1 Overview

Despite challenges during the initial months of the fiscal year, the third quarter of FY15 ended with a visible improvement in the country's macroeconomic environment. External sector, which has been the weakest link in Pakistan's economy, improved considerably: (a) the current account, benefiting from a robust growth in workers' remittances, higher inflows under Coalition Support Fund (CSF), and a sharp reduction in oil prices, posted a notable surplus in Q3-FY15;[1] and (b) the SBP's liquid FX reserves more than doubled the level seen a year ago, enough to finance three months of the country's import bill.

The resulting stability in the exchange rate, together with the government decision to pass-on the benefit of fall in international oil prices to domestic consumers and the prudent monetary management, not only pushed YoY CPI inflation down to a decade's low, but also eased inflation expectations as shown by IBA-SBP's Consumer Confidence Survey (CCS).[2] A marked shift in the financing of budgetary deficit away from SBP, may have also contributed to low inflationary environment.

Encouragingly, the reform process agreed under the IMF program is broadly on track, and all the quantitative (performance) targets for end-March 2015 were met. The real GDP growth at 4.24 percent, though lower than the target, has reached the highest level in the last seven years. Recently, Moody's Investor Service has upgraded Pakistan's credit rating by a notch, and assigned a stable outlook.

With these improvements, the policy focus is gradually moving from stabilization to economic growth. Specifically, SBP has already initiated monetary easing to support economic activity by cutting its policy rate to a historic low.[3] The government has also increased its spending on development projects, which is both directly and indirectly contributing to economic growth. Investment, which has been a key concern for economic growth in recent years, is likely to benefit from monetary easing and planned investment under the China-Pakistan Economic Corridor (CPEC).

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[1] This is the second time in a decade that current account has posted a surplus during the quarter, the first one being the Q4-FY11.

[2] The IBA-SBP's Consumer Confidence Survey conducted in Mar 2015 indicates lower inflation expectations for the next six months (for details, please see **Chapter 3**).

[3] On aggregate, SBP has cut the ceiling rate of interest rate corridor (IRC) by 300 bps in four consecutive monetary policy announcements to 7.0 percent by end-May 2015.

Despite significant improvement in key economic indicators, there is a need to focus on some long-standing structural issues, which have been constraining the performance of various sectors. The first and foremost, exports, the prime source of foreign exchange earnings for the country, have been stagnant in the recent past, and declined during Jul-Mar FY15. Secondly, as the non-debt inflows remained subdued, the country has to rely on debt inflows for the financing of current account deficit, and building up of liquid FX reserves. Net FDI inflows, though maintained the last year's level, could not match the outflow under repatriation of profits/dividends.

Thirdly, the modest growth in tax collections continued to be a challenge. In fact, low growth in tax revenues and high share of non-discretionary spending, squeezed the fiscal space to promote growth. Finally, inter-agency receivables remain a major constraint on the efficient functioning of the energy sector.

Table 1.1: Selected Economic Indicators

	Jul-Mar FY14	FY15 Targets	Jul-Mar FY15
Growth rate (percent)			
LSM[a]	4.6	7.0	2.5
CPI (period average)[a]	8.1	8.0	5.1
Private sector credit [b]	10.0	na	5.5
Money supply (M2)[b]	5.9	na	5.7
Exports (customs)[a]	5.9	5.8	-6.0
Imports (customs)[a]	0.8	6.2	2.8
Tax revenue -FBR (billion Rs)[c]	1574.8	2,605*	1775.1
Exchange rate (+app/-dep%)[b]	1.1	na	-3.1
billion US dollars			
SBP's reserves (end-period) [b]	5.4	na	11.6
Worker remittances [b]	11.6	16.7	13.3
FDI in Pakistan [b]	0.7	4.3	0.7
Current account balance [b]	-2.7	-2.8	-1.6
percent of GDP[1]			
Fiscal balance[d]	-3.9	-5.1	-3.8

Targets set by the government in the Annual Plan for 2014-15; *: The original FBR tax revenues target was Rs 2,810 billion, which was twice revised to Rs 2,605 billion.
[1] Based on the full-year GDP estimates stated in the Annual Plan for 2014-15; na: not applicable.
Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

1.1 Economic Review

Provisional estimates of National Income Accounts, indicate that the real GDP grew by 4.24 percent in FY15 (**Table 1.1**). Though it was the highest since FY08, it fell short of 5.1 percent target for the year, as most of the challenges to economic activity continued to persist.[4] Agriculture sector posted a slightly higher growth (2.9 percent) in FY15, compared with 2.7 percent in FY14. This was primarily driven by healthy growth in livestock,[5] while the

[4] The Annual Plan for FY15 envisaged better energy supplies, visible increase in investment, political stability, and favorable weather conditions. None of these factors could mark a notable improvement during the year, which continued to limit economic growth during the year.
[5] Value addition of livestock is calculated by subtracting intermediate consumption from the gross value addition (GVA). The swing factor is the intermediate consumption (mainly fodder), which is

crop sector grew by only 1.0 percent. None of the important crops other than rice and cotton, could repeat the performance of last year, let alone the target for the year. To be precise, important crops grew by only 0.3 percent in FY15, compared with the growth of 8.0 percent last year. The restraining factors were the heavy rains (floods in certain areas of Punjab) during *kharif* and prolonged low temperature in *rabi*.[6]

Spillover effects of weak crops (like sugarcane) are also visible from the manufacturing sector.[7] In addition to this, subdued external demand and persistent energy shortages (albeit less severe), undermined the manufacturing during the year. Large scale manufacturing (LSM) grew by only 2.5 percent during Jul-Mar FY15, compared with the target of 7.0 percent for the year, and growth of 4.6 percent during the same period last year (**Table 1.1**).

Within LSM, automobiles and construction related industries performed better than the last year. While the former benefited heavily from the introduction of new car models and the Punjab government's Apna Rozgar Scheme, the latter gained from healthy construction activity. Construction sector grew by 7.0 percent in FY15, on top of 7.2 percent in the last year. Given the strong backward and forwards linkages, healthy construction bodes well for the economy.

Despite lower growth in commodity producing sectors (agriculture and industry), services managed to grow by 5.0 percent in FY15, which was higher than 4.4 percent of last year.[8] The impetus came from *general government services*, reflecting increase in the salaries and pensions of government employees. Another push factor was healthy growth in *finance & insurance*, primarily driven by financial institutions' investment in government securities.

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directly linked to the performance of the crop sector. In FY15, intermediate consumption grew by only 0.8 percent compared with 6.0 percent in FY14, which pushed up the growth in livestock sector.

[6] It may be noted that farm income must have recorded a sharp decline, as prices of both rice and cotton also plummeted during the year.

[7] The sugar sector posted a YoY decline of 6.1 percent during Jul-Mar FY15, against the double-digit growth in the same period last year.

[8] Within services, performance of wholesale and retail trade, with 18.3 percent share in GDP, is closely linked to the growth in commodity producing sector. It is, therefore, not surprising that the wholesale and retail trade posted a relatively low growth of 3.4 percent in FY15 compared with 4.0 in the previous year.
Another reason was the slow growth in *transport, storage & communication*. Details indicate that visible improvement in Railways and Air transport was eclipsed by a negative growth in *communication*. Cellular subscribers were lower as the service providers were focused on the authentication of sim-cards. With the introduction of innovative packages based on 3G/4G spectrums, *communication* services are likely to rebound in the coming year.

Like FY14, commercial banks continued to channel their funds towards risk free government securities during the year. In absolute terms, with an increase of Rs 1.2 trillion in the first nine months of the year, commercial banks' investments in government securities reached an all time high of Rs 5.3 trillion by end-Mar 2015. The increase was almost equally distributed between PIBs and T-bills. This result was the interplay of both supply and demand side factors. While the commercial banks aggressively participated in primary auctions of government securities to lock-in their funds at higher yields in a declining interest rate scenario, the government was equally receptive as it mobilized well above the cumulative targets announced in the auction calendars. The relatively high mobilization from these auctions helped the government retire some of its borrowing from SBP. As a result, the government was not only able to contain its borrowing from SBP within the IMF ceiling for end-Mar 2015, but also met the limit of zero quarterly borrowing prescribed in the SBP Act, 1956.

Cognizant of massive government borrowing from commercial banks, SBP stepped up its liquidity injections from November 2014 onwards to ensure smooth flow of credit. However, credit to the private sector grew by only 5.5 percent during Jul-Mar FY15, compared with 10.0 percent during the same period last year. This marked slowdown was primarily attributed to demand side factors including: a sharp fall in commodity prices (oil, cotton, rice, edible oil, etc.) that reduced working capital requirements of the firms; healthy corporate profits; persistent energy shortages; and relatively high real cost of borrowing. Although it is not possible to disentangle the contribution of each factor to low credit off take, the impact of lower commodity prices could be analyzed by deflating working capital loans with the wholesale prices. Specifically, working capital loans to private sector businesses adjusted for steep fall in wholesale prices indicates a growth of 8.9 percent during Jul-Mar FY15, compared with 7.5 percent during the same period last year. Moreover, fixed investment loans grew by 9.3percent during Jul-Mar FY15, compared with 6.1 percent in Jul-Mar FY14 (**Chapter 3**).

Soft commodity prices and swift pass-through of lower oil prices to general public, helped reduce inflation. This, along with the lagged impact of cautious monetary tightening up to November 2014, stable exchange rate, and adequate supply of perishable food items, pushed CPI inflation down to 2.5 percent in March 2015, and eased inflation expectations. On aggregate, headline inflation during Jul-Mar FY15 eased to 5.1 percent from 8.6 percent during the same period

last year.[9] The reduction is broad-based: all measures of core inflation (non-food-non-energy, trimmed, and Relatively Stable Component of CPI) posted noticeable declines during the period of analysis (**Chapter 3**).

Inflation expectations, measured by IBA-SBP's Consumer Confidence Survey, continued to ease. In addition, financial markets measure of inflation expectations—yields on medium to long term government bonds—also recorded a visible decline during Jul-Mar FY15.

Above developments allowed SBP to significantly ease its monetary policy stance. Specifically, SBP has reduced the ceiling rate of interest rate corridor (IRC) by a cumulative 300 bps to a historic low of 7.0 percent in four consecutive monetary policy decisions during the past seven months (from November 2014 to May 2015). This cut in interest rates was supplemented by liquidity injections through OMOs from November 2014 onwards, which pushed up the volume of OMOs to Rs 1.0 trillion in April 2015. These higher volumes were required to reduce the money market overnight rate to the desirable level, and to ensure reasonable growth in monetary aggregates. In fact, SBP maintained an almost fixed spread between the OMO cut-off rates and the ceiling of IRC from mid-Feb 2015 onwards, for smooth transition to the new IRC framework implemented on May 25, 2015.[10]

Massive liquidity injections through OMOs had little impact on reserve money, which grew by only 4.9 percent during Jul-Mar FY15 compared with 8.0 percent in the same period FY14. In fact, the expansionary impact of OMOs injections and rising NFA, on the reserve money was partly offset by the net retirement in government borrowing from SBP. Similarly, broad money supply also expanded at a lower rate of 5.7 percent during Jul-Mar FY15, compared with 5.9 percent during the corresponding period of the previous year. This deceleration stemmed from lower growth in Net Domestic Assets (NDA) of the banking system.[11] Within NDA, the restraining factor was the lower credit to the private sector, while government borrowing for budgetary finance was slightly higher than the last year.

[9] Latest data indicate that annual average CPI inflation in FY15 decelerated to 4.5 percent, compared with 8.6 percent in FY14.

[10] SBP has introduced a new "SBP Target Rate" and narrowed the width of IRC from 250 bps to 200 bps in its monetary policy decision of May 2015. Under the new IRC framework, SBP has explicitly committed to the market that overnight money market rate will be maintained close to the target rate.

[11] On the other hand, net foreign assets (NFA) posted an expansion of Rs 134.4 billion during Jul-Mar FY15, against the net contraction of Rs 103.2 billion in Jul-Mar FY14, reflecting the comfort on the external front.

The budget deficit during Jul-Mar FY15 slightly narrowed to 3.8 percent of GDP, compared with 3.9 percent in the same period last year. However, FBR tax collections grew by 12.7 percent during Jul-Mar FY15, which were well below the 17.9 percent growth recorded in Jul-Mar FY14. This slowdown is attributed to a number of factors including: (a) fall in international oil prices, which have reduced tax collections on energy products; (b) some of the government measures to make up for the shortfall faced legal challenges; and (c) subdued manufacturing activity. In addition, slow progress towards documentation, improving efficiency and effectiveness of tax administration, and minimizing tax leakages, continued to constrain FBR tax collections.

Unlike the revenue side, the government efforts to control spending supported fiscal consolidation. Overall expenditures grew by 8.3 percent during Jul-Mar FY15, against 8.7 percent in the same period FY14. It is also encouraging to note that lower growth in expenditures was not at the expense of development spending, which grew by over 20 percent YoY during the review period. Provincial governments took the lead, as their spending on public sector development programs recorded a hefty YoY increase of 46.0 percent. Though current expenditures of provincial governments also grew at higher rate as compared to the previous year, they were able to post a combined surplus of Rs 194.0 billion during Jul-Mar FY15; reflecting their contribution towards fiscal consolidation.

Despite a higher share of non-discretionary spending, the federal government contained growth in its current expenditures at 8.3 percent in Jul-Mar FY15. All expenditure heads grew at a slower pace, except federal government grants (other than provinces) to honor contingent liabilities and to support PSEs. Interest payments, which accounted for over 40.0 percent of the federal government current expenditures, increased by 7.2 percent in Jul-Mar FY15, compared with 17.7 present in Jul-Mar FY14. The deceleration was largely attributed to semi-annual coupon payments on PIBs, which has changed schedule of debt servicing.[12]

There was also a notable improvement in sources of deficit financing, as the government reliance on bank financing reduced as compared to last year. Within the banking system, the government didn't resort to inflationary borrowing from SBP, instead it retired a huge sum of Rs 674.4 billion (on cash basis) during Jul-Mar FY15. Moreover, successful issuance of Sukuk in the international market

[12] Coupon payments on PIBs are made at a fixed rate on semi-annual basis. Fresh PIBs are generally issued once a year, and the same bond is reopened in subsequent auctions of the PIBs. It implies that second coupon payment of all the PIBs issued during first half of the year, would fall in Jul 2015, which would become part of fiscal operations for Q1-FY16.

and disbursements from IFIs (excluding the IMF) helped finance a fraction of deficit during Jul-Mar FY15 through external resources.

Pakistan's public debt stock recorded an increase of Rs 933.6 billion in the first nine months of the year, to reach Rs 17.4 trillion by end-Mar 2015. This was entirely driven by an increase in domestic debt, as the external debt saw a decline of Rs 83.0 billion during the year. This needs an explanation as the government has successfully mobilized US$ 1.0 billion by issuing Sukuk in the international market, IMF disbursements were higher than the repayments, and debt inflows from other IFIs (especially IDB) were also higher as compared to the corresponding period last year.[13] The swing factor was the revaluation gains amounting to US$ 4.4 billion (caused by the appreciation of US$ against major currencies), which more than offset the increase in external debt during the period of analysis.

Higher financial inflows and a sharp fall in international oil prices, led to a remarkable improvement in the external sector during Jul-Mar FY15. SBP's liquid foreign exchange reserves reached US$ 11.6 billion by end Mar 2015, which can finance three months of the country's import bill.[14] The net international reserves (NIR) also increased, as SBP continued to make spot purchases from the interbank market.

Current account balance posted a healthy surplus of US$ 778.0 million during Q3-FY15, which helped narrow the current account deficit for Jul-Mar FY15 to US$ 1.6 billion. Key drivers for the Q3 surplus included: (a) CSF inflows, which were double the amount received in Q3-FY14;[15] (b) robust growth in worker remittances, which were more than sufficient to finance trade deficit during the quarter; and (c) a sharp fall in international oil and commodity prices, which helped narrow the trade deficit.

Having said this, the favorable impact of lower oil prices on the country's imports, was largely offset by an increase in non-oil imports. In absolute terms, Jul-Mar FY15 imports stood at US$ 31.0 billion, compared with US$ 31.2 billion during the same period last year. Composition of imports shows that the increase was largely driven by higher import of metal products, machinery, auto parts

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[13] On aggregate, external loans disbursements (excluding the IMF) during Jul-Mar FY15 reached US$ 3.8 billion, against US$ 2.3 billion in Jul-Mar FY14.
[14] With an increase of US$ 1.5 billion, SBP's liquid FX reserves reached US$ 13.1 billion as of June 26, 2015.
[15] In aggregate, CSF inflows during Jul-Mar FY15 were US$ 1,452 million, as compared to US$ 675.0 million during the same period last year.

(including completely knocked down (CKD)/semi knocked down (SKD) vehicles), and other raw materials. Being a leading indicator of economic activity, these imports reflect a healthy growth in construction and transport sectors.

Compared to imports, reduction in exports was a concern. This reduction was broad based, indicating the dominant role of structural problems, weak external demand, and soft international commodity prices. Specifically, impact of weak international demand is visible from lower textile exports, while the soft commodity prices reduced yarn and naphtha exports.

Another weak link is the low volume of non-debt inflows. Net inflows from foreign direct investment (FDI) were US$ 711.0 million in Jul-Mar FY15, compared with US$ 741.0 million in Jul-Mar FY14. These inflows were lower than the repatriation of profits/dividends of US$ 2.2 billion on the existing FDI in Jul-Mar FY15. However, it is encouraging to note that Pakistan's prospects of attracting foreign investment have revived with the positive country assessment by credit rating agencies and the IMF.

1.2 Economic Outlook

With the implementation of stabilization policies during the past two years, and ensuing marked improvement in macroeconomic indicators in this fiscal year, Pakistan's economy is set to embark on a higher growth trajectory. Positive business sentiments are likely to strengthen real GDP growth in FY16. As envisaged in the Annual Plan for FY16, with some improvement in agriculture, major contribution is likely to come from the industrial and services sectors. In this context, four points are worth noting:

- SBP has already cut the policy rate to a historic low during the past seven months to support economic activity. The rate cuts are supplemented with liquidity injections to ensure adequate supply of credit to the private sector at a lower cost.
- With the import of LNG, and completion of few energy related projects, energy supply is expected to improve. Persistently low international oil price would also facilitate energy supplies by reducing the cost of tariff rationalization, and energy related expenses of the businesses.
- Construction activity is set to gain from mega infrastructure projects, and growing private sector residential projects. Moreover, work on road construction under China-Pakistan Economic Corridor (CPEC) is likely to gather pace during the next fiscal year. Manufacturing sector would be a major beneficiary as the construction and allied industries are likely to gain from this increasing activity.

- After a long time, the investments are expected to revive because: (a) energy shortage is likely to ease further; (b) as a result of the on-going campaign to eradicate terrorism, law and order situation has significantly improved; (c) positive assessment of the economy by IFIs and credit rating agencies, would help improve investors' confidence; (d) foreign direct investment would gain from inflows under CPEC; and (e) historic low interest rates will also support investment activity.

While above developments are encouraging, the persistence of structural problems remains a risk to economic outlook. In this context, although the government is pursuing a well-defined reform process (as a part of the IMF program), there is a need to capitalize on this opportunity by taking tough measures to promote sustainable economic growth. Three key areas are of particular importance.

First, lower tax-to-GDP ratio is a recurring problem. In our view, it seems challenging for the FBR to meet the revised target for the year end, despite various tax adjustments, and resolving legal challenges for GIDC collections in the recent months.[16] Efforts towards documentation of the economy, elimination of tax exemptions, improving governance, minimizing leakages in tax collections, and strengthening provincial taxation departments, along with effective contract enforcement, property rights, accountability, and provision of justice, are must to improve tax collections.

Second, loss making PSEs remain a contingent liability. The privatization process of these PSEs is yet to produce tangible results. So far, the government has divested its share in profitable financial institutions (UBL, ABL, and HBL) through capital market transactions. None of the divestment with the shift of management control could take place, as privatization of energy related PSEs is still at its initial stages. Given the fact that profitable entities were the first to be privatized, delay in the privatization of loss making PSEs, would be a burden on exchequer.

Third, despite a marked improvement in the external account, exports saw a decline of 3.2 percent during Jul-Mar FY15, against the 5.8 percent export growth envisaged in the Annual Plan FY15. Though weak external demand played a role, the real issue remains the structural bottlenecks. A well-thought long-term industrial policy aligned with the country's strategic objective, is a pre-requisite

[16] With an increase of 12.8 percent, FBR tax collections during Jul-Apr FY15 reached Rs 1,969.0 billion, which is 75.6 percent of revised target for the year.

for generating exportable surpluses. This must be supplemented with concerted efforts to improve productivity, and strengthen supply chains.

Fortunately, the recent positive developments and improving business sentiments have created much needed room for the policy makers to focus on a comprehensive growth strategy.