# 1 Overview

The provisional information presents a mixed picture of Pakistan's economy at the end of Q3-FY18. Maintaining its upward trajectory, the real GDP growth is estimated at a 13-year high of 5.8 percent in FY18, along with a benign inflationary environment. However, deterioration in external balances and high fiscal deficit remains a major source of concern. (**Table 1.1**)

**Table 1.1: Selected Economic Indicators**

| | | FY16[F] | FY17[P] | FY18[P] |
|---|---|---|---|---|
| *Growth rate (percent)* | | | | |
| Real GDP | Jul-Jun | 4.6 | 5.4 | 5.8 |
| Agriculture | Jul-Jun | 0.2 | 2.1 | 3.8 |
| Industry | Jul-Jun | 5.7 | 5.4 | 5.8 |
| o/w LSM | Jul-Jun | 3.0 | 5.6 | 6.1 |
| Services | Jul-Jun | 5.7 | 6.5 | 6.4 |
| CPI (period average)[a] | Jul-Mar | 2.6 | 4.0 | 3.8 |
| Private sector credit [b] | Jul-Mar | 8.1 | 9.9 | 9.1 |
| Money supply (M2)[b] | Jul-Mar | 6.0 | 5.9 | 4.8 |
| Exports [b] | Jul-Mar | 13.0 | -3.2 | 13.1 |
| Imports [b] | Jul-Mar | -4.4 | 18.3 | 15.9 |
| Tax revenue –FBR [c] | Jul-Mar | 17.7 | 8.6 | 15.8 |
| Exchange rate (+app/-dep%)[b] | Jul-Mar | -2.8 | 0.0 | -9.2 |
| Policy Rate [b] | Mar | 6.0 | 5.75 | 6.0 |
| ONMMR [b] | Mar | 6.1 | 5.7 | 5.7 |
| *billion US dollars* | | | | |
| SBP's reserves (end-period) [b] | Mar | 16.1 | 16.5 | 11.6 |
| Worker remittances [b] | Jul-Mar | 14.4 | 14.1 | 14.6 |
| FDI in Pakistan [b] | Jul-Mar | 1.8 | 2.0 | 2.1 |
| Current account balance [b] | Jul-Mar | -3.4 | -8.0 | -12.1 |
| *percent of GDP[1]* | | | | |
| Fiscal balance[d] | Jul-Mar | -3.5 | -3.9 | -4.3 |
| Current account balance | Jul-Mar | -1.6 | -3.5 | -5.0 |
| Investment | Jul-Jun | 15.7 | 16.1 | 16.4 |

P=Provisional; F= Final.
Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Federal Board of Revenue; and [d] Ministry of Finance

The estimates for FY18 also suggest that compared to FY17 all the three sectors remained vibrant. Agriculture sector on the back of improved cotton crop and record sugarcane is expected to comfortably surpass its growth target for FY18. Industrial sector, reflecting a robust domestic demand, is set to achieve a 10-year high growth. The services sector is estimated to maintain almost its last year growth based on spillover impact of healthy performance by commodity producing sector. In the same encouraging vein, inflation remained within manageable and supportive levels, largely owing to decline in its food component.

The combination of robust economic activity and low inflation had two important implications. First, it boosted confidence in the economy, which along with affordable cost of financing induced firms to borrow substantially. In particular, energy, textiles, and cement sectors focused more on capacity expansion to gear up for growing domestic demand. A healthy rise was also observed in working capital requirements; while the consumer finance posted the highest Jul-Mar flow during the last 12-years, driven mainly by a surge in auto and housing finance. Ample liquidity in the wake of maturity of government securities also supported this credit off-take.

The second impact relates to increased consumption, which along with recovering oil prices, further inflated the import payments. Higher import bill, despite 10 consecutive months of exports growth and rising workers' remittances, resulted in record widening of current account deficit. Even higher financial inflows from IFIs, bilateral sources, and issuance of sovereign bonds remained insufficient. Thus, the remaining payment gap fell on the country's FX reserves, which fell to only two months of import cover by end-March, 2018. The foreign exchange market also remained volatile and PKR depreciated by 9.2 percent against the US$ during Jul-Mar period of FY18.

These external sector developments started to impact inflation as well. The pass-through of rising global oil prices to domestic fuel prices pushed up the energy component of inflation, as the government passed on its impact to consumers. Similarly, the impact of PKR depreciation started to translate into costly imports and shoring up of inflationary expectations.

On the fiscal side, the healthy growth in revenue could not keep up pace with a sharp rise in fiscal expenditure in the Q3-FY18. Particularly, the development expenditure related to infrastructure and power projects increased sharply, with major contribution coming from provinces. As a result, the fiscal deficit in Q3-FY18 stood higher than corresponding period last year.

To finance the fiscal gap, the government had to rely both on SBP's borrowing and external sources. In particular, the government borrowings from SBP stood at Rs2.2 trillion in Q3-FY18 – the highest level in a quarter. External debt, owing both to higher commercial loans and revaluation impact of the PKR depreciation, also rose considerably.

In short, ensuring the continuity of expansion in economic activities and low inflation would depend on containing of current account and fiscal deficits. As these vulnerabilities are posing challenges to Pakistan's current growth cycle, implementation of both short-term and medium term policies would be crucial in this regard.

In short-term, concerted efforts could be made to rationalize fiscal expenditures given the tax relief measures approved in budget FY19. In the medium term, reforms would be needed to expand tax base besides enhancing efficiency of the existing system. Simultaneously, there is a need to arrange external financing in the short term. Also, more policy measures are required to contain the widening trade deficit. For this purpose, it is also crucial to resolve structural issues affecting exports competiveness.

## Economic Review

### Real Sector

The real GDP is estimated to grow by 5.8 percent during FY18, surpassing the decade-high growth of 5.4 percent achieved during FY17. This was achieved on the back of strong performances by agriculture and services sectors, both of which managed to grow at or above their targets.

The agriculture sector grew by 3.8 percent, higher than both the target of 3.5 percent and last year's growth of 2.1 percent. The sector benefitted from a strong showing by livestock and healthy production of major *Kharif* crops such as cotton and sugarcane. This, alongside contributions from cotton ginning segments, more than offset the contraction in wheat harvest due to decline in area under cultivation and lack of water availability.

In services sector, the improvement in *wholesale & retail trade and general government services* helped offset the deceleration in the *finance & insurance* and *transport, storage & communication* segments. Overall, the sector was able to keep its momentum intact and achieve the targeted growth of 6.4 percent during FY18.

The value addition in industrial sector grew by 5.8 percent during FY18 compared to 5.4 percent growth observed during last year. This was achieved on the back of a rise in large-scale manufacturing, coupled with a recovery in mining activities and continued surge in construction activities. However, the deceleration in electricity generation and distribution constrained the overall growth of the industrial sector below the target of 7.3 percent.

### Inflation and Monetary Policy

Monetary Policy Committee (MPC) raised the policy rate by 25 basis points to 6 percent in January 2018 – this was the first hike since November 2014. The key factors influencing the MPC's January decision included: (i) PKR depreciation of nearly 5 percent in December 2017; (ii) rising international oil prices; (iii) monetary tightening by other central banks (particularly the US Fed and Bank of England), with its concomitant impact on PKR interest rate differential; and (iv) a possible overheating of the economy as indicated by increased capacity utilization in a number of industries. Also, the expected rising trend in inflation and aggregate demand remained a consideration. Subsequently, the policy rate was maintained in March 2018.

Given that banks seemed to have already priced in the anticipated uptick in policy rate during Q2-FY18, the January policy rate hike did not trigger a similar upward adjustment in weighted average lending rates (WALR) for the most part. In fact, retail rates moderated slightly during February and March 2018, as banks had ample liquidity at their disposal. This stemmed largely from the banks' reluctance to roll over the bulk of maturing government securities in a perceived rising interest rate scenario. In turn, this liquidity comfort nudged the overnight rates below the policy rate during Q3-FY18.

With the cost of bank financing continuing to be attractive, demand for credit from the private sector remained strong. Furthermore, steady economic activity appeared to help maintain the growth in fixed investment loans, as both manufacturing and non-manufacturing firms (largely cement and textile) borrowed for the long term. As far as working capital loans is concerned, the sugar sector's borrowing was most notable during Q3-FY18, with the crushing season in full swing.

The government's reliance on SBP borrowings increased in Q3-FY18, as banks' participation in government paper auctions stood relatively low in contrast to the first two quarters. SBP lending to the government reached Rs2.2 trillion in the third quarter. This, coupled with high credit off-take and increase in loans to PSEs, led to an upsurge in the NDA of the banking system. However, the M2 growth remained subdued due to a concurrent contraction in NFA.

**Fiscal Operations**

A sharp increase in expenditures, amid a slower growth in revenue in Q3-FY18, led the fiscal deficit rising to 4.3 percent of GDP during Jul-Mar FY18 compared with 3.9 percent last year, and a full year target of 4.1 percent. The growth in revenue, though remained higher compared to last year, slowed down in Q3-FY18 compared to first two quarters of FY18. On the other hand, growth in expenditures accelerated from 12.4 percent in Q1-FY18 to 23.4 percent in Q3-FY18.

The slowdown in revenue collection was primarily due to direct taxes. More specifically, the drag came from a decline in voluntary payments, while withholding taxes and collection on demand increased considerably compared to last year. The decline in voluntary payments can partially be attributed to reduction in corporate tax rate and lower bank profitability. Meanwhile, growth in indirect and provincial taxes remained buoyant in line with expanding economic activity, and the pass-through of rise in the oil prices to domestic consumers. The non-tax revenue also recovered strongly, bolstered by a jump in provincial non-tax revenue, higher markup payment, dividend income and PTA /postal service profit.

The acceleration in growth of expenditures was more due to higher provincial spending, with both current and development expenditures growing sharply. The provincial development spending grew by 36.7 percent during Jul-Mar FY18 compared to 13.6 percent in the corresponding period of last year. Growth in federal development spending also remained high, close to 25 percent compared to 28.9 percent in last year. The push has come from urgency to complete the ongoing project before the terms of assemblies came to an end. Similar to growth in development expenditure, major contribution to a sharp increase in current expenditure came from provinces, especially in Q3-FY18. Higher debt servicing and defense spending at federal level and general public services, economic affairs, and public order and safety in case of provinces contributed to the increase in current expenditures.

The resulting higher fiscal deficit was largely financed through borrowing from SBP and external sources. In case of external financing, government heavily relied on commercial loans and sovereign bonds. Moreover, the revaluation losses, resulting from appreciation of major currencies against US$ and the depreciation of rupee against US$ also added significantly to external debt. Overall, these developments led to considerable increase in public debt, with record accumulation in Q3-FY18 since FY14.

**External sector**

The external account remained under pressure, despite a recovery in exports and remittances. A rebound in global oil prices, together with higher machinery and transport import, exacerbated the trade deficit. This led to the highest current account deficit of US$12.1 billion, the country has seen during Jul-Mar of a fiscal year.

Exports witnessed a broad-based growth of 13.1 percent YoY in Jul-Mar FY18 and reached US$ 17.1 billion. Notably, exports in Q3-FY18 alone recorded a growth of 17.2 percent YoY, the highest growth in Q3 in more than six years. Both traditional and non-traditional exports contributed to this improved performance. Moreover, extension of GSP plus status by EU, additional incentives announced by the government in October 2017 export package, and recovery in global demand also supported the export growth. As regards imports, the rising global crude oil prices together with lagged impact of machinery import payments have inflated the import bill during Jul-Mar FY18. About 70 percent of the import payments were contributed by three categories namely energy, machinery and metals. However, the recent decline in machinery imports is likely to reduce the payment pressure going forward.

A significant increase in financial inflows on account of a rise in official portfolio investment and loans, and a marginal growth in net FDI could not completely finance current account gap. In this scenario, the country's official reserves depleted by US$ 4.5 billion and reached US$ 11.6 billion by end-March FY18. Consequently, PKR depreciated by 9.6 percent on a cumulative basis during Jul-Mar FY18.

**1.2 Economic outlook**

The government has set a 6.2 percent real GDP growth target for FY19 largely on the back of accelerating growth momentum of the last few years. Higher PSDP and CPEC spending, a further ease in power supply, and continuation of industrial expansion plans, are other reassuring factors. However, the growing external vulnerability and high fiscal deficit will continue to pose major down side risks to the achievement of this target. Moreover, on the real side, the ongoing dry spell and water shortages may adversely impact the value addition potential of the agriculture sector.

High domestic demand, lagged impact of adjustment in energy prices, and PKR depreciation are likely to contribute to higher CPI inflation in FY19. Smooth supply of staple food items and soft oil price on the other hand could offset these underlying pressures and help keep inflation around the target of 6 percent set for FY19.

The government has set fiscal deficit target at 4.9 percent of GDP for FY19, which is based on a 12.7 percent anticipated growth in FBR tax revenues and a 10.0 percent increase in expenditures, with greater emphasis on current expenditure. While the current budget has reduced tax rates without rationalizing expenditure, achieving the fiscal deficit target in this backdrop appears challenging.

On the external side, the exports growth prospects remains encouraging on the back of PKR depreciation; recovery in global demand; fiscal incentives for exports; ease in power supply; and improved price outlook of rice and cotton in the international markets. Also, the growth in workers' remittances is expected to further gather some pace, partly on account of the steps taken by the government and SBP to attract inflows through the official channels. At the same time, a deceleration in imports is expected due to proactive monetary management by SBP, PKR depreciation and the continuation of administrative measures to dampen the domestic demand for non-essential import items.

However, the import bill is likely to stay high owing to a notable increase in international commodity prices, especially of oil. This would keep the trade deficit high in FY19 as well. Furthermore, the FDI inflows are expected to remain lower in FY19 than last year as a number of CPEC energy projects are in their advance stages of completion. Therefore, in overall terms, the high current account deficit, together with limited financial inflows, would continue to keep the balance of payments under pressure.