1 Overview

Taking comfort from visible improvement in macroeconomic environment, SBP initiated monetary easing in FY15, which continued during the first quarter of FY16.[1] This policy stance was augmented by a pro-growth budget for FY16.[2] In addition, marked improvement in security conditions, relatively better energy management, and persistently low global commodity prices, have positioned the economy to further improve on its performance going forward.

Some improvements were already visible from the changes in key macroeconomic indicators during the first quarter of the year. Economic activity seems to be gearing up as large scale manufacturing recorded a noticeable increase over the last year.[3] The current account deficit narrowed, which was comfortably financed by higher financial inflows; the country's FX reserves recorded all time high levels, and were sufficient to finance

Table 1.1: Selected Economic Indicators

	Q1-FY15	Q1-FY16[P]
Growth rate (percent)		
LSM[a]	2.6	3.9
CPI (period average)[1, a]	7.5	1.7
Private sector credit [2, b]	1.3	-0.6
Money supply (M2)[2, b]	-0.1	1.1
Exports [a]	-10.4	-14.1
Imports [a]	11.6	-14.7
Tax revenue (billion Rs) [c]	537.9	600.0
Exchange rate (+app/-dep%) [b]	-3.7	-2.6
million US dollars		
SBP's liq. reserves (end-period) [b]	8,943	15,245
Worker remittances [b]	4,775	4,967
FDI in Pakistan [b]	201	248
Current account balance [b]	-1,631	-351
percent of GDP		
Fiscal balance[d]	-1.2	-1.1

[P] Provisional estimate.
[1] YoY growth is the average of CPI index for the quarter;
[2] Percent change in September over June.
Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance.

[1] The policy rate was reduced by 400 bps to multi-decade low of 6.0 percent by end-September 2015. It was kept unchanged in the monetary policy decision of November 2015.
[2] Special emphasis on infrastructure projects (under China-Pakistan Economic Corridor) in the budget is a key to support investment activity.
[3] Increase in LSM during Q1-FY16 can be termed broad based as food (including edible oil and beverages), automobiles, fertilizer, pharmaceutical, cement and chemicals sectors posted higher growth over Q1-FY15.

import bill of seven months;[4] fiscal deficit was reduced, along with a shift in its financing away from SBP; and inflation remained on low trajectory (**Table 1.1**).

While these positive developments are welcome, much needs to be done to ensure their sustainability. Following are some points of concern:

- Although budget deficit for Q1-FY16 was lower than the same period last year, tax collection could not post the required growth. In order to keep the fiscal deficit within target without compromising on development spending, tax efforts have to be increased manifold, particularly by widening tax base and effective enforcement;[5]
- Loss making PSEs remained a contingent liability on scarce fiscal resources. The privatization process of such PSEs is still at initial stages. This must be expedited to improve quality of services, and stem losses to the exchequer;[6]
- Dwindling exports continued to eclipse overall healthy performance of the external sector. Specifically, exports recorded a YoY decline for the 3rd quarter in a row. More disturbingly, this decline was attributed primarily to lower quantums;[7]
- In addition to exports, FDI also needs to contribute more towards external sector sustainability. While it is encouraging that FDI from China is likely to increase due to progress on various infrastructure projects under the CPEC, the country also requires foreign investment in exportable sectors;[8] and

[4] Traditional rule of thumb, which is widely used to assess the reserve adequacy of the country, suggests the import coverage of three months.
[5] With recent tax measures, FBR taxes showed a YoY growth of 16.8 percent in Jul-Nov FY16.
[6] So for the privatization process has been confined to divesting government shares in profitable institutions through capital market transactions.
[7] The risks to external sector also arise from international developments: weaker external demand could further hurt already declining exports; and the Fed's initiation of the first cycle of interest rate hikes since 2006 carries the risk of unbalancing the currency markets.
[8] Key constraining factors for foreign investment are energy constraints, weak external demand, security concerns and inconsistent government policies (as also identified by Overseas Investors Chamber of Commerce & Industry (OICCI) in their latest survey of Business Confidence Index).

- Extreme weather conditions in recent years have increased vulnerability of Pakistan's agricultural sector. In FY16 also, *Kharif* crops (cotton and rice) have suffered from heavy rainfall.[9]

Finally, it is encouraging that 9th review of the IMF program has been completed successfully and several important reforms have been introduced, like independent statutory Monetary Policy Committee, Credit Bureaus Act, etc. However, the slow progress on privatization process, and persistent distribution & transmission losses in the power sector remain a challenge.

1.1 Economic review

The government envisaged GDP growth of 5.5 percent for FY16, anticipating better performance in all three economic sectors compared with the last year. Initial assessment suggests that achieving this target would be challenging. Major *Kharif* crops incurred losses due to depressed prices of agri products, and unfavorable weather conditions.[10] The preliminary estimates of cotton and rice production are not only well below their respective targets, but also indicate a decline compared to the last year's levels. In fact, heavy rains in July 2015 inundated a large area under rice and cotton, which reduced their average yield. The cotton crop also suffered from pest and virus attacks, due to moist weather in the subsequent period.

Industrial activity has gathered pace as large-scale manufacturing (LSM) recorded a growth of 3.9 percent during Q1-FY16, compared with a growth of 2.6 percent during the same period last year. This improvement was a function of: (i) continued softening of international as well as domestic prices of industrial raw material; (ii) better energy management, especially gas supplies to fertilizer plants; (iii) strong demand for construction material, such as cement, and steel; and (iv) pick-up in auto financing, which helped achieve a higher growth in auto

[9] Nonetheless, the agriculture sector continued to benefit from Crop Loan Insurance Scheme and Livestock Insurance Scheme introduced by SBP. Moreover, the announcement of Kisan package is also a welcome development to support farmers.

[10] Depressed prices of cotton and rice in the previous season, seems to be a major reason for a decline in area under cultivation of these crops. It seems, some of the farmers used their lands for other crops, e.g., spring maize, fodder, vegetable, etc. This shift may offset some of the losses to overall value-added in crop sector due to cotton and rice.

production. Given the strong backward and forward linkages, healthy growth in the industrial sector bodes well for overall economic activity.
The performance of the services sector is yet to reflect a clear sign of improvement. While the strong profitability of the banking system and a visible improvement in *transportation, storage and communication* are key positives, the situation for *wholesale & retail trade* (the biggest component of the services sector) remains unclear. The assessment of commodity producing sector suggests that damages to *Kharif* crops would reduce value addition of this sub-sector, whereas better performance by the large scale manufacturing is positive for *wholesale & retail trade*.

The services sector may also benefit from higher import quantum. Although the country's imports plummeted by 14.7 percent in Q1-FY16, this was largely attributed to low unit prices, which overshadowed the modest increase in import quantum. Exports also declined by 14.1 percent in Q1-FY16, compared with a fall of 10.4 percent in Q1-FY15. Unlike imports, the decline in export was caused by both quantum and price. In fact, quantum impact was dominating and the demand for most items posted a decline during the quarter.[11]

While both imports and exports posted a decline, the fall in imports was more pronounced, which reduced the trade deficit by 22.4 percent during Q1-FY16. This, together with a modest increase in remittances and continuation of CSF inflows, narrowed the current account deficit significantly.[12] To be specific, current account deficit for Q1-FY16 was only US$ 0.35 billion, compared with a deficit of US$ 1.6 billion in Q1-FY15. This small deficit was comfortably financed by inflows from the issuance of Eurobond;[13] commercial borrowings by

[11] Export quantum of cotton fabric, bed wear, readymade garments, seafood, fruits, leather and leather products, actually declined during the quarter.
[12] Remittances posted a growth of only 4 percent during Q1-FY16, compared to a growth of 22 percent during Q1-FY15. This sharp deceleration was largely attributed to a seasonal phenomenon. Similarly, the country received CSF inflows of US$ 713 million in Q1-FY16. For details, see **Chapter 5** on External Sector.
[13] Tapping into the international market, the government issued a 10-year maturity Eurobond at the cost of 8.25 percent (per annum) in the last week of September 2015. The bond was oversubscribed, and top class investors from different regions purchased the bonds. Specifically, 38 percent of the subscription was from North America; 38 percent from UK; 12 percent from Europe; and 12 percent from Asia.

the government; and an increase in FDI (though still persisting at low levels).[14] The external sector also benefited from the release of 8th tranche of the IMF program. As a result, the country's total FX reserves increased by US$ 1.4 billion to reach an all time high level of US$ 20.1 billion by end of the first quarter. These could easily finance 7 months of the country's import bill.

It is interesting to note that the buildup of FX reserves has accompanied with 2.6 percent depreciation of the PKR against the US Dollar during the quarter. This depreciation was concentrated in August 2015, as a chain-reaction of turmoil in Asian stocks and currency markets exerted pressure on the PKR.[15] Chinese Yuan was devalued by 2.7 percent in early August, which was followed by depreciation of other currencies in the Asian region.[16]

The PKR exchange rate, which anchors inflation expectations of businesses and directly impacts domestic prices of imported goods, created an upward pressure on inflation. However, this impact was more than offset by the swift pass-through of a fall in international commodity prices to domestic consumers during the quarter.[17] On aggregate, average CPI inflation was 1.7 percent in Q1-FY16, compared with 7.5 percent in the same period last year.

Lower commodity prices (especially of cotton and rice) also impacted credit flows during the quarter, by reducing the demand for working capital loans. In absolute terms, credit to the private sector contracted by Rs 25.4 billion in Q1-FY16, compared with a net expansion of Rs 47.0 billion in Q1-FY15. To put these numbers into context, it must be noted that: (a) average gross disbursements during Q1-FY16 were much higher over the same period last year; (b) long-term loans (fixed investment loans) recorded a net increase of Rs 27.0 billion during the quarter, against a net contraction of Rs 27.4 billion in Q1-FY15; and (c) credit

[14] FDI posted an increase of US$ 47 million during the first quarter of FY16, to reach US$ 248 million by end-September 2015. This increase was primarily on account of inflows from China in a coal-based power projects. Net FDI inflows from China stood at US$186 million in Q1-FY16, compared to a marginal inflow of US$ 2.2 million in the same period last year.
[15] PKR moved from 101.9 per US$ on 20th August 2015, to Rs 104.1 per US$ on 26th August 2015.
[16] For instance, currencies of Vietnam, Taiwan and India depreciated by 1.6, 3.1 and 2.2 percent, respectively.
[17] Nonetheless, CPI inflation picked up in the months of October and November 2015.

expansion in the last year was an exception, as the first quarter of the year is generally a period of retirement in the credit cycle of Pakistan.[18]
The contractionary impact of net retirements in credit to private sector on M2 was overshadowed by the expansionary impact of government borrowing from the banking system, and higher external inflows. Specifically, a visible improvement in external accounts led to a sharp increase in the NFA of the banking sector. As a result, broad money supply grew by 1.1 percent during Q1-FY16, in contrast with a contraction of 0.1 percent during the same period last year.

Another important development in the monetary sector, was increased liquidity injections by SBP through open market operations (OMOs) to ensure that the interbank overnight repo rate remain close to the policy rate. The volume of OMOs peaked at Rs 1,374.0 billion in the last week of September 2015. However, the expansionary impact of these injections was largely offset by the net retirement in government borrowing from SBP. Specifically, the government retired Rs 304.4 billion in Q1-FY16 to SBP, which was 7.8 times the amount retired in the same period last year.[19] As a result, the government was able to contain its budgetary borrowing from SBP within the IMF target for end-September 2015, and the quarterly limit of zero budgetary borrowing as prescribed in the SBP Act.

However, net retirements to SBP were primarily financed by government borrowing from commercial banks, which stood at Rs 443.8 billion for Q1-FY16 compared with Rs 178.9 billion in Q1-FY15. Despite this, overall amount of government borrowing from the banking system in Q1-FY16 remained unchanged at the last year's level. This containment in government borrowing reflects an improvement in fiscal accounts.

The budget deficit in the first quarter of FY16 was 1.1 percent of GDP, compared with 1.2 percent last year. The improvement was largely attributed to deceleration in current expenditures. Overall fiscal spending grew by 7.2 percent during Q1-FY16, which was much lower than the 12.7 percent increase in the same quarter last year. Encouragingly, the deceleration was entirely due to a strict control on

[18] It may be recalled that credit expansion in Q1-FY15 was primarily driven by trade financing, which do not follow a clear seasonal pattern. Specifically, import financing saw a huge increase of Rs 49.5 billion during the quarter due to unusually higher imports of fertilizer, basic metals, petroleum products and edible oil.
[19] The government has retired Rs 738.6 billion to SBP from June 2014 to September 2015.

current expenditures of the federal government, while the PSDP in Q1-FY16 saw a hefty rise of over 50.0 percent. Though total revenues increased by 11.6 percent in Q1-FY16 compared with only 1.2 percent in Q1-FY15, the growth was below the required level to contain fiscal deficit for FY16 at the targeted level. Cognizant of aforementioned macroeconomic developments, SBP continued with monetary easing in Q1-FY16. The policy rate was slashed by 50 bps in September 2015 to decades' low level of 6.0 percent. This monetary easing together with a sharp increase in development spending, paved the way for healthy economic activity.

1.2 Outlook for FY16

Despite interest rate hike by the US and a slowdown in China's economy, Pakistan's external sector outlook can be termed positive for the year. The trade deficit is likely to benefit from a sharp fall in prices of commodities in recent months.[20] Moreover, these prices are likely to persist at low levels due to abundant supplies, sufficient inventories and weak demand (especially of industrial raw materials).[21]

Table 1.2: Key Macroeconomic Targets and Projections

		FY16	
	FY15	**Target[1]**	**Projection[2]**
		percent growth	
Real GDP	4.2[4]	5.5	4.0 – 5.0
CPI (average)	4.5[4]	6.0	3.5 – 4.5
		billion US$	
Remittances	18.7[2]	19.0	19.0 – 20.0
Exports (fob)	24.1[2]	25.5	22.9 – 23.4
Imports (fob)	41.1[2]	43.3	40.0 – 41.0
		percent of GDP	
Fiscal deficit	5.3[3]	4.3[3]	4.0 – 5.0
Current a/c deficit	1.0[2]	1.0	0.5 – 1.5

Source:
1. Planning Commission;
2. State Bank of Pakistan;
3. Ministry of Finance;
4. Pakistan Bureau of Statistics.

The resulting relatively low trade deficit, will be largely offset by workers' remittances, and expected CSF inflows. While the pace of increase in workers' remittances is likely to be modest (as compared to the last year), we expect remittances to comfortably surpass the target for the year. This, together with lower freight charges would help contain current account deficit around 1.0 percent of the GDP (**Table 1.2**). The financing of this deficit may not

[20] Details indicate that prices of international commodities, which Pakistan imports (oil, metals, edible oil & fertilizer) have fallen at a faster pace as compared to the prices of our exportable items (cotton and rice).
[21] For details, please see World Bank's 'Commodity Market Outlook' of October 2015.

be an issue due to higher expected inflows, on account of project loans from China, and from international financial institutions (IFIs).

Loan disbursements during first four months of FY16 stood at 21.6 percent of the budgeted inflows, suggesting higher inflows for the rest of the year. These inflows would coincide with higher external debt repayments during the second half of the year, as the maturity of 10-year Eurobond (issued in FY06) would fall during the second half of the year. It is expected that the country's FX reserves will remain at an adequate level with the support of these debt inflows. However, the non-debt inflows (especially exports and FDI) will remain a challenge.[22]

While the slump in global commodity prices will continue to keep domestic CPI inflation low, there are some factors which pose upside risks to inflation: (a) an upward adjustment in domestic prices of energy products (electricity and gas); (b) the PKR depreciation of 2.8 percent against US$ since end-June 2015 till 21st December 2015; (c) additional taxation measures to make up for the shortfall in tax revenues;[23] and (d) expected higher growth in broad money supply, which could contribute to inflation by stimulating aggregate demand in the economy. The latest Consumer Confidence Survey (CCS) conducted in November 2015 indicates small build up of inflation expectations. However, despite these possible pressures, we expect CPI inflation to remain well below the target of 6 percent for FY16.

In the real sector, we expect a boost to construction and its allied industries due to progress on projects under the CPEC. LSM has already posted a notable increase in Q1-FY16, which is expected to strengthen further due to: (i) a marked improvement in security condition; (ii) better availability of electricity and gas; (iii) lower cost of industrial raw material; and (iv) historic low interest rates. Moreover, auto sector is likely to benefit from the modest recovery in auto financing and the government's *Apna Rozgar* scheme.

[22] Pakistan's exports have posted a decline of 10.7 percent YoY in Jul-Nov FY16. In case of FDI, inflows have reached US$ 540 million in Jul-Nov FY16, compared to US$ 498 million in the same period last year.
[23] The government has imposed regulatory duty on a wide range of luxury and non-seasonal items. The customs duty on imports of goods has also been increased by 1 percentage point.

The agriculture sector is passing through a vulnerable time. Damages to major *Kharif* crops are less likely to be compensated by *rabi* crops. Moreover, farm income has taken a hit due to persistent low prices of agri products, and the losses inflicted by bad weather. Cognizant of these hardships, the government's *Kisan* package is likely to ease financial constraints of small farmers to an extent. In addition, reduction in tax rate on the import of agriculture machinery, and tax holiday for Halal food processing industry, would support livestock sector in the coming years. Nonetheless, the immediate impact of these measures on agriculture growth in FY16, seems to be limited.

Finally, the services sector paints a mixed picture. Healthy growth in *transport, storage & communication* and *finance & insurance* should be balanced against the unclear situation of *wholesale & retail trade.* While a better performance of LSM is positive for *wholesale & retail trade*, the losses from *kharif* crops would reduce the value addition under this sub-head.