1 Economic Review

1.1 Overview

The economy experienced marked adjustments during FY19. The exchange rate was realigned with the market fundamentals; interest rates were sharply increased; public sector development expenditure was significantly curtailed; and energy prices were raised. These measures were taken to manage the twin deficit crisis, caused by the consumption-led growth of the past few years. The policy actions helped contain demand pressures and contributed to import compression, which led to a significant reduction in the current account deficit. However, in the process large-scale manufacturing contracted and inflation rose above its target after four years. Meanwhile, high input costs combined with water shortages undermined agriculture sector's output and the drag in the commodity-producing segments spilled over to the services sector as well. These developments impacted real rural incomes and urban wages, thus constricting the household budgets and ultimately savings and consumption. Resultantly, the real GDP growth fell to its lowest in the past nine years (**Table 1.1**).

To put the developments of FY19 into perspective, early warning signs of an impending correction had begun with large twin deficits by the close of FY18. As a result, SBP had begun proactively tightening of monetary policy as early as January 2018. However, the central bank's efforts were diluted to some extent, since a corresponding fiscal consolidation did not materialize.

Table 1.1: Selected Macroeconomic Indicators

	FY16	FY17	FY18[R]	FY19	
				Target	Actual[P]
percent growth					
Real GDP[1]	4.6	5.2	5.5	6.2	3.3
Agriculture	0.2	2.2	3.9	3.8	0.8
Industry	5.7	4.6	4.9	7.6	1.4
Services	5.7	6.5	6.2	6.5	4.7
Private sector credit[2]	11.2	16.8	14.9	-	11.6
CPI inflation[1]	2.9	4.2	3.9	6.0	7.3
percent of GDP					
Current a/c balance[2]	-1.7	-4.1	-6.3	-4.0	-4.8
Fiscal balance[3]	-4.6	-5.8	-6.6	-4.9	-8.9
Gross public debt[3]	67.7	67.0	72.1	68.0	84.8

P: Provisional; R: Revised

Data sources: [1] Pakistan Bureau of Statistics; [2] SBP; [3] Ministry of Finance

At the start of FY19, addressing the twin deficits and the precarious level of foreign exchange reserves was among the top priorities of the government. However, it initially opted for a homegrown stabilization program, rather than an IMF sponsored arrangement. On top of raising interest rates, this involved letting the value of Pak rupee to be aligned with macroeconomic fundamentals and undertaking several regulatory measures to contain imports. The strategy delivered positive results with a prominent decline in imports. This, along with a healthy growth in workers' remittances, led to a significant improvement in the current account deficit in FY19.

Despite this improvement, the overall reserve position remained challenging as plugging the current account deficit and financing external obligations became increasingly difficult. As the year progressed, it became obvious that such bilateral inflows could only serve as a complement – not a substitute – for an IMF program. Beyond direct BoP support, being under the umbrella of an IMF program gives comfort to other IFIs and helps the government in its efforts to attract foreign investors and raise funds from the international capital markets. Ultimately, the government reached an agreement with the IMF in May 2019.

In terms of fiscal imbalances, the new government announced partial reversal of tax reliefs and implemented PSDP cuts. By the end of the year, however, these measures proved insufficient as the tax revenue collection for the year fell well short of the target. Tax collection effort was also underscored by the fact that revenues could not even keep pace with nominal GDP growth during the year. Moreover, weak collection from sectors which typically contribute the bulk of revenue mobilization and over-reliance on non-tax revenues exposed high degree of dependency on just a handful of revenue spinners. Meanwhile, in order to close the revenue-expenditure gap throughout the year, the government continued to borrow heavily from SBP, which in turn somewhat diluted the impact of contractionary monetary policy.

The expenditure side proved to be equally frail. Despite a sharp decline in development spending, growth in overall expenditure remained higher than last year. Not only interest payments increased substantially, the control on non-interest current spending also remained weak. The result was that the primary deficit deteriorated while the overall fiscal deficit reached a historic high. This also led to a much faster accumulation of public debt while deviating further from the limit under FRDLA. These dynamics remained one of the major challenges facing the government at the onset of FY20.

Besides the tangible factors behind the economic moderation, a sense of unease remained a persistent theme for most of the year, stirred up by a number of underlying factors. These included: speculations on the signing of the IMF program; anxiety over possible implications of FATF reviews; uncertainty regarding currency depreciation; and cross-border tensions with India. These developments deflated the confidence of businesses and consumers, unsettled the currency and equity markets, and in some cases inadvertently caused a flight towards greater informality.

Meanwhile, steady increase in headline inflation remained a constant source of concern throughout FY19. The inflationary impact of underlying demand pressures from FY18 were further compounded by the government's decision to increase the administered energy prices to contain the fiscal deficit. This further stoked the inflationary pressures through the energy and transport components of CPI; prices of non-food items also rose as the second round impact came into play. Moreover, pass through of Pak rupee depreciation, which mainly affected imported goods as well as goods with a heavy imported content, and a sharp increase in food prices during Q4-FY19 added to the buildup of inflationary momentum. While six successive increases in the policy rate during the fiscal year helped subdue the demand-pull pressure on prices towards the end of FY19, inflation continued to be high. In particular, slippage in food inflation remained quite prominent since it also exposed the lax administrative measures and lack of contingency plans in case of unanticipated shocks, such as damage to the domestic minor crops.

In addition, macroeconomic challenges raised some concerns with respect to banks' non-performing loans (NPLs), which increased sharply during FY19. On a yearly basis, gross NPLs posted a growth of 23.2 percent during the year, which is the highest growth observed since FY11. This occurred along with a 3.3 percentage point decline in the growth of private sector credit, as the fixed investment component more than halved, in response to moderation in the economy and due to several stabilization measures. Nonetheless, owing to high input prices, working capital requirements expanded more than the previous year.

In the big picture, though real GDP growth picked up during FY17 and FY18, the sharp downturn in FY19 highlighted the fact that the economic expansion in these years had not been based on a sustainable strategy and was susceptible to various stabilization measures, such as the cut in development expenditure. This has exposed the structural deficiencies faced by the economy yet again, requiring immediate policy attention. For example, a steadily rising tax to GDP ratio is imperative for fiscal sector sustainability. However, the ratio, after expanding for two consecutive years, considerably shrank to single digit in FY19. Even more alarming is the high level of fiscal deficit in spite of a substantial decline in the development expenditures during the year. All this, in effect highlights the fundamental structural deficiencies in Pakistan's taxation system, which can be traced to weaknesses stemming from a low tax base and ad hoc approaches to tax policies. Indeed, more concerted efforts are needed to improve the tax system; beyond the federal level, provinces should also aim at enhancing their own revenue base.

Another concern is that, although exports posted a substantial growth in terms of volume during FY19, the overall export receipts declined in terms of value. This decline is explained by a reduction in the unit values of the major exporting products, such as apparel, cotton fabric, basmati rice, and leather garments, which otherwise experienced growth in volume terms. It is worth mentioning that regional competitors were also affected by the fall in unit values of such exporting commodities. Meanwhile, the drop in exports of wheat and sugar was attributed to the muted export subsidies on these commodities from Q2 onwards.

Moreover, certain structural imbalances and gaps have been building up over time. Paramount among these is the increasing share of services in the GDP break-up, which are mostly non-tradable, and therefore do not add to the exports base. Meanwhile, the contribution of commodity-producing sectors is weakening. Thus, there is a need for more profound structural reforms aimed at: (a) reversing the decline in commodity-producing sectors by further increasing competitiveness of Pakistani goods in both domestic and international markets through gains at production level; (b) adapting to international trends through good degree of product and market diversification; and (c) facilitating a gradual shift towards exportable services. This will only be possible if there is a meaningful improvement in human capital and productivity. Specifically, the provision of quality education, health, and vocational training needs to receive top priority. Since these are the pivotal factors that would determine the sustainability of growth, efforts are required from both the public and the private sector.

This also involves improving the share of investments in GDP, which has historically remained low in Pakistan especially when compared with other high performing Asian economies. In this regard, a considerable amount of literature singles out the importance of macroeconomic stability and factors such as savings for increasing the share of investments in Pakistan. However, as seen even in times of stability, in not too distant past, Pakistan's share of investments in GDP has stagnated. Therefore, digging beyond the conventional line of thinking of low savings, shallow financial markets, high dependency ratio, or large informal sector, the Chapter 7 of this report identifies the legal and institutional weaknesses which could be held responsible for a low level of investments in Pakistan. These include *de jure* and *de facto* differences in investment policies; stagnancy in SME sector owing, for example, to poor management practices; poor state of the human capital development; dysfunctional institutional and operational infrastructure; and dearth of access to equity and debt financing.

1.2 Review of Developments during FY19

Real Sector

Growth in real GDP decelerated to 3.3 percent in FY19, compared to 5.5 percent last year. While all the sectors of the economy contributed towards this lackluster performance, the major drag came from the commodity-producing sector. The slowdown was broadly attributed to contractionary economic policies and inflationary pressures in the aftermath of exchange rate depreciation. The services sector also grew at a relatively lower pace compared to the last few years.

In agriculture, slower growth could primarily be traced to below par performance of major crops. With the exception of maize, important crops posted lower output compared to last year. Lower water availability, especially in Sindh, constrained the area under cultivation, while low fertilizer uptake (mainly on account of higher prices) was behind less than impressive yields. The rest of the cropping sector was able to post marginal growth owing to some recovery witnessed in oilseed cultivation. Particularly noteworthy was the shortfall in cotton production relative to its annual target for the seventh consecutive year, attributed to reduced area under cultivation and depressed yields. Taking a leaf from the experiences of peer countries, **Box 2.1** sheds light on policy measures that may be adapted to the local context in order to boost production of cotton, which remains a cash crop and textile industry input of vital importance. Meanwhile, the livestock sector was able to sustain its growth momentum during FY19, driven mainly by value addition in dairy products.

The industrial sector faced a significant fallout of lower fiscal outlay and monetary tightening during FY19. The slowdown was more evident in construction-related industries due to lower investments made by both the public and private sectors. Furthermore, the automobile industry, with its low level of localization, was hit hard by exchange rate depreciation, with assemblers passing on the impact to consumers in the shape of higher retail prices. Meanwhile, the government's continued push towards cheaper sources of fuel for electricity generation undermined the prospects of the petroleum industry. In addition, the performance of the textile and food industries also remained subdued. Within the latter, sugar industry output was hindered mainly by surplus carryover stocks and lower availability of raw material. On the positive side, healthy growth in electricity generation and electricity and gas distribution moderated some of the impact of an otherwise broad-based decline in the industrial sector.

The impact of slowdown in the commodity-producing sector spilled over to the services sector as well. The *wholesale and retail trade* was especially affected from developments elsewhere in the real economy. Similarly, lower deposit mobilization and subdued bank lending to the private sector set the tone for the moderation in *finance and insurance activities*. By contrast, road transport services expanded appreciably, with growth almost doubling compared to a year earlier. Meanwhile, growth in *general government services* remained fairly robust, which may be due to the associated remuneration of the government employees.

Monetary Policy and Inflation

Keeping in view the rising headline inflation, low level of foreign exchange reserves and large twin deficits, SBP's monetary policy committee (MPC) continued with its monetary tightening stance throughout FY19. The committee noted as well the surge in core inflation. The central bank increased the policy rate in all six decisions during the year, by a cumulative 575 basis points.

The inflation was fueled by a number of factors, including underlying demand pressures, increase in administered prices, and pass-through of Pak-rupee depreciation. During the initial months of the fiscal year, core inflation predominantly explained the continuously rising trend in inflation. In the subsequent months, however, a sharp increase in food and energy inflation aggravated inflationary pressures further. Thus, headline CPI inflation in Pakistan clocked in at 7.3 percent during FY19, compared to 3.9 percent last year.

Meanwhile, growth of private sector credit moderated in FY19 as a result of monetary tightening. Importantly, the private credit offtake remained upbeat throughout the first half of the fiscal year, mainly due to heavy working capital financing availed by the export-oriented industries. Subsequently in H2-FY19, the credit growth decelerated as the economic slowdown deepened.

By contrast, government budgetary borrowings increased substantially in FY19 compared to last year. This was because of a significant increase in current expenditures coupled with a slowdown in the revenue collection, which overshadowed the impact of PSDP cut. Further, PSE debt jumped from 4.0 percent of GDP a year earlier to 5.3 percent in FY19. Thus, the growth of money supply remained skewed towards the public sector. This signifies that fiscal discipline needs to be maintained in order to enhance the effectiveness of monetary policy.

Fiscal Policy
Major fiscal indicators deteriorated further in FY19. The overall budget deficit during the year stood at historic high of 8.9 percent of GDP, which was well in excess of the 6.0 percent target set in the Budget 2018-19. This deterioration was due to a sharp decline in revenue collection and a steep rise in current expenditures. It is worth noting that factors beyond the control of fiscal authorities also contributed in the deterioration; these included, among others, a steep rise in interest rates (which escalated the debt servicing burden); legal constraints on the revenue side; and an overall slowdown in the economy.

Total revenues declined by 6.3 percent during FY19, largely stemming from a sharp reduction in non-tax revenues. Tax revenues also stagnated as FBR's collection fell significantly short of the annual target. Provincial collection improved but its level still remained too low to make an impact. A sharp decline in development spending was not enough to control the pace of total spending. The latter grew by 11.3 percent during FY19 as current expenditures recorded a sharp acceleration, mainly due to higher interest payments.

Domestic and External Debt
Debt dynamics deteriorated further in FY19. In absolute terms, Pakistan's total debt and liabilities reached Rs 40.2 trillion by end FY19 – an increase of Rs 10.3 trillion during the year. One third of this increase in TDL was due to financing needs. The rest of the change emerged from revaluation of the external debt stock due to depreciation of PKR, BoP support from friendly countries and lastly a sharp increase in the government borrowing that it has deposited in the banking system.

From debt management perspective, government undertook a major re-profiling of its domestic debt in FY19. The composition of long-term debt in total domestic debt rose from 45.8 percent a year earlier to 73.4 percent in FY19. While this structural shift mitigates the rollover risks, debt servicing may become costlier as a result. Within external debt, the share of commercial loans increased further in FY19. Foreign debt servicing is likely to become more challenging in the future as most of the loans had been secured at floating interest rates. Uptick in international benchmark interest rates or changes in credit rating by the rating agencies may pose serious questions particularly when external debt sustainability indicators have shown deterioration.

External Sector
With the macro adjustment policies in place, the external imbalances that had built up over the past two years started to show improvement in FY19. Specifically, the current account gap narrowed substantially, after reaching a historic high in FY18.

The improvement mainly came from a contraction in both merchandize and services import payments, and a healthy growth in worker remittances. The completion of early harvest CPEC projects and lower PSDP spending led to a sizable reduction in power and electrical machinery imports, whereas the normalization of aircraft import payments also helped. With the policy-induced slowdown impacting construction activity, demand for imported raw materials, such as iron and steel, and of transport fuel for heavy vehicular transport (i.e. HSD) shrank sharply, and contributed to the decline in import payments. Critical support also came from a softening in global oil prices during H2-FY19, which complemented the quantum decline in imports of crude oil and POL products, and led energy import payments to drop in both Q3 and Q4. As a result, the overall import payments declined substantially in the last two quarters, and offset the increase recorded during H1-FY19.

At the same time, worker remittances reached a record high in FY19. Most of the YoY increase came from the US, UK and Malaysia corridors. Encouragingly, inflows from the largest source – Saudi Arabia – also rebounded in the year, after declining over the last two years. The uptick can be traced to a number of incentives announced for both overseas Pakistanis and commercial banks, to increase the inflow of remittances via formal channels.

Despite the lower current account gap, the country had to arrange significant external financing to meet the upcoming loan and Eurobond repayments during the year. Financial inflows in the form of FDI, private FX inflows into the local equity market, and IFI financing were insufficient to bridge the CAD gap. As a result, the country had to rely on bilateral partners – namely China (both the Chinese government and commercial banks), Saudi Arabia, UAE and Qatar – to meet its external financing needs. Inflows from these sources proved to be critical, and helped cushion the fall in the country's FX reserves.

1.3 Factors Constraining Investments in Pakistan: Beyond the Macroeconomics

Investment is considered an integral part of the economic development process. However, Pakistan's investment to GDP ratio has not only been consistently falling since the 1980s, it also lags considerably behind the rates observed in other regional and peer economies. The macroeconomic determinants such as the overall stability, regulatory uncertainty, low savings rate, shallow financial markets, and a large informal economy are generally referred to in order to explain this worrying trend. However, as **Chapter 7** highlights, the macroeconomic factors alone do not present a complete picture, and investment dynamics in the country are more nuanced.

Over the years, issues such as the discrepancies between investment policies, laws and bilateral treaties, coupled with noticeable differences in the *de jure* and *de facto* operational environment for the enterprises, have also made domestic as well as foreign investors wary of expanding their capital formation activities in the country. Similarly, the complex nature of tax system; perception and incidence of corruption; and cumbersome documentation processes have resulted in a number of firms avoiding documentation of their operations and becoming a part of the tax net. With regard to the private sector, the inadequate management practices of small and medium enterprises have resulted in minimal focus on product innovation, machinery upgradation, operational advancement and growth. Likewise, the low level of human capital development and a poor standing in competitiveness rankings also explains why the country has fallen behind other economies in terms of investment attractiveness, facilitation and growth potential. What becomes evident is that the factors that constrain productive capital formation in Pakistan have been common across both domestic and foreign investors. However, due to limited information available with respect to the perception of domestic investors, the Chapter draws heavily from surveys that capture the opinion/ apprehensions of foreign investors, e.g., OICCI Perception and Investment Survey.

Encouragingly, the government has started focusing on streamlining the tax system and ramping up the policy advocacy and investment retention initiatives led by the country's investment promotion agency (BOI). However, a lot still remains to be done. First, provincial and federal policies on investment and human capital development must be aligned. Second, the investment laws and policy documents need to be modernized in light of the global best practices. Third, while SME segment incentivization is important, it should be carefully crafted to reward all firms with potential and ambition. Fourth, though the recent documentation and tax automation drive initiated by the government would bear positive results in the near future, such policy changes need to be clearly communicated to the private sector to assuage their concerns and ensure proper compliance. Lastly, the state must take a leading role to invest in important segments of the economy in order to provide the private sector with a dependable and conducive ecosystem in which to carry out R&D and capital formation activities.

1.4 Economic Outlook

Macroeconomic stabilization will continue to be the cornerstone of economic policies during FY20. Real GDP growth is likely to remain subdued, though the early signs of recovery are already visible. Development spending may play a pivotal role, since there has been an observed tendency that Pakistan's GDP growth and PSDP spending move in the same direction, and similar has been the case in FY19. On this note, it is worth highlighting that the government has budgeted a greater outlay for PSDP during the year compared to the actual spending in FY19. Other triggers may include an improvement in market sentiments vis-à-vis the IMF program. A better showing by the agriculture sector compared to last year, and further improvement in the current account balance, may also improve the final outcome.

Inflation, meanwhile, is expected to exceed its annual projection by the Planning Commission of Pakistan for FY20 (**Table 1.2**). While demand pressures have generally subsided, cost-related impact may be more pronounced in the first half of the fiscal year, taking the cue from one-off adjustment in prices of utilities and other FY20 budget-related measures. By the second half, further supported by the end of deficit monetization by the government, price pressures may begin to recede, setting the tone for considerably lower inflation in FY21. However, cross-border tensions (which have flared up intermittently since Q3-FY19 and worsened during Q1-FY20) represent an upside risk to this outlook, given their tendency to drive up food inflation. At the same time, the global slowdown may pose a downside risk to the outlook, especially if international oil prices fall more sharply than anticipated.

Table 1.2: Key Macroeconomic Targets and Projections

	FY19	FY20	
		Target[1]	**SBP Projections**[2]
		percent growth	
Real GDP	3.3	4.0	3.0 - 4.0
CPI (average)	7.3	8.5*	11.0 - 12.0
		billion US$	
Remittances	21.8	24.0	22.5 - 23.5
Exports (fob)	24.2	26.2	25.4 – 25.9
Imports (fob)	52.4	53.7	49.8 – 50.3
		percent of GDP	
Fiscal deficit	8.9	7.1	6.5 - 7.5
Current a/c deficit	4.8	3.0	2.5 - 3.5

Data sources: [1] Ministry of Finance and Planning Commission; [2] SBP
*Projection for CPI inflation, Annual Plan 2019-20, Planning Commission

The external sector's outlook is positive on the whole, albeit being subject to both upside and downside risks. The current account deficit, after shrinking on YoY basis during FY19, is anticipated to subside further in FY20. Exports are projected to pick up during the year, conditional on demand conditions among the country's major trading partners and buoyancy in commodity markets. In particular, onset of fiscal stimulus and successful resolution of trade negotiations involving major economies would be instrumental in supporting global consumer demand, which would in turn bode well for exporting partners, including Pakistan, along with improved prospects of foreign investments. The FTA-II with China and preferential trade agreement with Indonesia may also give a boost to exports. Decline in imports would be instrumental in improving the current account as the policy-induced import compression would continue on top of subdued prices, barring any adverse shock from international oil prices. Moreover, workers' remittances are expected to remain robust in FY20 on the back of measures taken and incentives given to overseas Pakistanis remitting under the Pakistan Remittance Initiative (PRI).

The outlook for the fiscal sector, by contrast, is not straightforward. The FY20 budget looks to fix the deficiencies of the tax system and represents an earnest effort to increase documentation. It envisages a sizeable reduction in the deficit, by enhancing revenues and squeezing expenditures. However, achieving the ambitious tax collection target in the middle of a broader economic slowdown may present a challenge. Moreover, even if things pan out more or less according to plan, the fiscal deficit may be in the neighborhood of 7 percent nevertheless, implying that there would still be some way to go before fiscal consolidation is achieved. That said, the government is expected to make a concerted effort to meet the IMF's quarterly targets, implying a measure of fiscal discipline.

On an optimistic note, the private sector would be mindful that even as the economy rebalances and there is reduced demand in some sectors, new opportunities are simultaneously opening up in other areas. For example, imports of many consumer items and finished goods are shrinking due to a combination of regulatory duties and exchange rate depreciation. This generates an opportunity for domestic companies to step in and fill in this demand in the short to medium term. Moreover, alignment of the exchange rate represents improved prospects for export-oriented enterprises. The government's stated commitment to foster the ease of doing business and pursue investor-friendly policies is also welcome.

Meanwhile, domestic investors should also be looking to tap underserved markets and segments. Beyond provision of traditional goods and services, innovation must be the new watchword. It is especially encouraging to see that proactive, technology-driven domestic startups have already ushered in a positive disruption in industries ranging from banking (fintechs) to transportation (ride-hailing apps) and consumer goods and food (delivery apps), to name just a few. Such examples may inspire those investors who have been sitting on the fence for some time now to abandon the wait-and-see mode, and take positions sooner rather than later. In the grand scheme of things, a collective shift in sentiment and more optimism could prove to be a much needed catalyst for the revival of economic activities.