	(4.56)	(5.85)	(2.22)	(6.57)	(2.68)
Revenue Growth (YoY)	13.12	11.01	19.80	5.90	(2.39)
Expenditure Growth (YoY)	7.58	17.33	14.03	10.12	5.53
Monetary Sector			(Percent & PKR Trillion)		
Credit to Private Sector (YoY Growth)	11.15	16.81	14.21	14.92	19.10
Government Budgetary Borrowing	7.2	8.3	8.6	9.4	10.0
Borrowing from SBP	1.4	2.4	2.3	3.6	4.9
Borrowing from Schedule Banks	5.8	5.9	6.2	5.8	5.2

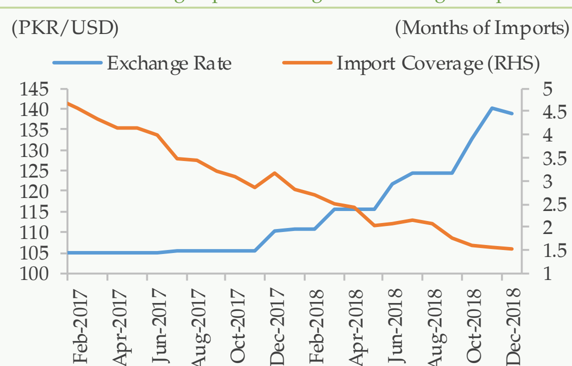
Source: Ministry of Finance, PBS and SBP

External account pressures remain instrumental risk to the growth…

In FY18, current account deficit has been 57.65 percent higher than FY17. Resultantly—absent matching inflows—SBP forex reserves declined by USD 6.4 billion to reach USD 9.8 billion by Jun-2018.

The external account vulnerabilities have continued into H1-FY19, despite marginal improvement in current account deficit. Though pickup in worker's remittances has provided some support, surge in trade deficit has overshadowed this improvement. Particularly, increase in international oil prices has led to rise in dollar value of imported petroleum products and overall imports. This coupled with a meager increase in exports has further worsened the trade deficit and curtailed the improvement in current account deficit **(Table 1.3)**.[80] Consequently, SBP's forex reserves have further declined to USD 7 billion by end Dec-2018; weakening the capacity to finance imports and leading to depreciation of domestic currency **(Chart 1.9)**.

Chart 1.9: Shrinking import coverage and exchange rate pressure



Source: State Bank of Pakistan

[78] In FY18 consumption expenditure have increased by 7.23 percent

[79] Large Scale Manufacturing (LSM) growth has turned negative to 1.82 percent during H1FY19 against 6.58 percent expansion in H1FY18.

[80] State of Pakistan's Economy – Second Quarterly Report 2018-19

…and more so the fiscal imbalance…

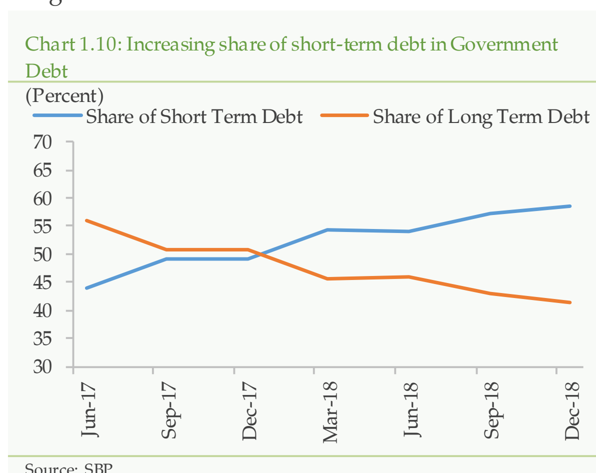
During FY18 the fiscal deficit widened to 6.57 percent from 5.85 percent in FY17. The upswing in deficit has sustained in H1FY19 despite cut in developmental spending. This increase has come from significant rise in overall expenditures and contraction in revenue collection. Resultantly, the revenue expenditure gap has widened leading to higher fiscal deficit in the first half of the current fiscal year.

Consequently, debt accumulates…

The widening twin deficits have been financed through increased borrowing from both the domestic and external sources. As of end CY18, Pakistan's gross public debt has reached to PKR 27 trillion (equivalent to 71.21 percent of GDP).

The domestic government debt has risen by 6.82 percent during H1FY19—up from 3.96 percent in H1FY18. The dynamics of domestic debt reveal that the debt structure has tilted towards short-term maturity **(Chart 1.10)**.[81] This concentration of debt at the lower end of the maturity spectrum has exposed the government to rollover risk.

Chart 1.10: Increasing share of short-term debt in Government Debt



Source: SBP

Besides, the government has heavily relied on bilateral and commercial loans leading to higher accumulation of external debt during H1FY19.[82] If the external account vulnerabilities persist, the foreign debt is likely to accumulate to bridge the financing gap leading to weakening in repayment capacity.

Besides twin deficits, growing inflationary pressures remain a concern….

Inflation began to rise since late FY18—largely due to demand pressures—and increased further during H1FY19. Average headline inflation has risen to 6.05 percent in H1FY19—up from 3.75 percent in the comparable period of the previous year. More importantly, core inflation (non-food non-energy) has increased to 8.0 percent in H1FY19 against 5.5 percent in H1FY18.

While demand pressures eased during H1FY19, rising price level is driven by a number of factors encompassing; (1) PKR depreciation (2) pass through of higher international oil prices to domestic consumers (3) upward adjustment in gas and electricity tariffs (4) higher regulatory duties on imports; and (5) increase in government borrowing from SBP.[83]

The Corrective policy measures are likely to contain domestic demand…

Notable adjustment in the exchange rate (cumulative depreciation of 23.61 percent in PKR), monetary tightening (425 bps rise in policy rate), cut in PSDP

[81] In rising interest rate scenario, banks have been reluctant to invest in long-term PIBs due to anticipated revaluation losses. Therefore, banks demanded higher return on long-term investments and kept their interest in TBills.

[82] Government's external debt has increased by USD 1.4 billion during H1FY19 reaching to USD 66 billion by the end of Dec-2018.

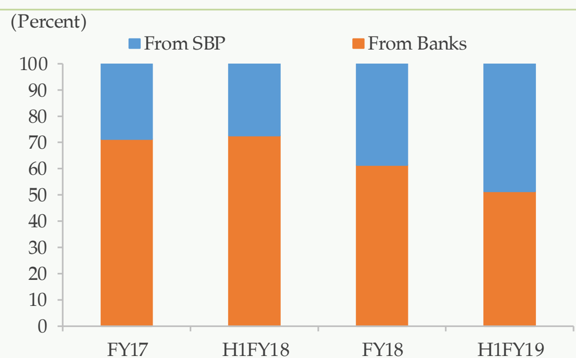
[83] Monetary Policy Statement during H1FY19.

expenditures[84], and increased regulatory duties[85] on imports during CY18, indicate a combination of policy measures taken to address the rising macroeconomic vulnerabilities. The stabilization measures have had an impact on economic activity but their full translation into moderation in aggregate demand may take some more time.

Despite monetary tightening, lending rates have been slow to respond…

In CY18, the rise of 268 bps in weighted average lending rates (**WALR**) despite 425 bps increase in policy rates indicate availability of ample liquidity with the banks. The shifting pattern of the government budgetary borrowing from banks[86] to SBP has improved banks' liquidity which led lower increase in WALR **(Chart 1.11)**.

Chart 1.11: Budgetary borrowing from the banking system as a percentage of total budgetary borrowing



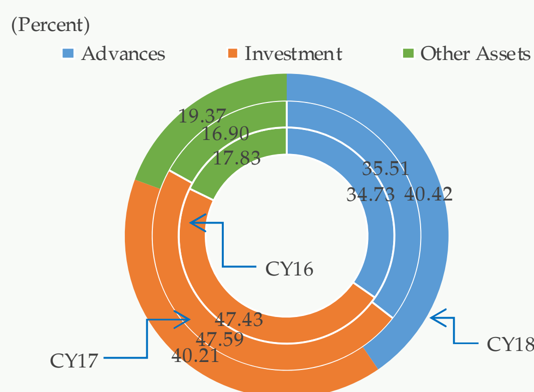
Source: SBP

…and the private sector advances have continued to surge

In the wake of ample liquidity, the banking sector has increased its lending to the private sector. The domestic private sector advances have surged by 20.03 percent (YoY) during CY18 as compared to 16.40 percent in the previous year. The robust increase in advances has resulted from higher working capital needs. However, fixed investment advances have decelerated to 8.25 percent during CY18 down from 14.97 percent in CY17. Moreover, the growth in private sector advances has been broad-based as textile, energy, chemicals, cement sectors along with individuals have availed advances **(See Chapter 3.1)**.

Resultantly, the advances share—in total assets—has risen to 40.42 percent in CY18 against 35.51 percent in CY17, while banking sector exposure to the government securities has declined **(Chart 1.12)**.

Chart 1.12: Asset mix of the banking sector



Source: SBP

A combination of higher interest rates and lower economic activity may undermine the repayment capacity…

The asset quality of the banking sector may come under stress due to continued monetary tightening and receding economic activity. With higher interest rates, re-pricing of existing loans could increase the financial costs for the borrowers. This may weigh on repayment capacity and earnings of the corporates, while hurting the profitability of the banks due to higher provisioning expense **(See Chapter 3.1 and 5)**.

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[84] PSDP expenditures during H1FY19 have declined by 36.86 percent.

[85] State of Pakistan's Economy – Second Quarterly Report 2018-19

[86] On net basis the government retired PKR 1073 billion to the banking sector.

The domestic economy is likely to follow slow growth trajectory in the short-term…

The much needed stabilization measures are expected to further rein in aggregate demand and higher inflation. The resultant slackness in economic activity would help abate the intensity of macroeconomic imbalances in the external and fiscal sectors. Reaching an adequate level of forex reserves seems to be the upfront challenge for favorable investor sentiments and lower risk perceptions.