1 Overview

Halfway through FY16, improvements in some of the macroeconomic indicators seem visible. LSM growth has improved in H1-FY16, helped along by an air of optimism on domestic construction.[1] Losses in crop sector are now expected to be modest, as an expected bumper wheat crop can partially offset decline in cotton production. Early signs for services sector are also positive, with healthy revenues expected in the telecom sector. A supportive policy environment bags much credit for this performance, while macroeconomic stability – as reflected in subdued CPI inflation; adequate FX buffers; stable exchange rate; low current account deficit despite a sharp decline in exports; and an improved fiscal position – had set the base (**Table 1.1**).

Table 1.1: Selected Economic Indicators

	H1-FY15	H1-FY16[P]
growth rate (percent)		
LSM [a]	2.7	3.9
CPI (period average) [a]	6.1	2.1
Private sector credit[1, b]	6.0	9.0
Exports (customs) [a]	-4.4	-14.5
Imports (customs) [a]	11.4	-8.1
Tax revenue [c]	16.1	20.4
Development spending [c]	32.0	32.6
Exchange rate (+app/-dep) [b]	-1.7	-2.8
million US dollars		
SBP's liquid reserves (end-period) [b]	10,513	15,884
Worker remittances [b]	9,162	9,736
FDI in Pakistan [b]	611	624
Current account balance [b]	-2,463	-1,425
percent of GDP		
Fiscal balance [c]	-2.4	-1.7

[P] Provisional. [1]Percent change in December over June.

Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Ministry of Finance.

That said, rising uncertainty in the global economy and financial markets continue to deflect otherwise buoyant sentiments in the domestic economy. Global trade and investment activity is shrinking due to a slow recovery in advanced economies and weakening in China. The continued slump in the commodity market has: (i) reduced cross-border investments; (ii) instilled disturbingly low levels of inflation across countries; (iii) slackened the pace of remittance flows to developing economies; and (iv) added fiscal burden for commodity-rich countries. Making things worse, European markets have become inward-oriented due to a weak Euro, whereas the regime shift in US monetary policy has tangled up global equity and currency markets.

[1] Local cement dispatches, one of the key indicators of construction activity in the country, have posted a growth of 16.3 percent YoY during H1-FY16, compared to only 9.1 percent a year earlier.

For Pakistan, the prevailing global conditions have both positive and negative effects. First the positives: the decline in oil prices allowed a 39.8 percent fall in the country's oil import bill (quantum and price effects combined), helping reduce the trade deficit by 1.6 percent in H1-FY16 over the same period last year. Furthermore, the pass-through of low prices by the government has contributed in pushing down the CPI inflation to a multi-decade low; inflation expectations have also become subdued.[2]

Together, the low inflation expectations and stability on the external front allowed SBP to cut the policy rate to its historically low level of 6 percent in September 2015; this has spurred up demand for private credit, especially for fixed investment purposes. The manufacturing sector was the clear beneficiary, as besides low-cost funding, it also enjoyed a reduction in fuel expense and material cost.[3] However, it appears that LSM has gained *more* from better energy management than the cheaper availability of raw materials: the import of LNG and LPG, and some diversion of gas away from transport and households, increased its availability for the industrial sector.[4,5]

On the flip side, the commodity recession has impacted the performance of crop sector, as the sowing area declined for many crops this season (**Chapter 2**). The cotton crop has been particularly affected, as its production is down also because of pest attacks and heavy rainfall. That said, the biggest impact of the global slowdown was seen on the country's exports.

After posting a decline of 4.4 percent in H1-FY15, exports slumped by another 14.5 percent YoY in the first half of FY16. Reflected primarily in quantums, this decline was broad-based both in terms of products and destinations (**Chapter 5**). On a similar note, very low inflation across the developed world and the GCC contributed in slowing down the pace of remittance inflows. In addition, the fragile global economy and growing turbulence in financial markets led to stagnation in FDI inflows to Pakistan.

[2] Pakistan was among those countries where the pass-through of decline in global oil prices was the strongest (**Box 3.2**).
[3] Credit off-take by manufacturing sector increased by Rs 164.4 billion in H1-FY16, compared to Rs 114.6 billion in the same period last year.
[4] Gas distribution firms, SSGCL and SNGPL, were directed by the government to divert natural gas from households to more productive sectors of the economy like power generation, cement and fertilizer.
[5] A marked improvement was seen in power sector: thermal generation via gas posted an increase of 50 percent in H1-FY16 over the last year, whereas generation via furnace oil and high-speed diesel declined sharply.

Pakistan can scale up its growth rate by expanding its export base and attracting more FDI into the country. More specifically, strong domestic demand, and a potential revival in investment in the country, will generate additional demand for (imported) capital goods and raw materials; this will be challenging to finance if FX earnings fail to keep pace. The surge in the country's non-oil import bill in Q2-FY16, along with a rise in trade deficit, flags this dilemma more distinctly.[6] Therefore, in order to make Pakistan's growth more sustainable, the cost of production and doing business has to be brought down; energy supplies must be smoothened further especially via investing in more broad-based and sustainable sources of generation; and export-friendly industrial policies should be laid out.

The good thing is that structural weaknesses are gradually being worked on, and important reforms are being introduced.[7] Multiple IFIs are engaged with the reform process that the government had introduced a couple of years ago. More recently, the tenth review of the EFF program was successfully concluded, as the government was able to meet nearly all the structural benchmarks, especially those related to fiscal consolidation. An encouraging aspect of this achievement is that the reform process is not choking the government's development spending; in fact, the government's effort to clear the infrastructure backlog will help improve the country's investment rate, which is currently around 15 percent of GDP – much less than the regional economies. However, to continue with this momentum and to make an effective contribution in optimizing productivity gains in times of a global downturn, the government needs to further expedite the required reforms in the fiscal and energy sectors.

1.1 Economic review

The impact of oil price decline was felt directly on CPI inflation: the transport group – a sub-index of CPI with 7.2 percent share – continued to decline for the fifth straight quarter in Q2-FY16, pulling down the overall inflation to only 2.5 percent. However, while the CPI inflation for Q2-FY16 was lower than that for Q2-FY15, it has inched up compared with Q1-FY16, mainly due to volatility in food and energy prices; non-food non-energy inflation was lower on both a quarterly and yearly basis in Q2-FY16.[8] In contrast, WPI index continued to post

[6] Non-oil imports posted an increase of 12.2 percent YoY in Q2-FY16, compared to a decline of 2.9 percent YoY in Q1-FY16.

[7] For instance, the cost of tax exemptions has been reduced from 1.9 percent of GDP in FY14 to 1.5 percent in FY15; number of personal income tax filers has increased by more than 200,000 over the last two years; independent statutory Monetary Policy Committee has been constituted; and the Credit Bureau Act, 2015 has been promulgated.

[8] Additional regulatory and customs duties imposed on a wide range of items in Q2-FY16, as well as an increase in prices of some food items (tea, pulses etc), contributed to a minor uptick in CPI inflation during Q2 over Q1-FY16.

YoY decline throughout H1-FY16.[9] Here, it must be pointed out that while lower prices have benefited consumers, these also have had a serious impact on some commodity-producing sectors of the economy: for instance, lower produce prices have hit farmers' incomes and affected their cropping decisions.

With losses in *kharif* crops, major crops are less likely to touch previous year's level in FY16. As for achieving this year's targeted growth for the overall agriculture, much depends on the performance of wheat as well as value-addition in livestock to compensate for losses in cotton production. As things stand, the prospects of both surpassing their targets are strong. While initial estimates suggest a decline in area under wheat cultivation, a marked improvement in yields has increased hopes for a bumper crop for third year in a row; timely rains and better input availability have reportedly improved the per-acre harvest.

The growth momentum in LSM continued to remain strong in H1-FY16, supported by better energy supplies; lower commodity prices; and accommodative policies (for instance, higher PSDP spending, Apna Rozgar scheme, and multi-decade low interest rates). The sector was able to record a growth of 3.9 percent YoY in H1-FY16, against 2.7 percent in H1-FY15. More encouragingly, this growth was realized despite some negative developments like halting of gas supply by SSGCL to Pakistan Steel Mills over non-payment of bills, and sluggish global demand.

Major contribution to LSM growth came from automobiles, fertilizer and construction-allied industries (particularly cement and paints). While the automobile sector benefited from the Apna Rozgar scheme that scaled up the production of commercial vehicles, the growth in fertilizer is attributed to better gas supplies. Similarly, the growth in construction-allied industries stems primarily from consistently rising public spending: after increasing by 26.7 percent in H1-FY15, the government's PSDP spending increased by another 40.3 percent in H1-FY16. Projects related to uplift of infrastructure, power generation, and development of railway network, were prime recipients of government funding.[10] The industry also gained an impetus through early harvest projects under China-Pakistan Economic Corridor (CPEC) program. The increase in industrial activity bodes well for the overall performance of services sector, which is expected to get additional impetus from healthy earnings in the telecom sector.

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[9] However, after posting a *deflation* for 13 consecutive months (i.e., from December 2014 to December 2015), WPI index inched up slightly in January and February 2016.

[10] This, in turn, was reflected in the solid growth in domestic cement dispatches, which more than offset the drop in the industry's exports during the period.

The encouraging aspect is that the higher development spending did not impede the government's fiscal consolidation efforts, as the overall budget deficit dropped appreciably during H1-FY16 over the corresponding period last year. This performance is attributed to better revenue generation as well as a decline in non-development spending. Government revenues have grown by 14.6 percent during H1-FY16, as compared to a meager increase of 5.0 percent last year. This improvement came on the back of additional tax measures that the government took during the 2nd quarter: (i) one percent across-the-board increase in customs duties; (ii) additional regulatory duty on 400 consumer items (with varying rates); and (iii) additional FED on cigarettes.

On the expenditure side, lower defence outlay helped keep the rise in current expenditures in check. In addition, the provinces yielded a cumulative surplus of Rs 208.6 billion in H1-FY16 – almost double of what they had provided in the same period last year. Therefore, in absolute terms, the consolidated gap between government revenues and expenditures fell to Rs 515.2 billion (1.7 percent of GDP) in H1-FY16 from Rs 651.8 billion (2.4 percent of GDP) in H1-FY15.

Not only has the government been able to reduce the fiscal gap, but the availability of external funding (including US$ 1.2 billion from the World Bank and ADB and US$ 500 million from Eurobond) also enabled it to shift its financing away from domestic resources: though these resources continued to finance a majority of the deficit, there was a sharp decline in their share compared to last year.

Meanwhile, since the quantum of government borrowing from the banking system was lower this year (Rs 183.3 billion in H1-FY16, against Rs 199 billion in H1-FY15), the growth in net domestic assets (NDA) of the banking system weakened.[11] However, some support to NDA came from an increase in private credit off-take during the period.

Despite a slower expansion of NDA, the increase in broad money supply (M2) in H1-FY16 was stronger than in the same period last year.[12] The higher growth in M2 is attributed to a sharp rise in NFA of the banking system, which more than

[11] The change in domestic money supply stems from two major sources: (i) net domestic assets, which comprise of net budgetary borrowings of the government; credit to private sector; and other items (net); and (ii) net foreign assets, which comprise of net claims of SBP and commercial banks on non residents.
[12] Broad money supply (M2) grew by Rs 479.7 billion during H1-FY16, against an increase of Rs 442.9 billion observed during the same period last year.

offset the slowdown in NDA; in fact, NFA growth in the period was three times the growth observed in H1-FY15. The entire increase was evident in SBP's NFA; as mentioned before, the government resorted to external sources for budgetary financing during H1-FY16, like IFI loans, Eurobond issuance, coalition support fund (CSF) receipts and commercial borrowings.

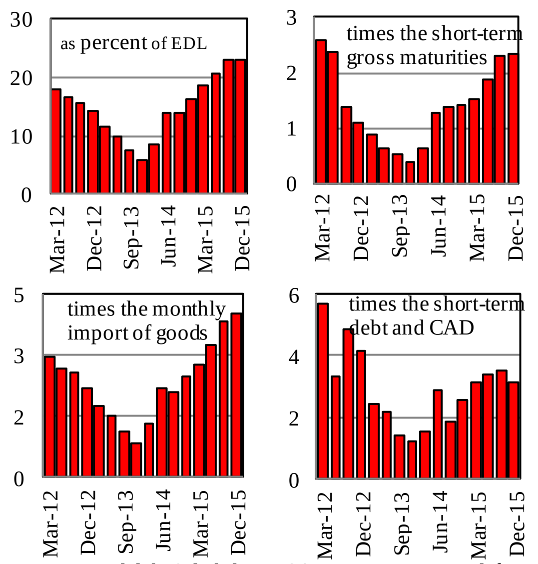
These official FX inflows also helped in financing the current account deficit during the period, and compensated for insufficient private investment inflows. The overall current account deficit reached US$ 1.4 billion during H1-FY16, significantly lower than the US$ 2.5 billion deficit recorded in the same period last year. Lower oil prices in the international market played an important role in reducing the deficits in the trade and services accounts. Additional support came from a steady increase in worker remittances, which further helped narrow down the current account deficit. Therefore, the overall external account posted a surplus in H1-FY16, which took the country's FX reserves to a record-high level of US$ 20.8 billion at end-December 2015. The country's FX reserves have increased by US$ 2.3 billion during H1-FY16, and the current level is now equivalent to 5 months of the country's import bill.

It was this comfort on the external front (especially in the first quarter), along with a benign outlook on inflation, which allowed SBP to reduce its policy rate to 6 percent in September 2015. The resulting decline in the borrowing cost for businesses, along with better liquidity conditions in the interbank market, resulted in higher credit expansion during H1-FY16. The increase in fixed investment loans is particularly notable, as this represents capacity expansions being pursued in a number of sectors, including power generation and distribution; transport; telecommunications; sugar; cement; and pharmaceuticals.

1.2 Outlook for FY16

Despite challenging global economic conditions, Pakistan's overall macroeconomic outlook appears stable. Growth is likely to pick up despite the constraints; fiscal position is strong; inflation is likely to stay low (despite inching up); and risks on the external front have been moderated to a large extent. Following points are important:

Figure 1.1: Strength of SBP's FX Reserves



EDL: external debt & liabilities; CAD: current account deficit
Source: State Bank of Pakistan

(i) SBP has accumulated a significant amount of liquid FX reserves over the past couple of years – via both FX purchases from the interbank, as well as government mobilization of external loans. In fact, the *rise* in reserves as percent of external debt and liabilities basically suggests that SBP's reserves have increased *more* than the increase in external debt (**Figure 1.1**).[13] More importantly, SBP's reserves at their current level can comfortably finance twice as much payments (gross) as are expected for the next 12 months. This looks especially comforting when compared with a vulnerable situation just two years ago;

(ii) On a related note, it is important to highlight that Pakistan's public external debt servicing obligations are not more than US$ 6 billion per annum until 2020. This amount of repayments does not raise much concern, as the country has successfully met similar amount of obligations in FY13 and FY14. Thus, debt servicing of US$ 5.5 billion due in CY2016 are well within manageable level, especially keeping in view the existing level of country's FX reserves and expected continuation of FX inflows;

(iii) Similar to the balance of payments, we do not see major risks on the inflation front in short-term. On the one hand, global commodity prices are not expected to recover anytime soon, and on the other, a stable PKR is likely to keep inflation expectations further at bay.[14] Recent consumer expectation survey and the yield spread between long-term and short-term government securities, signal the low inflation environment ahead (**Chapter 3**). It is important to mention here that the

[13] SBP liquid FX reserves used in this discussion exclude gold.
[14] While International Energy Agency (IEA) expects the oil glut to stay till 2017, the World Bank has recently lowered its 2016 forecast (January 2016) for crude oil prices to only US$ 37 per barrel from its previous forecast of $51 per barrel for the year (October 2015).

government has reduced domestic petrol prices by 6.6 percent and 11.9 percent in February and March 2016, respectively, following the free fall of oil prices to a 12-year low level in the international market. SBP expects average CPI inflation for FY16 to fall in the range of 3 to 4 percent, which is well below the target of 6.0 percent for the year;

(iv) The improvement in fiscal position is likely to be maintained in the second half of the year; while tax measures announced in October 2015 would continue to help FBR's collection, expenditures are expected to remain within target (**Chapter 4**). The pattern of budgetary financing would not be much different in the second half than the first, as the government is expecting more external funding down the road;

(v) The industrial sector will continue to get push from the upbeat construction and power sectors, as more projects are expected to materialize under the CPEC. The continuous growth in public spending and the recent boom in private housing will also contribute. The increase in private credit off take also bodes well for the industrial sector performance.

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	3.0 – 4.0
		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 stable macroeconomic environment means that the economic growth would maintain the momentum. We expect GDP growth during FY16 to be higher than the last year (**Table 1.2**). We are optimistic on the industrial sector's performance, but cannot firmly assess the final outcomes in agriculture and services. Major crops suffered due to low cotton production, but the overall agriculture growth would depend upon performances of livestock and minor crops. Services growth hinges upon the contribution of *wholesale and retail trade*. As things stand, the outlook for services is tightly balanced between an expected growth in *transport, storage and communication*, and a relatively modest performance of *finance and insurance* during the year.