THE STATE OF PAKISTAN’S ECONOMY

Third Quarterly Report
for the year 2016-17 of the
Board of Directors of State Bank of Pakistan

State Bank of Pakistan

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1 Overview

Real GDP growth has maintained its upward trajectory and increased to a decade-high of 5.3 percent in FY17. Some of the other macroeconomic indicators, such as subdued inflation, investment growth, and rising private sector credit, also showed an encouraging picture. However, decline in exports is overshadowing the otherwise reviving economic activity.

Table 1.1: Selected Economic Indicators

		FY15	FY16	FY17
Growth rate (percent)				
Real GDP[1]	Jul-Jun	4.1	4.5	5.3
Agriculture	Jul-Jun	2.1	0.3	3.5
Industry	Jul-Jun	5.2	5.8	5.0
o/w LSM	Jul-Jun	3.3	2.9	4.9
Services	Jul-Jun	4.4	5.5	6.0
Real fixed investment[1]	Jul-Jun	15.8	6.7	8.3
CPI (period average)[a]	Jul-Mar	5.1	2.6	4.0
Private sector credit [b]	Jul-Mar	5.7	8.1	9.9
Money supply (M2)[b]	Jul-Mar	5.7	6.0	5.9
Exports [b]	Jul-Mar	-3.8	-9.4	-1.3
Imports [b]	Jul-Mar	-0.1	-4.9	14.1
Tax revenue –FBR [c]	Jul-Mar	12.7	17.7	8.2
Exchange rate (+app/-dep%)[b]	Jul-Mar	-3.1	-2.8	-0.01
billion US dollars				
SBP's reserves (end-period) [b]	Mar	11.6	16.1	16.5
Worker remittances [b]	Jul-Mar	13.6	14.4	14.1
FDI in Pakistan [b]	Jul-Mar	0.8	1.4	1.6
Current account balance [b]	Jul-Mar	-2.0	-2.4	-6.1
percent of GDP[1]				
Fiscal balance[d]	Jul-Mar	-3.8	-3.5	-3.9
Current account balance	Jul-Mar	-1.0	-1.1	-2.5

1: Provisional numbers for FY17.
Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Federal Board of Revenue; and [d] Ministry of Finance

The revival in agriculture during FY17 is especially notable. This was supported by favorable policy measures, including subsidy on fertilizer, reduction in sales tax on tractors, and increased access to finance. Better agriculture had, in turn, positive spillover for trade and manufacturing sectors. Further, PSDP and CPEC-related activities also continued to boost construction related industries, such as cement and steel.

The overall improvement in business sentiments along with supportive policies (historic low interest rate, high infrastructure spending and better law and order) has encouraged a number of firms to pursue expansion plans. This was reflected in a significant surge in private sector credit off-take during FY17, with a sizable share of fixed investment loans. At the same time, a hefty increase in machinery imports was also noted.

While the imports of machinery, raw material and other capital goods bode well for the growth potential of the country, these could not be financed completely from non-debt creating FX inflows, like exports, remittances, and FDI. And while the country continued to enjoy IFI support and access to international capital markets, these inflows were not sufficient to finance the higher current account deficit. As such, SBP's FX reserves declined from US$ 18.1 billion as on end-June 2016 to US$ 15.3 billion on 9th June, 2017.

As the country has adequate level of FX reserves, despite some decline, there are no immediate concerns over its external position. However, going forward, it is imperative to exploit all sources of FX inflows – most importantly exports – in order to comfortably finance the rising import demand. Pakistan's exports have been afflicted by a number of structural, institutional and entrepreneurial gaps, which have constrained the country's competitiveness for the last many years.[1] The government has announced an incentive package for exporters. Moreover, general interest rates for businesses and special rates for export re-finance are at historic low. The private sector has the opportunity to fully benefit from these conditions by modernizing its business processes, investing in research and development, improving human capital, seeking international certifications, and meeting quality standards as expected by foreign consumers.

Low tax collection is another challenge faced by the economy. Some tax measures, like differential tax structure for filers and non-filers can potentially increase the tax base; however, recent fiscal incentives for investment, exports and domestic production have led to deceleration in tax collection.[2] While importance of such fiscal relief measures to support growth cannot be overemphasized, concerted efforts are required to further improve efficiency of the tax system.

Both these challenges, i.e., decline in exports and below target tax collection, are impacting two key macroeconomic balances – current account and fiscal. In order to maintain the growth momentum and hard-earned economic stabilization, these balances need to be kept at sustainable levels. For this purpose, both the public and private sectors have to play their roles: public sector through consistent and well thought policies; and private sector by enhancing its efficiencies.

1.1 Economic review

Real sector

Pakistan's economy grew by 5.3 percent in FY17, up from 4.5 percent growth

[1] See SBP Staff Notes 02/17 and Special Section 3 of SBP Annual Report FY15 for detailed discussions on structural issues affecting exports.

[2] For instance, tax relief on fertilizer and pesticides, zero-rating and duty drawback for exporters, sales tax exemptions on import of new machinery and raw material for textiles, and tax incentives to new energy projects.

recorded in FY16. This acceleration was achieved on the back of a strong performance of agriculture and services sectors, which grew by 3.5 percent and 6.0 percent respectively in FY17, compared with 0.3 percent and 5.5 percent last year.

The rebound in agriculture was primarily driven by five major crops (i.e. rice, cotton, sugarcane, wheat, and maize), which posted a growth of 3.5 percent, after declining 5.0 percent last year. The bumper crops of sugarcane, maize and cotton compensated for low growth in rice and wheat production.[3] The growth in livestock value added has also increased during the year. However, the performance of minor crops remained slightly lower as compared to the last year (see **Chapter 2** for detail).

The industrial sector posted a growth of 5.0 percent during FY17, compared with 5.8 percent last year. This moderation came mainly from decline in growth rates of *mining and quarrying* and *electricity and gas* sub-sectors. Against this, the large-scale manufacturing sector (LSM), a key contributor to industry, grew by 4.9 percent during FY17, compared to 2.9 percent last year.

The improvement in LSM growth was contributed by a wide range of industries, including sugar, cement, steel, pharmaceuticals, electronics, and heavy vehicles (like tractors and buses). At a broader level, support to the sector emanated from: (i) burgeoning domestic demand; (ii) sizable credit off-take; (iii) increased government development spending; (iv) improved law and order situation; (v) adequate availability of raw materials; and (vi) ease in energy supplies.[4]

The higher growth in agriculture and industry also had a positive impact on the performance of the services sector, with *wholesale and retail trade* a key beneficiary. In addition, growth of *finance and insurance* also went up, mainly due to high growth in deposits and advances of the banking sector. Meanwhile, the value addition in *general government services* remained low as compared to last year due to a smaller increase in wages and salaries.

Inflation and monetary policy

CPI inflation remained quite stable in the first two quarters of FY17, but picked up gradually in the third quarter. The average inflation during Jul-Mar FY17 was 4.0 percent, compared with 2.6 percent in the same period last year. However, it is

[3] The growth of five major crops during FY17 has been recorded as: wheat (0.5 percent), maize (16.3 percent), rice (0.7 percent), sugarcane (12.4 percent) and cotton (7.6 percent).

[4] Total power generation in the country increased by 3,166 GWh in Jul-Mar FY17 (source: NEPRA).

still significantly lower than the annual target of 6.0 percent. Some of the uptick in inflation was a result of partial pass-through of the increase in international oil prices to domestic POL prices; a surge in global prices of some key food commodities (like palm oil); increase in medicine prices; and upward revision in education fees (see **Chapter 3** for detail).

This gradual uptick in inflation along with external imbalances had a bearing on the monetary policy decisions during Jul-Mar FY17. Keeping in view the delicate balance between macroeconomic risks and ongoing growth momentum, the policy rate was kept unchanged at 5.75 percent throughout the year FY17. The low interest rate and benign business environment (as manifested by the country's better risk perception), stimulated demand for credit by the private sector, which reached Rs 438.6 billion during Jul-Mar FY17, against Rs 323.4 billion in the same period last year. Also, the increase in credit remained broad-based, with firms borrowing heavily to finance their capital expenditure: fixed investment loans accounted for 42 percent of the total increase in credit to private businesses in Jul-Mar FY17.[5] The demand for working capital loans also accelerated due to high input prices and greater availability of raw materials (e.g., sugarcane and cotton). In addition, to capitalize on the available commodity surplus and exporting opportunities, trade-related borrowings also went up during the period.

The uptick in credit off-take, along with budgetary borrowings, led to increase in NDA of the banking system. The government borrowed primarily from SBP and made retirements to commercial banks – the only exception was the third quarter when commercial banks participated actively in PIB auctions of government securities. In addition, credit to PSEs (especially energy-related) increased sharply, mainly to settle payables.[6] As a result, the expansion in the net domestic assets (NDA) of the banking system stood 75 percent higher than the expansion seen last year. However, this increase in NDA was offset by a decline in the net foreign assets (NFA) of the banking system, which led to a marginally lower growth in M2 during Jul-Mar FY17, compared with the last year.

On the supply side, banks had sufficient liquidity available for private sector lending during Jul-Mar FY17, on the back of high deposit mobilization and lower government borrowing from commercial banks. Moreover, a better outlook in terms of investment opportunities and gains in asset quality also played a part in encouraging banks to expand their credit portfolios.

[5] Over 90 percent of the increase in fixed investment loans by textiles was under SBP's long term financing facility for export oriented projects.

[6] See **Chapter 3** for more detail.

Fiscal operations

The fiscal deficit stood at 3.9 percent of GDP during Jul-Mar FY17, compared with 3.5 percent in the corresponding period last year. This was despite a surplus of Rs 227.6 billion provided by provinces during this period. In fact, revenue collection could not buoy up with the growing economic activities and fiscal needs. Particularly, FBR taxes showed a growth of 8.2 percent in Jul-Mar FY17, which was half the growth observed last year. Non-tax revenues also declined, mainly on account of lower receipts under Coalition Support Fund and SBP profit.

Encouragingly, the expenditure side of fiscal operations remained well-managed. While the growth in current expenditure declined during Jul-Mar FY17 (to 5.8 percent, against 6.5 percent last year), the government managed to maintain a double digit growth in development expenditures. The current expenditure were contained despite a significant increase in defense and security-related expenses.

Gross public debt rose to Rs 20.9 trillion as on end-March 2017, showing an increase of Rs 1.2 trillion during Jul-Mar FY17. A large part of this increase came from domestic borrowing, while increase in external debt remained moderate.

The debt & liabilities stock increased by US$ 595.6 million during Jul-Mar FY17 and reached US$ 62.0 billion. This lower accumulation in external debt took place on the back of revaluation gains (US$ 1.5 billion) and increased repayments made during the period (see **Chapter 4** for detail).

External sector

The current account deficit reached US$ 6.1 billion during Jul-Mar FY17 on the back of a large trade deficit and slowdown in remittances. The trade deficit swelled due to a decline in exports (-1.3 percent) and a sharp increase in imports (14.1 percent), which mainly consisted of capital goods and raw materials.

The increase in imports can be explained by continued power and infrastructure development, expansion plans of a number of industries, and increase in manufacturing activities. On the other hand, the decline in exports is mainly attributed to lower quantums despite recovery in global commodity prices (cotton and rice) during Jul-Mar FY17 (see **Chapter 5** for detail).

On the financing side, official external inflows in Jul-Mar FY17 (project, non-project and commercial loans, and sovereign bonds) stood around the same level as last year – indicating that IFIs and international capital markets are still supportive of Pakistan and comfortable with its growth trajectory (see **Chapter 5** for detail). Besides, both FDI and FPI inflows increased during the period. In addition to China, a significant amount of FDI also came from other countries through merger and acquisition transactions in food and electronics.[7]

However, these inflows were not sufficient to fully offset the widening in the current account gap. As a result, SBP's liquid FX reserves declined from US$ 18.2 billion by end-December 2016 to US$ 16.5 billion by end-March 2017.[8] However, the reserves adequacy indicators are still comfortable at this level: SBP's liquid FX reserves are sufficient to finance over four months of import of goods.

1.2 Economic outlook

Pakistan's macroeconomic indicators continue to improve and solidify grounds for a sustained upward growth trajectory. In particular, key constraints impeding the economy from achieving high growth – i.e. power supply and security situation – are gradually getting better. In this backdrop, the government envisages a higher real GDP growth of 6.0 percent for FY18, compared to 5.3 percent recorded in FY17.

Inflation is expected to remain within the target of 6 percent amidst some pick up on the back of recovery in global prices of oil and other commodities, and push from domestic demand factors. Meanwhile, the credit expansion is likely to maintain its pace with better prospects for investment and business activities.

The FY18 budget has set a fiscal deficit target of 4.1 percent of GDP for the year. This will be supported by 14 percent growth (Rs 4 trillion) in FBR tax revenues. Along with continuing some of the relief measures, the budget has also introduced a number of measures to achieve this enhanced revenue target. On expenditure side, while containing current expenditure, the budget has created substantial space for development spending; the PSDP for the next year is budgeted at Rs1 trillion, which is 40 percent higher than revised estimates of Rs715 billion for this year.

On the external front, the positive spillover of recovery in the global economy, particularly advanced economies, offers healthier trade prospects. Pakistani exports could also benefit from this evolving dynamic, if the exporters are able to diversify their products at competitive prices. The Annual Plan FY18 projects

[7] Pakistan received FDI inflows from the Netherlands (US$ 465.6 million) and Turkey (US$ 133.1 million) during Jul-Mar FY17. In the same period, FDI from China amounted to US$ 594.8 million.

[8] During this period, Pakistan also repaid US$ 500 million of SAFE China Deposits.

exports to grow by 6.8 percent, with impetus coming from removal of supply-side bottlenecks and a better performance by the industrial sector.

The import bill is likely to rise by 7.6 percent (according to the Annual Plan FY18) due to surge in demand for machinery and equipment. However, the impact of such imports on the external balance would remain muted due to availability of financing from IFIs and other bilateral sources.

In sum, the growth prospects of Pakistan's economy from FY18 onwards would largely hinge upon planned infrastructure projects and capacity expansion by industries. In order to make these plans a success story, enhanced coordination amongst all public sector institutions would be more crucial. Also, continuity and consistency in policies, especially those related to investment and industry, would be necessary to ensure sustainability of the growth momentum.

2 Real Sector

2.1 Overview

Continuing on its growth momentum, Pakistan's real GDP grew by 5.3 percent in FY17, compared to 4.5 percent last year. This was the highest growth achieved over the last decade. A sharp recovery in agriculture sector, healthy performance by services, and an uptick in the large scale manufacturing output contributed towards this encouraging performance.

The key factors enabling this performance include improved supply of energy, increased developmental spending, supportive monetary policy, and a better law and order situation.

Table 2.1: GDP and its Components

Share and growth in percent; contribution in percentage points

	Share FY17	**Growth**			**Contri. to**
		FY16^{R}	**FY17^{P}**	**FY17^{T}**	**growth**
Agriculture	**19.5**	**0.3**	**3.5**	**3.5**	**0.7**
Of which					
Important crops	4.7	-5.5	4.1	2.5	0.2
Livestock	11.4	3.4	3.4	4.0	0.4
Industry	**20.9**	**5.8**	**5.0**	**7.7**	**1.1**
Of which					
Mining and Quarrying	2.9	6.9	1.3	7.4	0.04
LSM	10.7	2.9	4.9	5.9	0.5
Electricity gen. & dist. and gas dist.	1.8	8.4	3.4	12.5	0.1
Construction	2.7	14.6	9.0	13.2	0.2
Services	**59.6**	**5.5**	**6.0**	**5.7**	**3.5**
Of which					
Wholesale & retail trade	18.5	4.3	6.8	5.5	1.2
Finance & insurance	3.4	6.1	10.8	7.2	0.3
General govt.	7.6	9.7	6.9	7.0	0.5
GDP	**100**	**4.5**	**5.3**	**5.7**	**5.3**
Memorandum item					
Investment-GDP ratio		15.6	15.8	17.7	

R: Revised; P: Provisional; T: Target

Data source: Pakistan Bureau of Statistics

The agriculture sector was able to achieve its targeted growth rate of 3.5 percent during FY17, with a broad-based improvement in the production of important crops. Price subsidy on fertilizer, and affordable access to credit facilities (owing to decades low policy rate), resulted in the important crops segment posting a growth of 4.1 percent against a contraction of 5.5 percent experienced last year.

The services sector – benefitting from a recovery in the agriculture sector, an increase in manufacturing, and a rise in trade activities – contributed around two-thirds of the growth witnessed during FY17, with *wholesale and retail trade* growth rising from 4.3 percent last year to 6.8 percent in FY17.[1] In addition,

[1] Manufacturing activities contribute more than half of the value addition in wholesale & retail trade. In comparison, share of the agriculture trade is around 18 percent.

finance and insurance posted a recovery on account of healthy deposit and advances of the banking sector.

The performance of the industrial sector, meanwhile, remained constrained as growth stayed below last year's level. This was the major reason GDP growth could not reach its targeted figure, as the agriculture and services sectors performed at and above the expected rates, respectively (**Table 2.1**). A decline in the growth rate of *electricity generation and distribution, mining and quarrying,* and *construction* constrained the industrial growth. On the other hand, large scale manufacturing (LSM) fared better than last year.

From demand-side perspective, the support to GDP growth mainly came from increased domestic consumption. Subdued inflation, growing income levels, improved liquidity among farmers (through roll-out of subsidy package), and higher demand from expanding middle class population bolstered consumer spending in the economy. Further support to domestic demand came from the investment on account of increased focus on CPEC and public infrastructure development projects during the year.

2.2 Agriculture

Agriculture sector was able to achieve its growth target envisaged in the Annual Plan for FY17, primarily due to better-than-expected performance of important crops which posted a growth of 4.1 percent in FY17 compared to a decline of 5.5 percent in FY16 (**Table 2.2**). The recovery is broad-based, as maize and sugarcane posted double-digit growth, while the rest of the important crops also contributed positively albeit with lower growth rates (**Table 2.3**). The improvement in crop sector could have been even better, had the country not faced a decline in area under cotton and dry weather during Rabi season. Finally, the livestock subsector, which contributes more than half of agriculture output, maintained its pace during the period under review.

Table 2.2: Value Addition by Agriculture
Share and growth in percent; contribution in percentage points

					Contribution	
	Share	**Growth**			**to growth**	
	FY17	**FY16^R**	**FY17^T**	**FY17^P**	**FY16^R**	**FY17^P**
Crop sector	37.2	-5.0	-	3.0	-2.0	1.1
Important crops	*23.9*	*-5.5*	*2.5*	*4.1*	*-1.4*	*1.0*
Other crops	*11.0*	*0.6*	*3.2*	*0.2*	*0.1*	*0.0*
Cotton ginning	*2.3*	*-22.1*	*2.5*	*5.6*	*-0.7*	*0.1*
Livestock	58.3	3.4	4.0	3.4	1.9	2.0
Forestry	2.3	14.3	3.0	14.5	0.3	0.3
Fishing	2.1	3.2	3.0	1.2	0.1	0.0
Overall	**100.0**	**0.3**	**3.5**	**3.5**		

R: Revised; P: Provisional; T: Target

Data source: Pakistan Bureau of Statistics

Input Situation

The input situation remained comfortable during Jul-Mar FY17. Fertilizer and credit off-take posted steady gains, while shortfall in water availability during Rabi 2016-17 was the only impeding factor that emerged during this period.

Table 2.3: Production of Major Crops

millions tons; cotton in million bales; growth in percent

				Growth	
	FY16	**FY17^T**	**FY17**	**FY16**	**FY17**
Cotton	9.9	14.1	10.7	-28.8	7.6
Rice	6.8	6.8	6.8	-2.9	0.7
Sugarcane	65.5	67.5	73.6	4.2	12.4
Wheat	25.6	27.4	25.8	2.2	0.5
Maize	5.3	4.6	6.1	6.8	16.3

Data source: Pakistan Bureau of Statistics; T: Target

Irrigation data showed a 10.0 percent drop in water availability in Rabi 2016-17, broadly in line with Indus River System Authority's projections.[2] Not only was there a shortfall in canal flows, prolonged dry weather during Oct-Dec cast a shadow on the prospects of wheat crop.[3] Wheat growers in the rain dependent areas of Potohar region suffered due to lack of moisture, however, growers elsewhere were able to draw groundwater to compensate for the surface water deficit.

A combination of cash subsidy, reduction in sales tax and voluntary reduction in prices by manufacturers consolidated the recovery in fertilizer off-take in FY17. Urea and DAP sales surged by 18.8 and 11.1 percent in Rabi 2016-17 compared to the corresponding period last year. Significant drop in fertilizer prices benefited the farmers (**Box 2.1**).

Box 2.1: Impact of Reduction in Urea and DAP Prices on Important Crops

According to our estimates, a typical grower involved in cultivation of important crops saved Rs 2,485 per hectare on urea in Jul-Mar FY17 compared to previous year (**Table 2.1.1**). The same

Table 2.1.1: Estimated Savings from Reduction in Fertilizer Prices (Jul-Mar)

	DAP		**Urea**	
	FY16	**FY17**	**FY16**	**FY17**
Quantity of fertilizer (# of 50 kg bag per hectare)[1] (a)	3.8	3.8	5.0	5.0
Price of fertilizer (Rupees per 50 kg bag)[2] (b)	3,494.8	2,589.0	1,903.4	1,392.8
Cost of fertilizer (Rupees per hectare) (a*b)	13,361.8	9,924.8	9,482.6	6,997.8
Savings per hectare (FY16-FY17)		**3,437.0**		**2,484.9**
Total savings -DAP + Urea (Rupees per hectare)				5,921.9
Area under important crops FY17 (million hectares)				16.8
Total benefit (billion Rupees)				**99.6**

[1] This is the average use of fertilizer for important crops weighted by area under these crops (Data source: Pakistan Bureau of Statistics, and State Bank of Pakistan)

[2] This is the weighted average price of fertilizer for Jul-Mar period (source: NFDC)

[2] Source: SUPARCO

[3] The country received 40 percent less precipitation during this year's Rabi season compared to the previous one.

grower saved Rs 3,437 per hectare in case of DAP during this time. Adding these savings for total area under important crops in FY17, reveals that these growers were better off to the tune of Rs 100 billion in Jul-Mar FY17 compared to the same period last year.

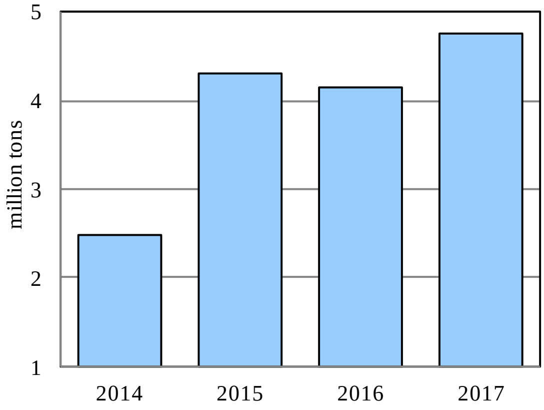
Agriculture credit demand remained strong during the period. Gross agriculture sector disbursements witnessed an upsurge of 22.7 percent during Jul-Mar FY17 compared to the same period last year. Both production and development loans registered impressive growth of 23.5 and 14.2 percent respectively during the period. Agriculture finance received added impetus this year due to: (a) stable interest rates; and (b) inclusion of Micro Financial Institutions (MFIs) in agri financing for the first time.

Wheat

Wheat output of 25.8 million tons in FY17 was 0.5 percent higher than the last year. This performance was appreciable in the aftermath of dry weather that prevailed during the crucial sowing and germination period. As mentioned earlier, the rain-fed wheat cultivation areas in particular suffered losses. However, these losses were offset by rise in production from the irrigated areas which can be attributed to increased use of fertilizer and groundwater withdrawals.

As has been the trend in the recent past, high procurement price kept wheat crop highly profitable, which, in turn has resulted in production surpluses. With domestic consumption averaging around 24.5 million tons each year,[4] there would be an excess of 1.3 million tons of wheat at home. On the other hand, unsold wheat stocks from previous harvests had increased to 4.8 million tons by April FY17; these were 15.7 percent more than last year's April figure (**Figure 2.1**).

Figure 2.1: Wheat Stocks - April



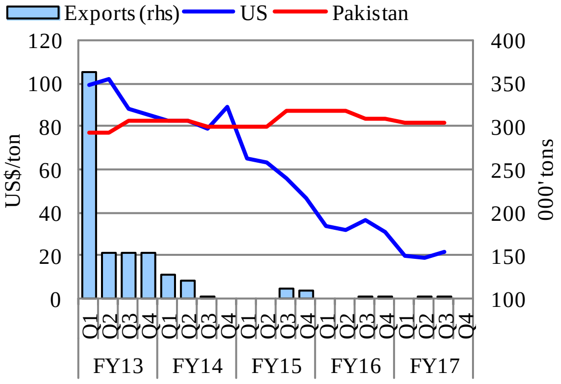
Data source: Provincial Food Departments

This year's bumper crop will add to the already substantial stockpile with no bright prospects for exports. Wheat exports seem implausible without adequate

[4] Source: Foreign Agriculture Service, United States Department of Agriculture- (FAS-USDA)

export subsidy, as the price differential between domestic and international market is unfavorable at this stage (**Figure 2.2**).

Figure 2.2: Wheat Price and Exports

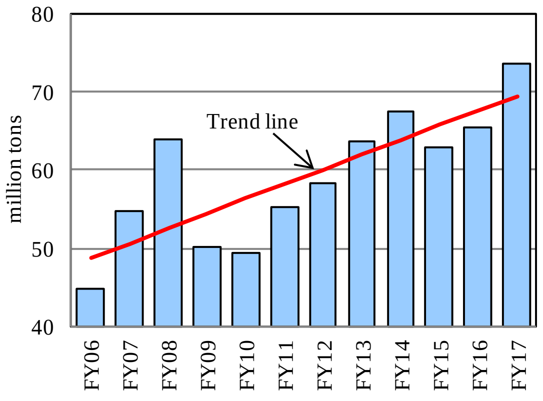


Data source: Pakistan Bureau of Statistics; World Bank; State Bank of Pakistan

Sugarcane

The country produced record sugarcane in FY17. The output of 73.6 million tons markedly exceeded both, the target of 67.4 million tons for the year, and 65.5 million tons realized in the previous year (**Figure 2.3**).

Figure2.3: Sugar Production

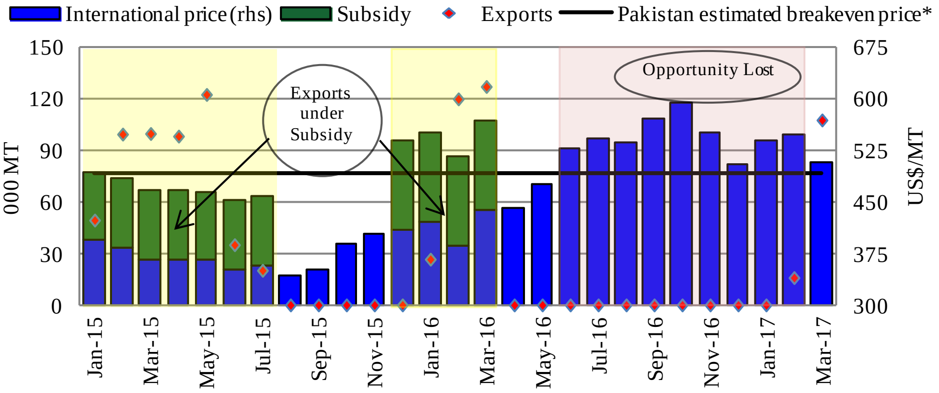


Data source: Pakistan Bureau of Statistics

Profitability and resistance (to pest and weather related shocks) has placed sugarcane in an advantageous position over cotton crop in recent years. This has led to increase in area under sugarcane crop at the expense of cotton. Area under sugarcane grew by 7.6 percent from the previous season, while area under cotton contracted by 14.2 percent. A 4.5 percent increase in the sugarcane yield in FY17 also contributed to the record output.

This growth in sugarcane production has direct implications for the sugar industry. For example, the reserves of sugar in the country have increased substantially to 5 million tons in April FY17, compared with 3.7 million tons last year.

Figure 2.4: Sugar Exports - Opportunity Lost



*10% sugar recovery rate, cost of sugarcane at indicative price and 15% overheads are assumed for calculation of break-even price

Data source: MNFSR; USDA; PBS and SBP's calculations

However, despite excess stock in hand, the sugar industry could not exploit export opportunities (**Figure 2.4**). Price of sugar in the international market remained high between June 2016 and March 2017. The country was not able to register worthwhile sugar exports during that time due to quantity restrictions and short time limit, despite possessing ample carryover stocks and record production. Recently, news about healthy sugarcane crop has led to a fall in international sugar price. This has reduced the profitability margins of Pakistani exporters substantially compared to a few months back.

2.3 Industry

The industrial growth remained short of both the target as well as last year's performance, mainly due to a drag from *mining and quarrying* (on the back of decline in natural gas, which has a weight of about 66 percent in the mining sector) and *electricity generation & distribution and gas distribution* subsectors. These subsectors, which contributed almost one-third of the industrial growth last year, could not maintain their momentum (**Table 2.4**). Similarly, the growth in *construction* moderated, but this was expected as this

Table 2.4: Growth in Industry

Share and growth in percent; contribution in percentage points

	Share in GDP	Growth			Contri. to industry growth	
		FY16	FY17	FY17T	FY16	FY17
Mining & quarrying	2.9	6.9	1.3	7.4	1.0	0.2
Manufacturing	13.4	3.7	5.3	6.1	2.4	3.4
Large-scale	10.7	2.9	4.9	5.9	1.6	2.5
Small-scale	1.8	8.2	8.2	8.2	0.7	0.7
Slaughtering	0.9	3.6	3.6	3.7	0.2	0.2
Electricity gene & distt and gas distt	1.8	8.4	3.4	12.5	0.7	0.3
Construction	2.7	14.6	9.0	13.2	1.7	1.1
Industry	**20.9**	**5.8**	**5.0**	**6.4**	**5.8**	**5.0**

T: Target; Data source: Pakistan Bureau of Statistics subsector had recorded a very strong growth of 14.6 percent last year. In contrast, *manufacturing* experienced a significant improvement over last year, stemming mainly from higher sugar production.[5]

Large-scale Manufacturing

LSM improved on a YoY basis, growing by 5.1 percent during Jul-Mar FY17, compared to 4.6 percent in the previous corresponding period (**Table 2.5**)[6]. Although, as mentioned earlier, the contribution of food industry (especially sugar) was the major growth stimulant, various industries such as pharmaceuticals, electronics, and steel also witnessed marked improvement. Increased energy supplies (bolstering efficiency), historically low policy rate (facilitating cheaper credit availability), better security situation, and widespread construction activities (stimulating associated industries) helped LSM step-up its growth momentum.

Table 2.5: YoY Growth in LSM Jul-Mar FY17

growth in percent; contribution to growth in percentage points

		Growth		**Contribution to growth**	
	wt.	**FY16**	**FY17**	**FY16**	**FY17**
LSM	**70.3**	**4.6**	**5.1**		
Textile	20.9	0.7	0.8	0.19	0.22
Cotton yarn	13	1.5	0.8	0.29	0.14
Cotton cloth	7.2	0.4	0.5	0.04	0.05
Jute goods	0.3	-36.7	-7.9	-0.12	-0.02
Food	12.4	3.2	9.6	0.72	2.1
Sugar	3.5	2.9	29.3	0.24	2.46
Cigarettes	2.1	-8.3	-42.5	-0.19	-0.86
Vegetable ghee	1.1	6.1	2.7	0.08	0.04
Cooking oil	2.2	6.1	2.0	0.21	0.07
Soft drinks	0.9	5.0	18.1	0.12	0.45
POL	5.5	2.4	-0.3	0.15	-0.02
Steel	5.4	-7.5	16.6	-0.28	0.56
Non-metallic minerals	5.4	10.3	7.1	1.03	0.75
Cement	5.3	10.5	7.2	1.04	0.75
Automobile	4.6	23.5	11.3	1.27	0.72
Jeeps and cars	2.8	29.7	4.7	0.81	0.16
Fertilizer	4.4	16	1.3	0.87	0.08
Pharmaceutical	3.6	6.8	8.7	0.54	0.71
Paper	2.3	-2.9	5.1	-0.1	0.17
Electronics	2	-5.3	15.3	-0.09	0.23
Chemicals	1.7	10.2	-2.2	0.24	-0.05
Leather products	0.9	10.1	-18	0.19	-0.35
LSM Excl. Sugar	**66.8**	**4.8**	**2.8**	**--**	**--**

Data source: Pakistan Bureau of Statistics

The improvement in LSM growth came despite some sector specific and regulatory challenges. For instance: (a) cigarettes industry suffered further contraction following the increase in the federal excise duty on sales announced in the FY17 budget; (b) the automobile industry (especially LCVs segment in which the production declined) experienced a slower growth than last year following the

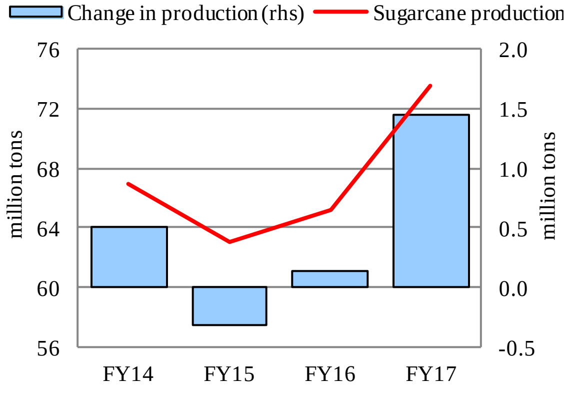
[5] Excluding sugar, the LSM grew by 2.8 percent during FY17, compared to 4.8 percent in FY16.
[6] According to National Income Accounts, LSM growth for FY17 is 4.9 percent (compared to 2.9 percent last year).

conclusion of the Apna Rozgar Scheme; (c) high inventory stocks, uncertainty over the subsidy program at the start of the year, coupled with a delayed export,[7] constrained growth in the fertilizer industry; (d) introduction of the regulation to sell higher quality (RON 92) fuel in the domestic market negatively impacted the production of refineries, as majority of the players faced capacity and technology constraints; and (e) inventory pressures (accumulated since last year) alongside international market price fluctuations of palm oil limited the output of vegetable ghee and edible oil sector. A detailed industry wise analysis follows:

Food

The performance of food sector recorded substantial improvement during Jul-Mar FY17 by growing at a rate of 9.6 percent against 3.2 percent during the same period last year. This growth was led by a surge in sugar production (**Figure 2.5**).

Figure 2.5: Sugar Production during Jul-Mar



Data source: Pakistan Bureau of Statistics

Bumper sugarcane crop, increased domestic prices (in tandem with international sugar prices), favorable weather, and timely commencement of crushing activities by millers helped the sugar industry record an impressive growth of 29.3 percent in Jul-Mar FY17 compared to 2.9 percent in the corresponding period last year. Permission to generate electricity via by-products not only incentivized the players to boost production but also resulted in the industry borrowing heavily from the commercial banks (for detail see **Chapter 3**).[8]

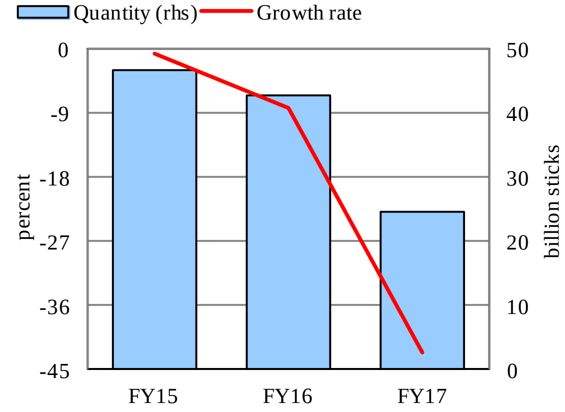
The cigarette production, on the other hand continued its declining trend on the back of an increase in federal excise duty in the FY17 budget and smuggling of competitive products. These factors forced the documented production to register a steep decline of 42.5 percent during Jul-Mar FY17 on top of 8.3 percent decline observed during same period in FY16 (**Figure 2.6**).

[7] Although the government allowed the export of 0.3 million tons of urea in H2-FY17 for a limited time, unavailability of logistic infrastructure for exports coupled with its higher domestic production cost makes exports challenging.

[8] In tandem with production figures of sugar in the Jul-Mar FY17 period, the energy generation through its by-products (baggasse) rose 63.4 percent on annual basis (from 359 GWh to 586 GWh).

Vegetable ghee and edible oil manufacturing also could not match their last year's pace, as the recent volatility in international prices of palm oil (a key input for the industry) enhanced uncertainty regarding the production decisions. Furthermore, regulatory restrictions on quality grounds caused a number of oil and ghee production units to suspend their operations.[9]

Figure 2.6: Trend in Cigarette Production (Jul-Mar)



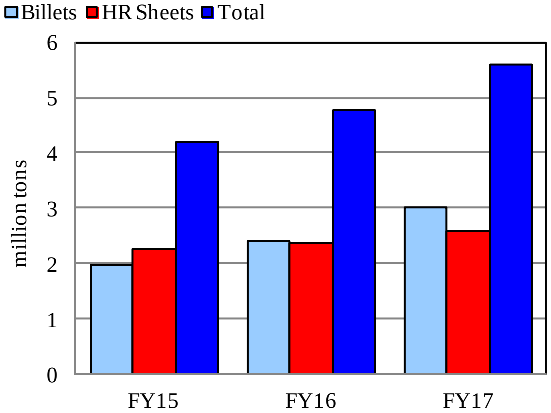
Data source: Pakistan Bureau of Statistics

Steel

The robust growth in construction activities also helped the steel sector to record a notable turnaround by growing 16.6 percent during Jul-Mar FY17, compared to a contraction of 7.5 percent in the corresponding period last year (**Table 2.5** and **Figure 2.7**). Stagnation in the imports of cheap Chinese steel products also helped, as the effect of anti-dumping duties started to materialize.[10]

Further support to industry came from improved energy supplies and some recovery in international steel prices.[11] These positive developments allowed the industry to

Figure 2.7: Trend in Private Steeel Production



Data source: Pakistan Bureau of Statistics

[9] During November, 2016, the Punjab Food Authority (PFA) declared various cooking oil and *ghee* brands unfit for human consumption due to rancidity (unpleasant odour), absence of Vitamin A, and inclusion of artificial flavor and other acid values.

[10] In early February 2017, the National Tariff Commission (NTC) imposed anti-dumping duties on imports of steel products (e.g., galvanized steel coils and sheets), in the range of 6 percent to 40.5 percent.

[11] International steel prices have rebounded by more than 27 percent at end March 2017, compared to end September 2016 (source: Bloomberg).

enhance economies of scale, earn higher margins,[12] and undertake expansionary plans.[13] Going forward, industry's efforts to reduce its dependence on imported raw materials and investment in cost efficient technology would provide basis for sustainable growth of the industry.

Electronics

The electronics sector was able to record a turnaround as it grew by 15.3 percent in Jul-Mar FY17, in a sharp contrast to a contraction of 5.3 percent witnessed during the same period last year. Consumer durables e.g., refrigerators, deep freezers and electric fans mainly contributed towards the sector's improved performance.

Better availability of electricity, coupled with increased levels of consumer financing, helped spur the demand for electronics in the urban areas.[14] Meanwhile, improved purchasing powers of farmers bolstered sales in rural areas as well. In the coming months, ongoing capacity expansions are expected to further boost the growth potential of the sector.[15]

Pharmaceutical

A number of factors explain the continued strong performance of the industry: for instance, the increased focus of the government on health;[16] the launch of new products (such as the introduction of Rotavirus vaccine in Punjab);[17] and the recently announced drug pricing policy (that aimed to address the counterfeiting trends and improve the transparency of the businesses). Resultantly, the industry built on its last year's healthy performance (6.8 percent) by growing 8.7 percent during Jul-Mar FY17.

[12] On average, gross profit margins of steel manufacturers increased from 15 percent to 20 percent (source: Company financials).

[13] Private steel manufacturers are investing heavily in increasing production capacities. In next 2 to 3 years production capacity would increase by about 50 percent (source: company financials).

[14] Electricity generation increased by 4.4 percent during Jul-Mar FY17 on YoY basis.

[15] In November, 2016, Turkish company Arçelik A.S. acquired home appliances brand Dawlance for US$243 million and is planning to invest about US$ 50 million in capacity expansion.

[16] By the end of third quarter, the funding released by NHSRC (National Health Services, Regulations, and Coordination Division) stood at Rs 21 billion as compared to Rs 13.5 billion during the Jul-Mar period of FY16. Furthermore, till Q3 FY16, the government had spent about 65 percent of the allocated amount (Rs 20.7 billion) on health related services. This year, the allocated amount (Rs 25.0 billion) is not only higher but is being spent faster as well. At the end of third quarter, around 84 percent of the allocated amount has been spent.

[17] In January 2017, the Punjab government introduced the Rotavirus Vaccine in the routine immunization schedule of the Expanded Program on Immunization.

Automobile

The automobile industry grew by 11.3 percent on top of 23.4 percent growth observed last year. While a deceleration in growth rate was expected following the conclusion of Apna Rozgar Scheme, a number of factors helped keep the momentum strong.

Foremost, an increase in the number of infrastructure related projects under CPEC (and construction activities due to urbanization trends) resulted in a higher growth in production of trucks and buses by 39.3 percent and 19.7 percent year-on-year respectively (**Table 2.6**).

Table 2.6: Vehicles Production and Sales

	Jul-Mar-FY16		**Jul-Mar -FY17**		**Growth %**	
Units	**Production**	**Sales**	**Production**	**Sales**	**Production**	**Sales**
Passenger Cars	**137,067**	**137,206**	**143,317**	**139,300**	**4.6**	**1.5**
Exc. Apna Rozgar Scheme	111,830	111,858	127,893	124,362	14.4	11.2
Trucks	**3,940**	**3,751**	**5,489**	**5,321**	**39.3**	**41.9**
Buses	**746**	**700**	**893**	**853**	**19.7**	**21.9**
LCVs, Vans & Jeeps	**30,150**	**29,692**	**19,449**	**19,038**	**-35.5**	**-35.9**
Exc. Apna Rozgar Scheme	4,813	4,344	5,237	5,050	8.8	16.3
Farm Tractors	**21,942**	**22,169**	**37,938**	**38,620**	**72.9**	**74.2**
Motorcycles & Three-Wheelers	**998,040**	**993,336**	**1,211,454**	**1,207,988**	**21.4**	**21.6**

Data source: Pakistan Automobiles Manufactures Association

Secondly, higher purchasing power of farmers (owing to improved commodity prices, better yields and assistance programs such as the Kissan Package) and a reduction in sales tax on tractors led to a surge in the demand of tractors as shown by 74.2 percent increase in sales during Jul-Mar FY17.[18] Encouragingly, domestic manufacturers have also started to exhibit inclination towards exports.[19] While the magnitude is nominal at the moment, the development marks a welcome change in their long-term strategy to diversify their serving markets.

Going forward, a comparatively low motorization rate,[20] rising consumption levels (backed by growing real incomes), increasing volume of auto financing (aided by

[18] Sales tax on tractors was reduced to 5 percent from 10 percent in the Federal Budget FY17.

[19] Millat tractors have started exports to Africa and Middle East, where the product is very well received due to its competitive price and quality.

[20] Motorization rate (cars/1000 inhabitants) stands at 16 in Pakistan in comparison with India (22), Afghanistan (47), Sri Lanka (50), Indonesia (83) and China (102) (source: International Organization of Motor Vehicle Manufacturers).

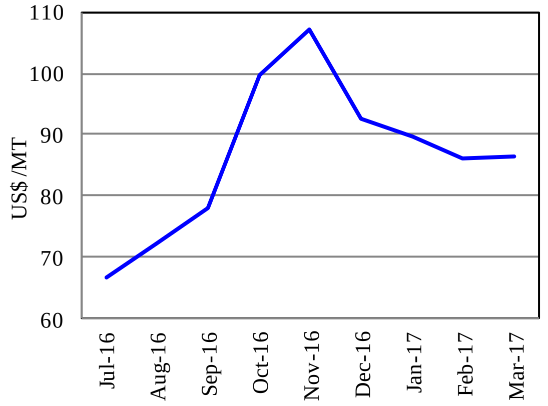
the historical low interest rates),[21] and anticipated entrance of new players through incentives offered in the Automotive Development Policy 2016-21, suggest the industry would be able to maintain its growing momentum.

Cement

Production activities in the cement sector remained buoyant during Jul-Mar FY17 as well and registered a growth of 7.2 percent over a high growth of 10.5 percent during the same period last year. The surge in domestic sales (growing by 10.9 percent YoY), led by the ongoing construction activities in the private sector and public spending on CPEC related (and other) infrastructure projects, more than offset the negative impact of declining exports.[22]

Further relief to the industry came from lower distribution costs, decreasing international coal prices (**Figure 2.8**), and increased electricity generation through waste heat recovery units (WHRU).[23,24] In this backdrop, the proposed capacity expansions signal towards a sustained growing potential of the industry.[25] In order to arrest declining exports and to sustain planned expansion, manufacturers are exploring new markets (such as the Philippines and Sri Lanka).

Figure 2.8: International Australian Coal Prices



Data source: Bloomberg

Textile

The textile sector managed a marginal growth of 0.8 percent during Jul-Mar FY17 as compared to 0.7 percent during the same period last year.

[21] Consumer auto-financing grew by 23.4 percent during Jul-Mar FY17 on top of a growth of 20.4 percent during the previous corresponding period.

[22] Due to implementation of border management system and some other issues, the resultant delays in transportation of cement (which has limited shelf life) has forced Afghan buyers to switch to Indian and Iranian cement. The overall cement exports have declined by 14.8 percent on YoY basis during Jul-Mar FY17.

[23] After accelerating to US$ 107.2 per metric ton in November 2016, the Australian coal prices started decreasing and currently hover around US$ 85.

[24] Manufacturers are investing aggressively on waste heat recovery (WHR) plants; on average WHR reduces fuel cost by about 40 percent (Source: Companies financials).

[25] The industry plans to increase its annual production capacity by 24 million tons (52 percent) during the next three years.

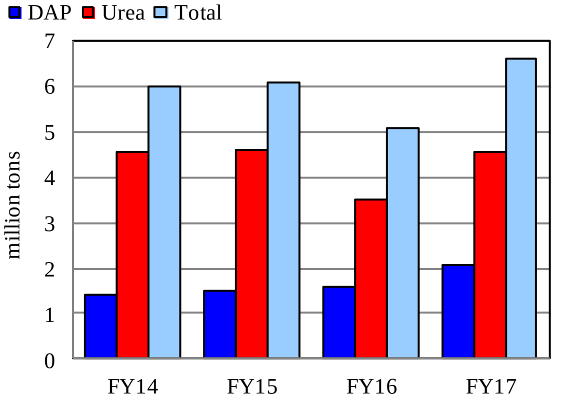
Robust domestic demand continued to compensate for the declining exports.[26] The recently announced export package by the government would take some time before its impact on the performance materializes. Only sufficient investment in BMR, efforts to concentrate on value-added products, and increased focus on improving operational efficiency would broaden the export potential of the products and stimulate the sector.

The jute subsector continued its contraction, as it recorded a negative growth of 7.9 percent during Jul-Mar FY17 compared to a decline of 36.7 percent during the corresponding previous period. The earlier ban on import of raw materials from Bangladesh kept on affecting the production cycle. Worryingly, only five of the ten remaining mills are operational at the moment due to various financial constraints. With the recent lifting of the aforementioned ban, the sector might experience some respite. However, the availability of cheap alternatives, dependence on imported raw material and inefficient technology are hurdles in the recovery of domestic jute industry.[27]

Fertilizer

Despite improved availability of gas to fertilizer companies, production remained subdued during Jul-Mar FY17 (growing 1.3 percent as compared to 16.0 percent last year).[28] Even at discounted prices, the higher off-take could not ease the accumulated supply glut (**Figure 2.9**).[29,30] On the other hand, variations in fertilizer prices in international market, high costs of production, and lack of logistic and infrastructure for exports

Figure 2.9: Fertilizer Off-take during Jul-Mar



Data source: National Fertilizer Development Center

[26] The lack of R&D and reliance on low-value added products has contributed towards decreasing exports and hence stagnancy in the sector.
[27] Jute bags are costlier compared to their substitute (e.g., polypropylene / polyethylene), if a plastic bag is available at Rs 60, the same 100kg capacity jute bag costs more than Rs 100.
[28] On the back of increased LNG imports (increased by 144.0 percent on YoY basis) and continuity of concessional gas supply from domestic sources (source: Pakistan Bureau of Statistics).
[29] The price of urea in the international market is around US$ 250 per ton, which is significantly lower than the price of locally produced urea (i.e., US$ 320 per ton).
[30] Urea stock at end March 2017 stood at around 1.5 million tons (source: NFDC).

constrained manufacturers to avail exporting opportunity provided by the government.[31]

Petroleum Products (POL)

After the imposition of regulation requiring RON 92 grade petroleum to be sold in the domestic market, the *POL industry* witnessed stagnation in growth as the majority of local players do not produce higher quality petroleum products.[32] As a result, the growth rate recorded a marginal decline of 0.3 percent during the Jul-Mar FY17 period compared to a growth of 2.4 percent in the corresponding period last year. Resultantly, import dependence increased to bridge the growing demand-supply gap.[33]

2.4 Services

The services sector continued to consolidate its share in the overall GDP, posting a growth of 6.0 percent in FY17 on top of the 5.5 percent improvement realized last year (**Table 2.1 & Table 2.7**).

Table 2.7: Performance of Services

	Share in GDP	Growth			Contri. to growth	
	FY17	FY16	FY17^{T}	FY17^{P}	FY16	FY17
Wholesale and retail trade	18.5	4.3	5.5	6.8	1.3	2.1
Trans., storage & communication	13.3	4.8	5.1	3.9	1.1	0.9
Finance and insurance	3.4	6.1	7.2	10.8	0.3	0.6
Housing services	6.6	4.0	4.0	4.0	0.5	0.5
General govt. services	7.6	9.7	7.0	6.9	1.2	0.9
Other private services	10.2	6.8	6.7	6.3	1.1	1.1
Services	**59.6**	**5.5**	**5.7**	**6.0**	**5.5**	**6.0**

Data source: Pakistan Bureau of Statistics

The performance of the largest subsector *wholesale and retail trade* (31 percent share in services) was particularly encouraging, as it built upon last year's growth of 4.3 percent by growing 6.8 percent in FY17. Increase in imports, and growth in both the commodity producing sectors (agriculture and industry) were the major stimulants for the subsector.

The performance of *finance and insurance* also remained remarkable, as it registered a growth of 10.8 percent in FY17 (compared to 6.1 percent in the previous year), mainly due to an encouraging growth in deposits and advances.[34]

[31] Earlier the government allowed export of 300 thousand tons of urea till end April, 2017, however only 3 thousand tons have been exported so far.

[32] Most of local refineries produce RON 90 Premium Motor Gas (PMG). The conversion to high quality fuel requires a substantial investment to acquire compatible technology.

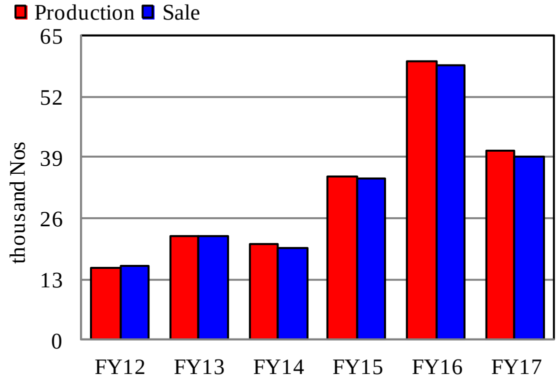
[33] During Jul-Mar FY17, imports of petroleum products increased by about 29.2 percent compared to same period last year (source: Pakistan Bureau of Statistics).

[34] The banking spread on stocks decreased by 29 bps during Jul-Mar FY17. Advances by commercial banks, on the other hand, recorded a substantial increase (**Chapter 3** on Inflation and Monetary Policy).

Thus, the value addition increased to 9.8 percent in FY17 from 5.9 percent in FY16. Similarly, the growth in *general government services* remained close to the target of 7.0 percent.

Slowdown in *transport, storage and communication* continued in FY17, registering a growth of 3.9 percent as compared to 4.8 percent during FY16. Constrained growth of Pakistan Railways, PIA, and lower growth in value addition by the road transport contributed to this slowdown.

Figure 2.10: Production and Sales of Commercial Vehicles (Jul-Mar)

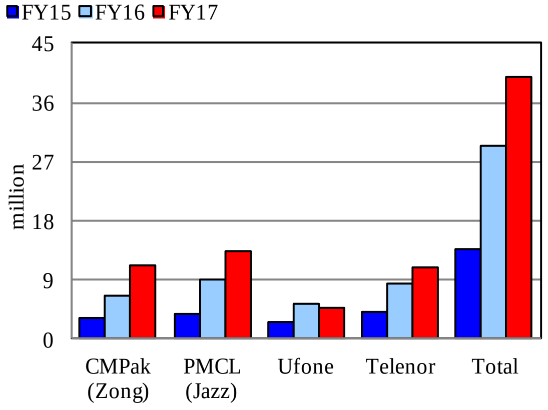


Data source: Pakistan Automotive Manufacturers Association

The slowdown in road transport was in sharp contrast with improvement in cargo handling activities but broadly in line with decline in sales and production of commercial vehicles during the period under review (**Figure 2.10**).[35] In view of the ongoing expansion in infrastructure, the outlook for the sector remains promising.

In the *telecom sector*, total teledensity continued its growth momentum from the last year.[36] On a parallel note, the number of broadband users increased to 42.3 million, up around 10 million over the course of just one year. A healthy growth in 3G/4G subscriptions (35 percent in the period under review) was a major contributor to this increase (**Figure 2.11**).[37]

Figure 2.11: Trend in 3G/4G Subscriptions



Data source: Pakistan Telecommunication Authority

[35] Although the sales of trucks and buses increased by 41.8 percent and 21.8 percent respectively, they were more than offset by a decline in the sales of LCVs (contracting by 35.9 percent) due to the conclusion of Apna Rozgar Scheme (source: Pakistan Automotive Manufacturers Association).
[36] Total teledensity reached 72.36 percent at the end of March, 2017 compared to 70.81 percent at the end of last fiscal year.

Going forward, recently introduced Digital Pakistan Policy 2017 would provide a platform for sustainable development of the sector, while continuous improvement in voice traffic and broadband is expected to keep augmenting telecom revenues and its contribution to the national exchequer.[38]

[37] After the introduction of Next Generation Mobile Services in the country in 2014, the 3G/4G technologies have been well received by the customers. The growth of 35 percent in Jul-Mar FY17 builds upon the impressive performance experienced in FY16 (when the subscription numbers grew by around a 118 percent).

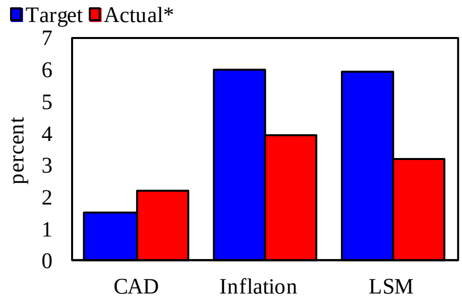
[38] Ministry of Information Technology and Telecom issued IT Policy "Digital Pakistan Policy 2017"in April 2017.

3 Inflation and Monetary Policy

3.1 Policy review

Broad macroeconomic conditions continued to guide monetary policy decisions during Q3-FY17. Around the January deliberations for monetary policy, the available data was showing a lower growth of large-scale manufacturing (LSM) as well as a subdued inflation – significantly lower than the target (**Figure 3.1**). On the other hand, domestic demand was gaining ground as evident in rising imports; steady increase in core inflation; and a sharp rise in private credit from Q2-FY17 onwards. Importantly, the current account deficit almost doubled in the first half of the year compared with the same period last year, resulting in a reduction of SBP's liquid foreign exchange reserves. Keeping in view these trends, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 5.75 percent.

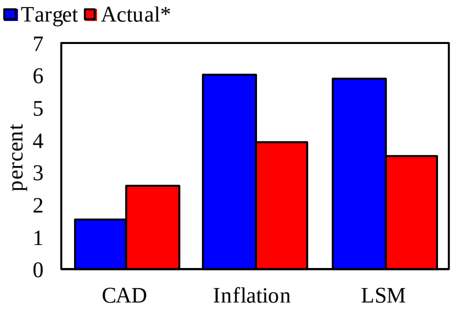
Figure 3.1a: Key Indicators for Jan 2017 MPC Meeting



* H1 for CAD (as % of GDP) and inflation (YoY CPI); Jul-Nov for LSM

Data source: Planning Commission, PBS and SBP

Figure 3.1b: Key Indicators for Mar 2017 MPC Meeting



* Jul-Feb for CAD and inflation; Jul-Jan for LSM

By the time the next MPC meeting was held in March 2017, the external sector challenges had deepened further. Also, while the YoY CPI inflation during Jul-Feb was unchanged from its H1-FY17 average, YoY inflation for February 2017 (4.2 percent) and underlying demand pressures captured by measures of core inflation suggested that the upward trend in inflation would most likely continue.[1,2] Meanwhile, to add to uncertainty for policymakers, LSM fluctuated

[1] YoY CPI inflation during both H1-FY17 and Jul-Feb FY17 averaged 3.9 percent.

[2] NFNE inflation increased to 5.3 percent in February 2017, from 4.5 percent in February 2016.

sharply in December 2016 and January 2017.[3] Thus, following the need to maintain macroeconomic stability, the MPC decided again to maintain the status quo.

The decision to continue with the low policy rate regime helped maintaining the growth momentum in private sector credit, which had gathered tremendous pace from Q2-FY17 onwards. This policy support became crucial because a large part of recent bank lending appears to be financing firms' capital expenditures. In Jul-Mar FY17 also, 42 percent of the total increase in businesses' credit came from fixed investment loans.

Apart from being a direct outcome of low interest rates, this trend also reflected an improvement in the investment climate manifested in the country's better risk perception and an improved energy outlook. Sugar, cotton, ready-made garments, cement, steel, dairy, petroleum refineries, fertilizer – virtually all major sectors availed more fixed investment loans during Jul-Mar FY17 compared to last year. Meanwhile, higher input prices and greater availability of raw materials (e.g., sugarcane and cotton) stimulated the demand for working capital loans by related industries.

Table 3.1: Changes in Monetary Aggregates
flows in billion Rupees

	Q3		Jul-Mar	
	FY16	**FY17**	**FY16**	**FY17**
Reserve money	99.3	50.3	433.6	314.3
Broad money (M2)	197.9	110.2	677.6	756.1
A. Net foreign assets	-66.7	-264.2	83.8	-284.8
SBP	-38.3	-189.7	141.4	-155.2
Scheduled banks	-28.5	-74.5	-57.6	-129.7
B. Net domestic assets	264.6	374.4	593.8	1,040.9
Budgetary borrowing*	354.8	287.6	538.0	694.7
SBP	-96.3	-100.5	-525.5	792.2
Scheduled banks	451.1	388.0	1,063.5	-97.5
Credit to private sector	27.7	77.9	323.4	438.6
Credit to PSEs	11.1	114.0	11.7	197.0
Other items (net)	-60.9	-24.6	-178.1	-166.9

*On cash basis
Data source: State Bank of Pakistan

On the supply front, banks were better placed to cater to this demand, on the back of high deposit generation during the year, and more importantly, net retirements by the government to commercial banks. Although banks' lending to the government increased in Q3-FY17, this did not have a significant impact on their liquidity since this period, as usual, coincided with the maturity of private credit cycle. Despite seasonal retirements in major sub-sectors therefore, the overall private credit posted a healthy expansion during the quarter. As a result, net expansion in private credit during Jul-Mar FY17 was 36 percent higher compared to the same period last year (**Table 3.1**).

[3] LSM grew 7.4 percent YoY in December 2016, followed by just 1.1 percent YoY in January 2017.

The impact of this stronger expansion on net domestic assets (NDA) of the banking system was reinforced by the growth-inducing fiscal stance, particularly an increase in development spending by the government. Budgetary borrowings from the banking system – mainly from SBP – remained higher than last year, as external and non-bank domestic financing could not fill the rising fiscal gap. A related and important development during this period was the sharp increase in credit to PSEs (especially energy-related). This can be traced to the re-emergence of circular debt, which apparently tightened liquidity conditions in the entire energy supply-chain.

As a result, the expansion in the overall NDA of the banking system was over 75 percent higher than the expansion seen last year. Thus, the stage was set for an acceleration in broad money growth, but this was not to be: M2 growth turned out to be marginally lower during Jul-Mar FY17 – and much slower during the third quarter – relative to last year.[4] The slowdown was entirely explained by the decline in NFA of the banking system, which continued for the third consecutive quarter of FY17. This decline mainly represented the rising deficit in the external account (**Chapter 5**).

So effectively, the trends in external imbalances had a bearing on monetary management in the country during Jul-Mar FY17. While these trends are likely to persist in the short-term, SBP will continue to strike the delicate balance between macroeconomic stability and growth. Here, it is important to reiterate that the effectiveness of pro-growth measures hinges upon the stability outlook of the economy.

3.2 Money market developments

Compared to the preceding quarter, liquidity conditions in the interbank market were somewhat tight in Q3-FY17. This was linked directly to an alteration in the government's pattern of budgetary borrowing: rather than primarily borrowing from SBP and retiring its debt to scheduled banks (as it had been doing during H1-FY17), the government opted to borrow from scheduled banks during the quarter. As a result, the overnight rates remained 8 basis points above the policy rate on average during Q3, compared to around 2 basis points in the previous quarter. Commercial banks' recourse to SBP's reverse repo facility was also more frequent.[5]

[4] Broad money grew by 5.9 percent during Jul-Mar FY17, compared to 6.0 percent a year earlier. However, the growth rate during Q3-FY17 (0.8 percent) was almost half of the growth rate in M2 during Q3-FY16 (1.7 percent).

[5] Commercial banks availed SBP's reverse repo facility on 8 days during Q3-FY17, compared to 6 days in Q2; moreover, in terms of volume, banks borrowed Rs 160.8 billion from the SBP window

These conditions necessitated higher intervention from SBP in terms of liquidity management. Specifically, the outstanding level of OMO injections – which had declined significantly during Q2 – reversed course, increasing from Rs 800 billion at end-December 2016 to Rs 1,100 billion by end-March 2017.[6] This proactive liquidity management fostered stability in medium- to long-term rates: the 6-month KIBOR, for instance, remained fairly stable (around 6.1 percent) during Jul-Mar FY17.

Reverting back to government borrowings, banks participated actively in all the T-bill auctions that were held during the quarter. In the seven T-bill auctions during the third quarter, scheduled banks placed bids in excess of the auction targets (**Figure 3.2a**). The government duly raised a combined amount of Rs 441.3 billion (net of maturity) from the auctions.[7] From scheduled banks' perspective, there was a clear preference for shorter tenor T-bills (3- and 6-month), indicating their anticipation that interest rates had bottomed out.

Figure 3.2a: Auction Profile of T-bills

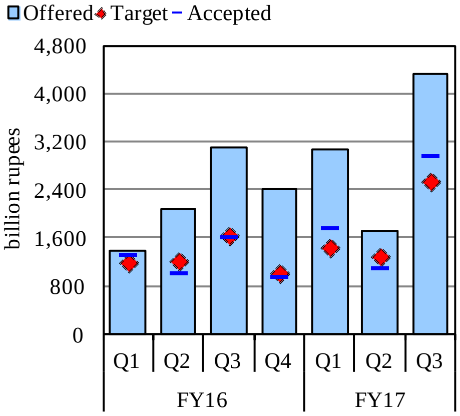
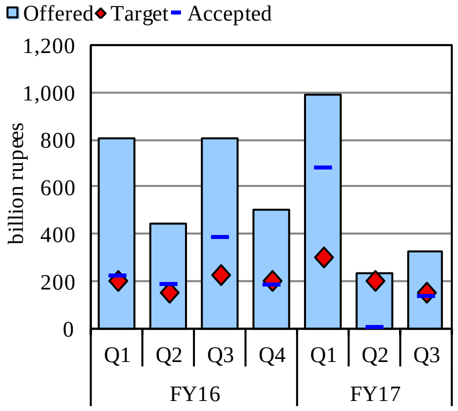


Figure 3.2b: Auction Profile of PIBs



Data source: State Bank of Pakistan

This anticipation was also reflected in PIB auctions, where banks' participation was relatively muted as compared to T-bills. However, unlike the auction outcome of December 2016, when banks had bid for a very small amount at excessively high rates, all the three auctions in Q3-FY17 were successful (**Figure 3.2b**). Not only did banks increase the offered amounts (especially in the auctions

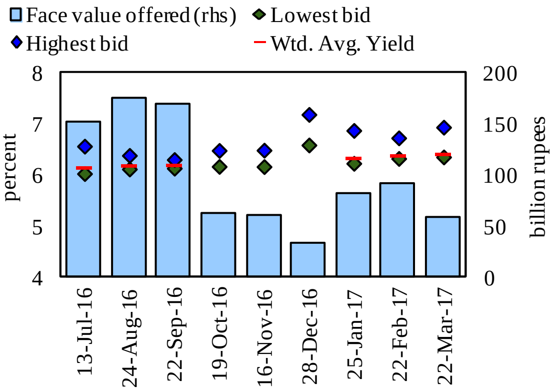
in Q3, compared to Rs 65.6 billion in Q2-FY17.

[6] For context, the outstanding level of OMO injections was Rs 1,147.3 billion at end-September 2016, and Rs 1,001 billion at end-March 2016.

[7] At face value; includes both competitive and non-competitive bids.

held in January and February), but the rate at which they bid at, was also fairly reasonable vis-à-vis previous cut-off yields (**Figure 3.3**). Overall, the government raised (net of maturity) Rs 132.4 billion from PIBs during Q3-FY17, against the target of Rs 150.0 billion. This was a markedly different outcome from the scrapped auctions of the previous quarter.

Figure 3.3: Bidding Pattern for 3-Year PIBs



Data source: State Bank of Pakistan

3.3 Monetary aggregates

In addition to the developments discussed already in **Section 3.1**, following changes in monetary aggregates were also noteworthy:

i. Reserve money growth slowed down during Q3-FY17, with flows equivalent to just half of the increase seen in the comparable period last year (**Table 3.2**). The slowdown occurred in spite of greater expansion in SBP's NDA during the quarter: the central bank stepped up its OMO injections to ensure that there was adequate liquidity in the interbank. Within NDA, there was a decline in budgetary lending as the government borrowed from commercial banks. However, the declining NFA of SBP (discussed in **Section 3.1**) eventually proved to be the major drag on reserve money growth during the quarter, as SBP actively sought to

Table 3.2: Factors Affecting Reserve Money

flows in billion Rupees

	Q3-FY16	Q3-FY17	Jul-Mar FY16	Jul-Mar FY17
A. Government sector, *o/w*	-96.6	-111.3	-534.9	804.2
Budgetary borrowings	-98.6	-113.6	-534.6	801.6
B. Non-govt. sector, *o/w*	1.8	14.1	22.5	97.4
Claims on scheduled banks	1.1	13.6	22.1	93.8
C. Other items (net), *o/w*	232.4	337.2	804.6	-432.1
OMO injection/ reverse repo	162.9	298.7	640.4	-408.4
D. NDA of SBP (A+B+C)	137.6	240.0	292.2	469.5
E. NFA of SBP	-38.3	-189.7	141.4	-155.2
Reserve money (D+E)	99.3	50.3	433.6	314.3

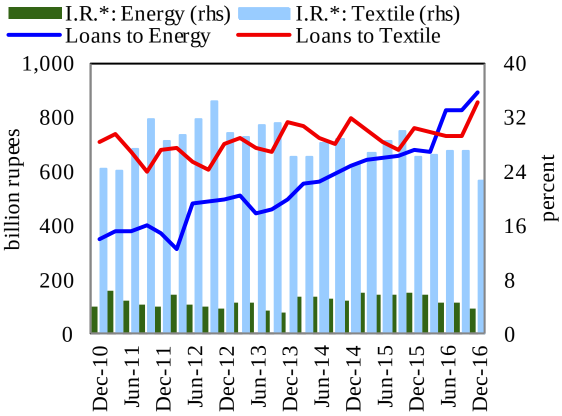
Data source: State Bank of Pakistan

minimize fluctuations in the foreign exchange market.[8]

ii. Credit availed by public sector enterprises (PSEs) was nearly 17 times higher in the current period compared to Jul-Mar FY16. In quarterly terms, the amount borrowed by PSEs during Q3-FY17 (Rs 114.0 billion) represented the highest credit off-take to PSEs in any quarter since Q3-FY12. Energy-related entities accounted for nearly 78 percent of this credit flow. Among the major PSE borrowers during the third quarter, WAPDA arranged financing for Rs 38 billion payment of hydel profit to the Punjab government for the years 2005-16; Power Holding Private Limited borrowed Rs 30 billion for the settlement of power sector payables; and PSO (classified as a PSE) availed Rs 15.3 billion financing to manage its liquidity constraints arising from circular debt.

iii. Partly as a result of the above, scheduled banks' exposure to the energy sector has shown a marked increase since FY14. Significantly, the concentration of loans to the energy sector overtook the traditionally largest borrower – textiles – in June 2015. The fact that energy sector loans generally carry low credit risk (most of these are government guaranteed), explains why scheduled banks have been comfortable extending loans to this sector aggressively (**Figure 3.4**). Effectively, energy projects pursued in tandem with public infrastructure tend to be as safe as government papers in terms of credit worthiness.

Figure 3.4: Infection Ratio (IR) of Energy & Textile Loans



Data source: SBP Financial Stability Report 2016

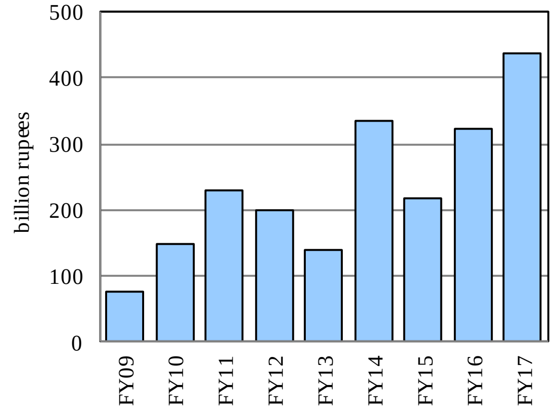
3.4 Credit to private sector

The resurgent activity of banks in the credit market continued during FY17: credit extension has crossed Rs 300 billion in three of the past four years (**Figure 3.5**). Both demand and supply-side factors were at play and reflected better

[8] NFA of SBP declined by 17.8 percent during Q3-FY17, compared to a 4.2 percent decline during Q3-FY16.

macroeconomic conditions, as evident in improved security situation and investment prospects triggered by CPEC.[9]

Figure 3.5: Credit to Private Sector (Jul-Mar)



Data source: State Bank of Pakistan

On the supply side, ample liquidity available with banks also contributed to higher credit off-take. Specifically, the ability of banks to extend credit increased during Jul-Mar FY17, thanks to impressively high deposit generation, lower government borrowing from banks, and modifications in subsidized SBP credit refinance schemes.[10] A better perception of the future in terms of investment opportunities and gains in asset quality also played a part in encouraging banks to expand their credit portfolios.[11]

The increase in credit to businesses sector was visible across all categories: working capital, fixed investment and trade finance (**Table 3.3**). While conventional banks continued to extend the biggest chunk of that credit, the combined share of Islamic banks and Islamic bank branches (IBBs) of conventional banks in the credit flow also increased (from 36.7 percent to 43.9 percent).[12]

[9] Even during FY15, there was considerable fixed investment borrowing by private businesses; the apparent slowdown in credit owed to lower demand for working capital loans, in the backdrop of depressed commodity prices. As a whole then, the FY14-FY17 pattern provides a marked contrast to the relatively uneventful FY09-FY13 spell in which credit reached at most Rs 200 billion during Jul-Mar periods.

[10] Banks generated deposits worth Rs 604.9 billion during Jul-Mar FY17 – the highest level since FY10 – compared to significantly lower mobilization of Rs 217.5 billion in the same period last year.

[11] This argument is based on discussions with commercial bankers regarding investment avenues and returns, as well as the decline in net NPL to net loans from 2.8 percent in March 2015 to 1.6 percent by March 2017.

[12] Unlike the case of conventional banks, there is a dearth of investment avenues for Islamic banks and IBBs, compounded by infrequent government auctions of Ijarah Sukuk. Thus, IBs and IBBs are aggressively competing with their conventional counterparts in the credit market.

Table 3.3: Loans to Private Sector Businesses (Jul-Mar)
flow in billion Rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY16	FY17	FY16	FY17	FY16	FY17	FY16	FY17
Total credit to private businesses	**249.0**	**368.4**	**65.4**	**150.9**	**140.3**	**155.1**	**43.3**	**62.4**
Of which								
1. Manufacturing	206.4	259.7	116.5	104.5	34.1	97.8	55.7	57.4
Sugar	56.9	101.1	51.7	79.3	4.7	15.5	0.4	6.2
Textile	82.5	87.0	58.0	35.5	9.3	26.2	15.1	25.3
Readymade garments	4.8	13.2	-0.6	0.4	1.0	4.3	4.4	8.5
Cement	-2.0	11.7	-3.0	-0.8	0.1	8.7	0.9	3.8
Dairy products	-1.7	10.3	-0.3	8.5	-1.8	2.0	0.4	-0.1
Refined petroleum and products	9.3	9.5	0.9	8.6	-6.1	4.2	14.5	-3.4
Fertilizers	28.2	-14.7	19.5	-26.7	5.9	10.9	2.7	1.0
2. Electricity, gas and water supply	39.8	38.3	13.0	21.7	31.9	14.2	-5.1	2.4
Production, transmission & distribution of electricity	37.8	39.5	12.7	22.1	30.1	15.0	-5.0	2.3
3. Construction	26.7	22.4	-2.6	7.4	28.1	15.8	1.3	-0.8
Roads	14.7	12.1	0.6	4.8	13.8	8.4	0.3	-1.1
4. Commerce and trade	11.3	19.3	4.0	21.0	7.1	-0.3	0.1	-1.4
Retail trade	10.6	19.3	3.3	18.2	5.0	-1.4	2.3	2.5
5. Mining and quarrying	-1.3	11.8	-2.7	-0.2	1.7	9.3	-0.3	2.7
6. Real estate	7.1	7.6	3.2	-2.5	1.0	6.4	3.0	3.7
7. Community and social service	7.1	0.6	6.1	1.9	1.2	-0.2	-0.1	-1.1
8. Agriculture	-1.4	0.1	-7.4	2.7	6.1	-2.4	-0.1	-0.2
9. Transport, storage and communications	20.9	-0.6	-9.2	-9.4	30.2	8.8	0.0	-0.1
10. Education	1.5	-6.2	-0.1	0.1	1.6	-6.3	0.0	0.0

Data source: State Bank of Pakistan

Sugar sector drove manufacturing loans

With more than 70 percent share in loans to private businesses during Jul-Mar FY17, manufacturing firms continued to be the dominant segment. However, unlike in the past when textiles dominated the credit market, sugar producers took a much larger share of the manufacturing credit in Jul-Mar FY17. Their higher demand for working capital loans was a result of impressive sugarcane crop this season. Furthermore, to capitalize on the available commodity surplus and exporting opportunities, the sector also scaled up its trade-related borrowings.

Capital expenditures spurred long-term loans

A number of sectors exhibited greater recourse to long-term financing from banks. For instance, borrowings of textile sector for fixed investment purposes remained stronger than last year.[13] An important contributing factor was the modification in SBP's subsidized financing scheme via which (i) the mark-up rate (end-user) exclusively for textile sector was reduced from 6 percent to 5 percent;[14] and (ii) the *entire* spinning and ginning sub-sectors were made eligible for availing the LTFF scheme.[15, 16] Over 90 percent of the increase in fixed investment loans during Jul-Mar FY17 by textiles was under the LTFF scheme. Similarly, in the cement sector, the initiation of a number of infrastructure projects and mega housing schemes has triggered impressive growth in domestic production and dispatches. To keep up with this demand, local manufacturers have undertaken aggressive expansion plans to increase their capacity. Moreover, firms in sugar, fertilizer, dairy, steel and petroleum refining sectors also availed more long-term loans.[17]

CPEC-related borrowing continued

Furthermore, the impact of CPEC activities was felt in credit developments within power, road infrastructure, and cement sectors. The former two continued to avail significant volume of credit during FY17, much as they did last year. However, their share of fixed investment in total credit availed by each sector declined, which indicates that, compared to last year, the expansion plans for power and road infrastructure sectors were slightly contained in FY17. Evidently, some of the long-term projects in the electricity sector are at advanced stages of development, with higher requirement for working capital.

[13] The government provided a number of tax incentives to the textile sector, one of which was an exemption of sales tax on import of machinery. As a result, imports of textile machinery rose from Rs 34.6 billion during Jul-Mar FY16 to Rs 42.0 billion during the same period of FY17. The higher imports were mainly concentrated in Q3-FY17 and were attributed to machinery relating to weaving, spinning, looms, winding, embroidery, and other accessories (see **Chapter 5** for details).

[14] SBP had reduced the end-user mark-up rate for LTFF scheme from 7.5 percent to 6 percent for all sectors in July 2015. However, effective from November 2015, it reduced this rate further for textile sector borrowers to 5 percent.

[15] SBP is now refinancing 100 percent of the loans extended by banks/DFIs for imported and locally manufactured new plant/machinery to be used by the export oriented projects of (the entire) spinning and ginning sectors under the LTFF scheme. Earlier, it was refinancing only 50 percent, and that too for only 6 specified processes of spinning sector (for details, see IH&SMEFD Circular No 18 of 2015, dated October 30, 2015).

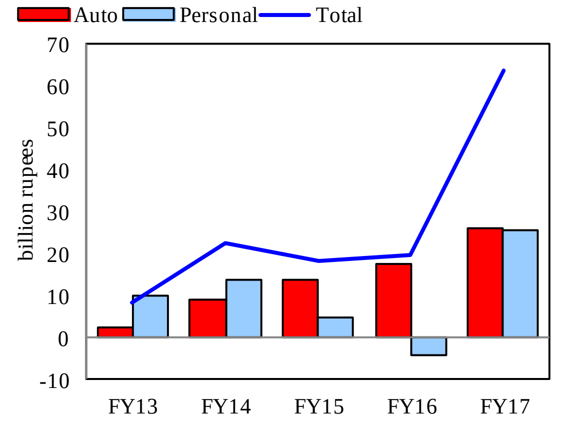
[16] Spinning sector borrowed Rs 19.7 billion during Jul-Mar FY17 under the LTFF, compared to net retirements of Rs 3.2 billion in Jul-Mar FY16. The import of spinning machinery (including machines for winding process) stood at US$ 92.4 million in Jul-Mar FY17 compared to US$ 46.7 million in Jul-Mar FY16.

[17] Dairy firms availed a significantly higher volume of credit during Jul-Mar FY17 compared to last year. Diversification into new product lines to capture market share could explain the demand for fixed investment credit.

Available inventories held back fertilizer sector

Last year, the fertilizer sector availed a significant amount of working capital credit due to both high domestic production as well as imports, which left a glut for the commodity in the domestic market during FY17. As a result, overall activity in the fertilizer sector was fairly subdued during Jul-Mar FY17, and the period was characterized by net retirement of working capital loans.

Figure 3.6: Consumer Financing by Category (Jul-Mar)



Data source: State Bank of Pakistan

Consumer financing picked up pace

While consumer financing was already buoyant during Jul-Mar FY14-FY16, its volume tripled in the same period of FY17.[18] Auto financing continued to hold the biggest share on the back of consistent rise in credit flow during Jul-Mar for four consecutive years (**Figure 3.6**). In addition to low borrowing rates, factors which boosted auto financing in FY17 included: high demand from customers due to emerging transport businesses (such as online taxi services) and release of new car models.[19] Personal loans also showed an impressive turnaround with growth in excess of 20 percent during Jul-Mar FY17.

Table 3.4: CPI Inflation
(percent)

	Overall	Food	Energy	NFNE	House rent (HR)	NFNE (w/o HR)
FY16						
Q1	1.7	0.3	-3.7	3.9	5.7	2.9
Q2	2.5	1.8	-1.2	3.8	5.4	2.9
Q3	3.8	3.3	1.7	4.5	5.5	3.9
Jul-Mar	2.6	1.8	-1.1	4.1	5.5	3.2
FY17						
Q1	3.9	4.0	-1.6	4.6	5.8	4.0
Q2	3.9	3.6	-2.1	5.2	6.7	4.4
Q3	4.3	3.8	0.4	5.3	6.6	4.5
Jul-Mar	4.0	3.8	-1.1	5.1	6.4	4.3

Data source: Pakistan Bureau of Statistics and State Bank of Pakistan

3.5 Inflation

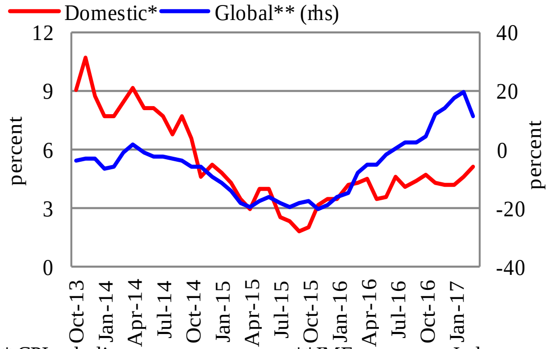
Average inflation, which remained quite stable in the first two quarters of FY17, increased to 4.3 percent in the third quarter (**Table 3.4**). This

[18] During Jul-Mar FY14-FY16, consumer financing averaged around Rs 20 billion, but during Jul-Mar FY17, it rose by Rs 63.9 billion.

[19] The auto industry has introduced a range of new models in Jul-Mar FY17, particularly of Suzuki (Vitara and Ciaz), Toyota (Fortuner and Hilux Revo) and Honda (City, Accord and Civic).

rise can be attributed to: (i) the pass-through of increase in international oil prices to domestic prices by the government (on four instances) in Q3-FY17; (ii) a steady increase in domestic demand as evident from the gradual rise in NFNE inflation; and (iii) the impact of a rise in global prices of some key food commodities in the quarter. Nonetheless, it is important to highlight that non-energy inflation in Pakistan has been quite lower than global non-energy inflation (**Figure 3.7**).[20]

Figure 3.7: YoY change in Global and Domestic Non-Energy Inflation



* CPI exluding energy component ;**IMF non-energy Index.
Data source: Pakistan Bureau of Statistics; State Bank of Pakistan; IMF

Global oil prices kept increasing in Q3-FY17, though some moderation was observed in the latter part of March 2017. As a result, the government increased the prices of petrol and high speed diesel (HSD) more frequently during Q3-FY17, which ultimately ended the 29-month spell of YoY deflation in fuel prices.[21] Moreover, the deregulation of CNG prices in December 2016 resulted in modest increase in its prices. In addition, LPG prices also remained higher despite explicit regulatory instructions to dealers to bring down prices for household consumption.[22] Resultantly, energy CPI – which was exhibiting deflation for the last nine quarters in a row – recorded inflation during the quarter under review (**Table 3.4**).

Within energy CPI, electricity tariffs remained unchanged, despite changes in

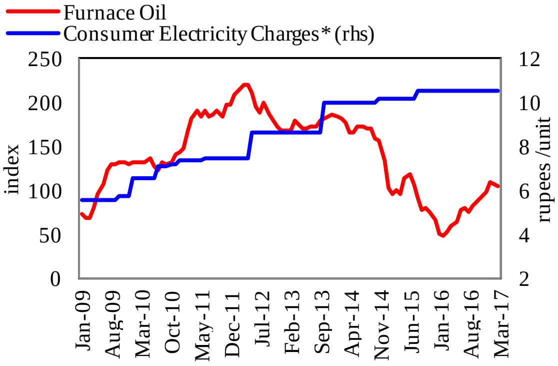
[20] Earlier, the non-energy inflation in Pakistan fell quite sharply in tandem with the global non-energy deflation from July 2014 to October 2015.

[21] During mid-January to 1st March 2017, the government increased petrol and HSD prices on four occasions, by a cumulative Rs 6.7/liter and Rs 6.8/liter. Petrol, HSD and CNG prices rose 0.9, 5.2 and 1.8 percent in Q3-FY17 on YoY basis, compared with fall of 3.9, 7.9 and 4 percent in Q3-FY16. The price of CNG has also gone up by Rs 2.05 per kg between December 2016 and March 2017, following the deregulation of CNG sector in December 2016 (vide Ministry of Petroleum and Natural Resources notification no. CNG-7(9)/16-Price, dated December 16, 2016).

[22] The price of 11.6 kg LPG cylinder rose 7.9 percent in Q3-FY17, compared with a 22.6 percent fall in Q3-FY16.

furnace oil prices (**Figure 3.8**).[23] From April 2016, domestic furnace oil prices recovered, but the consumer electricity tariff remained unchanged. This is mainly because the government reduced gas tariffs for major power producers.[24] It is important to recall here that the share of gas-based power generation in total power generation has increased to 29 percent in FY17.

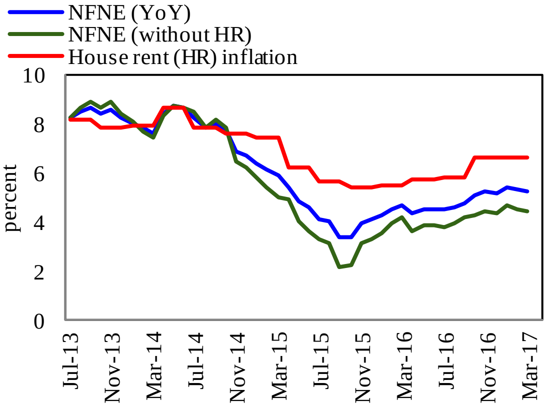
Figure 3.8: Trend in Furnance Oil and Consumer Electricity Tariff



*Average of five different slabs
Data source: Pakistan Bureau of Statistics

Core inflation, NFNE, is gradually inching up, primarily on the back of steady increase in house rent.[25] Typically, house rent exhibits quite persistent inflation; at the start of every quarter, it is revised upward based on regular quarterly surveys in urban areas (**Figure 3.9**).[26]

Figure 3.9: Trend in NFNE vis-a-vis House Rent Inflation



Data source: Pakistan Bureau of Statistics; State Bank of Pakistan

Having said this, NFNE without house rent is also picking up (**Table 3.4**). This is because of education and

[23] In Jul-Mar FY17, electricity generation from furnace oil increased to 23,011 GWh from 21,881 GWh in the same period last year. The share of furnace oil in electricity generation was 30 percent in Jul-Mar period of both FY16 and FY17.

[24] The government reduced gas tariffs for WAPDA, K-Electric and IPPs from Rs 613/mmbtu to Rs 400/mmbtu on December 30, 2016 (source: OGRA notification dated December 30, 2016).

[25] House rent rose 6.6 percent in Q3-FY17, compared with 5.5 percent in the same period last year.

[26] House rent is the single biggest item in CPI basket having weight of 21.8 percent. Pakistan Bureau of Statistics conducts quarterly surveys to assess house rent in urban areas. Anecdotal evidence suggests that the following factors are contributing to persistent increase in house rent: increasing migration from rural to urban areas; demand-supply gap of housing units; increasing cost of construction; rapid increase in land/real estate prices; and public tendency to save/invest in real estate.

health, which recorded double-digit price increases in Q3-FY17. The upward revision in education fees started quite early in the current fiscal year, i.e., from Q2-FY17 onwards, which resulted in 11.2 percent inflation in the education group in the third quarter, compared with 9.2 percent in the same period last year.[27] Likewise, health CPI rose 14.2 percent during the quarter under review, compared with only 3.7 percent in Q3-FY16. This increase mainly reflects an upward revision in medicine prices by a number of pharmaceutical firms.

Meanwhile, food inflation inched up during Q3-FY17 compared to last year (**Table 3.4**). Domestic prices of cooking oil/ghee and rice rose due to pick up in international prices of palm oil and rice in Q3-FY17. On top of this, the prices of perishable food items remained higher in the quarter on YoY basis.[28] Tight supply conditions due to implementation of stricter controls on trade payments, along with prolonged closures of the western border, and increasing transportation costs, were the main explanatory factors for this higher inflation in perishables.[29]

Outlook

Global oil prices, which rose 14.8 percent between November 2016 and May 2017, are forecast to remain around US$ 51.9–55 per barrel for the full calendar year 2017.[30, 31] As mentioned before, the government has passed on the increase in global oil prices only gradually (and partially) from January 2017 onwards, which has been helpful in diluting the second-round impact of rising fuel prices and taming inflation expectations of domestic consumers. However, going forward, recent regulatory changes in the motor fuel industry may lead to important adjustments in retail prices (**Box 3.1**). Some of the impact of these adjustments may be offset by the availability of sufficient stocks of key food items, like wheat and sugar.[32,33] In addition, the existing exchange rate stability

[27] In contrast to FY16, when educational fee were revised in Q3, the same fees started to rise from Q2-FY17 in the current fiscal year.

[28] Perishable food inflation rose 8.9 percent during Q3-FY17, compared with only 0.7 percent during same period last year.

[29] Compared to Q1-FY17 where implementation of trade controls along with tension on eastern border contributed to higher perishable prices, tensions on the western borders with Afghanistan resulted in disruption of food supplies in Q3-FY17. Western border closures/tension as reported, also resulted in heavy losses to traders in Pakistan. Furthermore, higher prices of petrol and HSD in Q3-FY17 resulted in rising transportation cost of fruits and vegetables which fed into higher consumer prices.

[30] From November 30, 2016 onwards, Saudi light crude prices oscillated in a band between US$ 45-55 per barrel. On June 16, 2017 it was trading at an average price of US$ 45.1 per barrel.

[31] Sources: IMF forecast as of May 29, 2017 and World Bank forecast as of April 26, 2017.

[32] With domestic consumption at around 24.5 million tons each year, there would be an excess of 1.2 million tons of wheat (for detail see **Chapter 2, Real Sector**). Further, the stock of wheat with

will also help in containing domestic inflation. On balance, therefore, SBP expects the FY18 inflation to stay within the target of 6 percent set by the government.

Box 3.1: Implications of Structural Shifts in the Domestic Fuel Economy

The motor fuel market in Pakistan has always been heavily regulated. Because of far-reaching spillover effects associated with the industry, the government monitors not only prices, but also product quality.[34] Therefore, movement in prices of motor fuel is typically considered as *administered*, which basically implies that global developments and/or the domestic demand-supply gap tends to affect inflation in this sector only when the government decides to pass on the impact to consumers.

While the motor fuel index carries a relatively small weight of 3.03 percent in the country's CPI basket, its actual impact on inflation is larger due to second-round impacts.[35,36] Over the past few years, significant deflation has been observed in this index – large enough to pull down the overall CPI inflation.[37] However, this box highlights recent regulatory changes in the industry which might foreshadow some upward adjustments in the pricing structure in the medium term.

Consumers may need to pay quality premiums

The quality of petrol has been upgraded from RON 87 to RON 92 in Pakistan from November 2016.[38] While consumers will derive benefits from this upgrade – including better engine performance of vehicles and reduced 'knocking' – the shift also entails a higher cost, which may ultimately put upward pressure on prices. For a crude gauge of rising costs entailed by the upgrade, the price differential between RON 87 and (costlier) RON 92 was around US$ 0.1 per liter on average during Nov-Apr FY17.[39]

Prices of HOBC and CNG will now be market-driven

Domestic pricing of HOBC and CNG was deregulated in November and December 2016, respectively. This was followed by an uptick in related prices.[40] In the case of HOBC, anecdotal

procurement agencies was approximately 4.9 million metric tons (MT) as of March 2017, compared to 4.6 million MTs as of March 2016.

[33] Sugar recorded 2.3 percent inflation during Q3-FY17, compared with 13.4 percent increase in the same period last year.

[34] Better quality motor fuel is associated with lower CO_2 emissions and environmental degradation.

[35] Motor fuel inflation is derived from the prices of petrol, CNG, HSD and LPG.

[36] In simple terms, the second round impact occurs when producers and service providers (for whom motor fuel is an input) embed the rising cost of fuel into the prices of their goods and services. This puts further upward pressure on the CPI beyond the initial increase in the motor fuel index alone.

[37] The motor fuel index posted a cumulative deflation of 23.8 percent between FY14 and FY16, before inching up in Q2 FY17 by 1.7 percent on YoY basis.

[38] The quality of petrol is assessed from its Research Octane Number (RON), where a higher number denotes better quality. Most countries are using at least RON 92 petrol. In efforts to provide better quality fuel, the government gave two years time to local refineries/OMCs to plan for the production of high grade petrol; however, local producers resisted this move. Ultimately in August 2016, the government decided to import RON92 and provided the product (initially in major cities) using the platform of OMCs in November 2016.

[39] Source: Bloomberg

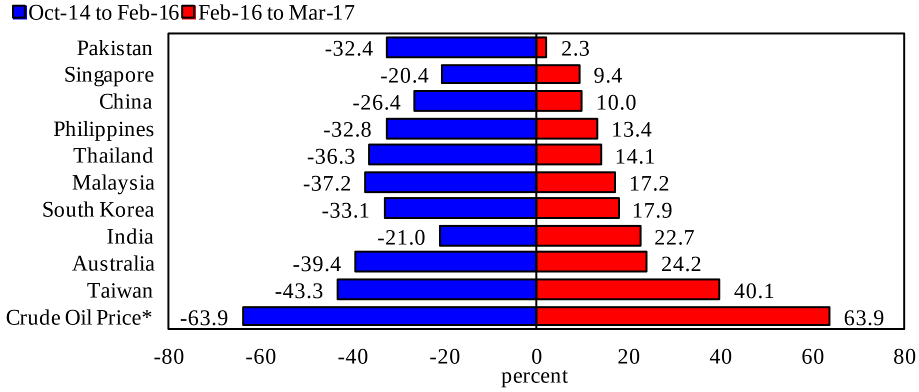
[40] Prior to deregulation, the average price for PSO's HOBC was Rs 73.05 per litre in November

evidence suggests that some sellers resorted to charging excessive margins, as upward ceilings were removed. For CNG, dealers increased prices on four occasions since the deregulation (up to mid-May 2017), citing an increase in input costs – particularly energy-related – during the period.

Price reversals have been contained compared to the benchmark

Globally, the trend in global gasoline prices has reversed (**Figure 3.1.1**). For example, Saudi Arabian Light oil, which traded at US$ 28.9 per barrel in Feb-16, crossed the US$ 51 per barrel mark merely two days after OPEC's agreement on November 30, 2016 to cut production.[41] In this altered scenario, many countries responded by raising domestic fuel prices. Some – like Taiwan and Australia – appeared to be more market-driven, as indicated by their contemporaneous price adjustments in line with global trends. By contrast, while Pakistan's response was fairly compatible in the falling oil price regime, its resistance to raise prices in the rising scenario was quite glaring. Lately, the government has started passing on some of the impact, but this has a political economy dimension: with general elections in 2018, prices may increase going forward, but probably not at a very high pace. This helps explain why Pakistan has thus far passed on the impact of rising global prices only gradually, and still remains among the ranks of countries where the room for further upward adjustments is quite large.[42]

Figure 3.1.1: Pass-through to Domestic Prices in Changing Oil Price Scenario



*Average of Brent, West Texas Intermediate, and the Dubai Fateh
Data source: Bloomberg; www.globaloilprices.com

Implications

Regardless of the pace of pass-through in Pakistan, trends in global oil will continue to influence the country's domestic prices. In this context, the global outlook remains uncertain: while agreed production cuts by OPEC and non-OPEC members in end November 2016 pushed up oil prices temporarily (till end February 2017), the fragile recovery remained vulnerable to, inter alia, increases

2016; by May, the price averaged Rs 81.41 per litre (PSO Altron X). Similarly, average CNG prices rose from Rs 69.8 per kg in December 2016 (pre-deregulation) to Rs 72.05 per kg by April 2017.

[41] This milestone deal marked OPEC's first production cut in eight years. It envisioned reduction in OPEC's output by approximately 1.2 million barrels per day by January. Significantly, even Russia – a non-OPEC member – agreed to cut production by 300,000 barrels per day.

[42] Pakistan ranks 32 out of 170 countries (1 being the lowest) in terms of gasoline prices (source: www.globalpetrolprices.com, accessed May 11, 2017).

in output of US shale and higher global inventories. As a counter measure, several OPEC members agreed (in a meeting held on May 25, 2017) to extend the output cut till Mar 2018. However, this agreement failed to have its desired impact, as prices fell to US$ 50 (on average) soon after the meeting, compared to US$52 per barrel prior to it.

On the domestic front, the post-May 25 dip in global oil prices coincided with the government's decision to cut domestic fuel prices in June 2017.[43] In the bigger picture, it appears that the impact of quality upgrades on domestic prices is yet to materialize. However, there has been one notable fallout already: an increase in import of refined petrol.[44] This is due to the inadequate capacity of local refineries to produce high quality gasoline. The situation calls for fresh investment and technology upgrades for local refineries, as higher import of refined products is unsustainable in the long run, and could stoke inflationary pressure. In the meantime, it is plausible that domestic petrol prices might gradually be raised in the medium term to offset some of the incremental cost of upgrades. On the face of it, there appears to be some room available for such a measure, since the pass-through in Pakistan has lagged behind the increase in global crude oil prices thus far (**Figure 3.1.1**).

[43] The government announced reduction of Rs 1.2 and Rs 1.6 per liter in prices of petrol and HSD for June 2017.

[44] The import-to-sales ratio of petrol rose from 56.7 percent in FY14 to 75.3 percent during Jul-Mar FY17.

4 Fiscal Policy and Public Debt

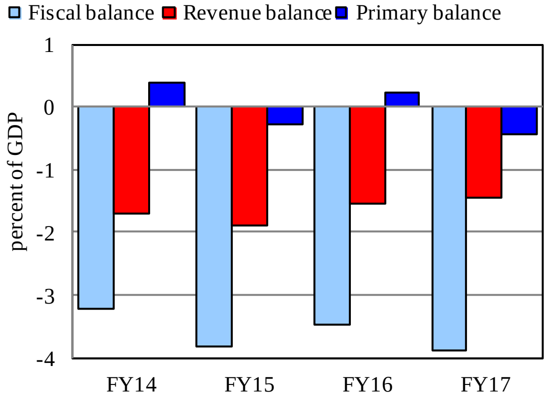
4.1 Overview

Fiscal deficit during Jul-Mar FY17 was 3.9 percent of GDP, which was higher than the full year target of 3.8 percent. While overall expenditures were managed well, the revenue collection could not accelerate. As a result, it became challenging to sustain the fiscal consolidation observed during the past few years, which is also evident from a large primary deficit during Jul-Mar FY17 against a surplus last year (**Figure 4.1**).

On a positive note, the revenue deficit improved slightly with restrained current expenditures. Despite an increase in defense and security related spending, the growth in current expenditures slowed down in Jul-Mar FY17 compared to the same period last year. This slowdown, in fact, was due to interest payments, which remained close to the last year's level. Contained interest expense, in the prevailing low interest rate environment, has provided fiscal space for development expenditures (**Figure 4.2**).

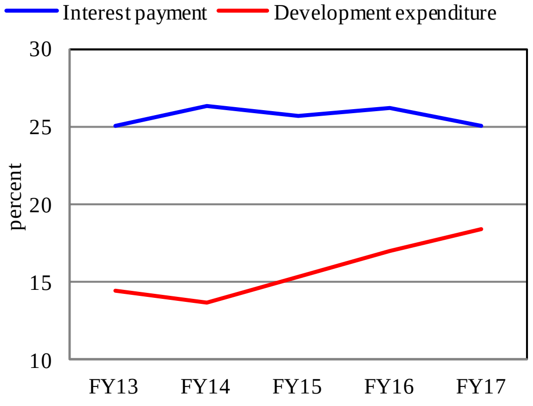
Meanwhile, the growth in total revenues decelerated significantly during Jul-Mar FY17 as compared to the last year. This was due to a considerable slowdown in tax collection, which was partly the result of fiscal relief measures and tax incentives provided to support investment

Figure 4.1: Fiscal Indicators (Jul-Mar)



Data source: Ministry of Finance and SBP's calculations

Figure 4.2: Share in Total Expenditures (Jul-Mar)



Data source: Ministry of Finance and SBP's calculations and growth in the economy.[1] The non-tax revenue also declined on account of lower receipts under Coalition Support Fund (CSF), SBP profit, and dividend income.[2]

Despite an increase in fiscal deficit, the debt accumulation was significantly lower during Jul-Mar FY17 as compared to the last year. This improvement took place on the back of revaluation gains accrued on external debt, along with the government's utilization of deposits held with the banking system (especially SBP).

4.2 Revenues

Total revenues grew by 6.2 percent during Jul-Mar FY17 as compared to 10.4 percent increase realized in the same period last year. As mentioned earlier, this slowdown was brought about by: (i) a 6.2 percent decline in non-tax revenues; and (ii) deceleration in growth of tax revenue to 8.6 percent in July-Mar FY17 from 20.3 percent realized last year (**Table 4.1**). The sluggish growth in overall tax revenues, despite a robust growth in provincial tax collection, largely came from a lower than targeted growth in FBR tax collection.

FBR taxes

As per the past pattern, the revenue collection gathered some pace in second and third quarters of FY17; yet, the growth momentum remained weak as compared to the last year despite a steady improvement in the economic activity. FBR tax collection grew by 8.2 percent during Jul-Mar FY17 as compared to an impressive 17.7 percent increase witnessed in the same period last year. Lower collection from both direct and indirect taxes contributed to this slowdown **(Table 4.2)**. This partly reflects the impact of fiscal relief measures and tax incentives to support investment, exports, and domestic production. Further, a divergence between tax collection and steadily improving economic activity highlights issues in the taxation system, which needs further efforts for improvements.

[1] For instance, government allowed sales tax exemptions/concessions on agriculture inputs (fertilizer and pesticides) to reduce the cost of production for farmers. Similarly, government announced incentives like zero-rating, exemptions of sales tax on import of new machinery and raw material for textiles and duty drawback to registered exporters to revive exports. Moreover, the government offered tax incentives to firms investing in energy projects.

[2] Pakistan received US$ 550 million under CSF during Jul-Mar FY17 against US$ 713 million in the same period last year.

Table 4.1: Summary of Fiscal Operations (Jul-Mar)
billion Rupees

	FY17 Budget	Actual		% of GDP	
		FY16	FY17	FY16	FY17
A. Total revenue	**5347.0**	**2,961.9**	**3,145.5**	**10.2**	**9.9**
Tax revenue	4,306.0	2,481.0	2,694.3	8.5	8.5
Non-tax revenue	1,041.0	480.9	451.2	1.7	1.4
B. Total expenditure	**6,623.0**	**3,971.3**	**4,383.6**	**13.6**	**13.8**
Current	5,198.0	3,407.0	3,605.1	11.7	11.3
Interest payments	*1,360.0*	*1,079.4*	*1,094.5*	3.7	3.4
Defence	*860.2*	*482.9*	*535.7*	1.7	1.7
Development	1,435.0	699.4	803.9	2.4	2.5
Net lending	-10	10.8	-34.2	0.0	-0.1
C. Statistical discrepancy	0.0	-145.8	8.8	-0.5	0.0
Fiscal balance (A-B-C)	**-1,276.0**	**-1,009.4**	**-1,238.1**	**-3.5**	**-3.9**
Revenue balance	149.0	-445.1	-459.6	-1.5	-1.4
Primary balance	84.0	70.0	-143.6	0.2	-0.5
Financing	1,276.0	1,009.4	1,238.0	3.5	3.9
External sources	234.0	222.9	220.2	0.8	0.7
Domestic sources	1,042.0	786.5	1,017.9	2.7	3.2
Banks	453.0	538.0	694.7	1.8	2.2
Non-bank	539.0	248.4	323.2	0.9	1.0
Privatization	50.0	0.0	0.0	0.0	0.0
% Growth					
Total Revenue		10.4	6.2		
Tax revenue		20.3	8.6		
Non-tax revenue		-22.4	-6.2		
Total Expenditure*		8.5	6.3		
Current		6.5	5.8		
Development		20.7	14.9		

*Excluding statistical discrepancy; Data source: Ministry of Finance and SBP's calculations

Table 4.2: FBR Tax Collection (Jul-Mar)
billion Rupees

	FY17 Budget	Collections		% Growth	
		FY16	FY17	FY16	FY17
Direct taxes	1,558.0	809.8	892.3	15.4	10.2
Indirect taxes	2,063.0	1,279.2	1,368.2	19.2	7.0
Customs duty	413.0	276.1	343.4	32.2	24.4
Sales tax	1,437.0	886.0	897.7	16.5	1.3
Federal excise duty	213.0	117.1	127.2	12.3	8.6
Total Taxes	**3,621.0**	**2,089.0**	**2,260.5**	**17.7**	**8.2**

Data source: Federal Board of Revenue and SBP's calculations

Direct taxes

Direct tax collection grew by 10.2 percent during Jul-Mar FY17 compared to 15.4 percent growth recorded in the corresponding period last year. This slowdown can be traced to reduction in corporate tax rate amid slower pace of increase in corporate profitability.[3] Banks' profits, in particular, declined by 40 percent during Jul-Mar FY17.[4]

Within the direct taxes, the growth in withholding tax (WHT) decelerated to 12.2 percent in Jul-Mar FY17 from 19.6 percent increase in the last year. However, WHT collection from dividend income registered a 24.3 percent increase in Jul-Mar FY17. This higher collection from dividend income can be traced to increase in WHT rates for both filers and non-filers.[5]

Similar to WHT, growth in voluntary tax payments (with a 26 percent share) fell to 7.3 percent in Jul-Mar FY17 from 25.0 percent last year. Collection on demand was the only component that rebounded with an increase of 10.0 percent from a 30.6 percent decline recorded in last year (**Table 4.3**).[6]

Table 4.3: Break-up of Withholding Taxes (Jul-Mar)
billion Rupees

	FY16	FY17	% Growth
I. Voluntary payments	230.9	247.7	7.3
II. Collection on demand	47.2	51.9	10.0
III. Withholding taxes	575.4	645.7	12.2
Imports	130.1	142.1	9.2
Salary	63.0	75.2	19.3
Dividends	24.9	31.0	24.3
Bank Interest	36.8	32.3	-12.3
Contracts	144.6	165.2	14.3
Cash withdrawals	21.0	21.6	3.0
Electricity	18.5	17.9	-3.0
Telephone	33.8	36.8	8.9
Others	102.8	123.7	20.3
IV. Miscellaneous	7.4	3.8	-48.4
Total	**860.9**	**949.1**	**10.2**

Data source: Federal Board of Revenue and SBP's calculations

Indirect taxes

The impact of fiscal relief measures and tax incentives was particularly reflected in lower collection from indirect taxes. The growth in indirect tax collection decelerated to 7.0 percent during Jul-Mar FY17 from 19.2 percent recorded in the last year.

[3] As explained in previous reports, direct taxes were also lower due to tax credits for employment generation/and new industrial undertakings and tax exemptions/relaxations given to companies working on CPEC related projects.

[4] The provisional numbers reported by banks show that banking sector profitability declined to Rs 137.8 billion in Jul-Mar FY17 from Rs 231.7 billion during previous year.

[5] The WHT rate on dividend income was increased to 12.5 percent from 10.0 percent for filers; and 20 percent from 17.5 percent for non-filers. In particular, dividend rate on mutual funds for individuals/associate of persons was increased to 15.0 percent from 10.0 percent for non-filers.

[6] This can be attributed to better handling of audit cases through introduction of risk-based audit.

This deceleration was broad-based. The major drag, however, came from decline in domestic sales tax and lower than expected FED collection.

The total sales tax collection, which accounts for two thirds of indirect taxes, grew by merely 1.3 percent during Jul-Mar FY17 as compared to 16.5 percent growth last year. This sluggish growth was primarily due to a 3.9 percent decline in domestic sales tax collection, as that from imports increased by 5.8 percent. Within domestic sales tax, collection from POL, fertilizer, cigarettes, and natural gas fell sharply; this more than offset the increase in sales tax collection from other sectors (**Table 4.4**).[7]

Table 4.4: Break-up of Sales Tax Collection (Jul-Mar)

billion Rupees

	FY16	FY17	% Growth
Domestic			
POL products	193.5	145.4	-24.9
Electrical energy	22.9	32.4	41.9
Cement	19.8	21.0	6.3
Cigarettes	12.1	9.7	-19.7
Fertilizer	15.0	2.9	-80.7
Natural gas	12.1	5.8	-52.0
Other	142.8	184.8	29.4
Total	***418.1***	***402.0***	***-3.9***
Imports			
POL products	142.8	145.8	2.1
Iron and steel	37.9	43.7	15.4
Machinery & mech. appliances	34.8	46.1	32.7
Electrical machinery	31.4	37.7	20.4
Vehicles (non-railway)	30.4	37.7	24.0
Other	190.7	96.1	-49.6
Total	***467.9***	***495.3***	***5.8***
Grand Total	**886.0**	**897.3**	**1.3**

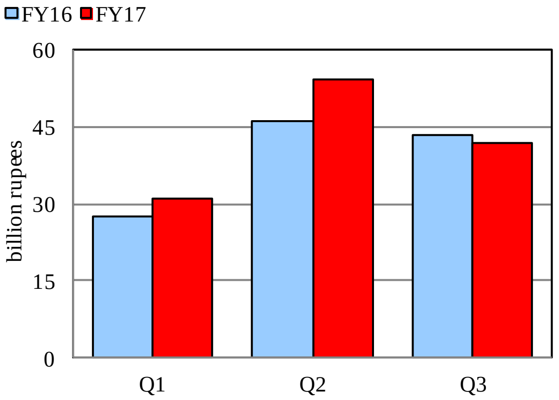
Data source: Federal Board of Revenue and SBP's calculations

FED collection grew by 8.6 percent during Jul-Mar FY17, against 12.3 percent growth witnessed in the last year, as the momentum gained in the second quarter could not be maintained in Q3-FY17 (**Figure 4.3**). This was mainly due to a 24 percent decline in collection from cigarettes (which accounts for one third of total FED collection) due to fall in its production following increase in the FED rate. Encouragingly, a significant increase in FED from booming cement and beverage industries, along with air travel services, more than offset the decline in FED on cigarettes.

[7] As explained in previous SBP reports, decline in sales tax collection from petroleum can be traced to the government's decision to absorb the increase in international prices of petroleum products in the start of the fiscal year and reduction in sales tax rates on petroleum products. Similarly, decline in sales tax collection from fertilizer was on account of reduction in GST rates from 17 to 5 percent under the Prime Minister's Kissan package coupled with reduction in feedstock prices to lower the per bag cost of fertilizer. Lower sales tax collection from cigarettes was due to decline in demand for locally manufactured cigarettes following the increase in FED rate on cigarettes. Cigarette consumers switched to low price black market alternatives.

Collection from customs duty grew by 24.4 percent during Jul-Mar FY17 compared to the 32.2 percent increase realized in the previous year. This steady growth in customs duty collection, despite reduction in rate of duty (on selected items) under the fiscal relief measures and tax incentives, can be attributed to a phenomenal increase in overall imports, especially those of raw material and machinery.[8,9]

Figure 4.3 : Quarterly Trend in FED Collection



Data source: Federal Board of Revenue

Non-tax revenues

The non-tax revenues declined by 6.2 percent during Jul-Mar FY17 compared with a decline of 18.8 percent in the corresponding period last year. This contraction was broad-based except for an uptick in mark-up income and passport fee collection, which have very small share in overall non-tax revenues. Lower CSF receipts, together with decline in SBP profit and dividend income, mainly led to contraction in non-tax revenues (**Table 4.5**).

Table 4.5: Non-tax Revenues (Jul-Mar)

billion Rupees

	FY17	Actual	
	Budget	**FY16**	**FY17**
Mark-up (PSEs and others)	81.1	11.1	12.1
Dividends	85.0	35.8	22.1
SBP profits	280.0	177.6	144.8
Defense (including CSF)	171.0	80.6	64.4
Profits from post office/PTA	81.0	5.4	0.7
Royalties on gas and oil	43.0	46.3	40.3
Passport and other fees	25.0	8.1	13.6
Discount retained on crude oil	10.0	5.7	5.9
Windfall levy against crude oil	10.0	1.6	1.0
Other	254.9	108.7	146.3
Total non-tax revenue	**1,041.0**	**480.9**	**451.2**

Data source: Ministry of Finance

4.3 Expenditures

The growth in expenditures slowed down for the second consecutive year. The consolidated federal and provincial expenditure grew by 6.3 percent in Jul-Mar

[8] The value of import (PBS) has grown by around 18.7 percent during July-Mar FY17. Specifically, import of machinery increased by 41.9 percent YoY in the same period.

[9] The custom duty on import of machinery and raw materials was reduced from 5 to 3 percent in the federal budget for FY17.

FY17, compared to 8.5 percent growth recorded in the last year. Most of the moderation in total expenditure growth came from a sustained decline in current expenditure growth. The development expenditure, on the other hand, increased by 14.9 percent during Jul-Mar FY17, on top of 20.7 percent increase registered last year.

Table 4.6: Analysis of Fiscal Spending (Jul-Mar)

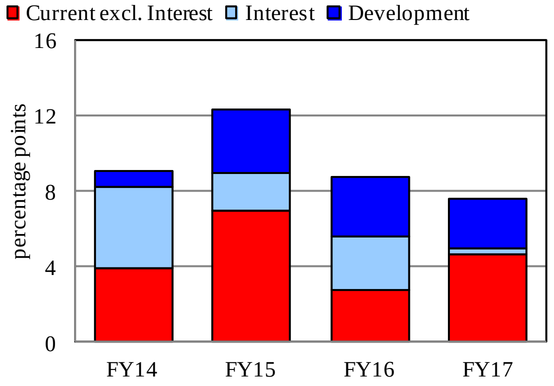
billion Rupees

	Actual		% Growth	
	FY16	**FY17**	**FY16**	**FY17**
Current expenditures	**3,407.0**	**3,605.1**	**6.5**	**5.8**
Federal	2,368.9	2,439.3	5.0	3.0
Interest payment	1,079.4	1,094.5	10.8	1.4
Defense	482.9	535.7	-0.6	10.9
Public order and safety	75.4	81.9	13.5	8.6
Others	731.2	727.2	0.3	-0.5
Provincial	1,038.0	1,165.8	10.1	12.3
Development expenditures	**699.4**	**803.9**	**20.7**	**14.9**
PSDP	623.4	764.6	24.8	22.7
Federal	251.3	324.0	20.8	28.9
Provincial	372.1	422.7	27.7	13.6
Others (incl. BISP)	76.0	57.2	-5.3	-24.7
Net lending	**10.8**	**-34.2**	-24.4	-416.7
Statistical discrepancy	-145.8	8.8	137.4	-106.0
Total Expenditure	**4,117.1**	**4,374.8**	**8.5**	**6.3**

Data source: Ministry of Finance and SBP's calculations

A break-up of the current expenditure, nevertheless, suggests that growth in provincial expenditures still remained strong, i.e., 12.3 percent in Jul-Mar FY17, compared to the 10.1 percent in the same period last year (**Table 4.6**). The spending under General Public Affair (Rs 566 billion), Public Order and Safety Affair (Rs 179.7 billion) and Fuel and Energy (Rs 38.2 billion) mostly contributed to the increase in provincial current expenditure.

Figure 4.4: Contribution to Growth in Expenditures (Jul-Mar)



Data source: Ministry of Finance and SBP's calculations

The federal current expenditure, on the other hand, increased by only 3.0 percent during this period despite a significant increase in defense and security related spending. It was primarily due to restrained interest expense, which rose marginally by 1.4 percent (or Rs 15.1 billion) during Jul-Mar FY17. This has somewhat increased the cushion for maintaining a steady growth in development spending (**Figure 4.4**).

4.4. Provincial fiscal operations

The consolidated provincial surplus reached Rs 227.6 billion in Jul-Mar FY17, about two thirds of the full-year target of Rs 339 billion. Most of the surplus was contributed by Punjab, followed by KP, Sindh, and Balochistan (**Table 4.7**).

Table 4.7: Provincial Fiscal Operations (Jul-Mar)
billion Rupees

	Punjab	Sindh	KP	Balochistan	Total	% Growth
FY 17						
A. Total revenue	808.4	500.3	263.1	164.3	1,736.1	13.7
Provincial share in federal revenue	665.6	382.2	224.3	150	1,422.1	13.5
Provincial revenues (I+II)	132.8	107.4	41.3	8.3	289.8	25.2
I. Taxes	112.3	101.7	12.1	4.5	230.5	23.5
II. Non-tax revenues	20.6	5.7	29.2	3.9	59.3	32.6
Fed loans and transfers	10.0	10.7	-2.4	5.9	24.2	-42.4
B. Total expenditure	723	455.5	290.2	129.8	1,598.5	12.6
Current[2]	484	363.4	216.4	112.1	1,175.9	12.3
Development	239.1	92.1	73.8	17.7	422.7	13.6
Gap (A-B)	85.4	44.8	-27.1	34.5	137.6	28.2
Financing[1] (overall balance)	**-82.7**	**-41.9**	**-67.0**	**-36.0**	**-227.6**	**2.9**
FY 16						
A. Total revenue	715.1	430.7	233	147.8	1,526.6	12.2
Provincial share in federal revenue	595.2	329.6	200.6	127.7	1,253.2	13.1
Provincial revenues (I+II)	113.9	87.3	23.4	6.8	231.4	27.1
I. Taxes	91.6	83.0	9.1	2.9	186.7	28.6
II. Non-tax revenues	22.3	4.3	14.3	3.9	44.7	21.1
Fed loans and transfers	6.0	13.7	9.0	13.3	42.0	-41.3
B. Total expenditure	706.6	348.8	231.5	132.4	1,419.3	14.0
Current[2]	484.4	283.1	175.4	104.3	1,047.2	9.9
Development	222.2	65.6	56.1	28.2	372.1	27.7
Gap (A-B)	8.5	81.9	1.5	15.4	107.3	-8.1
Financing[1] (overall balance)	**-57.4**	**-91.0**	**-66.2**	**-6.6**	**-221.2**	**14.0**

[1] Negative sign in financing means surplus; [2] Current expenditure data may not match with those given in Table 4.6 as numbers reported here includes the mark-up payments to federal government.

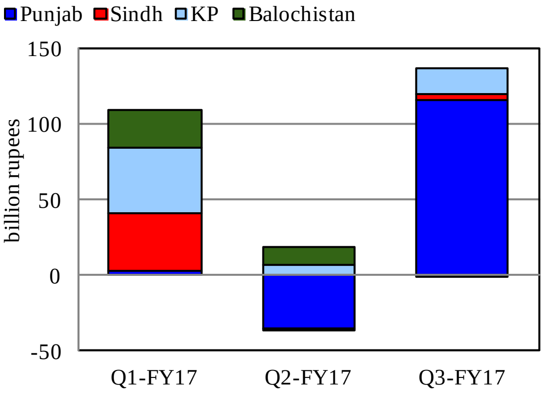
Data source: Ministry of Finance and SBP's calculations

Quarterly data shows that the provincial surplus significantly improved in Q3-FY17 by Rs 137.0 billion as compared to Rs 108.6 billion in Q1-FY17 and a deficit of Rs 18.0 billion in Q2-FY17 (**Figure 4.5**). This was an outcome of both higher revenue and a slower increase in total expenditures.

Besides higher federal transfers, the provinces' own taxation efforts also contributed to 13.7 percent increase in revenues during Jul-Mar FY17, as compared to 12.2 percent increase recorded in the corresponding period last year.

The provinces' revenue efforts are particularly evident from a steady increase in collection from General Sales Tax on Services (GSTS). The higher revenue collection from GSTS is a result of systematic taxation planning by the provinces, especially the establishment of Invoice Monitoring System for effective tax collection on services (**Figure 4.6**).[10]

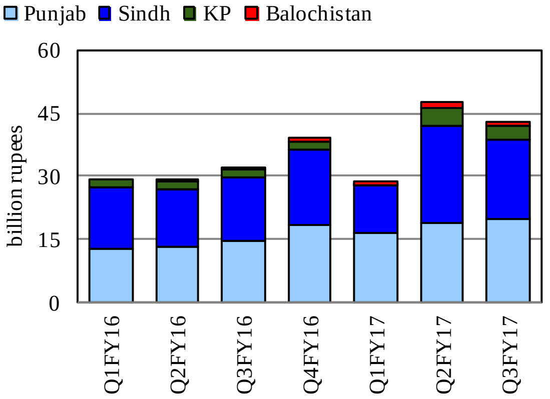
Figure 4.5: Trends in Provincial Surplus



Data source: Ministry of Finance

Besides GSTS, stamp duties and motor vehicle tax also contributed significantly to provincial revenue during Jul-Mar FY17. In particular, property taxes in Sindh grew by 73 percent during this period, which reflects contribution of initiatives regarding property valuation by setting-up automation of land record.[11] Similarly, revenue receipts of Khyber Pakhtunkhwa increased through profits from hydroelectricity under Hydro Power Policy 2016.

Figure 4.6: Trends in General Sales Tax on Services



Data source: Ministry of Finance

The growth in provincial expenditure, on the other hand, slowed down to 12.6 percent in Jul-Mar FY17 compared to 14.0 percent growth in the same period last year. Importantly, the main focus of provinces remained on infrastructure

[10] The Government of Punjab, in collaboration with Punjab Information Technology Board (PITB), has launched Invoice Monitoring System on various services especially restaurants and beauty parlors (source: Notification No.PRA/Orders.06/2012, Dated January 13th, 2015).

[11] Land Administration and Revenue Management Information System (LARMIS), Board of Revenue, Government of Sindh.

development and energy projects. Punjab spent 33 percent of its total expenditures on development projects with infrastructure and social sectors being priority.[12] Sindh and KP also increased their development spending during Jul-Mar FY17. On the contrary, Baluchistan registered lower development spending during the period under review compared to the last year.

4.5 Public debt

With an addition of Rs 1.2 trillion during Jul-Mar FY17, gross public debt reached Rs 20.9 trillion as of end-March 2017 (**Table 4.8**). More than 90 percent of the rise in public debt came from domestic borrowing, while increase in external debt remained moderate on account of revaluation gains and marginally higher debt repayments during the period.

Table 4.8: Pakistan's Public Debt Profile
billion Rupees

	Stock		**Flow**				
			Jul-Mar		**FY17**		
	Jun-16	**Mar-17**	**FY16**	**FY17**	**Q1**	**Q2**	**Q3**
Gross public debt (FRDLA definition)*	**19,676.7**	**20,873.9**	**1,787.7**	**1,197.2**	**866.1**	**-270.6**	**601.7**
Domestic debt	13,625.9	14,746.0	1,205.5	1,120.1	759.8	-193.1	553.5
External debt	5,417.7	5,501.4	415.40	83.8	97.3	-54.4	40.8
Debt from the IMF	633.1	626.4	166.8	-6.7	8.9	-23.0	7.4
External liabilities	377.1	368.1	4.7	-9.0	-1.1	-11.1	3.1
Net public debt**	17,823.2	18,925.4	1,360.2	1,102.1	458.8	103.6	539.7

*Fiscal Responsibility and Debt Limitation Act, 2005 (FRDLA) was amended in June 2016 to define "Total Public Debt" as "The debt of the government serviced out of consolidated fund and debts owed to International Monetary Fund (IMF)".
**Gross public debt minus government deposits with the banking system.
Data source: State Bank of Pakistan

Domestic debt

With higher fiscal deficit and net external financing slightly lower than last year, the burden of deficit financing fell on domestic sources during Jul-Mar FY17. Yet, the pace of domestic debt accumulation decelerated during the period. It grew by 8.2 percent during Jul-Mar FY17 compared to 9.9 percent increase recorded in the last year (**Table 4.9**). Almost entire increase in domestic debt during the period was contributed by short-term debt, as the government retired long-term debt. Quarterly break-up shows that there was a shift in borrowing away from SBP during the second and third quarters of FY17 (**Table 4.10**). In absolute terms, the government retired Rs 177.3 billion to SBP during second and third quarters of

[12] Medium Term Development Framework (MTDF) 2016-19, Government of Punjab.

FY17, after borrowing heavily from SBP in the first quarter. This retirement was made possible through: (i) drawdown in government deposits held with the SBP, and; (ii) increased borrowing from commercial banks.

Banks' interest in government securities, as evident from the bidding pattern in recent auctions, was also revived in Q3-FY17. Yet, the offer-to-target ratio was much higher in case of T-bill than in PIB auctions. Against a target of Rs 2.5 trillion, commercial banks offered Rs 4.3 trillion in T-bill auctions held during the third quarter. Moreover, most offers were in 3-months and 6-months T-bills (**Table 4.10**). The government accepted significantly higher amount in T-bill auctions compared to targets to facilitate retirement of maturing PIBs in the quarter.

Table 4.9:Absolute Change in Government Domestic Debt

billion Rupees

	FY16	FY17	FY17		
	Jul-March		Q1	Q2	Q3
Government domestic debt	**1,205.5**	**1,120.1**	**759.8**	**-193.2**	**553.5**
Permanent debt	754.2	-561.8	-746.2	26.0	158.4
Of which					
PIBs	622.6	-644.9	-780.9	0.0	136.0
Prize bond	94.1	83.1	34.8	26.0	22.4
Floating debt	354.9	1,599.9	1,480.0	-243.9	363.8
Of which					
MTBs	540.6	1,077.9	568.1	62.8	447.0
MRTBs	-219.2	734.6	911.9	-94.1	-83.2
Unfunded debt	96.2	82.0	26.0	24.6	31.3
Foreign currency loans	0.1	0.0	0.0	0.0	0.0

Data source: State Bank of Pakistan

Table 4.10: PIB and T-bills Auction Profile*

billion Rupees

	Target	Offer	Accepted	Maturity**
Q1-FY17				
T-bills	1,450.0	3,066.0	1,680.4	1,178.0
PIBs	300	995.4	678.5	1683.9
Total	**1,750.0**	**4,061.2**	**2,358.9**	**2,861.9**
Q2-FY17				
T-bills	1,300.0	1710.6	1,048.4	1,058.4
PIBs	200	234.7	0.0	35.5
Total	**1,500.0**	**1,945.2**	**1,048.4**	**1,093.9**
Q3-FY17				
T-bills	2,550.0	4,319.8	2,888.8	2,522.2
PIBs	150.0	323.6	132.4	207.6
Total	**2,700.0**	**4,643.4**	**3,021.2**	**2,729.8**
Grand total Jul-Mar-FY17	**5,950.0**	**10,649.8**	**6,428.5**	**6,685.6**

* Face value and competitive bids only; ** Principal plus coupon payments for PIBs

Data source: State Bank of Pakistan

PIB auctions depict relatively different picture in Q3-FY17. As a whole, the government did not meet pre-auction targets as banks were bidding for higher rates. With these developments, the composition of Pakistan's domestic debt saw a shift: significant substitution of long-term debt with short-term debt. Thus with an increase of Rs 1.6 trillion in Jul-Mar FY17, the share of floating debt rose to 44.8 percent by end-March FY17 from 36.7 percent as of end June 2016.

While short-term borrowings help curtail the servicing cost, these worsen the maturity profile and increase the government exposure to rollover and re-pricing risks. For instance, the debt re-fixing in one year increased to 53.6 percent in December 2016 from 47.7 in June 2015.[13] Similarly, the average time to maturity (ATM) fell to 2.1 years in December 2016 from 2.3 years in June 2015 (**Table 4.11**).

In terms of ownership, although a part of government securities shifted to non-bank financial institutions through secondary market trading, around eighty percent of the government securities are still held by the commercial banks (**Figure 4.7**). Like commercial banks, non-banks also substituted their investment from PIBs to T-bills during Q1-FY17. However, increased investment in both T-bills and PIBs represent fresh investment during second and third quarter of FY17, which is a healthy development.

Table 4.11: Risk Indicators of Domestic Debt*

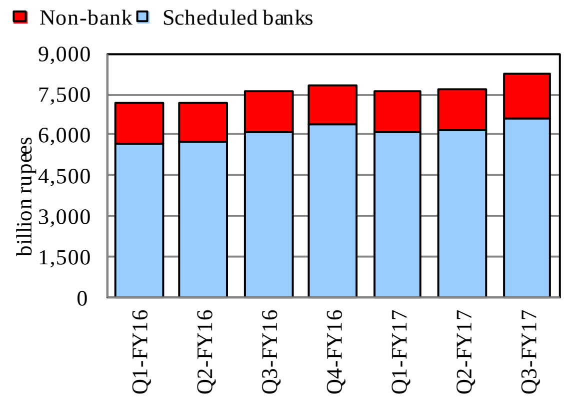
Number of years for ATM and ATR; percent of total otherwise

	2015	Mar-16	Jun-16	Dec-16
Interest Rate Risk				
Debt re-fixing in 1 year	47.7	53.3	52.8	53.6
Fix rate debt	58.9	61.2	61.6	54.3
ATR	2.3	2.0	2.1	2.1
Refinancing Risk				
Debt maturing in 1 year	47.3	52.4	51.9	52.7
ATM	2.3	2.1	2.1	2.1

*Corresponding information for end-March is not yet available
ATR: Average Time to Re-fixing; ATM: Average Time to Maturity

Data source**:** Debt Policy Coordination Office

Figure 4.7: Holdings of MTBs and PIBs



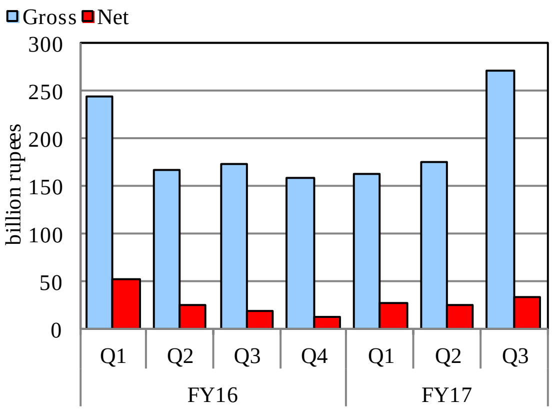
Unfunded debt

The net flows in National Savings Schemes (NSS) recorded marginal improvement in Q3-FY17 compared to the first half of FY17. This was expected as the impact of an upward revision in the rate of return on

[13] This ratio, nonetheless, is significantly lower than 67.2 percent in 2013.

some schemes during H1 started to become evident during the third quarter.[14] However, net inflows in NSS during Jul-Mar FY17 were still lower than the level observed during the same period last year.

Figure 4.8: NSS Inflow



Data source: Central Directorate of National Savings

At the same time, the gross inflows in these schemes proved to be more resilient to the profit rate changes during FY17, showing significant improvement in the gross inflows during the third quarter (**Figure 4.8**). It seems that investors re-priced their investments to get benefit of higher rates, as net inflows did not increase much.[15]

Public external debt

Pakistan's public external debt & liabilities stock increased by US$ 595.6 million during Jul-Mar FY17, reaching US$ 62 billion as of end-March 2017 (**Table 4.12**). Despite substantial disbursements, lower accumulation in external debt reflects US$ 1.5 billion revaluation gain during the period. At the same time, repayment of external debt also increased marginally during the period compared with the same period last year.

Disbursements

Gross external loan disbursements stood at US$ 4.9 billion during Jul-Mar FY17, largely in line with the full year target of US$ 7.6 billion announced at the beginning of FY17 (**Figure 4.9**). In addition to US$ 1.0 billion Sukuk bond proceeds, Pakistan also received substantial inflows from external creditors, especially from ADB, foreign commercial banks, and China.

[14] NSS rates have been revised on three occasions during Jul-Mar FY17 i.e., August 1, 2016; October, 1 2016, and; February 1, 2017.

[15] It is important to note that the number of national saving schemes is exempted from any direct penalty on early encashment that encouraged investors to re-invest their original certificates.

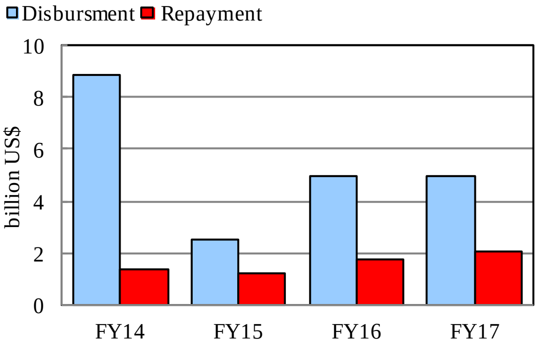
Table 4.12: Public External Debt & Liabilities
billion US$

	Stocks		Flows				
			Jul-Mar		FY17		
	Jun-16	Mar-17	FY16	FY17	Q1	Q2	Q3
Public external debt & liabilities (1+2+3)	61.4	62.0	4.1	0.6	1.0	-0.9	0.5
Public external debt (1+2)	57.7	58.5	4.1	0.9	1.1	-0.8	0.5
1.Government debt	51.7	52.5	2.6	0.8	1.0	-0.6	0.4
Of which							
Paris club	12.7	11.9	0.6	-0.8	0.1	-1.2	0.3
Multilateral	26.4	25.9	0.9	-0.4	-0.2	-0.4	0.2
Other bilateral	4.4	5.2	0.2	0.8	0.3	0.4	0.1
Euro/Sukuk bonds	4.6	5.6	0.0	1.0	0.0	1.0	0.0
Commercial loans	1.5	2.2	1.2	0.7	0.4	0.0	0.4
2.IMF	6.0	6.0	1.5	0.1	0.1	-0.2	0.1
3.Foreign exchange liabilities	3.6	3.5	-0.1	-0.1	0.0	-0.1	0.0

Data source: State Bank of Pakistan

Encouragingly, inflows from the multilateral donors continued, despite conclusion of the IMF program in the beginning of FY17.[16] Specifically, gross disbursement from IFIs stood at US$ 1.2 billion in Jul-Mar FY17. Within the multilateral flows, disbursements from ADB increased, while inflow from the World Bank declined. Another important development is the substantial financing availed from the foreign commercial banks.

Fgure 4.9: Gross Disbusment and Repayment of Government External Debt



Data source: Economic Affairs Division and State Bank of Pakistan

[16] Generally, inflows from multilateral donors (like ADB, World Bank etc) are contingent with the structural reforms under IMF program and usually dry out with the completion of program. However, as inflows remain intact, this shows that government is continuing its reforms program.

These included US$ 700 million from China Development Bank (CDB), US$ 300 million from Industrial and Commercial Bank of China (ICBC) and US$ 315 million from the Noor Bank.

Servicing of external debt

The servicing of public external debt increased by only US$ 40.5 million during Jul-Mar FY17 (**Table 4.13**). This main servicing burden was due to repayment to the multilateral donors that reached around US$ 1.0 billion during Jul-Mar FY17. In addition, the government also repaid China Safe Deposits worth US$ 500 million.

Table 4.13: Servicing of Public External Debt (Jul-Mar)

million US$

	FY16	FY17	Change
Government debt	2,005.0	2,045.5	40.5
Of which			
Paris club	129.1	153.8	24.7
Multilateral	955.9	999.6	43.8
Other bilateral	200.0	233.4	33.3
Euro/Sukuk bonds	500.0	0.0	-500.0
SAFE China deposits	0.0	500.0	500.0
Commercial loans	200.0	139.8	-61.2
IMF	52.6	0.0	-52.6
External liabilities	0.0	0.0	0.0
Total	**2,057.6**	**2,045.5**	**-12.1**

Data source: State Bank of Pakistan

5 External Sector

5.1 Overview

Pakistan’s overall external balance recorded a deficit of US$ 1.6 billion in Jul-Mar FY17, against a surplus of US$ 1.1 billion in the same period last year. This was mainly caused by a large trade deficit on the back of high imports– without a matching performance by exports. The imports of fuel, machinery and food items (mainly palm oil and pulses), all increased sharply due to robust domestic demand and ongoing power and infrastructure development activity.[1] This dynamic pushed the current account deficit (CAD) to US$ 2.6 billion in Q3 – the highest since Q2-FY09. The higher CAD was recorded despite the receipt of US$ 550 million inflow under Coalition Support Fund in the third quarter. For Jul-Mar FY17, the current account gap amounted to US$ 6.1 billion, over twice the level recorded in the same period last year (**Table 5.1**).

Table 5.1: Summary of Pakistan’s External Sector (million US$)

	Q3		Jul-Mar	
	FY16	**FY17**	**FY16**	**FY17**
Current account balance	**-449**	**-2,570**	**-2,351**	**-6,114**
Of which				
Trade balance	**-3,933**	**-6,893**	**-13,356**	**-17,748**
Exports	5,545	5,600	16,328	16,120
Imports	9,478	12,493	29,684	33,868
POL imports	1,614	2,771	6,398	7,769
Non-oil imports	7,864	9,722	23,286	26,100
Food	1,160	1,503	3,367	3,993
Transport	467	641	1,331	1,852
Machinery	1,532	2,024	4,602	5,275
Services balance	**-746**	**-304**	**-2,033**	**-1,993**
Coalition Support Fund	0	550	713	550
Worker remittances	4,699	4,600	14,388	14,058
Capital account balance	47	150	213	260
Financial account balance	107	-1,138	-3,372	-4,805
Of which				
FDI in Pakistan	446	501	1,425	1,601
FPI in Pakistan	-613	-114	-393	631
Euro bond/Sukuk	0	0	500	1,000
FX loans (net)	1,109	229	3,769	1,964
IMF	503	0	1,455	102
Overall balance*	315	1,841	-1,144	1,614

Note: The table is as per the IMF’s Balance of Payments Manual 6; * Minus sign shows surplus, and plus sign shows deficit. Data source: State Bank of Pakistan

[1] The IBA-SBP Consumer Confidence Index reached its highest level of 176.5 points in March 2017, up 18.6 points from the level recorded in July 2016, which indicates increase in demand.

Though the SBP's reserves hit a peak of US$ 19.5 billion (in October 2016) as proceeds from US$ 1.0 billion Sukuk were received, sustaining that level was not possible in the wake of an increasing current account gap; lower external government financing; and the conclusion of the IMF program.[2]

Particularly, the FX reserves declined in the third quarter of FY17, as: (i) the monthly CAD crossed the US$ 1.0 billion mark in January 2017; (ii) Pakistan repaid US$ 500 million of SAFE China Deposits, also in January; and (iii) the merchandise trade deficit grew by almost US$ 3.0 billion YoY in Q3-FY17. While CSF inflows did materialize over the next two months and provided some breathing space, SBP's liquid FX reserves declined to US$ 16.5 billion by end-March FY17, from US$ 18.3 billion at end-December 2016. These were, nonetheless, sufficient to finance over four months of the country's merchandise import bill.

That said, the country did have access to funding avenues, both public and private, which partially financed the higher current account deficit. Net official external financing inflows in Jul-Mar FY17 – in the form of project, non-project and commercial loans, and sovereign bonds – stood around the same level as last year (i.e. US$ 1.9 billion). This indicates that IFIs and international capital markets are comfortable with Pakistan's growth trajectory.[3] In addition, foreign direct investment (FDI) inflows also increased; in a departure from last year, a majority of these flows came from countries other than China.[4] Net FDI from China rose marginally over last year, with investment mostly flowing into power and infrastructure projects; the 40 percent stake sale of the Pakistan Stock Exchange to a Chinese-led consortium also netted the country's foreign investment worth around US$ 61 million in March 2017.[5]

However, as mentioned earlier, these inflows were not sufficient to fully offset the widening in the current account gap. The following points are worth noting in this regard:

[2] SBP had received US$ 1.5 billion under the Extended Fund Facility in Jul-Mar FY16, and only US$ 102 million (as the residual tranche) in Jul-Mar FY17.

[3] In May 2017, the credit ratings agency Moody's maintained its B3 rating for Pakistan, with a "stable" outlook.

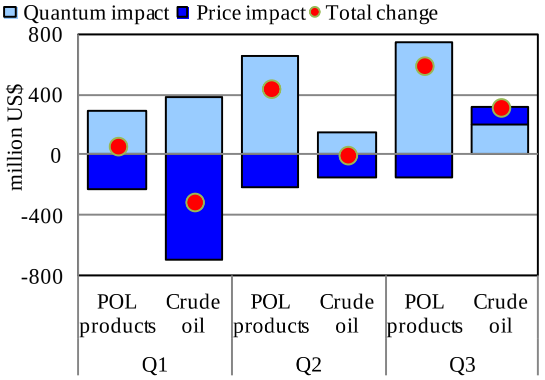
[4] This was mainly due to the conclusion of two acquisition deals in the food and electronics sectors by non-Chinese firms in the second quarter, which contributed a cumulative US$ 587.7 million to net FDI inflows during Jul-Mar FY17.

[5] While the total proceeds realized from the PSX stake sale amounted to around US$ 85 million, the component received from foreign investors was US$ 61.1 million (recorded as foreign investment), with the rest coming from domestic partner firms in the Chinese-led consortium.

(i) *The Q3-FY17 import bill hit an all-time high, pushing the Jul-Mar FY17 imports to* their *record as well*. This occurred as non-oil imports kept on their rising trajectory, largely reflecting: (a) progress on power generation and road infrastructure projects, as well as capacity expansions and upgradation pursued by industries like textiles and cement (which boosted machinery imports); (b) a drop in domestic production of minor crops (mainly pulses), which necessitated higher purchases from abroad; and (c) a price-driven hike in palm oil imports.

Meanwhile, the US$ 1.4 billion increase in the POL import bill in Jul-Mar FY17 (contributing 32.6 percent to the overall *rise* in import payments in the period) is largely driven by higher quantums.[6] Despite the recovery in international oil prices, unit values of Pakistan's POL product imports are still lower as compared to last year (**Figure 5.1**). While the price impact for crude oil turned positive from Q3-FY17 – in line with the movement in international oil prices[7] – yet, higher quantums still seem to be driving the increase in Pakistan's overall energy imports.

Figure 5.1: Breakdown of YoY Change in POL imports in FY17



Data source: Pakistan Bureau of Statistics and SBP's calculations

On this front, the government's decision to partially pass on the increase in global oil prices to domestic POL prices from December 2016 onwards, seems to have had a dampening effect on demand for POL products, as reflected by a slowdown in sales growth of both HSD and petrol in Q3-FY17 (**Figure 5.2**).[8] Per litre prices

[6] Another factor has been the rise in LNG imports into the country. According to SBP data, the LNG import bill amounted to US$ 844.0 million in Jul-Mar FY17, up 129 percent on YoY basis.

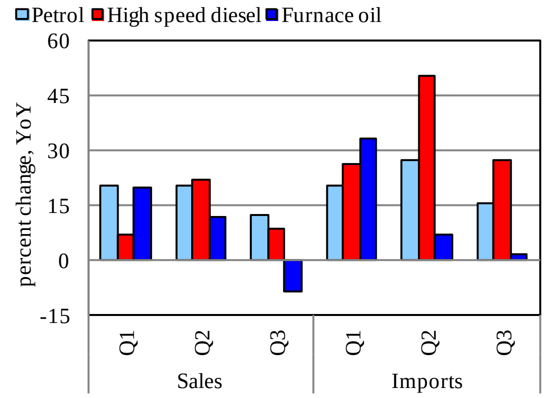
[7] Average Saudi Arabian Light oil prices during Q3-FY17, at US$ 52.9 per barrel, were 77.3 percent higher than they were in the same period last year (source: Bloomberg).

[8] In case of petrol, it is also possible that some consumers who had shifted to the fuel from CNG after the sizable reduction in petrol prices in 2016, have now switched back to CNG, following the increase in POL prices from Q2-FY17 onwards. Though per litre petrol and per unit CNG prices technically should not be compared due to differences in the nature of the fuels, it can be used as a rough proxy for discerning shifts in consumer behaviour. In January 2016, petrol prices were Rs 6.1 higher than per unit CNG prices. This differential had turned a *negative* Rs 5.9 in March 2016 (i.e.

of the two fuels were raised by Rs 5.8 and Rs 5.6 respectively in the third quarter, after having been kept almost unchanged during the previous two quarters.[9]

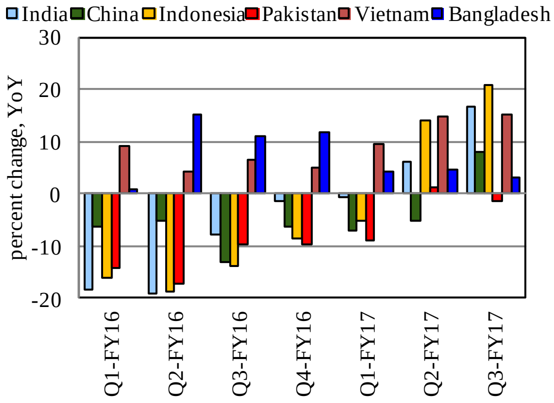
(ii) *Pakistan's export recovery lags* behind *other EMs'*. Like many other emerging markets (EMs), Pakistan also faced a challenging export environment over the last two years – with subdued commodity prices, muted demand from key western markets, and decline in shipments to China. However, many of these external dynamics had reversed by mid-2016: international cotton prices increased during Jul-Mar FY17,[10] and overall imports of key markets like the EU also rebounded.[11]

Figure 5.2: Sales and Imports of POL Products in FY17



Data source: Oil Companies Advisory Council

Figure 5.3: Export Performance of Some Emerging Markets



Data source: Haver Analytics

The confluence of these developments and the positive demand shock they generated, have contributed to a recovery in exports of multiple emerging markets (EMs) from Q2-FY17 onwards (**Figure 5.3**).[12] However, Pakistan's export performance during this period looks weak.

per unit CNG prices were Rs 5.9 higher than petrol prices). But after declining consistently since then, this differential had again reversed to a positive Rs 1.2 by March 2017.

[9] Petrol and HSD prices were unchanged during Jul-Nov FY17, before rising by Rs 2.8 and Rs 3.2 respectively in December 2016.

[10] Average international cotton prices during Jul-Mar FY17 were 14.5 percent higher as compared to Jul-Mar FY16 (source: Bloomberg).

[11] Overall imports of EU-28 countries rose by 3.7 percent YoY in Jul-Mar FY17, after declining by 11.6 percent in the same period last year (source: Eurostat).

[12] Yet, at the same time, clouds of protectionist and anti-trade sentiments swirl overhead and threaten the sustainability of this EM export rally. In fact, these sentiments prompted the IMF to note in its

One reason is that Pakistan's clothing and home textile products are fetching lower unit values in the key EU market than those of its competitors (**Section 5.4**). Both the product quality and competitive pricing issues seem to be at play here; exporters are also reported to be undercutting their margins by trying to out-price their competitors. For low-value added textile products, the recovery in international cotton prices over the past 12 months has translated into higher unit prices, but their export receipts are being pulled down by lower quantums. On an encouraging note, *basmati* rice exports recovered in Q3-FY17, mainly as a result of higher shipments to the UAE and Iran.[13]

(iii) *The decline in remittances has been offset by lower profit repatriations*. The nominal YoY decline in worker remittances amounted to US$ 330 million in Jul-Mar FY17. However, the decline in remittance inflows was more than offset by a US$ 371 million YoY decline in outflows in the form of profit and dividend repatriations, particularly by foreign oil and gas firms.

To sum up, Pakistan's external account has come under pressure due to an unfavorable trade balance. While a large share of imports is geared for growth-oriented activities, sluggish exports are more worrisome. To rectify this imbalance, the private sector needs to take the lead, by demonstrating an entrepreneurial spirit and investing in physical and human capital, in order to offer more competitive products in international markets.

Moreover, the changing global economic scenario also offers enhanced trade prospects, as the IMF now projects a brighter outlook for advanced economies.[14] This is particularly true for the US, where the new administration's fiscal policy proposals (a combination of hefty tax cuts and ramp up in infrastructure spending) are fuelling optimism. Besides, Europe and Japan are also expected to benefit from a recovery in global manufacturing and trade. That said, only those EMs can hope to benefit from this evolving dynamic, that have: a strong reliance on

World Economic Outlook April 2017 that " the post-World War II system of international economic relations is under severe strain despite the aggregate benefits it has delivered – and precisely because growth and the resulting economic adjustments have too often entailed unequal rewards and costs within countries".

[13] Pakistan's trade with Iran is likely to improve in the coming months, after SBP and the central bank of Iran devised a payment settlement mechanism (in Euros and Yen) for trade transactions between the two countries. In this regard, SBP issued relevant directions to Pakistani banks in May 2017, via FE Circular No. 4 of 2017.

[14] According to the IMF's World Economic Outlook for April 2017, advanced economies are likely to grow by 2.0 percent in 2017, up from last year's rate of 1.7 percent. The latest 2017 growth projection is also higher (by 0.1 percent) than the Fund's projection in January 2017.

regional trade; competitive industries; and a policy regime that shows flexibility and prioritizes market efficiency at the same time.

Pakistan can capitalize on these opportunities if it pursues long-lasting structural reforms, while private businesses in the country do a fundamental rethink about the way they operate and prioritize long-term growth over short-term profits. While the country did utilize the window of opportunity provided by low oil prices and IMF support over the past few years by building up FX buffers and addressing some supply-side bottlenecks, keeping up the reform momentum will be important, going forward.

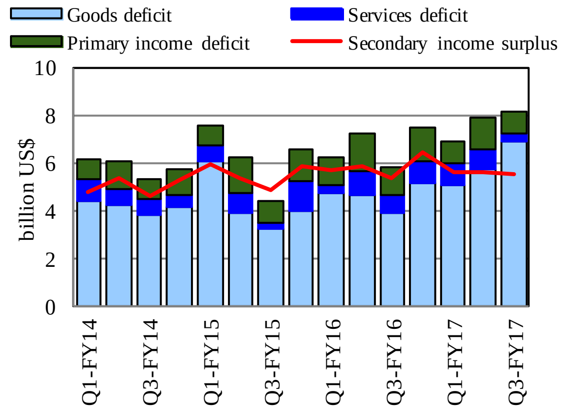
Meanwhile, rationalizing domestic POL prices with international rates (**Chapter 3**), minimizing market distortions, and discouraging unnecessary consumer imports by utilizing the full extent of regulatory measures at the disposal of fiscal and monetary authorities, are some steps that should be taken in the short-term to create financing space for critical capital goods imports.

5.2 Current account

The current account posted a deficit of US$ 6.1 billion during Jul-Mar FY17, more than double the level recorded during the same period last year. This deterioration was mainly attributed to the surging trade deficit, which hit an all-time high of US$ 6.9 billion in Q3-FY17. The import bill, in particular, has increased on the back of a strong demand for fuel, machinery and food items. In addition, remittances also dropped by 2.3 percent YoY during Jul-Mar FY17.

On the other hand, the services deficit has exhibited a slight improvement, based on relatively better performance of exports of telecom services, and a lower travel deficit. The primary income deficit has also narrowed by 17.4 percent providing some relief to the current account balance (**Figure 5.4**).

Figure 5.4: Composition of Current Account Balance



Data source: State Bank of Pakistan

Worker remittances

The global remittance business has not yet recovered, as the magnitude of cross-border flows were further squeezed during CY-2016.

Remittance flows to developing countries fell 2.4 percent in CY-2016, after declining 1.0 percent in CY-2015. This trend also prevailed in the South Asian region, which witnessed an overall decline of 6.4 percent during CY-2016.[15]

During Jul-Mar FY17, remittances to Pakistan dropped by 2.3 percent. The decline was observed from all major corridors, including Saudi Arabia, UAE, US and UK (**Table 5.2**); however, different factors – all exogenous in nature – were responsible for each destination (**Figure 5.5**).

Table 5.2: Country/ Region-wise Worker Remittances

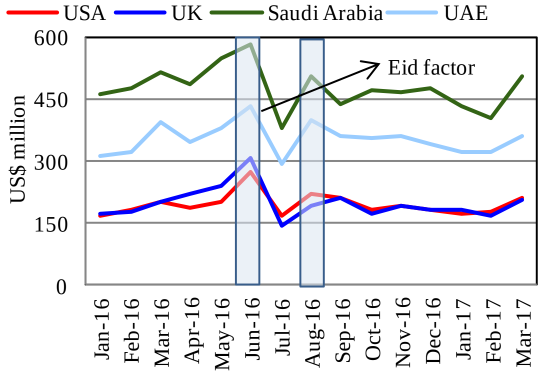
million US$

Country/ Region	Jul-Mar			
	FY16	**FY17**	**% Change**	**% Share**
USA	1,858.7	1,729.6	-6.9	12.3
U.K.	1,807.9	1,655.1	-8.5	11.8
Saudi Arabia	4,348.9	4,078.1	-6.2	29.0
UAE	3,203.7	3,124.4	-2.5	22.2
Other GCC	1,774.2	1,706.0	-3.8	12.1
EU	286.0	332.5	16.3	2.4
Others	1,085.5	1,422.9	31.1	10.1
Total	14,387.8	14,057.7	-2.3	100.0

Data source: State Bank of Pakistan

For GCC countries, subdued oil prices have led to adoption of fiscal consolidation measures, which in turn, caused workers layoffs.[16] The lower inflows, particularly from Saudi Arabia, seems to have been partially influenced by the Kingdom's tightening of labor market policies, such as discouraging hiring of foreign workers in order to lower the unemployment rate of nationals.[17]

Figure 5.5: Monthly Remittances Inflow from Major Source Countries



Data source: State Bank of Pakistan

This decline in inflows from

[15] Nevertheless, the magnitude of drop in remittances varied across countries during CY-2016. For example, India, Bangladesh and Nepal witnessed declines of 8.9 percent, 11.1 percent and 6.7 percent respectively during this period (Source: Migration and Development Brief 27, World Bank, April 2017)

[16] Besides layoffs, the number of Pakistani workers who proceeded to Saudi Arabia for work during Q3-FY17 dropped by more than 70 percent over the same period last year (source: Bureau of Emigration and Overseas Employment).

[17] Saudi Arabia has decided to restrict foreigners to work in the Kingdoms' shopping malls mainly to boost employment opportunities for its citizens as part of a long-term economic overhaul (Source: Bloomberg, 20 April 2017).

Saudi Arabia is expected to be compensated by a gradual pick up in inflows from other GCC countries, going forward. For instance, Kuwait's recent decision to lift visa restrictions on Pakistani citizens; the Expo 2020 in Dubai; and the FIFA World Cup 2022 in Qatar, are all expected to have a positive impact on remittance inflows. Furthermore, the government is planning to launch Pakistan Development Fund for the Pakistani diaspora in order to channelize their remittances more effectively.[18]

Services account

The services deficit has contracted by 2.8 percent in Jul-Mar FY17, as compared to an increase of 15.6 percent in the same period last year. This improvement occurred despite a widening in the freight deficit (due to a recovery in oil prices in the international market), and lower CSF inflows.[19] Higher exports of telecom services and a lower travel deficit mainly explain this development.

Nonetheless, it is worth noting that the persistent stagnation in Pakistan's services exports, along with the recent decline in export of goods, does not bode well for the country's current account balance. Further, Pakistan's services export to GDP ratio is lower than its regional peers (like India, Sri Lanka, Vietnam, Thailand, Indonesia and Malaysia) – mainly on account of challenging security environment in the country.[20] However, with the improved security situation, there is a need to pay more attention towards such exports, like computer services, so as to tap adequately their export potential.

Primary income account

The primary income deficit narrowed by 17.4 percent during Jul-Mar FY17 compared to the corresponding period last year. This happened primarily due to lower repatriation by oil and gas firms. Excluding this sector, the repatriation of profits and dividends on FDI grew slightly by US$ 58 million. Higher repatriations by food and petrochemical sectors were more than offset by lower repatriations by telecom and financial firms.

5.3 Financial account

Net financial inflows increased during Jul-Mar FY17 over the same period last year; though official inflows were close to last year's level. Major inflows so far this year have come from: (i) a US$ 1.0 billion Sukuk issued in October 2016; (ii) US$ 851.5 million from the Asian Development Bank; (iii) US$ 1.0 billion in

[18] Source: Ministry of Finance press release dated April 26, 2017.

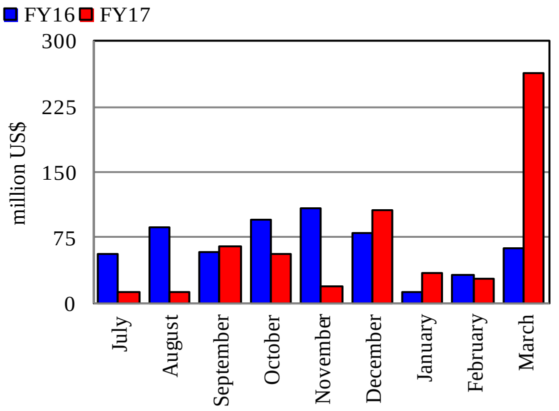
[19] During Jul-Mar FY17, average Arab Light Oil prices rose to US$ 48.0 per barrel, from US$ 40.1 in the same period last year (source: Bloomberg).

[20] Source: World Bank data (2015).

mostly project loans from China; (iv) commercial loans (both short- and long-term) of US$ 1.3 billion; and (v) around US$ 673 million in proceeds from stake sales of three local companies.[21] Commercial banks also borrowed heavily from commercial lenders, to the tune of US$ 848 million in Jul-Mar FY17, to ensure adequate dollar supplies in the wake of a surging current account deficit.[22]

In case of FDI, China continued to be the top contributor, accounting for 37.1 percent (US$ 594.8 million) of total net inflows of US$ 1.6 billion during Jul-Mar FY17. It is worth noting that slightly less than half of this Chinese FDI (i.e. US$ 262.5 million) materialized in March 2017 alone, mainly in electricity generation and construction sectors (**Figure 5.6**)[23]; the focus areas under the CPEC initiative. That said, FDI in the power sector declined 36.6 percent on YoY basis to US$ 389.3 million in Jul-Mar FY17;[24] at the same time, direct investment to the construction sector increased to US$ 264 million, from just US$ 34.8 million in Jul-Mar FY16.[25]

Figure 5.6: Net FDI Inflows from China



Data source: State Bank of Pakistan

[21] The inflow figures for ADB, China and commercial borrowings are in gross terms, as reported by the Economic Affairs Division, Ministry of Finance.

[22] In net terms, however, banks had retired US$ 263 million of short-term commercial loans during Jul-Mar FY16.

[23] During Jul-Feb FY17, net FDI from China had amounted to US$ 332.4 million, down 37.2 percent from the same period last year. A probable reason for the significant jump in inflows recorded in March 2017 is that the reporting of CPEC-related investment inflows by Pakistani commercial banks has improved, following the coming into force of EPD Circular Letter No. 14 of 2016, which had enhanced reporting requirements for transactions under special foreign currency accounts of power companies. For details, see Box 5.1 in SBP's State of the Economy Report for Q2-FY17.

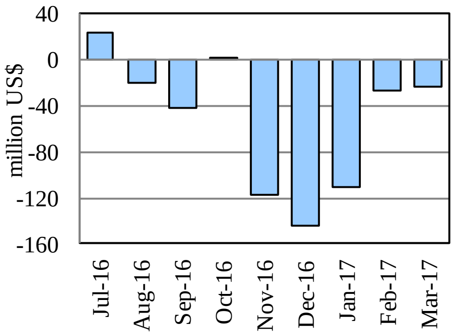
[24] While most of this YoY decline (US$ 157.7 million) was noted in thermal power generation, net FDI into coal-fired power projects during Jul-Mar FY17 was down by a relatively smaller US$ 59.6 million.

[25] Some construction projects that have received FDI from China in FY17 include the Havelian-Thaikot section of the Karakoram Highway, Sukkur-Multan section of the Peshawar-Karachi Motorway, and the Lahore Orange Line project, according to the Economic Affairs Division, Ministry of Finance.

Besides CPEC-related investments, the country also received significant FDI from three merger and acquisition transactions in food, consumer electronics and financial services industries this year.[26]

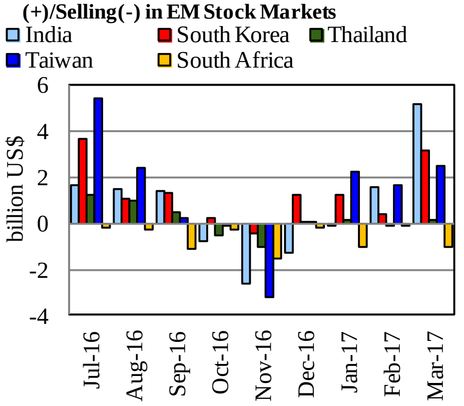
Meanwhile, portfolio investment was dominated by public sector inflows in Jul-Mar FY17 (as a result of the Sukuk), with private investors pulling out their funds from the local stock market on net basis. Most of these outflows (81.1 percent) were noted in the three month period of November 2016-January 2017, with the pace of foreign selling having slowed down considerably since then (**Figure 5.7a**).[27] This corresponds with the trend of foreign fund outflows from many EMs following the outcome of the US presidential elections (in November 2016), and the December 2016 federal funds rate hike.

Figure 5.7a: Foreign Investors Portfolio Investment (flows) in Pakistan Stock Exchange



Data source: National Clearing Company of Pakistan Limited

Figure 5.7b: Foreign Investors' Net Buying (+)/Selling(-) in EM Stock Markets



Data source: Bloomberg

However, after the brief volatile period, foreign funds started flowing back to some EMs from February 2017 onwards (**Figure 5.7b**). This dynamic didn't seem to change after the US Fed raised its benchmark rate for the second time in three months (in March 2017). As the rate increase was widely expected, global equity markets barely shrugged at the development.

[26] These included: US$ 458 million from the majority stake sale of Engro Foods to Dutch conglomerate FrieslandCampina; US$ 127.7 million from the complete sale of Dawlance Pakistan to Turkish firm Arcelik; and US$ 61 million from a 40 percent stake sale of the Pakistan Stock Exchange to a Chinese-led consortium.

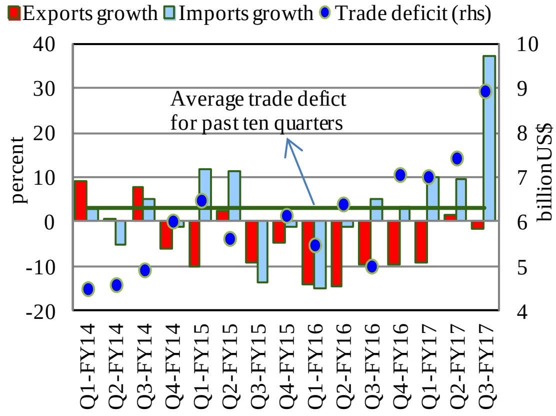
[27] Foreign investors have sold US$ 459 million worth of equities at the PSX during Jul-Mar FY17; of this, selling worth US$ 372.4 million was recorded in Nov-Jan FY17 (source: National Clearing Company of Pakistan Ltd).

In Pakistan's case, market analysts believe that foreign investor activity at the bourse in the short-term will be mainly driven by passive foreign funds, as the country formally rejoins the Morgan Stanley Capital International's (MSCI) Emerging Market Index in June 2017.

5.4 Trade account[28]

The trade deficit widened by 38.5 percent YoY during Jul-Mar FY17 to US$23.4 billion, against US$16.8 billion in the same period last year. This expansion was largely witnessed in the third quarter, when the deficit increased by 79.0 percent YoY and reached its highest level of US$ 8.9 billion (**Figure 5.8**). A hefty rise in imports alongside a decline in exports contributed to the widening deficit.

Figure 5.8: Trade Account

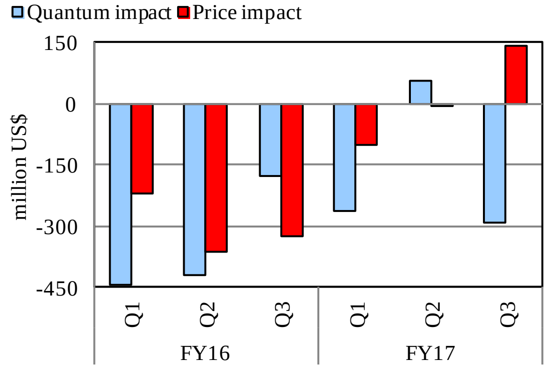


Data source: Pakistan Bureau of Statistics

Exports

Exports declined by 3.1 percent YoY during Jul-Mar FY17, after declining 13.0 percent in the same period last year. This was mainly due to a significant drop recorded in the first quarter, when both lower prices and quantums were in play. While the subsequent recovery in international commodity prices (mainly of cotton and rice) held some promise (particularly in the third quarter), their impact was more than offset by a decline in quantum exports of these commodities (**Figure 5.9**).[29]

Figure 5.9: Breakdown of YoY Change in Exports*



* 27 Items whose quantum & price data are available and having 82 percent share in total exports.
Data source: Pakistan Bureau of Statistics and SBP's calculations

[28] This section is based on customs data reported by the PBS, which is different from payments record data compiled by SBP: SBP reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif). For further detail, see Annexure on data explanatory notes.

Textile

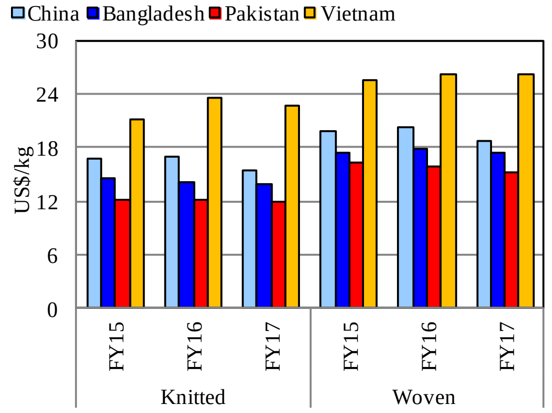
Textile exports fell by 1.0 percent during Jul-Mar FY17, after declining by 8.2 percent in the same period last year. The drop is mainly explained by lower quantum exports of low value-added products like cotton and fabric, as global cotton prices rebounded in the period under review. Exports of some high value-added items, like bedwear and readymade garments, increased during Jul-Mar FY17; encouragingly, their better performance was largely a result of higher quantums (**Table 5.3**), mainly due to a recovery in demand from the key EU market.[30]

Table 5.3:Textile Exports Price & Quantum Impact (YoY) during Jul-Mar FY17

million US$	Quantum	Price	Abs. change
Textile group			**-91.4**
of which			
Low value-added	**-186.9**	**23.4**	**-163.5**
Raw cotton	*-40.3*	*3.6*	*-36.7*
Cotton yarn	*38.1*	*-85.8*	*-47.6*
Cotton fabrics	*-174.9*	*104.2*	*-70.7*
Others	*-9.8*	*1.3*	*-8.5*
High value-added	**69.9**	**34.9**	**104.8**
Knitwear	*-57.9*	*45.8*	*-12.1*
Bedwear	*123.5*	*-40.2*	*83.3*
Towels	*4.5*	*-17.0*	*-12.5*
Tarpaulin	*25.9*	*12.9*	*38.7*
Readymade garments	*109.1*	*-13.5*	*95.7*
Synthetic textiles	*-135.2*	*46.9*	*-88.4*

Data source: Pakistan Bureau of Statistics

Figure 5.10: Unit Values of Clothing in EU market (Jul-Mar)



Data source: Eurostat and SBP's calculations

Nonetheless, in terms of price factor, the gains in export values are still not appearing. In fact, Pakistan's high value-added exports to advanced economies face tough competition from regional competitors. To make products more attractive, exporters slash their prices. In this way, they tend to maintain their product share in the international market. This situation has been clearly visible in the EU market this year, where Pakistani exporters have received lower unit prices for clothing items (both knitted and woven clothes), as compared to their regional competitors (**Figure 5.10**).

[29] This analysis is based on 27 items whose quantity and price data are available with PBS. They represent around 82 percent of the country's total exports.

[30] Textile and clothing imports of EU-28 countries rose by 4.1 percent YoY in terms of quantity during Jul-Mar FY17, after declining by 3.5 percent in the same period last year (source: Eurostat).

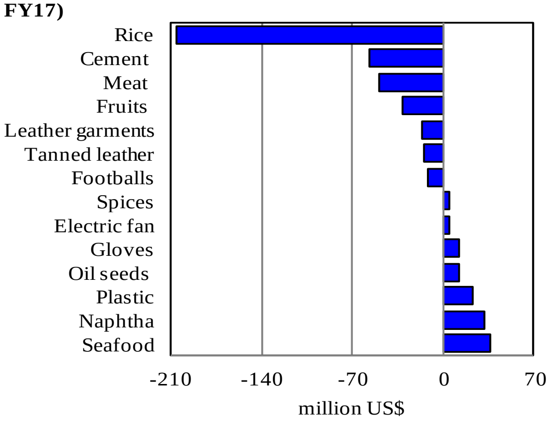
This performance is despite ample policy support available to the textile industry, which includes the Drawback of Local Tax and Levies (DLTL), tax rebates, and export finance schemes etc. In fact, the textile industry has been making good use of record-low interest rates and other policy incentives this year: imports of textile machinery and fixed investment borrowing by the sector have both recorded healthy increases in Jul-Mar FY17 (**Chapter 3**). More recently, a Rs 180 billion export incentive package has been announced to support the five key exporting industries.

However, these measures have yet to translate into a broad-based improvement in textile exports. The real benefits of this financial support will be realized when the exporters make the required efforts to increase their efficiency, improve product quality, explore new markets and keep track of changing customer preferences in their key markets. Also, they have to invest more in upgrading physical and human capital so that they could offer high-quality products at competitive prices.

Non-textile

The drop in non-textile exports moderated to 6.4 percent during Jul-Mar FY17, from 19.3 percent in the same period last year. Out of three major categories – food, other manufactured goods, and petroleum – only the POL group recorded an increase (of 8.0 percent YoY) during the period (**Figure 5.11**).

Figure 5.11: YoY Change in Non-Textile Exports (Jul-Mar FY17)

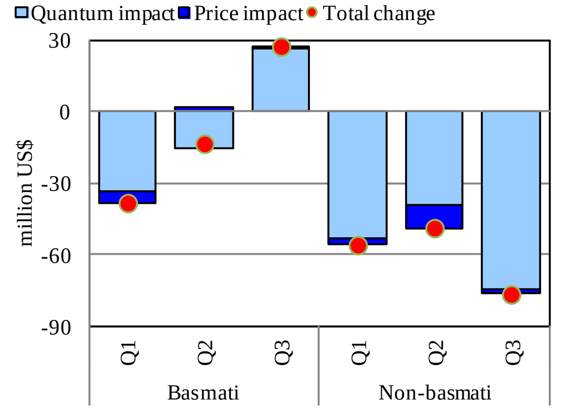


Data source: Pakistan Bureau of Statistics

In the food group, the growth in fish and oil seeds exports were offset by a decline in rice, meat and fruit shipments. The exports of rice (both basmati and non-basmati) fell 14.9 percent YoY in Jul-Mar FY17. That said, the entire decline in basmati exports was witnessed in the first half of FY17, as consignments grew by 31.3 percent YoY in the third quarter (**Figure 5.12**). This increase was driven by higher quantums, as demand from two markets – UAE and Iran – improved during the period. Moreover, basmati exports to Iran are likely to increase further in the coming months, as the Iranian government has removed import restrictions and lowered the import duties on brown/husked and milled rice.[31]

In contrast, weaker demand for non-basmati rice from our traditional markets (i.e. African countries, Malaysia and Philippines) has suppressed export quantums throughout the year; this has more than offset the positive spillover of a recovery in global prices of the commodity since October 2016. Import restrictions by some African countries put further pressure on the export of non-basmati rice varieties.[32]

Figure 5.12: Breakdown of YoY Change in Rice Exports

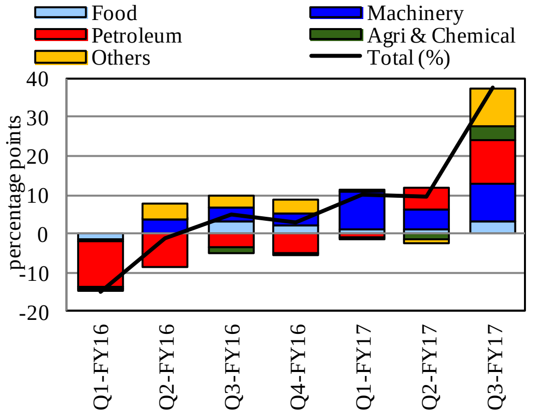


Data source: Pakistan Bureau of Statistics and SBP's calculations

Imports

The imports continued to surge and reached a historic peak of US$ 38.5 billion in Jul-Mar FY17. Most of this increase was observed in Q3-FY17, when imports of *petroleum, machinery and chemical* items all rose significantly (**Figure 5.13**): in fact, machinery and petroleum imports contributed around 55 percent to the overall increase in imports in Q3-FY17.

Figure 5.13: Contribution in Import Growth



Data source: Pakistan Bureau of Statistics and SBP's calculations

[31] Iran reduced import duties on husked and milled rice to 5 and 26 percent from 32 and 40 percent respectively from January 2017. The surcharge of US$ 154 per ton was also abolished on both products.

[32] Nigeria placed a 50 percent levy on the import of husked and milled rice in December 2016. Senegal suspended rice imports from December 2016 as well, in order to facilitate the placement of privately held local stockpile.

Petroleum

POL imports during Jul-Mar FY17 were entirely driven by higher quantum product imports, with crude oil shipments declining during the period on YoY basis (**Table 5.4**). The rise in petroleum product imports reflected strong domestic demand by the transport and power sectors: sales of high speed diesel (HSD) and petrol increased by 12.9 percent and 17.4 percent YoY respectively. Meanwhile, furnace oil imports rose by 7.3 percent YoY during the period.[33] Infrastructure development activities under CPEC boosted the demand for HSD, which is mainly used by heavy commercial vehicles. This was also reflected by rising imports as well as sales of heavy vehicles.[34] On the other hand, the increase in furnace oil imports corresponded with a rise in power generation from the fuel during the period.[35]

Table 5.4: Contribution in POL Import Growth (Jul-Mar)

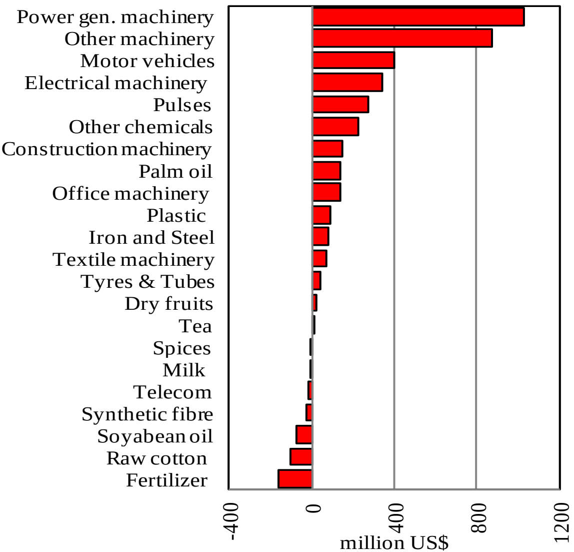
percentage points	FY16	FY17
Petrol	6.0	4.0
High speed diesel	-0.8	4.5
Furnace oil	-1.7	4.1
Other products	0.2	0.1
Crude oil	4.9	-2.4
Total (%)	**8.6**	**10.2**

Data source: Oil Companies Advisory Council

Non-POL

Imports of all major non-oil industries rose significantly during Jul-Mar FY17 (**Figure 5.14**). This was entirely an outcome of higher quantums, as the unit values of most items (except palm oil) fell during the period.

Figure 5.14: YoY Change in Non-POL Imports



Data source: Pakistan Bureau of Statistics

[33] Source: Oil Companies Advisory Council.

[34] The import of both CKDs/SKDs and CBUs of heavy vehicles increased by 34.0 percent YoY during Jul- Mar FY17 (source: Pakistan Bureau of Statistics). According to the Pakistan Automotive Manufacturers Association, the sales of heavy vehicles (trucks and buses) also increased by 38.7 percent YoY during the period.

[35] Total power generation in the country increased by 3,166GWh in Jul-Mar FY17, of which 1,130GWh was contributed by furnace oil (source: NEPRA).

Machinery

Machinery imports contributed more than 40 percent to the overall import growth during Jul-Mar FY17, with power, electrical and construction-related equipment leading the charge (**Table 5.5**).

Table 5.5: Machinery Imports - YoY Growth (%)

	FY17			FY16	FY17
	Q1	Q2	Q3	Jul-Mar	
Machinery group	**60.1**	**26.9**	43.8	**14.1**	42.0
Of which					
Power	164.8	78.6	24.8	43.6	76.8
Office	125.3	31.2	38.2	-26.4	60.4
Textile	5.7	16.3	42.8	-1.2	20.8
Construction	15.3	122.1	98.2	12.3	66.8
Electrical	32.6	-7.2	63.4	51.2	25.9
Telecom	-12.4	1.1	4.6	-2.2	-1.8
Agriculture	15.1	23.9	71.3	-20.5	35.2
Others	73.9	26.0	64.9	1.0	52.7

Data source: Pakistan Bureau of Statistics

Meanwhile, an increase in textile machinery (mainly for spinning and weaving) was observed in Q3-FY17. This basically reflects higher investment by the sector, as firms start taking benefit of various policy support measures (like the export package announced in January 2017, the removal of sales tax on import of textile machinery, and record-low interest rates).[36]

Besides, strong domestic construction activities (both CPEC and non-CPEC related) have led to a sizable increase in demand for cement in the country.[37] To cope with this surging demand, many cement manufacturers are investing in capacity expansions. This, in turn, has boosted the import of related machinery, which are classified in the "other machinery" category (**Figure 5.14**).[38] The low interest rate environment also benefitted cement manufacturers, which was reflected in the higher bank borrowing.[39]

To promote the information & communication technology sector, the exemption of sales tax on import of laptops and personal computers was granted in the budget 2016-17. This measure has led to a significant increase in the import of these

[36] This policy support already seems to be having the intended effect: outstanding financing under Long-Term Financing Facility (LTFF) increased by Rs 30 million during Jul-Mar FY17; of this, textile sector was responsible for an increase of Rs 28.4 million. Within textiles, most of the financing was availed by spinning and weaving segments.

[37] Domestic cement dispatches increased by 10.9 percent YoY in Jul-Mar FY17 (source: All Pakistan Cement Manufacturer Association).

[38] According to detailed SBP data, imports of grinding and crushing machinery for cement plants rose by US$ 105.7 million during Jul-Mar FY17, compared to a minor increase of US$14.0 million noted in the same period last year.

[39] Fixed investment and trade financing for the cement sector rose to Rs 8.7 billion and Rs 3.8 billion in Jul-Mar FY17, from Rs 0.1 billion and Rs 0.9 billion respectively in the same period last year (for further details, see **Chapter 3**).

products; laptops and personal computers have a 36 percent share in total imports of office and data processing machinery during Jul-Mar FY17.[40]

Food

The rise in food imports during Jul-Mar FY17 was mainly led by higher purchases of palm oil and pulses. In case of palm oil, the recovery in its international prices in FY17 is entirely responsible for the 11.5 percent YoY increase in its imports in Jul-Mar FY17; quantum imports actually declined by 7.0 percent YoY during the period (**Table 5.6**).[41] Meanwhile, lower domestic production of pulses could be the possible reason which necessitated higher imports of pulses to ensure sufficient supplies in the domestic market.

Table 5.6: Import of Palm Oil (YoY change in abs. values)
million US$

	FY17			FY16	FY17
	Q1	**Q2**	**Q3**	**Jul-Mar**	
Quantum impact	-85.9	13.4	-14.3	264.7	-86.8
Price impact	16.5	69.4	143.8	-363.2	229.7
Total change	-69.4	82.8	129.5	-98.6	142.9

Data source: Pakistan Bureau of Statistics

Summing up, the trade outlook is likely to continue with the prevailing trend in the remaining period of FY17. The import bill will remain high due to robust demand for fuel, machinery and food items, whereas exports may get some boost in the wake of recently announced fiscal incentives, improved business environment, and ease in energy supplies.

[40] According to SBP data, the import of laptop and personal computers increased by US$ 101.7 million during Jul-Mar FY17, compared to a rise of US$52.1 million recorded in the same period last year.

[41] Global palm oil prices increased by 25.0 percent YoY in Jul-Mar FY17 as compared to last year (source: IMF).

Annexure: Data Explanatory Notes

1) **GDP:** SBP uses the GDP target for the ongoing year, as given in the Annual Plan by the Planning Commission, for calculating the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

   Period average inflation (π_{Ht}) = $\left(\dfrac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$

   YoY inflation (π_{YoYt}) = $\left(\dfrac{I_t}{I_{t-12}} - 1 \right) \times 100$

   Monthly inflation (π_{MoMt}) = $\left(\dfrac{I_t}{I_{t-1}} - 1 \right) \times 100$

   Where I_t is consumer price index in t^{th} month of a year.

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing,

whereas borrowing is adjusted for government deposits with the banking system, when calculating the financing data; (ii) changes in the stock of debt also occur due to changes in the exchange rate, which affects the rupee value of external debt, and (iii) the movement of various other cross-country exchange rates also affect the US Dollar rate and, hence, the rupee value of external debt.

4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). The Ways and Means Advance is extended for the government borrowings up to Rs 100 million in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum.

Borrowing from scheduled banks: This is mainly through the fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs). The Government of Pakistan also borrows by auctions of 3, 5, 10, 15, 20 and 30 year Pakistan Investment Bonds (PIBs). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, public debt, debt servicing, foreign trade, etc., often does not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases are given below:

   (a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

   (b) **Foreign trade (SBP vs. PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on exchange record data, which depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif).

   In addition, the variation in import data also arises due to differences in data coverage; e.g., SBP import data does not include non-repatriable investments (NRI) by non-resident Pakistanis;[1] imports under foreign assistance; land-borne imports with Afghanistan, etc. In export data, these differences emerge as PBS statistics do not take into account short shipments and cancellations, while SBP data does not take into account land-borne exports to Afghanistan, export samples given to prospective buyers by exporters, exports by EPZs, etc.

[1] The non-repatriable investment (NRI) consists of small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad and the purchases made from the *duty-free shops.*

Acronyms

ADB	Asian Development Bank
ATM	Average Term to Maturity
ATR	Average Time to Re-fixing
BISP	Benazir Income Support Programme
BMR	Balancing, Modernization and Replacement
CAD	Current Account Deficit
CBU	Complete Built Up
CDB	China Development Bank
CDNS	Central Directorate of National Savings
CIF	Cost, Insurance and Freight
CKD	Completely-Knocked-Down
CNG	Compressed Natural Gas
CO_2	Carbon Dioxide
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
CY	Calendar Year
DAP	Diammonium Phosphate
DFI	Development Finance Institution
EAD	Economic Affairs Division
EMs	Emerging Markets
EPD	Exchange Policy Department
EU	European Union
FAS-USDA	Foreign Agriculture Service, United States Department of Agriculture
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FE	Foreign Exchange
FED	Federal Excise Duty
fob	Free on Board
FPI	Foreign Portfolio Investment
FRDLA	Fiscal Responsibility and Debt Limitation Act
FX	Foreign Exchange
FY	Fiscal Year

GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GST	General Sales Tax
GSTS	General Sales Tax on Services
GWh	Giga Watt hours
H1	First Half
HOBC	High Octane Blending Component
HR	House Rent
HSD	High Speed Diesel
HYDEL	Hydroelectric
IB	Islamic Banks
IBA	Institute of Business Administration
IBB	Islamic Banks and Branches
ICBC	Industrial and Commercial Bank of China (Limited)
IFIs	International Financial Institutions
IH&SMEFD	Infrastructure Housing and SME Finance Department
IMF	International Monetary Fund
IPP	Independent Power Producer
IR	Infection Ratio
IT	Information Technology
KIBOR	Karachi Interbank Offered Rate
KP	Khyber Pakhtunkhwa
LARMIS	Land Administration and Revenue Management Information System
LCVs	Light Commercial Vehicles
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSM	Large-Scale Manufacturing
LTFF	Long-Term Financing Facility
M2	Broad Money Supply
MMBTU	Million British Thermal Units
MPC	Monetary Policy Committee
MRTBs	Market Related Treasury Bills
MSCI	Morgan Stanley Capital International
MT	Metric Tons

MTBs	Market Treasury Bills
MTDF	Medium Term Development Framework
NDA	Net Domestic Assets
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NFDC	National Fertilizer Development Centre
NFNE	Non-Food Non-Energy
NHCR	National Health Services, Regulations, and Coordination Division
NPL	Non-Performing Loan
NSS	National Savings Scheme
NTC	National Tariff Commissions
o/w	Of which
OGRA	Oil & Gas Regulatory Authority
OMCs	Oil Marketing Companies
OMO	Open Market Operation
OPEC	Organization of the Petroleum Exporting Countries
PBS	Pakistan Bureau of Statistics
PFA	Punjab Food Authority
PIA	Pakistan International Airlines
PIB	Pakistan Investment Bond
PITB	Punjab Information Technology Board
PMG	Premium Motor Gas
POL	Petroleum, Oil, and Lubricants
PRA	Pakistan Revenue Authority
PSDP	Public Sector Development Programme
PSE	Public Sector Enterprise
PSO	Pakistan State Oil
PSX	Pakistan Stock Exchange
PTA	Pakistan Telecommunication Authority
Q1	Quarter 1
Q2	Quarter 2
Q3	Quarter 3
Q4	Quarter 4
Repo	Repurchase Agreement

Reverse repo	Reverse Repurchase Agreement
rhs	Right Hand Side
RIMS	Restaurant Invoice Monitoring System
RON	Research Octane Number
Rs	Rupees
SBP	State Bank of Pakistan
SKD	Semi-Knocked-Down
SUPARCO	Pakistan Space and Upper Atmosphere Research Commission
T-Bills	Treasury Bills
UAE	United Arab Emirates
US	United States
US$	US dollar
WAPDA	Water and Power Development Authority
WHRU	Waste Heat Recovery Units
WHT	Withholding Tax
YoY	Year on Year
3G	Third Generation
4G	Fourth Generation