1 Overview

1.1 Economic Review

During the first quarter of FY20, Pakistan's economy moved progressively along the adjustment path. So far, the policy mix appears adequate to address the macroeconomic imbalances and push the economy towards stability.

In terms of policies, a number of developments were important. First, the macroeconomic stabilization process picked up momentum with the initiation of the IMF's Extended Fund Facility program. While the SBP continued to keep the monetary policy consistent with the medium-term inflation target, consolidation efforts were also visible on the fiscal front, both on the revenue and expenditure sides. Second, the system of a market-based exchange rate was implemented, to which the interbank foreign exchange market – barring initial edginess – adjusted relatively well. Third, the government abided by its commitment to avoid deficit monetization, including rollover of SBP debt, which is instrumental for ensuring effective monetary management. Fourth, the government actively pursued documentation efforts, including asset revaluations, tight financial scrutiny, and the introduction of structured mechanisms to formalize businesses' value-chains.

While the success of documentation measures hinges upon the policy consistency and would manifest in revenue mobilization over the medium term, the payoff from the ongoing stabilization efforts has become visible in the form of declining twin deficits (**Table 1.1**). Specifically, the current account deficit (CAD) in Q1-FY20 fell to less than half of last year's level. This improvement came on the back of significant import

Table 1.1: Economic Indicators

	FY19	Q1-FY19	Q1-FY20
	Growth rate (percent)		
LSM[a]	-3.4	-0.6	-5.9
CPI (period average YoY)[a,1]	7.3	5.6	11.5
Private credit[b]	11.6	2.1	-0.3
Money supply[b]	11.3	0.1	0.6
Exports[a]	-1.1	4.2	2.5
Imports[a]	-9.9	-0.04	-20.9
Policy rate spread (basis points)[2]	-6.6	-5.9	-11.9
FBR tax revenue (billion Rs)[d]	3,828.5	832.3	959.1
Exchange rate (+app/-dep%)[b]	-24.1	-2.2	2.4
	million US dollars		
SBP's liquid reserves (end-period)[b]	7,280.4	8,408.7	7,936.6
Workers' remittances[b]	21,838.6	5,557.6	5,478.1
FDI in Pakistan[b]	1,668.0	559.4	542.1
	percent of GDP		
Current account balance[b]	-4.9	-5.5	-2.3
Fiscal balance[c]	-8.9	-1.4	-0.7
Primary balance [c]	-3.5	-0.1	0.6

[1]YoY growth in the average of CPI index (old base) for the quarter (2007-08=100). [2]Difference between SBP's policy rate and overnight rate

Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Ministry of Finance; and [d] Federal Board of Revenue compression and the ongoing shift towards renewables and indigenous coal in the energy mix, whereas volumetric gains were also visible in the country's exports. Thus, with the payments gap narrowing in the interbank, the available financial inflows helped the SBP accumulate foreign exchange reserves.

On the fiscal front, the improvement came from a healthy growth in both tax and non-tax collections and containment in current spending, both at the federal and provincial levels. As a result, the overall fiscal deficit remained lower as compared to the same period last year, and the primary balance recorded a surplus for the first time in 7 quarters.[1] Importantly, development expenditures recorded a sharp rise of 30.5 percent in Q1-FY20.

However, despite these stability gains, the overall confidence among businesses and consumers remained weak, as they struggled to preserve their purchasing powers and dealt with operational constraints stemming from the adjustment process. For consumers, the increase in inflationary pressures in the economy (especially food items) was particularly disconcerting, as it impacted their real incomes. This high inflation outcome was driven largely by the pass-through of the exchange rate depreciation, correction in energy prices, shortage of food items, and revenue measures taken by the government. For businesses, perceptions about the current economic conditions remained below the threshold level (index value below 50, which represents prevalence of more negative views than positive views), as depicted in the IBA-SBP survey waves of August and October 2019. In addition to the government's revenue measures and tight credit conditions, this may also reflect the impact of the FBR's instructions to businesses to record CNIC numbers of buyers and suppliers while filing sales tax returns.

While large businesses (especially export-oriented and import-competing industries) remained bullish on fundamentals, they refrained from taking a long-term view. This cautious behavior, coupled with tapering demand and the compression of unregistered businesses – which dominate the network of dealership and wholesale infrastructure of registered firms – reinforced the economic slowdown. On the whole, a number of industries within the large-scale manufacturing (LSM) struggled with inventory build-ups amid rising input costs during the quarter. With gross margins squeezed and financing costs rising, firms scaled back their operations to save their bottom lines from dropping further. As a result, a contraction was observed in a majority of LSM sub-sectors.

[1] The primary balance refers to the fiscal position after adjusting for the impact of interest payments.

From the policy perspective, it is important to continue with the adjustment process despite weakening economic activity, as well as the visible stability gains in terms of the falling twin deficits. The policy continuation is warranted given the lingering vulnerabilities in the economy and the chronic nature of the structural weaknesses. In this regard, three aspects are important. First, most of the improvement in the current account has come from a reduction in the country's import bill; exports have yet to contribute significantly, as healthy quantum gains are not supported by price trends. Furthermore, while the drawdown in foreign exchange reserves has been reversed, the overall reserves position remains below the comfort level (in terms of import coverage).

Second, the announced documentation-related measures must be implemented in order to bring the needed diversification in the revenue base. This is important to rebalance the country's fiscal revenue structure, which is currently over-reliant on very few sectors. Specifically, tax collection is concentrated in industry-related revenues, as agriculture and services sectors under-contribute compared to their respective shares in GDP. Furthermore, a disproportionately large contribution from import-related collections makes Pakistan's taxation system excessively vulnerable to business cycles and overall import trend.

Third, managing food prices has lately become challenging. It is important to note here that the impact of the aforementioned one-off factors is likely to dissipate going forward. However, supply-management issues, such as weak governance in commodity procurement agencies, hoarding practices and regional trade bottlenecks, may potentially perpetuate food inflation going forward. This runs the risk of undermining the impact of softening demand pressures in the economy, as reflected in the somewhat stabilizing core inflation.

Keeping these challenges in view, it is vital that the government continues to address the underlying structural vulnerabilities and put the economy on a balanced and sustainable growth trajectory. Furthermore, there is a need to build on gains on the ease of doing business front, which requires not just the capacity development in key public institutions, but also a continuous dialogue with relevant stakeholders to ensure smooth implementation. Side by side, it is equally important for firms to leverage on the facilitative policies, particularly the export promotion incentives, and gain a foothold in the global value chains (GVCs); this would not only align our product mix with trends in global demand, but also put the exports on a sustainable growth path (**Special Section 1)**.

1.2 Executive Summary

Real Sector

Following the modest GDP growth of 3.3 percent last year, the government set a 4.0 percent growth target for FY20. This recovery was premised on a better performance by the agriculture and industrial sectors, whereas the target for the services sector was similar to the growth observed a year earlier. However, based on the sluggish start during the first quarter, it appears that achieving the annual targets for agriculture and industry may prove to be challenging.

In the agriculture sector, revised estimates for the *kharif* season suggest that the production of important crops is likely to fall short of targets for FY20. Specifically, untimely rains and pest attacks held back the cotton output to some extent. For sugarcane, the experience of farmers in the previous *kharif* season, when they were unable to realize expected returns on the crop, led to a fall in area under cultivation. In contrast, rice crop delivered a strong showing during the review period, as it comfortably surpassed the annual target for FY20. This can be linked to greater export potential of basmati and non-basmati varieties, which encouraged growers to apportion a greater area to rice cultivation as compared to last year.

As for industry, the decline in LSM deepened during Q1-FY20. The impact of macroeconomic stabilization policies and the second-round impact of exchange rate depreciation contributed to both supply-side pressures (expensive inputs) and lower demand (marginal growth in real incomes) for domestic industries. With the increase in financial and operational costs, a number of industries, including steel, automobiles, chemicals and cement, cut their production. Furthermore, the government's policy to shift away from furnace oil for power generation forced local refineries to scale back their operations. In contrast, previous corrections in the exchange rate helped export-oriented industries, as reflected in the relatively better performance of textiles and leather. Meanwhile, fertilizer production benefited from improved supply of natural gas.

In the services sector, trends in proxy indicators – like the decline in LSM and imports, and lower sectoral credit offtake compared to Q1-FY19 – suggest that *wholesale and retail trade* activities were relatively subdued. Similarly, in case of *transport, storage and communication*, commercial vehicle sales and POL sales to the transport sector both declined during the first quarter. By contrast, higher commercial bank profits during Q1-FY20 over last year may bode well for the full-year prospects of the *finance and insurance* segment. The improvement in banks' earnings primarily reflects the impact of rising interest rates and banking spreads, which increased their net interest incomes.

Inflation and Monetary Policy

In its July 2019 decision, the Monetary Policy Committee (MPC) raised the policy rate by 100 basis points. This decision took into account the imminent pressures on inflation, stemming from: (i) the announcement of a substantial increase in gas tariffs (up to 168 percent) from July 2019 onwards; (ii) revenue measures announced in the budget 2019-20; and (iii) the pass-through of the impact of exchange rate depreciation towards the end of FY19. As the quarter progressed, these pressures began to manifest in the inflation numbers. The headline CPI inflation recorded a broad-based increase of 11.5 percent during the quarter – the highest quarterly inflation since Q4-FY12. Importantly, the contribution of core inflation remained more or less unchanged at last year's level, which indicated softening demand pressures in the economy amid the ongoing macroeconomic stabilization efforts. However, the increase in food and energy inflation pushed up the overall inflation.

Energy prices posted the steepest rise of 32.5 percent during the quarter, with the upward revision in gas prices alone contributing 1.6 percentage points to the headline inflation. Food inflation rose to 11.8 percent during Q1-FY20, as the exchange rate depreciation increased the cost of imported products (such as pulses and vegetables) and also escalated transportation costs. Revenue measures also contributed, as traders/manufacturers passed on the impact of higher federal excise duty (FED) on cigarettes and edible oil, and increased sales tax on sugar, to end-consumers. Since these pressures were already taken into account in the July 2019 decision, the MPC decided to keep the policy rate unchanged in its September meeting.

The overall growth in money supply (M2) stood at 0.6 percent in Q1-FY20, compared to only 0.1 percent last year. The entire increase in M2 stemmed from a surge in net foreign assets (NFA) of the banking system, reflecting the improvement in the country's balance of payments and the receipt of the first tranche of the IMF's EFF program – this is the first time that the IMF's lending for balance of payments support will also be utilized by the government to finance the budget deficit. In contrast to NFA, the net domestic assets (NDA) of the banking system contracted, as the increase in net budgetary borrowings (on accrual basis) was more than offset by credit retirement by the private sector and a decline in other items net (reflecting an increase in the SBP's profit).

Within the budgetary borrowings, a clear shift was observed, with the government borrowing heavily from commercial banks to retire its SBP debt. This was unlike last year, when the government had borrowed heavily from the SBP to retire its commercial bank debt. This shift was attributed to two factors. First, the government strictly adhered to its commitment of not resorting to deficit monetization. Second, the commercial banks' own appetite for investing in government papers remained strong, as they expected interest rates to have plateaued. Moreover, they also remained averse to private sector lending.

With regards to private sector credit, a general slowdown in the manufacturing and commercial activities resulted in significantly lower credit appetite of businesses. This, coupled with higher interest rates, led firms in a number of sectors to deleverage, whereas fresh applications for working capital finance also decreased notably. In cumulative terms, private businesses retired Rs 85.4 billion loans, compared to an offtake of Rs 99.0 billion during Q1-FY19.

Fiscal Sector and Debt

Fiscal indicators recorded a marked improvement in Q1-FY20. A strong growth in revenue collection and containment of current expenditures helped reduce the fiscal deficit to 0.7 percent of GDP (the lowest in 15 quarters), compared to a deficit of 1.4 percent last year. The revenue deficit also contracted sharply, whereas a surplus was recorded in the primary balance after a gap of 7 quarters.

The consolidated revenues grew by 35.1 percent during the quarter, with both tax and non-tax revenues contributing almost equally. This growth in revenues was possible on the back of tax measures announced in the budget for the year 2019-20. For instance, the preferential tax treatment was eliminated for certain sectors (e.g. sugar, steel and edible oil) and the zero-rating regime for five export-oriented sectors (textile, leather, carpets, sports goods and surgical goods) was ended. Similarly, measures such as the increase in the sales tax rates, especially on petroleum products and sugar, upward revision in income tax rates for both salaried and non-salaried persons, reinstatement of withholding tax and sales tax on mobile top-ups, increased excise duty on cement and cigarettes, and upward adjustment in power tariffs, also contributed significantly to the higher revenue collection in Q1-FY20. The growth in non-tax revenues remained strong as well, largely due to a sharp rise in the SBP's profit and partial collection of the much-awaited renewal fee of GSM licenses.

At the same time, the growth in total expenditures decelerated to 8.0 percent in Q1-FY20 from 12.1 percent in the same period last year. Unlike last year, when a sharp cut in development spending (mainly PSDP) drove the trajectory of overall expenditures, containment of current spending explained the overall slowdown in total expenditures in Q1-FY20. Both interest payments (on cash basis) and defence-related expenditures recorded lower growth compared to Q1-FY19. This created room to increase development expenditures (especially PSDP) by 30.5 percent, without undermining the overall fiscal consolidation efforts.

Despite lower financing needs and stable exchange rate, the pace of debt accumulation increased further in Q1-FY20. While the government strictly adhered to its commitment to avoid deficit monetization, it continued to build up its deposits with the banking system (cash buffers) to ensure smooth debt management going forward. The pace of external debt accumulation in Q1-FY20 was relatively slower compared to Q1-FY19 in the wake of revaluation gains due to depreciation of other currencies against the US dollar and higher debt repayments.

External Sector

The balance of payments continued to improve during Q1-FY20. Led by a sharp decline in the import bill, the current account deficit decreased to less than half of the level witnessed during Q1-FY19. With the receipt of the first EFF tranche and the increase in foreign portfolio investment (FPI), the current account gap was easily plugged by the available financial flows. These inflows also helped the SBP to increase its foreign exchange reserves by US$ 656.2 million and reduce its net forward liabilities by US$ 1.3 billion during the quarter. The Pak rupee appreciated by 2.4 percent against the US dollar during Q1-FY20.

Import payments fell by a sharp 22.7 percent, with energy imports contributing almost one-third to the overall decline. As mentioned earlier, the shift away from furnace oil and towards indigenous coal reduced the import demand for both these commodities. Furthermore, lower international prices allowed the country to import more petrol and LNG, without pushing up their import payments. The demand for non-energy imports also remained subdued in response to inventory build-up from last year (in case of DAP fertilizer, palm oil and automobiles) and a slowdown in industrial activity (iron and steel).

On the export front, volumes of a number of products rose substantially, but earnings recorded only a marginal increase. This signifies pressures on unit values stemming from slumping commodity prices, and cutthroat competition amid economic slowdown in the major destinations. These factors have suppressed export earnings of other emerging markets as well, but the impact on Pakistan's unit prices was more pronounced. This suggests that the currency adjustment has enabled Pakistani exporters to undercut their competitors without giving up much on their margins (in Pak rupee terms).

In response to these dynamics, the trade deficit fell to its lowest level in over three years. However, workers' remittances posted a decline of 1.4 percent YoY during the quarter, mainly due to tight employment conditions in the Gulf Cooperation Council (GCC) countries. Lower remittances from these countries more than offset the increase in inflows from the UK, EU and the US.

On the financing side, FPI flowed into government securities (T-bills and PIBs) after a gap of over two years, as investors responded to the continued increase in reserve buffers; sustainability of the exchange rate regime; and the comfort offered by the inception of the IMF program. However, FDI remained almost stagnant, with a steep decline recorded in inflows to the construction and power sectors owing to the completion of various CPEC projects. This was partially offset by a one-off inflow into a telecom firm for renewal of the GSM license fee.

1.3 Economic Outlook

The current account balance is expected to improve over the projections presented in the Annual Report for 2018-19.[2] This mainly reflects a more-than-expected contraction in imports. With the industrial sector under stress, its demand for imported raw material is expected to stay low. Commodity prices are also subdued, amid the slowdown in the world economy and the absence of key triggers (resolution of the US-China trade dispute and Brexit). On the flip side, the tepid global growth outlook and commodity prices may also weigh on both exports and remittances. Nonetheless, any negative impact on these earnings would be more than offset by the reduction in import payments. On balance, therefore, the current account deficit for FY20 is likely to stay within the range of 1.5 – 2.5 percent of GDP.

However, the performance of the commodity producing sectors is likely to remain subdued. In case of agriculture, targets for the overall crop sector may not be achieved, as the production of both cotton and sugarcane is estimated to remain lower than in FY19. The industrial sector is also expected to remain under stress. The latest LSM estimates for October 2019 show an 8.0 percent decline on a year-on-year basis, steeper than the 5.9 percent decline recorded in Q1-FY20. Nonetheless, the export-oriented industries continue to perform better. Also, the government's decision to postpone regulatory actions for businesses for implementation of the CNIC restriction up till February 2020 (and also, axle load

[2] In fact, the current account recorded a surplus for the first time in 50 months, in October 2019. After adjusting for CSF inflows, the current account had last recorded a surplus 59 months back. During Oct-Nov FY20, the current account deficit was recorded at US$ 249 million, which was down 89.8 percent from the same period last year.

management), may ease manufacturers' operational constraints to some extent.[3] In view of these developments, achieving the real GDP growth target of 4 percent appears unlikely.

In case of inflation, pressures are expected to recede in the second half of the fiscal year, in light of a continued softness in domestic demand (which is expected to keep core inflation in check), and stability in the exchange rate on the back of improving CAD and financial inflows. For the full-year, the SBP estimates average headline CPI inflation to stay within the range of 11 – 12 percent. This forecast is subject to upside risks in the form of a reversal in global crude prices, exchange rate depreciation and increased budgetary borrowings.

[3] To curb overloading of vehicles, the government had put limits on axle load on motorways and national highways effective from June 1, 2019. However, this limit was postponed for one year on a major motorway (sources: NHA press release dated May 22, 2019 and PM office press release dated October 27, 2019).