1 Overview

The overall economic environment continues to remain conducive for growth. An accommodative monetary policy stance; increase in development spending; substantial growth in private sector credit, especially for fixed investment; and ongoing CPEC-inspired activity in power sector and infrastructure, are providing the needed support.

Table 1.1: Selected Economic Indicators

	H1-FY16	H1-FY17[P]
Growth rate (percent)		
LSM [a]	3.9	3.9
CPI (period average) [1, a]	2.1	3.9
Private sector credit [2, b]	7.4	8.6
Money supply (M2) [2, b]	4.3	5.0
Exports [a]	-14.5	-3.9
Imports [a]	-7.9	10.1
Exchange rate (+app/-dep%) [b]	-2.8	0.2
billion Rs		
Private sector credit [3]	295.7	383.7
Tax revenue [c]	1,371	1,467
million US dollars		
SBP's liquid reserves (end-period) [b]	15,884	18,272
Worker remittances [b]	9,688	9,458
FDI in Pakistan [b]	978	1,081
Current account balance [b]	-1,865	-3,527
percent of GDP		
Fiscal balance[d]	-1.7	-2.4

[P] Provisional estimate.

[1] YoY growth in the average of CPI index for the quarter.

[2] Percent change in December over June. [3] Flows since end-June

Sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance.

These factors have also led to an improvement in the investors' confidence, which is particularly reflected in capacity expansion plans by a number of industries and acquisition of domestic companies by foreign investors.[1] Meanwhile, recent pick up in the large-scale manufacturing (LSM) growth, improving energy supplies,[2] and an increase in value-added textile exports in Q2-FY17 further add to the optimism.[3] Moreover, agriculture growth is also likely to rebound as indicated by an increase in the production of major crops over the last year.

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[1] Several industries, including cement, steel, beverages, and automobiles, have announced capacity expansion plans; some of these are already underway. Moreover, in November 2016, a Turkish company acquired Pakistani home appliance firm Dawlance, and a Dutch food conglomerate completed its purchase of a majority stake in Engro Food in December 2016. More foreign investment is in the pipeline, particularly in construction-allied, automobile and food industries.

[2] Two new power projects came online in December 2016 and February 2017, adding a cumulative 433 MW to the grid. Furthermore, a 1,320 MW coal power plant at Sahiwal has started trial operations, and the Chashma Nuclear Power Plant Unit-4 is expected to start its operation soon as well. In addition, overall gas supplies have also improved, enabled by an increase in LNG imports during H1-FY17 (**Chapter 2**).

[3] After falling for last seven quarters consecutively, textile exports grew by 3.2 percent in Q2-FY17.

In addition to favorable spillover from commodity producing sectors, the current trends in key variables – like rising sale of commercial vehicles, oil consumption by the transport sector, internet subscription, external trade volume, etc. – reflect positively on the performance of the services sector. These developments suggest that the economy is maintaining its growth momentum.

In this backdrop of increased domestic supplies, ongoing expansion in economy's future capacity to produce, and muted impact of uptick in international commodity prices, inflation remained lower than the target. The low inflation also shows the impact of sustained decrease in fiscal deficit and stability in external sector over the last few years. However, these have started to show signs of strains recently.

Specifically, the current account deficit in H1-FY17 was almost twice the level recorded in the first half of FY16. This was largely due to delayed realization of Coalition Support Fund (CSF), a decline in the exports, and a surge in the imports.[4] From the external sector stability standpoint, such increase in the current account deficit does not bode well, particularly in view of bottoming out of global commodity prices (especially oil prices) along with some shifts in the international capital markets due to rise in the US interest rates.

However, two points are important to consider about the external sector. First, the surge in imports is mainly concentrated in the growth-inducing capital goods: the import of machinery, fuel and metal groups accounted for more than half of the total imports during H1-FY17.[5] When the economy is taking off, it is natural to expect some widening in the current account deficit. Nevertheless, it needs to be contained within sustainable levels. Second, the external inflows in the country have been sufficient to finance the current account deficit so far. More importantly, the current level of SBP's foreign exchange reserves can comfortably finance more than five months of imports.

On the fiscal side, coupled with increase in development spending and security related expenditures, the decline in revenue collection has led the fiscal deficit to widen by 0.7 percent of GDP in H1-FY17 as compared to the last year. Going forward, lower-than-expected growth in tax revenues could undermine the

[4] Pakistan received US$ 550 million under CSF in two tranches: one in February 2017 (US$ 350 million) and the other in March 2017 (US$ 200 million). In FY16, US$ 713 million under CSF were received in the first half.

[5] Within the machinery group, power generation machinery increased by 112.6 percent; textile machinery by 11.3 percent; construction and mining machinery by 54.8 percent; electrical machinery 7.5 percent; and, others by 29.4 percent. For more details, see **Section 5.5**.

government's efforts to keep the fiscal deficit at the targeted level and at the same time increase the development spending.

The challenges in the external and fiscal accounts need to be addressed to sustain macroeconomic stability, which has just started to push the economy towards a desirable (low inflation-high growth) balance. In addition to boosting foreign exchange receipts from reviving exports and private foreign investment, urgent measures are needed to contain imports, especially of consumer and luxury items – to keep the overall import bill manageable.[6] A combination of improved competitiveness and administrative measures would produce desirable results in this regard. In particular, there is a need to further reduce cost of doing business, enhance productivity, and remove structural impediments in the export sector.

Similarly, the structural reforms and stabilization measures undertaken by the Government to reduce the fiscal deficit during the last three years need to be further deepened. In particular, the continuity of concerted efforts aimed at broadening the tax base is necessary to gear up momentum in revenue collection and create the fiscal space required for higher spending on social and infrastructural development.

1.1 Economic review

Preliminary data on crops indicates that agriculture growth will rebound in FY17. The production of major *kharif* crops, including cotton, sugarcane, and maize is estimated to increase significantly this year. The output of major *rabi* crop, i.e., wheat is also expected to remain close to the last year's bumper crop of 25.4 million tons on the back of timely and widespread rains.[7] Besides improved water situation (from January 2017 onwards), an increase in fertilizer off take (33 percent higher), and higher credit disbursement (up 32 percent) during *Rabi* season also point to a better performance of the crops subsector.

Encouragingly, LSM growth has picked up momentum in Q2-FY17 (rising by 5.8 percent YoY). This partly compensated the sluggish Q1-FY17 growth of 2.1 percent. As a result, the cumulative growth during H1-FY17 increased to 3.9 percent, same as the last year. The major contribution to LSM growth during H1-FY17 came from food, steel, cement and pharmaceutical industries.

[6] In order to contain import growth, SBP has imposed 100 percent cash margin on import of consumer and luxury items (BPRD Circular No. 02 of 2017, dated 24 February 2017).

[7] Although there are reports of a slight decline in area under cultivation due to dry weather and water shortages during the sowing season in barani areas, this is likely to be partially offset by the expected increase in productivity.

These industries largely benefited from accommodative monetary and fiscal policies; improved energy supplies; better availability of raw materials (e.g., sugarcane); rising domestic demand (particularly for cement and steel, owing to ongoing CPEC-related power and infrastructure projects); and clarity on drug pricing mechanism. In addition, the recently announced export package would also provide much needed support to export industries, especially textile – the historical mainstay of LSM growth.

On the other hand, the available information on services sector indicators points to a mixed performance. Healthy trends in transport (given the surge in sales of trucks, buses, and POL products); increased (external) trade volumes along with better output of agriculture and industry (having positive spillover for *wholesale and retail trade*); significant increase in bank credit; and a rise in 3G/4G subscription base (27 percent) during H1-FY17, all indicate towards an uptick in the services sector's performance. At the same time, losses of Public Sector Enterprises (PSEs), and a decrease in banks' profitability, act as potential drags. On balance, however, the services sector is expected to keep up last year's growth momentum (see **Chapter 2** for details).

Meanwhile, ongoing investments in energy and infrastructure sectors (and strong transport sector activity) resulted in a sharp increase in import demand, especially for capital goods and raw materials. Led by higher imports of machinery (power and construction) and petroleum (including LNG), the total import bill grew by 6.0 percent during H1-FY17, compared to 8.9 percent decline in the corresponding period last year.[8]

This surge in imports was partly a result of rising commodity prices, especially crude and palm oil. This, combined with the non-receipt of CSF in H1-FY17 and decline in exports and remittances, resulted in the almost doubling of the current account deficit to US$ 3.5 billion during first half of the year. (Here, it is worth mentioning that the receipt of CSF in Q3-FY17, and recently announced package for exports may help balance of payments going forward.)

Encouragingly, available financial inflows were more than sufficient to finance the higher current account deficit. Major foreign exchange inflows included US$ 1 billion from a Sukuk and net loans of US$ 1.4 billion (including US$ 900

[8] The increase was mainly concentrated in Q2-FY17, when import payments rose sharply by 11.5 percent YoY. In addition to elevated non-oil imports, POL imports rebounded for the first time since Q1-FY15 (on YoY basis) and contributed significantly to the rise in the overall import bill during Q2-FY17.

million of commercial borrowings). In addition, net FDI increased by 10.5 percent to US$ 1.1 billion during H1-FY17, from US$ 978 million last year.

As a result, SBP's liquid FX reserves recorded a net increase of US$ 129 million during H1-FY17 (see **Chapter 5** for details). Here, it must be acknowledged that while imports are essential at the moment to address infrastructure and energy bottlenecks, there is a need for an equivalent increase in foreign exchange earnings to finance these imports and thereby maintain the external sector's stability.

The official foreign inflows also helped financing of the fiscal deficit, which was 2.4 percent of GDP during H1-FY17 compared to 1.7 percent in the corresponding period last year. Both an increase in expenditures and a decline in revenues contributed to this widening of fiscal deficit. The decline in total revenue was largely due to 31.8 percent fall in non-tax revenue on account of non-realization of CSF in H1-FY17, lower SBP profit, and a decline in dividend income.

Moreover, growth in tax revenue also decelerated to 6.2 percent during H1-FY17 compared to over 20 percent increase in the last year. This slowdown seems to be an unintended consequence of various tax measures to support investment, growth, and exports. Notwithstanding these factors, the need to address structural weaknesses in the tax system for a sustainable increase in tax revenue, commensurate with development and social spending requirements cannot be overemphasized.

On the expenditure side, overall spending accelerated to 10.7 percent during H1-FY17 – more than twice the growth of 5.0 percent recorded in H1-FY16. The pattern of expenditure shows that the government is largely maintaining its focus on improving the security situation and providing a boost to investment and economic activity through higher development spending. Spending on these two accounts grew by 10.9 percent and 16.7 percent respectively during the period under review (see **Chapter 4** for details).

Notwithstanding the higher fiscal deficit, the public debt increased by only Rs 583.4 billion during H1-FY17; this was almost half of Rs 1,097.7 billion increase observed in the corresponding period of the last year. The slowdown in debt accumulation was caused by deceleration in both the external and domestic debt. The net increase in public external debt and liabilities during H1-FY17 amounted to only US$ 130 million, against an increase of US$ 2.3 billion in H1-FY16. This slowdown in external debt accumulation reflected revaluation gains, mostly due to the depreciation of the Japanese yen against the US dollar. On the other hand, the government retired its domestic debt to the tune of Rs 193.2 billion during Q2-FY17, as it utilized a large part of its deposits held with the banking system instead of resorting to fresh borrowing.

As the economic activities are picking up the domestic demand is also rising (see **Chapter 2** for detail). This, along with the revival in global commodity and oil prices, has pushed up average CPI inflation to 3.9 percent during H1-FY17 from 2.1 percent in H1-FY16. However, the year-on-year inflation fluctuated in a narrow range around 4.0 percent since the start of the fiscal year. In fact, a limited pass-through of the rise in global oil prices to domestic POL prices during H1-FY17 partially offset upward pressures stemming from higher food prices (especially of fresh vegetables and edible oil).

Keeping in view the prevailing economic trends, i.e., healthy economic growth, contained inflation and at the same time increasing current account deficit, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 5.75 percent during H1-FY17. This, combined with a comfortable liquidity position in the interbank market, led to a continuation of stable market interest rates.

These developments in the banking system induced growth in the private sector credit. The overall credit to the private sector increased by Rs 383.7 billion during H1-FY17 against an expansion of Rs 295.7 billion in the same period last year. A part of this reflects an increase in working capital requirements of manufacturing firms, in view of the rise in the raw material prices. Credit for fixed investment, i.e., the amount borrowed mainly for capacity expansion, also grew sharply following an increase in the public sector development spending. Besides hefty corporate sector borrowing, consumer loans also picked up.

As mentioned earlier, the encouraging trend in private sector credit was partly supported by a hefty retirement of Rs 485.5 billion (on cash basis) by the government to commercial banks. A sizeable portion of this, Rs 212.6 billion, was due to maturity of Ijara Sukuk, and the rest came from low turnover in auctions of government securities. The retirement to commercial banks was made possible through the government's recourse to borrowings from SBP and external sources.[9]

[9] Government borrowing from SBP (on cash basis) increased by Rs 892.6 billion during H1-FY17, against a retirement of Rs 429.2 billion witnessed in the corresponding period of last year.

To a great extent, SBP neutralized the impact of the increase in the government's borrowing on reserve money growth by scaling down the outstanding stock of OMO injections.[10] This helped contain the reserve money growth to 6.6 percent in H1-FY17, against 10.6 percent recorded in the corresponding period of last year. Nevertheless, growth in broad money accelerated to 5.0 percent during H1-FY17 from 4.3 percent last year. This growth came entirely from an expansion in Net Domestic Assets (NDA) of the banking system. On the other hand, Net Foreign Assets (NFA) of the banking system saw a contraction of Rs 20.6 billion in H1-FY17, against an expansion of Rs 150.6 billion seen last year. Although most of the contraction was contributed by scheduled banks, NFA of the SBP also declined by Rs 3.4 billion in Q2-FY17.

1.3 Outlook for FY17

The real GDP growth in FY17 is expected to be higher than the last year. Major contribution is expected from the rebound in agriculture and increased pace of work on infrastructure and energy projects. In particular, the completion of early harvest energy projects under CPEC is expected to provide additional boost to industrial growth. These expectations are in line with continuing robust trends in private sector credit and import of machinery and raw materials.

The growth in industry, though likely to fall short of its target, is expected to maintain last year's level. The textile industry, the largest sub-component of the LSM, is expected to post some recovery in H2-FY17, as exporters cash-flow constraints may ease following the recently announced export package. The commencement of operations of new power plants and the sustained increase in LNG imports are expected to help electricity generation and gas distribution to maintain last year's momentum. Similarly, as indicated by strong trends in cement and steel production, the growth in construction sector is likely to remain robust in FY17 as well.

The services sector, though showing a mixed trend as discussed in **Chapter 2**, is expected to achieve its target growth rate for the year. The current trends in trade, especially imports; higher production and sale of commercial vehicles; substantial increase in bank credit; flourishing housing schemes; and rising internet subscription, all suggest a vibrant services sector. Incorporating these developments, the latest projections indicate real GDP growth in the range of 5 to 6 percent in FY17 (**Table 1.2**).

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[10] The net outstanding stock of OMO injections was brought down from the peak of Rs 2,033.4 billion in mid July 2016 to Rs 800 billion by end-December 2016.

Increase in agriculture production and sufficient food supplies, stable exchange rate, and a limited pass-through of rising international commodity prices to domestic prices are expected to keep inflation low and stable. Importantly, in case of oil prices, less-than-warranted increase in domestic motor fuel prices would limit its direct and second round impact on CPI inflation. Moreover, the recent increase in investment demand as reflected by the widening of twin deficits may not have an adverse impact on inflation in the remaining months of FY17. Therefore, full-year average CPI inflation is expected to remain in 4 to 5 percent range.

Table 1.2: Key Macroeconomic Targets and Projections

	FY16	FY17	
		Target[1]	Projection[2]
		percent growth	
Real GDP	4.7[4]	5.7	5.0 – 6.0
CPI (average)	2.9[4]	6.0	4.0 – 5.0
		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.

In view of strong growth in imports and taking stock of developments in international commodity prices and global economic trends, the current account deficit is likely to increase; however, the country's foreign exchange reserves will remain at comfortable level. Some gains in exports due to the recently announced export package are expected to be offset by muted remittance growth. Declining number of migrant workers going to the GCC (reflecting stressed fiscal conditions in these countries due to low oil prices); the pound sterling's depreciation against the US dollar, and stricter regulatory controls in US, are the main factors that will likely keep remittance inflows close to last year's level.[11]

Given the actual fiscal deficit of 2.4 percent of GDP in the first half, and keeping in view that the deficit is usually higher in the second half, the full-year fiscal gap will be higher than the target of 3.8 percent. This projection incorporates the impact of the recently announced export package, and assumes no significant change in the current pace of revenue collection in the absence of additional revenue generating measures. On the other hand, expenditures are likely to remain elevated due to the government's commitment to complete most of the power and infrastructure projects by close of FY18 and ongoing operations aimed to further improve the country's security environment.

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[11] The recent decision of Kuwait government to lift restrictions on issuing visas to Pakistani nationals bodes well for increased remittance flows going forward.