1 Economic Outlook

1.1 Overview

While emerging economies are facing slower economic growth, Pakistan's economy did reasonably well in FY15.[1] GDP growth posted a marginal increase over last year, whereas key macroeconomic indicators, like inflation, fiscal balance and current account balance, recorded improvements (**Table 1.1**).

Table 1.1: Macroeconomic Indicators

	FY12	FY13[F]	FY14[R]	FY15 Target	FY15 Actual[P]
growth in percent					
Real GDP[1]	3.8	3.7	4.0	5.1	4.2
Agriculture	3.6	2.7	2.7	3.3	2.9
Industry	2.6	0.6	4.5	6.8	3.6
Services	4.4	5.1	4.4	5.2	5.0
CPI inflation[1]	11.0	7.4	8.6	8.0	4.5
as percent of GDP					
Current account balance[2]	-2.1	-1.1	-1.3	-1.1	-1.0
Fiscal balance[3]	-6.8	-8.2	-5.5	-4.9	-5.3
Public debt[2]	64.5	65.1	65.1	--	64.8

F: Final; R: Revised; P: Provisional

Source:
[1] Pakistan Bureau of Statistics; [2] State Bank of Pakistan; [3] Ministry of Finance.

Particularly, the external sector has become more stable on account of a robust growth in worker remittances; continued support from IFIs; and a sharp decline in global oil prices. The country's FX reserves have reached an all-time high level of US$ 18.7 billion, which can finance over 5 months of the country's import bill.[2] This improvement in the external sector was critical in maintaining exchange rate stability during the year, and also in diluting global risk perception for Pakistan.

The stable PKR parity also helped in keeping the CPI inflation under control, and in lowering inflation expectations in the country. That said, the significant reduction in CPI inflation during FY15 was caused primarily by a sharp decline in oil and other commodity prices. The average CPI inflation fell from 8.6 percent last year, to only 4.5 percent in FY15. A stable outlook of inflation and balance of payments even allowed policymakers to implement pro-growth strategies.

For instance, on the monetary side, SBP cut its policy rate significantly during the year: in four consecutive monetary policy decisions between November 2014 and May 2015, SBP reduced the policy rate by a cumulative 350 bps.[3] Similarly, on the fiscal side, development expenditures by the government remained strong through most of the year, focusing mainly on infrastructure development – these expenditures grew by over 27 percent YoY during Jul-Mar FY15 before falling in the fourth quarter. Overall public investments grew by 18.9 percent during the year.

Some impact of the policy stimulus was visible on GDP growth; for instance, government's infrastructure spending led to buoyancy in construction activity, and increased manufacturing of steel, cement, etc. Similarly, the rise in salaries and pensions spurred up growth in *general government services*. Even the recovery in *finance and insurance* is also associated with banks' investment in government papers. However, the overall impact of these policies appears muted: production cuts due to factors like bad weather (in the crop sector), energy shortfall, and low external demand, impacted

[1] The key emerging economies experiencing marked slowdown in recent months include China, Brazil and Russia.
[2] International standard for reserves adequacy is to cover 3-month of imports.
[3] The ceiling rate of the interest rate corridor (IRC), which used to be the policy rate till 24th May 2015, fell by a cumulative 300 bps during FY15. Later on, effective from 25th May, 2015, SBP introduced the 'target rate' for overnight money market repo transactions as the new policy rate, set 50 bps below the ceiling of the IRC. Hence, the cumulative decline in the policy rate during FY15 came out 350 basis points.

GDP growth. In fact, the FY15 growth of 4.2 percent looks much decent in the presence of these factors.

The above discussion accentuates the need to address structural weaknesses in the economy, before macro policies can make a meaningful impact. Private investment is the case in point. Despite a sharp reduction in interest rates and an increase in public investments, private investments did not recover. Investors' confidence demands the presence of a predictable macroeconomic environment with a well-coordinated and consistent long-term industrial and trade policies. Unless this is provided, investors would remain reluctant to put in their capital into the system.

Another factor which is presently daunting domestic and foreign investors is the state of domestic energy supplies in Pakistan. Businesses have suffered in the previous few years, as power and gas outages remained rampant. Although the situation improved slightly in the last couple of years, several industries like leather, paper, glass, are still not able to produce at optimal capacities.[4] At its core, this shortage of energy also reflects the lack of a coherent policy.[5]

Finally, a sustainable increase in economic growth requires a continuous expansion in the country's export base. The absence of an export-oriented growth strategy or a rational import-substitution focus, over the years has resulted in recurring stress on the external account, which did not allow the economy to move towards a high growth trajectory. To increase exports, the government should fix the fundamentals first: stricter regulations should be in place on quality; research and labor institutions must be strengthened; technology up-gradation should be pursued; and efforts must be made to ensure product diversification and tariff rationalization (**Special Section 3**).

Having said that, macroeconomic conditions are more stable in Pakistan and security situation has improved markedly. As a result, our negative image in the international community is now diluting gradually. However, this improvement is too fresh to provide necessary confidence to investors. In the meantime, focus now should be on reducing structural impediments from our economy, and maximizing the benefits from available opportunities.

1.2 Assessment of FY15

Real sector

Pakistan's real GDP growth improved slightly to reach 4.2 percent in FY15 – a seven year high level – underpinned by a pickup in the services sector, and a modest recovery in agriculture. While several long standing structural constraints (for example, low investment rate and continuing energy shortages) keep on hindering sharp economic recovery, the challenge became more complex in FY15 due to adverse weather shocks and weak external demand. The GDP growth, therefore, fell short of the target of 5.1 percent.

In agriculture, a better performance by the livestock sector (having 11.8 percent share in GDP) pushed up the overall growth in FY15 to 2.9 percent, marginally higher than 2.7 percent growth last year. The crop sector, on the other hand, faced multiple setbacks, such as the September 2014 floods, heavy rains in April 2015, and the decline in domestic prices of agri produce in tandem with the global trends. In addition, the increase in fertilizer prices pulled down its demand, particularly during the rabi season, which in turn, further weakened the already low yields for most of the major crops.[6]

[4] In FY15 also, production in these energy-intensive industries declined primarily due to gas outages.
[5] For instance, low prices of water and gas encourage wastages in irrigation and household heating.
[6] The YoY decline in urea offtake during kharif (Apr-Sep) as well as rabi (Oct-Mar), mainly driven by a rise in its prices, hampered growth in crop yields. At the same time, the depressed prices of agri produced discouraged growers from maximizing their output (for example, in the case of cotton, some of the farmers did not wait for the third or fourth picking due to unattractive market prices).

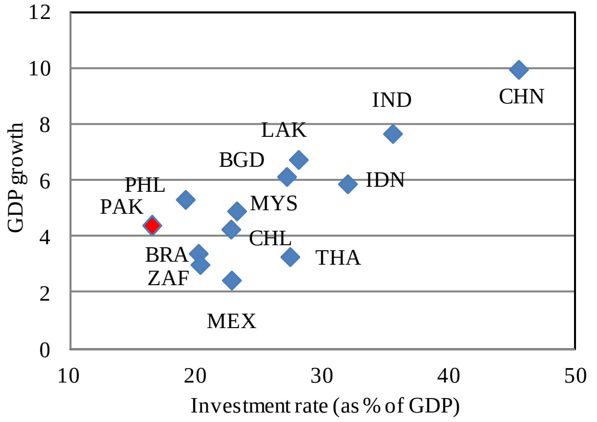
Persistent low yields bring up concerns on long-term food security in the country,[7] particularly when the prospects of increasing area under cultivation are limited; and growing population is pushing up the demand for food (**Chapter 2**).[8,9] Ensuring food sustainability becomes more challenging in the long term due to climate change and its looming threat on food and water security. In terms of water stress, the importance of more storage capacity, improved productivity and conservation cannot be overemphasized.

Industry could not perform well during FY15 despite some positive developments (e.g., steep decline in the global prices of minerals, metals and other industrial inputs; and robust growth in construction). The major slowdown was recorded in the LSM sector, which could grow by 3.3 percent in FY15, compared to 4.1 percent last year, and the target of 7.0 percent. While some slowdown was expected due to a strong base-effect in some of the industries (e.g., sugar, fertilizer, cooking oil & ghee and POL); the weak external demand (impacting cotton yarn, clothing and other textile items) and continued energy shortages in other industries (such as, textile, glass, paper, leather) further pulled down the LSM growth in FY15.

The services sector grew by 5.0 percent in FY15, comfortably surpassing the FY14 growth of 4.4 percent, mainly due to a sharp recovery in *general government services* and *finance & insurance*. As mentioned earlier, the increase in salaries and pension explain a sharp rise in contribution from *general government*. Within *finance & insurance*, the banking sector of Pakistan continued to show strong performance on the back of improved earnings. The profits of the banking industry increased sharply during FY15, largely due to their investment in government securities. The rest of the subsectors under the services head recorded a lower growth in FY15 than the last year.

From the demand side, the consumption continues to anchor the GDP growth, whereas the investment rate remained stagnant at around 15 percent in FY15. There is a direct relation between investment and growth, as shown by the cross country evidence (**Figure 1.1**). Thus a persistently low level of investments is one of the reasons the country has not been able to post sustained and high growth in GDP.

Figure 1.1: Investment Rate and GDP Growth (Average 2005-2014)



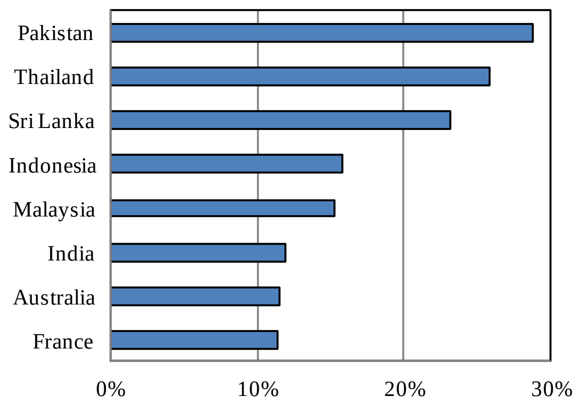
Source: Haver Analytics
BGD: Bangladesh; BRA: Brazil; CHN: China; CHL: Chile; IDN: Indonesia; IND: India; LAK: Sri Lanka; MYS: Malaysia; MEX: Mexico; PAK: Pakistan; PHL: Phillippines; THA: Thailand; ZAF: South Africa

[7] For an agro-based economy like Pakistan, increasing food availability through improved yields is crucial, as importing food would further accentuate balance of payments constraints.
[8] According to ranking presented by The Economist Intelligence Unit (EIU), Pakistan stands low at 77 out of 109 countries in terms of food security.
[9] Water shortages, urbanization and soil degradation are some of the factors that limit the scope for increasing area under cultivation.

Energy sector

The drastic fall in the global oil prices in FY15 had varying implications for different segments of the energy sector. The government decision to pass on the benefit of declining oil prices to end-consumers sharply reduced the cost of key fuels (e.g., high speed diesel, motor spirit, furnace oil).[10] In fact, the pass through of global decline in oil prices to local retail fuel prices was stronger in Pakistan compared to many regional and advanced economies (**Figure 1.2**).[11] Consequently, the domestic demand for petrol in transport sector grew sharply during the year, reflecting a switch of CNG users to petroleum products.

Figure 1.2: Decline in Gasoline Price Between Oct'14-Aug'15



Source: www.globalpetrolprices.com/gasoline_prices/

On the other hand, the accumulating arrears in the power sector continue to drag its performance. The total power generation grew by 1.6 percent during FY15 – this was insufficient to meet the growing demand for electricity, thereby leading into a persistent load management during the year (**Chapter 3**).

While improving governance is imperative to address the underlying structural issues in the power sector, the decline in the average cost of generation from falling prices of residual furnace oil (RFO), offered government a room to arrest the growing receivables by holding back benefits to consumers.[12,13] However, as Nepra passed on this gain to power consumers, the liquidity constraints stemming from circular debt continued to hamper the functioning of the system. Interestingly, government also decided to reduce country's dependence on imported RFO as per the recently announced Power Policy. Thus, despite the fall in oil prices, the share of RFO in the total power generation mix came down from 38.5 percent in FY14 to 33.2 percent in FY15.[14] The overall power generation exceeded the last year's level due to better gas supplies (reflecting diversion from the transport sector) and a strong recovery in hydel generation during May-June 2015.

Furthermore, effective from 1st July 2015, the government has introduced new surcharges that would bring power tariffs closer to the cost of generation. In a sense, the new tariff transfers a bulk of cost of poor governance and inefficiency in the power sector to end-users.[15] The transmission and distribution companies, on the other hand, have no incentive to improve their operations, even if they are privatized.

[10] During FY15, the domestic price of petrol (premium quality) and high speed diesel (HSD) fell by 28 percent, and 20.3 percent respectively.

[11] The magnitude of this pass through however varies across countries depending upon their economic situation and the prevailing mechanism for fuel price determination. For more details, see **Box 1.1** on 'Decline in Crude oil Prices and Pass through to Domestic Gasoline Prices', in ***SBP Second Quarterly Report*** for FY15.

[12] The outstanding volume of circular debt reached Rs 648 billion by end-June 2015 from Rs 526 at end-Sep 2014 (Source: Pakistan IMF Country Report No. 15/278, October 2015).

[13] The decline of 30.1 percent in price of furnace oil reduced the cost of power generation by 22.2 percent during FY15. This also enabled government to reduce the tariff differential subsidy (TDS) from Rs 230 billion in FY14 to Rs 174 billion in FY15. Had Nepra not passed on the benefit in generation cost to consumers (through frequent downward adjustment in fuel price adjustment charges), this would have arrested the buildup in circular debt and further reduced the TDS.

[14] While the import of FO fell by 6.2 percent in FY15, its domestic production grew by only 2.6 percent (compared to 9.4 percent in FY14).

[15] However, life-line electricity consumers remain protected in this new tariff structure.

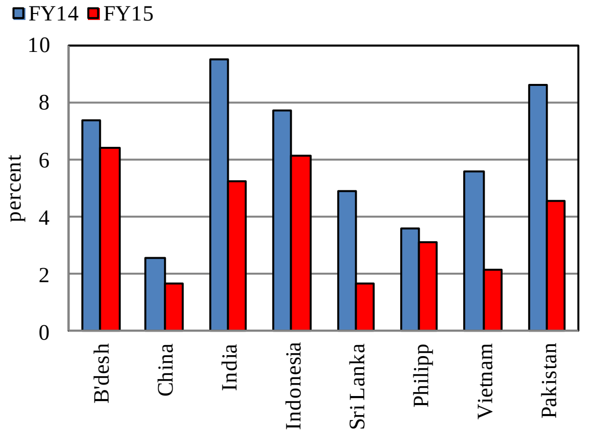
Finally, while capacity issues, administrative constraints and security concerns continue to impede development of the gas sector in Pakistan, the decline in wellhead prices in response to falling crude oil prices have further dampened the prospects of future gas exploration and production in the country.[16] This is a concern as the proven gas reserves as well as annual gas production are already on the declining trajectory. Besides, slow pace of development in the hydel and alternate energy resources are likely to increase Pakistan's future energy dependence on costly foreign resources, thereby increasing vulnerabilities in the external sector.

Inflation

As mentioned earlier, the average CPI inflation came down sharply in FY15 to 4.5 percent, from 8.6 percent last year – this was well below both, the target of 8.0 percent for the year, and SBP projections at the beginning of the year. Several factors explain this slowdown in inflation.

- Foremost is the sharp fall in global commodity prices which moderated CPI inflation in many other countries as well (**Figure 1.3**). The impact on domestic inflation in Pakistan was significant, as the government largely passed on the benefit of lower POL prices to consumers. Further gains came when the spillover effect of low POL prices also contained inflation in other commodities of the CPI basket.[17]
- The PKR remained stronger vis-à-vis the US Dollar during Jul-Feb FY15, compared to the same period last year.[18] Therefore, imports were less costly in Rupee terms during the same period;
- The combined impact of stable PKR and low POL prices also helped softened inflationary expectations as measured by IBA-SBP's Consumer Confidence Survey (CCS).[19, 20]

Figure 1.3: Average CPI Inflation



Source: Haver Analytics

In overall terms, the fall in CPI inflation is broad-based, with dominant contribution from lower food and POL prices (**Chapter 4**).[21] All measures of core inflation (non-food-non-energy; trimmed; and relatively stable component of CPI) recorded noticeable declines during the year.

The impact of a sharp fall in international commodity prices was more evident in the case of wholesale price index (WPI) which registered deflation or disinflation *throughout* the year. This was because the WPI includes more imported items (e.g., furnace oil, fertilizer, cement, steel/metals, glass sheet, and timber) compared to CPI.

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[16] Specifically, the average Brent crude oil price of US$ 111.87/bbl in June 2014 yielded wellhead gas price of US$ 6.3 per MMBTU. As the crude oil prices came down to US$ 62.35/bbl in June 2015, the wellhead gas price also dropped to US$ 5.1 per MMBTU.

[17] The items in the CPI basket whose prices are administratively controlled, showed a deflation of 0.3 percent during FY15, compared to inflation of 7.8 percent last year.

[18] The *average* PKR parity vis-à-vis US Dollar, posted a YoY depreciation of 3.8 percent during the period Jul-Feb FY15.

[19] Major indices (overall, non-food-non-energy and energy) of inflation expectations, recorded YoY declines in 5 out of 6 surveys conducted during the year.

[20] In Pakistan, businesses use PKR, and households focus on POL prices, to anchor their inflation expectations.

[21] Deflation in seven items from food and POL categories explains more than 45 percent of the ease in inflation during FY15.

Monetary policy and liquidity management

The growing comfort on external account; a sharp reduction in inflation and inflationary expectations; and contained fiscal deficit, allowed SBP change its monetary policy stance from a more conservative to a considerable easing.[22] Specifically, during the four consecutive monetary policy decisions from mid-November 2014 to May 2015, SBP cut the ceiling rate of the interest rate corridor (IRC) by a cumulative 300 bps to a multi-decade low of 7.0 percent.[23]

In terms of liquidity management, the key challenge for the central bank stemmed from government efforts to contain its borrowing from SBP within the ceiling prescribed by IMF. In doing so, the government retired Rs 434.3 billion to the central bank in FY15, against the *net borrowing* of Rs 159.8 billion in FY14.[24] This created pressure on domestic Rupee liquidity, as the government funded its retirement to SBP through borrowing from commercial banks.

Banks were also eager to lock-in their funds in government securities in anticipation of further softening of interest rates. As a result, investment of commercial banks in government securities saw an increase of Rs 1.4 trillion to reach an all time high of Rs 5.5 trillion by end-June FY15. SBP responded, particularly during the second quarter, by stepping up its liquidity injections through open market operations (OMOs) to ensure adequate supply of loanable funds for the private sector. These liquidity injections also made monetary policy more effective by improving the pass through of policy signals to retail rates.[25] The volumes of OMOs increased sharply to near Rs 1.0 trillion, and remained high for rest of the year.[26] Interestingly, the large borrowing needs of the government, along with sizeable OMO injections, provided commercial banks room to fund some of their investments in government papers using short-term liquidity from SBP.[27]

The credit to private sector, however, could expand by Rs 208.7 billion in FY15, compared to Rs 371.4 billion in the previous year. Several factors explain this slowdown: (a) a sharp fall in commodity prices that reduced the demand for working capital and trade financing loans during the year; (b) non-price constraints (e.g., power shortages, and weak external demand); (c) a steeper decline in inflation than in lending rates that increased the real cost of borrowing; and (d) some sector specific developments like lower production of sugarcane. Encouragingly, fixed investment loans (having maturity of more than one year) increased by Rs 126.9 billion in FY15, compared to Rs 72.3 billion in FY14. Most of these loans were concentrated in construction and allied industries, which have strong forward and backward linkages with other sectors of the economy. Having said this, private sector credit-to-GDP ratio in Pakistan is not only the lowest in the region, it has been facing a steep decline. Moreover, the overall credit allocation is heavily concentrated in the manufacturing sector, and in a few large size borrowers (**Special Section 1**). Given that the financial sector in Pakistan is dominated by banks, it is important that they look beyond the blue-chip corporate, and extend credit to under-served segments (e.g., SME, agriculture, and consumers). For this, they must think out of box and come up with better structured financing products.

Finally, overall commodity loans expanded by Rs 71.8 billion in FY15 – three times higher than the increase seen in FY14. This pushed the outstanding stock of commodity operations loans to all time

[22] During the one year period from mid-November 2013 to mid-November 2014, SBP had kept its discount rate unchanged at 10 percent.
[23] The ceiling rate reduced further following a 50 basis points cut in SBP's target rate, effective from 14th September, 2015.
[24] These retirements were sufficient to meet the quarterly IMF ceiling on net budgetary borrowing from SBP for the second and the third quarter of the year.
[25] The weighted average lending rates, on incremental loans, fell by 213 bps during June 2014 to June 2015 period.
[26] The expansionary impact of these liquidity injections on reserve money was offset by the net retirement in government borrowing from SBP.
[27] The average spread between secondary market yield for 3-month T-bill and overnight repo rate for the month of June 2015 was 41 bps – way above the term premium of only 4 bps between 3 and 6 month T-bills for the same month.

high level of Rs 564.5 billion by end-June 2015.[28] Out of this, 52 percent represents receivables on account of sales proceeds and subsidies. Smooth settlement of these receivables is critical for containing financial cost of commodity operations and improving fiscal transparency.

Fiscal policy

The fiscal deficit improved slightly to 5.3 percent of GDP in FY15, from 5.5 percent recorded last year. This is a welcome development, given that the sharp decline in oil prices and subdued manufacturing activities during the year had made already sluggish tax collections more difficult.

Specifically, the tax revenues could increase by 17.7 percent during FY15, considerably lower than the target of 30.1 percent. Within tax, Federal Board of Revenue (FBR) mobilized Rs 2,588 billion in FY15, which even fell short of the downward revised target of Rs 2,605 billion.[29] While administrative weakness and issues in tax enforcement continue to hamper tax collection, challenges for FBR compounded due to the collapse of the global oil prices. This not only suppressed the growth in sales tax on domestic sales, but also contained other energy related revenues (i.e., royalties on oil and gas, discount retained and windfall levy on crude oil) for the government.

Within direct taxes, the government has been focusing more on raising revenue through withholding taxes. As a result, contribution of withholding tax in direct taxes increased to around 65 percent in FY15 from 50 percent in FY10. On a positive note, income tax 'on demand' saw a sharp growth in FY15 (**Chapter 5**). The need to tap more potential taxpayers using information base available with NADRA cannot be overemphasized, as the current tax-to-GDP ratio of 11.0 percent, though marginally higher than the last year, is still one of the lowest in the region.[30]

Achieving the fiscal deficit target of 4.9 percent for FY15 became more difficult due to a steep decline in provincial surplus; the actual surplus was Rs 87.3 billion in FY15, against the target of Rs 289 billion. This was mainly because (1) the shortfall in Federal tax revenues this year, also lowered the amount that provinces receive from the divisible pool (as provinces continue to rely on transfers from the federal government); (2) the growth in their own tax collection is now tapering off, reflecting capacity constraints and procedural issues; and (3) provinces increased their current expenditures by 18.2 percent in FY15, compared to 7.0 percent last year.

With tax collection and provincial surplus falling short of the target, the burden of fiscal consolidation fell more on development expenditures. Specifically, the government slashed the development outlays by 16.7 percent of the target.[31] At the same time, the federal government also contained the growth in current expenditure to 7.3 percent in FY15, compared to 10.4 percent in the year before. Among other factors, lower subsidies on power sector also contributed to the subdued growth in current expenses during FY15.

Although the government was able to largely contain the fiscal deficit, the financing pressures on domestic sources were significantly higher than the last year. This was because, unlike FY14 when Pakistan Development Fund and issuance of Eurobonds, provided considerable comfort, the external inflows during FY15 remained subdued. Within domestic sources, the government relied more on

[28] The increase in FY15 was mainly due to lower seasonal retirement of past loans by the procurement agencies. This was because the private sector had already imported 0.7 million tons of cheaper wheat during FY15, leaving procurement agencies with unsold wheat stock, before the arrival of new crop.

[29] The original target for FBR tax collection was Rs 2,810 billion for FY15.

[30] Of these, FBR taxes are 9.5 percent of GDP; the rest are provincial and other taxes.

[31] After maintaining a high pace of development expenditure up to the third quarter of FY15 with a growth rate of above 27 percent (as discussed in SBP **3rd Quarterly Report FY15**), government had to holdback expenses in the last quarter as revenue shortfall continued.

commercial banks. As mentioned earlier, government also retired the central bank's debt through borrowing from commercial banks.

Public debt

The improvement in current account balance and a largely contained fiscal deficit helped in tapering off the debt build-up. Further support came from the revaluation gain of US$ 4.2 billion (due to appreciation of US Dollar against major currencies – **Chapter 6**). As a result, country was able to marginally reduce its public-debt-to-GDP ratio to 64.8 percent in FY15 from 65.1 percent last year.[32] This was despite the successful launch of 5-year Sukuk bond in November 2014, which allowed the government to raise US$ 1.0 billion against the initial target of US$ 500 million.

Within the domestic debt, the ownership structure witnessed a gradual shift away from SBP, towards commercial banks, as the government retired large debt to central bank during FY15, mainly to contain its borrowing from SBP within the IMF ceiling. As a result, the share of central bank in domestic debt fell to 18.6 percent at end-June 2015, from 26.0 percent in June 2014.

More importantly, the maturity profile of domestic debt which started improving in second half of FY14, continued well into FY15. In overall terms, the share of PIBs in total debt stock reached 33.9 percent by end-June 2015, from 29.4 percent a year earlier. However the pace of this transition changed during the fiscal year in response to market liquidity conditions and the interest rate outlook.

Initially, banks were reluctant to invest in government securities (both T-bills and PIBs), as SBP was maintaining largely tight liquidity conditions to stabilize the FX market.[33] However, the appetite of commercial banks for government papers revived in September 2014 mainly due to a fall in inflation and subdued inflation expectations. In particular, 3-year PIBs became more attractive when the government decision to accept large amounts in the auction drove up the term premium for this tenor.[34, 35] Commercial banks therefore over-bid in PIB auctions, especially during the second quarter of the year, when the ease in external account set in market expectations for a cut in policy interest rate.

The second cut in the policy rate in January 2015, and the fact that the government by and large adhered to its pre-auction targets, reduced the term premium between 3-year PIBs and 6-month T-bills. This induced commercial banks to invest also in T-bills. Later on, as the fourth consecutive cut in the policy rate in May 2015 convinced the market that the interest rates have bottomed out, the shorter tenor government securities (3-month in T-bills and 3-years in PIBs) became more attractive. This perception was further strengthened by an increase in T-bills and PIBs cut-off rates in auctions held during June 2015.

The change in ownership and maturity profile has its implication for interest payments. As the government paid off T-bills held by SBP, this led to an increase in interest payments. The impact of change in the maturity profile however was mixed. In the case of PIBs, semi-annual coupon payment on instruments issued in recent years (when interest rate were high), fell due in January 2015 – this led to a sharp increase in interest payments. On the other hand, as the maturity of most of the T-bills

[32] This ratio is based on the SBP's definition of public debt, which is different from Ministry of Finance (MoF) coverage of public debt. According to MoF, public-debt-to-GDP ratio fell from 63.8 percent in FY14 to 63.4 percent in FY15. For details, see Data Explanatory Notes 5(b), **Annexure A** on data explanatory notes.

[33] The sharp increase in current account deficit and the delay in the finalization of IMF 4th Review had put the balance of payments under stress during Q1-FY15.

[34] Banks offered Rs 828.6 billion in PIB auctions during Q2-FY15 against the cumulative target of only Rs 150.0 billion. The government realized Rs 354.3 billion from these auctions (more than double the target).

[35] The average term premium between 3-year PIBs and 6-month T-bills was 244 bps and 131 bps during Q1-FY15 and Q2-FY15, respectively.

picked up by commercial banks would fall in FY16, the interest payment on T-bills (auctioned) was lower in FY15.

Lastly, the public debt to GDP ratio that still exceeds the 60 percent limit stipulated in the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005, is a concern for policymakers. In a bigger picture, after releasing the divisible pool under the 7th NFC Award and the 18th amendment, federal government is left with limited resources which can only meet interest payments and defence expenses. This structural bottleneck in the fiscal account has made achieving targets in the FRDL more challenging for the government.

External sector

The improvement in the external sector recorded last year strengthened further in FY15. The current account deficit narrowed to US$ 2.6 billion, from US$ 3.1 billion last year. This was because the robust growth in worker remittances more than compensated the widening deficit in the trade account and higher repatriation of profits. The trade deficit grew due to both, a decline in exports and a rise in imports. The overall imports increased by 1.7 percent even with a contraction of US$ 3.2 billion in petroleum imports following a slump in oil market. The reason was the strong non-oil imports during this period.[36] Nonetheless, the inflows in the financial account were sufficient to fund the current account deficit. In this situation, the IMF support of US$ 2.0 billion made the overall external account more comfortable.

The comfort in the external account was well reflected in country's FX reserves which increased by US$ 4.6 billion, reaching an all time high of US$ 18.7 billion by the end-June 2015 (**Chapter 7**). These reserves can comfortably finance more than five months of the country's import of goods and services. The PKR also remained largely stable vis-à-vis US Dollar through most of the year. Thus, not surprisingly, rating agencies also upgraded country' credit standing.[37]

While the gains in external account are encouraging, these primarily stemmed from higher remittances and more external borrowings.[38, 39] Clearly, the country cannot rely for ever on these two sources to finance higher import of capital, industrial input, and machinery – a precondition for accelerating economic growth.

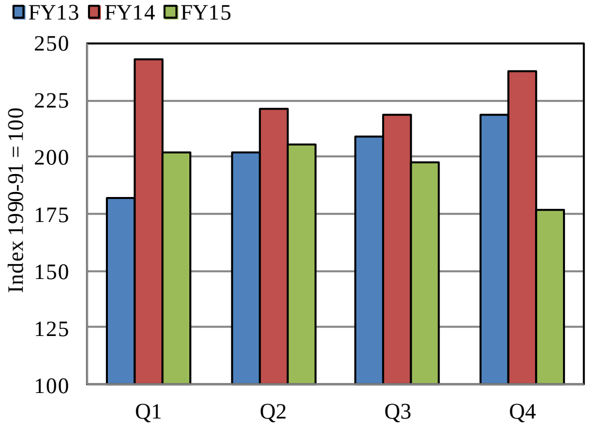
We know the excessive reliance on external borrowing is not desirable (as repayment burden further tightens FX constraints for the economy). Similarly, while the remittance inflows are strong, their growth is already tapering off. Although the collapse of the oil prices in the global market created challenges for GCC countries, their heavy spending in non-oil sector (mainly in physical infrastructure) has so far sustained economic activities in these economies, and supported remittance inflow into Pakistan. Hence, around 80 percent of the incremental remittance inflow in FY15 came from GCC countries alone. Indeed, the future remittance *growth* is at risk, if the slump in the oil market persists.

On the other hand, exports and foreign direct investment – more sustainable sources of foreign exchange earnings – are not showing any encouraging picture. The decline of 5.7 percent in FY15

[36] According to trade data prepared by Pakistan Bureau of Statistics, the imports increased on the back of higher imports of raw material and machinery (e.g., steel and its products, machinery, and chemicals) and consumer goods (including food).
[37] In June 2015, Moody's upgraded Pakistan's sovereign rating from Caa1 to B3.
[38] The growth in remittances has been the strongest among top 20 countries – pulling up remittances to a record high level of US$ 18.7 billion in FY15, from US$ 15.1 billion last year. In the case of external borrowings, the Sukuk issuance (US$ 1.0 billion), higher FX loans of the government (US$ 1.3 billion) and IMF support remained prominent.
[39] The increased collaboraton of domestic financial institutions with global money transfer organization and steps taken by Pakistan Remitttance Initiative (PRI) also diverted remittances from informal to formal channels.

exports compared to an increase of 2.7 percent last year, is disappointing.[40] In particular, export volumes fell sharply in Q4-FY15 after remaining stable for most of the year (**Figure 1.4**). Similarly, FDI inflow remained low, reaching nearly half of volume realized in FY14, mainly due to divestment (in cement, metal and pharmaceuticals), and lower inflows in oil & gas exploration (following the decline in crude oil prices) and telecom.

Figure 1.4: Quantum Index of Exports



Source: Pakistan Bureau of Statistics

The recent slowdown in China and the surge in capital outflows from emerging markets expecting monetary tightening by the Fed – these global events are making it challenging for Pakistan to generate FX earning. However, the on-going implementation of China Pakistan Economic Corridor; and improvement in domestic security situation, offer an opportunity to better integrate with regional markets, and push up exports and investment. In order to capitalize on this opportunity, we need substantive reforms in key regulatory and policy institutions.

1.3 Outlook

The overall macro environment for FY16 appears positive for the country: outlook for external account is stable; inflation is expected to remain below target; fiscal account would be in good shape; and global commodity prices are likely to remain soft. In addition, country can also benefit from following developments:

1. Policy rate has been reduced to a 42-year low.

2. The security situation has improved following the recent campaign against terrorism. While the better security is improving country's image as an attractive investment destination, the benefit would spread to other sectors of the economy (**Box 1.1**).

3. China Pakistan Economic Corridor (CPEC) offers a unique opportunity to fix our chronic problems in infrastructure and energy sector. In addition, the membership of Shanghai Cooperation Organization would provide Pakistan an easy access to a large market for its exports, and attract investments in the energy and infrastructure sector.

Table 1.2: Key Macroeconomic Targets and Projections

		FY16	
	FY15	**Target[2]**	**SBP Projection[1]**
		percent growth	
Real GDP	4.2[4]	5.5	4.0 – 5.0
CPI (average)	4.5[4]	6.0	3.5 – 4.5
		billion US$	
Remittances	18.7[1]	19.0	19.0 – 20.0
Exports (fob)	24.1[1]	25.5	22.9 – 23.4
Imports (fob)	41.1[1]	43.3	40.0 – 41.0
		percent of GDP	
Fiscal deficit	5.3[3]	4.3	4.0 – 5.0
Current a/c deficit	1.0[1]	1.0	0.5 – 1.5

Source:
1. State Bank of Pakistan;
2. Planning Commission;
3. Ministry of Finance;
4. Pakistan Bureau of Statistics.

[40] While falling commodity prices lowered export receipts this year, the export quantum has also declined. Pakistan suffered most in the booming US market, where overall imports reached record high levels.

4. The US deal with Iran, will open up the Iranian market to many countries. With Iran's reintegration with the global economy, Pakistan can focus on this market to improve trade, and meet energy needs.

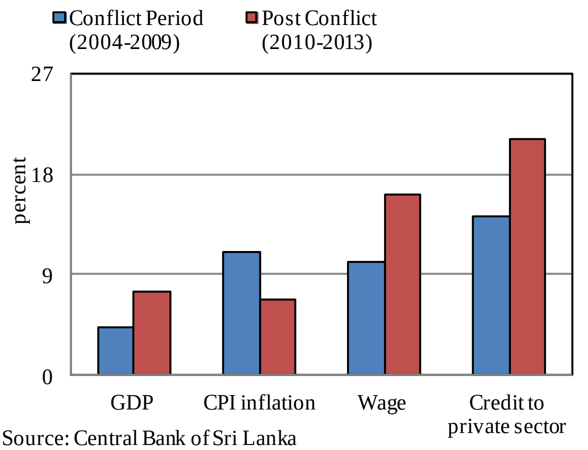
The government has set a GDP growth target of 5.5 percent for FY16, with all sectors (viz. agriculture, industry, and services) expected to grow at a higher rate than FY15. According to Annual Plan FY16, the likely investments in energy and infrastructure projects under CPEC would not only bolster industrial growth, but its spillover impact on *transport, storage and communication* subsector would also support growth in the services sector.

Box 1.1: Recent Improvement in Security Situation – Looking Forward to Peace Dividend

The December 2014 terrorist attack on Army Public School in Peshawar altered the course of war against terrorism in Pakistan, as this incident galvanized a broad-based public support for a decisive action against militant elements operating in the country. In particular, the implementation of National Action Plan has led to a tangible improvement in overall security situation in recent months. We expect the elimination of a major threat to national security would also take out one of the most important growth-retarding factor for the country.

Looking back, the prolonged war against terrorism has inflicted heavy losses to Pakistan since 2001. Apart from loss of lives and human sufferings, the country has faced several other costs, for example,

Figure 1.1.1: Sri Lanka Eco. Indicators (average growth)



Source: Central Bank of Sri Lanka

- The war caused large damages to physical infrastructure that resulted in significant financial loss;
- Country's exports suffered due to disruption in domestic business activities (exporters could not meet orders on time). In some cases, the uncertainty due to the threat of terrorism, forced foreign buyers to move to other more reliable sources;
- Doing business became costlier due to higher insurance premium (reflecting the risk factor for the country);
- Increased spending on security and social safety of people, not only weakened the fiscal position, this also crowded out more growth enhancing public and private investments (particularly in education and health);
- Increase in uncertainty weakened investors' confidence and discouraged investment inflows.

According to Pakistan Economic Survey, the war on terror has cost Pakistan around Rs 8.7 trillion since 2001 – this is almost one-third of the nominal GDP for FY15.

With this backdrop, the improvement in security situation offers an opportunity to realize sizeable economic benefits in terms of growth and macroeconomic stability. We already have example of Sri Lanka, where following the end of long running civil war, the country experienced a significant improvement in a number of macroeconomic indicators (**Figure 1.1.1**). While the fiscal expenses on war on terror may not fall in immediate term, we expect the relatively stable security situation in the country would help in rebuilding the business and investor confidence. This would encourage private investment, which is critical for sustained economic growth. However, to capitalize on this peace dividend, Pakistan needs to implement structural reforms in the area of fiscal policies, energy sector, and delivery of public services.

The major risk to overall GDP growth stems from agriculture sector where some damages to cotton crop from the recent rains and floods have been reported. [41] In addition, the continuing depressed prices may discourage growers from increasing their spending on better quality inputs.[42]

The CPI inflation for FY16 on the other hand is likely to remain below the target of 6.0 percent for the year. The downside risk to outlook comes from steeper than expected slowdown in Chinese economy, which may put further downward pressure on global commodity prices. However, unlike advanced economies (particularly the Euro area countries) where deflation has emerged as a challenging economic problem, we do not expect CPI inflation in Pakistan to fall below zero percent (**Special Section 2**). A number of developments support this assessment: (a) the recent increase in power tariffs and recovery of Gas Infrastructure Development Cess (GIDC); (b) stable PKR against the major trading partners which lowered the risk of importing low inflation; (c) global oil prices would not fall as sharply as they did last year; and finally, (d) the domestic demand is likely to remain strong given the planned infrastructure spending, monetary easing and improvement in law and order situation.

The outlook of the external sector appears comfortable, as we expect exports to benefit from the recent weakening of the PKR; a decline in policy rate;[43] and several measures taken by the government to boost exports.[44] Imports are also likely to stay low if oil prices remain depressed.[45] The only difficulty comes from a possible slowdown in infrastructure spending in the Gulf at the back of depressed oil prices, which may hold back remittance growth in Pakistan.

In terms of the fiscal deficit, the government is targeting to lower this by one percentage point to 4.3 percent in FY16. This target, however, assumes 19.9 percent growth in FBR revenues (Rs 3,104 billion, compared to Rs 2,588 billion last year). This target appears challenging given that the global commodity prices are likely to stay low next year as well, which may exert downward pressure on tax collection (mainly customs duty and sales tax) and some of the non-tax revenues.

While these developments are indeed positive and set the stage for a sustained and high GDP growth in the medium term, the long standing growth hampering issues (continuing energy shortages, water scarcity, low tax-to-GDP ratio, sluggish investment rate) needs to be resolved on priority basis. The Vision 2025 aims at GDP growth of above 8 percent from 2018 and onwards. This would require a substantial boost to productivity levels, through investment in human capital. Furthermore, an effective and well-coordinated industrial policy is needed to attract investment, and expand industrial and export base. The resulting transition would not only help achieve higher growth in per capita income, this would also resolve FX constraints to growth.

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[41] The Cotton Crop Assessment Committee, in its last meeting held on 11th November 2015, estimated the cotton production for FY16 at 11.3 million bales. At this level, the cotton output not only misses the target of 15.5 million bales by a wide margin, this also remains lower than 14.0 million bales realized in the preceding year.

[42] The government has recently announced a relief package of Rs 341 bln for agriculture, which includes direct cash support (Rs 147 bln) and provision of soft agriculture loans (Rs 194 bln). We expect this package to compensate growers against the impact of lower commodity prices on their income.

[43] The PKR has depreciated by 2.5 percent and 3.8 percent against the US Dollar and Euro, respectively, during 30th June to 21st September 2015 period. As mentioned earlier, the ceiling rate of the interest rate corridor was further reduced to 6.5 percent in September 2015.

[44] The government has announced various measures to increase exports in Federal Budget 2015-16: (i) establishment of EXIM Bank of Pakistan; (ii) reduction in export refinance rate and long-term financing facility; (iii) establishment of land port authority; (iv) launch of Technology Up-gradation Fund; etc.

[45] OPEC is still pumping record volumes of crude oil despite low prices.