# 1 Overview

After achieving a growth rate of 4.7 percent in FY16, the real GDP growth target for FY17 was set at 5.7 percent. The higher growth is expected to be driven by a rebound in agriculture, and an enhanced contribution from industry.

According to the preliminary data, the real economic activities are expected to maintain their momentum. Specifically, the higher production of cotton, sugarcane and maize crops is encouraging. Moreover, better supplies of minor crops also signal some recovery in the agriculture growth.

**Table 1.1: Selected Economic Indicators**

| | Q1-FY16 | Q1-FY17[P] |
|---|---|---|
| *Growth rate (percent)* | | |
| LSM[a] | 3.9 | 2.2 |
| CPI (period average)[1, a] | 1.7 | 3.9 |
| Private sector credit [2, b] | -0.6 | -2.9 |
| Money supply (M2)[2, b] | 1.1 | 0.2 |
| Exports [a] | -14.3 | -9.1 |
| Imports [a] | -14.9 | 10.5 |
| Tax revenue (billion Rs) [c] | 723.5 | 739.2 |
| Exchange rate (+app/-dep%)[b] | -2.6 | 0.2 |
| *million US dollars* | | |
| SBP's liq. reserves (end-period) [b] | 15,245 | 18,491 |
| Worker remittances [b] | 4,966 | 4,698 |
| FDI in Pakistan [b] | 403 | 249 |
| Current account balance [b] | -579 | -1,381 |
| *percent of GDP* | | |
| Fiscal balance[d] | -1.1 | -1.3 |

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

Regarding industrial activities, though the performance of large-scale manufacturing (LSM) has remained subdued so far, we expect the growth to gain some pace going forward, on the back of supporting policies and encouraging outlook for automobile, sugar, pharmaceuticals and construction-related sectors (see **Chapter 2** for detail).

Notwithstanding the expected pickup in economic activities, the first quarter of FY17 experienced a widening of current account and fiscal deficits – the two key macroeconomic indicators – which suggests that the underlying structural issues are still there (see **Table 1.1**).

While the absence of inflows under Coalition Support Fund (CSF) in Q1-FY17 also contributed to the rising current account deficit, the decline in remittances shows that the FX comfort available to finance a persistently high trade deficit, is now weakening.[1] Moreover, the fall in exports entered in its 10th straight quarter in Q1-FY17, and FDI inflows were also low.

The absence of CSF inflows (along with lower SBP profits) also led to a rise in the fiscal deficit during Q1-FY17; but the underlying rigidity in the tax structure continues to figure prominently. It is evident from lower than expected tax collection during Q1-FY17.

While the role of well integrated and coherent trade and fiscal policies cannot be overemphasized, the overall performance of the economy will depend on how the private sector responds to the existing policy support offered by the government. While the government has announced several fiscal incentives in the FY17 budget, SBP has been maintaining a historic low interest rate. In this backdrop, the private businesses have an opportunity to demonstrate that they can compete with their peers in other emerging markets and contribute to the growth momentum of Pakistan's economy.

## 1.1 Economic review

The initial assessment indicates the economy is moving on its growth trajectory, amid some challenges. In agriculture, sugarcane and maize harvests (accounting for 14.6 percent of the crop sector) are expected to reach record levels in FY17.[2] Furthermore, though the cotton production missed the target of 14.1 million bales by a significant margin, it is still higher than the last year's level.[3]

However, lower production of rice (compared to the last year) and a decline in sowing area in the cotton belt of Punjab, raise some concerns. Specifically, rice production has remained below last year's level – this was the third consecutive year when rice recorded a YoY decline. Similarly, the shortfall in cotton production, when compared to the target, is mainly due to a 20.8 percent decline in area under the crop in Punjab. This in itself was the result of low cotton prices at the time of sowing, and the

[1] Remittances declined by 5.4 percent in Q1-FY17 for the first time in four years.
[2] The performance of minor crops also appears encouraging.
[3] Cotton production is estimated at 10.5 million bales during the current year, compared with 9.9 million bales last year.

exceptional losses last year due to pest infestation.[4] We generally expect farmers to switch to crops offering better prices (like sugarcane and wheat – having price security to a large extent); there are however reports of some growers having left their fields fallow for this season.

LSM – a major component of the industrial sector – witnessed a significant slowdown during Q1-FY17. This sluggish performance appears quite surprising given the sustained growth noted in many of its sub-sectors (e.g., automobile, fertilizer, pharmaceuticals and construction-related industries). A number of developments explain this apparent disconnect. In the case of textiles, the largest subsector in LSM, supply constraints (as cotton production remained low for the second consecutive year) and continued weak demand from China and some advanced economies, reduced the domestic production, particularly of low value added products (e.g., yarn and cloth). The POL output, on the other hand, fell due to a policy shift to improve the quality and standard of motor gasoline in the local market.[5] Similarly, in order to reduce tobacco consumption, the government substantially increased excise duty on cigarettes in the FY17 federal budget, which in turn held back production. The lower POL and cigarette production explains over one percentage point loss in LSM growth this year.

It is expected that a better crop performance would provide a boost to *wholesale and retail trade*– the largest subsector in services. Within *transport, storage and communication*, the merger of two leading telecom firms during Q1-FY17 is a major development. Similarly, the exceptional growth in sales and import of both commercial vehicles and petroleum products points to sustained economic activities in the transportation sector. However, the performance of *finance and insurance* appears less promising, as the impact of low interest rates is visible on the profitability of the banking system. Specifically, the banking sector posted a profit of Rs 71 billion during Q1-FY17, which was down 11.9 percent from last year.

Although the first quarter of the fiscal year coincides with seasonal credit retirement to banks, the magnitude of this retirement was unusually large in Q1-FY17, due to: (1) the exceptional rise in credit off-take during June 2016, which was retired next month

[4] Cotton has strong forward linkages with the textile industry – the largest exporting sector of the economy.

[5] Since most of the refineries were in the process of upgrading their infrastructure to produce higher grade (Premier Motor Gasoline) PMG, this led to output decline during the interim period.

(in line with expectations); and (2) large corporates shied away from leveraging further despite historic low interest rates, as they already have sufficient liquidity with them. A positive development, however, was the higher loan demand for fixed investment purposes, particularly for energy-related capital expenditures.

The heavy retirement by private businesses during July 2016, in turn, improved the availability of funds in the interbank market. However, the major challenge for the central bank, in terms of managing the SBP target rate, came when a record maturity of PIBs (worth Rs 1.4 trillion) and Eid-related cash withdrawals, influenced liquidity conditions in the market. A sizable volume of maturing injections under Open Market Operations (OMO) in July 2016 provided a comfort as this absorbed inflows from maturing PIBs. SBP effectively managed the interbank liquidity throughout the quarter to ensure stability in the overnight rates, despite significant volatility in interbank liquidity flows. This was also reflected in the stability of the 6-month KIBOR – a benchmark rate used by commercial banks and private businesses.

The first quarter also witnessed a shift in borrowing patterns of the government. Specifically, the government made net retirement worth Rs 268.1 billion to commercial banks, as opposed to net borrowing of Rs 443.8 billion in Q1-FY16. Simultaneously, in order to meet its increased budgetary needs in the wake of a higher fiscal deficit, the government resorted to SBP borrowings.[6] This further reduced the demand for funds available with commercial banks in the quarter. The resulting increase in liquidity with banks led to a decline in the weighted average lending rates of commercial banks.

The shift in government borrowings from SBP did not impact the reserve money, as it was largely offset by the roll-back of OMO injections from the interbank market.[7] The growth in overall money supply (M2) remained almost muted due to heavy retirements under private sector credit.

In this backdrop, SBP adopted a cautious stance in its monetary policy reviews of July, September and November, 2016, and kept the policy rate unchanged. SBP has also been closely watching a gradual rise in CPI inflation and developments in the

[6] In net terms, the government borrowed Rs 567.8 billion from SBP in Q1-FY17, which was quite opposite to the net retirement of Rs 304.4 billion during Q1-FY16.
[7] The outstanding volume of OMO injection fell from its peak of Rs 2 trillion in mid July 2016 to Rs 1.15 trillion by end-September 2016.

external sector, like falling exports, rising imports and declining remittances (see **Chapter 3** for detail).

Specifically, the average headline CPI inflation rose to 3.9 percent YoY in Q1-FY17, against 1.7 percent in the corresponding period of FY16. While a part of the recovery was expected as inflation had already dipped to ultra-lows last year, further impetus came from supply-side factors.[8] While trends in actual inflation were important, from policy perspective, SBP was also closely tracking changes in inflationary expectations in the economy. The Consumer Confidence Survey for September 2016 reflected lower expectations about prices for the next six months.

The moderate inflation expectations were because of: (1) the government did not increase petroleum prices and power tariffs, despite an increase in global oil prices; and (2) the exchange rate – an important anchor for inflation expectations – remained stable during the quarter. The stability in the exchange rate, in turn, came on the back of healthy financial inflows. These inflows not only covered a worsening current account and declining foreign investment, but also led to a buildup in foreign exchange reserves for the 8th consecutive quarter.

As mentioned earlier, the current account mainly weakened in Q1-FY17 due to absence of CSF inflows. Further pressure came from a widening trade deficit (with rising imports and declining exports) and a fall in remittances (the first such decline in the past 14 quarters).[9]

Focusing on imports, the non-oil import bill increased sharply during Q1-FY17, mainly due to higher import of machinery (power generation, electrical and construction) on the back of CPEC-related activities. The overall imports, however, benefited from a significant decline in oil payments during the quarter.[10] This highlights the exposure of the country's external sector to global commodity prices.

[8] These include a gradual rise in international prices of some key commodities (e.g., palm and soybean oil, crude oil, sugar, cotton, iron, coal, copper); increase in taxes by the government; and measures to control informal trade on both eastern and western borders of the country.

[9] To put this in perspective, the Q1-FY17 current account deficit more than doubled to US$ 1.4 billion from the level recorded in Q1-FY16, whereas FDI inflows dropped by 38.2 percent to US$ 249 million during the quarter.

[10] According to BoP data, the non-oil imports increased by US$ 494 million, whereas oil imports fell by US$ 364 million.

Hence, the recent gradual recovery in international prices of crude oil becomes a concern, given that non-oil imports are already expected to remain high, considering the priority attached to CPEC projects. It is, therefore, important that CPEC-related projects continue at their scheduled pace, so that associated inflows from China is available to offset the rise in the import bill.

Ideally, a country's rising imports should be funded through export earnings (and other non-debt creating inflows, like, remittances and FDI). However, in our case, exports are almost half of imports, and have been on a declining path for over two years now. Reversing the downtrend in exports has become more daunting due to continued soft demand in traditional export markets (particularly China) and rising popularity of anti-trade sentiments, mainly in developed economies.

For the past several years, the country had been relying on remittances to fund the widening trade deficit. During Q1-FY17, remittances, however, recorded a decline for the first time in four years. Though the decline was partly due to a seasonal (Eid) factor – which had inflated personal transfers in June 2016 and then led to a big drop in the following month – other impediments (like fiscal consolidation in the GCC and a constricting environment for global correspondent banking) were also in play.

In this situation, official inflows not only financed the current account deficit, but also led to a buildup of FX reserves. Increased loan disbursements, particularly from China, more than offset the decline in investment inflows. This change probably reflects a broader shift in the nature of inflows from China: while investment flows dominated Q1-FY16, long-term loan disbursements were the leading component this year.

Thus, the external debt of public sector increased by US$ 1.0 billion and reached US$ 58.8 billion by end-September 2016. As mentioned earlier, this rise came mainly due to long-term commercial loans of US$ 700 million (from China). The government also made a net retirement of US$ 315 million short-term commercial loans during the quarter. The substitution of short-term loans with long-term debt would improve the maturity profile of the external debt.

The overall stock of public debt increased by Rs 866.1 billion in Q1-FY17, with over 85 percent of the incremental debt contributed by government borrowings from domestic sources. While a part of this additional debt funded the fiscal deficit of Rs

438 billion for Q1-FY17, the rest of the amount led to a buildup of government deposits with the banking system. Moreover, the maturity of a significant volume of PIBs in July 2016, along with the large issuance of short-term debt, shortened the maturity profile of the domestic public debt.

In terms of GDP, the fiscal deficit reached 1.3 percent in Q1-FY17 – the highest first-quarter level since FY12. More importantly, the deficit increased despite an exceptional growth in provincial surpluses. The major drag came from a sharp decline in non-tax revenues (mainly due to the absence of CSF inflows, drop in dividends from public sector enterprises, and lower profit from SBP).[11] The tax revenues also remained well below expectations.[12] On the expenditure side, the government was more prudent, as current spending registered a marginal decline. Development expenditures, on the other hand, increased by 12.4 percent in Q1-FY17 on YoY basis, on top of the 47.4 percent rise recorded in Q1-FY16.

A number of incentives offered by the government to encourage new investments led to a decline in direct tax collection. Indirect taxes, on the other hand, recovered sharply during the quarter following the rationalization of tariff slabs, increase in customs duty for certain slabs, and higher import volumes. The turnaround in sales tax collection is worth mentioning as it was realized despite a lower effective tax on petroleum products.[13]

Meanwhile, the government has been able to contain current expenses due to lower spending on subsidies. Interest payments, however, remained unchanged as the gains realized from low interest rates were largely offset by an accumulation of public debt stock. On the other hand, the strong growth in development expenditure during the quarter was led by the provinces, as federal development spending posted a YoY decline of 7.6 percent in Q1-FY17. Most of the spending by provinces went to infrastructure improvement, followed by health and education.

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[11] The low oil prices reduced the profitability of PSEs in the energy sector. SBP profits declined due to falling interest rates and lower stock of government debt with the central bank. The outstanding stock of government borrowing from SBP (on cash basis) fell from an average of Rs 2.1 trillion in FY15 to Rs 1.6 trillion during FY16.

[12] The government normally collects 20 percent of the annual revenue target during the first quarter. In Q1-FY17, tax collection reached only 16 percent of the revenue target of the full year.

[13] The government absorbed the steady rise in global oil prices, and kept domestic petroleum prices unchanged during Q1-FY17.

## 1.3 Outlook for FY17

As mentioned earlier, the GDP growth is expected to strengthen further during the year. While the cotton crop missed its target by a significant margin, an increase of 6.3 percent in its production would still translate into higher growth for agriculture. Furthermore, the improved performance of sugarcane and maize; better supply situation of fruits and vegetables; and steady increase in the global prices of cotton and sugar, are key positives for growth outlook. However, the performance of the upcoming wheat crop (which contributes over 40 percent of the value addition by the major crops) would be an important determinant of agriculture performance during FY17.

**Table 1.2: Key Macroeconomic Targets and Projections**

| | | FY17 | |
|---|---|---|---|
| | **FY16** | **Target[1]** | **Projection[2]** |
| | | *percent growth* | |
| Real GDP | 4.7[4] | 5.7 | 5.0 – 6.0 |
| CPI (average) | 2.9[4] | 6.0 | 4.5 – 5.5 |
| | | *billion US$* | |
| Remittances | 19.9[2] | 20.2 | 19.5 – 20.5 |
| Exports (fob) | 22.0[2] | 24.7 | 21.5 – 22.5 |
| Imports (fob) | 40.3[2] | 45.2 | 42.0 – 43.0 |
| | | *percent of GDP* | |
| Fiscal deficit | 4.6[3] | 3.8[3] | 4.0 – 5.0 |
| Current a/c deficit | 1.2[2] | 1.5 | 1.0 – 2.0 |

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

The LSM growth so far is fairly low compared to last year. However, we expect some pick up in its pace on the back of continued supportive policies, like low interest rates, reduced cost of energy with improved availability, strong domestic demand, healthy corporate margins, and a conducive investment environment. Some sector-specific developments are also worth noting. For example, a better sugarcane crop and the recent surge in international sugar prices would result in higher sugar production;[14] the increased pace of work on infrastructure and CPEC-related projects would boost the demand for cement and steel products; and the launch of a new model of passenger car by Honda this year would partially compensate for the lowering of sales after Apna Rozgar scheme (which was ended last year). Furthermore, the recent recovery in cotton prices would likely benefit the domestic textile industry (which has a sizeable share in LSM).

[14] The liquidity position of sugar mills would ease as the higher prices make sugar exports feasible.

The expected recovery in LSM would also have strong spillover impact on *wholesale and retail trade*, which is one of the major subsectors under services. Similarly, transport sector is likely to perform well due to CPEC related activities.

In the case of inflation, an uptick was already expected in FY17. The recent revival of global oil prices after OPEC's agreement on oil supply may lead to higher non-food inflation. On the other hand, food inflation may remain in check as the current stocks of staple food (wheat and rice) seem sufficient. On balance, therefore, the inflation is expected to remain within the target for the year (**Table 1.2**).

Given the revenue shortfall during Q1-FY17, achieving the annual fiscal deficit target of 3.8 percent of GDP would be challenging. It will require additional fiscal consolidation efforts on the part of the government.

We expect the current account deficit to remain in the range of 1-2 percent of GDP in FY17, which is higher than the earlier forecasts.[15] The outlook on remittances has been marginally lowered, as the expected recovery in inflows from the seasonal slowdown in July 2016 has not materialized yet. Furthermore, remittances from the GCC countries (which contributed over 60 percent of total remittances) have declined on YoY basis during Jul-Nov FY17, due to fiscal consolidation measures being undertaken in the region. Similarly, remittances from the UK fell mainly due to the sharp depreciation of the pound against the US dollar following *Brexit*.[16] The downward revision in export growth projections has come on the back of renewed concerns about demand conditions in advanced economies; and a further weakening of export prices for basmati rice.[17]

[15] Earlier forecast for current account deficit was in the range of 0.5 – 1.5 percent of GDP, as reported in SBP Annual Report, FY16.
[16] Consequently, the US dollar-value of remittances from the UK is now lower for the same volume of remittances expressed in pound sterling.
[17] On a positive note, exports recorded a positive growth in both October and November 2016, suggesting that the declining trend has finally bottomed out.