1 Overview

Pakistan's economy faced several challenges in the initial months of FY15. The fourth review of the Extended Fund Facility (EFF) could not be finalized in the early-August meetings with the Fund. This caused uncertainty in the FX market, as the fourth tranche was delayed. In mid-August, political events in Islamabad impacted the economic activity in the country. In September, floods inundated a large part of the country's agriculture heartland (Punjab), which damaged standing crops. It was feared these losses may push the price of perishable food items up, which fueled inflation expectations.

Against this backdrop, key macroeconomic indicators could not follow up positive developments observed in the second half of FY14.[1] Q1-FY15 saw higher deficits in the current and fiscal accounts, which had to be financed via domestic resources (**Table 1.1**). SBP's FX reserves fell slightly, and the PKR depreciated by 3.7 percent during the quarter. Meanwhile, the prospect of achieving the FY15 GDP growth target was hindered by a slowdown in LSM, and a below-target performance of *kharif* crops. The only exception was headline CPI inflation, which continued to decline throughout the quarter.

Table 1.1: Selected Economic Indicators

	Q1-FY14[E]	FY15[T]	Q1-FY15[E]
Growth rate (percent)			
LSM[a]	6.8	7.0	2.0
CPI (period average)[1,a]	8.1	8.0	7.5
Private sector credit[b]	-0.5	NA	1.6
Money supply (M2)[b]	0.2	NA	-0.1
Exports (customs)[a]	9.0	5.8	-10.4
Imports (customs)[a]	3.0	6.2	11.6
Tax revenue -FBR (billion Rs)[c]	475.3	2,810	537.9
Exchange rate (+app/-dep%)[b]	-6.0	NA	-3.7
billion US dollars			
SBP's liq. reserves (end-period)[b]	4.7	NA	8.9
Worker remittances[b]	3.9	16.7	4.7
FDI in Pakistan[b]	0.2	4.3	0.2
Current account balance[b]	-1.3	-2.8	-1.6
percent of GDP[2]			
Fiscal balance[d]	-1.1	-4.9	-1.2

[E] Provisional estimate; [T] Targets set by the government in the Annual Plan for 2014-15;
[1] YoY growth in the average of CPI index for the quarter;
[2] Based on the full-year GDP estimates stated in the Annual Plan for 2014-15; NA: not applicable.

Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

Having said that, there has been a marked improvement in the economy during the second quarter of FY15, which is likely to persist through rest of the year. Most importantly, global oil

[1]However, situation improved significantly during the second quarter of the year. For a more updated discussion, please see Section 1.2, and SBP's Monetary Policy Statement for January 2015.

prices have slumped to a five-year low, which is being passed on to domestic consumers (**Section 1.3**). The YoY November and December CPI inflation was only 4.0 and 4.3 percent respectively, which is the lowest in 13 years. Other than easing food inflation, lower oil prices would also help contain Pakistan's import bill and its trade deficit. Furthermore, discussions related to the fourth and fifth reviews of the IMF program, were concluded successfully in November, and the Board approval came through on 19th December 2014.

The IMF is broadly satisfied with the progress on economic reforms, and has released a combined 4th and 5th tranche of US$ 1.1 billion in December 2014. The government has already issued Sukuks in the international market worth US$ 1.0 billion, and is likely to get more external support via divestures, and additional funding from the World Bank, ADB, and coalition support fund. In this context, we expect less government demand from commercial banks in the remaining part of the year, which would then need to deploy their funds more productively with the private sector.

1.1 Economic Review

The government envisaged GDP growth of 5.1 percent for FY15. It is too early to conclude whether or not this target is achievable; however, preliminary estimates suggest some difficulties in the commodity producing sector. Farmers reduced the area used for sugarcane cultivation due to lower incomes last year, which caused a decline in its production. Although cotton was grown on a larger area this year, production is expected to remain below-target (**Chapter 2**).

The industrial sector is presenting a mixed picture. Higher cement dispatches, steel imports and strong PSDP spending, suggest a pick-up in construction activity in Q1-FY15 (**Section 2.2**). In contrast, LSM growth posted a decline in Q1-FY15, as local manufacturers faced gas shortages (especially in fertilizer, textiles, paper, glass and leather sectors). Furthermore, textiles also remain dull on account of lower demand for yarn and fabric from China and Bangladesh.

The fall-out of a weak commodity producing sector, can also be seen in *wholesale and retail trade* activity. However, the vibrancy in *finance and insurance*, and *telecommunications*, appears to have provided services a boost this year. While banks' profitability has been boosted by the volume of PIBs they carry in their portfolio, telecom benefited from the roll out of 3G/4G services in the country (see **Chapter 2**). Cellular firms have been spending heavily to upgrade their network, and as customers begin to use the wider set of services, this should have a strong positive impact on other services in the country (e.g., finance, advertising, entertainment, social networking, etc.).

Telecom based imports cost an *additional* US$ 188.3 million to Pakistan's import bill during Q1-FY15.[2] Steel imports added another US$ 233.3 million, whereas textiles (mainly synthetics) and fertilizer together chipped in US$ 166.6 million during the quarter. In overall terms, the country's imports grew by 11.6 percent during Q1-FY15, compared to only 3.0 percent in the same period last year.[3]

Commodity prices impacted Pakistan's exports, which declined by 10.4 percent during Q1-FY15, compared to an increase of 9.0 percent in the same period last year. The biggest decline was seen in naphtha, where prices are closely related to oil prices. Despite higher production, the export decline probably suggests that traders have been waiting for prices to stabilize (and recover) in the international market, before they offloaded their inventories. Furthermore, the decline in unit values of knitwear, ready-made garments and towels, eclipsed the quantum increase in export of these commodities. Furthermore, export of yarn and fabric remained low due to faltering Chinese demand, and declining exports of Bangladesh – countries that import textile raw-materials from Pakistan.

As a result, the overall trade deficit increased by US$ 1.6 billion in Q1-FY15, compared to the same period last year. This increase was partly compensated by US$ 765 million increase in home remittances during the quarter. A large part of this increase came from remittances from GCC countries, especially the UAE and Saudi Arabia. Construction-related Pakistani workers are benefiting from higher infrastructure spending in this region (especially Dubai). Additional support also came from the coalition support fund, which lowered the services deficit by US$ 401 million. In overall terms, this led to a US$ 332 million increase in the current account deficit in Q1-FY15 over last year, to reach US$ 1.6 billion. Financing this deficit remained a concern as foreign investments remained low, and official assistance was less than expected. Consequently, SBP's FX reserves declined by 1.7 percent, and the PKR depreciated by 3.7 percent during the quarter.

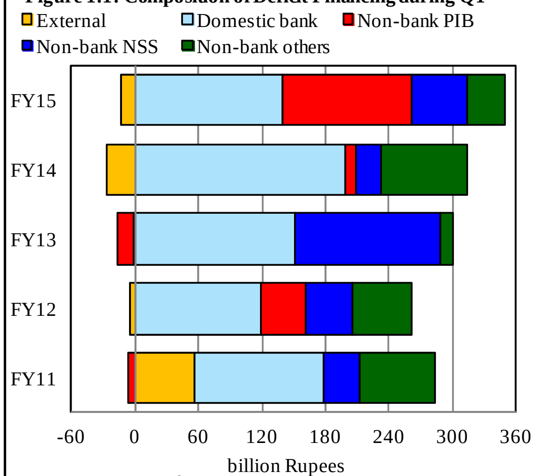
The rising current account deficit, coupled with the uncertainty in the FX market, was one of the key factors that guided SBP's decision to keep monetary policy tight during the quarter. The other important factor, CPI inflation, also raised some concerns initially – e.g., fears about flood-related crop losses, and a rise in electricity tariffs; but these gradually dissipated.

[2]Telecom imports increased by US$ 96.3 million in Q1-FY15, compared to Q1-FY14; whereas the import of data processing equipment were US$ 92.0 million higher than last year. This increase mainly reflects network up-gradation by telecom companies to provide their customers 3G/4G services.

[3] Source: Pakistan Bureau of Statistics

Nonetheless, SBP kept the discount rate unchanged, and also kept rupee liquidity tight in the interbank market. Overall money supply posted a net contraction of 0.1 percent during the quarter, against an expansion of 0.2 percent in the same quarter last year (these low values reflect the seasonal reduction in M2 during the first quarter of the fiscal year). In our view, tight liquidity was not the *major* factor behind this contraction; it was driven primarily by falling net foreign assets (NFA) of the banking system, and relatively contained government borrowing. Private sector credit posted an increase of 1.6 percent in Q1-FY15, compared to net retirement in the same period last year.

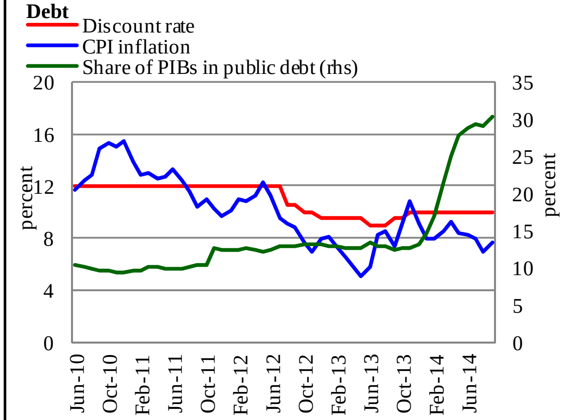
Figure 1.1: Composition of Deficit Financing during Q1



Source: Ministry of Finance

As far as government borrowing is concerned, it remained lower than last year because the government was able to borrow more from non-banks via PIBs and NSS (**Figure 1.1**). Within the banking system, instead of borrowing from the central bank, the government borrowed from commercial banks, which also remained lower than the same period last year. Banks' interest in PIBs persisted throughout the quarter, as the difference in rates between T-bills and PIBs, remained abnormally high. Furthermore, banks had been anticipating a cut in interest rates, which encouraged them to lock-in funds in PIBs (**Figure 1.2**).

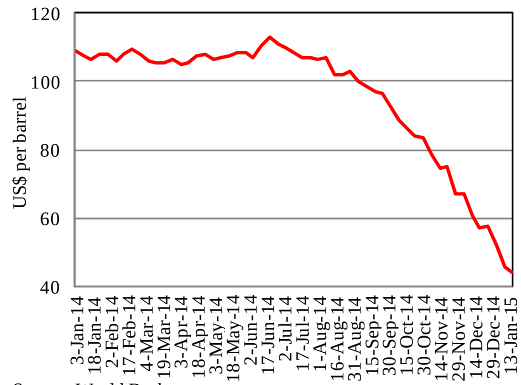
Figure 1.2: Inflation and the Composition of Domestic Debt



Source: State Bank of Pakistan

For the government, these placements helped improve the maturity profile of domestic debt, but would continue to increase its servicing burden. More specifically, the 31 percent YoY growth in interest payments during Q1-FY15, was the major factor responsible for a higher fiscal deficit during the quarter. On the other hand, the government was able to run a primary surplus, which reflects some expenditure restrain.

Figure 1.3: Weekly Global Crude Oil Prices (Saudi Arabian Light)



Source: World Bank

Revenue collection remained weaker than last year: the growth in total revenues came down from 19.9 percent in Q1-FY14, to only 1.2 percent in Q1-FY15. However, adjusting for the one-off factors that had inflated the non-tax collection last year, the total revenue growth increases to 8.4 percent for Q1-FY15.[4] The slowdown in tax revenues basically reflects a decline in collection under the gas development surcharge. Furthermore, the higher growth in Q1-FY14 had come primarily from a sharp rise in provincial tax revenues (especially by Punjab), that had started collection on services. This base effect was also not available in Q1-FY15.

1.2 Assessment and Outlook

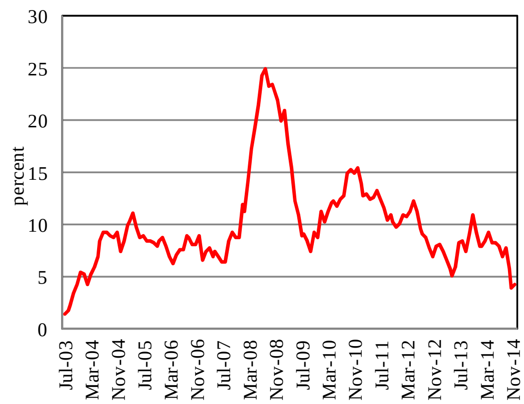
It has now been more than a year since Pakistan entered into the extended fund facility with the IMF. Structural reforms have been *initiated* in the fiscal and power sectors, and efforts are being made to build the country's FX reserves by mobilizing resources from the international market, and IFIs.[5] Furthermore, the government is currently evaluating various options of importing natural gas into the country, to alleviate the growing gas shortage that is adversely impacting domestic industry. From this perspective, the deterioration in key macroeconomic variables in Q1-FY15, suggest that the reform process in important sectors will take some time to materialize. However, we believe the broader consequences would not be as severe in subsequent quarters, as they were in the first quarter. Without doubt, the most important development is the sharp fall in global oil prices since the start of this fiscal year (**Figure 1.3**). Crude oil

[4] The government had mobilized Rs 67.0 billion from the universal service fund and Rs 56.7 billion from PSEs, in Q1-FY14; these one-off resources were not available in Q1-FY15.

[5] For instance, in FY14, the government issued euro bonds and divested UBL; whereas in FY15, it has issued Sukuk in the international market, as well as have plans to sell its stake in other entities (like HBL).

prices (Saudi Arabian Light) slumped by 60.4 percent during end-June to 16th January. It was expected that OPEC would cut back production when it met in Vienna on November 27th, but OPEC decided not to change its production strategy for the next six months – implying that a price recovery is not in sight.[6] The market responded to this decision by pushing prices down by 10.6 percent in the following week.[7]

Figure 1.4: Headline CPI Inflation in 12 Years



Source: Pakistan Bureau of Statistics

Pakistan's external sector would benefit most from the decline in oil prices, as petroleum directly makes up nearly 35 percent of our import bill. Inflation is also likely to end up much lower than initial expectations, as the government has steadily been reducing retail POL prices in line with international prices.[8] Headline inflation has reached a 13-year low of 4.0 percent in November and 4.3 percent in December, pushing down the Jul-Dec inflation to only 6.1 percent, against the full-year target of 8.0 percent (**Figure 1.4**). In addition to fuel prices, low inflation was realized by deflation in some key food items like wheat, wheat flour, onions and tomatoes. Furthermore, as has been mentioned in previous reports, households anchor their inflation expectations on energy and fuel prices. Based on these factors, we expect the full-year inflation to stay within the range of 4.5 – 5.5 percent in FY15.

The external position is also likely to improve in subsequent quarters. In addition to fuel prices, the following factors would contribute:

(i) Discussions with the IMF over the fourth and fifth reviews of the EFF have successfully been concluded. The Fund showed its satisfaction over the

[6] OPEC was divided on this issue, with Venezuela and Iran on one hand – wanting a cutback in oil production; and the Gulf and Russia on the other, allowing the oil prices to fall.

[7] Some analysts call this a new price war between Gulf countries and the US, while others call it OPEC's tactic to price out US firms that extract oil from shale formation. Whatever is the case, the depressed oil prices bode well for oil importing countries like Pakistan.

[8] After reducing petrol prices by Rs 1.1 per liter in Q1-FY15, the government made further reductions of Rs 2.9 per liter for October; Rs 9.4 per liter for November; and Rs 9.7 per liter for December 2014.

progress made and output growth, and released US$ 1.1 billion tranche in December 2014;

(ii) Pakistan has successfully issued Sukuk in the international market in November 2014.[9] Initially the target was set at US$ 500 million, but like the Euro Bonds, the Sukuk was oversubscribed and the government was able to mobilize US$ 1.0 billion;

(iii) After the divesture from UBL in FY14, the government is now planning to sell its stakes in ABL and HBL in FY15. These divestures would not only provide budgetary financing to the government, but could provide FX support of over a billion dollar during the year; and

(iv) There has been a broad-based recovery in exports in Q2-FY15 (2.7 percent YoY), along with a significant increase in FDI into the country (telecom sector).

This positive outlook on the external sector, and low inflation in the second quarter, provided SBP the room to cut the policy rate by 50 basis points to 9.5 percent in November. The timing of this cut was important, as seasonal demand for credit generally picks up in November and December. SBP has further reduced the policy rate by 100 basis points to a multi-year low of 8.5 percent, in January 2015.

As far as the fiscal sector is concerned, it might be challenging to achieve the consolidation target of 0.6 percentage points during the year.[10] In terms of revenue mobilization, FBR had envisaged a growth of 24.0 percent in tax collection during the year, but achieved only 13.1 percent growth in Q1-FY15. This leaves much to be done in the next three quarters. FBR revenues must increase by 27 percent in Oct-Jun, if it is to achieve the full-year target.[11] In addition, the significant decline in oil prices during the second quarter, may reduce government revenues from this source. On the expenditure side, interest payments will remain strong, but this growth may weaken keeping in view the market

[9] With an offered amount of US$ 2.3 billion, Sukuk was 5 times oversubscribed (Source: http://www.finance.gov.pk/releases_nov_14.html).

[10] Government has set the target of reducing fiscal deficit from 5.5 percent of GDP in FY14, to 4.9 percent of GDP in FY15.

[11] During the period Oct-Jun, tax collection has grown by an average growth of 17 percent in last five years.

expectations that the declining interest rate trend will continue. The government has already reduced the returns on PIBs and NSS instruments.[12]

As mentioned before, financing the deficit is likely to be less of a concern in the remaining quarters of the year. Nonetheless, important reforms are needed to reduce the structural component of the fiscal deficit. The government has formulated a medium-term strategy to implement fiscal reforms, ranging from improving revenue generation to promoting private sector participation in loss-making PSEs (like PIA and Pakistan Steel). Plans are also underway to restructure Pakistan Railways, Gencos and Discos, so that these PSEs can contribute positively to Pakistan's economic development. However, these plans should be fast-tracked, with a specific focus on their managerial and operational inefficiencies, and their spill-overs on the fiscal sector and the rest of the economy.

[12] In the PIB auction held on 20th November, the cut-off rate on 3-year PIBs was reduced by 160 basis points, compared to the previous auction (23rd October – before the monetary policy decision). On 5-year and 10-year PIBs, the government reduced the cut-off rates by 190 and 150 bps, respectively. Similarly, on NSS instruments, rate of returns were reduced as follow: 215 bps on regular income certificates; 167 bps on defence saving certificates; 200 bps on special saving certificates; and 132 bps on pensioners' benefit accounts.