# 1 Overview

Pakistan's growth momentum remained strong in the first quarter of the current fiscal year. Several coincident indicators point to a further strengthening of the aggregate supply and demand (**Table 1.1**). The production of all major *kharif* crops increased, while Large-scale Manufacturing clocked in a nine-year high growth rate. With increasing consumer demand, several manufacturers announced new investments. At the same time, infrastructure projects upped their momentum. As the exports receipts recorded a broad-based recovery after three years of decline, foreign direct investment inflows posted a nine-year high level. The robust demand also allowed the FBR to achieve the highest tax collection during the last five years.

**Table 1.1: Select Economic Indicators**

| | FY15 | FY16 | FY17 | Q1-FY17 | Q1-FY18[P] |
|---|---|---|---|---|---|
| | | | *growth rate (percent)* | | |
| LSM[a,e] | 3.3 | 2.9 | 4.9 | 1.8 | 10.0 |
| CPI (period average)[a,1] | 4.5 | 2.9 | 4.2 | 3.9 | 3.4 |
| Private sector credit[b,2] | 5.9 | 11.2 | 16.8 | -2.8 | -0.7 |
| Money supply (M2)[b,2] | 13.2 | 13.7 | 13.7 | 0.2 | -0.6 |
| Exports[a] | -5.7 | -12.2 | -1.6 | -8.9 | 10.9 |
| Imports[a] | 1.7 | -2.5 | 18.1 | 9.9 | 22.2 |
| FBR Tax revenue (billion Rs)[c] | 2,588 | 3,112 | 3,361 | 627.1 | 765.0 |
| Exchange rate (+app/-dep%)[b] | 1.4 | -2.8 | -0.4 | -1.7 | -0.7 |
| | | | *million US dollars* | | |
| SBP's liquid reserves (end-period)[b] | 13,526 | 18,143 | 16,144 | 18,491 | 13,857 |
| Workers' remittances[b] | 18,721 | 19,917 | 19,351 | 4,740 | 4,791 |
| FDI in Pakistan[b] | 988 | 2,305 | 2,731 | 423 | 663 |
| Current account balance[b] | -2,795 | -4,867 | -12,439 | -1,637 | -3,698 |
| | | | *percent of GDP* | | |
| Fiscal balance[d] | -5.3 | -4.6 | -5.8 | -1.4 | -1.2 |
| | | | interest rates | | |
| Spread b/w average ONMMR and PR[b,3] | -0.08 | 0.06 | 0.07 | 0.09 | 0.05 |
| WALR[b,4] | 8.60 | 7.41 | 7.28 | 7.09 | 7.03 |

Sources: [a]Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance, [e] Economic Survey of Pakistan
[P] Provisional estimate
[1]YoY growth in the average of CPI index for the quarter.
[2]Percent change in September over June
[3]ONMMR: Over Night Money Market Rate; PR: Policy Rate
[4]WALR: Weighted Average Lending Rates

Moreover, with stable conditions in the money and foreign exchange markets, SBP's policy stance remained broadly accommodative in the first quarter of FY18 as well. The spread between the policy and actual overnight money market rates further decreased, as the weighted average lending rates also nudged downwards. Enhanced monetary policy signaling and its transmission mechanism in recent times owe much to SBP's calibrated operations within the improved Interest Rate Corridor framework since FY15.

Indeed, policy support, with prudent interventions, timely initiatives, and favorable cyclical movements, helped consolidate gains made in the last three fiscal years. What stands out is the role of benign inflationary environment for some time now that has helped spur the expansion in economic activities. Low and stable prices have facilitated and eased the process of economic decision making. Second, and more tangibly, falling inflation along with healthy agriculture output and stable exchange rate has resulted in higher real rural incomes and urban wages. The resultant boost in consumption forms an integral part of the current economic growth paradigm. Third, among other considerations, low inflation has also allowed the SBP to cumulatively cut the policy rate by 425 bps since the autumn of 2014. Thus, along with growing confidence, this triggered uptick in the private sector credit, especially its fixed investment component, which has expanded for the twelfth consecutive quarter in Q1-FY18.

Judged by the aforementioned metrics, Pakistan's economy is doing well; but, is the economy doing well enough to sustain the virtuous equilibrium of high growth-low inflation into the medium- and long-term? As highlighted in FY17 Annual Report, this Report also accentuates upon the need to address the long-standing structural reforms in the fiscal and external sectors.

On the fiscal front, while the current rebound in FBR tax revenues is noteworthy, it is also due to increased economic activities. New infrastructure projects, surge in imports, higher consumption of consumer durables, and increased price and consumption of POL products significantly contributed to both direct and indirect taxes. Thus, earlier efforts aimed at increasing the tax base need to be more concerted and perhaps require new, innovative methods. In this regard, successful experiences of some developed and transition economies which have applied the predictions of behavioral economics to voluntarily encourage filing of tax returns can serve as a model for Pakistan.

For the external sector, recent gains in exports growth and foreign direct investments while significant were not enough to contain the overall balance of payments deficit. On the back of an expanding economy, import payments far exceeded the aforementioned positives and the stability in external sector remained under pressure. Widening of current account deficit associated with increased economic activity is a recurrent phenomenon in Pakistan and has undermined maturing growth cycles in the past. There is therefore an urgent need to find more avenues for foreign exchange earnings, including realigning policy in favor of exports growth by addressing its long-term structural impediments.

Finally, current developments under CPEC could provide the industrial sector of Pakistan with an opportunity to be more efficient and competitive. While, the direct impact of construction and energy related projects is often highlighted, more attention is required to the development of Special Economic Zones (SEZs) across the country.

## 1.1 Economic Review

***Real Sector***

On the agriculture front, initial estimates reveal that all the major *kharif* crops either achieved or surpassed the FY18 target; except for cotton which nonetheless exceeded last year's production. Supporting this performance was sufficient water availability, healthy fertilizer off take, and an encouraging 50 percent YoY increase in agricultural credit disbursements.

The large-scale manufacturing sector has also been performing well, as it experienced a 10.0 percent growth during Q1-FY18 – the highest quarterly growth since FY09. The performance was encouraging as, barring fertilizer, all segments contributed positively. While cement and steel industries benefitted from the ongoing infrastructure and construction activities, production of white goods was aided by the rising domestic demand. Certain sector specific policies, meanwhile, helped push the production of food, especially cigarettes, and leather sectors up. This broad-based growth can be credited to better energy availability, improved security situation, and rising consumer demand which is also due to higher purchasing power and affordable access to credit facilities.

The healthy performance of commodity producing sectors had a positive impact on the services sector as well. While *wholesale and retail* would be a direct beneficiary of higher production and rising imports, an increase in the sales of commercial vehicles and POL products reveal that the *transport* segment is off to a strong start. Similarly, growing cellular density and substantial increase in broadband subscriptions bode well for the telecom sector. While profitability of the commercial banks continues to be affected by lower margins, a one-off settlement payment by a large bank resulted in overall bank profitability decline during Q1-FY18. However, encouraging growth trend in advances and deposits would potentially offset any adverse implications.

***Inflation and Monetary Policy***

The Monetary Policy Committee opted for status quo in both of its meetings during Q1-FY18, holding the policy rate at 5.75 percent. In addition to external sector risks, the decision was premised on: the need to sustain the favorable investment climate; projections of below-target headline CPI inflation for the full year; and the expectation that financial inflows would be forthcoming as a result of the government's increased engagements with international lenders.

Regarding transmission of monetary policy to market rates, liquidity conditions were relatively tight in the interbank during Q1-FY18 compared to last year. This primarily stemmed from lower net retirements by the private sector and higher budgetary support availed by the government from scheduled banks in the current review period. However, owing to SBP's proactive interventions, the spread between the policy rate and overnight rates remained lower (on average) compared to Q1-FY17.

The relative stability in money market rates enabled banks to extend financing to the private sector at lower rates compared to Q1-FY17. Fixed investment loans in particular continued to grow at a robust pace. The overall borrowing was fairly broad-based, with textiles, food and beverages, construction and construction-allied sectors particularly keen to avail financing. A host of economic developments spurred credit demand, ranging from SBP's subsidized schemes and PSDP and CPEC-related infrastructure development at home, to improving sentiment among major trading partners like the EU and US, with its inherent upside for prospects of some export-centric firms.

Moreover, the government and public sector enterprises also tapped the resources of scheduled banks (for budgetary support and project financing respectively). The combined effect was a rapid rise in net domestic assets of the banking system. However, its impact on money supply was offset by a sharp decline in corresponding Net Foreign Assets. Ultimately, broad money shrank by 0.6 percent during Q1-FY18.

***Fiscal Deficit and Debt***

The fiscal deficit was 1.2 percent of GDP in Q1-FY18; lower than 1.4 percent recorded in the corresponding period of last year. In Q1-FY18, the primary balance turned into a surplus while revenue deficit shrank compared to Q1-FY17. The former indicates that expenditures excluding interest payments remained contained while the latter reflects that growth in revenue collection outpaced growth in current expenditures.

Total revenue recovered strongly; showing 18.9 percent increase in Q1-FY18 against 8.0 percent decline recorded in the same period last year. Although provincial tax collection also continued to gather pace, the major contribution came from FBR taxes, which grew by 22.0 percent in Q1-FY18 compared to 6.3 percent growth in Q1-FY17. The growth in FBR taxes was not only the highest in Q1 during the last five years, but also broad-based. Both the direct and indirect taxes contributed to higher FBR taxes. Moreover, non-tax revenue also recorded a marginal increase of 1.9 percent.

Against this, the consolidated federal and provincial expenditures grew by 12.8 percent compared to 2.8 percent increase in the same period last year. Much of the increase in overall expenditure was due to a sharp increase in current expenditure, which grew by 15.9 percent in Q1-FY18 against a decline of 1.3 percent recorded last year. Meanwhile, development expenditures grew by 15.4 percent in Q1-FY18, on top of 12.4 percent growth in Q1of FY17.

The resulting financing requirement was largely met through banking channels as mobilization from non-bank and net external financing in Q1-FY18 remained considerably lower compared to their respective levels in the last year.

The pace of public debt accumulation slowed down to 3.0 percent during Q1-FY18 from 4.4 percent increase in the same period last year. In absolute terms, the public debt stock reached Rs 22.0 trillion by end-September 2017, up from Rs 21.4 trillion by end-June 2017.

This slower pace of accumulation in public debt – Rs 526.3 billion during Q1-FY18 compared to Rs 759.8 billion in Q1-FY17 – was largely due to lower domestic borrowing. It is worth highlighting that last year the government had borrowed more than its requirement and kept the additional funds in deposits with the banking system, which was not the case this year. On the other hand, external debt increased despite lower availability of net external financing for budget. This was because of revaluation losses of US$ 438.2 million, mostly due to the depreciation of US dollar against Euro and SDR.

***External Sector***

From a global perspective, relative strengthening in the economies of the US, EU and UK in 2017, along with partial recovery in commodity prices, boosted the prospects of those emerging economies whose growth tends to hinge on exports and remittances. For Pakistan as well, both these sources of foreign exchange inflows picked up during Q1-FY18. In case of exports, strong performances by textiles, rice, sugar and leather manufactures led to a broad-based recovery. Regarding remittances, lower inflows from GCC countries were offset by an improvement in remittances from non-GCC corridors, particularly the US and UK.

However, these positive developments were overshadowed by a mounting burden of imports, which exacerbated the pressure on the country’s balance of payments. Payments related to the import of petroleum, machinery, metal, and transport were particularly heavy during Q1-FY18.

For POL products, a rise in international crude prices played its part in inflating the import bill, apart from the quantum impact. This was amplified by furnace oil imports, whose payments were significantly higher during the quarter, despite quantum purchases being lower than the comparable period of last year.

Meanwhile, machinery imports broadly tapered off as per customs records, and even declined on YoY basis for some items, like power generation machinery. However, the lagged impact of earlier payments remained strong in the interbank during the quarter. Moreover, a notable exception was the import of textile machinery, which surged on the back of revival in textile exports and SBP's subsidized credit schemes.

Taken together, the net result of the import spurt was a historic high trade deficit. Moreover, the current account deficit increased to US$ 3.7 billion during the quarter, which was more than twice observed in Q1-FY17.

Financing the deficit proved to be a challenge. While foreign direct investment posted significant YoY growth, foreign investors in the equity market seemed particularly sensitive to brewing uncertainty over the political climate as well as the exchange rate outlook. More importantly, the bulk of loan inflows were utilized to honor debt repayments due in the quarter. Consequently, funding the current account deficit led to a decline in the country's foreign exchange reserves. Specifically, SBP's foreign exchange reserves declined by US$ 2.3 billion during Q1-FY18, with the remaining reserves capable of providing cover for nearly three months of the country's imports.

## 1.2 Economic Outlook

Broadly, there is no major change in the macroeconomic outlook from that set out in the last Annual Report of FY17 (**Table 1.2**).

The only revision is in the export growth projection which has been revised upwards due to three main reasons. First, while some of the structural headwinds still persist, such as lack of product and market diversification, uninterrupted energy supplies to the manufacturing sector is going to add on to the

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

| | FY17 | FY18 | |
|---|---|---|---|
| | | Target[4] | SBP Projection[2] |
| | | *percent growth* | |
| Real GDP[1] | 5.3 | 6.0 | 5.0 – 6.0 |
| CPI (average)[1] | 4.2 | 6.0 | 4.5 – 5.5 |
| | | *billion US$* | |
| Remittances[2] | 19.3 | 20.7 | 19.0 - 20.0 |
| Exports (fob)[2] | 21.9 | 23.1 | 23.0-24.0 |
| Imports (fob)[2] | 48.6 | 48.8 | 53.0 – 54.0 |
| | | *percent of GDP* | |
| Fiscal deficit[3] | 5.8 | 4.1 | 5.0 – 6.0 |
| Current a/c deficit[2] | 4.1 | 2.6 | 4.0 – 5.0 |

Sources: [1] Pakistan Bureau of Statistics; [2] State Bank of Pakistan; [3] Ministry of Finance; [4] Planning Commission current growth momentum. Second, improving cyclical factors, such as increasing global demand and commodity prices, is another positive for Pakistani exports. Third, recent exchange rate depreciation is expected to reflect positively on the exports.

At the same time, as per current projections, rising oil price while exerting an upward pressure on imports would further widen the services deficit through increased transportation cost. Nonetheless, significant base effect and recent imposition of regulatory duties and depreciation of PKR against US$ would likely restrict the import growth during the remainder of FY18. Therefore, the current account deficit projection range remains unchanged. Furthermore, inflows related to recently launched *Sukuk* and Eurobond, sharp increases in FDI, and expected CSF inflows would help keep the external sector stable to some extent in FY18.

Similarly, fiscal accounts balance may remain under pressure as well. This is largely because the recent trends show that the performance of tax collection has been as per expectation, development spending is also maintaining the momentum. However, current expenditure has risen significantly. The past trends suggest that current expenditure usually increases sharply in election year. Containing current expenditure as per announced budget may be challenging going forward. Therefore, even with growth in revenue and development expenditure remaining close to as originally envisaged the fiscal deficit target for FY18 could be missed.

Meanwhile, prospects for GDP growth remain strong. As mentioned earlier, supply side indicators suggest that the economy is well poised to achieve the target growth of 6 percent for FY18. From the demand side, rising income levels of consumers are fueling retail sales and commercial activities. Businesses, meanwhile, are in the middle of an expansionary phase, with the international investors' attention boosting the level of competition and quality in the domestic market. The evidence of this can be found in sectors such as cement, steel, automobile, and electronics, where substantial capacity expansions are already underway. This is also reflected in the Overseas Investors Chamber of Commerce and Industry (OICCI) survey of October 2017 which reports buoyant sentiments of the business community largely influenced by the retail and wholesale trade sector.

However, fertilizer manufacturers are facing operational constraints in the form of gas diversions, expensive LNG supplies, and build-up of inventories forcing a few of the players to shut down their plants. This would have implications for the industrial as well as the agriculture sector. Also, policy uncertainty regarding furnace oil based power plants further adds to industrial sector challenges especially refineries' activities. All in all, owing to more than the last year *kharif* crop produce and buoyant uptake in private sector credit for fixed investment and the ensuing activities, the balance of risk favors an upside for GDP growth.

Owing to rising domestic demand, underlying inflationary pressures continued to strengthen in the first quarter of FY18 as well. However, adequate supplies of soft commodities, normalization of pulses' price, and a significant decline in tobacco component restricted the overall growth in CPI. Similar trends in both the demand and supply side sources are expected in the remaining months of the current fiscal year. Some of the leading indicators, such as the aforementioned OICCI survey Report, indicate bullish sentiments about the economy on the back of growth in retail and wholesale trade sector; while, IBA-SBP Consumer Confidence Survey, November 2017 edition, indicates an increase in inflation expectations for the next six months. However, staple food stock from last year, along with gains in agriculture yields in current year's *kharif* crops are nonetheless expected to keep a check on rising demand pressures in CPI. Additional drag can come from investments in various manufacturing sectors for capacity expansion. Therefore, average CPI inflation in FY18 would remain below its annual target of 6 percent.

There are however two major risks to this inflation forecast. First, recent exchange rate depreciation through expectations channel, and after some lag, through the higher imported goods' price can seep into domestic prices. Second, uncertain global oil price poses both upside and downside risks. Recent developments, however, indicate more upside risks. This is mainly due to agreements between OPEC and non-OPEC countries to cut oil production, unfavorable effects of political shakeup in Saudi Arabia, and rising tensions in Middle East, coupled with government's recent behavior and intent on passing on the increase in oil price to domestic consumers.