THE STATE OF PAKISTAN'S ECONOMY

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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.

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[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.

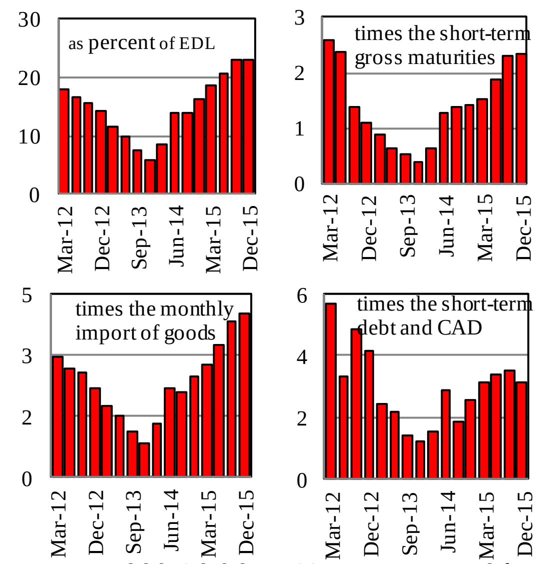
These official FX inflows also helped in financing the current account deficit during the period, and compensated for insufficient private investment inflows. The overall current account deficit reached US$ 1.4 billion during H1-FY16, significantly lower than the US$ 2.5 billion deficit recorded in the 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.

2 Real Sector

2.1 Overview

Preliminary information on commodity producing sectors suggests that the economic growth is picking up modestly. An expected healthy wheat crop will partially compensate for the adverse impact of *kharif* crops (particularly cotton and rice), but the performance of livestock and minor crops would be more critical in determining growth in the agriculture sector. Similarly within services, indicators relating to transport and telecommunications sectors have particularly done well during the first half. However, performance of *wholesale and retail trade* may suffer a setback from weak showing by *kharif* crops. Encouragingly, large scale manufacturing has performed better during H1-FY16 than the last year due to improvement in energy availability, continued decline in global prices of raw materials, robust construction activities, higher PSDP spending and the launch of *Apna Rozgar* scheme.

2.2 Agriculture

While the estimates on overall performance of the agriculture sector will be available with the release of National Income Accounts later this year, the available information on crop sector (which is 25.6 percent of agriculture) does not portray a very encouraging picture. Preliminary estimates suggest that all kharif crops have missed their respective targets; cotton and rice did not achieve last year's production level.[1] In particular, the recent reports of severe pest attacks on cotton means the output would be lower than the last estimate of 10.9 million bales released by Cotton Crop Assessment Committee (CCAC) in its fourth meeting held on 14th December 2015.

On a positive note, not only did the area sown under wheat crop exceed the target, growing conditions have also remained favorable so far (e.g., supportive weather and adequate availability of inputs). Thus, barring any adverse random shock going forward, wheat crop would likely achieve the target of 26.0 million tons. This means even with best performance, wheat crop would not be able to completely offset the impact of cotton damages.

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[1] These represent estimates from Pakistan Cotton Ginners' Association; Pakistan Cotton Consultative Committee; National Fertilizer Development Centre; and the US Department of Agriculture.

Cotton

Cotton crop suffered multiple shocks this season. At first, sowing was delayed in some areas due to late harvest of FY15 wheat crop.[2] Later on, prolonged and frequent rains badly hit the standing cotton crop.[3] Additional crop losses came from severe attack of pink bollworm. While the crop generally becomes more susceptible to pest attacks during rainy season, the risks heightened further this year as the plant was still in the early stage of growth due to sowing delays. At the same time, low prices discouraged farmers from investing in fertilizer and pesticides.[4,5] In fact, in some cases, frequent rains even washed away pesticides applied to crops.[6]

Table 2.1: Cotton Crop Estimates
million bales

	Date	Punjab	Sindh	Balochistan	Total
1st estimate	1-Sep-15	9.3	3.7	0.6	13.6
2nd estimate	18-Sep-15	9.3	3.5	0.6	13.4
3rd estimate	11-Nov-15	7.4	3.4	0.6	11.4
4th estimate	14-Dec-15	7.4	3.4	0.1	10.9

Source: Cotton Crop Assessment Committee

As reports of crop damages came to light, CCAC also revised its estimate downward, with 10.9 million bales in its latest projections released on December 14, 2015 (**Table 2.1**). Since then, there are reports of more damages due to pest attack, particularly in Punjab. It is perhaps for this reason that the US Department of Agriculture (USDA) in its

Table 2.2: Cotton Arrival at Ginning Firms
million bales

	FY14	FY15	FY16
PCGA cotton arrival[1]			
1st Feb[2]	13.1	14.4	9.6
1st May	13.4	14.9	9.9
Cotton arrival converted into 170 kg bale			
If average bale size is 165 kg	13.0	14.5	9.6
If average bale size is 160 kg	12.6	14.0	9.3
Actual cotton crop	12.8	14.0	

[1] Bale size generally varies between 155-165 kg.
[2] Around 97 percent of the crop arrives by 1st Feb each year.
Source: Cotton arrival is reported by PCGA; actual cotton crop figure is taken from Pakistan Bureau of Statistics.

[2] Source: Cotton Review, Vol. 48, No. 03, Pakistan Central Cotton Committee.
[3] Rainfall during Apr-Sep 2015 was 1,661 mm more than the volume witnessed in the corresponding period last year for 12 cotton producing stations or nearby proxy areas. The stations included were Bahawalnagar, Bahawalpur, Dera Ghazi Khan, Faisalabad, Jhang, Multan, Rahimyar Khan, Sahiwal, Toba Tek Singh, Shaheed Benazirabad, Mirpurkhas and Sukkur.
[4] According to Agriculture Policy Institute, the average cost of production of 40 kg of phutti (seed cotton) remained at Rs 2,511 for the current season. On the other hand, the price of cotton seed varied between Rs 1,800 and Rs 2,000 in the early part of the harvest season. The price recovered to Rs 2,800-3,000 per 40 kg in January 2016 when reports about crop damages transpired.
[5] Cotton prices in the domestic market have remained bearish broadly in line with the global trends. It may be noted that the international cotton prices have been facing downward pressure due to weak demand and ample stocks. According to International Cotton Advisory Committee, the weak demand for cotton reflects a slowdown in China and increasing preference for alternative polyester fiber (as it has become cheaper following the sharp fall in the price of crude oil).
[6] Reportedly, growers facing financial constraints could not apply additional pesticides.

report released on February 9th, 2016 has projected cotton crop for Pakistan at 9.2 million bales.[7]

This assessment also receives support from recent data on cotton arrival reported by Pakistan Cotton Ginners Association (PCGA). As shown in **Table 2.2**, expected cotton arrival by season end would be around 9.6 million bales of 170 kg.[8,9]

Rice

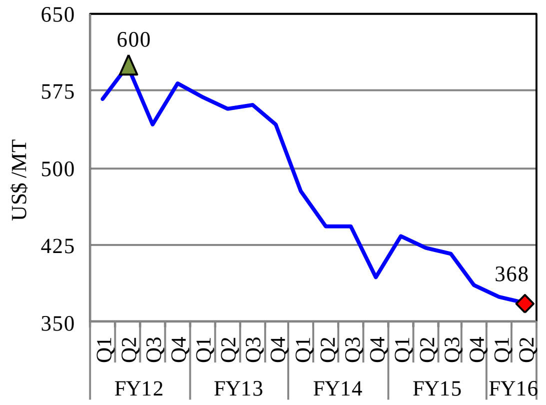
As mentioned in SBP First Quarterly Report for FY16, area under rice cultivation has declined by 4.8 percent over last year. Preliminary estimates released in October 2015 showed a lower rice crop of 6.6 million tons, against the target of 6.9 million tons and last year's level of 7.0 million tons. Though confirmed numbers are still awaited, we do not expect any major revision in this assessment. In fact, crop reporting centers of both Punjab and Sindh confirmed a decline in rice production from last year.[10,11] Rice production in Balochistan is also likely to decline this season, mainly due to a fall in area under cultivation.

Table 2.3: Rice - Domestic Availability and Consumption
million tons

	FY14	FY15
1- Production	6.8	7.0
2- After 10 percent deduction for seed, feed and wastage	6.2	6.4
3- Exports	3.7	3.9
4- Domestic availability (1-2-3)	2.5	2.5
5- Estimated domestic demand[1]	2.17	2.21
Estimated excess supply (4-5)	0.31	0.25

[1]This is based on 0.97 kg/per capita per month consumption taken from Household Integrated Economic Survey, 2011-12 by Pakistan Bureau of Statistics.

Figure 2.1: Price of Thai White Rice, 5 percent broken



Source: Haver Analytics

[7] For FY16, USDA has projected 7.2 million cotton bales of 480 pound each (which is the standard used for reporting cotton production in the US). At 170 kg for bales (which is the standard used in Pakistan), the cotton crop comes out to be 9.2 million bales.
[8] According to data released by PCGA on 15th February 2016, cotton arrival in Punjab was down by 44 percent YoY.
[9] See **Chapter 5** for the implication of weak cotton crop for imports.
[10] Crop reporting centers have reported rice production at 3.5 million tons for Punjab and 2.6 million tons for Sindh – both are down by 0.1 million tons over last year's production.
[11] Punjab and Sindh have accounted for 92 percent of total rice production, on average, over the past three years.

More importantly, growers have suffered as rice prices in the domestic market have posted a fall of 17 YoY percent during Q2-FY16. The downward pressure on prices was due to comfort in domestic rice availability from past healthy harvest (**Table 2.3**), and the continued ease in international prices (**Figure 2.1**).[12]

Sugarcane

According to recent information, sugarcane production in Sindh has recovered from its low level recorded in FY15, whereas Punjab has been able to maintain last year's production.[13] If Khyber Pakhtunkhwa also achieves its historical average, overall production would comfortably exceed FY15 output of 62.8 million tons, but would remain lower than the target of 68 million tons.

Wheat

Assuming a yield of 2,898 kg per hectare, the government has set FY16 wheat target at 26 million tons – slightly higher than 25.5 million tons wheat produced in FY15.[14] The achievement of this target was contingent on adequate availability of inputs (e.g., urea , DAP, credit and water). Wheat support price however was kept unchanged at last year's level of Rs 1,300 per 40 kg.

Wheat outlook appears encouraging so far: area under cultivation has exceeded the target (**Table 2.4**), and not only have prices of fertilizer (DAP and urea) remained soft, its off-take has also grown strongly.[15,16] Furthermore, weather conditions proved conducive: rainfall in October ensured timely sowing of wheat in rain-fed cultivation areas; and rains in second half of January provided much needed precipitation and brought down mercury levels, which bodes well for germination (**Table 2.5**).[17] Moreover, water

Table 2.4: Area Under Wheat Crop
thousand hectares

			FY16	
	FY14	**FY15**	**Target**	**Actual**
Punjab	6,778	6,910	6,677	6,937
Sindh	1,122	1,107	1,150	1,155
KPK	740	778	746	756
Balochistan	399	385	400	333
Pakistan	**9,038**	**9,179**	**8,973**	**9,181**

Source: Ministry of National Food Security & Research

[12] The local price of rice may, however, get some support from the expected increase in rice exports following the removal of international sanctions on Iran.
[13] Sindh and Punjab contribute over 90 percent of the sugarcane crop in the country.
[14] The historical maximum yield achieved in Pakistan is 2,833 kg per hectare for the 2010-11 crop.
[15] SPI data reveals that price of one bag of DAP declined by 13 percent during Jul-Feb FY16, while price of one bag of urea remained stable during the same period.
[16] DAP off-take posted an increase of 26.4 percent YoY during *rabi* season, whereas urea off-take recorded 8 percent growth.
[17] Source: Pakistan-Satellite based Crop Monitoring System, December 2015, Suparco.

availability remained adequate and credit disbursement recorded significant increase.[18]

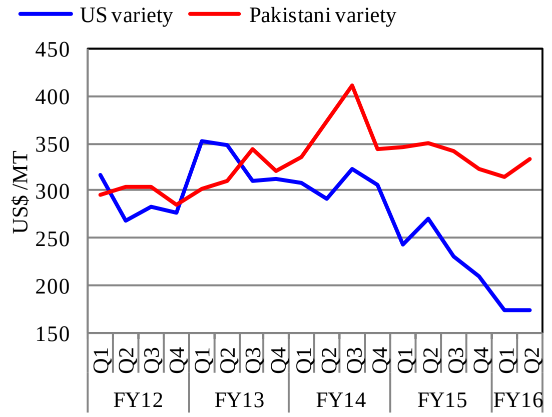
While the likely promising wheat crop would partly offset losses from badly hit cotton crop, this would also pose some major policy challenges. For example, given that wheat stocks in the country have already reached four-year high of 7.4 million tons, this severely weakens the government's ability to procure large quantities from growers without first depleting existing reserves. The policy challenge becomes more complex as international wheat prices continue to remain lower than domestic prices, which makes export of wheat unfeasible despite the subsidy allowed by the government;[19] global wheat prices are likely to remain soft going forward due to abundant supply (**Figure 2.2**).[20]

Table 2.5: Input Situation (Oct-Dec)

	FY14	FY15	FY16
Fertilizer off-take (000 MT)			
Urea	1,702	1,530	1,659
DAP	876	954	1,206
Irrigation water (MAF)	20.6	22.1	20.9
Pesticides import (million US$)	29.1	41.6	38.9
Agriculture credit (billion rupees)	88.5	121.4	149.9

Source: NFDC for fertilizer; Suparco for water availability; Pakistan Bureau of Statistics for import; State Bank of Pakistan for credit

Figure 2.2: Wheat Prices in International Market



Source: Haver Analytics and Pakistan Bureau of Statistics

2.3 Large-scale manufacturing (LSM)

The overall growth in LSM improved to 3.9 percent during H1-FY16, from 2.7 percent during the corresponding period of last year (**Table 2.6**). More encouragingly, this broad-based growth was achieved despite a decline in sugar production and closure of Pakistan Steel Mills (PSM) since July 2015.[21,22]

[18] Agriculture credit disbursement registered an increase of 23.5 percent in Q2-FY16 compared to 37.1 percent growth in the same period last year.
[19] Wheat exports remained almost nil during H1-FY16.
[20] Global wheat stocks are projected to increase by 24 million tons this year and reach a record level of 233 million tons (source: USDA Report on "Wheat: World Markets and Trade", February 2016).
[21] Given that sugarcane crop performed better in FY16 than last year, sugar production is likely to increase going forward.

Excluding sugar and PSM, large-scale manufacturing grew by 4.7 percent during H1-FY16, compared to only 2.2 percent in H1-FY15.

While the further decline in global commodity prices benefited many industries in Pakistan (e.g., food, auto, cement, and chemical), a number of policy developments also helped manufacturing sector post this improved performance (**Table 2.7**). For example, (i) increased Public Sector Development Program (PSDP) utilization (from Rs 269.4 billion in H1-FY15 to Rs 378.0 billion in H1-FY16) supported construction and allied industries; (ii) weighted average lending rate on marginal lending reached 7.3 percent in December 2015, which is the lowest level since 2005; (iii) the PKR remained relatively stable; (iv) Punjab government launched Apna Rozgar Scheme that required delivery of 50,000 vehicles during Dec 2014 to Feb 2016 to unemployed youth on soft terms;[23] and (v) improved gas availability facilitated manufacturing of fertilizer and cement.

Table 2.6: YoY Growth in LSM (Jul-Dec)
percent

		Growth rate		**Contribution to growth**	
	wt.	**FY15**	**FY16**	**FY15**	**FY16**
LSM	70.3	2.7	3.9		
Textile	21.0	1.2	1.0	13.4	8.0
Cotton yarn	13.0	1.4	1.8	10.8	9.2
Cotton cloth	7.2	0.0	0.7	0.1	1.6
Food	12.4	-1.9	0.1	-12.9	0.4
Sugar	3.5	-17.5	-14.2	-5.8	-4.2
Vegetable ghee	1.1	1.5	4.4	0.8	1.6
Cooking oil	2.2	-0.5	8.9	-0.7	8.5
Soft drinks	0.9	15.8	6.4	14.4	4.6
POL	5.5	5.3	6.8	12.6	11.6
Steel	5.4	31.0	-8.6	34.7	-8.6
Private	4.4	27.5	8.2	1.2	0.4
PSM	1.0	6.1	-100	0.1	-0.7
Non-metallic minerals	5.4	4.2	6.7	16.1	18.3
Cement	5.3	4.4	6.7	16.9	18.1
Automobile	4.6	13.6	32.3	24.3	44.3
Jeeps and cars	2.8	18.5	47.2	15.3	31.3
Fertilizer	4.4	-1.6	15.0	-3.6	22.9
Pharmaceutical	3.6	4.8	6.8	14.4	14.7
Paper	2.3	-2.8	-14.1	-4.5	-14.8
Chemicals	1.7	6.2	11.8	5.4	7.4
Caustic soda	0.4	-1.4	26.1	-0.2	2.8
Paints & varnishes	0.4	21.0	18.7	1.9	1.6
Leather products	0.9	16.6	1.2	10.7	0.6
Excl. sugar	66.8	3.3	4.4		
Exc. PSM	64.9	1.9	4.3		
Excl. sugar & PSM	61.4	2.2	4.7		

Source: Pakistan Bureau of Statistics

[22] The bailout package announced in FY15 had allowed PSM to increase its production by 117.3 percent in FY15. However, capacity utilization could reach only 13.4 percent in FY15. PSM, which has been struggling to operate on a sustainable basis over the past several years despite multiple bailout packages from the government, completely ceased production in July 2015 when Sui Southern Gas Company Limited (SSGCL) suspended its gas supply over non-payment of bills.

[23] It may be noted that unlike H1-FY16, the corresponding period of FY15 did not include the full impact of '*Apna Rozgar* Scheme', which was introduced by the Punjab government in December 2014. Under this scheme, the provincial government has committed to provide vehicles to unemployed youth on installments at a discount of Rs 70,000 over market price. The markup on the loans will also be paid by the government.

Going forward, we expect sugar sector to post some recovery as the crushing cycle matures. In addition, construction and allied industries would further gain from the development work on projects announced under China-Pakistan Economic Corridor (CPEC) gains more pace. The overall manufacturing sector would also benefit from a recent cut in electricity tariff by Rupees 3.0/unit, which would bring tariffs down to a single digit. Finally, a better law and order situation would help in improving investors' confidence.[24]

Table 2.7: International Commodity Prices

		Change over (percent)		
Commodities	**US$***	**3-months**	**6-months**	**12-months**
Crude oil				
WTI (bbl)	37	-18.7	-34.9	-30.5
Brent (bbl)	37.3	-22.5	-38.2	-35
Arabian light (bbl)	31	-32.2	-48.9	-43.3
Coal (mt)	49.3	-1	-16	-22.5
Urea (mt)	240	-12.7	-23.8	-36
Gold (oz)	1,061	-6.8	-9.2	-10.2
Cotton (lb)	63	5.5	-6.1	-3.3
Copper (mt)	214	-8.4	-19.3	-24.6
Steel (lb)	391	-6.5	-17.7	-35.4
DAP (mt)	418	0	-9.7	-18.1
Rubber (kg)	114	-7.7	-25.3	-25.3
Iron (mt)	42	-19.7	-21.4	-38.4

* As of 31st December, 2015

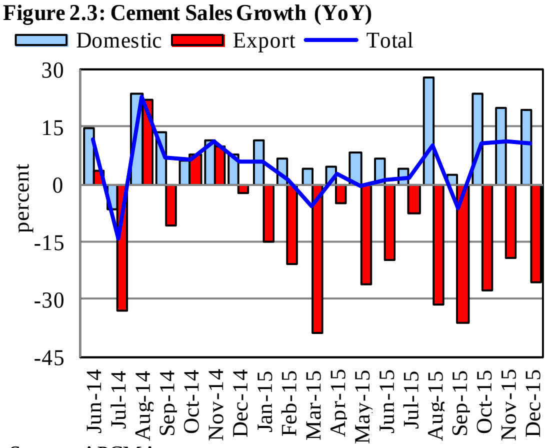
Source: Bloomberg

Sectoral performance

Better performance of construction allied industries

The demand for construction related products (cement, steel, paints and varnish) remained robust during H1-FY16, primarily due to increased focus of the government on PSDP projects and the development work in recently launched private sector housing schemes. While the cement and chemical industries came out as clear beneficiaries of this higher demand, the steel industry could not maximize gains from vibrant construction activities (see section on Steel).

Figure 2.3: Cement Sales Growth (YoY)



Source: APCMA

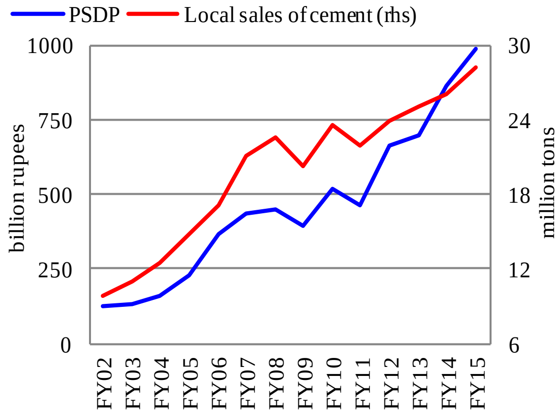
[24] Overseas Investors Chamber of Commerce and Industry's (OICCI) 11th survey of business confidence already shows significant improvement in overall business sentiment during last six months.

Cement

Cement manufacturers benefitted further from a steep fall in the global price of coal – a primary energy input constituting one-third of the production cost. Specifically, prices of coal from South Africa fell by 24.4 YoY percent in December 2015, which reflects slowing global economy as well as a shift away from coal-based power generation. At the same time, freight cost on import of coal also reduced in line with the softening of global oil prices. More benefits to the domestic cement industry came from lower cost of borrowing when SBP reduced its policy rate to historic low of 6 percent. The manufacturers, however, did not pass on these benefits to consumers, as the retail price for cement fell by 1 percent YoY only in December 2015.[25]

As mentioned earlier, the cement industry also gained from vibrant construction activities. The local sale of cement therefore posted an impressive growth of 16.3 YoY percent in H1-FY16, compared to 9.1 percent in H1-FY15. The cement exports, on the other hand, fell by 25.7 YoY percent during H1-FY16 (**Figure 2.3**). In particular, exports to South Africa suffered from imposition of antidumping duty and devaluation of Rand, whereas those to Afghanistan fell due to slower growth in development spending and tough competition from cheap Iranian cement.[26] Nonetheless, the sizeable increase in domestic sales more than offset the loss of export volumes. Indeed, strong local demand and improved margins[27] encouraged firms to increase their capacity utilization from 77 percent during H1-FY15 to 80 percent in H1-FY16.[28]

Figure 2.4: PSDP Utilization and Local Cement Sales



Source: APCMA, Ministry of Finance

Encouragingly, in view of expected demand from development projects under PSDP and CPEC (**Figure 2.4**), and the ongoing housing

[25] The average price of 50 kg cement fell from Rs 518.2 in December 2014, to Rs 513.4 in December 2015.

[26] Afghanistan and South Africa are the two major markets, having about 80 percent share in Pakistan's total cement exports.

[27] Gross profit margins increased by about 30 percent as evident from financials of thirteen cement companies, listed on Pakistan Stock Exchange.

[28] Source: All Pakistan Cement Manufacturers Association (APCMA).

schemes in the public and private sector, the cement industry is looking forward to expand its production capacity, from existing level of about 46 million tones to approximately 53 million tons in next two to three years.[29]

Chemicals

The chemical industry performed exceptionally well during H1-FY16, mainly due to: (i) a healthy growth in paints and varnish segment owing to robust construction activity and higher automobile production; and (ii) start of the commercial operation by a large caustic soda producing unit from June 2015. The overall growth of chemical production almost doubled to 11.8 percent during H1-FY16, from 6.2 percent during corresponding period of FY15.

Steel

Robust construction activity also created substantial demand for iron and steel products.[30] The local industry, however, could not take the full advantage from this demand surge, as the production of iron and steel recorded a *decline* of 8.6 percent during H1-FY16, compared to a remarkable growth of 31.0 percent during the corresponding period of FY15.

The availability of cheap imports from China and Ukraine hurt private producers in the domestic markets. Specifically, falling prices in the global market increased import of iron and steel by 20.1 YoY percent during H1-FY16 on top of 42 percent during H1-FY15.[31] While the import of iron and steel scrap, which witnessed an increase of about 50 YoY percent in H1-FY15, remained sluggish with a growth of only 2.7 percent during H1-FY16. Hence, the growth in iron and steel production by private manufacturers declined to 8.2 percent during H1-FY16, from 27.5 percent in the corresponding period last year. The overall production of iron and steel came under further pressure when continuing financial constraints forced PSM to close down its production in July 2015.

On a positive note, we expect some recovery going forward as the government has recently imposed anti-dumping duties for four months on imports of cold-rolled

[29] Cherat, Attock, Lucky and DG Khan Cement have all formally announced plans to enhance their annual manufacturing capacity by 1.3 million tons, 1.1 million tons, 2.6 million tons, and 2.7 million tons respectively.

[30] As per international standards, every five tons of cement used in infrastructure projects requires one ton of steel. This means, an increase in domestic sales of 2.1 million tons of cement during H1-FY16 would have created demand for additional 0.427 million tons of steel during this period.

[31] The import unit value of finished steel declined by 13 percent YoY during H1-FY16.

coils and sheets from China and Ukraine.[32] However, the closure of PSM would continue to overshadow performance of private producers.

While the demand for iron and steel would continue to grow due to a persistent surge in construction activities, there is a need to reduce the country's dependence on imported products. In Pakistan, most of the manufacturing plants are small-sized and therefore lack benefits from economies of scale. Even the technology used in production is obsolete and energy inefficient in most cases. PSM, which has the largest production capacity in the country, is using outdated technology and is far from self-reliant due to administrative and financial constraints. As a result, domestic iron and steel products struggle to compete with cheap imports from countries where manufacturers enjoy scale benefits and use advanced technology. Challenges to manufacturers are compounded further due to inconsistent policies and lack of effective control over malpractices in imports (**Topical Section on Steel**).

Auto sector continued to grow strongly

Auto sector recorded a growth of 32.3 percent during H1-FY16, compared to 13.6 percent growth in same period last year. Manufacturers gained from a decline in global steel prices, stable exchange rate, and low funding cost.[33] At the same time, sales volume remained healthy due to: (i) continuation of concessional Apna Rozgar Scheme launched by the Punjab government; (ii) continued appetite for passenger cars, with introduction of new models last year; and (iii) renewed focus of commercial banks on auto financing (**Table 2.8**).[34] Higher demand for automobiles allowed manufacturers to pass on the additional duty imposed on the import of CKDs/CBUs to end-consumers. In addition to passenger cars, demand for motorcycles and three wheelers also contributed to higher production in the auto sector.

Table 2.8: Segment-wise Sales of Automobiles (units)

	FY15		FY16		Growth in H1-FY16 over H1-FY15
Category	**Q1**	**Q2**	**Q1**	**Q2**	
Cars	27,630	31,097	44,372	45,452	53.0
Trucks	830	799	1,039	1,155	34.7
Buses	126	129	192	259	76.9
Pick-ups	3,983	4,145	10,198	11,276	164.2
Total	**32,569**	**36,170**	**55,801**	**58,142**	**65.8**

Source: PAMA

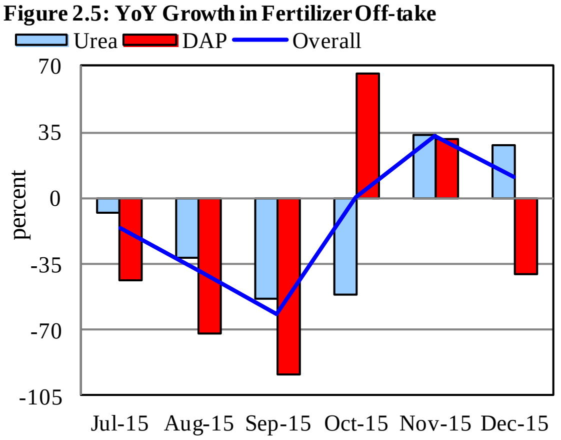
[32] These import duties, which were imposed in January 2016, vary in the range of 8.3 and 19.0 percent.
[33] International steel prices declined further by more than 17.7 percent during H1-FY16, while cost of borrowing (weighted average lending rate) declined further by 96 bps during H1-FY16.
[34] During H1-FY16, banks extended Rs 13.3 billion for auto finance, compared to Rs 7.4 billion during same period last year.

While the expected completion of Apna Rozgar Scheme in February 2016 may ease automobile sales, the overall demand would benefit from an improved availability of auto finance and the likely rise in demand for commercial vehicles (particularly trucks) following the start of infrastructure projects in the pipeline. More importantly, the industry is awaiting announcement of the auto policy.[35] This policy would bring more clarity on key issues relating to auto sector (e.g., fair competition, implementation of safety standards, import of new and used cars), and is expected to pave the way for new potential entrants from South Korea and Europe.

Despite several challenges, performance of fertilizer sector remained impressive
The overall environment remained challenging for fertilizer sector due to persistent decline in international urea prices. Global urea prices, which had already been trending downward due to supply glut, fell further during H1-FY16 in line with low oil/gas prices and expectations of subdued demand.[36] The softening of import prices weakened the sector's ability to pass on the impact of increase in gas prices to consumers.[37] The fertilizer sector therefore had to absorb most of the increase in gas prices.

Nonetheless, an improved availability of gas to fertilizer plants during H1-FY16 led to a strong growth of 15.0 percent in production, compared to a contraction of 1.6 percent during the same period last year.[38]

Figure 2.5: YoY Growth in Fertilizer Off-take



Source: National Fertilizer Development Centre

Two major factors that kept fertilizer off-take sluggish during Q1-FY16 were increase in urea and DAP prices in early September 2015, and the fact that farmers were waiting

[35] The auto policy, which was due in 2013, is still under review.
[36] The average price of urea produced by Ukraine fell from US$ 504 per metric ton in September 2011 to US$ 214 in January 2016 (source: Haver Analytics).
[37] From September 1st 2015, urea manufacturers increased their prices by Rs 160 per bag following 63 percent and 23 percent hike in feed and fuel stock prices respectively.
[38] Fertilizer sector received 150-200 mmcfd *additional* gas during HI-FY16, compared to the same period last year.

for notification on fertilizer subsidy announced in the Federal Budget for 2015-16. Implementation of Kissan Package and discounts offered by domestic companies (by absorbing increased gas prices) helped in recovery of fertilizer off-take during Q2-FY16 (**Figure 2.5**).[39]

Food sector benefited from improved economy and lower commodity prices
Overall production index of the food sector remained low during H1-FY16, mainly due to a decline in sugar production. Oil and ghee on the other hand posted a recovery; with the international price of palm oil having bottomed out, millers used their inventories of palm oil imported last year to meet increased local demand for oil and ghee. Meanwhile, cooking oil recorded growth of 8.9 percent during H1- FY16, compared to a production decline of 0.5 percent during the same period last year.

Sugar
Sugar production fell by 14.2 YoY percent during H1-FY16 on top of 17.5 percent decline recorded in H1-FY15. Cane crushing has already been started and we expect sugar production to gain momentum in coming months. The overall sugar production for FY16 is likely to increase over last year's level, largely due to improvement in sugarcane crop.[40]

Both domestic and external factors kept textile growth low
The performance of textile, the largest subsector in LSM, remained lackluster during H1-FY16 due to several factors: (i) subdued demand from importing partners (e.g., the EU and China) in view of global economic slowdown; (ii) inability of producers to adjust their products in response to change in consumer preferences; and (iii) ongoing domestic energy shortages. Resultantly, the sector was unable to benefit fully from GSP Plus status in the EU, declining cotton and energy prices, and lower cost of borrowing.

Meanwhile, following the addition of more efficient spindles by India, China and Bangladesh, it is not possible for our textile sector to compete internationally. To catch up with competitors, textile industry in Pakistan needs to invest heavily in balancing, modernization and replacement. Broadly speaking, the textile industry has to focus more on value-added items.

[39] The government notified the subsidy on 15th October, 2015.
[40] Sugarcane crop posted improvement from 62.8 million tons in FY15 to 65.4 million tons during the current season.

2.4 Services sector

While it is too early to make a robust assessment of services sector performance for the full-year, most of the indicators suggest a positive trend (**Table 2.9**). Transport and telecommunications sectors have particularly done well during the first half.

Table 2.9: Services Sector Indicators

	% share in GDP	H1 FY15	H1 FY16
Wholesale and retail trade	**18.3**		
Credit off-take (flow) billion rupees		18.5	23.2
Imports (billion US$)		24.15	22.21
LSM (YoY growth in percent)		2.7	3.9
POL sale (000 MT)[1]		9,002.9	9,293.6
Transport, storage & communication	**13.4**		
Credit off-take (flow) billion rupees		10.3	13.2
POL sales to transport sector (000 MT)[2]		4,320.7	5,137.5
Commercial vehicle production (nos.)		17,920	43,915
Commercial vehicle sales (nos.)		16,699	43,635
Of which: Bolan and Ravi		13,012	38,468
Cargo handling (million tons)		21.7	24.5
Broadband users (million nos.)		11.4	26.3
PTCL consolidated profit (billion rupees)		-4.32	-1.30
Finance and insurance	**3.1**		
Return on assets (percent)		2.2	2.5
Return on equity (percent)		24.3	25.8
Profit after tax (billion rupees)		89	100
General government services	**7.4**		
Expenses on general govt & defence (billion rupees) [3]		1,260	1,312

Sources: Pakistan Bureau of Statistics, State Bank of Pakistan, OCAC, PAMA, PTCL and KPT.
[1] This represents total domestic sales of all POL products to all sectors for the first five months of FY15 and FY16.
[2] This includes domestic sales of all POL products to the transport sector only for the first five months of FY15 and FY16.
[3] Consolidated current expenditure, excluding interest payments and grants, used as proxy for this sub-sector.

Production and sales of commercial vehicles has registered a phenomenal growth during H1-FY16, on the back of Apna Rozgar scheme launched by the Punjab government, and an uptick in overall commercial activity in the country. Other important sources of optimism over transport sector performance include: (i) a sharp increase in petrol sales; (ii) an increase in cargo handling at domestic ports; and most importantly (iii) a drastic containment of losses borne by Pakistan Railways and Pakistan International Airlines.[41] Low oil prices and stable exchange rate have indeed played an important role in improving the financial health of these public sector entities. Pakistan Railways has also gained from growing volumes of both freight as well as passenger transport.

In case of *telecommunication* sector, the role of increased usage of 3G/4G broadband services all across the country has been dominating. Financial health

[41] PIA financials show after tax loss of Rs 5.7 billion for the quarter ended September 30, 2015, compared to Rs 10.8 billion for the same period last year.

of most telecom firms has improved, benefitting primarily from data revenues.[42] Cellular firms have also partnered with leading commercial banks in the country to support the penetration of internet banking services. These firms are also actively participating in money transfer services all across Pakistan. So, effectively, telecom sector is now playing a dominant role in modernizing Pakistan's payment system infrastructure, and is also contributing to the wider objective of enhancing financial inclusion in the country for marginalized/ unbanked segments of the society.

PTCL group, the market leader, has continued to incur losses during H1-FY16; however, it has been able to reduce its losses compared to the same period last year. It is also important to highlight that losses incurred during H1-FY15 stemmed from both the PTCL company, as well as the group (which also includes its cellular subsidy, the Ufone); however, the PTCL company was able to generate profit of Rs 2.7 billion.

Finance and insurance subsector had recorded 6.1 percent growth during FY15, which was mainly driven by exceptional increase in profitability of commercial banks. These profits improved further during H1-FY16, but its pace remains significantly lower than the last year.[43] Hence, finance and insurance would remain strong in FY16, though it may not repeat the last year's performance.

General government services had registered 9.5 percent growth against the annual target of 4.3 percent for FY15. This year also, we believe the subsector would end up registering a modest growth due to the ongoing military operation in the country and the expected settlement of the Temporarily Displaced Persons (TDPs) in their areas.

Wholesale & retail trade is likely to benefit from: (i) higher LSM growth in H1-FY16 compared to the same period last year; (ii) a continuous increase in import quantums (especially non-oil) as well as a vibrant domestic demand that is likely to keep trading margins intact; and (iii) expectations of a bumper wheat crop on the back of strong yields. These factors are likely to partially offset the losses emanating from poor *kharif* crops.

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[42] Average revenue per user (ARPU) of Mobilink and Telenor has posted an increase during H1-FY16 over the same period last year. Data revenues of Mobilink have jumped from Rs 2.7 billion in H1-FY15 to Rs 4.8 billion in H1-FY16.

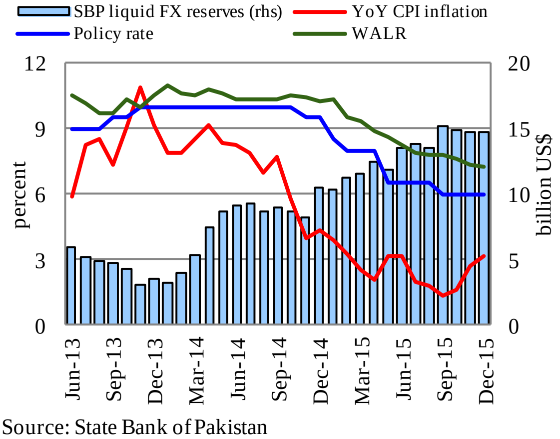
[43] Commercial banks' profits posted an increase of 11.7 percent YoY during H1-FY16, compared to steeply higher growth of 59.5 percent in H1-FY15.

3 Inflation and Monetary Policy

3.1 Overview

Declining inflation, stability in exchange rate, significant rise in foreign exchange reserves, and contained budgetary borrowings from SBP, has created room to decrease the policy rate to a historically low level of 6 percent in September 2015 (**Figure 3.1**).[1] In the subsequent monetary policy reviews of November 2015 and January 2016, SBP decided to keep the policy rate unchanged because the trends of key macroeconomic indicators and their future path suggested that the benefits and risks were held in balance. Furthermore, the realization of the lagged impact of aggressive monetary easing from November 2014 to September 2015, indicated by a pickup in real economic activity and higher bank credit to the private sector, also supported SBP's decision to keep the policy rate unchanged.

Figure 3.1: Policy Environment - Key Indicators



Source: State Bank of Pakistan

Notwithstanding positive developments, a few indicators witnessed adverse movements in H1-FY16. For instance, there was a sharp increase in currency in circulation, which surged by 2.6 times the rise observed during H1-FY15. At the same time, deposit mobilization was subdued in H1-FY16, and was only 50 percent of the rise in bank deposits seen in the same period last year. Inflation appeared to have bottomed out, as it inched up for four consecutive months since September 2015. Pressures in the foreign exchange market resulted in a 2.8 percent depreciation of the PKR (upto 10th March 2016) against the USD, mainly due to a rise in the current account deficit in Q2-FY16. This, together with

[1] At 6 percent, the policy rate is the lowest since August 1973. Cumulatively, the policy rate has been reduced by 400 bps since November 2014.

continued government borrowings from commercial banks, kept the overnight repo rate slightly above the policy rate in recent months.[2]

In the money market, SBP injected liquidity through open market operations (OMOs) and maintained the cut-off rate very close to the policy rate. Moreover, since September 2015, notable rise in bank deposits and decline in currency in circulation has also played an important role in supporting the interbank liquidity.[3]

The credit demand from both fiscal authorities (for budgetary support) and private sector resulted in a monetary expansion of Rs 479.7 billion in H1-FY16, as compared to Rs 442.9 billion in the equivalent period of the previous fiscal year. Component-wise, net foreign assets (NFA) of the banking system demonstrated noteworthy expansion of Rs 150.6 billion in H1-FY16, largely due to higher official inflows in the NFA of SBP during Q1-FY16. On the other hand, increase in net domestic assets (NDA) of the banking system was modest in H1-FY16 as compared to H1-FY15.

In absolute terms, government budgetary borrowing from the banking system (on cash basis) was Rs 183.3 in H1-FY16. The fiscal authorities resorted to financing their deficit through borrowings from external resources and commercial banks. As a result, they were able to retire SBP debt of Rs 429.2 billion during the period. This shift in borrowing from SBP to commercial banks has enabled the government to meet the IMF targets for end-September and end-December 2015 set under the Extended Fund Facility.

In this situation, developments in the credit market were encouraging. Private sector credit (PSC) expanded by Rs 352.9 billion in H1-FY16 against Rs 222.3 billion in the same period last year. The expansion in PSC was broad based as a large number of sectors (including textiles, fertilizer, retail trade, construction, and electricity) availed higher credit in FY16. Furthermore, significant developments in the credit market also included: (i) higher advances for fixed investment purposes to construction-related sectors, telecommunications, land transport, and electricity and gas production, and (ii) continuation of higher consumer credit for housing and automobiles.[4] Higher expansion in PSC is attributable to the

[2] This document uses the name commercial banks and scheduled banks interchangeably.
[3] During H1-FY16, currency in circulation has been higher while deposit generation has been lower as compared to the same period last year. This was particularly true during eid festival at the end of Q1-FY16.
[4] However, there were few sectors that availed lesser volumes of fixed investment loans in H1-FY16 compared to the same period last year. These included spinning, refined petroleum, beverages, weaving of other textiles, cattle/dairy farming, and sugar.

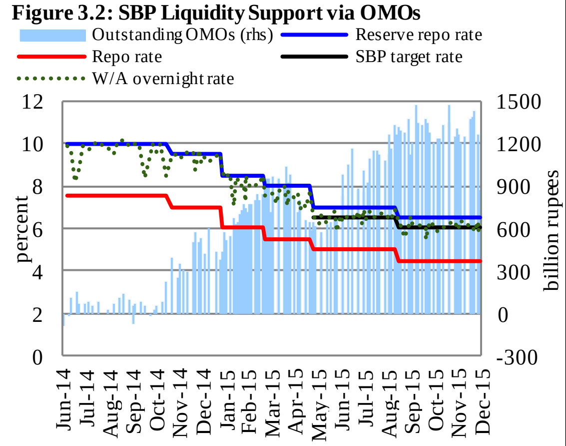
improved business environment (better security situation and improved energy management); lower cost of borrowing;[5] and modest risk premium for banks.

Low prices of international commodities (particularly oil) and subdued monetary expansion along with contained budgetary borrowings from SBP, resulted in a decline of average CPI inflation to only 2.1 percent in H1-FY16 as compared to 6.1 percent during H1-FY15. The trend of CPI suggested that inflation might have bottomed out by end of Q1-FY16. The reversal in Q2-FY16 was mainly due to both direct and indirect impact of food and energy groups. In particular, the following factors played a major role: upward adjustment in petroleum prices in November 2015; lagged impact of PKR depreciation against the USD during Q1-FY16; and imposition of regulatory duties on imports of various items, along with a percentage point across-the-board increase in customs duties (see **Section 3.4** for details).

3.2 Money market developments

SBP injected liquidity through OMOs during Q1-FY16 for broadly two main reasons: (i) to keep the overnight money market rate close to SBP target rate of 6 percent and; (ii) to partially neutralize the impact of high government borrowing from commercial banks on interbank liquidity. This has led to increase in the level of OMO injections during Q1-FY16 (**Figure 3.2**). However, post-monetary policy announcement of September 2015, OMO injections have comparatively remained unchanged.

Figure 3.2: SBP Liquidity Support via OMOs

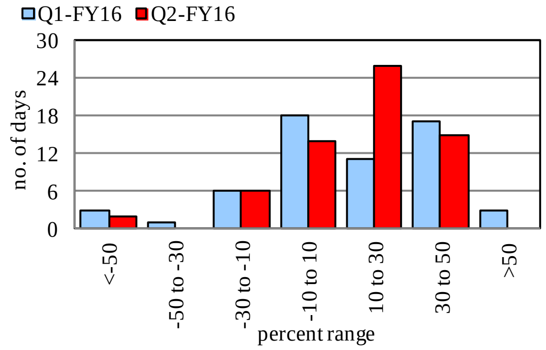


Source: State Bank of Pakistan

[5] Weighted average lending rates during H1-FY16 were 276 bps lower than in the same period last year.

Despite the high level of OMO injections, overnight interbank rates stayed, on average, 13 basis points above the SBP target rate of 6 percent in Q2-FY16 (**Figure 3.3**).[6] This was partially a result of SBP's efforts to keep the build-up of pressures in foreign exchange market at bay.[7]

Figure 3.3: Deviation of Overnight Market Rate from the SBP Target Rate*



*+ve difference in basis points means overnight rate higher than SBP target rate and vice versa
Source: State Bank of Pakistan

The relatively comfortable interbank liquidity situation in Q2-FY16 is attributed to better fiscal position and higher bank deposits. Healthy growth in tax revenues and timely receipt of foreign flows in the quarter also allowed the government to contain its borrowings from the banking system.

Table 3.1: Auction of Government Securities in FY16
billion rupees

	Target	Maturity	Accepted	Accepted: Net of target	Accepted: Net of maturity
PIB					
Q1	200.0	403.7	218.3	18.3	-185.4
Q2	150.0	5.7	182.9	32.9	177.2
T-bills					
Q1	1,200.0	862.6	1,321.2	121.2	458.6
Q2	1,225.0	1,146.4	1,014.0	-211.0	-132.4
Ijara					
Q1	-	-	-	-	-
Q2	100.0	233.8	117.7	17.7	-116.1
All					
Q1	1,400.0	1,266.3	1,539.5	139.5	273.2
Q2	1,475.0	1,385.9	1,314.5	-160.5	-71.4

Source: State Bank of Pakistan

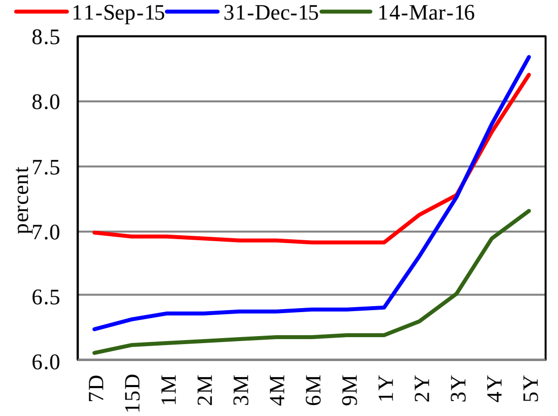
Fiscal authorities mobilized Rs 44.7 billion through PIBs and T-bills from commercial banks in Q2-FY16, as compared to Rs 273.2 billion in Q1-FY16. As indicated in **Table 3.1**, the government accepted lower amounts than both targets and maturity in primary auctions. The main reason behind government's lower borrowing from commercial banks was the successful Ijara Sukuk auction in December 2015, which reduced

[6] Daily overnight interbank rate remained higher than the target rate in 79 percent of days in Q2-FY16 as compared to 71 percent in Q1-FY16.
[7] Kerb market premium against USD rose from Rs 0.1 at end-September 2015 to as high as Rs 2.0 during December 2015.

pressures from the conventional banks to finance government budgetary requirements.[8]

Given the market liquidity situation and 50 bps cut in the policy rate announced on 11th September 2015, the secondary market yield curve displayed a downward shift in case of all tenors of less-than-3 year maturities up to end-December 2015 (**Figure 3.4**). However, as per the latest data (up to 14th March 2016), the long end of the yield curve has also declined, indicating a successful transmission from short-term to long-term rates. The transmission mechanism also affected the lending rates offered by commercial banks.

Figure 3.4: Secondary Market Yield Curve



Source: State Bank of Pakistan

In line with the declining policy rate trend, the weighted average lending rate (WALR) continued to slide, reaching its lowest level in over a decade to 7.3 percent during December 2015, from 10.3 percent in January 2015.[9] The average WALR during H1 indicates that the cost of borrowing in FY16 was 7.6 percent as compared to 10.4 percent in FY15. Due to this lower cost of borrowing and relatively stable liquidity conditions, credit to private businesses increased; this, in turn, was one of the key contributors to the expansion in money supply in Q2-FY16.

3.3 Developments in monetary aggregates

Broad money supply expanded by Rs 479.7 billion in H1-FY16 – slightly higher than the increase of Rs 442.9 billion seen in the same period last year (**Table 3.2**). However, unlike last year, when the entire expansion was concentrated in Q2, this year's increase was observed in both quarters. Budgetary borrowings from commercial banks and credit to private sector contributed to the overall expansion.

[8] Islamic banks with surplus liquidity were looking for investment avenues because the last Ijara auction was held 18 months ago in June 2014, and a number of auctions worth Rs 233.8 billion matured in Q2-FY16.

[9] The last time the WALR was lower than 7.3 percent was in April 2005.

Table 3.2: Absolute Changes in Monetary Aggregates
billion rupees

	FY15			FY16		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Money supply (M2)	-6.0	448.9	442.9	119.8	360.0	479.7
NDA	25.2	368.9	394.1	8.2	321.0	329.2
SBP	-66.9	-140.3	-207.2	205.2	-71.6	133.6
Commercial banks	92.1	509.2	601.3	-197.0	392.6	195.5
NFA	-31.2	80.0	48.8	111.6	39.0	150.6
SBP	-8.2	74.7	66.5	150.9	28.8	179.7
Commercial banks	-23.0	5.3	-17.7	-39.3	10.2	-29.1

Source: State Bank of Pakistan

On the liability side, the currency in circulation (CIC) saw a marked increase of Rs 325.4 billion during H1-FY16, which was about 2.6 times the rise seen during the same period last year. This increase was largely because of Eid holidays during the first quarter of the year and the imposition of withholding tax (for non-filers) on all banking transactions exceeding Rs 50,000. Specifically, the CIC increased by Rs 415.7 billion during Q1-FY16, which was followed by a decrease of Rs 90.2 billion during the second quarter of the year.

Private sector deposits, which are a prime source of funding for commercial banks, increased by Rs 144.4 billion (1.8 percent growth) during H1-FY16, compared with Rs 292.2 billion (4.0 percent growth) in the same period last year. The entire increase (Rs 457.0 billion) came during second quarter of the year, as the funds started flowing back into the banking system after a hefty rise in CIC during Q1-FY16.

Net Foreign Assets (NFA)

NFA of the banking system expanded by Rs 150.6 billion in H1-FY16, more than three times the increase witnessed in the same period last year. The bulk of this flow (Rs 111.6 billion) was concentrated in Q1-FY16, as NFA of SBP expanded due to official inflows from issuance of Eurobond, commercial borrowing by the government, and CSF receipts.

On the other hand, NFA of scheduled banks contracted by Rs 29.1 billion during H1-FY16.[10] Detailed analysis shows that trade financing against FE-25 deposits increased by US$ 304 million to US$1.5 billion during H1-FY16. Only a small part of this financing was catered through increase in FE-25 deposits (US$ 59.0

[10] In Q2-FY16, the trend in NFA of scheduled banks reversed and expanded by Rs 10.2 billion, partially offsetting the contraction in the previous quarter.

million), with the major funding coming via liquidation of commercial bank's FX claims on non residents.

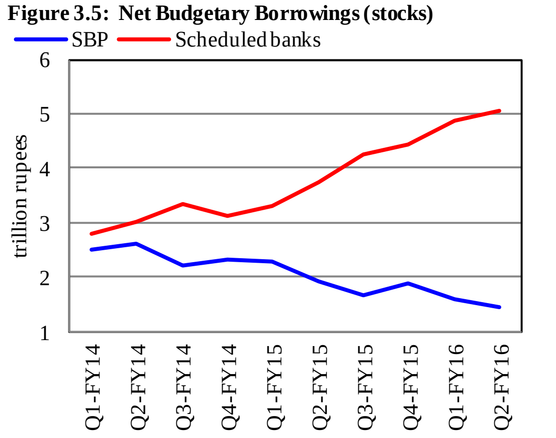
Net Domestic Assets (NDA)

NDA of the banking system increased by Rs 329.2 billion (3.1 percent) in H1-FY16 as compared to Rs 394.1 billion (4.2 percent) in the same period last year. This lower expansion in NDA was largely attributed to relatively healthy retirement of loans for commodity operations and contained government borrowing for budgetary finance. These two factors partially offset the expansionary impact of a pickup in credit to private sector.

Government borrowing for budgetary support[11]

The government borrowed Rs 183.3 billion from the banking system in H1-FY16 as compared to Rs 199.0 billion in the same period last year. Most of the budgetary borrowing in H1-FY16 was in the first quarter, with only Rs 43.9 billion borrowed in Q2-FY16.

Figure 3.5: Net Budgetary Borrowings (stocks)



Source: State Bank of Pakistan

Within the banking system, the government continued to retire SBP debt, which declined by Rs 429.2 billion in H1-FY16.[12] This net retirement to SBP allowed the government to meet the quarterly limit of zero budgetary borrowing set under the SBP Act 1956 and the target set by the IMF for both quarters of FY16. Furthermore, **Figure 3.5** depicts that budgetary requirement of the government has gradually shifted away from SBP to scheduled banks over the past few quarters.[13]

Since the government was in deficit (albeit at lower level) for H1-FY16, it implies that net retirements to SBP had to be financed from other sources of funding. Specifically, the government borrowed Rs 944.4 billion from commercial banks,

[11] Numbers of budgetary borrowings are on cash basis.
[12] Government retired SBP debt in the first and second quarters of both FY15 and FY16.
[13] Stock of government borrowing from SBP declined from its recent peak of Rs 2,248.0 billion at 15th June 2015 to Rs 1,457.5 billion at end-December 2015.

non-bank, and external resources during H1-FY16, which was considerably higher than the deficit of Rs 515.2 billion for the same period.

Commodity operations

Loans for commodity operations recorded a net contraction of Rs 41.8 billion during H1-FY16, which was higher than the retirement in the same period last year (**Table 3.3**). This contraction entirely stemmed from wheat loans, as financing for all other commodities saw a modest rise during the review period.

Table 3.3: Loans for Commodity Operations
billion rupees

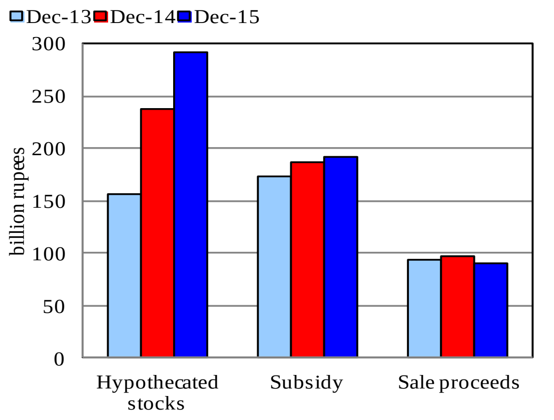
	H1-FY15	H1-FY16
Wheat	-23.1	-47.9
Sugar	-2.0	1.6
Fertilizer	-0.5	4.1
Cotton	0.0	0.4
Rice	0.1	0.0
Total	-25.6	-41.8

Source: State Bank of Pakistan

Wheat stocks with procurement agencies were recorded at 7.4 million tons at the end of H1-FY16 – 1.6 million tons lower than stocks at end-June 2015.[14] This offloading of stock enabled the procurement agencies to make loan retirements.[15]

Unlike last year, there was a net expansion in loans for fertilizer imports. To avoid shortage of fertilizer due to an expected fall in domestic production in the winter season, the government imported 1.6 million tons of fertilizer during Jul-Dec FY16.

Figure 3.6: Total Receivables of Procurement Agencies



Source: State Bank of Pakistan

Despite healthy retirement during the first half of the year, the outstanding stock of loans for commodity operations reached Rs 522.6 billion by end- December 2015. As shown in **Figure 3.6**, a large portion of these loans was backed by hypothecated stocks. However, receivables on account of

[14] The decline in stock during Jul-Dec FY15 was 0.9 million tons.

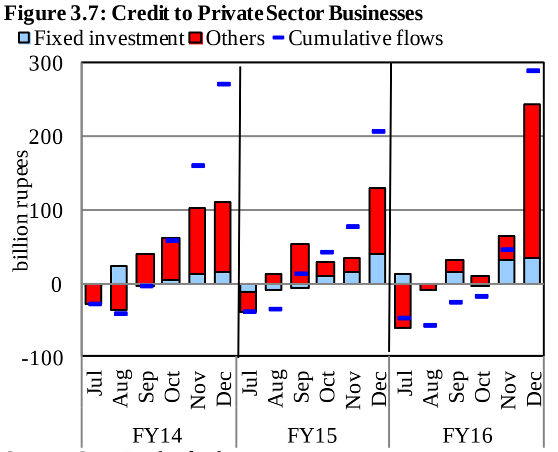
[15] It must be recalled that in FY15, private sector imported 0.7 metric tons of wheat to benefit from price differential between international and domestic prices. As a result, procurement agencies were unable to offload their stock due to this additional wheat in the market.

sale proceeds and subsidies stood at Rs 89.6 billion and Rs 192.0 billion by end-December 2015. Timely realization of these receivables would help reduce outstanding volume of loans for commodity operations.

3.4 Credit to private sector

Credit to private sector expanded by Rs 352.9 billion in H1-FY16 as compared to Rs 222.3 billion in the same period last year.[16] A significant part of this credit was availed by private sector businesses (**Table 3.4**). There was high credit off-take in December 2015, which was enough to compensate for the lower cumulative flow during earlier months of the year (**Figure 3.7**).[17] This should not be surprising, as private sector credit generally takes off from November onwards due to the beginning of the credit cycle. It is worth noting that the monthly flow in December 2015 – being twice as high as the average monthly flow in December of FY14 and FY15 may not just be a seasonal phenomenon.

Figure 3.7: Credit to Private Sector Businesses



Source: State Bank of Pakistan

The demand for private sector credit was high due to lower cost of credit and better market conditions. Similarly, the inclination and ability of banks to lend to the private sector also improved, as suggested by: (i) frequency and volume of SBP OMO injections; (ii) high deposit growth in Q2-FY16; (iii) comparatively lower government budgetary borrowings; and (iv) relatively high return on private sector lending.[18]

[16] A portion of this increase can be attributed to reclassification of selected assets of Islamic banks to advances in Q2-FY16. Even with the exclusion of this rise, the expansion in credit to private sector in H1-FY16 is visible.

[17] During FY11-15, average credit to private sector businesses during the month of December was only Rs 117 billion, against Rs 244 billion in December 2015. Given the depressed commodity prices in December 2015, such a massive increase in nominal credit off-take looks intriguing. The higher credit during the month was mainly extended to manufacturing (of food products, beverages, textiles, chemicals and petroleum products), commerce (wholesale and retail trade), and agriculture (major crops).

[18] Cut-off rates for 3-year PIBs have stayed lower than the weighted average lending rate in almost all months since January 2015.

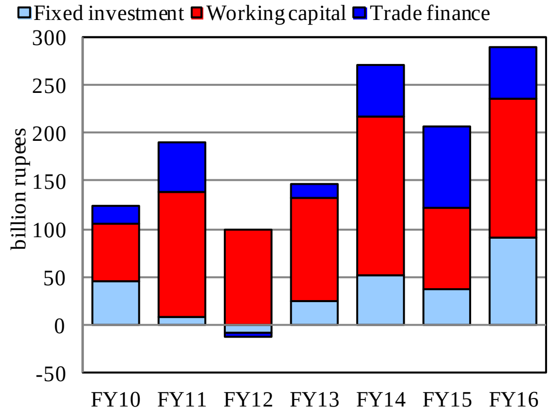
Table 3.4: Loans to Private Sector Businesses (Jul-Dec)
billion rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Total	207.6	290.1	84.5	144.5	36.9	90.9	86.1	54.7
1) Agriculture	18.3	17.7	11.1	14.1	7.5	3.0	-0.3	0.6
2) Manufacturing	114.6	164.4	27.1	92.6	19.8	20.5	67.7	51.3
Food & beverages	15.0	4.9	-17.1	-19.3	9.5	8.4	22.6	15.8
Textiles	57.7	82.6	34.8	72.5	-1.4	1.4	24.4	8.7
Coke & petroleum	14.4	19.3	7.3	1.2	5.7	-2.1	1.3	20.2
Chemicals	2.2	40.9	-5.4	28.6	7.5	6.8	0.0	5.6
3) Electricity, gas & water	-4.4	20.4	6.5	3.2	-9.5	18.7	-1.4	-1.5
4) Construction	11.8	20.9	1.2	5.9	10.6	12.5	0.0	2.4
5) Commerce and trade	18.3	22.4	6.0	20.8	1.5	0.7	10.8	1.0
6) Transport & comm.	10.3	13.2	11.5	-7.1	-0.9	21.0	-0.3	-0.6
7) Real estate	14.0	15.7	9.8	8.9	5.6	5.0	-1.4	1.8
8) Others*	24.6	15.4	11.4	6.0	2.2	9.6	11.0	-0.2

*Others include Fishing, Mining and Quarrying, Ship breaking, Hotels, Education, Health, Community service and other private business. Fall in trade financing in *Others* during Jul-Dec FY16 came primarily from Ship breaking.
Source: State Bank of Pakistan

Improvement in credit to private sector in FY16 over the previous year primarily came from the manufacturing sector, followed by commerce and trade, construction, and electricity. With the exception of ship breaking (which received Rs 13.4 billion lower cumulative flows in FY16 over FY15), the improvement can be considered broad-based.

Figure 3.8: Credit to Private Sector Businesses (Jul-Dec)



Source: State Bank of Pakistan

While credit for working capital and fixed investment categories showed higher growth, credit for trade financing was lower in H1-FY16 as compared to FY15. This lower trade financing was primarily a function of net retirement of non-EFS loans, which dragged down the overall number.

A welcome development was the gradual rise in net credit disbursement for fixed investment to Rs 90.9 billion in H1-FY16 (**Figure 3.8**). It appeared that many firms were expanding their operations by availing fixed investment loans. The expansion was particularly notable in: production, transmission and distribution of electricity; road transport; construction of roads; telecommunications; sugar; manufacturers of electricity distribution machinery; cement; fertilizer; and pharmaceutical sectors. Given the medium-term nature of these loans, this indicated that private sector was taking the benefit of lower cost of funding. A sustained growth in credit for fixed investment bodes well for overall investment rate in the country, which currently hovers around 15 percent of GDP – much lower than the regional economies (**Box 3.1**).

A continuation of credit demand requires favorable monetary conditions and improvement in performance of manufacturing and services sectors. Realization of this could bode well for growth in private sector going forward.

Agriculture sector

Net disbursement to agriculture sector expanded Rs 17.7 billion in H1-FY16 as compared to Rs 18.3 billion in the same period FY15. However, credit extension in Q2-FY16 was much higher as compared to Q2-FY15. The biggest beneficiary was livestock, which availed half (Rs 8.7 billion) of the total credit to the sector during the second quarter. Commercial banks made gross disbursement (excluding retirement) of Rs 220.1 billion to the agriculture sector during H1-FY16 as compared to Rs 204.8 billion in the same period last year. The higher cumulative flow is entirely attributed to *production* rather than *development*; credit to the latter declined by Rs 4.5 billion in the period.

Manufacturing sector

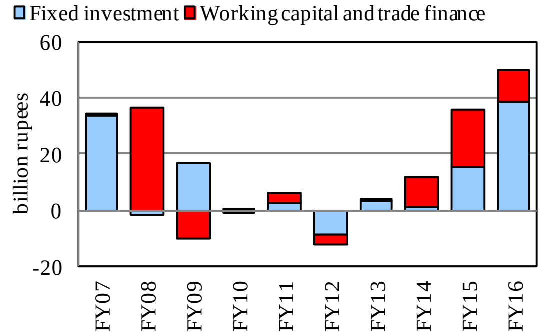
Credit to manufacturing sector showed a higher growth of 9.6 percent during H1-FY16, as compared to 7.0 percent in the same period last year. The main beneficiaries were textile and chemicals sectors.

Loans to textile sector witnessed a net increase of Rs 82.6 billion in H1-FY16 as compared to Rs 57.7 billion in H1-FY15. As usual, most of this increase was concentrated in Q2, when cotton procurement by textile firms peaked.[19] The majority of the credit was for working capital requirement, followed by trade finance. It seems that due to subdued textile exports (down 9 percent YoY during H1-FY16) following low commodity prices and subdued international demand, the textile industry was not upbeat about expanding as a small increase in fixed investment loans was largely for balancing, modernization and replacement.

[19] There was a net contraction of Rs 8.7 billion in Q1-FY16 as compared to Rs14.8 billion in the same period last year.

The chemicals sector showed the biggest improvement within manufacturing by availing Rs 40.9 billion credit in H1-FY16, as compared to a negligible Rs 2.2 billion in the same period of FY15. It availed credit during both quarters; most of this was for working capital. About 75 percent of the credit within chemicals was availed by the fertilizer sector; the reason being a rise in capacity utilization of local urea manufacturers to cater to local demand.[20]

Figure 3.9: Credit to Construction-related Sectors* (Jul-Dec)



* Includes construction, transport, storage, communications and real estate.
Source: State Bank of Pakistan

<u>Other private sector businesses</u>

Developments in construction-related sectors hinted at a pickup in economic activity, probably due to the initiation of CPEC-related projects.[21] For instance, the total credit availed by this group was Rs 49.8 billion — the highest since FY07 (**Figure 3.9**). Even better, category-wise data shows that a majority of the financing was for fixed investment purposes.

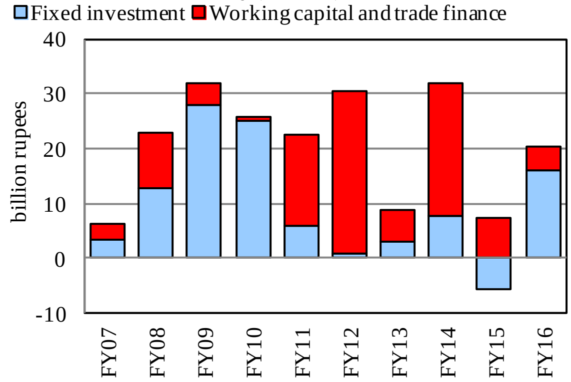
Similarly, production, transmission and distribution of electricity availed Rs 20.3 billion credit during H1-FY16, against a negligible Rs 1.7 billion in the same period last year. Majority of the credit (Rs 16.0 billion) was availed for fixed investment purposes, which is the highest since FY10 (**Figure 3.10**). It is a good sign for the sector, which has lagged behind in growth over the past few years.

[20] Given the government's willingness to grant concessions in gas prices, urea manufacturers have agreed to reduce the commodity price by Rs100 from every 50kg bag in addition to the relief of Rs 500 given on each bag of di-ammonium phosphate (DAP) fertilizer. The lower price would have increased the demand.

[21] Includes construction, transport, storage, communications and real estate.

Cumulative credit flow to retail trade was a healthy Rs 18.2 billion during H1-FY16 – nine times the amount availed in the same period last year.

Figure 3.10: Credit to Production, Transmission and Distribution of Electricity (Jul-Dec)



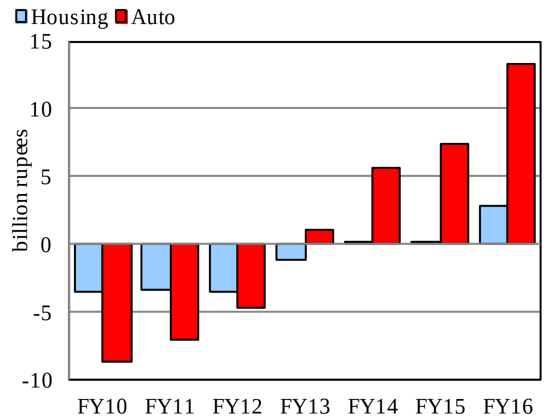
Source: State Bank of Pakistan

Consumer financing

Consumer financing reported a cumulative flow of Rs 11.4 billion in H1-FY16 as compared to Rs 12.3 billion in the same period last year. Yet, there was a noticeable improvement in the second quarter of the year, when credit to consumers grew by Rs 16.3 billion as compared to just Rs 6.8 billion in Q2-FY15. The rise in the credit is attributed to auto and house building loans.

Auto financing rose by Rs 13.3 billion throughout H1-FY16 (particularly in December 2015) as compared to Rs 7.4 billion in H1-FY15. Similarly, house building loans showed a considerable improvement, rising Rs 2.7 billion in H1-FY16 against Rs 0.2 billion in the same period last year.[22] Since FY10, loans for auto and house building showed a rising trend (**Figure 3.11**), as interest rates fell and SBP allowed financing of cars up to 9 years old. Preliminary data suggests that auto financing has started to benefit the sales of local car assemblers, which are expected to post a healthy rise in FY16 (**Chapter 2**).

Figure 3.11: Consumer Financing during H1



Source: State Bank of Pakistan

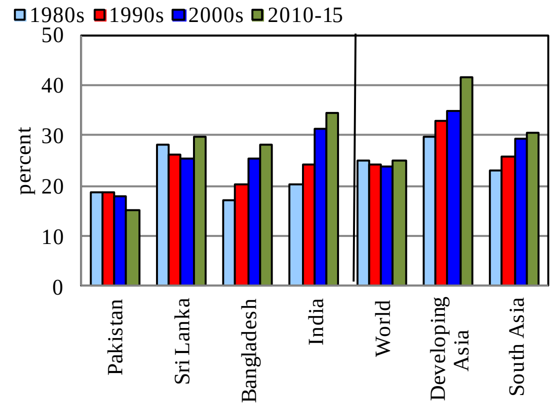
Despite the impressive performance of these sectors, Rs 6.0 billion in net retirement of personal loans in H1-FY16 was enough to dampen the overall flow in consumer financing during the period. The Rs 13 billion

[22] Majority of the increase in house building loans (Rs 1.5 billion) was realized in Q1-FY16.

contraction in the first quarter was mainly due to high retirements of personal loan disbursed in the past few years. Yet, encouragingly, there was a Rs 7.0 billion rise in personal loans during Q2-FY16.

Box 3.1: Why Saving and Investment are Low in Pakistan?
Most of Pakistan's economic issues center around low saving and investment rates. Pakistan's investment to GDP ratio is around 15 percent, which is much lower than other South Asian economies, where rates are on a growing path (**Figure 3.1.1**).[23] Similar is the situation with saving rate, Pakistan's saving to GDP ratio averaged at 14.5 percent as compared to 22.7 percent for other South Asian economies in the last 36 years.[24]

Figure 3.1.1: Investment to GDP Ratio



Source: Haver Analytics

The main factors behind low saving and investment rates, as highlighted in a recent SBP Staff Note,[25] are given below:

- **Role of financial sector**: Financial sector plays a key role in financing of development in an economy. Within the financial sector the role of specialized financial institutions is critical for promoting investment and long term projects. Historically, Pakistan had adopted long-term financing from specialized financial institutions, like PICIC, IDBP, NDFC, etc. However, these institutions are now a history due to their inefficiencies, mismanagement, increasing non performing loans and their burden on public finances. This situation has also negatively affected the development process/investment in the economy. On the other hand, Pakistan's financial sector is presently dominated by commercial banks, which are not specialized for long-term financing due to their short term nature of funding sources i.e. deposits. Mortgage financing is one such area where the domestic banking system has struggled to penetrate.
- **Declining foreign investment**: While Pakistan has been attracting foreign companies since independence in different sectors, it attracted substantial amount of foreign investment in mid 2000s in banking and telecommunication sectors. However, due to deteriorating security situation after 2007 coupled with global financial crisis of 2008-09, foreign investors avoided Pakistan as an investment destination.

[23] Here it is important to qualify that being an important ally in the global war against terrorism, Pakistan has paid a heavy price over the past decade in the form of security concerns and low investment rate.
[24] These South Asian economies are Bangladesh, India, Nepal and Sri Lanka
[25] Ali, Amjad (2016), Saving and Investment in Pakistan; *SBP Staff Note*, 01/16; January 2016. The paper is available at: http://www.sbp.org.pk/publications/staff-notes/SavingInvestmentStaffNote-Jan-16.pdf

- **Low saving rate**: While foreign savings are important in financing the saving-investment gap, the most reliable source of funds for investment in a country is its own saving – Pakistan's record in this aspect is also not encouraging. A number of factors are responsible for low savings rate in Pakistan, as mentioned below:
    - **Income level**: As saving is positively associated with income, an important reason for decline in saving is persistently low real GDP growth in Pakistan during the last many years.
    - **Inflation**: High inflation reduces the value of saving; and with given nominal interest rates, it is a disincentive to save in financial instruments. In Pakistan, a continuous five years of double digit inflation between FY08-FY12 has also contributed to decline in saving rates during this period.
    - **Rate of return**: Rate of return on saving is the most important factor affecting saving rate. Data for Pakistan suggests that national saving rates have followed the trend on real interest rate in general. Particularly, private sector saving has strong association with the real interest rate – having a correlation coefficient of 0.62.[26]
    - **Other factors**: Empirical literature[27] on determinants of saving behavior also finds education, financial deepening, culture, religion, and demographic factors (like labor force participation rate, dependency ratio, etc.) as important factors affecting saving rate.
    - **Lack of savings products**: Presently, the formal financial sector offers very limited range of savings products to its customers (e.g., deposits, mutual funds). Products are particularly limited for those individuals who do not prefer interest-based returns due to religious orientation. Therefore, people are drawn towards holding cash, gold, and FX either at their homes, or in bank lockers. These savings are not documented anywhere.
    - **Lack of efforts to mobilize savings**: Institutions involved in savings mobilization like CDNS, asset management companies and commercial banks, do not seem to make strenuous efforts to penetrate in the market to attract customers. It appears that many households are not even aware of savings instruments offered by these institutions, which leads them to use bank lockers to hold savings.
    - **Large undocumented economy**: Due to complex taxation system in the country, households deliberately avoid the modes of savings that necessitate documentation.
- **Difficult business conditions**: Terrorism across the country during the last many years, deterioration of general law and order in big cities and energy shortages made the business environment difficult in Pakistan, which not only kept foreign investors away from the country, but also dissuaded local businesses from expanding their investments in recent years. Pakistan's ranking on the ease of doing business index of World Bank has persistently deteriorated. This index had worsened by 51.5 percent between 2005 and 2015.
- **Policy weaknesses:** Although Pakistan has now achieved reasonable political stability, it has a history of frequent changes in political regimes, which had compromised the quality and

[26] Weighted average deposits rates have been used for this analysis. SBP policy rate and NSS rates (on Special Savings Certificates) have almost perfect correlation with weighted average deposits rates.
[27] See for example: (a) Edwards, Sebastian 1995; Why are Savings Rates so Different Across Countries? An International Comparative Analysis; NBER Working Paper No. 5097; and (b) Kazmi, Aqdas Ali 2001; A Study on Saving Functions for Pakistan: The Use and Limitations of Econometric Methods; Lahore Journal of Economics; 6:2; Jul-Dec.

consistency of economic decision making.[28] Such weaknesses in policy making not only impacted existing businesses but also kept away new investment.

- **Decline in public sector investment**: Public sector investment, particularly in infrastructure, crowds in private investment, and helps growth. However, in Pakistan the share of public investment has declined from an average of 9.5 percent in 1990s to only 5.5 percent in FY15. One obvious reason is increasing fiscal constraints due to low tax to GDP ratio and meager external financing, which hardly allows the government to spend much on development programs.

The recent low inflation, better balance of payments situation and improved security conditions have provided an opportunity to the policy makers to fix structural issues such as energy constraints, improving governance and increasing public investment. The low inflation would also give cushion to urban households to mobilize savings. However, uplifting the rural saving rate could be a challenge due to the prevailing soft commodity prices. Similarly, a business friendly environment with coherent economic policies can provide adequate incentives for manufacturers to move up in the value chain, and invest in technology that will allow shift from producing low value added goods to high value products.

3.5 Inflation

Benefiting from the persistent slump in international commodity (especially oil) prices and subdued monetary expansion, headline CPI inflation declined to an average of 2.1 percent in H1-FY16, compared to 6.1 percent during the same period last year. This visible decline, however, conceals a key development during the period: inflation has bottomed out. Year-on-year inflation inched up for all three months of the second quarter and reached 3.2 percent by December 2015, against the gradual decline observed in Q1-FY16. As a result, average inflation for Q2-FY16 reached 2.5 percent, compared with 1.7 percent in Q1-FY16 (**Table 3.5**).[29]

This reversal was largely attributed to; (i) lagged impact of depreciation of the PKR during Q1-FY16; (ii) pick up in prices of a number of food items, especially pulses, tea and a few perishables;[30,31] (iii) imposition of regulatory duties on a

[28] For example, a number of incentives were given for investment in fertilizer, power and CNG sectors with a commitment of uninterrupted gas supplies. But such commitments were made without having a fair assessment of available gas resources.

[29] The marginal increase in YoY inflation was not a surprise. With a continuous fall in CPI inflation to only 1.3 percent YoY in September 2015, and fall in WPI for the consecutive eleven months from November 2014 to September 2015, few segments of the society raised concerns of deflation. However, a detailed analysis showed that the headline CPI inflation is likely to bottom out in near future (**Special Section 2** on **Analysis of Deflation** in SBP Annual Report for FY15).

[30] In addition, electricity and gas prices also rose by 3.4 and 9.9 percent on YoY basis respectively in Q2-FY16, compared with only 1.2 percent for electricity charges and no change in gas price in Q2-FY15.

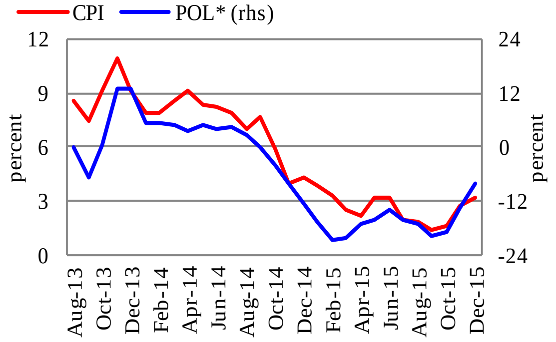
wide range of luxury and non-seasonal items, and a one percentage point increase in customs duties; and (iv) an upward adjustment in petroleum prices (w.e.f. 1st November 2015) (**Figure 3.12**).

Table 3.5: CPI Inflation (percent)

		Overall	Food	Non-food	Energy	Core		
						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
H1		6.1	5.1	6.9	3.0	7.6	6.4	7.8
	Q3	3.2	1.9	4.2	-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	-3.5	3.9	2.8	4.3
	Q2	2.5	1.8	3.0	-1.2	3.8	2.8	4.4
H1		2.1	1.0	2.8	-2.4	3.8	2.8	4.3

*Relatively Stable Component of CPI, its detailed methodology and group-wise items along with their weights can be viewed at: http://www.sbp.org.pk/publications/wpapers/2013/wp66.pdf
Source: Pakistan Bureau of Statistics and State Bank of Pakistan

Figure 3.12: Headline Inflation in CPI and POL Prices (YOY)



*POL: Average of YoY changes in prices of super petrol and high-speed diesel
Source: Pakistan Bureau of Statistics and State Bank of Pakistan calculations

Excluding two most volatile commodity groups from the CPI basket, non-food-non-energy (NFNE) inflation averaged 3.8 percent for Q2-FY16. This was not only well below the level of NFNE inflation (7.1 percent) that prevailed during the same quarter last year, but was also slightly lower than the level in Q1-FY16. Similarly, RSC-CPI recorded 4.4 percent increase in Q2-FY16, compared to 7.4 percent in Q2-FY15. All these core indicators imply that the recent increase in headline inflation was largely driven by both direct and indirect impact of food and energy groups.

[31] The government, faced with revenue shortfall in Q1-FY16, took a number of additional revenue measures in Q2-FY16. These included imposition of regulatory duties and increase in customs duty. Moreover, the government also increased sales tax rates on petrol and high speed diesel in Q2-FY16.

The food group, which accounts for more than one-third of the CPI basket, saw an average inflation of 1.8 percent during Q2-FY16, compared with only 0.3 percent in Q1-FY16. This rise largely stemmed from a sharp increase in prices of a few commodities (including onions, tomatoes, tea, cigarettes, gram and related products); the number of composite food items showing inflation remained almost unchanged during both the quarters.[32] The increase was attributed to different factors, including a pick-up in international tea prices, damages to gram crop, and an upward revision in federal excise duty on cigarettes.[33,34,35]

Among the sub-indices of the CPI basket, the highest increase was recorded in the alcoholic beverages and tobacco group.[36] Average inflation for this group was 18 percent in H1-FY16, compared with 22 percent in H1-FY15, as some products (like cigarettes) are being sold for higher-than-retail prices in different parts of the country.[37]

Another important development during Q2-FY16 was a deflation of 8.6 percent YoY in the transport group, down from 11.6 percent in Q1-FY16. In fact, following two downward adjustments in retail prices of petroleum products in Q1-FY16, there was an upward adjustment in November 2015.[38] Moreover, petroleum prices were kept unchanged in December 2015 despite a sharp reduction in international oil prices. As a result, the pass-through of international oil prices to domestic prices slightly slowed during the second quarter. However, it is important to mention here that the pass-through in Pakistan is still stronger as compared with regional and advanced countries (**Box 3.2**).[39]

Among other indices, housing services (house rent, water, gas and electricity) posted an average inflation of 5.1 percent YoY in H1-FY16, compared with 7.3

[32] Prices of perishable food items recorded an increase of 0.7 percent YoY in Q2-FY16, compared to a reduction of 9.8 percent in Q1-FY16.

[33] Domestic tea prices increased following an uptick in international prices. A seasonal increase in local demand also contributed to the rise in tea prices.

[34] Cognizant of damages to gram crop, the government allowed the import of 50,000 tons of gram in September 2015.

[35] Federal excise duty on sales of cigarettes was increased from Rs 3,030 to Rs 3,155 per thousand cigarettes (source: Federal Board of Revenue vide SRO 1181(I)/2015).

[36] This group includes cigarettes, betel leaves, and betel nuts only.

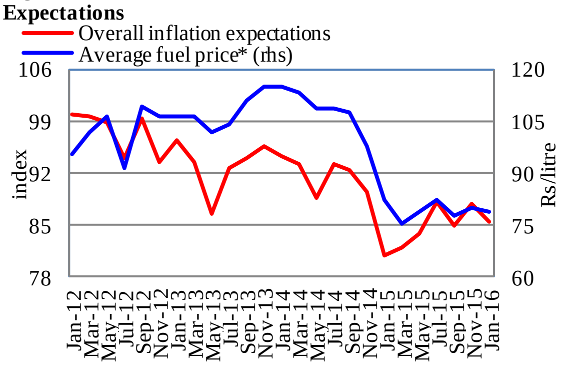
[37] In addition to cigarette, soft drink and kerosene oil are selling at higher prices than fixed by manufacturers/government. This behavior is evident from detailed CPI data. Furthermore, this issue has been highlighted several times in the SBP's State of the Economy reports. However, the benefits of checks on prices from relevant authorities have yet to materialize.

[38] Petrol and diesel prices were increased by Rs 2.5 and Rs 1.75 per liter respectively in November 2015.

[39] The benefit of the fall in international oil prices was passed on to consumers in February 2016.

percent during the same period last year.[40] Moreover, inflation in this group was remarkably stable for both quarters. A relatively lower inflation in house rent during Q2-FY16 was enough to offset the upward revision in gas tariffs for households during September 2015.

Figure 3.13: Fuel Prices and Consumers' Inflation Expectations



*Average of price of super petrol, and high-speed diesel
Source: Pakistan Bureau of Statistics and State Bank of Pakistan calculations

<u>Outlook</u>

The recent iteration of the consumer expectation survey in January 2016 shows a significant decline in inflation expectations compared to the previous survey. Low inflationary expectations were visible in all the commodity groups for the coming six months. It seems that consumers have factored in the potential impact of a sharp fall in international oil prices and stability in the PKR against the USD (**Figure 3.13**).[41,42]

The government reduced domestic petrol prices by 6.6 percent and 11.9 percent in February and March 2016, respectively, following the free fall in international crude prices to 12-year lows.[43] Both direct and indirect impact of lower fuel prices is likely to offset some of the inflationary pressures stemming from additional taxation measures introduced in the second quarter of the year.

Like the consumer expectations survey, a market-based indicator of inflation expectations (yield spread between long-term and short-terms government securities) also points towards lower inflation going forward. Specifically, the secondary market yield spread between 10-year PIBs and 3-month T-bills is gradually edging down from the first week of December 2015 onwards, after

[40] House Rent Index carries a weight of 29.41 percent in the CPI basket. This group includes house rent, electricity, gas, water, kerosene oil, firewood, construction items and construction related wage rate.

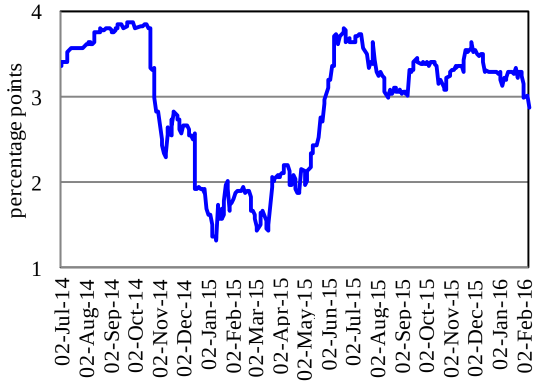
[41] After depreciating during Q1-FY16, the exchange rate has moved in a narrow range of Rs 104 to 105 per US$ in the last few months.

[42] Government has in fact revised petrol and high-speed diesel prices downward by Rs 8.84 per litre and Rs 4.67 per litre respectively.

[43] Global oil prices plunged to 12-year lows of around US$ 35 per barrel in 2015, and are expected to remain considerably low in 2016. In Pakistan, the price of petrol and high speed diesel oil fell by an average of 26.4 and 22 percent, respectively, between October 2014 and December 2015.

inching up in October and November 2015 (**Figure 3.14**).[44] This implies that the market expects inflationary pressures to remain subdued going forward.

Figure 3.14: Secondary Market Yield Spread: 10-year PIB and 3-month Treasury Bills



Source: State Bank of Pakistan

Finally, there is a need to account for the potential impact of the low level of prevailing interest rates (through aggregate demand), taxation measures, and movements in the exchange rate on inflation. Taking all these issues into account, 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.

Box 3.2: The Economics of Oil Prices Pass-through in Pakistan

Following the persistent reduction in crude oil prices from July 2014 onwards, many countries lowered their fuel prices, which also helped reduce inflation worldwide.[45] The magnitude of this price pass-through has led to perceptions that there exists a one-to-one relationship between international and domestic prices of petroleum products. Similarly, some analysts in Pakistan attribute the fall in oil prices alone for lowering inflation in the country. We briefly review these two points.

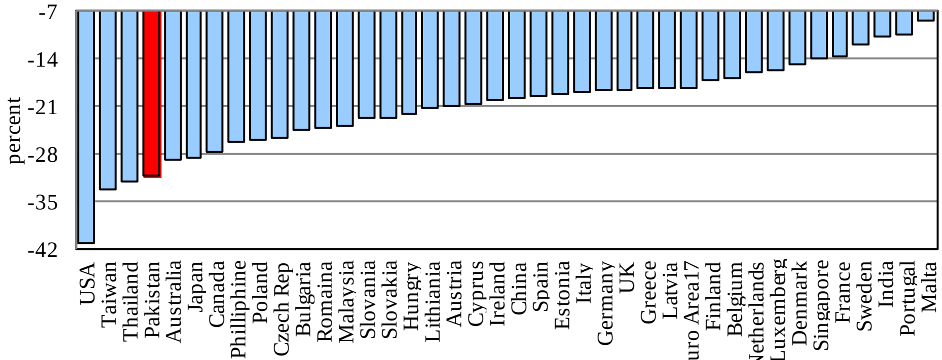
A. Pass-through and one-to-one relationship

Pakistan has followed a prudent policy for the pass-through of the decline in international oil prices to domestic consumers. On the one hand, it has made larger reduction in domestic oil prices compared with a number of other regional countries (**Figure 3.2.1**); on the other hand, it has held up some of the potential consumer surplus with itself. It is not just that the government was able to realize some revenues from this policy; it also helped domestic demand management.

[44] The secondary market yield of 10-year PIBs saw a reduction of 21 bps in January 2016 as compared to a marginal increase of 7 bps during the months of November and December 2015.

[45] International oil prices persistently fell from US$ 105.2 per barrel in July 2014 to US$ 36.5 per barrel in December 2015.

Figure 3.2.1: Change in Retail Gasoline Price in Selected Economies between Oct 2014 and Feb 2016



Note: Prices include taxes charged by respective governments on gasoline
Change is taken as percentage change in local currency per litre
Source: Bloomberg and State Bank of Pakistan calculations

Reducing oil prices means an increase, not only in demand for oil, but also of other consumer goods (as consumers may shift some surplus to other commodities). This could have led to a rise in excess demand and, in turn, led to undesirable fluctuations in the general price level and relative prices.

This policy of cautious pass-through also helped the government prevent a situation of deflation (in consumer prices) in the country, which is even more harmful for economic activity.[46] Inflation in Pakistan remained more stable during the last one and a half years compared to other regional countries.[47] It is important to note that a few countries, like Taiwan and Thailand, faced a deflationary situation mainly because they aggressively passed on the benefit of continuously falling oil prices to their domestic consumers.[48]

Further, higher volatility in prices is harmful for overall economy, as it causes uncertainty in business decision making. Therefore, from economic point of view, it is prudent for the government to create a buffer between global and domestic prices, in order to ensure stability in domestic prices.

In Pakistan, domestic fuel prices are notified by the Oil and Gas Regulatory Authority (OGRA) according to a defined mechanism for linking domestic and international oil prices. Usually, the government adjusts prices on monthly basis to account for changes in international prices and/or exchange rate. However, it must be kept in mind that the pass-

[46] For details see **Special Section 2** on **Analysis of Deflation** in SBP Annual Report for FY15.
[47] The coefficient of variation of YoY CPI inflation during July 2014 to December 2015 is lower in case of Pakistan, compared to Philippines, Singapore, Sri Lanka, Taiwan, Thailand, and Vietnam.
[48] Taiwan was in deflation from January 2015 to August 2015, while Thailand has been facing deflation from January 2015 to January 2016 on YoY basis (source: Haver Analytics).

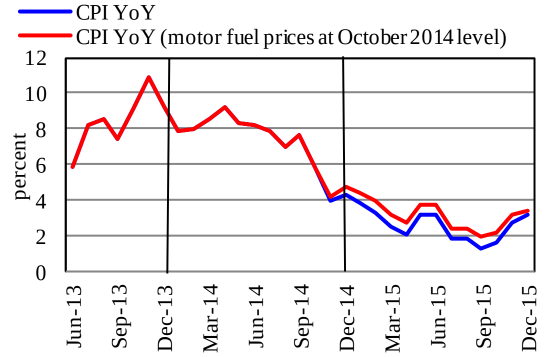
through of changes cannot be one-to-one due to a number of factors, such as taxes, inland freight, and margins of distributors and/or dealers etc.[49]

B. Are falling oil prices the sole cause of lower inflation?

Oil prices have both direct and indirect impact on the prices of goods and services in the CPI basket.[50] It is relatively difficult to measure the indirect impact of oil prices; however, the direct effect of the same can be easily calculated.

For this purpose, we re-calculated the headline inflation from October 2014 onwards by assuming oil prices at the level of October 2014 and compared it with the actual CPI inflation rate (**Figure 3.2.2**). It is evident that inflation shows a declining trend in Pakistan even after excluding the direct impact of fall in oil prices.[51] In fact, inflation in Pakistan started declining in December 2013 – well before the global oil prices began to slide in July 2014.

Figure 3.2.2: Direct Impact of Lower Motor Fuel Prices on Headline Inflation



Source: Pakistan Bureau of Statistics and State Bank of Pakistan calculations

In sum, though the fall in oil prices was one of the major factors behind the recent decline in inflation, others factors such as lower commodity prices (wheat, rice and edible oil) also contributed in softening of CPI inflation. Moreover, a stable exchange rate and a lagged impact of tight monetary policy during FY13 and initial months of FY14 have also played a role to keep inflation on a low trajectory.

[49] Effective April 16, 2006 OGRA is notifying different fuel prices. Also, effective June 1, 2011, refineries and Oil Marketing Companies (OMCs) notify ex-refinery and ex-depot prices of motor spirit (MS), high octane blended component (HOBC), light diesel oil (LDO) and some airline fuels such as JP1, JP4 & JP8. The components for determining prices of different fuel products are ex-refinery price based on concept of "Import Parity", government levies (excise duty and Petroleum Development Levy), inland freight, distributor and dealer margins, and sales tax. For details, see: http://ocac.org.pk/pricingFormula and http://www.ogra.org.pk/cats_disp.php?cat=86

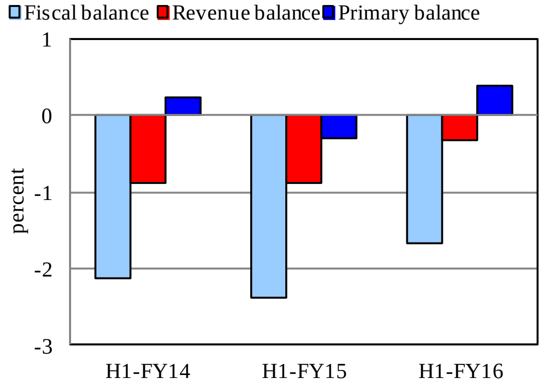
[50] It should be noted that lower international prices of both oil and other commodities such as wheat and rice are among other factors that have contributed to the recent fall in inflation.

[51] As regards the indirect impact, the first round impact of oil prices is on the transport sector. If we adjust this, the overall CPI inflation still shows a declining trend.

4 Fiscal Policy and Public Debt

4.1 Overview

Figure 4.1: Fiscal Balance Indicators (percent of GDP)



Source: Ministry of Finance

The overall fiscal position strengthened during H1-FY16 on the back of important policy measures for both the revenue mobilization and expenditure management. The budget deficit was reduced to 1.7 percent of GDP during this period, from 2.4 percent in H1-FY15 **(Figure 4.1)**. Importantly, the revenue balance posted an improvement of 0.6 percentage points during the same period, whereas the primary balance turned positive (0.4 percent of GDP).

In response to a weak fiscal outcome during Q1-FY16 – especially in terms of revenue collection, the federal government announced new tax measures during Q2-FY16, including additional customs and regulatory duties on certain items, as well as an increase in FED on cigarettes. In the meantime, withholding tax on all financial transactions for non-filers was continued in a bid to promote tax filing culture in the country.[1] If this momentum of resource mobilization is carried on in the second half of the year as well, the FBR tax-to-GDP ratio, which is currently hovering around 9 percent, may increase.[2]

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[1] However, the impact of this particular tax in terms of financial exclusion and growth of informal sector cannot be ruled out. The increase in the informal economy, in turn, has negative implications for tax collection in the long run.

[2] If FBR tax collection shows a growth rate higher than the nominal GDP growth during FY16, then FBR tax-to-GDP ratio will be higher than last year. This can happen if FBR maintains its current growth rate of 18.2 percent for the whole year and nominal GDP growth rate does not exceed 12 percent, as projected in the Annual Plan FY16.

On the expenditure front, the government slashed its non-development spending (excluding interest payments), which reinforced fiscal consolidation during the first half of FY16.[3] Although debt servicing remained higher in H1-FY16 as compared to the corresponding period last year, current expenditure did not post any significant rise. Moreover, net lending to PSEs remained negative. These factors helped the government ensure continuation of broad-based infrastructure projects; provided room for spending on special areas;[4] and helped settle down temporarily displaced persons (TDPs).

Table 4.1: Summary of Fiscal Operations

billion rupees

		Actual		% Growth	
	Budget FY16	**H1-FY15**	**H1-FY16**	**H1-FY15**	**H1-FY16**
A. Total revenue	4,712.0*	1,749.1	2,004.9	5.0	14.6
Tax revenue	3,729.5	1,361.1	1,639.1	16.1	20.4
Non-tax revenue	958.5	388.0	365.9	-21.4	-5.7
B. Total expenditure	6,016.6	2,400.9	2,520.1	8.9	5.0
Current	4,786.1	1,989.0	2,104.4	5.4	5.8
Interest payments	*1,279.9*	*572.7*	*632.4*	-4.2	10.4
Development	1,234.9	321.4	426.2	32.0	32.6
Net lending	-4.4	9.6	-1.8		
C. Statistical discrepancy	0.0	80.9	-8.6		
Fiscal balance (A-B-C)	-1,304.7	-651.8	-515.2	20.7	-21.0
Revenue balance	-74.1	-239.9	-99.4		
Primary balance	-24.8	-79.1	117.3		
Financing	1,304.7	651.8	515.2		
External sources	321.7	141.5	203.2		
Domestic sources	982.9	510.3	311.9		
Banks	283.4	199.0	183.3		
Non-bank	649.5	296.1	128.7		
Privatization	50.0	15.2	0.0		
percent of GDP					
Total revenue	15.4	6.4	6.5		
Tax revenue	12.2	5.0	5.3		
Total expenditure	19.6	8.8	8.2		
Current	15.6	7.3	6.9		
Development	4.0	1.2	1.4		
Fiscal balance	-4.3	-2.4	-1.7		
Revenue balance	-0.2	-0.9	-0.3		
Primary balance	-0.1	-0.3	0.4		

* Includes grant of Rs 24 billion

Source: Ministry of Finance

[3] Non-development expenditure (excluding interest payments) was recorded at Rs 1,461.4 billion during H1-FY16, as compared to Rs 1,506.8 billion during H1-FY15.

[4] These areas include AJK, Gilgit-Baltistan, and FATA.

The improved fiscal balance reduced the overall financing needs as well. Of the deficit of Rs 515.2 billion, the government financed Rs 203.2 billion from external resources, which is 43.6 percent higher than last year. This helped the government significantly reduce its reliance on domestic sources (**Table 4.1**).

4.2 Revenues

Total revenues recorded a growth of 14.6 percent and reached Rs 2,004.9 billion during H1-FY16, against a 5.0 percent rise witnessed during the comparable period last year. This strong growth came primarily from a significant 20.4 percent increase in tax revenues (**Table 4.1**). Main sources of revenue were taxes on income and profits (Rs 540.8 billion), goods and services (Rs 667.9 billion), trade (Rs 179.4 billion), and energy (Rs 130.1 billion). The federal government collected almost 92 percent of total taxes during H1-FY16. However, revenue collection from non-tax resources remained slightly lower than last year.

<u>FBR tax collection</u>

The federal government announced additional tax measures during the second quarter, which helped FBR to collect Rs 1,384.9 billion during the first half of the year – showing a growth of 18.2 percent (**Table 4.2**). These additional measures included:

- A 1 percent additional customs duty on auto industry and goods specified in the First Schedule of Customs Act, 1969.[5] This resulted in an increase in existing duty on the import of tractors, non-CNG buses, auto-rickshaws (except four-stroke ones), and other vehicles. This policy was also applicable on motorcycle spare parts;[6]
- Additional regulatory duty on 400 imported household consumer goods with varying rates.[7] These included a wide range of food products such as poultry, fish, milk products and fruits, along with personal care items like cosmetics and shampoos;
- Up to 60 percent regulatory duty on the import of luxury and sports vehicles;[8] and
- Additional Federal Excise Duty (FED) on cigarettes.[9]

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[5] Federal Board of Revenue vide SRO 1190(I)/2015 and SRO 1178(I)/2015.
[6] The duty was earlier withdrawn for one year.
[7] Federal Board of Revenue vide SRO 1177(I)/2015.
[8] Federal Board of Revenue vide SRO 1190(I)/2015.
[9] For cigarettes with price exceeding Rs 3,600 per thousand sticks, the duty was increased to Rs 3,155 from Rs 3,030. The duty on low-value cigarettes (priced below Rs 3,600 per thousand sticks), was raised to Rs 1,420 from Rs 1,320 (source: Federal Board of Revenue vide SRO 1181(I)/2015).

Table 4.2: FBR Tax Collection
billion rupees

		Collection		% Growth	
	Budget FY16	**H1-FY15**	**H1-FY16**	**H1-FY15**	**H1-FY16**
Direct taxes	1,347.9	458.9	540.8	20.1	17.8
Indirect taxes	1,755.8	713.0	844.1	9.8	18.4
Customs duty	299.1	135.3	179.4	22.9	32.6
Sales tax	1,250.3	513.8	591.0	6.7	15.0
FED	206.4	64.0	73.7	11.0	15.2
Total taxes	3,103.7	1,171.9	1,384.9	13.7	18.2

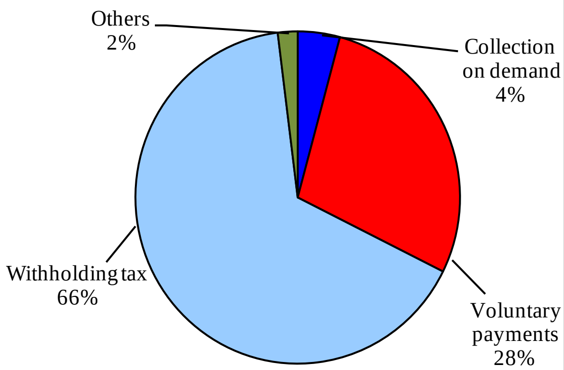
Source: Federal Board of Revenue

Apart from these measures, FBR also addressed tax compliance issues and made efforts to bring more taxpayers into the tax net. In this regard, it introduced a simplified four-year Voluntary Tax Compliance Scheme (VTCS) for traders, allowing them to file single-page tax returns.[10]

Direct taxes

FBR collected Rs 540.8 billion through direct taxes during H1-FY16, which was Rs 82 billion higher than the revenue collected during H1-FY15 (**Table 4.2**). Most of this collection came from withholding taxes (Rs 376.8 billion), while voluntary payments and collection on demand contributed Rs 161.5 billion and Rs 24.1 billion respectively. As shown in **Figure 4.2**, two-third of the total direct taxes came from withholding taxes, most of which are applied on economic transactions. This introduces an element of regressivity in the direct tax

Figure 4.2: Break-up of Direct Taxes during H1-FY16



Source: Federal Board of Revenue

[10] This scheme was especially for traders, having working capital less than Rs 50 million during FY15, who were outside the tax net. Traders could come into the tax net by paying only 1 percent of their working capital for tax year 2015 and filing a simplified one page return. For subsequent three years, a trader would have to pay 0.2 percent of its turnover with conditions that: (i) for tax year 2016, he would declare turnover at least three times of the working capital declared during tax year 2015; and (ii) for tax years 2017 and 2018, he would declare turnover on which tax paid is at least twenty five percent more than the tax paid for the preceding tax year (for details see FBR website).

system, which should be reduced by making more efforts on the part of tax authority and increasing documentation of the economy.

Indirect taxes

Indirect taxes posted a growth of 18.4 percent YoY and reached Rs 844.1 billion during H1-FY16. Most of these (70 percent) were generated through sales tax. Within sales tax receipts, major part came from POL products (Rs 216.3 billion), energy (Rs 27.7 billion) and iron & steel (Rs 22.7 billion).

Collection via customs duty showed a growth of more than 30 percent on the back of additional duties introduced recently, as mentioned above. Similarly, levy of additional FED on cigarettes led to a tax collection of Rs 32.1 billion in H1-FY16, compared with Rs 27.9 billion in the same period last year.

<u>Non-tax revenues</u>

Non-tax resources contributed 18.2 percent to the total revenues mobilized during H1-FY16. Overall non-tax revenues were recorded at Rs 365.9 billion during H1-FY16; this was Rs 22.1 billion lower than the level observed during H1-FY15 (**Table 4.3**). SBP profits added Rs 122.6 billion, while defence and royalties on gas & oil contributed Rs 78.2 billion and Rs 31.5 billion to the national exchequer.

Table 4.3: Non-tax Revenues

billion rupees

	Budget	Actual	
	FY16	**H1-FY15**	**H1-FY16**
Mark-up (PSEs & others)	69.2	4.1	2.2
Dividends	88.1	39.5	31.4
SBP profits	280.0	137.5	122.6
Defence (incl. CSF)	154.0	80.2	78.2
Royalties on gas & oil	58.6	40.9	31.5
Passport & other fees	25.0	7.2	6.2
Discount retained on crude oil	21.0	5.4	4.2
Windfall levy against crude oil	18.0	8.7	1.4
Total non-tax revenue	**958.5**	**388.0**	**365.9**

Source: Ministry of Finance

With the fall in crude oil prices, windfall levy as well as discount retained against crude oil also dropped down to only Rs 5.6 billion during H1-FY16, from Rs 14.1 billion during the corresponding period last year.

4.3 Expenditures

Consolidated fiscal spending dropped from 8.8 percent of GDP in H1-FY15 to 8.2 percent during H1-FY16. This was primarily on account of the cut in current spending from 7.3 percent of GDP to 6.9 percent during the period under review (**Table 4.1**). Furthermore, net lending to PSEs remained negative in the first half of FY16, providing space to maintain the momentum of ongoing development projects. This increased the share of development expenditures in total expenditures from 13.9 percent in H1-FY15 to 16.9 percent in H1-FY16.

Within current expenditure, provincial current expenses were the highest, followed by interest payments by the federal government, while defence expenditures were lower than last year (**Table 4.4**). The higher growth in provincial current expenditure reflects the provinces' increasingly higher responsibilities of running government affairs after the 18th Amendment.

On the development front, spending remained broad-based, with a special focus on infrastructure-building and power generation. In this regard, Rs 31.3 billion were released for the construction of roads and highways, Rs 55.8 billion for power projects, and Rs 7.8 billion for the development of railways. Apart from this, Rs 17.4 billion were spent on projects in AJK, Gilgit-Baltistan and FATA; while Rs 59.1 billion were released for temporarily displaced persons and Rs 20 billion for community development programs.[11]

Table 4.4: Analysis of Fiscal Spending during H1
billion rupees

	Actual		% Growth	
	FY15	**FY16**	**FY15**	**FY16**
Current expenditures	**1,989.0**	**2,104.4**	**5.4**	**5.8**
Federal	1,385.7	1,436.7	2.4	3.7
Interest payment	572.7	632.4	-4.2	10.4
Defence	329.6	303.3	11.6	-8.0
Public order and safety	43.8	47.0	12.9	7.3
Others	439.6	454.0	4.4	3.3
Provincial	603.3	667.7	12.8	10.7
Development expenditures	**321.4**	**426.2**	**32.0**	**32.6**
PSDP	269.4	378.0	26.7	40.3
Federal	125.5	155.8	5.8	24.2
Provincial	143.9	222.1	53.2	54.4
Others (incl. BISP)	52.0	48.2	68.3	-7.2
Net lending (to PSEs)	**9.6**	**-1.8**	**-88.4**	**-119.0**
Total expenditure*	**2,320.0**	**2,528.7**	**4.8**	**9.0**

*Excluding statistical discrepancy
Source: Ministry of Finance

4.4 Provincial fiscal operations

The consolidated provincial surplus reached Rs 208.6 billion in H1-FY16; this is around 70 percent of the full-year target of Rs 297 billion (**Table 4.5**). Sindh provided the highest surplus of Rs 88.9 billion, followed by KPK with Rs 61.9 billion, Punjab Rs 36.0 billion and Balochistan Rs 21.7 billion.

Total provincial expenditures grew at a steady 19.0 percent during H1-FY16 – in line with the growth of 18.6 percent witnessed during the same period last year. Owing to a robust growth of 54.4 percent in provincial development spending, the provinces' share in consolidated expenditures rose marginally from 32.5 percent in H1-FY15 to 36 percent in H1-FY16.

[11] Source: PSDP 2015-16, Status of releases as on 31-12-2015, Ministry of Planning, Development & Reform.

Table 4.5: Provincial Fiscal Operations during H1
billion rupees

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY15	FY16	FY15	FY16	FY15	FY16	FY15	FY16	FY15	FY16
A. Total revenue	412.5	496.8	249.8	293.0	141.4	165.0	93.2	96.2	897.0	1051.0
Share in federal revenue	336.0	415.6	189.7	227.1	118.9	140.0	79.1	85.4	723.7	868.1
Provincial revenues	56.8	76.4	45.3	56.4	14.9	17.0	2.6	3.8	119.6	153.6
Tax revenues	46.0	60.7	42.3	53.9	5.5	6.0	1.2	1.8	95.0	122.4
Property taxes	3.9	4.3	1.3	0.5	0.2	0.3	0.0	0.0	5.4	5.0
GST on services	-	25.7	-	28.4	-	3.5	-	0.9	-	58.4
Excise duties	0.8	1.2	1.7	1.8	0.0	0.0	0.2	0.2	2.7	3.1
Stamp duties	9.4	11.2	2.9	3.3	0.3	0.3	0.2	0.1	12.8	15.0
Motor vehicle tax	4.6	5.8	1.8	2.3	0.4	0.6	0.3	0.3	7.1	9.0
Other	27.4	12.7	34.6	17.6	4.5	1.3	0.6	0.2	67.0	31.8
Non-tax revenues	10.8	15.7	3.0	2.5	9.5	10.9	1.4	2.1	24.6	31.3
Federal loans & transfers	19.7	4.7	14.9	9.5	7.5	8.1	11.5	6.9	53.6	29.2
B. Total expenditure	351.4	453.8	208.5	215.6	125.5	148.6	68.3	77.8	753.7	895.8
Current	274.5	312.4	170.6	178.7	104.8	116.5	59.8	66.0	609.8	673.7
Development	76.9	141.4	37.9	36.8	20.6	32.1	8.5	11.8	143.9	222.1
Gap (A-B)	61.1	43.0	41.4	77.4	15.9	16.4	24.9	18.4	143.3	155.2
Financing* (Overall balance)	-33.8	-36.0	-37.7	-88.9	-17.9	-61.9	-20.9	-21.7	-110.4	-208.6

* Negative sign in financing means surplus.
Source: Ministry of Finance

Table 4.6a: Pakistan's Public Debt Profile
billion rupees

	Stock		Share in total		Flow			
							FY16	
	Jun-15	Dec-15	Jun-15	Dec-15	H1-FY15	H1-FY16	Q1	Q2
Public debt	17,757.7	18,855.4	100.0	100.0	578.4	1,097.7	768.8	328.9
Public domestic debt	12,192.5	12,879.6	68.7	68.3	602.7	687.1	522.1	165.0
Public external debt	5,565.2	5,975.8	31.3	31.7	-24.4	410.6	246.7	163.9
Govt. external debt	4,770.0	5,072.9	26.9	26.9	-80.6	303.0	182.7	120.3
Debt from the IMF	417.6	523.1	2.4	2.8	60.0	105.5	57.7	47.8
External liabilities	377.6	379.7	2.1	2.0	-3.8	2.2	6.3	-4.1
Memorandum items:								
Public debt (MoF definition)*	17,380.2	18,475.7			582.2	1,095.5	762.5	333.0

*MoF does not include external liabilities in its definition of public debt, while SBP includes these liabilities which are: central bank deposits, swaps, allocation of SDR and non-resident local currency deposits with central bank.
Source: State Bank of Pakistan

However, resource mobilization remained sluggish at the provincial level. Of the Rs 1,051 billion in provincial revenues, provinces generated Rs 153.6 billion from their own resources, while the rest came from federal transfers and loans. Although the 18th Amendment authorized provincial governments to mobilize resources by taxing services and agriculture sectors, the provinces have yet to exploit this potential.

4.5 Public debt

Pakistan's public debt stock increased from Rs 17.8 trillion as on end-June 2015 to Rs 18.9 trillion by end-December 2015, which was 61.5 percent of GDP (**Table 4.6a**). While a major part of this debt is domestic, the external debt also increased significantly in H1-FY16. However, despite this increase, the external debt-to-GDP ratio continued to decline (**Table 4.6b**). It may be noted that the increase in external debt was coincided with a build-up of the country's FX reserves, which in turn, bodes well for debt servicing capacity of the country.

Table 4.6b: Pakistan's Public Debt Profile (key indicators)

percent

	FY10	FY11	FY12	FY13	FY14	FY15	H1-FY15	H1-FY16
Indebtedness indicators								
PD/GDP	62.1	60.1	64.5	65.2	65.1	64.8	61.7	61.5
DD/GDP	31.3	32.9	38.1	42.5	43.5	44.5	42.0	42.0
ED/GDP	30.8	27.2	26.4	22.7	21.6	20.3	19.7	19.5
Short-term ED/ED	1.6	1.1	0.7	0.5	1.3	1.9	1.8	2.2
Debt servicing indicators								
Int. payment on DD/TR	27.8	28.0	32.0	30.9	29.5	30.7	30.0	28.8
Int. payment on ED / FEE	2.7	2.3	2.1	1.9	1.8	2.3	2.3	2.7
Int. payment on ED /XE	4.5	3.7	3.6	3.3	3.2	4.4	4.4	5.4
EDS/XE	16.9	11.1	14.9	21.4	23.4	16.4	18.1	15.3
Liquidity indicators								
Reserves/short-term ED (ratio)	19.7	28.5	40.1	41.7	19.3	18.5	14.8	16.6
Memorandum item;								
Public debt/GDP (MoF definition)	60.6	58.9	63.3	63.9	63.8	63.5	60.5	60.2

PD: public debt; DD: public domestic debt; ED: public external debt; TR: total revenues; FEE: foreign exchange earnings; XE: export earnings; EDS: public external debt servicing (interest payment & principal repayments)

Source: State Bank of Pakistan; Ministry of Finance

Domestic debt

Pakistan's domestic debt expanded by Rs 687.1 billion in H1-FY16, compared to an increase of Rs 602.7 billion in the same period last year (**Table 4.7**). A significant part of this increase was witnessed in the first quarter, as a relatively smaller budget deficit and the resumption of multilateral flows reduced the pace of domestic debt accumulation during Q2-FY16.

While the government retired its debt to SBP, it borrowed more from scheduled banks during H1-FY16. However, the break-up of data reveals that commercial banks followed a different lending pattern during Q2-FY16 as compared to the first quarter. With inflation inching up in Q2-FY16 (**Chapter 3**), banks changed their interest rate outlook, and increased their participation in relatively shorter tenured government securities. As shown in **Table 4.8**, commercial banks offered higher amounts in T-bills compared to PIBs during Q2-FY16. Moreover, around half of the entire amount offered in T- bill auctions was concentrated in 3-month T-bills.

On a cumulative basis, the government borrowed Rs 2.6 trillion from commercial banks in primary auctions during H1-FY16, largely in accordance with the target set for the period. However, the bidding pattern of auctions held in Q2-FY16 shows that the government accepted Rs 1.1 trillion, which is lower than both the maturity and the target set for the quarter. In addition to substantial external inflows, other factors responsible for lower borrowing from commercial banks included: (i) successful conduct of Government Ijara Sukuk (GIS) auction in December 2015, which partially neutralized the GIS maturities falling during the quarter; and (ii) mobilization of Rs 208.5 billion through outright purchase of GIS on deferred payment basis in November 2015.

Table 4.7: Absolute Change in Government Domestic Debt
billion rupees

	H1		FY16	
	FY15	**FY16**	**Q1**	**Q2**
Govt. domestic debt	**602.7**	**687.1**	**522.1**	**165.0**
Permanent debt	615.4	189.0	90.8	98.3
PIBs	587.5	240.8	55.6	185.2
Ijara Sukuk	0	-116.1	0	-116.1
Floating debt	-180.7	420.6	377.4	43.2
Bai Muajjal*	0	212.6	0	212.6
T-bills	64.7	506.9	614.7	-107.9
MRTBs	-331.1	-119.8	-58.2	-61.6
Unfunded debt	168.0	77.2	53.7	23.5
Foreign currency loans	0.1	0.1	0.1	0

* Includes Rs 0.013 billion of treasury bills on tap
Source: State Bank of Pakistan

Table 4.8: PIB and T-bills Auction Profile-Competitive Bids only
billion rupees

	Target	Offer	Accepted	Maturity
Q1-FY16				
T-bills	*1,200.0*	*1,387.0*	*1,260.6*	*676.1*
3-m		314.7	286.8	230.4
6-m		498.9	469.5	431
12-m		573.4	504.2	14.7
PIBs	*200*	808.2	218.2	163.3
3-y		469.6	134.6	139.3
5-y		281.1	77.0	16.7
7-y				7.3
10-y		57.5	6.6	
Total	**1,400.0**	**2,195.2**	**1,478.8**	**839.4**
Q2-FY16				
T-bills	1,225.0	2,060.9	946.5	1,146.4
3-m		910.8	449.6	372.8
6-m		600.5	273.1	395.7
12-m		549.6	223.8	377.9
PIBs	150.0	447.0	182.9	0.0
3-y		263.3	111.6	
5-y		169.2	67.8	
10-y		14.5	3.5	
Total	**1,375.0**	**2,507.9**	**1,129.4**	**1,146.4**
Grand total	**2,775.0**	**4,703.1**	**2,608.2**	**1,985.8**

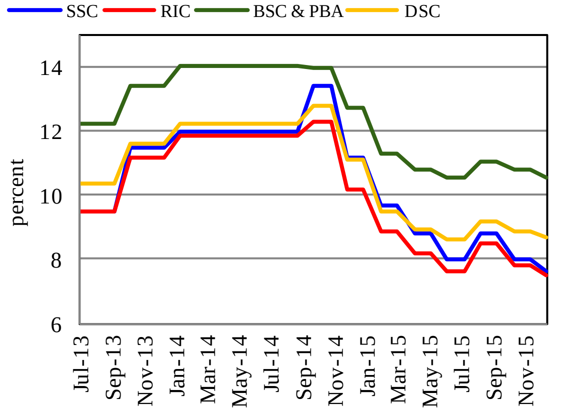
Source: State Bank of Pakistan

Fund mobilization through NSS

Following the cut in the policy rate, profit rates on National Savings Schemes were also revised downward and reached 12-year lows by December 2015 **(Figure 4.3)**.

This caused a deceleration in both gross and net flows during H1-FY16 (**Table 4.9**).[12] Specifically, net mobilization through NSS during H1-FY16 was less than half the level seen in the same period last year. Some deceleration was expected, as high mobilization in November 2015 was primarily driven by institutional investment in NSS.[13] In addition, the government's decision to increase withholding tax on profits for non-filers also dampened flows to NSS during the period.[14]

Figure 4.3: Rate of Return on Major NSS Instruments



Source: Central Directorate of National Savings

Table 4.9: Receipts under NSS Instruments during H1
billion rupees

	FY15		FY16	
	Gross	**Net**	**Gross**	**Net**
DSC	23.7	8.6	13.3	1.1
SSC	124.0	28.0	87.1	4.9
RIC	85.3	40.3	35.3	-5.3
BSC	68.0	26.5	80.3	39.5
SSA	96.9	54.6	77.1	25.3
Others	107.6	9.6	119.0	11.8
Total	505.4	167.6	412.1	77.2

Source: Central Directorate of National Savings (CDNS)

Public External Debt & Liabilities

Pakistan's public external debt & liabilities recorded an increase of US$ 2.3 billion during H1-FY16, reaching US$ 57.0 billion by end-December 2015 (**Table 4.10**). This was mainly due to an increase in loan disbursements by multilateral donors and receipts from the IMF's Extended Fund Facility (EFF).

[12] Profit rates on NSS were adjusted downward in October 2015 and December 2015.
[13] In November 2015, net investment in Special Savings Accounts stood at Rs 56.6 billion.
[14] The withholding tax on profit on NSS was increased to 17.5 percent for non-filers in Finance Act 2015, while it was left unchanged at 10 percent for filers.

Disbursements
External loan disbursements rose by US$ 840.8 million in H1-FY16 over the same period last year (**Table 4.11**). Details of gross inflows from main creditors during the period are as follows:

- China disbursed US$ 561.4 million, mainly for power sector infrastructure projects;
- Inflows from ADB included US$ 47.2 million under the Social Protection Development and US$ 394.0 million for sustainable energy reform program;
- Pakistan received US$ 489.4 million from IDA, under the Power Sector Reform Development Policy Credit;
- The government borrowed US$ 956.1 million from commercial lenders;
- Pakistan received US$ 500 million as proceed of the Eurobond issued in September 2015.

Servicing of External Debt
External debt servicing declined by US$ 549.2 million in H1-FY16, compared to the same period last year (**Table 4.12**). One of the key factors

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

	Jun-15	Dec-15	Change
Public debt	54,673.6	56,985.4	2,311.8
Government debt	46,861.2	48,375.6	1,514.4
IMF	4,103.0	4,988.6	885.6
External liabilities	3,709.4	3,621.2	-88.2

Source: State Bank of Pakistan

Table 4.11: External Loan Disbursement during H1
million US$

	FY15	FY16	Absolute Δ
ADB	318.0	607.4	289.4
IDA	94.5	594.9	500.3
IDB	121.5	39.3	-82.2
IBRD	34.1	36.2	2.1
IDB (short term)	793.8	378.5	-415.3
UK	205.6	247.2	41.6
China	505.3	561.4	56.1
Saudi Arabia	16.5	0.0	-16.5
Japan	57.7	26.5	-31.1
USA	58.5	80.7	22.1
Euro/Sukuk bond	1,000.0	500.0	-500.0
Commercial banks	50.0	956.1	906.1
Others	55.7	123.9	68.3
Sub total[1]	**3,311.2**	**4,152.0**	**840.8**
IMF[2]	1,607.0	1,005.0	-602.0

Source: [1]Economic Affairs Division, Islamabad; [2]State Bank of Pakistan

Table 4.12: Servicing of Public External Debt-H1
million US$

	FY15	FY16	Change
Government debt	1,278.6	1,533.9	255.9
of which			
Paris club	227.7	222.1	-5.7
Multilateral	711.2	699.4	-12.5
Other bilateral	163.4	158.2	-5.5
Commercial loans	8.2	219.7	211.4
IMF	874.4	74.3	-800.1
External liabilities	48.2	43.8	-4.5
Total	**2,201.2**	**1,652.0**	**-549.2**

Source: State Bank of Pakistan

behind this fall was the significant decline in repayments to the IMF; these had peaked out last year. On the other hand, repayments to multilateral and bilateral donors remained almost at the same level as last year.

The impact of the recent fall in external debt servicing is visible in indicators of the country's debt servicing capacity. Specifically, the ratio of external debt servicing to exports improved to 15.3 percent in H1-FY16 compared to 18.1 in the same period last year.

5 External Sector

5.1 Overview

The global commodity slump continued to figure prominently in improving Pakistan's balance of payments during the first half of FY16. Oil prices tumbled to 12-year low by end-December, which instigated further cuts in the country's import bill (**Table 5.1**). Although a steep decline in exports offset much of the gains, the overall deficit in the current account during H1-FY16 was significantly lower than the level seen in the same period last year. As foreign investments remained short, the financing of this deficit was mainly done via IFI loans and commercial borrowings, plenty of which were available. Therefore, the country's reserves continued to grow, with SBP's net international reserves moving on the targeted trajectory.

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

	Q1-FY15	Q1-FY16	Q2-FY15	Q2-FY16	H1-FY15	H1-FY16
Current account balance	-1,631	-351	-832	-1,074	-2,463	-1,426
Trade balance	-6,054	-4,700	-3,884	-4,541	-9,938	-9,241
Export receipts	5,959	5,321	6,205	5,497	12,164	10,818
Import payments	12,013	10,021	10,089	10,038	22,102	20,059
Oil imports	4,476	2,582	3,122	1,882	7,598	4,464
Services balance	-658	-177	-833	-836	-1,491	-1,013
Worker remittances	4,775	4,967	4,387	4,769	9,162	9,736
FDI in Pakistan	201	248	410	376	611	624
Portfolio inv. in Pakistan	133	390	991	-152	1,124	238
Eurobond / Sukuk	0	500	1,000	0	1,000	500
FX loans (net)	431	632	912	1,958	1,342	2,590
Country's FX reserves (end-period)	13,511	20,075	15,268	20,812	15,268	20,812

Source: State Bank Pakistan

This improvement, albeit welcome, is not much reassuring. As in case of other emerging markets, vulnerabilities have grown as the global economy embraces new norms for some time: a lackluster economic recovery; structural shifts in the oil market that engendered excess supplies; very low inflation rates across advanced economies; and nervy global equity and currency markets amid weakening in China and policy reversal in the US.[1] Major emerging market

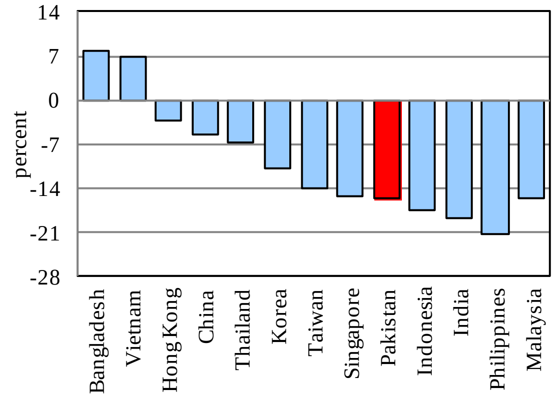
[1] The global economy is estimated to have grown by 3.1 percent in 2015, down from 3.4 percent in 2014. Growth in advanced economies has risen marginally, but this was more than offset by a steep

economies (EMs) have lately seen their exports falling; remittances been slowing down; and a much contained cross-border investments. Pakistan is being affected alike.

Worryingly, the decline in Pakistan's exports entered its fourth straight quarter in Q2-FY16, and at a much stronger pace compared to the preceding three quarters.[2] In the meantime, non-oil imports continued to firm up as domestic demand stayed vibrant; import of machinery, steel and other raw materials was particularly strong to fuel the on-going domestic construction activity. Since remittance growth could not keep pace to even out this growing imbalance, the current account deficit increased by 29.1 percent YoY in the second quarter, after falling in the first (**Section 5.2**).

So effectively, external conditions have recently started to play out adversely for Pakistan.[3] This primarily reflects Pakistan's inability to step into the league of countries that were able to defy global downturn – either by increasing their nominal competitiveness, and/or by introducing and following through on structural reforms.

Figure 5.1: Export Growth (YoY) in Emerging Economies - Jul-Dec 2015



Source: Haver Analytics

More specifically, Bangladesh and Vietnam were able to put up enviable export performances in H1-FY16, when import demand from the largest markets – the US and the EU – remained low (**Figure 5.1**).[4] Here, it is important to recall that a large part of the export decline for most EMs has been concentrated in commodity-dependent products, as lower prices translated into

cut in the growth of emerging market economies. China, in particular, has posted a 25-year low growth of 6.9 percent in 2015 (source: IMF World Economic Outlook, January 2016 Update).

[2] The decline in Pakistan's exports reached 14.6 percent YoY in Q2-FY16, compared to 14.3 percent in Q1-FY16; 4.8 percent in Q4-FY15; and 9.2 percent in Q3-FY15 (source: Pakistan Bureau of Statistics).

[3] Side by side, it is important to note that the ongoing structural reform programme, and the expected activity under the CPEC umbrella, would go a long way to strengthen Pakistan's external sector.

[4] Total imports of the US and EU have posted a decline of 5.5 percent and 13.9 percent YoY respectively during Jul-Dec 2015 (source: Eurostat and ITC).

lower dollar earnings. However in case of Pakistan, the export drop was broad-based and mostly due to lower quantities. High production costs and lack of product depth are indeed taking their toll.

Similarly, external conditions certainly contributed in pushing down foreign investments, but we must not forget that these inflows were already falling before the global investments dried up.[5] In addition to domestic policy issues, security conditions, and energy shortages, the concentration of FDI in the oil and gas sector over the past few years was also an important reason: the dramatic fall in crude prices limited reinvestments by oil & gas MNCs operating in the country.[6] Additionally, low profitability in this sector strained the KSE-100 index, which was already under pressure amid fears of crackdown on high profile brokers. The index's fall was exacerbated by foreign investors taking out US$ 240.7 million from the KSE during the first half of FY16.[7]

Under these circumstances, the China-Pakistan Economic Corridor provides a dash of optimism. Besides being a stable source of FX inflows over the program period, these investments will help remove major supply-side constraints (power and infrastructure) for the industrial sector, and may also contribute to a fall in the cost of doing business.

That said, we believe that Pakistan needs much more FDI inflows in other sectors of the economy as well; unless we are able to attract investment in exporting sectors, structural imbalances cannot be addressed. To this end, formulating and implementing a smart industrial and trade policy that actively seeks to diversify Pakistan's export base and destinations, is a must. It is also imperative to carefully evaluate Pakistan's trade balance under existing FTAs and adopt a cautious stance in negotiating new agreements. In particular, Pakistan should actively seek to discourage the influx of low-tech and unproductive goods into the country under such agreements.

[5] FDI into 'Developing Asia' grew by 15.5 percent in CY 2015 (source: UNCTAD Global Investment Trends Monitor 2015), while inflows to Pakistan registered a big drop of 54 percent in the year.

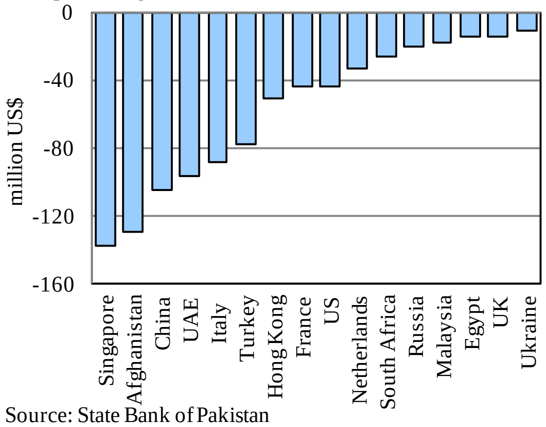
[6] In the previous five years, inflow into the oil & gas exploration alone constituted nearly 66 percent of total FDI in the country. During H1-FY16, FDI into this sector virtually stayed unchanged at US$ 157 million compared to H1-FY15.

[7] Source: National Clearing Company of Pakistan Limited (NCCPL).

5.2 Current account: Falling exports offset gains from lower oil import bill

Low oil prices continued to benefit the current account, as the deficit declined significantly in H1-FY16 compared to last year. However, as mentioned before, the entire improvement came in the first quarter, as the decline in export receipts in the second quarter was steep enough to offset the modest decline in the country's import payments (**Section 5.5**). As shown in **Figure 5.2**, the decline in exports was not concentrated in a particular destination, though Asian economies and the EU contributed the most.

Figure 5.2: Country-wise YoY change in Pakistan's Export Receipts during H1-FY16

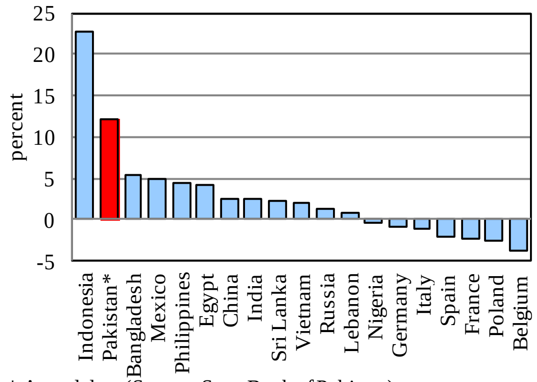


Source: State Bank of Pakistan

Worker Remittances

The pace of remittances to developing countries has slowed down in recent months mainly due to very low inflation across advanced economies, and a slow global economic recovery.[8] Pakistan has not been immune to this trend, as the growth in remittances has begun to weaken. That said, among the top-20 remittance recipients worldwide, Pakistan has been able to post a relatively decent growth in calendar year 2015, along with Indonesia (**Figure 5.3**). In fact, these two countries stand out glaringly among the leading recipients; in case of Pakistan, this seems to be an outcome of efforts under the Pakistan Remittance Initiative (PRI), to deepen the remittance services business

Figure 5.3: Estimated YoY Growth in Remittances in CY 2015 over CY 2014



* Actual data (Source: State Bank of Pakistan)
Source: World Bank

[8] Remittances to developing countries registered a modest growth of 2 percent in 2015, compared with 3.3 percent in 2014 and 7.7 percent (on average) from 2010 to 2013 (source: World Bank).

Table 5.2: Country-wise Remittances into Pakistan
million US$

	Q1		Q2		H1	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Total	**4,775.1**	**4,966.5**	**4,387.0**	**4,768.8**	**9,162.2**	**9,736.0**
USA	737.5	715.9	672.1	631.6	1,409.5	1,347.5
U.K.	656.6	671.9	555.9	580.2	1,212.5	1,252.1
GCC	2,936.6	3,148.7	2,750.6	3,094.6	5,687.2	6,243.2
Saudi Arabia	1,347.0	1,440.9	1,302.8	1,455.0	2,649.8	2,895.9
U.A.E.	1,037.7	1,114.8	949.0	1,058.8	1,986.8	2,173.5
Dubai	537.9	763.2	494.9	704.1	1,032.8	1,467.3
Abu Dhabi	482.9	332.3	437.9	337.9	920.8	670.2
Other GCC	551.8	593.0	498.8	580.8	1,050.6	1,173.8
EU	112.5	93.6	85.6	98.1	198.1	191.7
Other countries	332.0	336.6	322.8	364.3	654.9	700.9

Source: State Bank of Pakistan

by engaging more money transfer operators (MTOs), domestic postal services, and the telecom sector.

More recently, however, the tapering in remittance growth has intensified (**Table 5.2**). During H1-FY16, remittance inflows into Pakistan have grown by only 6.3 percent YoY, compared to 17.6 percent in the same period last year. Importantly, while the decline in growth during Q1-FY16 was primarily a seasonal phenomenon, the slowdown in Q2-FY16 represents the impact of adverse global conditions.

In particular, inflows from the US have dropped by 6.0 percent YoY during Q2-FY16, compared to an increase of 8.0 percent during the same period last year. This is surprising because overall unemployment in the US has steadily been declining.[9] We can identify two factors contributing to this decline: first, the anticipation of a Fed rate hike through most of the period might have impacted the asset allocation plans of expatriates who send money to Pakistan for investment purposes; and second, anecdotal evidence suggests that high skilled Pakistani workers engaged in America's oil industries have faced salary cuts and layoffs. However, these two factors *alone* cannot explain the magnitude of the fall in remittances from the US.

As for the GCC, which constituted around 60 percent remittance growth over the previous five years, the slowdown was expected keeping in view the public

[9] The unemployment rate in the US has dropped from 5.6 percent in December 2014 to 5.0 percent in December 2015 (Source: US Bureau of Labor Statistics).

spending in the region. However, remittance growth from this region is still higher compared with other countries. More importantly, the number of Pakistani workers going into this region has increased in recent months (**Table 5.3**). This basically suggests that the impact of falling oil prices is yet to translate into lower labor demand from GCC via reduced spending on infrastructure and transport.

Table 5.3: Number of Workers Going Abroad and Registered with BEOE (Jul-Dec)

	Numbers			Growth rate%	
	FY14	**FY15**	**FY16**	**FY15**	**FY16**
Total	622,714	752,288	946,571	20.8	25.8
Saudi Arabia	102,527	164,107	274,005	60.1	67.0
UAE	273,234	350,344	326,986	28.2	-6.7
Qatar	8,119	10,042	12,741	23.7	26.9
Oman	47,794	39,793	47,788	-16.7	20.1
Malaysia	2,031	20,577	20,216	913.1	-1.8
Others	189,009	167,425	264,835	-11.4	58.2

Source: Bureau of Emigration and Overseas Employment

So far, this region has been resisting big cuts in fiscal spending, as support from their previously accumulated FX reserves has been available. It must also be noted here that certain expenditures cannot be compromised by the governments in this region, like Expo 2020 related expenses in Dubai, and FIFA World Cup 2022 related expenses in Qatar. However, countries that have been operating at high (fiscal) break-even prices are now finding it hard to sustain their spending spree; their reserves are depleting fast.

For instance, FX reserves of the Saudi Arabian Monetary Agency (SAMA) have fallen by US$ 116 billion in the past 12 months, to finance the huge fiscal deficit (of 15 percent of GDP) ran by the Kingdom.[10] To avoid such depletion next year, the government is planning to cut the deficit primarily via expenditure controls; side by side, it is also planning to privatize state-owned entities to generate more funds. Similarly, the UAE is planning to cut its infrastructure spending. However, not all states would follow the austerity path; as mentioned before, Dubai has to continue preparations for Expo 2020, for which it has announced a 12 percent increase in its overall spending.[11]

Going forward, we expect remittances to grow modestly as most of the factors outlined above are likely to remain in play in the medium-term. Pakistan government is working through diplomatic channels with most countries in the Gulf to increase the participation of its workforce in infrastructure activity in the region. Pakistani banks are also expanding their network of existing tie-ups with

[10] Source: Haver Analytics
[11] Source: Department of Finance, Government of Dubai (http://dof.gov.ae/en-us/media/news/Pages/2016budget.aspx).

leading money transfer operators, to provide their customers efficient and convenient money transfer facilities, which would eventually help switch more remittances from informal to formal sector.[12]

5.3 Financial account

The financial account posted a stable picture during H1-FY16, mainly due to hefty inflows from IFIs. Against the budgeted foreign inflows of US$ 9.2 billion for FY16, Pakistan received US$ 4.2 billion during H1-FY16.[13] These receipts included US$ 500 million from a Eurobond issue; US$ 1.2 billion from the World Bank and ADB; and over US$ 400 million in bilateral inflows. However, there was also a noticeable increase in short-term borrowings during the period by the government. Commercial banks also borrowed US$ 371 million from commercial lenders to curb volatility in the interbank market.

Table 5.4: Net FDI inflows
million US$

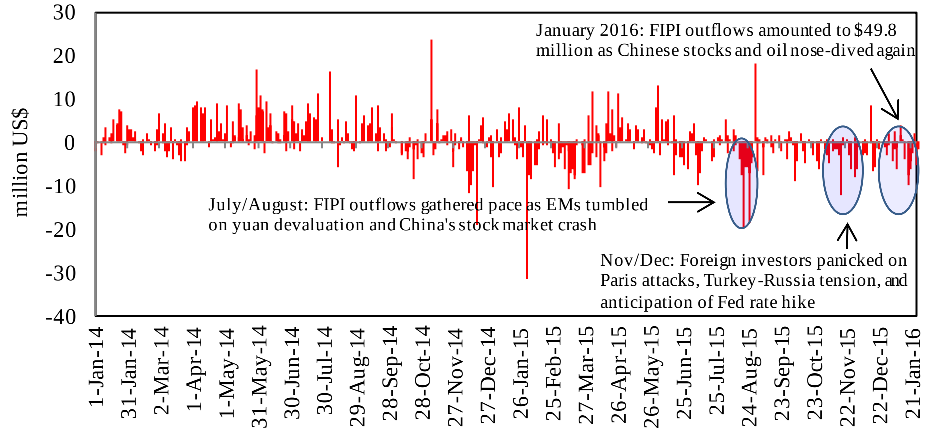
	Q1		Q2		H1	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Total FDI inflows	201.0	248.0	410.0	379.9	611.0	623.7
FDI from China	2.2	186.0	178.2	214.2	180.5	400.2
FDI excl. China	198.8	62.0	231.8	165.7	430.5	223.5

Source: State Bank of Pakistan

While global FDI inflows picked up pace in 2015, much of the increase appeared concentrated in cross-border mergers and acquisitions; investments in greenfield projects stayed virtually flat in nominal terms. In Pakistan, there was a marginal uptick in FDI during H1-FY16: an increase in inflows from China has more than offset the decline in inflows from other countries (**Table 5.4**). Within power, most of the *increase* in investment flows was noted in coal-based generation.[14] China has also increased its investment in Pakistan's telecom sector during the period under review.

[12] For instance, a leading MTO, *Transfast*, has recently launched mobile and online money transfer services to its partner commercial banks in Pakistan. This facility would enable Pakistani expats in the US and Canada to send money to their families online, without needing to visit a *Transfast* outlet in person.
[13] Of the total, US$ 896 million were for project aid and over US$ 3 billion for non-project aid. Furthermore, US$ 3.5 billion of the budgeted inflows were in the form of loans, with only US$ 365 million in grants (source: Economic Affairs Division).
[14] FDI into the power sector went up to US$ 320.2 million during H1-FY16 from US$ 85.3 million in H1-FY15. Of this, coal-based projects received FDI of US$ 230 million during H1-FY16.

Figure 5.4: Foreign Investors Portfolio Investment (FIPI) - Net buying/selling (Jul-Jan FY16)



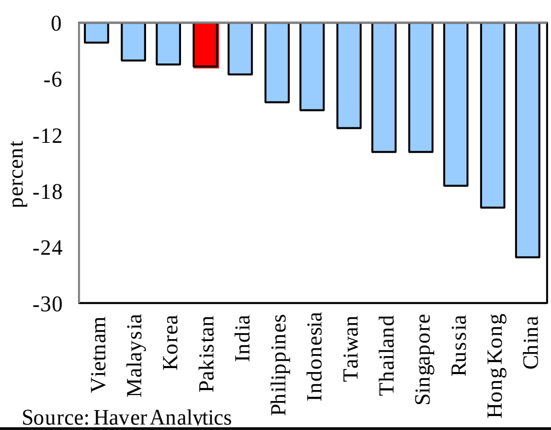
Source: National Clearing Company of Pakistan Limited

For the remaining year, we expect more FDI in power and infrastructure from China. However, investments from other countries will take some time to pick up, as (i) global economic growth is expected to remain subdued; and (ii) low oil prices will keep oil-related FDI on the sidelines.

Global equity market suffered massive sell-off during Jul-Dec 2015. Emerging markets in particular saw capital outflow of US$ 735 billion in 2015, of which US$ 676 billion was taken out from China alone. In addition to a weak outlook on global oil prices, this pressure also represented several other factors: (i) an anticipation of interest rate hike by the Fed through most of the period (which eventually took place in December); (ii) volatility in China's currency and equity markets and fears about its spreading to other EMs; and (iii) adverse geo-political developments, like the Paris attacks and growing rifts between Turkey and Russia (**Figure 5.4**).

Like other emerging markets, Pakistan also saw net foreign selling from the local equity market. However, as shown in **Figure 5.5**, Pakistan was among those countries whose equity markets were least affected from the global sell-off.

Figure 5.5: Performance of Equity Markets in Emerging Economies between July and December 2015



Source: Haver Analytics

However, the local equity market came under renewed pressure in January 2016, as the stock market rout worsened in China and oil prices continued to slide. Foreign investors were net sellers of $49.7 million worth of stocks at the Pakistan Stock Exchange-100 index (earlier KSE-100) during the month.

5.4 Trade account[15]

Pakistan's trade deficit reached US$ 11.9 billion during H1-FY16, showing a marginal decline over the same period last year. The entire improvement was witnessed in Q1-FY16, as the second quarter recorded a 14.2 percent YoY increase in the deficit. This deterioration can be traced to a sharp decline in exports, which outpaced a marginal decline in imports during the quarter (**Table 5.5**).

Table 5.5: Foreign Trade (percent growth YoY)

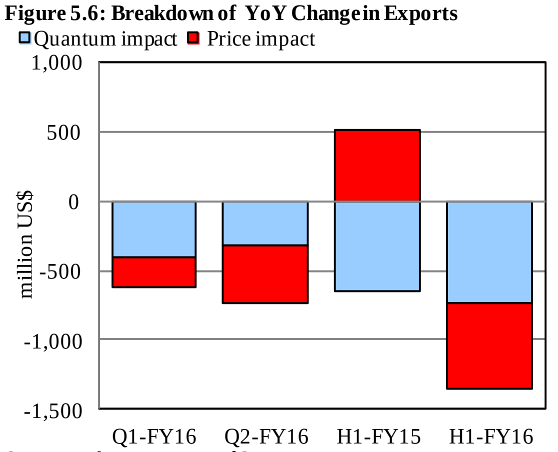
		Exports	Imports	Trade deficit
Q1	FY15	-10.4	11.6	44.4
	FY16	-14.3	-14.9	-15.5
Q2	FY15	2.3	11.2	22.8
	FY16	-14.6	-0.8	14.2
H1	FY15	-4.4	11.4	33.5
	FY16	-14.5	-8.1	-1.7

Source: Pakistan Bureau of Statistics

Exports

Weak global demand and structural constraints in Pakistan's commodity producing sectors, continued to affect the country's exports. The decline in H1-FY16 was broad-based, but most prominent in cotton, cotton yarn, bed-wear, plastic, leather manufactures, pharmaceutical and cement (**Table 5.6**). As shown in **Figure 5.6**, falling quantums led the overall export slump, though unit prices also contributed to some extent.

Figure 5.6: Breakdown of YoY Change in Exports



Source: Pakistan Bureau of Statistics

[15] This section is based on customs data reported by the PBS. The information in this section does not tally with the payments record data, which is reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

Table 5.6: Growth in Quantum Exports (YoY)
percent

	Q1		Q2		H1	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Basmati	-13.7	0.5	4.3	-10.5	-5.3	-5.1
Non-basmati	-12.5	21.7	14.1	16.0	5.0	17.6
Meat	-24.1	25.2	-4.3	-1.4	-14.5	10.9
Raw cotton	-21.6	21.3	0.5	-73.3	-9.9	-34.4
Cotton yarn	-16.6	-23.4	16.7	-38.6	-1.4	-31.6
Cotton fabrics	-24.4	3.7	-28.0	5.9	-26.2	4.8
Knitwear	-1.6	4.3	-2.2	1.9	-1.9	3.1
Bed-wear	-0.8	-7.1	4.7	-1.4	1.7	-4.4
Towels	0.2	24.8	1.2	-4.4	0.7	9.6
Readymade garments	4.8	-1.9	11.2	6.6	7.9	2.4
Synthetic textiles	-22.5	12.2	14.8	-28.5	-6.9	-8.8
Leather tanned	-15.8	-26.1	-13.0	-31.1	-14.5	-28.5
Leather garments	-19.2	-14.9	-33.9	-17.8	-27.2	-16.3
Footwear	-7.9	-27.4	-3.9	10.2	-6.2	-11.0
Plastic material	-22.6	-10.5	-15.5	-58.2	-18.7	-37.6
Pharmaceutical	-7.3	-26.7	17.4	-29.0	4.3	-27.9
Electric fan	-0.2	-35.1	-7.5	-23.5	-3.1	-30.7
Cement	-4.3	-36.9	15.2	-27.0	4.0	-32.3

Source: Pakistan Bureau of Statistics

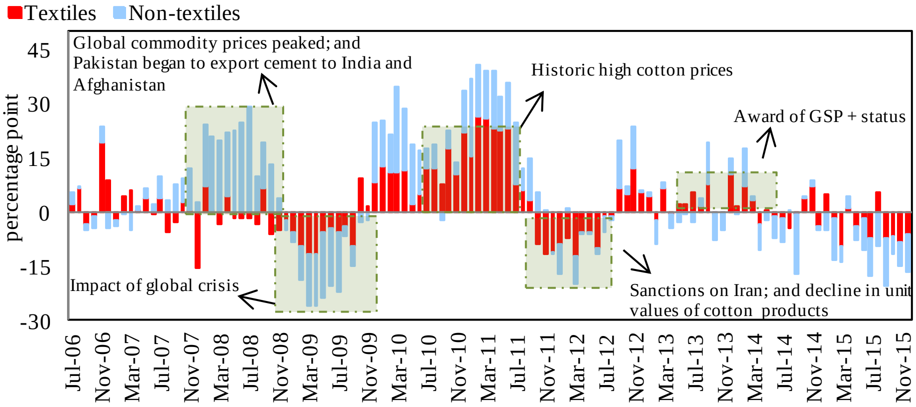
A patchy performance over the last decade

Pakistan's exports performance has remained unimpressive over the previous decade. Except for a couple of episodes of high growth due to one-off factors, export growth has been quite volatile especially after the crisis years of 2008 and 2009 (**Figure 5.7**).

This performance is an outcome of a confluence of both demand and supply-side factors. On the supply side, energy shortages, and low level of skill set have been some major issues behind the downtrend in the country's exports over the past few years. Investment in exporting sectors has remained disturbingly low, as a cut-throat competition with emerging players like Bangladesh and Vietnam, has made margins in the exporting business fairly unattractive; this, together with a rise in production costs, has dented the overall viability of exporting business in the country (especially for our traditional items). Because of consistently low levels of investment, the exporters are not geared up to position themselves against changing consumer preferences in partner countries.

On the demand side, a major factor constraining Pakistan's export growth has been the slowdown in the economies of our major importing partners – China and the EU. While the Chinese economy is going through a historic phase of rebalancing, the EU has lately become quite inward-oriented, especially after the Euro went through a massive depreciation vis-à-vis US Dollar and other currencies. As far as the US is concerned, although its import demand has been modest all through these years, Pakistan has not been able to supply into this market due to change in market preferences. As a result, while Pakistan has been able to maintain its share in the EU and Chinese markets, it has lost its share in the US market to more dynamic exporters like Vietnam.

Figure 5.7: Trends in Exports (Composition of YoY Growth)



Source: Pakistan Bureau of Statistics

Export to Asia plunges the most

The decline in exports to Singapore, China and Afghanistan was particularly steep. In case of Singapore, the decline appears price-led, as petroleum oils and other POL products constitute the bulk of our exports to the city state. In contrast, China has continued to reduce its demand for Pakistani yarn and fabric; its value-added textile products are losing competitiveness in the EU and US markets due to wage build-up. Other low-cost countries are undercutting their prices significantly.[16] Nonetheless, China's demand for consumer items from Pakistan like seafood and leather products, has also declined as the overall Chinese economy weakened. In case of Afghanistan, most of the decline in export was visible in cement. A recovery is not likely in the near future, as Afghanistan is likely to switch some import orders to Tajikistan, with which it has lately signed a trade deal.

[16] Moreover, China itself is now more inclined towards high-tech products instead of low-tech products like textiles and footwear to advance further on the technology front.

Vietnam weakens Pakistan's export credentials

With the recent conclusion of the negotiations for the Trans-Pacific Partnership (TPP) agreement, Vietnam has already begun to expand its export base at the cost of other Asian countries like China, Pakistan and India. Anticipating zero tariffs on most of the textile and related goods, markets along the Pacific Rim are partnering with Vietnamese exporters to maximize the benefits of the agreement. Pakistan is particularly vulnerable to rising penetration of Vietnamese products in the US market, which is still the largest destination of our export products.

In the case of EU, it will be a great challenge ahead for Pakistani exporters to compete, when the FTA between the EU and Vietnam (EVFTA) – that will eliminate nearly all tariffs, would become operational. Currently the major exports of Vietnam to EU are electronic products, footwear, textiles and clothing, rice, seafood, and furniture. Except for electronic products, the product profile of Vietnam and Pakistan in this market is fairly similar. As in case of the US, the cooperation among Vietnamese and EU traders has started picking up: during H1-FY16 also, while the overall imports by the EU declined by 13.9 percent YoY (including imports from Pakistan), its imports from Vietnam has increased by 16.8 percent YoY.[17]

Imports

Imports declined by 8.1 percent YoY during Jul-Dec FY16, compared to a sharp rise of 11.4 percent in the same period last year. This decline was entirely due to price impact, as quantum effect for most of the products like fertilizer, raw cotton, and steel, was positive. In effect, the significant decline in petroleum imports more than offset the positive growth in non-oil imports (**Table 5.7**).

Table 5.7: Growth in Import Values - Major Categories

percent

	Q1		Q2		H1	
	FY15	**FY16**	**FY15**	**FY16**	**FY15**	**FY16**
Oil products	-1.4	-41.1	-15.0	-38.2	-7.8	-39.8
Non-oil	18.8	-2.9	24.6	12.2	21.7	4.7
Non-oil non-food	15.7	-0.8	22.5	14.5	19.0	6.9
Food	37.2	-13.3	37.3	0.5	37.3	-6.5
Machinery	23.0	-3.4	25.9	23.3	24.5	10.4
Transport	-1.0	3.5	32.8	1.5	14.1	2.5
Textile	21.2	-1.1	1.7	51.3	10.8	24.7
Agri & chemical	19.5	-4.3	17.9	0.3	18.7	-1.9
Fertilizer	33.0	27.2	23.7	12.3	27.3	18.4
Metal	22.0	-1.1	34.2	13.3	27.8	6.0
Total imports	11.6	-14.9	11.2	-0.8	11.4	-8.1

Source: Pakistan Bureau of Statistics

POL: Price impact is dominant

Petroleum imports declined by 39.8 percent in H1-FY16 compared to the same period last year, primarily due to lower unit values (**Table 5.8**).

[17] Source: Eurostat

Intriguingly, quantum import of petroleum products declined in H1-FY16 despite record-low prices; inventories probably made up for a modest increase in domestic consumption during the period.[18] More specifically, total petroleum sales in the country grew by only 4.1 percent YoY in H1-FY16, as compared to a rise of 11.5 percent in the same period last year. This increase was met by higher production by local refineries, on the back of crude inventories that were built over the previous few months.

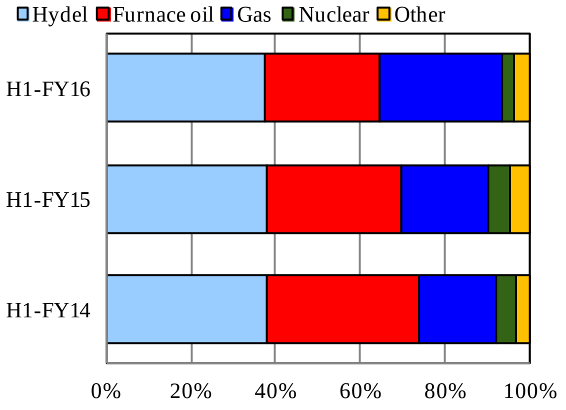
Table 5.8: Pakistan's Energy Imports in Jul-Nov*

	Quantity (000 MT)		Value import (million US$)	
	FY15	**FY16**	**FY15**	**FY16**
Motor spirit	1,061.0	1,612.0	979.0	929.3
Furnace oil	2,832.7	1,032.4	1,740.5	689.4
High speed diesel	1,342.2	1,272.8	1,003.4	579.8
LNG	0.0	363.6	0.0	199.5
LPG	33.1	67.7	26.8	62.3
Coal	2,097.6	1,906.8	218.3	186.3
Coke of coal	29.8	32.8	13.4	9.5
Kerosene	44.2	40.2	42.8	24.2

*Detailed data for Dec-2015 will be available by 25th March 2016
Source: Pakistan Bureau of Statistics

Within the petroleum products, the demand for motor spirit was the strongest. According to the Oil Companies Advisory Committee, sale of petrol has increased by 32 percent in Jul-Dec FY16 over the same period last year. This higher demand can be traced to multiple factors: (i) petrol prices remained 25 percent lower on average in Jul-Dec FY16, compared with the same period last year; (ii) lower availability of CNG triggered fuel substitution in favor of petrol; and (iii) a sharp rise in car sales.[19]

Figure 5.8: Use of Various Fuels for Power Generation



Source: NEPRA

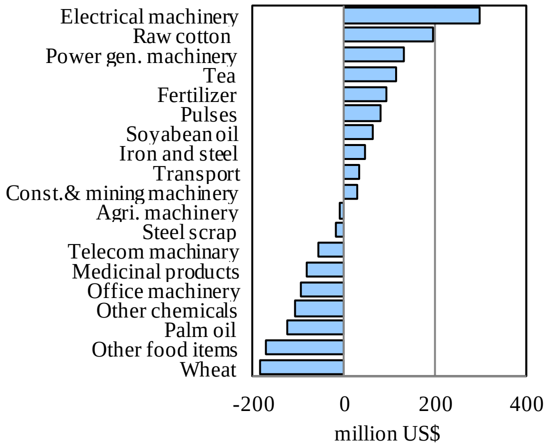
[18] Quantum import of petroleum (both crude and products) stood at 8.2 million MT during H1-FY16, compared to 9.6 million MT in H1-FY15 (a decline of 13.8 percent YoY).
[19] According to PAMA, car sales were 53.0 percent higher during Jul-Dec FY16, compared to the same period last year.

In the case of furnace oil, sales remained lower than last year as more natural gas was available for thermal generation (**Figure 5.8**).[20] Not only has the imported LNG been provided to power companies, more piped gas has also been diverted from households towards power generation.

Non-oil imports

After declining in the first quarter, non-oil imports surged again in the second quarter, posting a YoY growth of 12.2 percent. This mainly reflects vibrancy in domestic economic activity, especially on the back of ongoing investment in power and infrastructure projects. Most of the increase was seen in import of machinery related to power generation and construction. Even the increase in import of electrical machinery, was primarily used for power generation and distribution (**Figure 5.9**).

Figure 5.9: Major Non-oil Imports during Jul-Dec FY16 (YoY absolute change)



Source: Pakistan Bureau of Statistics

Steel imports posted 5.1 percent growth in Jul-Dec FY16, compared to a sharp rise of 54.3 percent in the same period last year. Most of the demand was observed for finished and semi finished products like, hot rolled coils, line pipes, boiler tubes and other items.

Cotton imports contributed additional US $198 million to the country's import bill during Jul-Dec FY16, mainly due to a sharp decline in cotton production this year.[21] Most of the imports were realized in November and December 2015 mainly from India and USA. Despite the inventories of cotton and yarn with the local textile industry and the imposition of 10 percent regulatory duty on import of cotton yarn, imports are likely to remain strong to compensate for lower domestic production.

[20] Sales of furnace oil during Jul-Dec FY16 were 9.0 percent lower than the same period last year.

[21] Total cotton imports stood at US$ 310.9 million in H1-FY16, compared to only US$ 113.0 million in H1-FY15.

Within the food group, import of palm oil declined largely because of lower global prices, as the quantum increased during Jul-Dec FY16 to support domestic production of edible oil.[22] Global prices, after having plummeted to historic lows in 2015, have somewhat recovered on speculation of lower supplies owing to unfavorable weather conditions and increased domestic demand in Indonesia (higher use of bio-diesel).[23] Among all the imported items, tea turned out to be a major exception in a sense that its import has increased primarily due to a rise in prices. Global tea prices remained strong because of production shortfalls in two of the world's largest exporters: Kenya and India.

Fertilizer imports posted a rise of 18.4 percent during Jul-Dec FY16, compared with a sharp increase of 27.3 percent in the same period last year. This increase can be traced to the government's decision to ensure sufficient quantity of urea for Rabi 2015-16, amid fears of gas curtailment in winters (November to January) which could potentially curtail domestic production during the season. However, gas supplies to fertilizer plants continued smoothly as the government decided to shift the fuel from households to more productive sectors like fertilizer, cement and power generation.[24] As a result, domestic urea production increased significantly.[25] Side by side, import of DAP also firmed up and constituted nearly 65 percent of the total fertilizer imports.

[22] Production of edible oil posted an increase of 8.9 percent YoY in H1-FY16.
[23] The Indonesian government has announced the B20 program in 2016, which primarily refers to increasing the use of biodiesel (80 percent diesel; 20 percent biofuels). Since Indonesia is using more of its palm oil domestically for blending into diesel, it has reduced the overall supplies of the commodity in the international market. The increase in use of biodiesel would eventually help Indonesia in meeting its earlier commitments on cutting carbon emission.
[24] According to gas distribution firms, about 440 mmcfd of gas was provided to three main sectors, fertilizer, cement and power generation in winter season (November to January). This includes 210 mmcfd from the SNGPL and 231 mmcfd from SSGCL.
[25] Fertilizer production increased by 15.0 percent during Jul-Dec FY16 as compared to a decline of 1.6 percent in the same period last year.

Topical Section: Steel Sector: The Need for a Long Term Strategy

For overall economic development of a country, a developed steel industry is very crucial. In the early stages of economic development, steel consumption is expected to increase at a faster rate because huge quantities of steel are required to build basic infrastructure, including bridges, dams, railways, and power generation, distribution and transmission projects, etc. Steel is also a principal raw material in the production of all kinds of machinery, equipment and vehicles.

Pakistan is a developing economy with abundant potential to attain faster industrial growth. However, sustainable industrial and economic growth depends on an assured supply of steel. Inadequate availability of steel acts as a natural drag on development efforts in almost all sectors of the economy. Therefore, planning for steel production should be a critical part of overall development planning in the country.

Presently Pakistan produces around six million metric tons of steel per year. This includes: raw products (iron ore and scrap); flat products (sheets and plates, used in the automotive sector); and long products (steel bars, wire rods, rails and structures used in infrastructure development and tubes and pipes). However, per capita steel consumption in Pakistan is very low at 23.5 kilograms, against 58.6 kilograms in India, as well as the Asian average of 261.3 kilograms and the global average of 216.9 kilograms (**Table S1.1**).

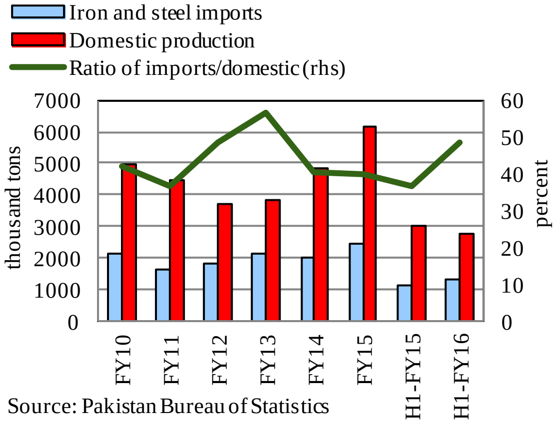
Table S1.1: Per Capita Consumption of Finished Steel Products (kg)

	2010	2011	2012	2013	2014
Bangladesh	12.3	13.1	14.9	15.5	16.9
Pakistan	16.5	16.3	18.1	19.3	23.5
India	52.8	55.9	57.3	57.6	58.6
Vietnam	119.7	108.6	121.3	128.8	156.2
Indonesia	37	44.7	50.4	50.5	50.7
China	438.2	475.6	487.0	539.5	519.0
South Korea	1,067.2	1,142.5	1,089.9	1,038.4	1,108.8
Asia	226.7	242.9	247.5	266.3	261.3
World average	193.2	206	207.4	217.8	216.9

Source: Steel Statistical Yearbook 2015

The government's increased focus on infrastructure has resulted in the initiation of a series of development projects during the last two years. These include foreign-funded projects, particularly those under the China-Pakistan Economic Corridor (CPEC) framework. Besides, this policy focus has also encouraged private firms to invest in various projects. Given the critical role of steel in the development of roads, railway, dams and power infrastructure, as well as the current pace of development projects being pursued in the country, the demand for steel and allied products is expected to increase significantly. In order to meet this higher demand without resorting to imports over the medium- to long-term, the country will need sizable investment in this industry in the coming years.

Figure S1.1: Steel Imports and Domestic Production



Source: Pakistan Bureau of Statistics

Pakistan's steel industry comprises a complete and a closely intertwined value chain – from pig iron furnaces to downstream sectors and end-user industries. However, steel production has not been very stable in the country (**Figure S1.1**).[1] Part of the reason for this lack of dynamism is that the steel industry is extremely fragmented: there are at least 600 players in the industry, with no clear leaders that are able to provide vision and direction.

Moreover, Pakistan's steel industry is characterized by small plants, most of which are utilizing obsolete technology. In particular, most melting, re-rolling and fabricating firms have small-size plants compared to their competitors in steel-exporting countries. Similarly, the use of outdated (and energy inefficient) technology raises these firms' cost of production and results in output with low quality and varying standards.[2]

As a result, these products cannot compete with cheaper imports, particularly from India and China,[3] where manufacturers enjoy benefits from economies of scale

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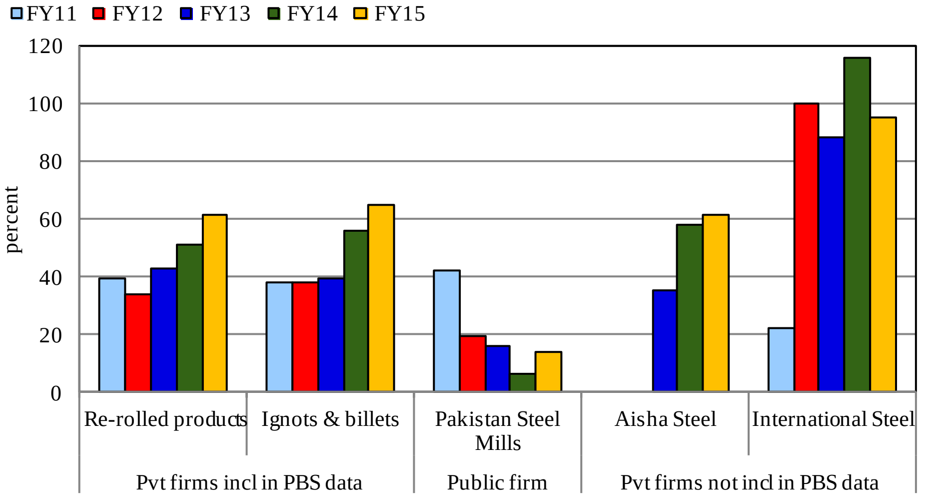
[1] Although the industry is far from exploiting its full market potential, some individual players have seen significant growth in the past few years. These include Agha Steel, which produced 150 thousand tons in 2015 (and aims to double this capacity to 300 thousand tons in 2019); Amreli Steels which manufactured 180 thousand tons in 2015 (and aims to reach half a million tons in 2017); and International Steel Limited, which produced 463 thousand tons in 2015 (and aims to increase this capacity to a million tons in 2016).

[2] Steel production is highly energy intensive (energy constitutes 20 to 40 percent of total cost). Sophisticated energy management systems have led to reductions of about 60 percent in the energy required to produce a ton of crude steel since 1960 in most top steel producing countries (World Steel Association). However, in Pakistan, most of the domestic production units are about half as efficient in their energy consumption as international benchmarks.

[3] A big challenge for Pakistan's steel industry is Chinese imports. Pakistan has a free trade agreement with China, which ensures that finished goods are imported at concessional rates of duty. In 2015, China produced 823 million tons (about 50 percent of world steel production) and exported a record 100 million tons; Pakistan, being one of its largest importers, witnessed a sharp increase (of 22 percent) in steel imports from China during H1-FY16.

and more efficient production processes.[4] The domestic industry therefore operates at only 60 percent of its installed capacity, despite strong local demand for steel products (**Figure S1.2**); this further raises the firms' cost of production.[5] Thus, not surprisingly, almost all segments of the value chain continue to remain heavily dependent on imports. Indeed, the healthy growth of 24.8 percent in steel production during FY15 was associated with a 34 percent increase in quantum imports of iron and steel scrap (at a cost of US$ 2.6 billion).[6]

Figure S1.2: Capacity Utilization of Different Segments of Steel Sector



Sources: Pakistan Bureau of Statistics, PSM, PSMA, Companies' Financial Reports

Power shortage is also a big concern for local manufacturers; besides, the cost of electricity is also very high. These, coupled with the challenge of competing with low-cost imports, has compelled steel manufacturers to divert investment to self electricity generation and dedicated feeders. From a long-term policy perspective, the local industry will need to acquire economies of scale and modern, efficient technology to become competitive. This is not to say that no large manufacturers currently exist in Pakistan: Pakistan Steel Mill (PSM), International Steel, Aisha Steel and Amreli Steel etc. are some large-scale domestic producers. But they require adequate policy support in order to smoothly run their operations.

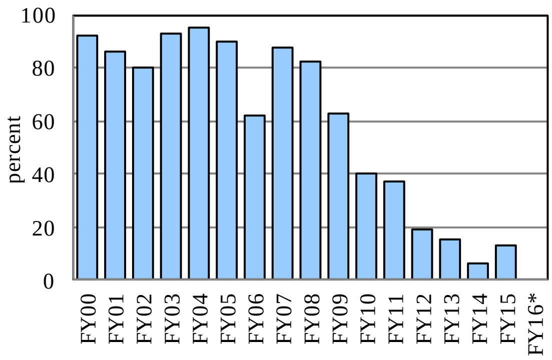
[4] Local plants are unable to meet the domestic demand for high quality products (particularly those that are used in the assembling of automobiles and appliances).
[5] The global average capacity utilization has remained around 80 percent during the last few years.
[6] Falling international prices of iron, steel and allied products over the last few years made it feasible for the domestic sector to import huge quantities; the industry would not be able to sustain this level of imports if prices revert.

PSM, despite having outdated technology, still holds the largest production capacity in the country.[7] However, despite several bailout packages, the persistent administrative and financial constraints are keeping it far from becoming self-reliant, (**Figure S1.3**).[8,9]

PSM's sluggish performance has repercussions for the entire value chain: most of the small firms in steel smelting and re-rolling rely on low quality scraps (mainly form ship breaking). The resulting quality impacts output in the later stages of the value-added chain. Privatization would help restore PSM's operations on a sustainable basis, and this would also have positive spillover on the rest of the supply chain.

In the private sector, two large-scale steel plants (International Steel and Aisha Steel)[10] utilizing efficient and internationally proven technology came online during the last five years.[11] Tuwairqi, the largest steel complex in Pakistan, could not start commercial operations, primarily due to gas pricing issues. As far as Aisha and International Steel are concerned, they have the potential to contribute to the

Figure S1.3: Capacity Utilization of Pakistan Steel Mills



*H1-FY16
Source: Pakistan Steel Mills

[7] PSM can feed downstream industry – steel melters, re-rollers and engineering industries – with a wide variety of products, like pig iron, billets, slab sheets and coils.
[8] The government had provided several bailout packages to retire PSM's outstanding liabilities, but these could not revive the mill's operations on a sustainable basis. For example, on 25th April 2014, the Economic Coordination Committee had approved a restructuring plan of Rs 18.5 billion. Despite this support, PSM's capacity utilization remained below 20 percent during FY15, against the target of 77 percent. Since July 2015, PSM's production has come to a standstill due to unavailability of gas.
[9] Since 2006, PSM's debt and accumulated losses (net) have soared to Rs 170 billion. Due to nonpayment of dues (Rs 18.1 billion), gas supply to the firm has also been stopped, resulting in a complete closure of the mill. This is adding around Rs 1.6 billion in losses a month (Source: PSM).
[10] Aisha Steel Mill started commercial operations in 2009 and produces hot rolled (HR) and cold rolled (CR) products. International Steel came online in 2011 and manufactures HR, CR, galvanized and color-coded steel products.
[11] Both plants are based on Japanese technology.

industry with their large scale and modern technology, if adequate policy support is provided.

In view of the significance of steel for other sectors of the economy, Pakistan needs a clear and consistent policy. Such a policy should identify segments in the steel chain that need protection at the initial stage; define and enforce quality and performance standards; and ensure fair competition in the market. This policy should also consider the level of protection available to steel manufacturers in Pakistan's competitors, especially China and India. Here it is important to recall that due to ongoing public developmental spending, and the initiation of infrastructure projects under CPEC, steel consumption is likely to remain strong in coming years. If investment and domestic production in the country fails to keep pace, the additional demand for steel will have to be met by imports, putting additional burden on the country's balance of payments.

Annexure A: Data Explanatory Notes

1) GDP: SBP uses the GDP target for the ongoing year, as given in the Annual Plan by the Planning Commission, for calculating 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:

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

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

Monthly inflation (π_{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 does 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 are 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):** Public debt reported by SBP is composed of: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities. The external liabilities include: central bank deposits, Swaps, allocation of SDR and non-resident local currency deposits with central bank.

   MoF defines public debt as "the portion of total debt which has a direct charge on government revenues, as well as debt obtained from the IMF." Thus, MoF does not include external liabilities in its definition of public debt, while SBP does. Furthermore, SBP includes non-resident holdings of local securities (T-bills & PIBs) in external debt, while MoF takes the same as a part of domestic debt.

   (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 depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP 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 arises due to differences in data coverage; e.g., SBP import data does not include non-repatriable investments (NRI) by non-resident Pakistanis;[1] 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.

[1] 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.*

Acronyms

ADB	Asian Development Bank
APCMA	All Pakistan Cement Manufacturers Association
ARPU	Average Revenue per User
bbl	Billion Barrels
BEOE	Bureau of Emigration and Overseas Employment
BISP	Benazir Income Support Programme
bps	Basis Points
BSC	Bahbood Savings Certificate
CA	Current Account
CBU	Complete Built Up
CCAC	Cotton Crop Assessment Committee
CDNS	Central Directorate of National Savings
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CR	Cold Rolled
CSF	Coalition Support Fund
CY	Calendar Year
DAP	Diammonium Phosphate
DSC	Defence Savings Certificate
EDL	External Debt and Liabilities
EDS	External Debt Servicing
EFF	Extended Fund Facility
EM	Emerging Markets
EU	European Union
EVFTA	European Union Vietnam Free Trade Agreement
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FEE	Foreign Exchange Earnings
FIFA	Fédération Internationale de Football Association

FIPI	Foreign Investors Portfolio Investment
FO	Furnace Oil
fob	Free on Board
FTAs	Free Trade Agreements
FX/FE	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GIS	Government Ijara Sukuk
GSP	Generalized System of Preferences
H1	First Half
HOBC	High Octane Blending Content
HR	Hot Rolled
HSD	High Speed Diesel
IBA	Institute of Business Administration
IBRD	International Bank for Reconstruction and Development
IDA	International Development Assistance
IDB	Islamic Development Bank
IDBP	Industrial Development Bank of Pakistan
IEA	International Energy Agency
IFI	International Financial Institution
IMF	International Monetary Fund
ITC	International Trade Center
KPK	Khyber Pukhtunkhwa
KPT	Karachi Port Trust
KSE	Karachi Stock Exchange
LDO	Light Diesel Oil
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
M2	Broad Money Supply
MAF	Million Acre Feet
mmcf	Million Cubic Feet

MNCs	Multinational Corporation
MoF	Ministry of Finance
MRTBs	Market related Treasury Bills
MS	Motor Spirit
MT	Metric Tons
MTO	Money Transfer Operators
MW	Mega Watt
NCCPL	National Clearing Company of Pakistan Limited
NDA	Net Domestic Assets
NDFC	National Development Finance Corporation
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NFDC	National Fertilizer Development Centre
NFNE	Non-Food Non-Energy
NSS	National Savings Scheme
OCAC	Oil Companies Advisory Committee
OGRA	Oil & Gas Regulatory Authority
OICCI	Overseas Investors Chamber of Commerce & Industry
OMCs	Oil Marketing Companies
OMOs	Open Market Operations
PAMA	Pakistan Automotive Manufacturers Association
PBA	Pensioner's Benefit Account
PBS	Pakistan Bureau of Statistics
PCGA	Pakistan Cotton Ginner's Association
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PICIC	Pakistan Industrial Credit and Investment Corporation
PKR	Pakistani Rupee
POL	Petroleum, Oil and Lubricants
PRI	Pakistan Remittance Initiative
PSC	Private Sector Credit
PSDP	Public Sector Development Programme
PSEs	Public Sector Enterprises
PSM	Pakistan Steel Mills

PTCL	Pakistan Telecommunication Company Limited
Q2	Second Quarter
rhs	Right Hand Side
RIC	Regular Income Certificate
Rs	Rupees
RSC-CPI	Relatively Stable Component of Consumer Price Index
SAMA	Saudi Arabian Monetary Agency
SBP	State Bank of Pakistan
SDRs	Special Drawing Rights
SNGPL	Sui Northern Gas Pipelines Limited
SRO	Statutory Regulatory Order
SSA	Special Saving Account
SSC	Special Saving Certificate
SSGCL	Sui Southern Gas Company Limited
T-bills	Treasury Bills
TBs	Treasury Bills
TDPs	Temporarily Dislocated Persons
TPP	Transpacific
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
USD	US Dollar
VTCS	Voluntary Tax Compliance Scheme
WALR	Weighted Average Lending Rates
WPI	Wholesale Price Index
WTI	West Texas Intermediate
YoY	Year on Year