THE STATE OF PAKISTAN'S ECONOMY

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Acknowledgment

Analysts:

Chapters:

1. Overview	Mahmood ul Hasan Khan
2. Real Sector	Syed Sajid Ali; Muhammad Akmal; Sabahat; Imtiaz Hussain
3. Inflation and Monetary Policy	Mahmood-ul-Hasan Khan; Syed Zulqernain; Amjad Ali
4. Fiscal Policy and Public Debt	M. Farooq Arby; Muhammad Shamil; Syed Tariq; Muhammad Idrees
5. External Sector	Asma Khalid; Junaid Kamal; Naila Irem
Formatting:	Muhammad Idrees

Publication Manager: Mahmood ul Hasan Khan

Director: Muhammad Farooq Arby

Publication Review Committees:

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For feedback and queries: quarterly.report@sbp.org.pk

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1 Overview

Taking comfort from visible improvement in macroeconomic environment, SBP initiated monetary easing in FY15, which continued during the first quarter of FY16.[1] This policy stance was augmented by a pro-growth budget for FY16.[2] In addition, marked improvement in security conditions, relatively better energy management, and persistently low global commodity prices, have positioned the economy to further improve on its performance going forward.

Table 1.1: Selected Economic Indicators

	Q1-FY15	Q1-FY16[P]
Growth rate (percent)		
LSM[a]	2.6	3.9
CPI (period average)[1, a]	7.5	1.7
Private sector credit [2, b]	1.3	-0.6
Money supply (M2)[2, b]	-0.1	1.1
Exports [a]	-10.4	-14.1
Imports [a]	11.6	-14.7
Tax revenue (billion Rs) [c]	537.9	600.0
Exchange rate (+app/-dep%) [b]	-3.7	-2.6
million US dollars		
SBP's liq. reserves (end-period) [b]	8,943	15,245
Worker remittances [b]	4,775	4,967
FDI in Pakistan [b]	201	248
Current account balance [b]	-1,631	-351
percent of GDP		
Fiscal balance[d]	-1.2	-1.1

[P] Provisional estimate.
[1] YoY growth is the average of CPI index for the quarter;
[2] Percent change in September over June.
Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance.

Some improvements were already visible from the changes in key macroeconomic indicators during the first quarter of the year. Economic activity seems to be gearing up as large scale manufacturing recorded a noticeable increase over the last year.[3] The current account deficit narrowed, which was comfortably financed by higher financial inflows; the country's FX reserves recorded all time high levels, and were sufficient to finance

[1] The policy rate was reduced by 400 bps to multi-decade low of 6.0 percent by end-September 2015. It was kept unchanged in the monetary policy decision of November 2015.
[2] Special emphasis on infrastructure projects (under China-Pakistan Economic Corridor) in the budget is a key to support investment activity.
[3] Increase in LSM during Q1-FY16 can be termed broad based as food (including edible oil and beverages), automobiles, fertilizer, pharmaceutical, cement and chemicals sectors posted higher growth over Q1-FY15.

import bill of seven months;[4] fiscal deficit was reduced, along with a shift in its financing away from SBP; and inflation remained on low trajectory (**Table 1.1**).

While these positive developments are welcome, much needs to be done to ensure their sustainability. Following are some points of concern:

- Although budget deficit for Q1-FY16 was lower than the same period last year, tax collection could not post the required growth. In order to keep the fiscal deficit within target without compromising on development spending, tax efforts have to be increased manifold, particularly by widening tax base and effective enforcement;[5]
- Loss making PSEs remained a contingent liability on scarce fiscal resources. The privatization process of such PSEs is still at initial stages. This must be expedited to improve quality of services, and stem losses to the exchequer;[6]
- Dwindling exports continued to eclipse overall healthy performance of the external sector. Specifically, exports recorded a YoY decline for the 3rd quarter in a row. More disturbingly, this decline was attributed primarily to lower quantums;[7]
- In addition to exports, FDI also needs to contribute more towards external sector sustainability. While it is encouraging that FDI from China is likely to increase due to progress on various infrastructure projects under the CPEC, the country also requires foreign investment in exportable sectors;[8] and

[4] Traditional rule of thumb, which is widely used to assess the reserve adequacy of the country, suggests the import coverage of three months.
[5] With recent tax measures, FBR taxes showed a YoY growth of 16.8 percent in Jul-Nov FY16.
[6] So for the privatization process has been confined to divesting government shares in profitable institutions through capital market transactions.
[7] The risks to external sector also arise from international developments: weaker external demand could further hurt already declining exports; and the Fed's initiation of the first cycle of interest rate hikes since 2006 carries the risk of unbalancing the currency markets.
[8] Key constraining factors for foreign investment are energy constraints, weak external demand, security concerns and inconsistent government policies (as also identified by Overseas Investors Chamber of Commerce & Industry (OICCI) in their latest survey of Business Confidence Index).

- Extreme weather conditions in recent years have increased vulnerability of Pakistan's agricultural sector. In FY16 also, *Kharif* crops (cotton and rice) have suffered from heavy rainfall.[9]

Finally, it is encouraging that 9th review of the IMF program has been completed successfully and several important reforms have been introduced, like independent statutory Monetary Policy Committee, Credit Bureaus Act, etc. However, the slow progress on privatization process, and persistent distribution & transmission losses in the power sector remain a challenge.

1.1 Economic review

The government envisaged GDP growth of 5.5 percent for FY16, anticipating better performance in all three economic sectors compared with the last year. Initial assessment suggests that achieving this target would be challenging. Major *Kharif* crops incurred losses due to depressed prices of agri products, and unfavorable weather conditions.[10] The preliminary estimates of cotton and rice production are not only well below their respective targets, but also indicate a decline compared to the last year's levels. In fact, heavy rains in July 2015 inundated a large area under rice and cotton, which reduced their average yield. The cotton crop also suffered from pest and virus attacks, due to moist weather in the subsequent period.

Industrial activity has gathered pace as large-scale manufacturing (LSM) recorded a growth of 3.9 percent during Q1-FY16, compared with a growth of 2.6 percent during the same period last year. This improvement was a function of: (i) continued softening of international as well as domestic prices of industrial raw material; (ii) better energy management, especially gas supplies to fertilizer plants; (iii) strong demand for construction material, such as cement, and steel; and (iv) pick-up in auto financing, which helped achieve a higher growth in auto

[9] Nonetheless, the agriculture sector continued to benefit from Crop Loan Insurance Scheme and Livestock Insurance Scheme introduced by SBP. Moreover, the announcement of Kisan package is also a welcome development to support farmers.

[10] Depressed prices of cotton and rice in the previous season, seems to be a major reason for a decline in area under cultivation of these crops. It seems, some of the farmers used their lands for other crops, e.g., spring maize, fodder, vegetable, etc. This shift may offset some of the losses to overall value-added in crop sector due to cotton and rice.

production. Given the strong backward and forward linkages, healthy growth in the industrial sector bodes well for overall economic activity.
The performance of the services sector is yet to reflect a clear sign of improvement. While the strong profitability of the banking system and a visible improvement in *transportation, storage and communication* are key positives, the situation for *wholesale & retail trade* (the biggest component of the services sector) remains unclear. The assessment of commodity producing sector suggests that damages to *Kharif* crops would reduce value addition of this sub-sector, whereas better performance by the large scale manufacturing is positive for *wholesale & retail trade*.

The services sector may also benefit from higher import quantum. Although the country's imports plummeted by 14.7 percent in Q1-FY16, this was largely attributed to low unit prices, which overshadowed the modest increase in import quantum. Exports also declined by 14.1 percent in Q1-FY16, compared with a fall of 10.4 percent in Q1-FY15. Unlike imports, the decline in export was caused by both quantum and price. In fact, quantum impact was dominating and the demand for most items posted a decline during the quarter.[11]

While both imports and exports posted a decline, the fall in imports was more pronounced, which reduced the trade deficit by 22.4 percent during Q1-FY16. This, together with a modest increase in remittances and continuation of CSF inflows, narrowed the current account deficit significantly.[12] To be specific, current account deficit for Q1-FY16 was only US$ 0.35 billion, compared with a deficit of US$ 1.6 billion in Q1-FY15. This small deficit was comfortably financed by inflows from the issuance of Eurobond;[13] commercial borrowings by

[11] Export quantum of cotton fabric, bed wear, readymade garments, seafood, fruits, leather and leather products, actually declined during the quarter.
[12] Remittances posted a growth of only 4 percent during Q1-FY16, compared to a growth of 22 percent during Q1-FY15. This sharp deceleration was largely attributed to a seasonal phenomenon. Similarly, the country received CSF inflows of US$ 713 million in Q1-FY16. For details, see **Chapter 5** on External Sector.
[13] Tapping into the international market, the government issued a 10-year maturity Eurobond at the cost of 8.25 percent (per annum) in the last week of September 2015. The bond was oversubscribed, and top class investors from different regions purchased the bonds. Specifically, 38 percent of the subscription was from North America; 38 percent from UK; 12 percent from Europe; and 12 percent from Asia.

the government; and an increase in FDI (though still persisting at low levels).[14] The external sector also benefited from the release of 8th tranche of the IMF program. As a result, the country's total FX reserves increased by US$ 1.4 billion to reach an all time high level of US$ 20.1 billion by end of the first quarter. These could easily finance 7 months of the country's import bill.

It is interesting to note that the buildup of FX reserves has accompanied with 2.6 percent depreciation of the PKR against the US Dollar during the quarter. This depreciation was concentrated in August 2015, as a chain-reaction of turmoil in Asian stocks and currency markets exerted pressure on the PKR.[15] Chinese Yuan was devalued by 2.7 percent in early August, which was followed by depreciation of other currencies in the Asian region.[16]

The PKR exchange rate, which anchors inflation expectations of businesses and directly impacts domestic prices of imported goods, created an upward pressure on inflation. However, this impact was more than offset by the swift pass-through of a fall in international commodity prices to domestic consumers during the quarter.[17] On aggregate, average CPI inflation was 1.7 percent in Q1-FY16, compared with 7.5 percent in the same period last year.

Lower commodity prices (especially of cotton and rice) also impacted credit flows during the quarter, by reducing the demand for working capital loans. In absolute terms, credit to the private sector contracted by Rs 25.4 billion in Q1-FY16, compared with a net expansion of Rs 47.0 billion in Q1-FY15. To put these numbers into context, it must be noted that: (a) average gross disbursements during Q1-FY16 were much higher over the same period last year; (b) long-term loans (fixed investment loans) recorded a net increase of Rs 27.0 billion during the quarter, against a net contraction of Rs 27.4 billion in Q1-FY15; and (c) credit

[14] FDI posted an increase of US$ 47 million during the first quarter of FY16, to reach US$ 248 million by end-September 2015. This increase was primarily on account of inflows from China in a coal-based power projects. Net FDI inflows from China stood at US$186 million in Q1-FY16, compared to a marginal inflow of US$ 2.2 million in the same period last year.
[15] PKR moved from 101.9 per US$ on 20th August 2015, to Rs 104.1 per US$ on 26th August 2015.
[16] For instance, currencies of Vietnam, Taiwan and India depreciated by 1.6, 3.1 and 2.2 percent, respectively.
[17] Nonetheless, CPI inflation picked up in the months of October and November 2015.

expansion in the last year was an exception, as the first quarter of the year is generally a period of retirement in the credit cycle of Pakistan.[18]
The contractionary impact of net retirements in credit to private sector on M2 was overshadowed by the expansionary impact of government borrowing from the banking system, and higher external inflows. Specifically, a visible improvement in external accounts led to a sharp increase in the NFA of the banking sector. As a result, broad money supply grew by 1.1 percent during Q1-FY16, in contrast with a contraction of 0.1 percent during the same period last year.

Another important development in the monetary sector, was increased liquidity injections by SBP through open market operations (OMOs) to ensure that the interbank overnight repo rate remain close to the policy rate. The volume of OMOs peaked at Rs 1,374.0 billion in the last week of September 2015. However, the expansionary impact of these injections was largely offset by the net retirement in government borrowing from SBP. Specifically, the government retired Rs 304.4 billion in Q1-FY16 to SBP, which was 7.8 times the amount retired in the same period last year.[19] As a result, the government was able to contain its budgetary borrowing from SBP within the IMF target for end-September 2015, and the quarterly limit of zero budgetary borrowing as prescribed in the SBP Act.

However, net retirements to SBP were primarily financed by government borrowing from commercial banks, which stood at Rs 443.8 billion for Q1-FY16 compared with Rs 178.9 billion in Q1-FY15. Despite this, overall amount of government borrowing from the banking system in Q1-FY16 remained unchanged at the last year's level. This containment in government borrowing reflects an improvement in fiscal accounts.

The budget deficit in the first quarter of FY16 was 1.1 percent of GDP, compared with 1.2 percent last year. The improvement was largely attributed to deceleration in current expenditures. Overall fiscal spending grew by 7.2 percent during Q1-FY16, which was much lower than the 12.7 percent increase in the same quarter last year. Encouragingly, the deceleration was entirely due to a strict control on

[18] It may be recalled that credit expansion in Q1-FY15 was primarily driven by trade financing, which do not follow a clear seasonal pattern. Specifically, import financing saw a huge increase of Rs 49.5 billion during the quarter due to unusually higher imports of fertilizer, basic metals, petroleum products and edible oil.
[19] The government has retired Rs 738.6 billion to SBP from June 2014 to September 2015.

current expenditures of the federal government, while the PSDP in Q1-FY16 saw a hefty rise of over 50.0 percent. Though total revenues increased by 11.6 percent in Q1-FY16 compared with only 1.2 percent in Q1-FY15, the growth was below the required level to contain fiscal deficit for FY16 at the targeted level.
Cognizant of aforementioned macroeconomic developments, SBP continued with monetary easing in Q1-FY16. The policy rate was slashed by 50 bps in September 2015 to decades' low level of 6.0 percent. This monetary easing together with a sharp increase in development spending, paved the way for healthy economic activity.

1.2 Outlook for FY16

Despite interest rate hike by the US and a slowdown in China's economy, Pakistan's external sector outlook can be termed positive for the year. The trade deficit is likely to benefit from a sharp fall in prices of commodities in recent months.[20] Moreover, these prices are likely to persist at low levels due to abundant supplies, sufficient inventories and weak demand (especially of industrial raw materials).[21]

Table 1.2: Key Macroeconomic Targets and Projections

		FY16	
	FY15	**Target[1]**	**Projection[2]**
		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[2]	19.0	19.0 – 20.0
Exports (fob)	24.1[2]	25.5	22.9 – 23.4
Imports (fob)	41.1[2]	43.3	40.0 – 41.0
		percent of GDP	
Fiscal deficit	5.3[3]	4.3[3]	4.0 – 5.0
Current a/c deficit	1.0[2]	1.0	0.5 – 1.5

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

The resulting relatively low trade deficit, will be largely offset by workers' remittances, and expected CSF inflows. While the pace of increase in workers' remittances is likely to be modest (as compared to the last year), we expect remittances to comfortably surpass the target for the year. This, together with lower freight charges would help contain current account deficit around 1.0 percent of the GDP (**Table 1.2**). The financing of this deficit may not

[20] Details indicate that prices of international commodities, which Pakistan imports (oil, metals, edible oil & fertilizer) have fallen at a faster pace as compared to the prices of our exportable items (cotton and rice).
[21] For details, please see World Bank's 'Commodity Market Outlook' of October 2015.

be an issue due to higher expected inflows, on account of project loans from China, and from international financial institutions (IFIs).

Loan disbursements during first four months of FY16 stood at 21.6 percent of the budgeted inflows, suggesting higher inflows for the rest of the year. These inflows would coincide with higher external debt repayments during the second half of the year, as the maturity of 10-year Eurobond (issued in FY06) would fall during the second half of the year. It is expected that the country's FX reserves will remain at an adequate level with the support of these debt inflows. However, the non-debt inflows (especially exports and FDI) will remain a challenge.[22]

While the slump in global commodity prices will continue to keep domestic CPI inflation low, there are some factors which pose upside risks to inflation: (a) an upward adjustment in domestic prices of energy products (electricity and gas); (b) the PKR depreciation of 2.8 percent against US$ since end-June 2015 till 21st December 2015; (c) additional taxation measures to make up for the shortfall in tax revenues;[23] and (d) expected higher growth in broad money supply, which could contribute to inflation by stimulating aggregate demand in the economy. The latest Consumer Confidence Survey (CCS) conducted in November 2015 indicates small build up of inflation expectations. However, despite these possible pressures, we expect CPI inflation to remain well below the target of 6 percent for FY16.

In the real sector, we expect a boost to construction and its allied industries due to progress on projects under the CPEC. LSM has already posted a notable increase in Q1-FY16, which is expected to strengthen further due to: (i) a marked improvement in security condition; (ii) better availability of electricity and gas; (iii) lower cost of industrial raw material; and (iv) historic low interest rates. Moreover, auto sector is likely to benefit from the modest recovery in auto financing and the government's *Apna Rozgar* scheme.

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[22] Pakistan's exports have posted a decline of 10.7 percent YoY in Jul-Nov FY16. In case of FDI, inflows have reached US$ 540 million in Jul-Nov FY16, compared to US$ 498 million in the same period last year.

[23] The government has imposed regulatory duty on a wide range of luxury and non-seasonal items. The customs duty on imports of goods has also been increased by 1 percentage point.

The agriculture sector is passing through a vulnerable time. Damages to major *Kharif* crops are less likely to be compensated by *rabi* crops. Moreover, farm income has taken a hit due to persistent low prices of agri products, and the losses inflicted by bad weather. Cognizant of these hardships, the government's *Kisan* package is likely to ease financial constraints of small farmers to an extent. In addition, reduction in tax rate on the import of agriculture machinery, and tax holiday for Halal food processing industry, would support livestock sector in the coming years. Nonetheless, the immediate impact of these measures on agriculture growth in FY16, seems to be limited.

Finally, the services sector paints a mixed picture. Healthy growth in *transport, storage & communication* and *finance & insurance* should be balanced against the unclear situation of *wholesale & retail trade.* While a better performance of LSM is positive for *wholesale & retail trade*, the losses from *kharif* crops would reduce the value addition under this sub-head.

2 Real Sector

2.1 Overview

The Annual Plan envisages a GDP growth target of 5.5 percent for FY16, compared to 4.2 percent realized in the preceding year (**Table 2.1**). The higher growth assumes a recovery in the crop production; improvement in energy supply; and increased investment under China Pakistan Economic Corridor (CPEC). The energy and infrastructure projects are the key components of the FY16 growth strategy for their increased focus on projects related to power, transport and communication subsectors – these projects also have large spillover impact on construction and manufacturing activities.

Table 2.1: GDP Growth

percent

	Share	Growth	
	FY15	**FY15**	**FY16^T**
Agriculture	**20.9**	**2.9**	**3.9**
Major crops	5.3	0.3	3.2
Other crops	2.3	1.1	4.5
Livestock	11.8	4.1	4.1
Industry	**20.3**	**3.6**	**6.8**
Large scale	10.6	2.4	6.0
Electricity gen& distt and gas distt	1.7	1.9	6.0
Construction	2.4	7.0	8.5
Services	**58.8**	**5.0**	**5.7**
Wholesale and retail trade	18.3	3.4	5.5
Transport, storage & comm	13.4	4.2	6.1
Finance and insurance	3.1	6.2	6.5
Housing services	6.8	4.0	4.0
General government services	7.4	9.4	6.0
Other private services	9.9	5.9	6.4
GDP	**100.0**	**4.2**	**5.5**

Source: Pakistan Bureau of Statistics; Targets are sourced from Annual Plan for 2015-16 issued by Planning Commission

T: Target

So far, prospects of achieving the target GDP growth have become challenging due to damages to FY16 *kharif* crops. Preliminary estimates suggest below-target production for all major *kharif* crops (cotton, rice, and sugarcane) due to bad weather, virus attacks and sluggish agri commodity prices. More importantly, cotton and rice crops would not be able to achieve the last year's production levels.

Encouragingly, the large scale manufacturing has shown some signs of recovery on the back of: (1) a steep fall in global prices of key raw materials; (2) robust growth in construction (mainly bolstered by increase in public sector spending), and auto sector; and (3) better gas availability to fertilizer.[1] However, despite these positive developments, LSM needs further momentum to achieve full year growth target of 6.0 percent.

Within the services sector, we expect *transport*, *storage & communication* and *finance & insurance* subsectors (with combined share of 28.1 percent in services) to grow strongly. However, the outlook for *wholesale & retail trade* subsector (having 31.1 percent weight) remains unclear: while a better performance by the large scale manufacturing is positive for *wholesale & retail trade,* the overall trading of agri produce is likely to remain weak due to production declines for rice and cotton crops.

2.2 Agriculture

The initial assessment of *kharif* crops is reflective of vulnerabilities. While all major crops are expected to miss their targets, cotton and rice (having combined share of around 40 percent in value addition by major crops) may not even achieve the last year's level (**Table 2.2**).

Table 2.2: Production Estimates for Kharif Crops

million tons

	Share in major crops (FY15)	FY14	FY15	FY16 Target	FY16 Estimates
Rice	12.4	6.8	7.0	6.9	6.6
Sugarcane	12.1	67.5	62.8	68.0	65.4
Cotton (mln bales)	28.0	12.8	14.0	15.5	10.9

Source: Planning Commission; Ministry of National Food Security & Research; and Cotton Crop Assessment Committee

A number of factors explain this weak performance. For example, the depressed prices of cotton and rice in the previous season encouraged farmers to shift to other crops (e.g., spring maize, fodder, vegetable, etc.). Moreover, heavy rains in July 2015 damaged rice and cotton. The cotton crop suffered the most as the moist weather also attracted pest and virus attacks.

Despite heavy rains in July 2015, the water availability during *kharif* remained lower than the last year (**Table 2.3**).[2] The use of fertilizer (both urea and DAP) also recorded a decline during Apr-Sep 2015, probably owing to rising cost and pressure on farmers' income.[3]

[1] Fertilizer imports remained strong during Q1-FY16, despite lower off-take, comfortable inventories and better domestic production. This reflects government's decision to import 150,000 tons of urea to overcome any shortage during the *rabi* 2015-16 due to possible gas curtailment for fertilizer industry during winters.

[2] The availability of irrigation water was lower than the average of 67.1 MAF for kharif season (Source: Indus River System Authority).

[3] The price of urea increased from Rs 1,882 per 50kg at end-June 2015 to Rs 1,975 at end-September 2015. DAP prices also rose from Rs 3,692 to Rs 3,710 per 50 kg during the same period.

It may be noted that growers in Pakistan have faced several shocks during the last year. For example, September 2014 floods and heavy rains in July 2015 inflicted damages to major crops. The income of growers came under further pressure when prices of agriculture produce in domestic market fell in line with the global trends, whereas the input cost (seeds, fertilizer and pesticides) increased. Realizing difficulties faced by farmers, the government announced a relief package of Rs 341 billion for agriculture on 15th September 2015, which included direct cash support and provision of soft agriculture loans (**Box 2.1**). While this package would not change the outcome for *kharif* crops, we expect growers would receive the much needed financial support before the sowing of *rabi* crops.

Table 2.3: Input Situation (Apr-Sep)

	Fertilizer Off take (000MT)		Irrigation water (MAF)
	Urea	DAP	
2013	2851.7	616.4	65.54
2014	2715.5	560.5	69.27
2015	2660	557.6	65.48
Growth			
2014	-4.8	-9.1	5.7
2015	-2	-0.5	-5.5

Source: NFDC for fertilizer; Suparco Report for irrigation water; State Bank of Pakistan for bank credit.

Furthermore, the government, since early 2015 has initiated a subsidy program to export sugar and wheat. So far 524 thousand tons of sugar has been exported to yield US$ 232.7 million as export proceeds under this program. The wheat export has been rather slow, and 9.4 thousand tons have been exported so far to yield US$ 3.1 million.

Cotton *(28.0 percent share in major crops)*

According to latest estimates, cotton crop for FY16 is likely to reach 10.9 million bales, falling well below the target, as well as the production realized in the preceding year (**Table 2.4**).[4] Heavy rains and floods inflicted damages to the standing crop in major cotton growing areas of Punjab and Sindh. Further losses came from pest attacks, particularly in Punjab.[5]

Table 2.4: Performance of Cotton Crop

	Area (million hac)			Production (million bales)		
	FY15	FY16		FY15	FY16	
		Target	Estimate		Target	Estimate
Punjab	2.32	2.42	2.25	10.28	10.50	7.40
Sindh	0.60	0.65	0.65	3.57	4.40	3.40
Balochistan	0.04	0.04	-	0.11	0.59	0.06
Total	**2.96**	**3.12**	**2.90**	**13.96**	**15.49**	**10.86**

Source: Cotton Crop Assessment Committee

4 Cotton Crop Assessment Committee (CCAC) in its 4th meeting held on 14th December, 2015, further lowered cotton production estimates to 10.86 million bales from 11.3 million bales assessed in November 2015.

5 Source: Pakistan Central Cotton Committee.

Anticipating a decline in cotton production, domestic mills are keen in buying the seed cotton.[6] This has partly offset losses to growers as prices of seed cotton have been recovering in some of the key markets in Sindh and Punjab. Nonetheless, these prices still remain depressed compared to their levels in the corresponding period of the previous year. In international markets, a slowdown in demand from China is likely to keep cotton prices low despite a fall in global cotton production.[7]

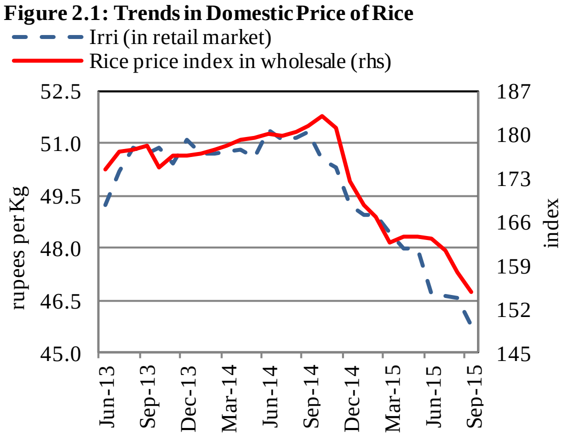
Rice *(12.4 percent share in major crops)*
Preliminary estimates from provincial crop centers suggest a fall of 4.8 percent in area under rice cultivation over the last year (**Table 2.5**). As mentioned earlier, depressed prices and rising cost of production encouraged farmers to substitute rice with fodder and maize. The heavy downpours in July 2015 also affected paddy cultivation. The overall production in FY16 is therefore likely to be 6.6 million tons, compared to the target of 6.9 million tons, and production of 7.0 million tons in FY15.

Table 2.5: Area under Rice (000 hectare)

	FY15	FY16		% growth over	
		Target	Estimates	FY15	Target
Punjab	1,878	1,800	1,789	-4.8	-0.6
Sindh	782	781	720	-7.9	-7.8
KPK	57	70	70 [1]	38.5	0.0
Balochistan	174	185	174	-2.9	-5.8
Pakistan	**2,891**	**2,836**	**2,753**	**-4.8**	**-2.9**

[1]Area estimates from KP are still awaited.
Source: Provincial Crop Reporting Centers

Figure 2.1: Trends in Domestic Price of Rice



Source: Pakistan Bureau of Statistics

Despite expected production decline, rice prices in domestic market recorded a steep fall in recent months (**Figure 2.1**). This sharp drop in prices mainly reflects pressure of

[6] The pace of cotton arrival into ginning factories has also remained subdued so far. Pakistan Cotton Ginners Association has reported arrival of 8.6 million bales upto 1st December, which is significantly lower than 12.1 million bales arrived during the corresponding period of previous year.
[7] December 2015 report of the International Cotton Advisory Committee available at following link: https://www.icac.org/cotton_info/publications/updates/2015/English/ectm12_15.pdf

large carryover stock from a record FY15 rice harvest. Specifically, abundant rice supply (owing to healthy crop in both FY14 and FY15), and sluggish exports particularly of basmati, has led to a steep rise in rice stocks.[8]

This means, pressures on domestic rice prices would subside or reverse only if the country is able to enhance its exports significantly. However, probability of any rebound in rice exports is low. In the case of Basmati rice, Pakistan's exports are already facing tough competition from India in the UAE market.

As for the export of non-basmati varieties is concerned, severe drought in Thailand – the largest exporter of non-basmati varieties – creates opportunities for Pakistan to increase exports. However, at the same time, the import demand from some of the African countries is likely to falter due to better harvest in that region, as well as their commitment to reduce reliance on imports.

Finally, we also do not expect any sharp recovery in the global rice prices as the carryover stocks are sufficiently large, and 2015 harvest is projected to remain good despite dry weather conditions in some of the rice exporting countries.[9]

***Sugarcane** (12.1 percent share in major crops)*

The area under sugarcane crop cultivation almost achieved its target for the year (**Table 2.6**). The production would reach 65.4 million tons, though higher than the last year's level of 62.8 million tons, this is significantly lower than the target of 68 million tons, as envisaged in the Annual Plan for FY16.

Table 2.6: Area under Sugarcane (000 hectare)

	FY15	FY16		% growth over	
		Target	Estimate	FY15	Target
Punjab	711	690	701	-1.4	1.6
Sindh	317	320	313	-1.3	-2.2
KPK	113	130	113	0.0	-13.1
Balochistan	1	1	1	-6.4	-34.5
Pakistan	1,141	1,141	1,128	-1.2	-1.2

Source: Provincial Crop Reporting Centers

We expect the cane price dispute between growers and government would continue this year as well. As mills have not been able to clear out their growing sugar stocks before the arrival of new crop, this has delayed cane crushing. Interestingly, sugar prices in the international market saw some gains in recent

[8] The export of basmati rice fell by 21.6 percent (on quantum basis) during FY15. This downtrend continued in FY16 as well, with a 14.9 percent YoY decline during Jul-Sep FY16.

[9] The global production of milled rice in 2015 still remains almost unchanged at the last year's level of 494.5 million tons (Source: Rice Market Monitor, Vol XVI1I, Issue No. 3, October 2015, Food and Agriculture Organization of the United Nations).

months on expectations of supply shortfall.[10] However, the global price of sugar is still lower than the domestic price, which makes export of sugar from Pakistan difficult.

Box 2.1: Relief package for agriculture

The growers in Pakistan faced multiple shocks during FY15. For example, September 2014 floods and heavy rains in July 2015 inflicted damages to major crops.[11] The income of growers came under further pressure when (1) the prices of agriculture produce in the domestic market fell in line with the global trends;[12] and (2) the input cost (seeds, fertilizer and pesticides) increased.

In order to support farmers, the government on 15th September 2015, announced a relief package of Rs 341 billion for agriculture, which includes direct cash support (Rs 147 billion) and provision of soft agriculture loans (Rs 194 billion) **Table 2.1.1**. [13]

The relief package provides a total of Rs 40 billion as cash support to rice and cotton growers. The government is also setting up a Rs 20 billion fund to reduce prices of fertilizers which will lessen Rs 500 per bag of Potassium and Nitrate fertilizers.[14] In addition, government is calling on fertilizer manufacturers to revert back the recent hike of Rs 159 per bag in urea prices (which was due to increase in gas tariffs).

Table 2.1.1: Relief Package
billion rupees

Total	341
Direct benefit	147
Loans	194
Of which	
Cash support to cotton growers (upto 12.5 acre)	20
Cash support to rice growers (upto 12.5 acre)	20
Fund to reduce price for fertilizer	20
Premium on agri insurance	2.5
Mark up on loans for solar tube well (7 years)	12.5
Bank loan guarantee	30

Source: Press Release by PM Secretariat

[10] The market fears supply disruption as more sugarcane is diverted to ethanol production in Brazil (the largest producer of sugar) and expected decline in sugarcane crop in India (the second largest producer of sugar). As a result, sugar prices increased from US$ 230.2 per metric ton in August 2015 to US$ 341.3 in December 2015. These prices are still lower than US$ 348.7 per metric tons recorded in November 2014 when the government announced freight subsidy of Rs 10 per kg on export of sugar.

[11] According to Pakistan's Economic Survey FY15, heavy rainfall and floods in September 2014 damaged the standing crops of cotton, rice and sugarcane particularly in the districts of Jhang, Muzzafargarh, Multan and Sargodha. In addition, the rabi crops (mainly wheat) suffered from heavy rains and hailstorm in April 2015, particularly in KPK and Punjab.

[12] For example, the World Bank commodity prices index for grains fell by 22.8 percent from March 2014 to June 2015. The wholesale price of wheat and rice in the domestic market fell by 22.3 and 8.4 percent, respectively, during this period.

[13] The budgetary impact of this relief package would be limited to Rs 60 billion, which will be met through reallocation of expenses from other heads.

[14] The price of Potassium Sulfate (POS) increased from Rs 4,793 per 50 kg bag in July 2014 to Rs 5,300 in July 2015; whereas the price of Calcium Ammonium Nitrate (CAN) recorded a marginal ease from Rs 1,604 per 50 kg bag to Rs 1,582 during the same period.

Furthermore, as a part of this package, the government has announced several tax measures as well. For example:

- The custom duty, sales tax and withholding tax on the agriculture machinery have been reduced from 45 percent to 9 percent;
- The Government would bear the premium on agricultural insurance which will benefit 0.7 million small farmers;
- Solar tube-wells will be provided on mark up free loans to the farmers who own up to 12.5 acre of land. Fix electricity price for running tube-wells at Rs 10.35 per unit during peak hours and Rs 8.85 at off-peak hours. Sales tax on these bills to be borne by the federal government;
- Guarantee would be provided to banks for financing to small farmers;
- Time-limit to pay back outstanding loan on the rice traders would be extended up to June 30, 2016;
- Rice millers were given full exemption on the turn-over tax for year 2015-16;
- Traders of agriculture commodities, fruits, vegetables and fish would get an exemption of three years on income tax;
- Sales tax on cold chain machinery had been reduced from 17 to 7 percent;
- The installation of production unit of Halal meat that will be registered before December 31, 2016 will be given a four-year exemption on income tax.

In terms of the impact of this package on crops, we expect that an early pay out of this direct support is likely to improve yields for the upcoming rabi crops (as better cash flows would enable farmers to enhance the use of fertilizer and pesticides).

2.3 Large scale manufacturing (LSM)

The large scale manufacturing has been showing some encouraging signs from Q1-FY16, as YoY growth reached 3.9 percent in this quarter compared to 2.6 percent in the corresponding period last year (**Table 2.7**). A number of factors explain this recovery:

- Industries particularly in food, steel, auto, cement, and chemical sectors benefited strongly from persistent low prices of key raw materials and inputs in the global market (**Table 2.8**).[15] Further improvement in firms' margins came from lower funding cost, reflecting a sharp fall in lending rates.[16,17]

[15] During Q1-FY16, PKR recorded a depreciation of 2.6 percent against US Dollar, which partly diluted the advantage available to importers from lower raw material prices. However, imports from China (one of the major source country for our imports) remained attractive, as PKR depreciated by just 0.2 percent against Chinese Yuan during this period.

[16] The weighted average lending rate charged by banks on their gross disbursement fell from 11.14 percent in September 2014 to 8.36 percent in September 2015.

[17] The decline in input cost also curtailed the financing needs of firms.

- The continued healthy performance by the construction sector, led by an increase in public sector development spending, provided a much needed boost to allied industries of cement, glass, paint, and steel.[18]

Table 2.7: YoY Growth in LSM (Jul-Sep)
percent

		YoY Growth		Contribution in Growth	
	wt.	FY15	FY16	FY15	FY16
LSM	**70.3**	**2.6**	**3.9**		
Textile	21.0	1.5	0.7	18.4	5.8
Cotton yarn	13.0	1.9	1.3	15.6	6.9
Cotton cloth	7.2	0.1	0.6	0.4	1.7
Food	12.4	1.6	4.3	9.5	16.7
Vegetable ghee	1.1	1.8	3.4	1.0	1.3
Cooking oil	2.2	-7.2	7.4	-11.1	6.9
Soft drinks	0.9	11.6	12.7	13.5	10.9
POL	5.5	7.4	4.5	19.2	8.2
Steel[1]	5.4	13.9	-5.3	18.2	-5.2
Non-metallic minerals	5.4	2.1	4.5	8.5	12.2
Cement	5.3	2.2	4.6	8.8	12.3
Automobile	4.6	13.6	31.4	26.0	44.4
Jeeps and Cars	2.8	11.5	46.4	10.7	31.5
Fertilizer	4.4	-4.1	15.1	-10.2	23.8
Pharmaceutical	3.6	3.2	7.2	10.2	15.6
Paper	2.3	1.0	-22.6	1.9	-26.6
Chemicals	1.7	7.3	13.9	6.8	9.1
Caustic soda	0.4	6.3	36.7	1.0	4.2
Leather products	0.9	8.0	-0.2	5.8	-0.1

[1.] The decline in steel production during Q1-FY16 is due to complete shutdown of Pakistan Steel Mills in July 2015.
Source: Pakistan Bureau of Statistics

Other factors included better gas availability for some of the fertilizer plants, which led to a pickup in this sector. Similarly, a rise in auto financing together with the impact of 'Apna Rozgar' scheme by the Punjab government helped auto sector achieve higher production.[19]

Encouragingly, a number of firms in cement, textile, iron & steel, and POL sectors are making investment for capacity expansions; debottlenecking of plants;[20] Balancing, Modernization and Replacement (BMR); installation of coal fired or captive power plants, etc. While FDI inflows remained scanty, these investments are expected to be funded through domestic resources.

[18] The consolidated expenses on PSDP recorded a steep rise from Rs 93.0 billion in Q1-FY15 to Rs 146.4 billion in Q1-FY16. The government is already targeting to increase PSDP spending from Rs 987.8 billion in FY15 to Rs 1,235 billion in FY16.
[19] According to corporate report of Pak Suzuki, the company sold 32,041 units of Bolan and Ravi till end-September 2015, against the total demand of 50,000 units under Apna Rozgar Scheme. The entire demand is expected to be met by February 2016.
[20] Debottlenecking is the increase in production capacity of an existing plant through modifications in the equipment configuration or workflow.

Better gas availability led to higher growth in fertilizer

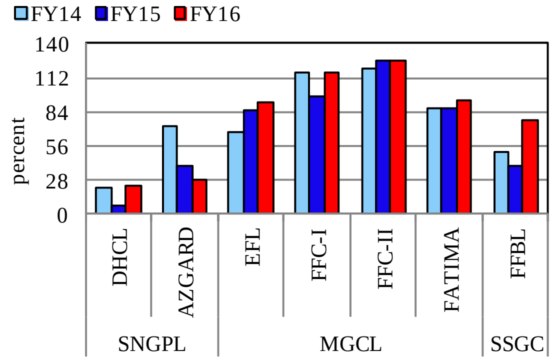
The better availability of gas to fertilizer plants helped industry achieve a promising growth of 15.1 percent in Q1-FY16. As shown in **Figure 2.2**, almost all manufacturing units performed better in Q1-FY16 than the corresponding period last year. However, the fertilizer off-take remained sluggish due to (1) increase in urea and DAP prices in early September 2015;[21] (2) pressure on growers income following collapse of agriculture commodity prices; and (3) farmers were waiting for notification on fertilizer subsidy announced in the Federal Budget for 2015-16.[22]

Table 2.8: Global Prices of Key Raw Material

		Q1 FY15	Q1 FY16	YoY Growth Q1 FY15	YoY Growth Q1 FY16
Coal (South African)	US$/MT	70.2	54.3	-2.9	-22.6
Iron ore	US$/MT	90.4	55.0	-32.0	-39.1
Copper	US$/MT	6,996	5,267	-1.3	-24.7
Crude oil (Dubai Fateh)	US$ per barrel	101.5	49.9	-4.4	-50.9
Rubber	US$/MT	1,832	1,457	-29.3	-20.4
Palm oil (Malaysian)	US$/MT	772.0	574.0	-6.7	-25.6

Source: Haver Analytics

Figure 2.2: Capacity Utilization of Different Fertilizer Plants



Source: National Fertilizer Marketing Limited and Corporates' websites

Robust demand bolstered growth in the auto sector

The auto sector recorded a robust growth in Q1-FY16 (**Figure 2.3**). The launching of Apna Rozgar scheme by Punjab government; the introduction of new sedan models; and aggressive marketing of auto financing products by commercial banks supported the strong growth in the passenger car segment.[23] We expect some slowdown in car production after February 2016 when the demand under Apna Rozgar Scheme would be over.[24]

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[21] In early September 2015, the manufacturers raised prices of urea and DAP in response to increase in gas tariffs. However, while announcing the agriculture package government indicated a possible reversion of urea prices to previous levels.

[22] The government notified the subsidy on 15th October, 2015.

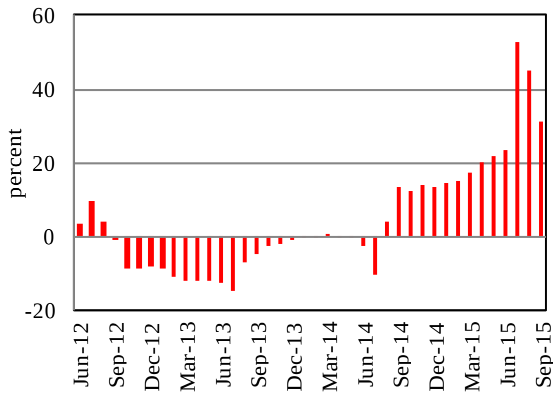
[23] The auto financing by commercial banks increased by Rs 5.9 billion in Q1-FY16, compared to Rs 3.6 billion in same period last year.

[24] To put this in perspective, the auto industry produced 20,505 *additional* units of car and light commercial vehicles during Q1-FY16 compared to the corresponding period last year. Of that, more than half were produced under Apna Rozgar Scheme.

Local demand kept up the cement industry

The cement industry witnessed a higher growth of 4.6 percent in Q1-FY16 against 2.2 percent in the same period of FY15. The growth was mainly driven by increased demand from mega–infrastructure and residential projects. The external demand on the other hand remained sluggish as reflected in a substantial fall in cement exports during Q1-FY16.[25]

Figure 2.3: YoY Growth in Automobiles*



* Total number of all automobiles
Source: Pakistan Bureau of Statistics

We expect domestic demand for cement to increase further in view of infrastructure projects under China Pakistan Economic Corridor (CPEC) and up gradation of Tarbela and Bhasha Dams. The leading cement producers are already gearing up to meet this surge in demand by expanding their capacities.

Chemical sector experienced capacity expansion

Chemical production grew by 13.9 percent in Q1-FY16 on top of 7.3 percent increase recorded last year. This growth mainly came from caustic soda segment, where one large manufacturer started commercial production from its newly established plant in June 2015.[26] Further expansion in this sector is also on cards as the same company is installing another plant which is expected to commence its production in 2017.

While performance of PSM remained dismal, private steel manufacturers are growing strongly

The complete shutdown of Pakistan Steel Mills (PSM) since Jul 2015 masked the overall growth in steel sector during Q1-FY16. The overall steel production fell by 5.3 percent during Q1-FY16, compared to a robust growth of 13.9 percent in the corresponding period of the previous year. Steel manufacturers in the private sector, however, exhibited a strong growth of 12.9 percent – higher than 11.3 percent increase in Q1-FY15 (**Table 2.9**).

[25] The volume of cement export dropped by 36.7 percent in Q1-FY16 (on YoY basis), compared to a fall of 4.3 percent in the corresponding period previous year. This decline was evident in all three main markets i.e., Afghanistan, India and South Africa.

[26] Ittehad chemical established a new Ion Exchange Membrane plant, which is operational since June 2015

The governance issues continue to hamper PSM production. Currently the production is on halt and the cash strapped mill could not generate enough resources to pay salaries to its employees. [27]

Table 2.9: Steel Production (Jul-Sep)
000 tons

	FY15	FY16
Private sector		
Billets	576,680	684,258
H.R sheets/strips	708,851	766,000
Pakistan Steel Mills		
Pig iron	50,075	1,509
Billets	1,149	-
H.R. Sheets/Strips/Plates/Coils	34,820	-
C.R. Sheets/Strips/Plates/Coils	1,427	-

Source: Pakistan Bureau of Statistics

Textile continued to face subdued global demand
Textile sector posted a lower growth of 0.7 percent in Q1-FY16 as compared to 1.5 percent in Q1-FY15.[28] Cloth manufacturing progressed slowly due to depressed demand from European market. In the US, Pakistani manufacturers are losing their shares to other exporting countries like India, Vietnam (**Chapter 5**).

In the yarn segment, availability of cheaper yarn from India posed serious challenges to local manufacturers. However, the situation is expected to improve, as the government has imposed 10 percent duty on yarn imports effective from 1st November 2015.

Competition from imports pressuring the paper industry
Paper production experienced a fall of 22.6 percent in Q1-FY16, compared to a rise of 1.0 percent during corresponding period of the previous year. The stiff competition from cheap imported products forced industry to reduce their prices to remain competitive in the local market. In addition, a large manufacturing plant underwent maintenance during Q1-FY16, which further reduced the production of paper and board segment.

It may be noted that production of paper & allied industries had already suffered last year due to gas shortages in Punjab. Consequently, manufacturers had to rely on furnace oil, which increased their cost of production.

[27] On 25th April 2014**,** government approved a restructuring plan of Rs 18.5 billion to retire outstanding liabilities, and payment of salaries for employees.
[28] However, the textile sector showed some improvement after Q1, and posted a growth of 0.96 percent in Jul-Oct FY16.

2.4 Services

The leading indicators pertaining to the services sector paint a mixed picture for Q1-FY16 (**Table 2.10**). For instance, within *wholesale and retail trade*, the benefit from improved performance of the large scale manufacturing would be partly offset by sluggish *kharif* crops.

Table 2.10: Services Sector Indicators
billion rupees, otherwise specified

	Jul-Sep	
	FY15	FY16
Wholesale and retail trade (18.3%)		
Credit off take for wholesale & retail(flow)	3.0	-6.0
Imports (US$ billions)	12.5	10.7
LSM (YoY growth)	2.6	3.9
Petrol & diesel sale (000 MT)	2,645	3,056
Transport, storage & communication (13.4%)		
Credit off take (flow)	-2.0	0.4
POL sales to transport sector (000 MT)	798.4	969
Commercial vehicle production (Nos.)	14,137	22,633
Cargo handling (million tonnes)	10.8	12.4
Cellular density (end period)	60.7	63.3
Broadband users (million Nos.)	16.9	21.2
PTCL consolidated profit	-0.41	-0.37
Finance and insurance (3.1%)		
Return on assets (percent)	2.2	2.6
Return on equity (percent)	24.2	26.6
Profit after tax	41.5	49.2
Overall Credit (flow)	143.6	131.9
General government services (7.4%)		
Expenses on general govt & defense [1]	359.0	410.0

Figure in parentheses show share in GDP during FY15.
Sources: PBS, SBP, OCAC, APCMA, PAMA, KPT.
[1.] This includes federal general administration, pension and provincial current expenditure

Indicators relating to *transport, storage & communication* have shown improvement during Q1-FY16, as reflected in increased POL sales to the transport sector; higher production of commercial vehicles; and more cargo handling at ports compared to the last year.[29]

In addition, the financial position of Pakistan Railways has improved after passenger and freight sectors attracted commuters and traders. This was in response to reduction in fares; availability of more locomotives in the freight sector; and improved punctuality of passenger trains.

Telecom has also shown improvement during Q1-FY16 with increased number of broadband users; better cellular and teledensity; and decline in PTCL financial losses. PTCL – a major contributor to value addition by communication services – posted a lower consolidated loss of Rs 371 million during Q1-FY16 compared to a loss of Rs 407 million in the same period last year. The number of broadband

[29] Cargo handling at Karachi port showed a growth of 14 percent at 12.4 million tonnes during Q1 FY16, compared to 10.8 million tonnes a year earlier.

users though increased significantly, could not translate into increased number of data users due to price competition and high tax incidence in the telecom sector (**Box 2.2**).

The value addition by *finance & insurance* depends upon the performance of the banking sector which observed an improvement in Q1-FY16. Profit after tax increased to Rs 49.2 billion in Q1-FY16, from Rs 41.5 billion in the corresponding period of last year. Key profitability indicators, e.g., return on assets (ROA) and return on equity (ROE), improved over the last year. The growth in earnings was achieved due to the placement of funds in government papers.

Box 2.2: What is holding back mobile and internet density in Pakistan?

Despite being among top 10 countries of the world in terms of number of mobile users, share of broadband and mobile users in Pakistan is still low (**Table 2.2.1**). The country presents a huge market of about 130 million people that needs broadband services; currently, there are 16.7 million broadband users. This shows large untapped potential in the broadband segment.

Table 2.2.1: Mobile Cellular (2014)

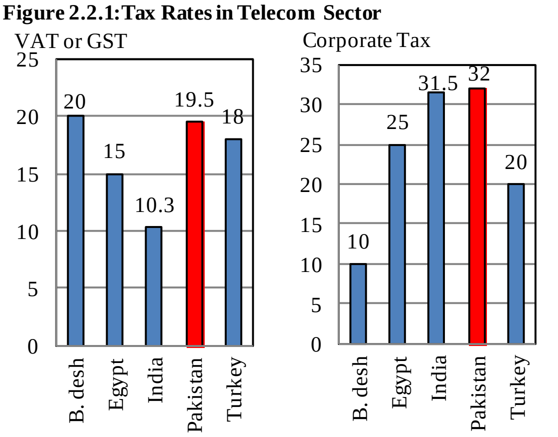
	Ranking	Pakistan	World
Mobile density	167	73.3	96.3
No. of subscribers (million)	10	135.8	6965
Internet density	152	13.8	40.7

Note: Mobile and internet density is measured as users per 100 population

Source: World Development Indicators.

Beside other issues such as quality of services, complex price structure, and high charges of devices, heavy taxation in this sector is the major reason of lower mobile and broadband usage (**Figure 2.2.1**). From the perspective of mobile operators, high cost of entry, costlier devices, poor fixed line infrastructure, and taxation on imported equipment hinder the new investment necessary for the expansion of such services to the un-served areas of the country.

Figure 2.2.1: Tax Rates in Telecom Sector



Source: Groupe Speciale Mobile Association

Mobile sector is heavily taxed in Pakistan, impacting devices, usage and sim cards. Following are the key taxes that directly impact consumers and providers of mobile industry in Pakistan:

- 19.5 percent GST on

mobile services;
- 14 percent withholding tax on mobile services;
- Custom duty of Rs 250 on mobile handsets;
- On Broadband Internet Services, the tax rate is 19.5 percent in Punjab for more than 2 mbps speed.[30] In Sindh the tax is 18 percent if broadband bill exceeds Rs 1500;
- 10 percent duty on import of equipment used for voice reception, switching and routing of data, etc.
- Corporate tax of 32 percent.

Data services or mobile internet have been exempted from taxes all over the world because of its benefits to masses and its effects on social developments and economic growth. Studies show that increased internet usage contributes positively to country's economic growth. Based on an analysis of 120 countries, the World Bank has indicated that for every 10 percent increase in the penetration of broadband services, there is an increase in economic growth of 1.3 percentage points.[31] Another study also found that the internet plays a positive and significant role in economic growth.[32] Therefore, we believe heavy taxation on mobile services in Pakistan does not bode well for economic growth in the country.

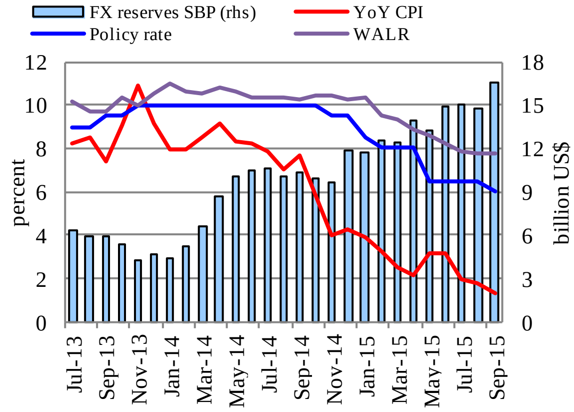
[30] The tax imposed on 28th May, 2015 by the Punjab government, was later withdrawn on 25th November, 2015 through notification No. SO (tax) 1-1 /2014-15 (Vol-II).
[31] World Bank, Qiang 2009; Economic Impact of Broadband (http://siteresources.worldbank.org/EXTIC4D/Resources/IC4D_Broadband_35_50.pdf)
[32] Choi, Changkyu and Myung H. Yi. "The effect of the Internet on economic growth: Evidence from cross-country panel data". Economic Letters 105(2009) 39-41.

3 Inflation and Monetary Policy

3.1 Overview

Monetary easing, which was initiated last year, continued during the first quarter of FY16 as well. SBP slashed its policy rate by 50 bps to decades' low of 6.0 percent in September 2015, on top of a cumulative 350 bps reduction in FY15. Favorable macroeconomic environment was the key: a sharp fall in headline CPI inflation, together with subdued inflationary outlook; comfort on external front including all time high level of the country's FX reserves;[1] and contained budgetary deficit along with the continued shift in its financing away from SBP. In addition, elevated real cost of borrowing (inflation adjusted lending rates) and weak investment activity, called for a rate cut (**Figure 3.1**).[2]

Figure 3.1: Policy Environment - Key Indicators



Source: State Bank of Pakistan

Headline CPI inflation continued to decline in Q1-FY16. It fell from 7.5 percent in Q1-FY15, to only 1.7 percent in the quarter under review. Though prudent monetary management was a containing factor, primary impetus came from a continued fall in international oil and other commodity prices. Continuation of swift pass-through of a fall in international oil prices to domestic consumers in Q1-FY16 contained inflation both directly and indirectly. It led to 11.6 percent YoY deflation in *transport* group of CPI basket, and helped moderate inflation expectations of the households. Food inflation also receded due to lower commodity prices (wheat, rice & edible oil) and adequate supply of perishables. Controlling for the impact of these factors, core inflation comprising non-food and

[1] With an increase of US$ 1.4 billion during the quarter, Pakistan's liquid FX reserves surged to US$ 20.1 billion by end-September 2015. As of 23rd December 2015, the liquid reserves stood at US$ 21.1 billion. For detailed discussion, please see Chapter 5 on '**External Sector**'.

[2] CPI inflation adjusted weighted average lending rates stood at 5.2 percent in FY15, and 6.1 percent in Q1-FY16.

non-energy items, eased to 3.9 percent in Q1-FY16, compared with 8.0 percent during the same period last year.

However, recent developments have slightly enhanced upside risks to this low inflation. Specifically, the PKR has depreciated by 2.8 percent against US$ since end-June 2015 till 21st December 2015; petroleum prices have been revised upward from 1st November 2015; and higher growth in money supply, which may contribute to inflation by stimulating aggregate demand in the economy. Balancing the impact of these upside risks against the slump in international commodity prices, SBP projects average CPI inflation for FY16 to fall in the range of 3.5 to 4.5 percent; visibly lower than the inflation target of 6.0 percent for the year.

In addition to favorable impact on inflation, fall in international commodity prices continued to support Pakistan's external sector. The current account deficit for Q1-FY16, narrowed to only US$ 0.1 billion, which was comfortably financed by higher financial inflows: the issuance of Eurobond, commercial borrowing, and modest increase in FDI.

Impact of higher financial inflows is visible from changes in monetary aggregates. In absolute terms, net foreign assets of the banking system expanded by Rs 111.6 billion in Q1-FY16, against a net contraction of Rs 31.2 billion in Q1-FY15. Within the banking system, the expansion was entirely concentrated in SBP's NFA, reflecting official nature of financial inflows. This together with the expansionary impact of SBP's liquidity injections through open market operations, increased the reserve money by Rs 342.1 billion in Q1-FY16.

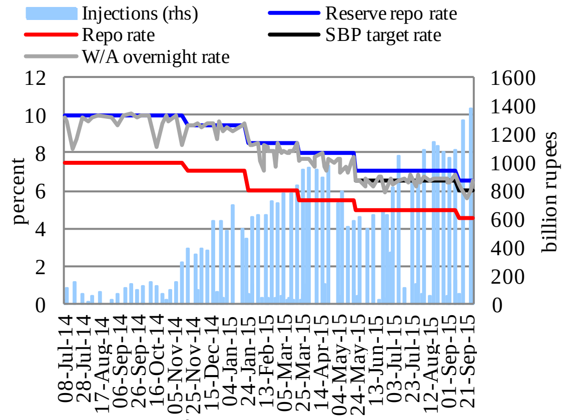
Despite a large increase in reserve money, the broad money supply (M2) expanded by only Rs 119.8 billion in Q1-FY16, due to net contractions in both NFA and NDA of scheduled banks. Specifically, change in NFA of scheduled banks reflects the monetary impact of an increase in trade financing against foreign currency (FE-25) deposits, which was largely financed by drawing down scheduled banks' assets held abroad.[3] The NDA of commercial banks, on the other hand, declined by Rs 197.0 billion in the quarter.

Within commercial banks' NDA, the private sector credit decreased by Rs 25.4 billion in Q1-FY16, compared with an increase of Rs 47.0 billion in Q1-FY15. These contrasting trends in CPS should be interpreted with caution because: (a)

[3] This led to a shift in scheduled banks' claim from foreigners (non-residents) to domestic (residents) borrowers.

gross disbursements of Rs 2,780.5 billion in Q1-FY16 were considerably higher than Rs 2,526.6 billion during the same period last year;[4] (b) fixed investment loans recorded a net increase of Rs 27.0. billion in Q1-FY16, against a net contraction of Rs 27.4 billion in the same period last year; (c) commodity prices, especially of cotton and rice are substantially lower in Q1-FY16, which have reduced working capital required for industrial raw materials; and (d) last year was an exception as the first quarter of the year is generally a period of retirement in credit cycle of Pakistan.[5]

Figure 3.2: SBP Liquidity Support via OMOs

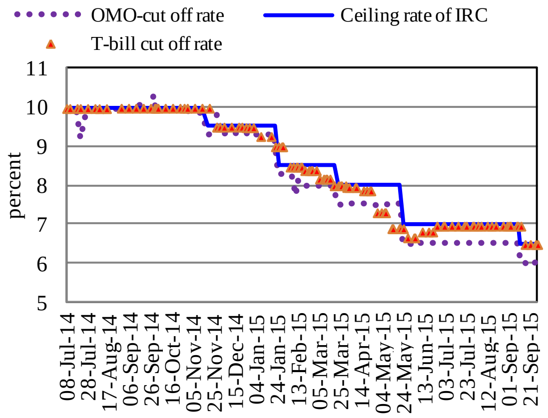


Source: State Bank of Pakistan

3.2 Money market developments

With the introduction of 'SBP policy rate' within the existing interest rate corridor (IRC) in May 2015, SBP ensures the overnight repo rate adjust according to the policy rate. As shown in **Figure 3.2**, SBP continued to inject liquidity through open market operations (OMOs) to keep the weighted average overnight repo rate close to the policy rate. This led to a substantial increase in the volume of OMOs, which peaked at Rs 1,374.0 billion in the last week of September 2015. In line with the revised IRC framework, SBP maintained OMO cut-off rates very close to the policy rate throughout the quarter (**Figure 3.3**). As a result, the acceptance to bid

Figure 3.3: OMO & T-bill Cut Off Rates



Source: State Bank of Pakistan

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[4] The rise in gross disbursements was also reflected in healthy economic activity. LSM recorded a YoY growth of 3.9 percent in Q1-FY16, compared with a growth of 2.6 percent in Q1-FY15.

[5] Seasonal pattern was distorted by a sharp rise in trade financing in Q1-FY15, which overshadowed the seasonal retirements. Within trade financing, the expansion was primarily driven by higher imports of fertilizer, basic metals, petroleum products and edible oil.

ratio (on average) reached 92.8 percent in Q1-FY16, compared with 85.1 percent in the same period last year.

Despite huge liquidity injections, weighted average overnight rate generally fluctuated between the ceiling rate of IRC and the policy rate. Specifically, it was slightly above the policy rate for 44 of 59 working days during the quarter. However, the overnight rate was well below the IRC ceiling rate. This spread in money market interest rates, together with higher cut-off rates in T-bill auctions (close to the ceiling rate of IRC), created an opportunity for commercial banks to finance some of their investments in government securities by short term liquidity from SBP (**Figure 3.3**).

Table 3.1: Changes in Monetary Aggregates (Jul-Sep)
changes in billion rupees, growth in percent

	Change		Growth rate	
	FY15	**FY16**	**FY15**	**FY16**
Broad money (M2)	-6.0	119.8	-0.1	1.1
NFA	-31.2	111.6	-5.3	13.7
SBP	-8.2	150.9	-1.7	20.9
Scheduled banks	-23.0	-39.3	-20.7	-43.5
NDA	25.2	8.2	0.3	0.1
SBP	-66.9	205.2	-3.6	10.2
Scheduled banks	92.1	-197.0	1.2	-2.3
Government borrowing	97.1	157.2	1.6	2.3
For budgetary support (cash basis)	139.8	139.4	2.6	2.2
SBP	-39.0	-304.4	-1.7	-16.1
Scheduled banks	178.9	443.8	5.7	10.0
Commodity operations	-23.7	5.4	-4.8	0.9
Non government sector	46.5	-8.6	1.1	-0.2
Credit to private sector	47.0	-25.4	1.3	-0.6
Credit to PSEs	-0.4	17.2	-0.1	4.0
Other items net	-118.5	-140.4	15.7	16.0

Source: State Bank of Pakistan

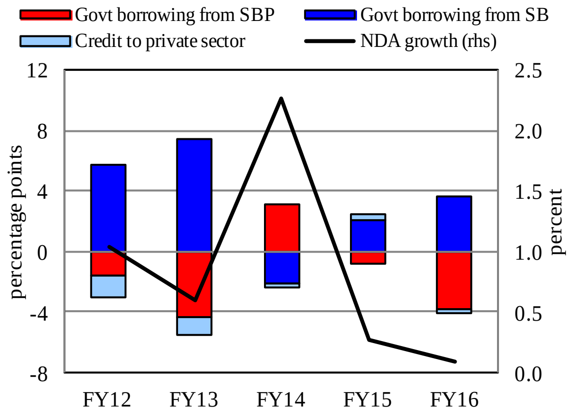
3.3 Developments in monetary aggregates

Broad money supply (M2) expanded by 1.1 percent in Q1-FY16, against a minor contraction of 0.1 percent during the corresponding period of FY15. Monetary expansion was largely driven by a visible improvement in external account, liquidity injections through OMOs, and government borrowing for budgetary finance. Within monetary aggregates, expansionary impact of these factors was partly offset by government's retirement to SBP and net contraction in credit to the private sector. In these setting, causative factors are briefly reviewed in the following discussion.

3.3.1 Net foreign assets (NFA)

Reflecting the monetary impact of favorable developments taking place on the external front, net foreign assets (NFA) of the banking system expanded by Rs 111.6 billion in Q1-FY16 against the contraction of Rs 31.2 billion in Q1-FY15. Within the banking system, the expansion was entirely concentrated in NFA of SBP, which increased by Rs 150.9 billion during the quarter. This was largely attributed to the issuance of Eurobond, commercial borrowing by the government, and CSF inflows.

Figure 3.4: Contribution to NDA Growth (Jul-Sep)



Source: State Bank of Pakistan

However, the expansionary impact of notable increase in SBP's NFA, was partly offset by Rs 39.3 billion contraction in NFA of commercial banks. A rise in trade financing against FE-25 deposits (US$ 152 million) was largely funded by withdrawing investments/ placement abroad, as the foreign currency deposits of commercial banks saw a net reduction in Q1-FY16.[6]

3.3.2 Net domestic assets (NDA)

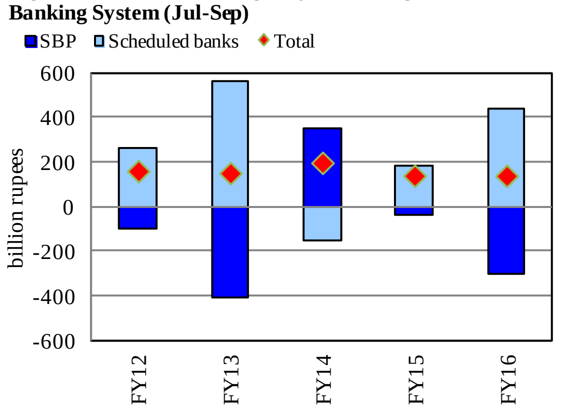
NDA of the banking system increased by only Rs 8.2 billion in Q1-FY16, compared with a rise of Rs 25.2 billion during the same period last year. This deceleration was attributed to net retirement in credit to the private sector, and increased liabilities of commercial banks (higher borrowing from SBP)(**Figure 3.4)**. These two factors largely contained the expansionary impact of government borrowing for budgetary finance during the quarter. Contributions of loans for commodity operations and credit to PSEs, were negligible in the overall NDA growth.

[6] With a net reduction of US$ 192 million during the quarter, FE-25 deposits of commercial banks stood at US$ 6,270 million by end-September 2015.

Government borrowing for budgetary support

On aggregate, the government's reliance on banking system for its budgetary support in Q1-FY16, was almost unchanged compared with the same period last year.[7] The pattern of borrowing also remained the same: net retirements to SBP, while borrowing from commercial banks. However, the volumes of net retirements to SBP and borrowing from commercial banks, were substantially higher in Q1-FY16, compared with Q1-FY15 (**Figure 3.5**).

Figure 3.5: Source of Budgetary Borrowings from the Banking System (Jul-Sep)



Source: State Bank of Pakistan

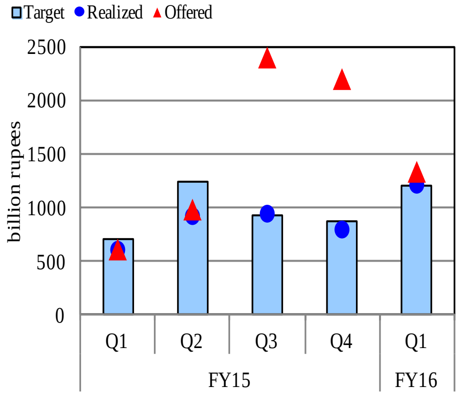
Specifically, the government borrowed Rs 443.8 billion (in net terms) from commercial banks in Q1-FY16, which was more than double the level of borrowing in Q1-FY15. This had notable implications for monetary management. On a positive note, the government retired Rs 304.4 billion (in net terms) to SBP during the quarter, which was more than seven times the level of retirement to SBP in the first quarter of last year. As a result, the government was able to contain its budgetary borrowing from SBP within the IMF target for end-September 2015. In addition, the government also met the quarterly limit of zero budgetary borrowing as prescribed in the SBP Act. Despite these favorable implications, it must be noted that heavy reliance on commercial bank funding may have reduced the scope for private sector credit.

Demand for government securities also remained high as commercial banks were eager to lock-in their funds in risk-free government securities in a declining interest rate scenario. Within government securities, PIBs were the preferred securities. The offered amount was four times of PIBs target in Q1-FY16, while the offered amount in T-bill auctions was close to the target (**Figure 3.6a & 3.6b**). This relatively higher demand for PIBs, allowed the government to realize the target amount at lower yields. Specifically, 3-year PIBs cut-off rate saw a reduction of 49 bps in the auction held in August 2015, indicating that the market

[7] In absolute term, the government borrowed Rs 139.4 billion for budgetary financing from the banking system in Q1-FY16, compared with Rs 139.8 billion in Q1-FY15.

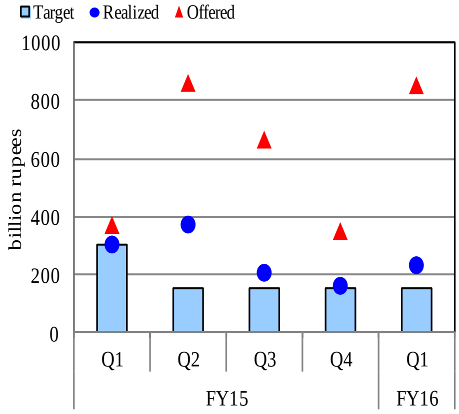
had factored in the 50 bps cut in the policy rate before the monetary policy announcement in September 2015.

Figure 3.6a: Auction Profile of T-Bills



Source: State Bank of Pakistan

Figure 3.6b: Auction Profile of PIBs



Source: State Bank of Pakistan

Commodity operations

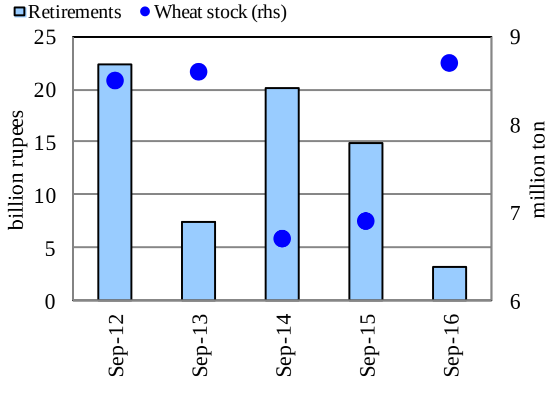
Despite being a period of seasonal retirement, loans for commodity operations saw a net increase of Rs 5.4 billion in Q1-FY16, against a net retirement of Rs 23.7 billion during the same period last year. This off-season rise was largely attributed to fresh borrowing for the procurement of sugar, fertilizer and rice, to stabilize domestic prices. Specifically, procurement agencies purchased sugar and rice from the domestic market.[8] Borrowing for these interventions contributed to pushing outstanding loans for commodity operations to Rs 569.8 billion by end-September 2015.

In addition to fresh borrowing, lower seasonal retirements also kept the outstanding level high. Specifically, loans for wheat procurement recorded a net retirement of only Rs 1.7 billion in Q1-FY16, which was one tenth of the amount retired during the same period last year. In fact, procurement agencies were unable to offload their last year's wheat stock, before the arrival of fresh crop (the procurement season). Wheat stock stood at 8.7 million ton by end-September 2015, compared with 7.0 million ton by end-September 2014. This impaired the

[8] The prices of sugar fell sharply in the international market, which incentivized the private sector to import 7.1 (000 MT) sugar during Jul-Sep FY16 compared with imports of 1.7 (000 MT) during Jul-Sep FY15. Specifically, the import unit value declined from 622US$/ton to only 401US$/ton. Similarly, 0.6 million MT of fertilizer was imported during the first quarter of FY16 compared with 0.4 million MT in Q1-FY15.

repayment capacity of the procurement agencies. As shown in **Figure 3.7,** higher wheat stocks accompanied by lower net retirement. Finally, the receivables on account of sale proceed (Rs 90.2 billion) and subsidies (Rs 182 billion) of the procurement agencies stood at Rs 272.2 billion by end September 2015. This has also undermined the ability of procurement agencies to retire some of their loans during the quarter.

Figure 3.7: Stock of Wheat Held by Procuring Agencies and Loan Retirements

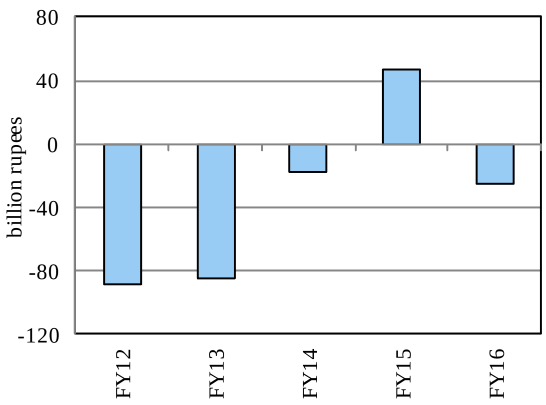


Source: State Bank of Pakistan

3.4 Credit to private sector

Credit to private sector recorded a net contraction of 0.6 percent in Q1-FY16, in contrast to an expansion of 1.3 percent during the same period last year. This must be interpreted with caution as: (a) the first quarter of the fiscal year is a period of seasonal retirement, and last year expansion was atypical of credit cycle (**Figure 3.8**);[9] (b) the net retirement in Q1-FY16 was much smaller than the average of last five years, i.e., Rs 33.9 billion; (c) gross disbursements were higher in Q1-FY16, compared with the same period last year; and (d) segment-wise distribution of loans to private business indicates that the net contraction in Q1-FY16 was entirely stemming from working capital and trade financing loans, which more than offset the rise in fixed investment loans (**Figure 3.9**). In addition, the sector specific developments also played a key role determining credit flows, which are briefly reviewed in the following discussion.

Figure 3.8: Credit to the Private Sector (Jul-Sep)



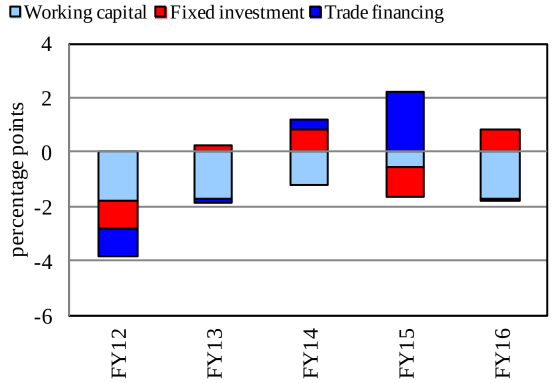
Source: State Bank of Pakistan

[9] Seasonal pattern was distorted by a sharp rise in trade financing in Q1-FY15, which overshadowed the seasonal retirements. Within trade financing, the expansion was primarily driven by higher imports of fertilizer, basic metals, petroleum products and edible oil.

Credit to agriculture sector

Loans to agriculture sector expanded by Rs 2.6 billion in Q1-FY16, which were one-fourth of the increase in Q1-FY15. Within major crops, credit need of rice crop was low due to fall in area under rice cultivation, and little incentive to invest on rice crop due to subdued price.[10] Cotton growers also faced similar challenges, with additional damages from heavy rains and pest attacks.[11] The use of input especially fertilizer recorded a decline during the period under review which also partially explains the slowdown in credit off-take. Lastly, accumulated wheat stocks with the procurement agencies (8.7 million tons as on 30 September 2015) and lower wheat price in international markets, suggest that credit for wheat crop is also likely to be low.[12]

Figure 3.9: Contribution to Private Sector Businesses Loans (Jul-Sep)



Source: State Bank of Pakistan

Credit to manufacturing sector

Loans to ***Food & beverage*** saw a net contraction of Rs 49.0 billion in Q1-FY16, which was more than double the amount retired in the same period last year (**Table 3.2**). The net retirement was concentrated in working capital and trade financing loans, while the fixed investment loans saw a modest increase during the quarter.

Within food sector, while the overall retirement by the ***rice*** mills was unchanged compared to the last year, there was a small increase in fixed investment loans in Q1-FY16. Anecdotal evidence suggests that some of the rice mills are investing in *rice bran oil extraction plants*.

[10] The price of rice fell by roughly 12.0 YoY percent during Q1-FY16.

[11] The production of cotton is estimated to fall from 13.96 million bales in FY15, to 10.86 million bales in FY16.

[12] Disbursements under relief package for agriculture, announced in September 2015, will have consequences on the credit cycle going forward.

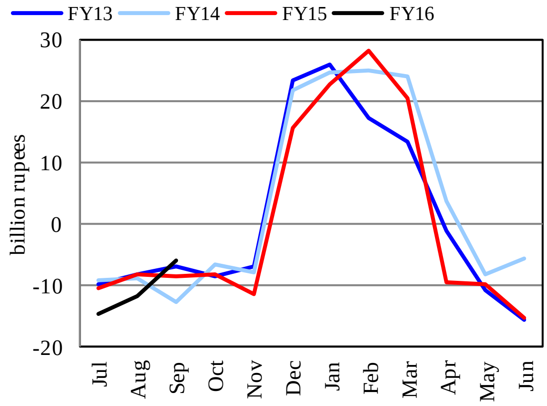
Table 3.2: Loans to Private Sector Businesses (Jul-Sep)

billion rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY15	FY16	FY15	FY16	FY15	FY16	FY15	FY16
Private sector business	13.6	-25.0	-16.9	-49.3	-27.4	27.0	57.9	-2.8
1) Agriculture	9.5	2.6	6.1	0.0	3.4	2.8	0.1	-0.1
2) Manufacturing	-14.7	-28.2	-46.6	-33.0	-9.4	7.7	41.2	-2.8
Food & beverages	-24.8	-49.0	-39.6	-50.9	0.4	2.7	14.5	-0.8
Rice	-11.5	-11.0	-12.3	-9.9	0.1	1.3	0.7	-2.4
Sugar	-27.2	-32.5	-35.1	-30.9	6.6	0.9	1.3	-2.4
Beverages	-3.3	-9.5	-4.1	-9.1	-0.1	-0.1	0.9	-0.3
Textile	-14.8	-8.7	-9.6	6.3	-6.5	-2.9	1.3	-12.1
Cement	2.8	0.9	2.8	-4.7	-1.2	5.2	1.3	0.4
3) Electricity	-2.1	-6.1	15.1	-8.8	-16.3	2.5	-0.8	0.1
4) Telecom	-0.6	-5.9	0.5	-7.4	-1.0	1.8	-0.2	-0.3
5) Ship breaking	8.0	-3.9	-0.1	-0.8	0.1	0.0	7.9	-3.2
6) Construction	-2.5	-2.5	-2.7	-2.3	0.0	0.9	0.2	-1.0
7) Real estate	8.8	6.8	5.0	2.2	1.5	2.6	2.2	2.0
8) Commerce & trade	1.3	-0.8	-2.6	-3.5	0.1	2.1	3.8	0.5
9) Land transport	0.1	6.7	0.1	0.0	-0.1	6.6	0.0	0.0
10) Others	5.9	6.3	8.2	4.3	-5.7	0.0	3.4	2.0

Source: State Bank of Pakistan

Figure 3.10: Sugar Credit Cycle (Monthly Flows)



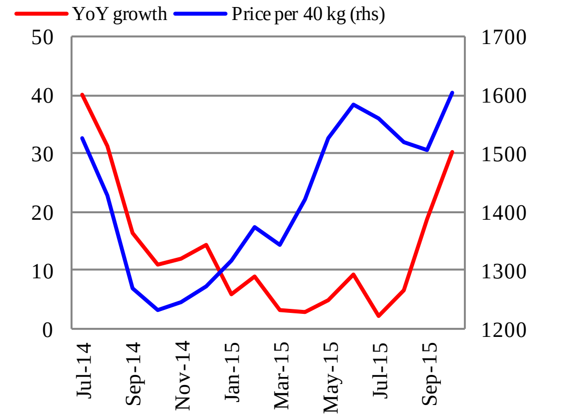
Source: State Bank of Pakistan

Sugar sector made slightly higher net retirements during Q1-FY16 compared to the same period last year (**Figure 3.10**). This was largely attributed to the fact that sugar mills were able to offload some of their stocks to the procurement agencies during the quarter.

The net retirements of ***textile*** in Q1-FY16 were almost half the amount retired in Q1-FY15. The composition of loans also changed drastically in Q1- FY16: working capital loans increased by Rs 6.3 billion during the quarter, in contrast with a decline of Rs 9.6 billion in Q1-

FY15. Although the production (quantum) of cotton is estimated to have declined from 13.9 million bales last year to 10.9 million bales in FY16, rise in cotton prices together with a modest increase in export of cotton, knitwear and towels, created demand for working capital loans during the quarter (**Figure 3.11**).

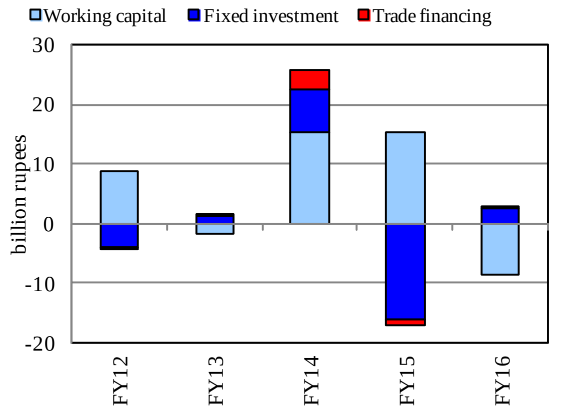
Figure 3.11: Cotton Seed Prices



Source: Pakistan Bureau of Statistics

Trade financing loans on the other hand recorded a net contraction of Rs 12.1 billion in Q1-FY16, in contrast with a net expansion of Rs 1.3 billion in Q1-FY15. This reversal was an outcome of deceleration of loans under the category of EFS. It must be recalled that in July 2014, EFS rate was cut from 8.4 percent to 7.5 percent after a gap of more than a year, which led to higher demand of EFS loans.[13] The rate was further reduced to 6.0 percent in February 2015. Since such loans had to be retired within 180 days; some of the loans availed in H2- FY15 were retired in Q1-FY16.

Figure 3.12: Distribution of Loans to Power Sector (Jul-Sep)



Source: State Bank of Pakistan

Eased liquidity conditions amid sharp fall of international oil prices bode well for producers and distributors of the ***power*** industry. Retirements made during Q1-FY16, were three times higher compared to the same period last year. Moreover, changes in composition of loans also differed from that of the last year. In Q1-FY15, retirement under the category of fixed investment loans was the major factor; this year

[13] It is pertinent to highlight that weaving and spinning mills are generally the biggest users of bank credit. However, knitwear and towel manufacturers were the major borrower in FY16.

retirements under the working capital loans pulled down the overall credit (**Figure 3.12**).

Loans for ***Land transport*** saw a notable expansion in Q1-FY16. This could be attributed to land transport for construction and road network, especially under China Pakistan Economic Corridor (CPEC).

Consumer financing

Consumer financing recorded a contraction of Rs 4.9 billion in Q1- FY16, against a rise of Rs 5.5 billion during the same period last year (**Table 3.3**). This decline in consumer financing is primarily attributed to personal loans, which concealed the increase recorded in auto financing.

Table 3.3: Consumer Financing

billion rupees, share in percent

	End September 2015		Change during Jul-Sep		
	Stock	**Share**	**FY14**	**FY15**	**FY16**
Consumer financing	268.9	100.0	13.6	5.5	-4.9
House building loans	41.7	15.5	-0.1	0.2	1.5
Auto loans	89.5	33.3	3.1	3.6	5.9
Credit cards	24.1	9.0	0.6	-0.1	0.2
Consumers durable	0.9	0.3	0.0	-0.1	0.5
Personal loans	112.7	41.9	10.1	1.9	-13.0

Source: State Bank of Pakistan

Within consumer financing, personal loans contracted by Rs 13.0 billion in Q1-FY16 against net expansions in the previous two years. As mentioned in earlier reports, a number of banks introduced innovative personal loan products such as Cash for Gold, Enhanced-Gold Schemes, especially designed to cater to the needs of the middle income group. As a result, personal loans saw a visible rise in the last two years. The retirement of such loans, along with lower fresh disbursements, dragged the overall consumer financing downwards.

Encouraging development in consumer financing is the successive rise in auto loans for the third year in a row, reflecting revival of auto financing. Quite similarly, house building loans also increased, which could be attributed to healthy construction activity.

3.5 Inflation

Headline inflation maintained its declining trajectory, and reached a 12-year low of 1.3 percent in September 2015. Average inflation for Q1-FY16 also plummeted to 1.7 percent, from 7.5 percent in the same period last year (**Table 3.4**). This deceleration was primarily driven by fall in international oil and commodity prices.[14] In addition, the prudent monetary management, and the favorable changes in the financing mix of budgetary deficit, also played their role in lowering inflation.

Table 3.4: CPI Inflation
percent

					Core inflation		
	Overall	Food	Non-Food	Energy	NFNE	Trimmed	RSC-CPI
FY15							
Q1	7.5	6.6	8.2	9.1	8.0	7.3	8.2
Q2	4.7	3.6	5.5	-2.5	7.1	5.5	7.4
Q3	3.2	1.9	5.5	-6.1	6.2	4.2	6.5
Q4	2.8	2.0	3.4	-5.0	4.9	3.6	5.2
FY16							
Q1	1.7	0.3	2.6	-4.0	3.9	2.8	4.3

Source: Pakistan Bureau of Statistics and State Bank of Pakistan

It is important to note that the decline in inflation was realized despite expected pressures from: (a) seasonal increase in prices due to Ramadan and Eid; (b) heavy rains in July 2015; and (c) upward adjustments in electricity and gas tariffs. Commodity-wise data indicates that rains in July did not have any significant impact on the prices of perishable items due to adequate supplies.[15] Similarly, upward adjustments in electricity and gas tariffs during the quarter, were more than offset by the fall in prices of petroleum products.

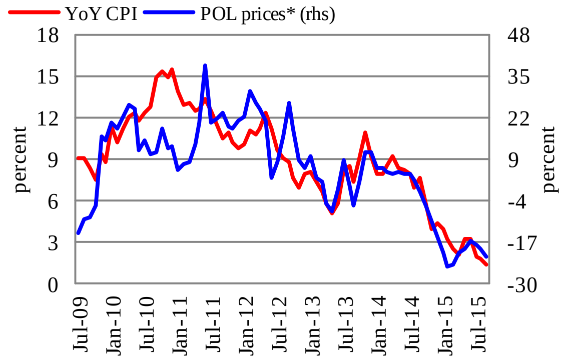
In fact, the government reduced the retail prices of POL products in two consecutive months (August and September 2015), which led to significant deflation of 11.6 percent in transport group of CPI basket in Q1-FY16 (**Figure 3.13**). In addition to this direct impact, the fall in oil prices also helped easing inflation expectations of households, and softening prices of other commodities in the CPI basket, through its spillover effects. The deflationary impact would have

[14] On YoY basis, there was a notable fall in international oil and commodity prices in Q1-FY16: crude oil (51%), sugar (30.1%), palm oil (10.7%), soybean (10.2%), cotton (2.5%), rice (7.8%) and wheat (3.6%). Source: Bloomberg

[15] Perishable items (fresh fruits, fresh vegetables, potatoes, onions and tomatoes) saw a deflation of 9.8 percent in Q1-FY16, compared with an inflation of 11.3 percent during same period last year. Imports from neighboring countries also helped check on prices of some perishable items such as tomatoes.

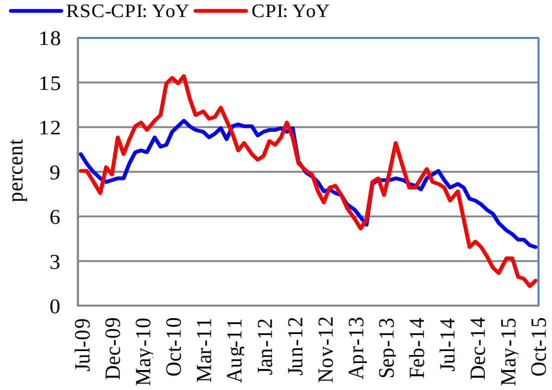
been much higher, had the government not increased the rate of sales tax on petrol from 20.0 to 25.5 percent in September 2015.
Like transport, food and beverages group of the CPI basket also recorded a deflation of 0.7 percent in Q1-FY16, against an inflation of 5.8 percent in Q1-FY15. Within the group, a sharp fall in prices of potatoes, tomatoes, edible oil, wheat and rice offset the inflationary impact of higher prices of pulses, tea, milk, and onions.[16]

Figure 3.13: Headline Inflation and Change in POL Prices



Source: Pakistan Bureau of Statistics
*YoY change of average price of super petrol, high speed diesel and CNG

Figure 3.14: Overall CPI and Relative Stable Components of Inflation



Source: Pakistan Bureau of Statistics and State Bank of Pakistan

Controlling for commodities with volatile prices, different measures of core inflation for Q1-FY16 are in the range of 3 to 4 percent. It implies that prices of many items in the CPI basket, are either relatively stable or showing a gradual rise. Core inflation comprising of non-food and non-energy items, was 3.9 percent in Q1-FY16, compared with 8.0 percent during the same period last year. Similarly, RSC-CPI, an index based on relatively stable components of the CPI basket, registered 4.3 percent inflation in Q1-FY16, compared with 8.2 percent in the same period of last year (**Figure 3.14**).[17]

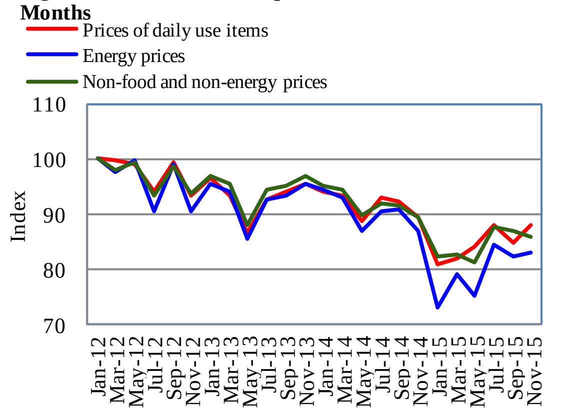
[16] Tea prices in international market increased due to a fall in production in Kenya. Tea prices in Pakistan simply followed. In case of pulses, fall in domestic production, contributed to price rise. Cognizant of this, the government allowed import of 50,000 tons of gram in September 2015, to manage the demand-supply gap.
[17] Detailed methodology of RSC-CPI and group wise items along their weights can be viewed at: http://www.sbp.org.pk/publications/wpapers/2013/wp66.pdf

Moreover, analysis of 89 composite commodities in the CPI basket from July 2009 to September 2015 revealed that 46 composite items including house rent have *always* recorded YoY inflation. These items have a combined weight of 56.4 percent in the CPI basket. This suggests that remaining items, which include most of the food and fuel related items, are responsible for volatility in inflation. Moreover, prices of many items in these two groups are administered by the government, reflecting its role in controlling inflation.

Inflation expectations

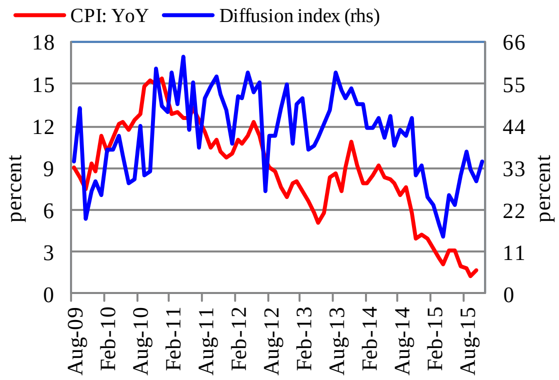
Inflation expectations measured by IBA-SBP Consumer Confidence Survey (CCS) conducted in July 2015, reported growing inflation expectations of households. This could be largely attributed to expected rise in electricity and gas tariffs, and taxation measures announced in the Federal budget. However, these expectations proved to be short lived due to a reduction in retail POL prices in July and August 2015. The CCS of September 2015 recorded lower inflation expectations for the next six months. The results indicate that households expect fall in prices of energy and non-food items in the next six months (**Figure 3.15**). However, the Consumer Confidence Survey for November 2015 recorded marginal upward revision in households' inflation expectations, as the government increased fuel prices in November 2015. Similarly, same inference can be drawn from the diffusion index developed by

Figure 3.15: Consumers Expectations of Prices in Next Six Months



Source: State Bank of Pakistan

Figure 3.16: Headline Inflation and Inflation Diffusion Index



Source: Pakistan Bureau of Statistics and State Bank of Pakistan

SBP (**Figure 3.16**).[18] Despite this, a financial market based measure of inflation expectations points towards low inflation, as long terms rates (10 years PIBs) fell by 58 bps between June and November 2015, against 50 bps cut in the policy rate in September 2015.

Going forward, inflation may slightly pick up from its existing low levels in the remaining months of FY16. Upward pressure is likely to come from: (i) depreciation of PKR against USD; (ii) second round effect of modest increase in electricity and gas tariffs; (iii) upward adjustment in domestic POL prices;[19] and (iv) historic low interest rates, which would stimulate demand. However these upside risks must be weighed against the continued slump in international oil and commodity prices.

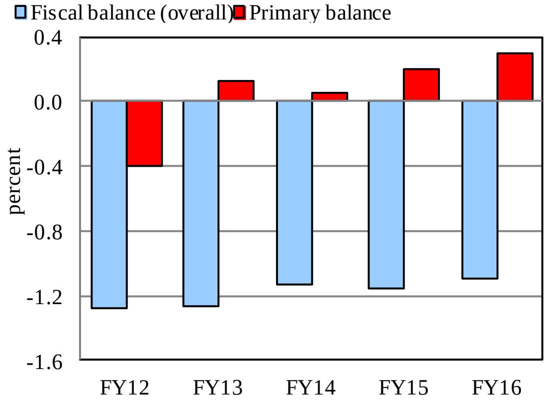
[18] For details, see http://www.sbp.org.pk/publications/Inflation_Monitor/index.htm
[19] Government increased price of petrol and diesel by Rs2.50 and Rs1.75, respectively in November 2015.

4 Fiscal Policy and Public Debt

4.1 Overview

The budget deficit in the first quarter of FY16 was 1.1 percent of GDP, showing a marginal improvement over the same period last year.[1] Though tax collection remained below expectations amid lower inflation, the reduction in the budget deficit was primarily due to moderate growth in current expenditures. The expenditure control also helped improve primary balance – another key indicator of fiscal performance (**Figure 4.1**).

Figure 4.1: Budget Balances in Q1 (% of GDP)



Source: Ministry of Finance

The tax collection by FBR was about Rs 40 billion less than expected during the first quarter, which was mainly due to sluggishness in sales tax. The direct taxes, on the other hand, showed significant growth on the back of new measures taken in the federal budget FY16 (**Box 4.1**). There was also no support from non-tax revenues, which remained at last year's level.

Therefore, the burden of fiscal consolidation fell on government expenditures. On a positive note, the government managed a moderate growth in current expenditures and directed the flow of funds towards various development works.[2] However, the expenditure should be further rationalized through minimizing expenses relating to loss-making PSEs and circular debt, in order to contain the fiscal deficit.

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[1] In Q1-FY15, budget deficit was 1.2 percent of GDP. In terms of rupees, it declined by 2.7 percent to Rs 328 billion in Q1-FY16. In comparison, the target for the budget deficit for Q1-FY16 was Rs 294 billion, as agreed with the IMF

[2] As a result, the PSDP increased by 57.4 percent during Q1-FY16, which is an encouraging development.

Meanwhile, the financing pattern of the budget deficit saw heavy reliance on commercial bank borrowings which increased to Rs 443 billion during the quarter. On a positive note, the government retired some of its debt with the central bank. Similarly, deficit financing through external resources also increased, which was largely derived from issuance of Eurobonds in the international market.[3]

Table 4.1: Summary of Fiscal Operations

billion rupees ; growth in percent

	Budget FY16	Actual		Growth	
		Q1-FY15	Q1-FY16	Q1-FY15	Q1-FY16
A. Total revenue	4,688	839.7	937.0	1.2	11.6
Tax revenue	3,729	626.9	723.5	11.7	15.4
Non-tax revenue	958	212.9	213.5	-20.8	0.3
B. Total expenditure	6,017	1176.5	1265.1	5.4	7.5
Total expenditure (booked)		1170.2	1254.0	12.7	7.2
Current[1]	4,786	1050.1	1085.2	20.9	3.3
Of which					
Interest payments	1,280	394.5	415.9	31	5.4
Development	1,231	115.3	169.9	32.3	47.4
PSDP	1,235	93.0	146.3	16.9	57.4
Others		22.3	23.6	193.3	5.7
Net lending		4.8	-1.1		
Statistical discrepancy		6.4	11.1		
Fiscal balance (A-B)	-1,305	-336.8	-328.2		
Financing	*1,305*	*336.8*	*328.2*		
External sources	322	-13.5	55.3		
Domestic sources	983	350.3	272.9		
Banking system	283	139.9	139.4		
SBP	-65	-39.0	-304.4		
Scheduled banks	348	178.9	443.8		
Non-bank	650	210.4	133.5		
% of GDP					
Overall fiscal balance	-4.3	-1.2	-1.1		
Revenue balance	-0.3	-0.7	-0.5		
Primary balance	-0.2	0.2	0.3		

[1]Includes pensions, grants, subsidies, and general government expenses.

[3] Pakistan issued 10-year bond of US $ 500 million in the international bond market at a coupon rate of 8.25 percent in September 2015.

Source: Ministry of Finance

Box 4.1: Key taxation measures announced in Federal Budget FY16[4]

In federal budget for FY16, the government targeting the tax to GDP ratio of 11.1 percent and to contain the deficit to 4.3 percent of the GDP. The budget envisaged a growth of 17.5 percent in taxes during the year, and introduced a number of new tax measures. The key proposals are given below:

New taxes / rate increases

- A one-time tax of 3 percent on individuals at income in excess of Rs 500 million, and 4 percent on associations, companies and banks, for the rehabilitation of Temporarily Displaced Persons (TDPs);
- Expansion in the coverage of differential taxation scheme for filers and non-filers in order to encourage tax filing: e.g., tax rate on dividend is increased from 10 percent to 12.5 percent for tax filers and 17.5 percent for non-filers;
- Income tax of 0.6 percent on all banking instruments levied on non-filers of tax returns, which was later reduced to 0.3 percent after negotiations with the stakeholders;
- Increase in Capital Gains Tax from 12.5 percent to 15 percent for 1st year, and 10 percent to 12.5 percent for next year;
- A uniform rate of 35 percent on all sources of banking companies' income to remove tax arbitrage;
- Reduction in various exemptions (under SROs) equivalent to Rs 120 billion.

Tax rate reduction/ concessions

- Reduction in the number of slabs of customs duty to 4 for simplification, and reduction in duty rates from 25 percent to 20 percent;
- A plan for reducing the corporate income tax rate by 1 percent annually to bring it down from 35 percent to 30 percent during the next 6 years.
- Reduction in income tax rate from 5 percent to 2 percent for salaried taxpayers with income less than 0.5 million and in excess of 0.4 million;
- Reduction in customs duty on imported construction machinery from 30 percent to 20 percent.
- Introduction of a reduced sales tax (non-adjustable) of 7 percent instead of 17 percent to encourage farm mechanization. Similarly, the customs duty, sales tax, and withholding tax rates on imports of agricultural machinery were also proposed to be reduced.
- In order to promote certain sectors, the government has announced tax holidays. These include Halal food production which is tax exempted for four years and rice mills for one year. The government has declared a 10-year tax exemption on projects on developing and setting of electricity transmission lines in the country and 5-year tax exemption for projects for manufacturing equipments for solar and wind energy.

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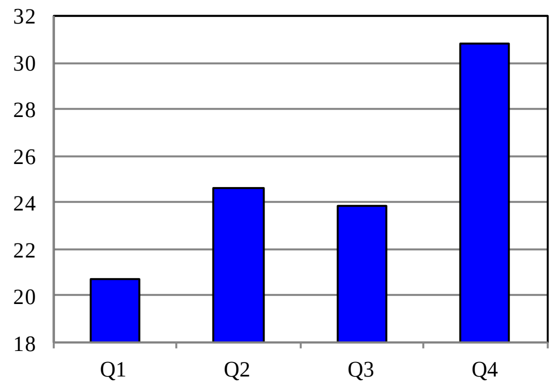
[4] The government took some additional revenue measures in November 2015 to make up for the revenue shortfall during the first quarter, including: (i) imposition of 5–10 percent regulatory duty on luxury and non-essential items (including fruits, vegetables, bakery items, cosmetics, shampoos, some sanitary fixtures); (ii) imposition of 1 percent customs duty across the board; (iii) increased FED on cigarettes; and (iv) raised fixed duty on import of old and used vehicles (above 1000cc) (Source: S.R.O 1177(1)/2015 and S.R.O 1178(1)/2015.)

4.2 Revenues

The revenue collection improved by 11.6 percent against a dismal growth of 1.2 percent a year ago. While the non-tax revenues showed virtually no growth, the tax collection picked up by 15.4 percent. The pace of tax collection, though encouraging, is still lower than what it should be: tax collection in Q1-FY16 is 19.3 percent of the full year target; however, according to past seasonal pattern, it should be about 21 percent of the annual revenues (**Figure 4.2**).

Figure 4.2: Seasonal Pattern of tax collection (percent share)



Source: Ministry of Finance

The shortfall witnessed in first quarter implies that much higher growth is required in subsequent quarters to achieve the annual target. For instance, a growth of 24.6 percent in tax collection will be needed in Q2, given the full year target of Rs 3,729 billion and the fact that around 25 percent of annual tax is collected in Q2 (**Figure 4.2**). .

FBR taxes

The tax collection by FBR posted 11.6 percent growth during the quarter (**Table 4.2**). [5] Encouragingly, the direct taxes yet again witnessed a robust growth of 26.3 percent which has also increased its share in total tax collection from 35.3 percent in Q1-FY15 to 39.9 percent in Q1-FY16.[6] The increase in direct taxes is largely due to enhanced coverage of the withholding taxes (**Box 4.2**).

The indirect taxes, on the other hand, posted a sluggish growth of 3.6 percent against a moderate 11.0 percent improvement in the same period last year. The overall deceleration in fuel prices and subsequently the inflation rate severely impacted the sales tax collection, which has shown negative growth during the

[5] The share of FBR taxes in total tax revenues, though still higher than 80 percent, is declining as provinces are vested with more powers to implement their tax regimes.
[6] The increase in the share of direct taxes is desirable, as it implies reduction in the regressiveness of the taxation structure.

quarter.[7] Meanwhile the customs duty witnessed 23.4 percent growth owing to increased tariffs on imported items as well as inclusion of new items under the customs levy[8].

Table 4.2: FBR Tax Collection

billion rupees; Growth in percent

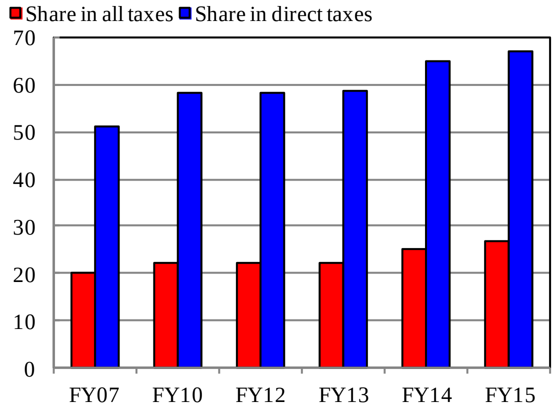
	Budget	Actual		Growth	
	FY16	**Q1-FY15**	**Q1-FY16**	**Q1-FY15**	**Q1-FY16**
Direct	1,348	189.7	239.7	17.3	26.3
Withholding tax	na	141.1	171.9	20.4	21.8
Indirect	1,756	348.1	360.5	11.0	3.6
Customs	299	64.5	79.6	23.1	23.4
Sales tax	1,250	258.2	253.4	9.5	-1.9
Federal excise	206	25.4	27.5	0.0	8.2
Total taxes	**3,104**	**538.0**	**600.0**	**13.1**	**11.6**

Source: Federal Board of Revenue

Box 4.2: Growing reliance on withholding taxes

The withholding tax (WHT) is levied by the governments, across the globe, on sources of income, and purchase of goods and services. Pakistan inherited WHT on salary and interest income under British Income Tax Ordinance (ITO) 1922, which was repealed by the Income Tax Ordinance, 1979. During 1990s, the withholding tax coverage was expanded substantially on various transactions and making most of them presumptive. Recently, its scope has been further enhanced to increase tax net and to address the issue of low and declining tax-to-GDP ratio. In the presence of large informal economy and poor culture of voluntary tax payments on one hand, and structural issues in tax administration on the other, the WHT has become a highly dependable means of generating revenues.

Figure 4.2.1: Rising Trend of Withholding Taxes (percent)



Source: Federal Board of Revenue

The WHT does have its merits. It is considered as low cost tool to raise revenues with the possibility of less leakages and minimum contact

[7] Within the petroleum group, the petrol prices plummeted by 29 percent (YoY) while the price of diesel fell by 22 percent.

[8] The government rationalized the custom duty by proposing withdrawal of various concessions and exemptions in federal budget FY16.

between the payers and tax official. It is therefore easy to broaden its coverage by including it on various services and income sources. Recently, the FBR has introduced a WHT mechanism, which separates out filers of income tax returns and non-filers. This mechanism is a tool to document the economy, whereby filers of tax returns pay lower tax rates than non-filers, thus incentivizing the tax filing.[9]

As a result of enhanced coverage and differential rates on filers and non-filers, the share of WHT in direct taxes increased to 67.1 percent in FY15, compared with less than 60 percent three years back (**Figure 4.2.1**). Further, the contribution of WHT in total tax collection surpassed 26 percent in FY15 making it as the most reliable tax resource. During the last three years, WHT collection from all sources witnessed a compound annual growth rate (CAGR) of 24.5 percent, compared with the growth of 8.9 percent in overall FBR taxes.

The key sources of the withholding tax are contracts and international trade, which together make half of the total collection. Tax deducted from salaries constitues 11.5 percent of the total WHT. Other important sources are bank interest and securities and cash withdrawal. [10]

The coverage of WHT on banking transactions has been further enhanced in FY16 budget with higher rates for non-filers.[11] The measure is expected to generate additional revenue as well as to curtail undocumented flow of funds from the banking channels. Although there are some adverse implications for banking sector, as people may opt out of the banking channel, we believe it will be short-lived; in the long-run this tax may help documentation of the economic transactions.

But there are also some demerits of WHT; (a) it carries a substantial compliance cost for withholding tax agents. This requires more human resource, I.T. infrastrucutre and other overheads to manage the collection mechanism and deposit with the FBR; (b) withholding tax on utilities (telephone bills, electrity bills, education fee, etc) may create additional burden on tax payers as it, though adjustable for tax filers, invloves time lags for refunds; and (c) its incidence is regressive, like indirect taxes, particularly when applied on transactions.

Non-tax revenues

The non-tax revenues posted a minimal growth of 0.3 percent (Rs 0.6 billion) due to absence of any significant one-time inflow that boosted the revenues in previous years. Moreover, due to lower international petroleum prices that continued to prevail, the revenue collected vide discount retained on crude oil and windfall levy contributed less than the same quarter last year and is expected

[9] The number of tax filers saw a steady increase in early 2000s and reached a peak of 1.8 million in FY07. However, the momentum could not prevail and tax filing declined in FY08-14 to just 0.75 million in FY14. One of the key factors behind this decline could be the increase in the income tax threshold from Rs 180,000 in FY08 to Rs 400,000 in FY14. However, steps taken by FBR resulted improvement in tax filing with 0.85 million in FY15, and expected to surpass 1 million in FY16.

[10] The WHT on cash withdrawal from banks was introduced in Finance Act 2005. The tax rate was initially set at 0.1 percent on cash withdrawals in excess of Rs. 25000 per day. The rate was revised upwards to 0.2 percent in FY07 and 0.3 percent in FY10. Meanwhile, the cash limit was enhanced to Rs 50,000 per day in federal budget FY13.

[11] See Box 4.1

to miss the budgetary targets (**Table 4.3**).[12] Similarly, the royalties on gas and oil also declined due to price effect. Meanwhile, other major components such as SBP profits, CSF inflows and dividend earnings continued to support the non-tax revenues.

Table 4.3: Non-tax Revenues
billion rupees

	Budget FY16	Actual		
		Q1-FY14	**Q1-FY15**	**Q1-FY16**
Mark-up (PSEs & others)	57	56.8	0.9	0.9
Dividend	88	3.7	10.9	16.3
SBP profits	280	80.0	67.5	67.6
Defence (incl. CSF)	154	2.0	77.3	75.7
Royalties on gas & oil	59	19.2	20	17.6
Passport & other fees	25	4.0	2.7	3.4
Discount retained on crude oil	21	3.9	2.3	2.1
Windfall levy against crude oil	18	3.8	5.3	1.0
Foreign grants	40	10.1	8	7.1
Other federal	53	74.6	5.5	7.2
Provincial	168	10.7	12.4	14.9
Total non-tax revenue	**963**	**268.8**	**212.9**	**213.5**

Source: Ministry of Finance

4.3 Expenditures

The consolidated fiscal spending witnessed 7.2 percent growth during the quarter under review which is much lower than 12.7 percent increase in same quarter last year. This slowdown was broad-based; however, sharp reduction in growth was witnessed in interest payments – the highest item in the current expenditure (**Table 4.4**).

The interest payments showed a modest growth of 5.4 percent in Q1-F16. This was mainly on account of lower growth in PIB coupon payments during the quarter. Both low interest rates and less borrowing through PIBs during FY15 were responsible for this lower growth.[13]

[12] Discount retained on crude oil is the share of government in selling price of local crude oil produced by exploration companies. Similarly, windfall levy against crude oil is the gain realized in case of fluctuations in international oil prices.
[13] The government borrowed Rs 933.2 billion during FY15 through PIBs against 1.9 trillion in FY14.

The sluggish growth in the current expenditures paved way for the government to increase its development spending. As a result, the federal PSDP increased by 80 percent during the quarter which was also complemented by 40.6 percent rise in provincial PSDP. The federal government directed significant resources towards improving transport infrastructure, revamping of railways and improving water resources and distribution network. Moreover, PSDP disbursements were also made towards the Higher Education Commission (HEC), National Highway Authority (NHA) as well as rehabilitation of the IDPs. Likewise, the provinces also focused on developing physical infrastructure by laying road networks and development spending on public welfare.

Table 4.4: Analysis of (Consolidated) Fiscal Spending – Q1
billion rupees; growth in percent

			Growth	
	FY15	**FY16**	**FY15**	**FY16**
Total expenditure	**1,176.5**	**1,265.1**	**5.4**	**7.5**
Total expenditure(booked)	1170.2	1254.0	12.7	7.2
Current	1,050.1	1,085.2	20.9	3.3
Federal	772.1	768.2	20.7	-0.5
Interest payments	394.5	415.9	31.0	5.4
Domestic	375.9	396.9	31.3	5.6
External	18.6	19.0	24.8	2.2
Pension	39.7	42.5	8.8	7.0
Grants	52.8	56.7	26.3	7.3
Defence	164.6	145.6	12.4	-11.5
Public order & safety	21.3	21.8	16.3	2.2
Health & education	12.7	16.5	-9.6	30.1
Others	86.7	69.2	6.5	-20.1
Provincial	278	317.0	21.5	14.0
Development	115.3	169.9	32.3	47.4
PSDP	93.0	146.4	16.9	57.4
Federal	39.6	71.3	-11.9	80.0
Provincial	53.4	75.1	54.4	40.6
Other dev. expenditure	22.3	23.6	193.3	5.8
Net lending	4.8	-1.2	-94.2	-124.0
Statistical Discrepancy	6.3	11.2	-91.9	75.7

Source: Ministry of Finance

4.4 Provincial fiscal operations

The fiscal position of provinces showed deterioration in overall balance. The provinces are expected to maintain surplus to provide sufficient cushion for consolidated fiscal outcome. However, the aggregate balance reduced considerably from a surplus of Rs 45.3 billion in Q1-FY15 to Rs 7.4 billion in Q1-FY16.[14] This decline is largely attributed to increased provincial expenses by 17.9 percent as well as reduction in transfers from divisible pool (**Table 4.5**). [15]

[14] Based on financing amounts of provincial budgets.
[15] On contrary to a growth of 11.6 percent in FBR taxes, the federal transfers to provinces went down by 7.2 percent during Q1-FY16.

Table 4.5: Provincial Fiscal Operations

billion rupees ; growth in percent

	Punjab	Sindh	KPK	Balochistan	Total	Growth
Q1-FY16						
Total revenue	167.7	103.4	55.1	39.8	366.0	-6.8
Share in federal revenue	134.2	72.9	46.3	35.5	288.9	-7.2
Taxes	28.8	27.0	3.0	0.4	59.2	32.5
Non-taxes	7.0	1.4	5.2	1.2	14.9	19.9
Federal loans and transfers	-2.3	2.0	0.6	2.6	3.0	-87.8
Total expenditure	196.2	101.9	58.4	38.4	395.0	17.9
Current	145.8	88.3	50.0	35.8	319.9	13.6
Development	50.4	13.6	8.4	2.6	75.1	40.6
Overall balance	-28.5	1.5	-3.3	1.4	-29.0	
Financing	31.3	-5.4	-13.0	-20.2	-7.4	
Q1-FY15						
Total revenue	183.5	104.9	63.6	40.7	392.7	1.1
Share in federal revenue	145.3	79.2	52.3	34.5	311.3	-3.5
Taxes	23.9	17.5	3	0.3	44.7	6.2
Non-taxes	5.4	1.7	4.7	0.6	12.4	15.9
Federal loans and transfers	8.9	6.5	3.6	5.3	24.3	88.4
Total expenditure	150.9	95	59.9	29.1	334.9	25.6
Current	120.3	81.9	52.7	26.8	281.7	21.2
Development	30.6	13.2	7.3	2.3	53.4	54.3
Overall balance	32.6	9.8	3.6	11.6	57.6	-52.5
Financing	-16.7	-6.4	-9.1	-13.1	-45.3	

Source: Ministry of Finance

Although the provinces were able to collect 32.5 percent higher taxes during the quarter, the revenues generated were not sufficient to meet their needs. Since the 18th amendment, the provinces are free to impose taxes on agricultural income and various services; the federal government has also shifted its cost center of various current expenditures such as public order and safety, education and health towards the provinces which has increased the current expenditures. As a result, the current expenses increased by 13.6 percent.

A disaggregated analysis reveals that Punjab posted a large deficit of Rs 31.3 billion in Q1-FY16, against a surplus of Rs 16.7 billion last year same period. While its expenditure increased by 30 percent mainly on the back of development expenses, its revenues showed a decline of 8.6 percent during the quarter. All other provinces have shown surpluses – the highest surplus by Balochistan. While total revenues by other provinces were also lower in Q1-FY16, compared with the previous year, they managed to show surpluses by controlling their expenditures.

4.5 Public debt

Pakistan's public debt stock increased by Rs 768.8 billion during Q1- FY16, reaching Rs 18.5 trillion as of end-September 2015. This was driven by rise in both the domestic and external debt (**Table 4.6**).

Table 4.6: Debt Burden
billion rupees

	Stock		Absolute Change	
	June-15	Sep-15	Q1-FY15	Q1-FY16
Public debt	**17,757.7**	**18,526.5**	**215.1**	**768.8**
Public domestic debt	12,192.5	12,714.6	189.4	522.1
Public external debt	5,565.2	5,811.9	25.7	246.7
Govt external debt	4,770.0	4,952.7	16.8	182.7
Debt from the IMF	417.6	475.3	1.7	57.7
External liabilities	377.6	383.9	7.2	6.3
Memorandum Item				
Public debt (MoF)[1]	17,380.2	18,142.6	207.8	762.5

[1] MOF defines public debt as "The portion of total debt which has a direct charge on government revenues as well as debt obtained from IMF".
Source: State Bank of Pakistan

Domestic debt

Despite some improvement in fiscal deficit and higher availability of external resources, domestic debt during Q1-FY16 increased by almost three times of the same period last year (**Table 4.7**). This can be explained by temporary buildup of government deposits with the central bank.[16]

Table 4.7: Absolute Change in Government Domestic Debt
billion rupees

	Q1-FY15	Q1-FY16
1. Government domestic debt	189.4	522.1
Permanent debt	248.0	90.8
of which		
PIBs	234.0	55.6
Floating debt	-112.9	377.4
of which		
MTBs	37.2	614.7
MRTBs	-216.7	-58.2
Outright sale of MRTBs	66.6	-179.1
Unfunded debt	54.1	53.7
Foreign currency loans	0.2	0.1

Source: State Bank of Pakistan

[16] Government's deposits with SBP increased by Rs 252.0 billion during Q1-FY16 against Rs 161.5 billion decline in the same period last year.

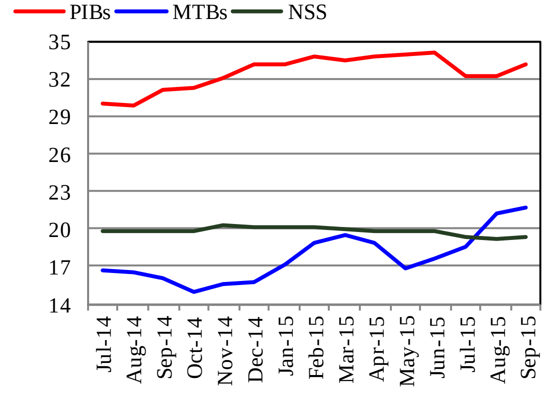
Like previous year, the government continued to borrow mainly from commercial banks in Q1-FY16 and retired some of its debt to SBP. With this strategy, the government not only successfully met the IMF ceiling on its borrowing from SBP for end-September 2015, but also satisfied the zero quarterly limit, prescribed in the SBP Act, 1956.

The pattern of borrowing from commercial banks shows that the share of long term securities in the domestic debt declined during the quarter.

The MTBs share, on the other hand increased to 21.7 percent by end September 2015, from 17.6 percent at end-June 2015 (**Figure 4.3**). While these changes could reduce the fiscal burden in terms of lower interest payments, government's exposure to rollover and re-pricing risk may increase in future.[17]

From commercial banks point of view, long term securities were still attractive, as they were anticipating a cut in the policy rate. The banks were, therefore, aggressively participating in PIB auctions throughout the quarter.

Figure 4.3: Share in Domestic Debt



Source: State Bank of Pakistan

Table 4.8: MTBs and PIBs Auction Profile (Face value)

billion rupees

Auction date	Target	Offer	Acceptance[1]	Maturity[2]
MTBs				
9-Jul-15	150.0	143.9	102.9	81.6
23-Jul-15	125.0	263.8	220.0	67.3
6-Aug-15	225.0	360.3	356.5	140.4
20-Aug-15	300.0	248.6	239.5	263.1*
3-Sep-15	150.0	210.5	195.6	101.3
17-Sep-15	250.0	160.0	146.1	208.8
Q1-FY16	**1,200.0**	**1,387.0**	**1,260.6**	**862.6**
PIBs				
15-Jul-15	100	175.5	51.7	139.3
12-Aug-15	50	364.4	63.1	16.7
9-Sep-15	50	252.8	87.9	7.3
Q1-FY16	**200**	**792.6**	**202.7**	**163.3**

[1] Competitive bids only
[2] Maturities for PIBs pertain to whole month.
*Includes outright maturities of Rs 186.5 billion MTBs.
Source: State Bank of Pakistan

[17] Rollover risk indicates inability to refinance debt falling due in a specific period if new borrowing rates are exceptionally high or investors are unwilling to purchase the debt. Re-pricing (or interest rate) risk refers to the possibility of higher interest rates at the time of refinancing.

The cumulative amount offered by banks in PIB auctions were almost four times of the target (**Table 4.8**). One of the key factors behind this was the substantial term premium available for PIBs.[18] However, the outcome of auctions shows that the government stuck to its pre-auction targets.

Funds mobilization through NSS
Despite frequent downward revisions in the rates of returns, funds mobilized through National Savings Schemes (NSS), maintained their pace in Q1-FY16, as in last year (**Table 4.9**).[19] Among the NSS, main contribution came from Special Saving Account (SSA) and Behbood Saving Certificate (BSC) that posted a net inflow of Rs 19.7 billion and Rs 22.6 billion respectively. At the same time, investment in Special Saving Scheme (SSC) went down significantly, mainly due to larger maturities during the quarter.

Table 4.9: Net Receipts under NSS Instruments
billion rupees

	FY13	FY14	FY15	FY16
DSC	17.9	1.7	3.2	0.6
SSC	13.7	3.7	17.1	7.3
RIC	12.2	5.0	14.6	-2.8
BSC	15.8	11.0	15.2	22.6
SSA	73.1	3.8	-2.4	19.7
Others	4.7	0.4	4.4	5.7
Total	**137.3**	**25.6**	**52.1**	**53.1**

DSC: Defence Saving Certificates, SSC: Special Saving Certificate, RIC: Regular Income Certificate, BSC: Behbood Saving Certificates, SSA: Special Saving Accounts
Source: Central Directorate of National Savings (CDNS)

Table 4.10: Pakistan's Public External Debt & Liabilities
million US dollars

	Jun-15	Sep-15	Change
Public external debt & liabilities	**54,674.6**	**55,608.9**	**935.3**
Government debt	46,861.2	47,387.7	526.5
of which			
Paris club	11,664.1	11,737.3	73.2
Multilateral	24,262.7	24,146.1	-115.6
Other bilateral	3,941.2	3,880.9	-60.3
Euro/Sukuk bonds	4,550.0	5,050.0	500.0
Commercial loans	300.0	100.0	-200.0
Multilateral(ST)	982.8	821.7	-161.1
Commercial loans(ST)	0	515.0	515.0
IMF	4,103.0	4,548.1	445.1
Federal government	52.0	0.0	-52.0
Central bank	4,051.0	4,548.1	497.1
External liabilities	3,709	3,673	-36.0

Source: State Bank of Pakistan

External debt & liabilities
Public external debt and liabilities posted a US$ 935.3 million increase during the quarter, reaching US$55.6 billion by end-September 2015. This increase was driven by US$ 515 million commercial loans and US$ 500 million Eurobonds

[18] As mentioned earlier, banks were expecting reduction in interest rate in the backdrop of declining inflation.
[19] The rates on NSS observed temporary reversal during August 2015 but these rates are still lower while compared to Q1-FY15.

(**Table 4.10**).[20] In addition, the country received 8th tranche under extended fund facility (EFF), which added US$ 497.1 million to total EDL during the quarter. [21]

The data of gross disbursement of external loans shows that the country received an amount of US$ 1.5 billion in Q1-FY16, compared to only US$ 663.7 million last year.[22] Moreover, fresh commitments by international donors continued to support ongoing reform process in the country (**Box 4.3**).

Debt servicing of external debt

External debt servicing declined by US$ 274.7 million in Q1-FY16, compared to the same period last year (**Table 4.11**). This was mainly on account of decline in repayments to the IMF. On the contrary, the servicing of the government debt increased due to (i) rise in the repayment to multilateral donors, and (ii) commercial loan matured during the period. Moreover, the external debt repayments are expected to increase in H2-FY16, mainly due to maturity of 10-year Eurobond issued in FY06 (For detail See SBP's **Annual Report FY15**).

Table 4.11: Public External Debt Servicing - Q1

million US dollars

	FY15	FY16	Change FY16
Public debt (a+b+c)	**1,171.6**	**896.9**	**-274.7**
Principal	958.7	697.1	-261.6
Interest	212.9	199.8	-13.1
a. Government debt	620	811	191.4
Principal	439	645	205.6
Interest	181	167	-14.3
b. IMF	533	63	-470.3
Principal	520	53	-467.2
Interest	13	10	-3.1
c. Foreign exchange	19	23	4.2
Principal	0	0	0.0
Interest	19	23	4.2

Source: State Bank of Pakistan

Box 4.3: IFIs fresh loan commitments

The International Financial Institutions (IFIs) are the major sources of financial and technical support for developing countries and play a critical role to support infrastructure development and institutional reforms. During the recent years, the ADB and World Bank were central in helping Pakistan's power sector. A brief description of projects financing agreements by the two institutions is given below:

[20] The bond was oversubscribed twice and the coupon rate was 8.25 percent; equal to the rate of Eurobond, issued in April 2014. In terms of geographical spread, 38 percent of subscription came from North America, 38 percent from UK, 12 percent from Europe and 12 percent from Asia.

[21] This amount is different than given in BOP numbers due to exchange rate valuation.

[22] This excludes inflows from IMF during the quarter.

ADB

Sustainable Energy Sector Reform Program - Subprogram 2: This program will support policy measures to address extensive debts in the power sector, as well as further market reforms to improve the efficiency of public sector power companies and to encourage competition through more private sector participation. ADB approved US$400 million loan for the program in November 20, 2015 (of which; US$ 100 million is under ordinary capital resources (OCR)).[23]

Second Power Distribution Enhancement Investment Program: The investment program aims to improve the financial viability of the power sector. By introducing the advance metering infrastructure to power distribution companies, this program will not only modernize the electricity metering and billing system but will also help to reduce losses and improve revenues. ADB has approved loan assistance of nearly US$1.0 billion on November 20, 2015 (of which; US$ 970 million is under OCR).

Sindh Provincial Road Improvement Project: The ADB has approved US$197.8 million on October 12, 2015 to rehabilitate highways in the Sindh. The proposed project aims to improve connectivity between city centers and local markets.

National Motorway M-4 Gojra–Shorkot Section Project: ADB approved loan assistance of US$ 178.0 million to fund M-4 motorway connecting Gojra to Shorkot on September 30, 2015. At the same time, ADB would also manage US$92 million grant for the project from the DFID.

Pakistan: Flood Emergency Reconstruction and Resilience Project: The project will contribute to the economic and social recovery of flood-affected areas through the rehabilitation and reconstruction of high-priority infrastructure. The ADB has approved assistance of over $220 million on June 30, 2015 for the project.

World Bank

Disaster and Climate Resilience Improvement Project: The World Bank approved US$125 million on June 02, 2015 for restoration of resilient flood protection infrastructure and to strengthen the government capacity to manage disasters and climate variability.

Fiscally Sustainable and Inclusive Growth: The World Bank approved US$125 million credit on June 18, 2015to boost economic growth through fostering private and financial sector development, and mobilizing revenue while expanding fiscal space to meet social needs.

Sindh Barrages Improvement Project: The World Bank approved US$188 million on June 19, 2015 for the project to improve the reliability and safety of the Guddu Barrage and to strengthen the Sindh Irrigation Department's capacity to operate and manage the barrages.

[23] OCR constitutes of the ADB's lending pool that provides funds to lower to middle-income countries. OCR operations are quite diversified and the main sources of funding include; paid-in capital, retained earnings, and proceeds from debt issuance. ADB issues debt in the international capital markets and its debt securities carry good investment ratings from major international credit rating agencies.

Support for Temporarily Displaced Persons of FATA: The World Bank approved US$ 75 million on August 26, 2015to support the recovery of families affected by the militancy crisis, promote child health, and to strengthen emergency response safety net delivery systems in the affected areas of Federally Administered Tribal Areas (FATA).

*Second Development Policy Credit::*The World Bank approved US$500 million on November 12, 2015 for the project to support the ongoing reform process in the energy sector that will improve its financial, technical and commercial performance of the sector

Water Sector Capacity Building & Advisory Services Project: The project aims to improve the management, planning and development of water resources for the Indus River Basin in Pakistan with better environmental and social considerations. The World Bank approved financing of US$35 million on December 21, 2015 for the project.
Source: World Bank and Asian Development Bank websites

5 External Sector

5.1 Overview

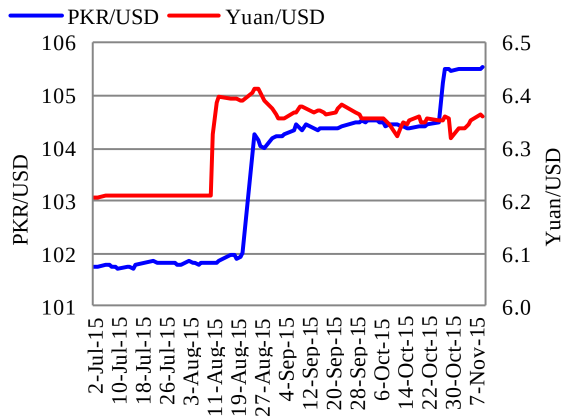
The on-going slump in global commodity prices continued to support Pakistan's external sector. Oil prices posted a fresh decline of 25 percent during Jul-Sep 2015, and averaged 51 percent lower than the same period last year. This not only helped reduce the country's import bill, but also contributed to a much smaller deficit in the services account (**Table 5.1**). As a result, the current account posted a lower deficit than last year, which was comfortably financed via Eurobond issuance; FDI inflows; and commercial borrowings by the government.[1] The release of 8th tranche of the IMF program further strengthened external position. As a result, the country's total FX reserves increased by US$ 1.4 billion during the quarter, to surpass US $20 billion – first time ever, at end-September 2015.

Table 5.1: Summary of Pakistan's External Sector
million US$

	Q1-FY15	Q1-FY16	*Abs change*
Current account balance	-1,631	-351	1,280
Trade balance	-6,054	-4,700	1,354
Exports	5,959	5,321	-638
Imports	12,013	10,021	-1,992
Oil imports	4,476	2,582	-1,894
Services balance	-658	-177	481
CSF	735	713	-22
Freight deficit	-766	-395	370
Worker remittances	4,775	4,967	192
FDI in Pakistan	201	248	47
Portfolio inv. in Pakistan	133	390	257
Euro bond	0	500	500
FX reserves (end-period)	13,511	20,074	6,563

Source: State Bank of Pakistan

Figure 5.1: PKR and Yuan vis-a-vis US Dollar

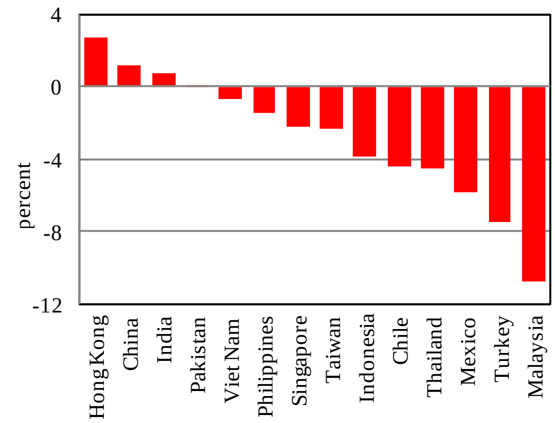


Source: State Bank of Pakistan

[1] Due to delays in budgeted disbursements of project and program loans, the government borrowed US$ 513 million short-term commercial loans from private lenders during Q1-FY16.

The PKR depreciated by 2.6 percent against the US Dollar during Q1-FY16. This depreciation mainly represents turmoil in Asian stocks and currency markets during August: Yuan's reference rate was reduced by 2.7 percent (**Figure 5.1**). In relative terms, the PKR depreciated marginally as currencies of our major trading partners like the EU, Japan and the UK, weakened vis-à-vis the US Dollar during the quarter.

Figure 5.2: Change in REER during Jul-Sep FY16



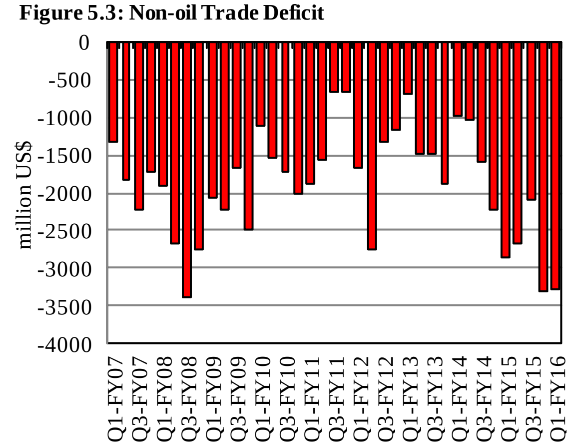
Source: Haver Analytics

More importantly, most Asian currencies have plummeted in real terms that may pose concern for Pakistan's trade competitiveness (**Figure 5.2**).

Additional challenges to external sector include the following:

(i) Non-oil trade deficit has reached 7-year high of over $3 billion in the first quarter (**Figure 5.3**). Last time this deficit touched $3 billion a quarter, was early 2008 when global prices were booming and our importers hurried purchases in an anticipation of further increase in prices. This time, however, the reason is different: it is the decline in non-oil exports (6th quarter in a row) that has caused non-oil deficit to touch this level.

Figure 5.3: Non-oil Trade Deficit



Source: Pakistan Bureau of Statistics

Non-oil imports have posted a YoY decline of 1.7 percent over last year;

(ii) FDI inflows, though remained higher than last year, are still low in volume (**Table 5.2**). Bulk of the investment during Q1-FY16 came from China; power projects were prime recipients. FDI in other sectors have dried up, as the slump in commodity prices and global economic uncertainty, has put many investment projects on hold. A related concern arises from the fact that FDI from other countries have remained low. While the US, Saudi Arabia and Sweden have divested from Pakistan during the quarter, inflows from Japan, the UK and UAE remained lower than last year; and

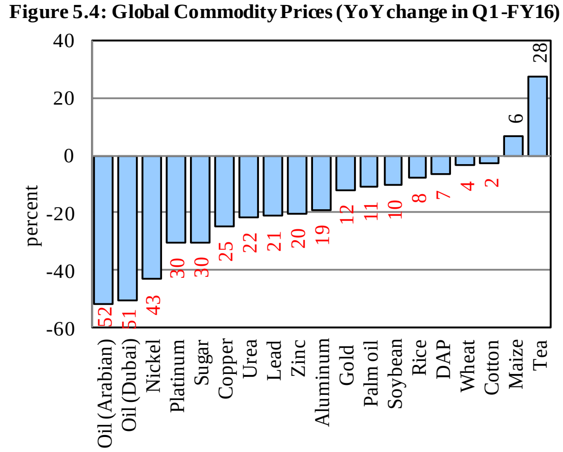
Table 5.2: FDI Inflows
million US$

	Q1-FY15	Q1-FY16
Total FDI inflows	201	248
FDI from China	2	186
FDI excl. China	199	62

Source: State Bank of Pakistan

(iii) Gulf countries that constitute nearly 61 percent of total worker remittances to Pakistan, rely heavily on oil revenues to finance infrastructure spending; if prices fail to recover, governments in this region may need to cut back their spending. Saudi Arabia seems particularly vulnerable: since January 2015, its FX reserves have been depleted by almost US$ 80 billion, to finance oil-led fiscal deficit.[2] IMF estimates the Kingdom's breakeven oil price to be much higher than the prevailing one; the Fund has recently cautioned Saudi Arabia against risk of reserves depletion within 5 years, if current level of deficit is sustained.[3,4]

Figure 5.4: Global Commodity Prices (YoY change in Q1-FY16)



Source: Bloomberg

[2] Saudi Arab's FX reserves (including FX, reserves position in the Fund and the US$ value of SDR holdings by Saudi Arabian Monetary Agency) have been reduced from US$ 764 billion in January 2015, to US$ 654 billion at end-September 2015 (Source: Haver Analytics).
[3] IMF defines fiscal breakeven oil price as, "the oil price that balances the government budget".
[4] Source: "Middle East and Central Asia", IMF's Regional Economic Outlook, October 2015.

5.2 Current account: *Commodity prices weigh in*

The current account benefited from the fact that price of commodities which Pakistan imports (like oil, metals, fertilizers and palm oil) fell much steeply than the price of commodities which Pakistan exports (like rice and cotton) (**Figure 5.4**). Therefore, the decline in imports was much stronger than the decline in exports during Q1-FY16. What concerns us is the fact that while the decline in imports is explained almost *entirely* by price effect, the decline in exports was caused by *both* lower prices and quantum (**Section 5.4**).

Worker remittances

Worker remittances posted a growth of only 4 percent YoY during Q1-FY16, compared to 22 percent growth during the same period of FY15. This slowdown basically represents seasonal factor (high base effect): expat Pakistanis typically send higher remittances during the early days of Ramadan for Eid related expenses and Zakat payments; in CY14, most of these disbursements were realized in the month of July (included in FY15), whereas in CY15, these fell in the month of June (also included in FY15).[5] Therefore, remittance inflow posted a YoY decline in July 2015, causing an overall slowdown during Q1-FY16.

Going forward, we expect remittances to comfortably surpass the target set in the Annual Plan for FY16.[6] However, the pace of increase is likely to be much modest compared to last year.[7] Besides seasonal factor, we believe that some slowdown may be driven by the government's decision to cut effective rebate on remittances with effect from July 1, 2015.[8]

Another factor that might weaken remittance inflow is the possible decline in public spending in the GCC that constituted the bulk of increase in remittances last

[5] In 2015, 1st Ramadan fell on 19th June, whereas last year it had fallen on 30th June 2014.

[6] The government has envisaged remittance inflow of US$ 19 billion for the full-year FY16 (Source: Planning Commission). This represents growth rate of only 1.4 percent over FY15.

[7] In FY15, remittances had grown by 18.2 percent. As mentioned earlier, this extraordinary growth stemmed mainly from seasonal effects.

[8] SBP vide *EPD Circular Letter No. 12 of 2015,* announced a cut in rebate from 25 SAR (Saudi riyal) to 20 SAR per transaction. Furthermore, the minimum amount of remittance to qualify for reimbursement of T.T. Charges has been increased from equivalent of USD 100 to USD 200. This rebate effectively works as reimbursement of telegraphic transfer (TT) charges that banks incur for funds transfer. Banks are also allowed to share this rebate with partner exchange companies and/or money transfer organizations, to encourage them mobilize more customers.

year.[9] In the oil and gas sector, some impact of oil slump is already visible in layoffs and salary cuts. Up till now, Pakistanis are largely unaffected, since most of them work in construction and services sectors; number of Pakistani migrants into this region is still following an upward trend.[10] This is because GCC governments have been able to sustain their fiscal spending with the help of FX reserves and funds mobilized via bond issuances.[11] However, a persistent weakness in oil prices would necessitate heavy fiscal adjustments, especially in those countries where breakeven oil price is much high (like Bahrain, Saudi Arabia, Oman and Yemen).

5.3 Financial account

Foreign direct investments

Net FDI posted an increase of US$ 47 million YoY during the first quarter of FY16. This increase was primarily on account of inflows from China in coal-based power projects, under the China-Pakistan Economic Corridor (CPEC). Excluding this, the overall FDI has actually dropped by US$ 137 million YoY (**Table 5.2**).[12]

The decline in FDI was attributed to divestment from Pakistan's petro-chemical sector.[13] This divestment mainly represents the decision of California-based Chevron Corporation, to dispose-off its downstream petroleum assets (like lubricants, fuel stations, etc.) from Pakistan, Egypt and Australia.[14] With 538 retail fuel outlets across Pakistan, and a market size of 5 percent, Chevron Pakistan (Caltex) will now be operated by Total Parco.

For the remaining year, more FDI is expected from China under the CPEC: the government has estimated disbursements of Rs 207 billion (around US$ 2.1

[9] GCC countries contributed 81 percent of the *increase* in worker remittances in FY15.

[10] Number of Pakistanis migrating to GCC countries has increased by 23 percent during January to September 2015, over the same period last year. Here it is important to mention that there is no data available on number of Pakistanis returning from abroad.

[11] Saudi Arabia issued sovereign bonds, first time after 2007, amounting SAR 15 billion (or US$ 4 billion) in July 2015, for deficit financing. Source: http://www.reuters.com/article/2015/07/10/saudi-bond-idUSL8N0ZQ03F20150710#Fcoh8Sx64YPHigz5.97

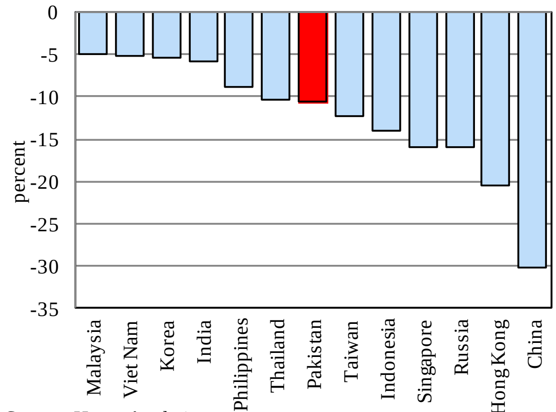
[12] China's FDI ($186 million) constituted 75 percent of total net FDI inflows during the period.

[13] Petro chemicals sector recorded huge outflow of $135.8 million during the quarter.

[14] Due to a sharp decline in oil price in the international market, Chevron has already pulled out of shale exploration in countries like Romania, Lithuania and Poland.

billion) from China in 2015-16 budget;[15] power and construction would be the prime recipients. Other than CPEC, no major activity is in pipeline: uncertainty in the international oil market, and the squeeze in institutional liquidity, has stalled growth in global FDI. Only if the government expedites its privatization process – and offer its stakes to foreign investors, we should expect more FDI inflows before June.[16]

Figure 5.5: Equity Performances in Major Asian Markets (change between Jun and Sep 2015)



Source: Haver Analytics

Portfolio investment

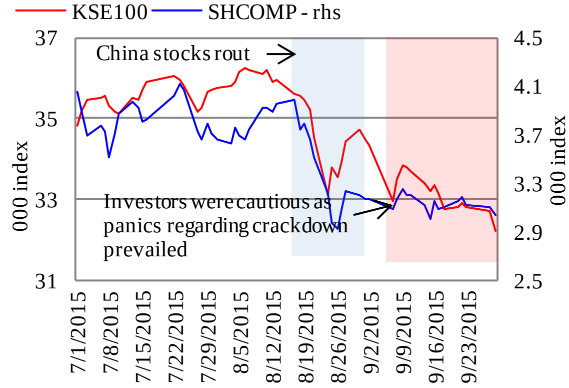
Portfolio investments in Pakistan posted an increase of US$ 257 million YoY during the first quarter of FY16. Most of the activity was seen in the public sector, as the government rolled out a 10-year Eurobond in the international market during the last week of September 2015. This was the third sovereign issue in past 17 months; similar to previous two instances, this was also oversubscribed. However, this time the government preferred to stick to its target of US$ 500 million, as coupons offered were quite above expectations. A significant improvement in Pakistan's credit worthiness could not trim the spread, as global bond market was facing tight conditions on account of a massive institutional sell-off (**Chapter 4**).

The situation in global equity market was not helpful either. Many emerging economies struggled with turbulent capital markets during the period, as investors turned wary of a slowdown in China and a possible hike in Federal funds rate (**Figure 5.5**). August was particularly painful, when Chinese stocks tumbled by 13 percent; Hong Kong by 12 percent; and Singapore and Vietnam by 9 percent each.

[15] Budget documents for 2015-16.
[16] Privatization of Heavy Electrical Complex (HEC), and Pakistan Steel Mills (PSM), is on cards.

Although Pakistan's largest bourse had, for long, been insulated from developments in global markets, this time it could not resist the shock: KSE lost nearly 3 percent during the month of August. Both local and foreign investors cut their positions in response to a near-crash in Chinese stocks (**Figure 5.6**). In dollar terms, there was a net outflow of US$ 85 million in SCRA during the month of August.[17]

Figure 5.6: Performance of KSE vis-a-vis Chinese Stocks*



* Measured by Shanghai Composite Index - SHCOMP
Source: Karachi Stock Exchange and Bloomberg

September turned out to be a better month for most Asian markets, but in case of Pakistan, it was no good. In fact, KSE was the worst-performing market in Asia during the month with nearly 9 percent decline in valuations. This was an outcome of rumors prevailing in the market regarding anti-corruption crackdown on major stock brokers. Investors were particularly flustered with regulatory action against certain brokers for not maintaining a clear segregation of own and clients' accounts. Foreign investors pulled away nearly US$ 46.7 million (or Rs 4.9 billion) from KSE during the month. It was only after the clarification from SECP in the last week of September (strongly dismissing reference of certain cases to NAB) that bulls returned to KSE: the market gained 6.1 percent in the subsequent month.[18]

Going forward, inflows under the portfolio investment would be influenced primarily by developments in the global bond and stocks markets. For instance, we expect the government to wait for better spreads, before it could mobilize another US$ 500 million via sovereign issuance to meet budgetary targets. On a positive note, Morgan Stanley Capital International (MSCI) has put Pakistan in its

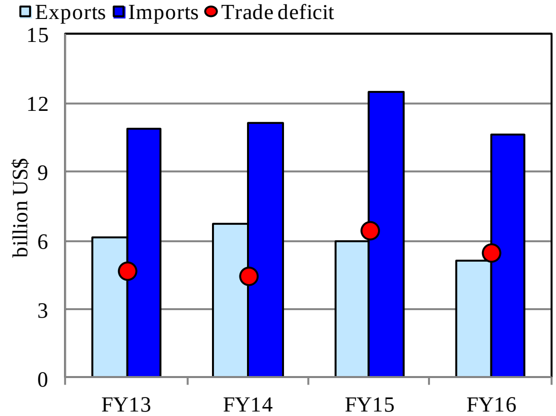
[17] Foreign investors can invest in Pakistan's stock and bond markets via special convertible rupee accounts (SCRA).
[18] On 29th September 2015, SECP clarified that NAB was approached to take punitive action exclusively against those brokers who embezzled shareholders' assets and have fled the country; no other case against brokerage houses has been referred to NAB for any regulatory violations.

review list for reclassification under 'Emerging Markets'.[19] However, this process will not be completed before June 2016, which means gains from this reclassification would be realized from FY17 onwards.

5.4 Trade account[20]

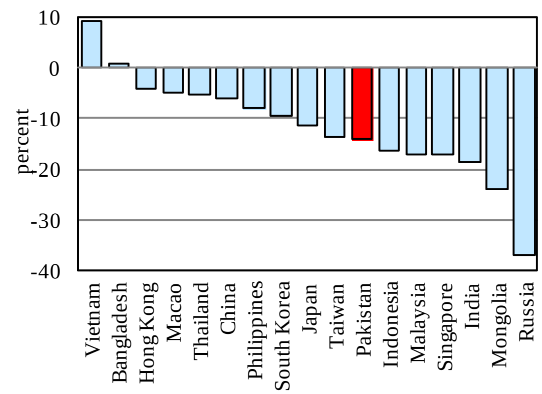
The country's trade deficit shrank during Q1-FY16 (**Figure 5.7**).[21] Both imports and exports posted a decline, but the fall in exports was more than offset by a sharp decline in imports: global commodity prices, which had been softening since July 2014, led to a greater contraction in the import bill.

Figure 5.7: Trade Account (Jul-Sep)



Source: Pakistan Bureau of Statistics

Figure 5.8: Export Growth (YoY) in Asian Economies in Jul-Sep FY16



Source: Haver Analytics

Exports

Exports declined by 14.1 percent in Q1-FY16, compared to a fall of 10.4 percent in the same period last year. The decline was broad-based, but most prominent in rice, cotton yarn, fabric, bed-wear, leather

[19] Pakistan was part of the MSCI Emerging Markets between 1994 and 2008. However, the temporary closure of the Karachi Stock Exchange in 2008 led MSCI to remove it from the Emerging Markets and classify it as a "standalone country index". MSCI made Pakistan a part of the Frontier Markets Index in May 2009, and it has remained as such since then.

[20] This analysis is based on provisional data provided by the Pakistan Bureau of Statistics, which is subject to revision. This data may not tally with the exchange record numbers posted in Section 5.2.

[21] This improvement was expected, as imports were exceptionally high last year when prices began to fall and importers were panicked anticipating price reversals.

and cement. Both lower prices and quantum contributed to this trend (**Table 5.3**).

Table 5.3: Change in Export Values – Quantum and Price Impact

million US$

	Percent Share in Exports *	Q1-FY15			Q1-FY16		
		Quantity	Price	Value	Quantity	Price	Value
Basmati rice	2.8	-21.2	20.6	-0.6	-23.0	-12.0	-35.1
Non-basmati rice	5.8	-31.3	-10.0	-41.3	59.0	-49.7	9.3
Fish	1.5	-12.6	6.1	-6.5	-8.2	-5.4	-13.6
Fruits	1.8	-22.1	4.5	-17.6	-21.3	8.0	-13.3
Sugar	1.3	41.8	-1.1	40.8	-60.5	-0.4	-60.9
Meat	1.0	-15.4	0.8	-14.6	13.1	8.7	21.7
Raw cotton	0.7	-14.2	-1.5	-15.7	17.2	-11.7	5.5
Cotton yarn	7.9	-98.2	-26.2	-124.4	-71.9	-13.2	-85.2
Cotton fabric	10.7	-177.3	80.5	-96.7	-45.1	-24.6	-69.7
Knitwear	9.7	-9.1	70.0	60.9	23.5	-21.7	1.8
Bed-wear	8.7	-4.4	-13.2	-17.7	-44.2	1.4	-42.8
Towels	3.2	0.4	7.6	8.0	28.6	-4.8	23.8
Garments	8.2	22.4	-15.6	6.9	-27.5	55.0	27.4
Synthetic textiles	1.5	-19.8	25.2	5.3	-10.8	-6.9	-17.7
POL	2.7	-7.7	0.4	-7.2	-0.6	-8.7	-9.3
Footballs	0.7	1.3	3.5	4.9	4.5	-5.2	-0.7
Leather	2.1	-20.4	14.8	-5.6	-39.5	13.0	-26.5
Leather garments	1.6	-21.3	14.6	-6.8	-16.3	-4.0	-20.2
Plastic	1.3	-18.9	-3.7	-22.7	-9.1	0.3	-8.9
Cement	1.9	-6.4	1.6	-4.8	-52.4	-2.6	-55.0

*Average share in total exports during FY14 and FY15.
Source: Pakistan Bureau of Statistics

In our view, exports fell primarily because of global factors: exports of most emerging economies posted YoY declines in Jul-Sep 2015. More importantly, Pakistan has been able to increase its share in EU and US markets (**Figure 5.8**).[22]

[22] Share of Pakistan in the EU and US import markets (total) has increased to 0.37 and 0.17 percent, respectively during Jul-Sep FY16, compared to 0.34 and 0.16 percent same period last year. In the US market, the decline in Pakistan's share in apparel imports was entirely offset by better performance of other commodities like cereals, surgical instruments, raw cotton, etc.

Table 5.4: EU Import of Clothing from Major Countries (Jul-Sep)
value in billion US$; growth and share in percent

	Value		Growth		Share	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
China	13.42	11.47	6.3	-14.5	45.3	43.0
Bangladesh	3.99	4.10	5.5	2.6	13.5	15.3
Indonesia	0.47	0.39	3.3	-15.7	1.6	1.5
India	1.55	1.39	11.7	-10.7	5.2	5.2
Pakistan	0.66	0.69	30.2	4.1	2.2	2.6
Vietnam	0.99	0.98	28.9	-0.7	3.3	3.7
Turkey	3.23	2.86	6.2	-11.5	10.9	10.7
Total	**29.60**	**26.71**	**8.5**	**-9.8**	**82.1**	**81.9**

Source: Eurostat

Table 5.5: EU Import of Home Textile from Major Countries (Jul-Sep)
value in billion US$; growth and share in percent

	Value		Growth		Share	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
China	1,228.0	1,137.4	15.5	-7.4	41.5	42.5
Bangladesh	107.2	84.1	-10.3	-21.5	3.6	3.1
Indonesia	16.0	10.4	4.8	-34.8	0.5	0.4
India	345.1	304.4	6.9	-11.8	11.7	11.4
Pakistan	431.4	409.4	25.2	-5.1	14.6	15.3
Vietnam	62.9	56.3	16.6	-10.5	2.1	2.1
Turkey	369.7	316.9	2.2	-14.3	12.5	11.8
Total	**2,957.0**	**2,674.8**	**11.9**	**-9.5**	**86.6**	**86.7**

Source: Eurostat

Table 5.6: US import of Non-Apparel from Major Countries (Jul-Sep)
value in billion US$; growth and share in percent

	Value		Growth		Share	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
China	3,271.4	3,568.8	-2.5	9.1	48.5	49.7
Bangladesh	35.1	43.1	-0.2	22.7	0.5	0.6
India	857.2	951.6	12.0	11.0	12.7	13.3
Indonesia	52.2	57.1	-14.9	9.4	0.8	0.8
Pakistan	379.6	396.6	-2.1	4.5	5.6	5.5
Vietnam	173.5	185.0	12.8	6.7	2.6	2.6
Cambodia	7.1	17.0	-17.0	140.8	0.1	0.2
Total	**6,740.9**	**7,178.3**	**1.5**	**6.5**	**70.8**	**72.7**

Source: OTEXA

Most of the decline was seen in case of textiles, where exports fell by 5.6 percent YoY during Q1-FY16. As mentioned before, shrinking global demand has hurt exports. More specifically, EU's overall import of textile and clothing declined sharply during Jul-Sep FY16. In case of clothing, all major countries faced export declines in the EU market, except Pakistan and Bangladesh (**Table 5.4** and **5.5**). These two countries enjoy duty-free access to this market: Pakistan via GSP+ and Bangladesh via Everything-But-Arms (EBA). Indonesia, China and Turkey suffered the most, with notable declines in their respective shares, whereas, India maintained its contribution in the market. However, in case of home textiles, export of Pakistan and Bangladesh also suffered setbacks.

Table 5.7: US Import of Apparel from Major Countries (Jul-Sep)
value in billion US$; growth and share in percent

	Value		Growth		Share	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
China	10.0	10.7	-0.1	6.3	41.0	41.3
Bangladesh	1.3	1.5	-3.4	10.0	5.4	5.7
India	0.8	0.9	5.1	5.6	3.4	3.4
Indonesia	1.3	1.3	-0.7	1.3	5.1	4.9
Pakistan	0.4	0.4	-4.2	-3.8	1.7	1.5
Vietnam	2.7	3.1	15.9	14.3	11.1	12.0
Cambodia	0.7	0.7	-6.1	7.6	2.7	2.8
Total	**24.4**	**25.8**	**2.7**	**5.6**	**70.4**	**71.6**

Source: OTEXA

Table 5.8: US Import of Cotton Apparel from Major Countries (Jul-Sep)
value in billion US$; growth and share in percent

	Value		Growth		Share	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
China	3.9	3.8	-10.0	-0.7	33.2	33.1
Bangladesh	1.0	1.1	-5.0	7.5	8.7	9.4
India	0.6	0.6	2.3	6.0	4.9	5.2
Indonesia	0.6	0.6	-6.1	-6.4	5.5	5.2
Pakistan	0.4	0.4	-6.4	-4.4	3.2	3.1
Vietnam	1.2	1.2	10.1	2.7	10.3	10.7
Cambodia	0.4	0.4	-5.8	-6.2	3.6	3.4
Total	**11.6**	**11.6**	**-3.5**	**-0.3**	**69.4**	**70.1**

Source: OTEXA

In the US market, the overall import demand for textile and apparel increased during Jul-Sep 2015; however, Pakistan has not been able to firm up its exports (**Table 5.6** and **5.7**). Following the trend in previous few years, the demand for cotton textile, which constitutes the bulk of Pakistan's exports, continued to decline in the US market. The market for man-made fiber products is expanding at a fast pace, but Pakistan has failed to diversify its product range accordingly.[23] Worryingly, Pakistan has now begun to lose its share even in the *cotton* apparel market of the US (**Table 5.8**).

Rice exports fell by 7.1 percent YoY in Q1-FY16 – entirely due to a decline in sales of basmati. This is because of the penetration of Indian basmati into major markets like UAE and other GCC countries, due to better marketing and branding strategies. On the contrary, the demand for non-basmati rice from Pakistan remained strong, as unit values of Pakistani varieties declined much sharply compared to the declines in unit prices of Thailand and India.[24] Going forward, we expect some recovery in global prices due to subdued production in major exporting countries.[25] In case of Pakistan also, production is expected to decline, but carryover stocks would not allow prices of Pakistan's variety to increase much.

As far as *cement* is concerned, some decline in exports was expected. South Africa – the 2nd largest buyer of Pakistani cement, had imposed anti-dumping duty on different Pakistani cement companies (ranging from 14.3 percent to 77.1 percent) in May 2015.[26] This decision was taken at a time when Afghanistan, our largest buyer, had already lowered the overall demand for cement because of political instability and deteriorating law and order condition. Imports

[23] Overall import of non cotton apparel by the US increased by 6.1 percent during Q1-FY16, compared to a fall of 3.5 percent in the same period last year.
[24] According to FAO, the price of Pakistan's 25 percent broken rice variety witnessed the fall of 16.0 percent YoY during Q1-FY16 over the last year. It is larger than the fall in price of Indian as well as Thailand's broken rice.
[25] The overall paddy production was declined by 2.6 percent in 2015, compared to a fall of 0.4 percent in 2014. Specifically, Thailand and Vietnam are expecting to cut their rice production due to drought like weather conditions. Thailand government has even banned rice plantings for off-season crop, which typically account for nearly 30 percent of national production. Similarly in India, poor monsoon rains may curtail production for the second consecutive year.
[26] This decision of International Trade Administration Commission of South Africa, has been challenged by Pakistan's largest cement exporter (Lucky Cement). Ministry of commerce has also decided to challenge this decision in WTO.

from Pakistan in this market suffered also because of influx of cheaper imports from Iran (especially in Kandahar region near the Iranian border). Iran enjoys a much lower production cost than Pakistan, and also benefits from proximity to many western and southern parts of Afghanistan.[27,28]

Imports

Imports have declined by 14.7 percent in Jul-Sep 2015, compared to a sharp rise of 11.6 percent during the same period last year. This decline is primarily attributed to lower unit prices, as quantum import of most products has increased. As mentioned before, a slump in global prices, particularly POL and palm oil, has helped reduce import values (**Table 5.9**).

Table 5.9: Import Performance during Jul-Sep
value in million US$; growth in percent

	Value			YoY Growth	
	FY14	**FY15**	**FY16**	**FY15**	**FY16**
Food	1,042.0	1,430.1	1,198.9	37.2	-16.2
Machinery	1,434.5	1,765.0	1,707.0	23.0	-3.3
Transport	625.4	619.3	637.7	-1.0	3.0
Petroleum	3,984.5	3,927.8	2,251.1	-1.4	-42.7
Textile	524.2	635.5	628.3	21.2	-1.1
Chemical	1,556.6	1,860.4	1,781.2	19.5	-4.3
Metal	742.3	905.9	896.3	22.0	-1.1
Rubber	92.7	118.1	127.3	27.5	7.7
Paper	86.9	126.5	121.3	45.6	-4.2
Other items	1,088.3	1,085.2	1,285.1	-0.3	18.4
Totals	**11,177.4**	**12,473.8**	**10,634.4**	**11.6**	**-14.7**

Source: Pakistan Bureau of Statistics

A rise in quantum imports for most products was observed along with a decline in prices, e.g., palm oil, petroleum products, crude oil, steel, paper, tyers, pulses, fertilizer, and polyester fiber (quadrant A of **Figure 5.9**). Similarly, the increase in price of milk, rubber, plastic, dry fruits, steel scrap and pharmaceuticals resulted in lower quantum import of these products (quadrant D). Pesticides and tea were few exceptions to this trend: both unit prices and quantum import of these commodities, posted a YoY increase during the quarter (quadrant B).

The demand for *petroleum* remained strong in the first quarter, as evident in higher sales of POL products in Jul-Sep 2015 (up 2.7 percent YoY). Within petroleum products, the demand for petrol was the strongest: according to Oil Companies Advisory Council (OCAC), petrol sales showed a 13-year high YoY growth of 38.7 percent in Jul-Sep 2015. This increase can be traced to two factors: first,

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[27] Iran is the 4th largest producer of cement in the world with an installed capacity of nearly 80 million MT. Pakistan's capacity is only 46 million MT.

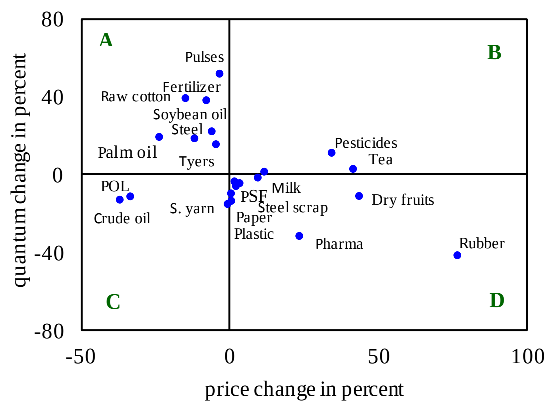
[28] In Afghanistan's north-eastern cities like Kabul and Jalalabad, Pakistani cement is still more competitive.

average petrol prices in Jul-Sep 2015 were nearly 30 percent lower than the average petrol prices during Jul-Sep 2014 (anecdotal evidence suggests that some CNG consumers have also shifted to using petrol due to low prices). And second, car sales were phenomenally higher in Jul-Sep 2015, compared to last year (posting a growth of 61 percent YoY).

Within the metal group, the demand for *steel* increased further on the back of on-going development projects related to power and infrastructure: PSDP outlay has posted a sharp increase of 57.4 percent YoY during Q1-FY16.[29] Private construction activity has also remained vibrant. However, local steel producers claim that a large chunk of imports is unwarranted, as they have the capacity to meet most of the country's steel demand. They particularly blame dumping from China for pricing them out of the market.

Recall here that Pakistan's steel industry is not the only complainant: over the past few months, steel producers all across India, UK, Brazil, Indonesia and Malaysia have been grumbling against dumping from China, which is sitting on massive inventory of raw-material and finished products. Large steel makers in Pakistan have filed petitions with National Tariff Commission (NTC), to impose anti-dumping duty on selected products (e.g., cold rolled coils and galvanized steel sheets). Meanwhile, some firms have also claimed that large quantities of flat steel are being imported into the country under the HS code of *alloy*, which enjoys duty-free status from China under the Free Trade Agreement. The NTC and Customs department are

Figure 5.9: A Cross-section Analysis of Imports in Q1-FY16 over Q1-FY15



Source: Pakistan Bureau of Statistics

[29] Total PSDP spending by federal and provincial governments increased from Rs 93.0 billion in Jul-Sep FY15, to Rs 146.4 billion in Jul-Sep FY16.

looking into these matters, to ensure a level-playing field to local producers, and curb imports.

Within *food*, quantum import of palm oil increased during Jul-Sep 2015. Taking benefit of 80-month low global prices, local traders are importing mostly ready-to-sell edible oil into the country. Local producers also edged up their production levels with the help of inventories built over the past few months. Analysts are divided over the path of palm oil prices in coming months: while some believe softer trend would prevail, others give much weight to possible damage to yields as a result of drought-like conditions in East Asia, and forest fires in Indonesia that have caused massive haze across the region.

Transport sector imports posted a growth of 3.0 percent over last year. Highest growth was seen in car segment (both CKD and CBUs), as domestic sales firmed up. This trend has puzzled many who believed that continuous fall in agriculture commodity prices and incomes would suppress car purchases. Auto assemblers attribute higher sales to low inflation and interest rates, relative improvement in law and order condition, and a pick-up in auto financing by commercial banks.[30] Continuation of Apna Rozgar scheme of Punjab government was another contributing factor in strengthening demand for certain brands.

Import of *fertilizer* posted an increase of 27.2 percent in Q1-FY16, compared with the 33 percent rise in the same period last year. Despite lower off-take and buffer stocks availability, ECC approved the import of 150,000 tons of urea by TCP. This decision was taken to overcome any expected shortage during the *rabi* 2015-16: the domestic industry might be unable to produce sufficient quantities due to possible gas curtailments in winters (for detail see chapter 2).
All other items, which are not classified elsewhere, posted an increase of 18.4 percent YoY (or US$ 199.8 million) in Jul-Sep 2015. This increase was driven by import of LNG worth US$ 121.6 million during the period.[31]

[30] As noted in Chapter 3, car loans increased by Rs 5.9 billion during Jul-Sep 2015, compared to Rs 3.6 billion in the same period last year.
[31] Although detailed data from Pakistan Bureau of Statistics is not available for this category for Jul-Sep, detailed information is available in SBP's payment record data (this data is also showing a sharp increase in 'other items').

For the remaining quarters of the year, we do not expect a major shift in trend in trade values, from what we have seen in the first quarter. Price of oil and other commodities have declined afresh post September 2015, and presently no stability is in sight. Imports have fallen by another 7.4 YoY in October 2015, whereas exports have posted a drop of 11.4 percent. The government has imposed additional regulatory duty on a large number of consumer goods, cotton and cotton yarn, which may further squeeze our import bill. Meanwhile, certain measures have been announced to boost exports, like an increase in credit subsidy for textile sector. Nonetheless, the dominating factor would be how the US economy embraces the increase in federal funds rate (which is due by end-December), and its impact on the global currency market: the demand from EU hinges much on the Dollar-Euro parity. At present, we expect full-year trade values for FY16 to remain less than both the last year, as well as target set for the year (**Chapter 1**).

Acronyms

ADB	Asian Development Bank
APCMA	All Pakistan Cement Manufacturers Association
bps	Basis Points
BSC	Behbood Saving Certificate
BOP	Balance of Payments
CAGR	Compound Annual Growth Rate
CAN	Calcium Ammonium Nitrate
CBU	Complete Built Up
CCAC	Cotton Crop Assessment Committee
CCS	Consumer Confidence Survey
CNG	Compressed Natural Gas
CKD	Completely-Knocked-Down
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
CY	Calendar Year
DAP	Diammonium phosphate
DFID	Department for International Development
EBA	Everything-But-Arms
ECC	Economic Coordination Committee
EDL	External Debt and Liabilities
EFF	Extended Fund Facility
EPD	Exchange Policy Department
EU	European Union
FAO	Food and Agriculture Organization
FATA	Federally Administrated Tribal Areas
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FOB	Free on Board
FX/FE	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council

GDP	Gross Domestic Product
GSP	Generalized System of Preferences
HSD	High Speed Diesel
HS	Harmonized System
IBA	Institute of Business Administration
IDA	International Development Assistance
IDB	Islamic Development Bank
IDPs	Internally Displaced Persons
IFI	International Financial Institution
IMF	International Monetary Fund
IRC	Interest Rate Corridor
Kg	Kilograms
KPK	Khyber Pukhtunkhwa
KPT	Karachi Port Trust
KSE	Karachi Stock Exchange
LCV	Light Commercial Vehicle
LNG	Liquefied Natural Gas
LSM	Large Scale Manufacturing
M2	Broad Money Supply
MAF	Million Acre Feet
MoF	Ministry of Finance
MRTBs	Market related Treasury Bills
MSCI	Morgan Stanley Capital International
MT	Metric Tons
MTBs	Market Treasury Bills
NAB	National Accountability Bureau
NDA	Net Domestic Assets
NDFC	National Fertilizer Development Centre
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Assets
NIR	Net International Reserves
NFNE	Non-Food Non-Energy
NSS	National Savings Scheme
NTC	National Tariff Commission

OCAC	Oil Companies Advisory Council
OCR	Ordinary Capital Resources
OMCs	Oil Marketing Companies
OMOs	Open Market Operations
OTEXA	Office of Textile and Apparel
PAMA	Pakistan Automotive Manufacturers Association
PBS	Pakistan Bureau of Statistics
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
POL	Petroleum, Oil and Lubricants
POS	Potassium Sulphate
PSEs	Public Sector Enterprises
PSDP	Public Sector Development Programme
PSM	Pakistan Steel Mills
PTCL	Pakistan Telecommunication Company Limited
QE	Quantitative Easing
REER	Real Effective Exchange Rate
rhs	Right Hand Side
ROA	Return on Assets
ROE	Return on Equity
RPI	Relative Price Index
Rs	Rupees
SAR	Saudi Arabian Riyal
SBP	State Bank of Pakistan
SCRA	Special Convertible Rupee Account
SDR	Special Drawing Right
SECP	Securities and Exchange Commission of Pakistan
SKD	Semi Knocked Down
SRO	Statutory Regulatory Order
SSA	Special Saving Account
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
TDPs	Temporarily Displaced Persons

T.T	Telegraphic Transfer
UAE	United Arab Emirates
WHT	Withholding Tax
WTO	World Trade Organisation
YoY	Year on Year

Annexure A: Data Explanatory Notes

1) **GDP:** In the absence of actual GDP data, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation } (\pi_{Ht}) = \left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation } (\pi_{YoYt}) = \left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation } (\pi_{MoMt}) = \left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where I_t is consumer price index in t^{th} month of a year.

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing,

whereas borrowing is adjusted for government deposits with the banking system, when calculating the financing data; (ii) changes in the stock of debt also occur due to changes in the exchange rate, which affects the rupee value of external debt, and (iii) the movement of various other cross-country exchange rates also affect the US Dollar rate and, hence, the rupee value of external debt.

4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). The Ways and Means Advance is extended for the government borrowings up to Rs 100 million in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum.

Borrowing from scheduled banks: This is mainly through the fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs). The Government of Pakistan also borrows by a quarterly auction of 3, 5, 10, 15, 20 and 30 year Pakistan Investment Bonds (PIBs). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, public debt, debt servicing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

   (a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

   (b) **Public debt (MoF vs. SBP):** SBP follows IMF guidelines for compiling public debt, which state that the "public sector includes the general government, monetary authorities, and those entities in the banking and other sectors that are public corporations."[1] Thus, public debt reported by SBP, is composed of: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities.[2]

   While both MoF and SBP follow the same definition of domestic public debt, the coverage of external debt compiled by MoF differs from that of SBP. Specifically, MoF does not include short-term debt, military debt and external liabilities in its compilation of external public debt. As a result, the overall public debt numbers from these two organizations do not match.

   (c) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on exchange record data, which depend on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP

[1] Source: IMF (2003), "External Debt Statistics, Guide for Compilers and Users."
[2] It may be noted, however, that due to the unavailability of detailed information, SBP public debt numbers do not include PSE's debt.

reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif).

In addition, the variation in import data also arise due to differences in data coverage, e.g., SBP import data does not include Non-Repatriable Investments (NRI) by non-resident Pakistanis,[3] imports under foreign assistance, land-borne imports with Afghanistan, etc. In export data, these differences emerge as PBS statistics do not take into account short shipments and cancellations, while SBP data does not take into account land borne exports to Afghanistan, export samples given to prospective buyers by exporters, exports by EPZs, etc.

[3] The non-repatriable investment (NRI) consists of small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad and the purchases made from the *duty-free shops.*