1 Overview

After facing some headwinds in the initial months of the fiscal year, the economy ended the first half of FY15 with some notable positives:

- Most significant was the sharp improvement in the external account, as the sudden fall in international oil prices along with strong growth in remittances, helped contain the current account deficit in Q2-FY15.[1] This, along with the disbursement of tranches from the IMF, and the successful issuance of Sukuk in the international market, pushed up the country's foreign exchange reserves to a comfortable level.

- The resulting stability in the exchange rate, and the fact that the government passed on the benefit of lower global oil prices to domestic consumers, not only softened inflationary expectations, but also pulled down headline CPI inflation to a decade-low.[2] SBP, therefore, responded by softening its monetary policy stance in November 2014, for the first time since June 2013.

- Fiscal data indicates that the government was able to contain its deficit mainly due to low growth in expenditure during H1-FY15. Also, the financing mix improved as increased external funding reduced the burden on the banking system, particularly on the central bank. Consequently, for the first time in the current IMF program, the country met *all* the quantitative (performance) targets for end-December 2014 (**Chapter 3**).

Having said this, the persistent structural weaknesses continue to take a toll on the country's overall economic performance. For example, energy shortages continue to be a serious issue, which held back growth in a number of industries. Similarly, Pakistan has not been able to attract sufficient foreign direct investment, even when our peer countries are experiencing rising FDI inflows. Moreover, tax revenue growth remains sluggish despite several measures introduced during the year; and the losses in Public Sector Enterprises (PSEs) remained a burden on scarce fiscal resources, as the restructuring and privatization program of PSEs could not gain momentum as expected.

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[1] The current account deficit in Q2-FY15 was only US$ 770 million, compared to US$ 1.6 billion in the preceding quarter, and US$ 688 million in the same quarter last year.

[2] We believe the YoY decline in the prices of perishable items and the lagged impact of monetary tightening in the past also contributed to ease in CPI inflation.

In this context, the windfall gain from the collapse in international oil prices, low inflation, and the improvement in balance of payments, provide an opportunity to expedite difficult structural reforms in the energy sector, PSEs, revenue generation, and overall governance, to put the economy on a higher growth trajectory.

Review of H1-FY15

Preliminary information about the real sector suggests a mix picture of the economy. Prospects of a better wheat crop, and some improvement in minor crops, are likely to offset the performance of cotton and sugarcane. However, farmers' income may be adversely affected by higher input cost (especially fertilizer), and the decline in output prices of cash crops.

Table 1.1: Selected Economic Indicators

	H1-FY14	FY15 Targets	H1-FY15
Growth rate (percent)			
LSM[a]	6.6	7.0	2.3
CPI (period average)[a]	8.9	8.0	6.1
Private sector credit [b]	9.6	na	6.0
Money supply (M2)[b]	6.0	na	4.4
Exports (customs)[a]	4.9	5.3	-4.4
Imports (customs)[a]	-1.1	4.2	11.7
Tax revenue -FBR (billion Rs)[c]	1,031.5	2,691[#]	1,171.9
Exchange rate (+app/-dep%)[b]	-5.4	na	-1.7
billion US dollars			
SBP's reserves (end-period) [b]	3.5	na	10.5
Worker remittances [b]	7.8	16.7	9.0
FDI in Pakistan [b]	0.4	4.3	0.5
Current account balance [b]	-2.0	-2.8	-2.4
percent of GDP[*]			
Fiscal balance[d]	-2.1	-4.9	-2.2

*: Based on the full-year GDP estimates stated in the Annual Plan for 2014-15. na=: not applicable.
#: Original FBR target was Rs 2,810 billion.

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

Large scale manufacturing (LSM) showed modest growth of 2.3 percent during H1-FY15, less than half the growth achieved during the same period last year (**Table 1.1**).[3] While the persistent energy shortages (especially of gas) constrained activity in textiles, paper, leather & glass, the delay in cane crushing took its toll on sugar production in the first half of the year.[4] However, a number of other sectors showed healthy growth, e.g., automobiles, electronics, and construction related industries like cement, steel, glass & paints, and rubber products. These sectors benefited primarily from a decline in global iron, steel and coal prices.

[3] However, this growth number for LSM should be used with caution, given some issues in the compilation of LSM data (see **Chapter 2** for detail).
[4] It is expected that sugar production would remain low in the full year, as sugarcane production declined by 5.3 percent over the last year.

While hard numbers for services are not available, we believe it will be challenging to achieve 6.1 percent growth in *wholesale and retail trade* (the largest sub-sector of GDP[5]) due to the weak performance of commodity producing sectors. However, overall services can benefit from encouraging performance of communication, finance & insurance, and government services.[6] While communication services are expanding following the auction of 3G/4G spectrum licenses, the value addition by *finance and insurance* is set to take advantage from strong profitability of the banking sector, primarily driven by massive investments in risk free government securities and increasing income from other banking services.

More specifically, commercial banks' investment in government securities increased by Rs 667.6 billion during H1-FY15, to Rs 4,735.0 billion. Throughout this period, commercial banks participated aggressively in primary auctions of longer-term securities as they anticipated a cut in the policy rate and also took advantage of the healthy term premium on PIBs. The government also accepted huge sums in these auctions to lengthen the maturity profile of its debt, and to substitute some of its borrowings from SBP. This enabled the government to contain its borrowing from SBP within the ceiling agreed with the IMF for end December 2014,[7] and meet the limit of zero quarterly net borrowing from the central bank under the amended SBP Act 1956.

Significant government borrowing from commercial banks, partly contributed to low private sector credit off-take, which was Rs 222.3 billion during H1-FY15, compared with Rs 321.3 billion in the same period last year. On the other hand, demand for bank loans was also low due to soft commodity prices (especially cotton, rice, and sugar cane), and a slowdown in LSM.

Encouragingly, the benefit of reduced international oil prices was passed on to consumers in Pakistan, to a larger extent compared with peer economies (see **Box 1.1**). This, along with a stable exchange rate and softened inflationary expectations, led to a steep fall in CPI inflation from 8.9 percent in H1-FY14, to only 6.1 percent during H1-FY15. As these factors are expected to prevail also in the remaining part of the year, the current low inflationary trend is likely to

[5] Wholesale & retail trade has a share of 20.2 percent in the GDP, followed by livestock (13.2 percent) and large-scale manufacturing (11.6 percent).
[6] Government expenditures on campaign against militancy, and facilitating internally displaced peoples (IDPs) are also counted towards value added by *General government services* – a sub sector of GDP.
[7] This also allowed SBP to meet its NDA ceiling agreed with the IMF for end December 2014.

continue. In fact, the results of IBA-SBP's Consumer Confidence Survey (CCS) also indicate subdued inflationary outlook (**Chapter 3**).

These developments allowed for a policy reversal: SBP reduced the policy rate by 50 bps in November 2014 – after keeping it unchanged for a year. SBP further reduced the policy rate in the subsequent two monetary policy decisions, by a cumulative 150 bps, taking it to a decade low of 8.0 percent. SBP supplemented these decisions with increased OMO injections from November 2014 onwards.[8] Crossing the level of Rs 500 billion in December 2014, these injections helped commercial banks meet the liquidity needs of both the government and private sector.

The cut in policy rate also helped normalize the earlier disconnect between T-bill and PIB segments of the yield curve. T-bill yields declined in line with the cut in policy rate, but the impact on PIB yields was more pronounced as banks were more aggressive in bidding up their prices (which reduced yields). This trend was supported by relatively low appetite for borrowing by the government, which can be linked to better availability of external funding, and the government's decision to remain around the target in PIB auctions.

In terms of the country's fiscal performance, the budget deficit as percent of GDP was slightly higher than the last year's level.[9] The government (federal and provincial combined) was able to contain expenditures growth to only 4.8 percent in H1-FY15, compared with 10.7 percent in H1-FY14, mainly due to a fall in interest payments.[10] Encouragingly, non-interest current expenditures were also controlled, while development expenditures showed a robust growth (**Chapter 4**).

However, revenue collection continued to be a major concern. Total revenue (federal and provincial) grew by only 5.0 percent in H1-FY15, compared with 13.9 percent last year. Even after adjusting for one-off inflows that had increased non-tax receipts in Q1-FY14, revenues showed a deceleration.[11] Although the government introduced several tax measures in the Budget for FY15, FBR revenues increased by only 13.6 percent during H1-FY15, compared with 16.0

[8] It is important to note that SBP cautiously kept the rupee liquidity tight during initial months of the year, to avoid any unnecessary pressures on the exchange rate, among other considerations.
[9] In H1-FY15, fiscal deficit was 2.2 percent of GDP compared to 2.1 percent in H1-FY14.
[10] The interest payments declined by 4.2 percent YoY in H1-FY15, as compared to an increase of 8.2 percent in the same period last year.
[11] In fact decline in non-tax revenues was already expected, as some one-off inflows, which were available last year (including universal service fund and the mark-up from PSEs against the circular debt settlement), were unlikely to recur this year. This is why budget target of non-tax revenues was set at Rs 874 billion for FY15 – less than the actual receipts of Rs 1,002.4 billion last year.

percent in the same period last year.[12] More worryingly, to achieve its revised target of Rs 2,691 billion by fiscal year-end, FBR has to realize revenue growth of 24.2 percent in the second half of FY15 – undoubtedly a challenging task.[13]

This task becomes more complicated due to the decline in fuel prices that may reduce POL-related revenues. The government has tried to compensate for this by increasing the sales tax rate on petroleum products. Tax collection may also benefit from a rise in POL sales. Further, some revenue impact is also expected from regulatory duties recently imposed on imports of a number of items. While these ad hoc measures may lift revenues to some extent, there is a dire need to address structural issues in the tax colleting system.

The sharp fall in international oil prices has positively impacted Pakistan's external sector. It saved over US$ 691 million in the country's oil import bill, which helped reduce the current account deficit in the second quarter (C**hapter 5**).[14] Healthy growth in remittances also remained a vital source of support, as it financed almost 40 percent of the country's import bill during H1-FY15. Further, around 80 percent of the annual remittance target has already been achieved up to March 2015, which suggests that remittances could easily surpass the target for yet another year.

Financing of the current account deficit was easier during the second quarter of FY15. The issuance of Sukuk in the international market was a success: it was oversubscribed and the government was able to mobilize US$ 1.0 billion, which was double the initial target. Moreover, the successful completion of the 5th review of the IMF program resulted in the disbursement of US$ 1.1 billion during Q2-FY15. These inflows pushed up the country's foreign exchange reserves to a comfortable level. As things stand, SBP's liquid reserves cover more than 3-month import of goods, and were more than sufficient to meet end-December 2014 IMF target of SBP's net international reserves (NIR). In the process, the PKR appreciated by 2.1 percent during the second quarter of the year.

[12] For instance removing exemptions, expanding the scope of withholding tax, increasing rates of different taxes have been announced in the budget. For details, see Box 4.1 in First Quarterly Report 2014-15.

[13] Although growth in tax collection usually increases in the later part of the year, the required growth this year is significantly higher than the average in H2 of last five years.

[14] Pakistan's oil payments have reduced from US$ 3.8 billion in Q2-FY14, to only US$ 3.1 billion in Q2-FY15. The current account deficit for H1-FY15 was US$ 2.4 billion, which was 20.7 percent higher than the same period last year; however, this increase was primarily due to high trade deficit in the first quarter of the year. Trade deficit during H1-FY15 was US$ 9.8 billion, 61 percent of which was incurred in Q1.

Outlook

In our view, some of the key positives in H1-FY15 will continue into the second half of the year, especially in the external sector. Several FX inflows have realized in H2-FY15, including: coalition support fund; proceeds from the further divesture of HBL; receipts from the IMF; and more are expected like disbursements from the ADB, World Bank and other sources. Furthermore, remittances are likely to maintain their robust growth for the rest of the year. While export growth will probably remain modest, the country's import bill will remain comfortable due to lower oil prices and imposition of regulatory duties on a number of items (see **Section 5.3**).

With this comfort in the balance of payments, the exchange rate is expected to remain stable in the second half, which coupled with low fuel prices, will continue to dampen inflationary expectations. SBP projects CPI inflation in the range of 4 to 5 percent for the whole year, compared with the original target of 8 percent.

We expect credit to the private sector to pick up, as sugarcane crushing gains momentum, and reduction in interest rate stimulates credit demand by businesses. Supply side of the credit to the private sector may also improve, as borrowing by the government is likely to be within target, with the availability of funds from external resources.

However, government borrowing for commodity operation may experience some pressure with the procurement drive for wheat. Purchasing wheat at the support price of Rs 1,300 per 40 kg, would lock-in a significant amount of money in wheat finance, unless existing stocks are offloaded. The ability to offload is challenging as a glut-like situation in the international market dampens export prospects, whereas available stocks and a large (expected) crop size, may not allow the government to break-even in the domestic market (**Chapter 2**). Already the outstanding stock of wheat procurement loans stood at Rs 363 billion by end-December 2014.

The full-year budget deficit is expected to remain higher than the target of 4.9 percent of GDP for several reasons: (i) the required growth rate for tax collection during H2-FY15, to achieve the revised target, is high; (ii) interest payments may increase in H2-FY15 with the 6-monthly coupon payments on PIBs in January 2015;[15] (iii) PSDP spending generally remains higher in the second half; and (iv) expenditures on Zarb-e-Azb, and rehabilitation of IDPs cannot be compromised

[15] The interest payments on domestic debt in January 2015 were Rs 208.3 billion (more than 80 percent of which were related to PIBs), compared with Rs 103.8 billion in January 2014.

on. Moreover, pressure from power related subsidies may continue despite a decline in generation cost (due to a reduction in global oil prices). Furthermore, the power sector continues to suffer from high transmission & distribution losses, and persistent shortfall in recoveries – how these costs would be settled at the year-end, remains to be seen.[16]

Finally, GDP growth is likely to remain higher than last year's level. A better wheat crop, on the back of favorable weather conditions and increase in support prices, may compensate for the sluggish performance of *kharif* crops. Construction is set to improve as more PSDP funds are released by the federal and provincial governments. While the challenges faced by LSM may continue, the services sector is likely to maintain last year's growth momentum.

[16] In the past, the government had to step in for the settlement of outstanding payables/receivables of the power sector.

Box 1.1: Decline in Crude oil Prices and Pass through to Domestic Gasoline Prices

The international oil prices saw a steep decline in H1-FY15, partly on account of weak demand in the global economies, and to some extent, due to substitution to other fossil fuels. In response, countries across the world have been passing on the benefit of lower international oil prices to their end-consumers. The magnitude of this pass through, however, varies across countries, depending upon their economic situation and the mechanism for fuel price determination.

Figure 1.1.1: Decline in Local Gasoline Price

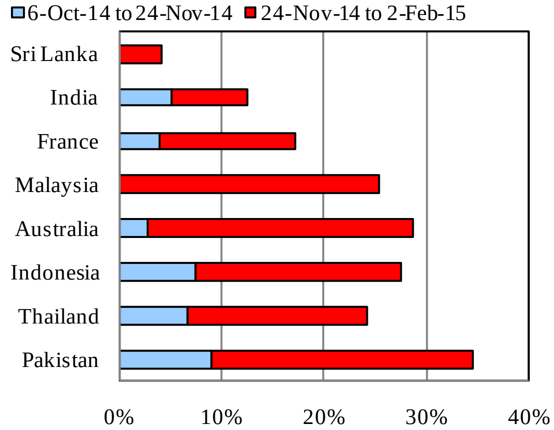
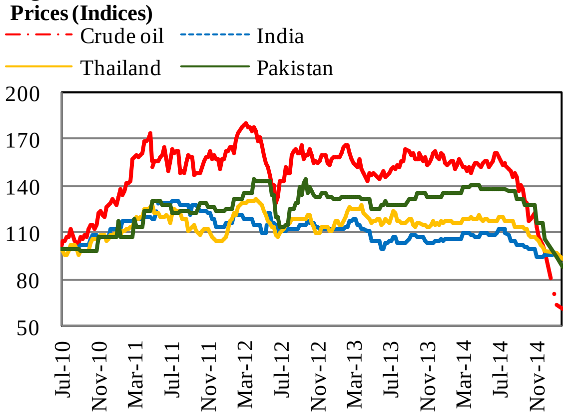


Figure 1.1.2: Trend in Crude Oil and Local Gasoline Prices (Indices)



Source: Bloomberg

It is clear from **Figure 1.1.1** that during the period from Oct 2014 to Feb 2015, Pakistan has gone beyond many regional economies (and also some advanced countries), in passing-on this relief to domestic consumers even after considering all taxes. In overall terms, the local gasoline prices fell by 34.6 percent during the last four months.[17]

In fact the domestic oil prices in Pakistan follow the global prices more closely, as these are deregulated with a defined pricing mechanism. Interestingly, the historical movements in domestic petroleum prices show a generally higher pass-through as compared to other regional countries, like India and Thailand, also having deregulated pricing mechanism (**Figure 1.1.2**).

Although the reduction in domestic fuel prices in Pakistan has adversely affected tax collection, the pass-through will benefit private sectors businesses, which are more efficient. Moreover, this will also help contain inflationary expectations, which is instrumental for macroeconomic stability.

[17] Gasoline prices, which are sourced from www.globalpetrolprices.com, are available from 6th October 2014. The growth in the index of World Crude Oil Prices is calculated from Haver Analytics while of Pakistan from the Pakistan Bureau of Statistics.