1 Overview

Pakistan's economy maintained its growth momentum during FY16, despite suffering from heavy losses in the crop sector within agriculture. The growth in the industrial sector, in particular, accelerated on the back of better energy supply and improvement in security situation. This growth, in turn, had significant spillover to the services sector.

Table 1.1: Selected Economic Indicators

	Jul-Mar FY15	FY16 Targets	Jul-Mar FY16
Growth rate (percent)			
LSM[a]	2.8	6.0	4.7
CPI (period average)[a]	5.1	6.0	2.6
Private sector credit [b]	5.7	na	8.1
Money supply (M2)[b]	5.7	na	6.0
Exports (customs)[a]	-6.0	5.5	-12.9
Imports (customs)[a]	2.8	6.0	-4.4
Tax revenue -FBR (billion Rs)[c]	1,775.1	3,104.0	2,103.0
Exchange rate (+app/-dep%)[b]	-3.1	na	-2.8
billion US dollars			
SBP's reserves (end-period) [b]	11.6	na	16.1
Worker remittances [b]	13.6	19.0	14.4
FDI in Pakistan [b]	0.8	3.3	1.0
Current account balance [b]	-2.0	-2.9	-1.7
percent of GDP[1]			
Fiscal balance[d]	-3.8	-4.3	-3.4

[1] Based on the full-year provisional GDP estimates stated in the Annual Plan for 2015-16; na: not applicable.
Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

Other key macro-economic indicators also improved during FY16: YoY average CPI inflation almost halved during Jul-Mar FY16, compared to level in the corresponding period of last year; fiscal deficit was contained at lower level than the last year; exchange rate remained stable in general; and FX reserves continued to increase (**Table 1**). Some of these developments were due to subdued commodity prices (particularly oil) in the global market.

Policy support also played a key role in improving macro fundamentals: expansionary monetary policy for the last one and a half year, and development focus of fiscal spending (particularly on infrastructure projects which also encouraged construction and related activities). Besides introducing sector specific policy initiatives, the government also ensured better energy management; for instance, LNG imports allowed adequate gas availability for fertilizer and other industries.[1] Finally, the initiatives under China-Pakistan Economic Corridor (CPEC) not only attracted foreign direct investment (FDI), but also helped in reviving the confidence of local businesses.

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[1] One of the examples of sector specific policy initiative is Apna Rozgar scheme by the Punjab government, which generated significant demand for passenger cars and commercial vehicles.

Having said this, some challenges still exist for the economy. Investment rate continues to remain low, whereas the non-CPEC FDI has not picked up the pace. The tax base stays narrow, despite stop-gap measures by the government to increase tax revenues. Furthermore, low commodity prices (and continued slowdown in the global economy) have also had an adverse impact on some sectors of the economy. For example, exports have continued to show weakness, and remittance growth is also slowing down (**Chapter 5**). Nonetheless, current FX reserves have reached their historic high, which would help the country in achieving high and sustained growth going forward. But this needs to be supplemented by deep rooted structural reforms so that the recent improvement in macro fundamentals can be sustained.

1.1 Economic review

Despite global economic slowdown, GDP growth in Pakistan maintained its modest pace, reaching an eight-year high of 4.7 percent in FY16, from 4.0 percent in the previous year.[2,3] A strong performance from the industry and services sector led this growth in GDP. Agriculture, on the other hand, suffered particularly from significant losses to the cotton crop, which recorded a massive 27.8 percent decline over the last year.

As a result, FY16 was the first time in 15 years when value addition in the agriculture sector recorded a decline.[4] Excessive rains and pest infestations (especially pink bollworm and whitefly) largely explained cotton damages (**Chapter 2**). Furthermore, continued low prices of raw cotton in the domestic market and rising cost of input, particularly pesticides and fertilizer, discouraged growers from investing in the crop.[5] The cotton harvest, therefore, could reach only 10.1 million bales, against last year's crop of 14.0 million and the target of 15.5 million bales.

In this backdrop, acceleration in the industrial growth from 4.8 percent last year to 6.8 percent in FY16 is a positive sign.[6] More encouragingly, this growth was

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[2] In fact, the continued sluggish growth in advanced economies, persistent low commodity prices, weak global trade, and diminishing capital flows prompted the World Bank to revise its 2016 global growth forecast down to 2.4 percent from the 2.9 percent projected in January.

[3] Pakistan Bureau of Statistics has downward revised FY15 GDP growth to 4.0 percent, from the provisional estimate of 4.2 percent.

[4] Agriculture recorded a decline of 0.2 percent in FY16, compared to an increase of 2.5 percent last year.

[5] In some cases, pressure on farmers' income increased further when untimely rains washed out the impact of fertilizer and pesticides applied earlier.

[6] The availability of imported raw cotton largely offset the direct impact of crop losses on local yarn manufacturing industry.

achieved despite sluggish external demand as evident from a persistent decline in exports since May 2015. In fact, it was the robust domestic demand that helped the industry to post strong growth in FY16.[7] From the supply side, continued low prices of key raw materials (POL, coal, palm oil), low financing cost, better law and order, and improved energy supplies supported growth in the industrial sector.[8]

The services sector also performed well, as growth improved sharply from 4.3 percent last year to 5.7 percent in FY16. The expansion was broad-based as, except for *transport, storage and communication*, all subsectors recorded higher growth than last year. While the growth in the industrial sector pulled up *wholesale and retail trade*, increase in salaries and pension of government employees bolstered the value addition by *general government services*. Finally, *finance and insurance* also grew on account of strong profitability of the banking sector, despite low interest rates.

Another positive for the economy was the considerable ease in overall inflationary pressures during FY16: Jul-Mar average CPI inflation almost halved to 2.6 percent, from 5.1 percent in the corresponding period of the previous year. In the meanwhile, inflationary expectations also subdued.

This ease in inflation primarily came on the back of continued low commodity prices in the global markets (and its swift pass through to domestic consumers, particularly for POL products), comfortable supplies of key food items, and stable exchange rate. The impact of these factors was so overwhelming that YoY CPI inflation touched the extraordinary low of 1.3 percent in September 2015.

As expected, inflation soon inched up in subsequent months from the ultra-low level, when the government imposed regulatory duties on a wide range of items (to curb pressure on imports) and increased gas tariffs.[9] At the same time, prices of some non-perishable food items (cigarette, fresh milk, tea, sugar, pulses and meat) also recorded a notable rise. In addition, a recovery in aggregate demand contributed to the underlying inflation, as evident from the rise in core inflation.

[7] The surge in construction activities (both in private and public sector) promoting allied industries (cement, private steel, paints, chemicals), and strong sales of automobiles (spurred by Apna Rozgar Scheme by Punjab government and cheaper auto financing) are some of the indicators of robust domestic demand.
[8] The government imported 465.2 thousand tons of LNG during Jul-Mar FY16.
[9] The YoY CPI inflation increased from lows of 1.3 percent in September 2015 to a high of 4.2 percent in April 2016. In May 2016 however, inflation stood at 3.2 percent.

Not surprisingly, the May 2016 wave of IBA-SBP Consumer Confidence Survey also points toward renewed expectations of inflation by households.

SBP therefore remained vigilant to this uptick in inflation (and inflation expectations), and kept the policy rate unchanged in three reviews of the monetary policy subsequent to a 50 bps cut in September 2015 (**Chapter 3**).[10] However, in its decision in May 2016 meeting, the Monetary Policy Committee (MPC) cut the policy rate by 25 bps.[11] The Committee gained comfort from the fact that despite gradual uptick in inflation and inflation expectations, the inflation outlook for the next year still remained benign. On the external sector, the balance of risk was neutral in the short-term: (a) the current account posted back-to-back surpluses in February, March and April 2016, thereby leading to buildup in FX reserves to historic high level; (b) from SBP perspective, risks to the external account (e.g., decline in exports, slowdown in remittance inflows, increase in non-oil imports, and low volume of non-CPEC FDI inflows) become a cause for concern only over the medium-term.

While the central bank was aiming to keep the overnight repo rate close to the target rate, the Rupee liquidity in the inter-bank market faced pressure from a pickup in credit to private sector, and continued government borrowing from scheduled banks (and retirement to central bank). The stress on liquidity compounded further due to subdued growth in bank deposits. In this situation, SBP stepped up its OMO injections to keep the overnight repo rate close to the policy rate.[12] Thus, a better liquidity management led to a more effective transmission of monetary policy to retail rates. Specifically, banks' lending rates fell by 65 bps after September 2015 – more than the cut of 50 bps in the policy rate.

Low cost of financing (along with improved business activities) also encouraged borrowing by private businesses: advances to private sector saw an expansion of Rs 249.0 billion in Jul-Mar FY16, compared to Rs 187.6 billion in the corresponding period of previous year. Not only were these loans fairly broad-based in terms of sectoral distribution, almost half of these reflected fixed investment in nature.

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[10] The policy rate was kept unchanged in the monetary policy reviews of November 2015, January 2016, and March 2016.
[11] This was the first time that the policy rate was changed with a magnitude of 25 bps.
[12] Outstanding OMO injections increased from an average of Rs 0.9 trillion before Sep 2015 to Rs 1.3 trillion after Sept 2015.

On the other hand, private sector deposits increased by Rs 149.4 billion during Jul-Mar FY16 – less than half of the rise recorded during the corresponding period of FY15. In fact, it was the first time since FY10 that the M2 expansion came more from currency in circulation than the total deposits. This trend, which can be explained by a gradual decline in deposits rates and imposition of withholding tax on financial transactions, does not bode well for financial deepening.

As mentioned earlier, besides low deposit growth, a higher government borrowing from commercial banks (and retirement to SBP) also required an increase in outstanding OMO injections by the central bank. To put this in perspective, during Jul-Mar FY16, the budgetary borrowing from commercial banks reached Rs 1.1 trillion, whereas the government retired Rs 525.5 billion to SBP.[13] [14] In the meanwhile, the outstanding stock of OMO injections recorded an increase of Rs 375.3 billion during the same period.[15] At the same time, the net retirement to SBP allowed the government to meet the quarterly limit of zero budgetary borrowing set under the SBP Act 1956.

In net terms, the government borrowed Rs 538 billion from the banking system during Jul-Mar FY16, compared to Rs 469.4 billion in Jul-Mar FY15. These higher borrowings, however, do not reflect the broad improvement seen in fiscal indicators: the budget deficit improved to 3.4 percent of GDP in Jul-Mar FY16, from 3.8 percent in Jul-Mar FY15.[16] More importantly, the country recorded a primary surplus during this period. Higher revenues, contained expenses and larger surplus from provinces led to this improvement in the fiscal account.

In terms of revenues, additional measures introduced from time to time during the year helped in achieving 18.5 percent increase in FBR tax collection during Jul-Mar FY16 – up from 12.7 percent growth in Jul-Mar FY15.[17] However, a YoY decline of 22.4 percent in non-tax revenue collection during Jul-Mar FY16 eroded much of gains from higher tax growth. Non-tax receipts fell on account of a

[13] Although the government retired Rs 100.3 billion of the commodity loans to commercial banks during Jul-Mar FY16 (almost twice the amount retired in corresponding period of last year), the outstanding loans still stood at Rs 464.2 billion by end-Mar 2016. Of this, Rs 367.3 billion pertained to wheat related operations.

[14] Government borrowed Rs 1,063.5 billion from scheduled banks during Jul-Mar FY16, which was Rs 80.2 billion lower than the borrowing in the same period of FY15.

[15] In fact, the outstanding level of SBP injections increased by Rs 1.0 trillion from end-Oct 2013 to end-Mar 2016, whereas the government retired Rs 1.4 trillion to SBP during this period.

[16] In absolute terms, the budget deficit was Rs 39.5 billion lower than the last year.

[17] Although the high growth in tax collection was encouraging, this required frequent changes in tax policy, particularly after the announcement of the annual budget – a practice that may lead to uncertain business environment.

decline in SBP profit (reflecting low interest rates), lower CSF inflows, and reduced revenue from crude oil (owing to ease in its price).

While the increase in tax revenues is a welcome development, the country still needs considerable effort to improve the efficiency and equity of the tax system. In particular, the taxation regime relies too much on indirect and transaction related withholding taxes – both are regressive in nature. In fact, the withholding tax contributes 67 percent of the direct tax collection. Efforts to increase direct tax collection are either inadequate or not bearing fruit.[18,19]

In addition to higher revenues, expenditure restraints also contributed towards the fiscal consolidation. Specifically, the government managed to bring down the growth in total expenditure to 6.4 percent during Jul-Mar FY16 (almost half from 13.5 percent in Jul-Mar FY15). This was achieved despite a continued strong growth in development spending, and a sharp increase in interest payments. A marginal decline in defence spending and a lower growth in provincial current expenditures helped the government contain its spending.

Indeed, a healthy growth of 27 percent in provincial surplus during Jul-Mar FY16 (over 6.6 percent in corresponding period of last year) vastly improved the consolidated fiscal position. While the provinces are exploring new avenues to generate taxes, effective utilization of existing resources has become quite challenging for them.

Despite improvement in fiscal account, the country's public debt stock increased by Rs 1.8 trillion during Jul-Mar FY16, reaching Rs 19.6 trillion as of end-March 2016 –two-thirds of the rise came from domestic borrowing.[20] A favorable development during the third quarter was the marked shift in the maturity profile of domestic debt. This shift happened because the government accepted large volume of PIBs.[21] In addition, the government also mobilized resources through two auctions of Ijara Sukuk conducted during Q3-FY16.

[18] The efforts to improve direct taxation are reflected in amount of income tax collected on demand. According to available data, collection on demand contributed only 5 percent of the direct taxes – indicating a considerable room for improvement.
[19] The government also launched Voluntary Tax Compliance Scheme (VTCS) to bring traders into the tax net. This initiative could not fetch the desired results.
[20] The wide disparity between the size of budget deficit and increase in public debt (except IMF debt with SBP) is because of the revaluation loss of US$ 1 billion (which does not have any implications for financing of the deficit); and increase in government deposits by Rs 427.6 billion in Jul-Mar FY16.
[21] On the other hand, the accepted amount in T-bill auctions remained well below the maturity and the target set for the quarter.

Within the external debt, the overall volume recorded a rise of US$ 4.1 billion – highest increase since FY08. This was despite some significant repayments during the year. Almost a quarter of the increase owes to revaluation losses which were mainly concentrated in Q3-FY16.[22,23] The actual disbursement came from IFIs, IMF and commercial lenders.

These foreign currency loans, together with largely contained oil payments and a modest rise in worker remittances, led to a surplus in the external account during Jul-Mar FY16. Focusing on remittances, though the YoY increase during Jul-Mar FY16 was 5.8 percent, against 17.3 percent seen last year, this growth appears quite decent compared to other regional countries.[24] Thus, SBP's reserves increased by US$ 2.6 billion during Jul-Mar FY16 to reach US$ 16.1 billion – this amount was sufficient to finance four months of the country's import bill, and more than twice the short-term payments.

The broad improvement in the external sector, however, conceals some major concerns: (i) exports faced a continuous decline during Jul-Mar FY16 due to sluggish demand in export destinations, low unit price and high cost of production;[25] (ii) a sharp increase in non-oil imports completely offset the gains from a decline in oil import payments; (iii) a slowdown in remittance inflows gradually reduced the FX comfort the country has been enjoying over the past several years; and (iv) non-CPEC FDI inflows remained inadequate.

1.2 Economic outlook

The broad improvement in macroeconomic indicators (low inflation, comfortable FX reserves, stable exchange rate, and contained fiscal deficit) sets the foundation for a higher and sustained economic growth. A better availability of energy supplies and an improved security situation have eased two of the major constraints which were holding back the country's economic growth. In this backdrop, the government envisages a higher growth of 5.7 percent in FY17,

[22] The overall external indebtedness is determined by converting obligations in different denominations into a single currency, usually US Dollar. Thus, any movement in the US Dollar vis-à-vis other currencies affects the country's outstanding stock of external debt. For example, the depreciation of US$ against Japanese Yen, SDR and Euro during Jul-Mar FY16 resulted in US$ 602.5, 225.0 and 151.0 million increase in the EDL respectively. By contrast, the country benefited from a large revaluation gain of US$ 4.2 billion during FY15.

[23] The depreciation of US$ against major currencies also improves the country's FX reserve position, to the extent that these reserves are denominated in non-Dollar currencies.

[24] Overall remittances to India dropped 2.1 percent YoY in CY2015, while those to Sri Lanka went down 0.05 percent; flows to Bangladesh grew by only 2.5 percent during the year (source: World Bank).

[25] The situation worsened further due to a decline in agriculture output, mainly cotton production.

compared to 4.7 percent recorded this year. This buildup in growth momentum depends on a recovery in the agriculture sector, and a further acceleration in industrial growth. The challenge, however, has become more complex, as the world faces heightened risks of a prolonged low growth,[26] and continued soft commodity prices – both have strong bearing on Pakistan's economy.

In the case of agriculture, a revival in growth in FY17 would depend on the performance of the crop sector, particularly cotton. However, presence of sizeable stocks in the global market is still pulling cotton prices down in both the global and domestic markets. As a result, the economic returns to cotton growers appear quite unattractive, especially with the looming risks of infestations.[27] In this situation, achieving cotton production target of 14.1 million bales next year will be challenging.

Industrial growth would gain from better energy supply, robust demand of consumer durables, and investment under CPEC. While cement manufacturers would be the immediate beneficiaries of infrastructure development, the steel industry would continue to face competition from cheap Chinese products. At the same time, low external demand (due to uncertainties in EU recovery and continued slowdown in Chinese economy) would hinder growth in export-oriented industries.

Undoubtedly, the continuous decline in exports is a big concern at the moment which needs immediate attention. An early revival in exports is difficult due to weak demand and subdued commodity prices in the global markets. However, changing market dynamic, particularly the exit of China from textile exports due to rising labor costs, offers Pakistan an opportunity to increase its market share and integrate with global supply chains.[28] This becomes more important as a deepening of commodity recession would also weaken our remittance growth. On the other hand, though import growth is likely to gain further momentum due to CPEC-related demand, its impact on country's external account would largely remain contained due to the expected funding from China. In addition, Pakistan

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[26] The risks of global slowdown have increased due to struggling Chinese economy and persistent weakness in Japan, US and Europe. In fact, in April 2016, IMF reduced its forecast for global economic growth for the third time in 10 months.

[27] International Cotton Advisory Committee has reported that whitefly infestation (which led to recent production losses in Indian provinces of Punjab and Haryana) is likely to persist in FY17 as well. This raises concerns for us, given the similar climatic conditions and the proximity of the areas, and the recent damages from whitefly in Pakistan.

[28] Currently, Pakistani exporters are neither able to compete with their counterparts in Bangladesh and Vietnam, nor are they part of these countries' value chains.

will possibly receive higher foreign portfolio investment after MSCI's decision to reclassify it as an emerging market on June 14, 2016.[29]

In terms of fiscal performance, Pakistan has achieved considerable consolidation over the last few years. However, it is important to maintain this discipline going forward, particularly following the completion of IMF program in September 2016. In the Federal Budget FY17, the government has further lowered its target for budget deficit to 3.8 percent of GDP. In this context, widening the tax base and bringing more people in the tax net should be the focal point for the fiscal reform agenda.

Encouragingly, the country's inflation outlook remains subdued. Although some rise in inflation was already expected owing to pickup in aggregate demand and expected taxation measures in the federal budget for the next fiscal year, the overall inflation for FY17 would still remain benign due to low commodity prices in the global markets.

Looking beyond FY17, PSDP spending on infrastructure and investment from China are going to have far reaching, long-term positive impact on Pakistan's economy. In particular, not only could these factors be decisive in attracting FDI from other countries, development of new economic cluster (special economic zones, industrial parks and nodal cities) would essentially redefine the industrial landscape for the country. However, a close coordination between the federal and provincial governments is imperative to maximize gains from this initiative.[30]

Similarly, while the government aims to complete several energy-related fast-track projects under CPEC in the next fiscal year, the existing gaps in the supporting infrastructure to handle import of coal and its transportation to power plants needs to be addressed at the earliest. Finally, besides attracting FDI, there is a need to pace-up the restructuring and privatization process of loss making PSEs.

[29] Pakistan had been a part of MSCI's Emerging Market Index from 1994 to 2008. However, it was classified as a "standalone country index" in late 2008 after the introduction of a "trading floor" at the Pakistan Stock Exchange following the stock market crash. The PSX was then made part of MSCI's Frontier Market Index in May 2009, from which it has now been upgraded back to the EM Index. The upgrade will take effect from May 2017.

[30] This is particularly relevant because development of industrial and investment policies is now a provincial matter after the 18th Amendment.