THE STATE OF
PAKISTAN'S ECONOMY

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for the year 2016-17 of the
Board of Directors of State Bank of Pakistan

State Bank of Pakistan

Acknowledgment

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1 Overview

The overall economic environment continues to remain conducive for growth. An accommodative monetary policy stance; increase in development spending; substantial growth in private sector credit, especially for fixed investment; and ongoing CPEC-inspired activity in power sector and infrastructure, are providing the needed support.

Table 1.1: Selected Economic Indicators

	H1-FY16	H1-FY17[P]
Growth rate (percent)		
LSM [a]	3.9	3.9
CPI (period average) [1, a]	2.1	3.9
Private sector credit [2, b]	7.4	8.6
Money supply (M2) [2, b]	4.3	5.0
Exports [a]	-14.5	-3.9
Imports [a]	-7.9	10.1
Exchange rate (+app/-dep%) [b]	-2.8	0.2
billion Rs		
Private sector credit [3]	295.7	383.7
Tax revenue [c]	1,371	1,467
million US dollars		
SBP's liquid reserves (end-period) [b]	15,884	18,272
Worker remittances [b]	9,688	9,458
FDI in Pakistan [b]	978	1,081
Current account balance [b]	-1,865	-3,527
percent of GDP		
Fiscal balance[d]	-1.7	-2.4

[P] Provisional estimate.

[1] YoY growth in the average of CPI index for the quarter.

[2] Percent change in December over June. [3] Flows since end-June

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

These factors have also led to an improvement in the investors' confidence, which is particularly reflected in capacity expansion plans by a number of industries and acquisition of domestic companies by foreign investors.[1] Meanwhile, recent pick up in the large-scale manufacturing (LSM) growth, improving energy supplies,[2] and an increase in value-added textile exports in Q2-FY17 further add to the optimism.[3] Moreover, agriculture growth is also likely to rebound as indicated by an increase in the production of major crops over the last year.

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[1] Several industries, including cement, steel, beverages, and automobiles, have announced capacity expansion plans; some of these are already underway. Moreover, in November 2016, a Turkish company acquired Pakistani home appliance firm Dawlance, and a Dutch food conglomerate completed its purchase of a majority stake in Engro Food in December 2016. More foreign investment is in the pipeline, particularly in construction-allied, automobile and food industries.

[2] Two new power projects came online in December 2016 and February 2017, adding a cumulative 433 MW to the grid. Furthermore, a 1,320 MW coal power plant at Sahiwal has started trial operations, and the Chashma Nuclear Power Plant Unit-4 is expected to start its operation soon as well. In addition, overall gas supplies have also improved, enabled by an increase in LNG imports during H1-FY17 (**Chapter 2**).

[3] After falling for last seven quarters consecutively, textile exports grew by 3.2 percent in Q2-FY17.

In addition to favorable spillover from commodity producing sectors, the current trends in key variables – like rising sale of commercial vehicles, oil consumption by the transport sector, internet subscription, external trade volume, etc. – reflect positively on the performance of the services sector. These developments suggest that the economy is maintaining its growth momentum.

In this backdrop of increased domestic supplies, ongoing expansion in economy's future capacity to produce, and muted impact of uptick in international commodity prices, inflation remained lower than the target. The low inflation also shows the impact of sustained decrease in fiscal deficit and stability in external sector over the last few years. However, these have started to show signs of strains recently.

Specifically, the current account deficit in H1-FY17 was almost twice the level recorded in the first half of FY16. This was largely due to delayed realization of Coalition Support Fund (CSF), a decline in the exports, and a surge in the imports.[4] From the external sector stability standpoint, such increase in the current account deficit does not bode well, particularly in view of bottoming out of global commodity prices (especially oil prices) along with some shifts in the international capital markets due to rise in the US interest rates.

However, two points are important to consider about the external sector. First, the surge in imports is mainly concentrated in the growth-inducing capital goods: the import of machinery, fuel and metal groups accounted for more than half of the total imports during H1-FY17.[5] When the economy is taking off, it is natural to expect some widening in the current account deficit. Nevertheless, it needs to be contained within sustainable levels. Second, the external inflows in the country have been sufficient to finance the current account deficit so far. More importantly, the current level of SBP's foreign exchange reserves can comfortably finance more than five months of imports.

On the fiscal side, coupled with increase in development spending and security related expenditures, the decline in revenue collection has led the fiscal deficit to widen by 0.7 percent of GDP in H1-FY17 as compared to the last year. Going forward, lower-than-expected growth in tax revenues could undermine the

[4] Pakistan received US$ 550 million under CSF in two tranches: one in February 2017 (US$ 350 million) and the other in March 2017 (US$ 200 million). In FY16, US$ 713 million under CSF were received in the first half.

[5] Within the machinery group, power generation machinery increased by 112.6 percent; textile machinery by 11.3 percent; construction and mining machinery by 54.8 percent; electrical machinery 7.5 percent; and, others by 29.4 percent. For more details, see **Section 5.5**.

government's efforts to keep the fiscal deficit at the targeted level and at the same time increase the development spending.

The challenges in the external and fiscal accounts need to be addressed to sustain macroeconomic stability, which has just started to push the economy towards a desirable (low inflation-high growth) balance. In addition to boosting foreign exchange receipts from reviving exports and private foreign investment, urgent measures are needed to contain imports, especially of consumer and luxury items – to keep the overall import bill manageable.[6] A combination of improved competitiveness and administrative measures would produce desirable results in this regard. In particular, there is a need to further reduce cost of doing business, enhance productivity, and remove structural impediments in the export sector.

Similarly, the structural reforms and stabilization measures undertaken by the Government to reduce the fiscal deficit during the last three years need to be further deepened. In particular, the continuity of concerted efforts aimed at broadening the tax base is necessary to gear up momentum in revenue collection and create the fiscal space required for higher spending on social and infrastructural development.

1.1 Economic review

Preliminary data on crops indicates that agriculture growth will rebound in FY17. The production of major *kharif* crops, including cotton, sugarcane, and maize is estimated to increase significantly this year. The output of major *rabi* crop, i.e., wheat is also expected to remain close to the last year's bumper crop of 25.4 million tons on the back of timely and widespread rains.[7] Besides improved water situation (from January 2017 onwards), an increase in fertilizer off take (33 percent higher), and higher credit disbursement (up 32 percent) during *Rabi* season also point to a better performance of the crops subsector.

Encouragingly, LSM growth has picked up momentum in Q2-FY17 (rising by 5.8 percent YoY). This partly compensated the sluggish Q1-FY17 growth of 2.1 percent. As a result, the cumulative growth during H1-FY17 increased to 3.9 percent, same as the last year. The major contribution to LSM growth during H1-FY17 came from food, steel, cement and pharmaceutical industries.

[6] In order to contain import growth, SBP has imposed 100 percent cash margin on import of consumer and luxury items (BPRD Circular No. 02 of 2017, dated 24 February 2017).

[7] Although there are reports of a slight decline in area under cultivation due to dry weather and water shortages during the sowing season in barani areas, this is likely to be partially offset by the expected increase in productivity.

These industries largely benefited from accommodative monetary and fiscal policies; improved energy supplies; better availability of raw materials (e.g., sugarcane); rising domestic demand (particularly for cement and steel, owing to ongoing CPEC-related power and infrastructure projects); and clarity on drug pricing mechanism. In addition, the recently announced export package would also provide much needed support to export industries, especially textile – the historical mainstay of LSM growth.

On the other hand, the available information on services sector indicators points to a mixed performance. Healthy trends in transport (given the surge in sales of trucks, buses, and POL products); increased (external) trade volumes along with better output of agriculture and industry (having positive spillover for *wholesale and retail trade*); significant increase in bank credit; and a rise in 3G/4G subscription base (27 percent) during H1-FY17, all indicate towards an uptick in the services sector's performance. At the same time, losses of Public Sector Enterprises (PSEs), and a decrease in banks' profitability, act as potential drags. On balance, however, the services sector is expected to keep up last year's growth momentum (see **Chapter 2** for details).

Meanwhile, ongoing investments in energy and infrastructure sectors (and strong transport sector activity) resulted in a sharp increase in import demand, especially for capital goods and raw materials. Led by higher imports of machinery (power and construction) and petroleum (including LNG), the total import bill grew by 6.0 percent during H1-FY17, compared to 8.9 percent decline in the corresponding period last year.[8]

This surge in imports was partly a result of rising commodity prices, especially crude and palm oil. This, combined with the non-receipt of CSF in H1-FY17 and decline in exports and remittances, resulted in the almost doubling of the current account deficit to US$ 3.5 billion during first half of the year. (Here, it is worth mentioning that the receipt of CSF in Q3-FY17, and recently announced package for exports may help balance of payments going forward.)

Encouragingly, available financial inflows were more than sufficient to finance the higher current account deficit. Major foreign exchange inflows included US$ 1 billion from a Sukuk and net loans of US$ 1.4 billion (including US$ 900

[8] The increase was mainly concentrated in Q2-FY17, when import payments rose sharply by 11.5 percent YoY. In addition to elevated non-oil imports, POL imports rebounded for the first time since Q1-FY15 (on YoY basis) and contributed significantly to the rise in the overall import bill during Q2-FY17.

million of commercial borrowings). In addition, net FDI increased by 10.5 percent to US$ 1.1 billion during H1-FY17, from US$ 978 million last year.

As a result, SBP's liquid FX reserves recorded a net increase of US$ 129 million during H1-FY17 (see **Chapter 5** for details). Here, it must be acknowledged that while imports are essential at the moment to address infrastructure and energy bottlenecks, there is a need for an equivalent increase in foreign exchange earnings to finance these imports and thereby maintain the external sector's stability.

The official foreign inflows also helped financing of the fiscal deficit, which was 2.4 percent of GDP during H1-FY17 compared to 1.7 percent in the corresponding period last year. Both an increase in expenditures and a decline in revenues contributed to this widening of fiscal deficit. The decline in total revenue was largely due to 31.8 percent fall in non-tax revenue on account of non-realization of CSF in H1-FY17, lower SBP profit, and a decline in dividend income.

Moreover, growth in tax revenue also decelerated to 6.2 percent during H1-FY17 compared to over 20 percent increase in the last year. This slowdown seems to be an unintended consequence of various tax measures to support investment, growth, and exports. Notwithstanding these factors, the need to address structural weaknesses in the tax system for a sustainable increase in tax revenue, commensurate with development and social spending requirements cannot be overemphasized.

On the expenditure side, overall spending accelerated to 10.7 percent during H1-FY17 – more than twice the growth of 5.0 percent recorded in H1-FY16. The pattern of expenditure shows that the government is largely maintaining its focus on improving the security situation and providing a boost to investment and economic activity through higher development spending. Spending on these two accounts grew by 10.9 percent and 16.7 percent respectively during the period under review (see **Chapter 4** for details).

Notwithstanding the higher fiscal deficit, the public debt increased by only Rs 583.4 billion during H1-FY17; this was almost half of Rs 1,097.7 billion increase observed in the corresponding period of the last year. The slowdown in debt accumulation was caused by deceleration in both the external and domestic debt. The net increase in public external debt and liabilities during H1-FY17 amounted to only US$ 130 million, against an increase of US$ 2.3 billion in H1-FY16. This slowdown in external debt accumulation reflected revaluation gains, mostly due to the depreciation of the Japanese yen against the US dollar. On the other hand, the government retired its domestic debt to the tune of Rs 193.2 billion during Q2-FY17, as it utilized a large part of its deposits held with the banking system instead of resorting to fresh borrowing.

As the economic activities are picking up the domestic demand is also rising (see **Chapter 2** for detail). This, along with the revival in global commodity and oil prices, has pushed up average CPI inflation to 3.9 percent during H1-FY17 from 2.1 percent in H1-FY16. However, the year-on-year inflation fluctuated in a narrow range around 4.0 percent since the start of the fiscal year. In fact, a limited pass-through of the rise in global oil prices to domestic POL prices during H1-FY17 partially offset upward pressures stemming from higher food prices (especially of fresh vegetables and edible oil).

Keeping in view the prevailing economic trends, i.e., healthy economic growth, contained inflation and at the same time increasing current account deficit, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 5.75 percent during H1-FY17. This, combined with a comfortable liquidity position in the interbank market, led to a continuation of stable market interest rates.

These developments in the banking system induced growth in the private sector credit. The overall credit to the private sector increased by Rs 383.7 billion during H1-FY17 against an expansion of Rs 295.7 billion in the same period last year. A part of this reflects an increase in working capital requirements of manufacturing firms, in view of the rise in the raw material prices. Credit for fixed investment, i.e., the amount borrowed mainly for capacity expansion, also grew sharply following an increase in the public sector development spending. Besides hefty corporate sector borrowing, consumer loans also picked up.

As mentioned earlier, the encouraging trend in private sector credit was partly supported by a hefty retirement of Rs 485.5 billion (on cash basis) by the government to commercial banks. A sizeable portion of this, Rs 212.6 billion, was due to maturity of Ijara Sukuk, and the rest came from low turnover in auctions of government securities. The retirement to commercial banks was made possible through the government's recourse to borrowings from SBP and external sources.[9]

[9] Government borrowing from SBP (on cash basis) increased by Rs 892.6 billion during H1-FY17, against a retirement of Rs 429.2 billion witnessed in the corresponding period of last year.

To a great extent, SBP neutralized the impact of the increase in the government's borrowing on reserve money growth by scaling down the outstanding stock of OMO injections.[10] This helped contain the reserve money growth to 6.6 percent in H1-FY17, against 10.6 percent recorded in the corresponding period of last year. Nevertheless, growth in broad money accelerated to 5.0 percent during H1-FY17 from 4.3 percent last year. This growth came entirely from an expansion in Net Domestic Assets (NDA) of the banking system. On the other hand, Net Foreign Assets (NFA) of the banking system saw a contraction of Rs 20.6 billion in H1-FY17, against an expansion of Rs 150.6 billion seen last year. Although most of the contraction was contributed by scheduled banks, NFA of the SBP also declined by Rs 3.4 billion in Q2-FY17.

1.3 Outlook for FY17

The real GDP growth in FY17 is expected to be higher than the last year. Major contribution is expected from the rebound in agriculture and increased pace of work on infrastructure and energy projects. In particular, the completion of early harvest energy projects under CPEC is expected to provide additional boost to industrial growth. These expectations are in line with continuing robust trends in private sector credit and import of machinery and raw materials.

The growth in industry, though likely to fall short of its target, is expected to maintain last year's level. The textile industry, the largest sub-component of the LSM, is expected to post some recovery in H2-FY17, as exporters cash-flow constraints may ease following the recently announced export package. The commencement of operations of new power plants and the sustained increase in LNG imports are expected to help electricity generation and gas distribution to maintain last year's momentum. Similarly, as indicated by strong trends in cement and steel production, the growth in construction sector is likely to remain robust in FY17 as well.

The services sector, though showing a mixed trend as discussed in **Chapter 2**, is expected to achieve its target growth rate for the year. The current trends in trade, especially imports; higher production and sale of commercial vehicles; substantial increase in bank credit; flourishing housing schemes; and rising internet subscription, all suggest a vibrant services sector. Incorporating these developments, the latest projections indicate real GDP growth in the range of 5 to 6 percent in FY17 (**Table 1.2**).

[10] The net outstanding stock of OMO injections was brought down from the peak of Rs 2,033.4 billion in mid July 2016 to Rs 800 billion by end-December 2016.

Table 1.2: Key Macroeconomic Targets and Projections

	FY16	FY17	
		Target[1]	Projection[2]
		percent growth	
Real GDP	4.7[4]	5.7	5.0 – 6.0
CPI (average)	2.9[4]	6.0	4.0 – 5.0
		billion US$	
Remittances	19.9[2]	20.2	19.5 – 20.5
Exports (fob)	22.0[2]	24.7	21.5 – 22.5
Imports (fob)	40.3[2]	45.2	42.0 – 43.0
		percent of GDP	
Fiscal deficit	4.6[3]	3.8[3]	4.0 – 5.0
Current a/c deficit	1.2[2]	1.5	1.0 – 2.0

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

Increase in agriculture production and sufficient food supplies, stable exchange rate, and a limited pass-through of rising international commodity prices to domestic prices are expected to keep inflation low and stable. Importantly, in case of oil prices, less-than-warranted increase in domestic motor fuel prices would limit its direct and second round impact on CPI inflation. Moreover, the recent increase in investment demand as reflected by the widening of twin deficits may not have an adverse impact on inflation in the remaining months of FY17. Therefore, full-year average CPI inflation is expected to remain in 4 to 5 percent range.

In view of strong growth in imports and taking stock of developments in international commodity prices and global economic trends, the current account deficit is likely to increase; however, the country's foreign exchange reserves will remain at comfortable level. Some gains in exports due to the recently announced export package are expected to be offset by muted remittance growth. Declining number of migrant workers going to the GCC (reflecting stressed fiscal conditions in these countries due to low oil prices); the pound sterling's depreciation against the US dollar, and stricter regulatory controls in US, are the main factors that will likely keep remittance inflows close to last year's level.[11]

Given the actual fiscal deficit of 2.4 percent of GDP in the first half, and keeping in view that the deficit is usually higher in the second half, the full-year fiscal gap will be higher than the target of 3.8 percent. This projection incorporates the impact of the recently announced export package, and assumes no significant change in the current pace of revenue collection in the absence of additional revenue generating measures. On the other hand, expenditures are likely to remain elevated due to the government's commitment to complete most of the power and infrastructure projects by close of FY18 and ongoing operations aimed to further improve the country's security environment.

[11] The recent decision of Kuwait government to lift restrictions on issuing visas to Pakistani nationals bodes well for increased remittance flows going forward.

2 Real Sector

2.1 Overview

The highlight of the second quarter for FY17 was the recovery in large-scale manufacturing (LSM) growth to 5.8 percent, from 4.0 percent in the corresponding period of FY16. As a result, LSM growth for H1-FY17 reached 3.9 percent – the same level as last year.

In agriculture, healthier crop production would help the sector rebound from the decline recorded last year. Meanwhile, we expect the services sector to maintain last year's growth momentum, based on an encouraging picture of *wholesale and retail trade* and *transport*. Thus, in overall terms, the GDP growth for FY17 is set to exceed last year's level.

2.2 Crop sector

While a better harvest of sugarcane and cotton (compared to the last year) provided a much-needed impetus to the crop sector during the *kharif* season, initial reports on the wheat crop suggest its production would remain close to last year's level of 25.4 million tons – slightly lower than the target of 26 million tons for FY17 (**Table 2.1**).[1]

Table 2.1: Wheat Targets for FY17

	Area (000 hectare)		Yield (kg per hectare)		Production (000 tons)	
	3-Year avg	**FY17 target**	**3-Year avg**	**FY17 target**	**3-Year avg**	**FY17 target**
Punjab	6,940	6,800	2,813	2,868	19,520	19,500
Sindh	1,128	1,150	3,372	3,652	3,802	4,200
KP	765	760	1,726	1,842	1,321	1,400
Balochistan	373	400	2,344	2,250	873	900
Pakistan	**9,205**	**9,100**	**2,772**	**2,857**	**25,516**	**26,000**

Source: Pakistan Agriculture Statistics; and SUPARCO

Notwithstanding water shortages witnessed during the early part of the rabi season (**Box 2.1**), the situation eased considerably in January 2017 after prolonged and widespread rains throughout the country. This, coupled with extended spells of low temperature and better availability of other inputs (fertilizer and credit), is likely to have a positive effect on wheat output.[2,3]

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[1] The Annual Plan 2016-17 set the wheat production target at 27.4 million tons, which was later revised down to 26 million tons by the Federal Committee on Agriculture. This target assumes a crop yield of 2,857 kg per hectare, which is higher than the average yield of 2,772 kg per hectare recorded during the past 3 years.

[2] In the Federal Budget 2016-17, the government had announced a cash subsidy of Rs 156 per bag on urea and Rs 300 per bag of DAP, at an estimated cost of Rs 27.16 billion (Rs 17.16 billion for urea

Box 2.1: Water Availability in Early Rabi

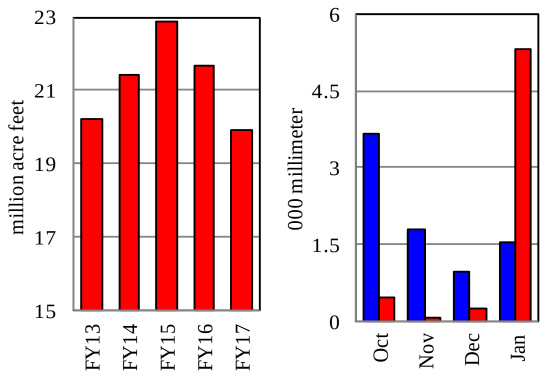
The irrigation water shortages and prolonged dry spell during the early rabi season led to some decline in the sowing area under the wheat crop (particularly in rain-fed regions of the country).

Specifically, irrigation water supply to Punjab and Sindh, which together account for more than 85 percent of the area under wheat, contracted by 8.1 percent during Oct 2016-Jan 2017 (**Figure 2.1.1**). This was on top of the 5.2 percent YoY decline recorded during the corresponding period of the previous year.

In the meantime, low precipitation in the country further stressed water resources.[4] The rain-fed areas under wheat account for 13.2 percent of total area under the crop, and contribute 6 percent to the total output (**Table 2.1.1**).

That said, the subsequent heavy rainfall in January 2017 provided a major relief to the crop sector.

Figure 2.1.1: Irrigation Water in Punjab & Sindh(oct-Jan) **Aggregate Rainfall**



Source: SUPARCO Source: IRSA

Table 2.1.1: Wheat Performance for Rain-Fed Areas
(Average 2010-11 to 2014-15)

	Rain-fed area under wheat (as % of total area under crop)	**Output from rain fed area** (as % of total production)	**Yield of rain-fed area** (as % of yield for irrigated land)
Punjab	10.2	4.7	42.9
Sindh	4.7	1.2	24.8
KP	55.9	43.0	59.4
Balochistan	7.9	4.7	57.1
Total	**13.2**	**6.0**	**42.1**

Source: Agriculture Statistics of Pakistan, Ministry of National Food Security & Research

With the expected output reaching last year's level, FY17 may be another year when domestic wheat production would exceed domestic consumption. This, in turn, would further augment wheat stocks available with government agencies.[5] This situation has arisen at a time when the Food and Agriculture Organization (FAO) is already expecting record global wheat output this year. As a result, the wheat glut in the

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and Rs 10.8 billion for DAP fertilizer). This cost was to be shared equally by the federal and the provincial governments. In addition, the government also reduced the GST on urea from 17 percent to 5 percent. These measures pulled down urea and DAP prices by 28 and 27 percent respectively.

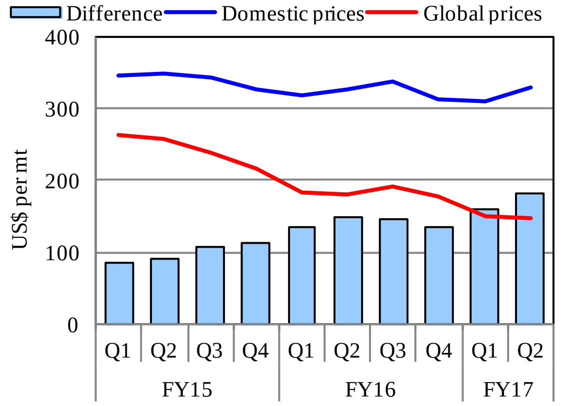
[3] Gross credit disbursement to agriculture sector grew by an impressive 32 percent in the ongoing Rabi season – both development and production loans contributed to this increase.

[4] In Q2-FY17, the country recorded nearly 90 percent less rainfall as compared to the same period last year.

[5] It may be noted that wheat stocks with government agencies have been rising consistently over the past few years, and reached 8.0 million tons by end-January 2017, from 3.75 million tons at end-January 2014.

international market is likely to deepen further, with stocks projected to reach a record 248 million tons by year-end. The resulting downward pressures on international wheat prices will pose a challenge for Pakistan as well, as this will make it difficult for the country to export the surplus wheat, even in the presence of sizeable government subsidies (**Figure 2.1**).[6]

Figure 2.1: Wheat Prices

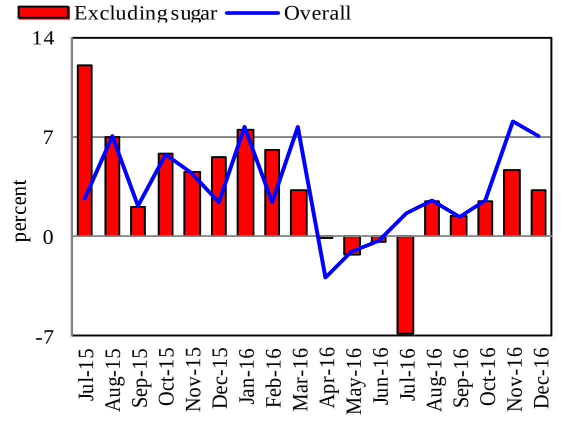


Source: Pakistan Bureau of Statistics and World Bank

2.3 Large-scale manufacturing (LSM)

LSM recorded a growth of 3.9 percent during H1-FY17, the same level realized last year (**Table 2.2**). After a dull first quarter (**Figure 2.2**), the recovery in LSM growth in Q2-FY17 came from food, steel, cement, pharmaceutical, automobiles and electronic industries.

Figure 2.2: YoY Growth in LSM



Source: Pakistan Bureau of Statistics

Going forward, multiple factors are likely to provide further impetus to LSM growth. These include supportive economic policies (low interest rate and higher PSDP spending); recently announced incentives for export industries;[7] improved energy supplies;[8]

[6] The government has permitted the export of 0.9 million tons of wheat, with a subsidy of US$ 120 per ton. So far, no significant exports have taken place, as Pakistan's FOB wheat price (even after adjustment for export subsidy) is still significantly higher than its closest competitors.

[7] The government recently announced an export stimulus package of Rs 180 billion (for H2-FY17 and FY18). This package offers several incentives, including removal of duty and taxes on some raw material and machinery, and rebate on exports, etc.

[8] LNG imports increased to 1,004 MT during H1-FY17 against 400 MT during the same period last year. The new Chashma Nuclear Power Plant (Unit-3) has added 315 MW electricity to the system.

strong domestic consumer demand;[9] and an uptick in private sector credit for fixed investment purposes.[10] Furthermore, the constraints that inhibited the growth of some industries in Q1-FY17, are expected to dilute in the future.[11]

Having said this, a sharp revival in LSM might be constrained by a number of factors:

(1) Most of the industries that have shown steady growth over the past few years (e.g., cement, autos, steel and pharmaceutical), have already achieved high levels of capacity utilization – further growth would therefore require capacity expansions;[12]

Table 2.2: YoY Growth in LSM (Jul-Dec)

		YoY growth		Contribution in growth	
	wt.	**FY16**	**FY17**	**FY16**	**FY17**
LSM	70.3	3.9	3.9		
Textile	21.0	1.0	0.1	0.30	0.04
Cotton yarn	13.0	1.8	0.4	0.36	0.08
Cotton cloth	7.2	0.7	0.2	0.06	0.02
Jute goods	0.3	-22.6	-38.6	-0.08	-0.10
Food	12.4	-0.1	6.9	-0.01	1.16
Sugar	3.5	-14.2	52.4	-0.43	1.32
Cigarettes	2.1	-10.6	-31.0	-0.23	-0.58
Vegetable ghee	1.1	4.9	2.3	0.07	0.03
Cooking oil	2.2	6.4	-0.5	0.24	-0.02
Soft drinks	0.9	4.0	18.8	0.11	0.52
POL	5.5	6.8	-1.3	0.45	-0.09
Steel	5.4	-8.6	15.6	-0.33	0.53
Non-metallic	5.4	7.1	9.3	0.75	1.02
Cement	5.3	7.1	9.6	0.75	1.03
Automobile	4.6	32.4	6.7	1.73	0.45
Jeeps and cars	2.8	47.2	-2.7	1.22	-0.10
Fertiliser	4.4	15.1	3.5	0.90	0.23
Pharmaceutical	3.6	7.2	7.9	0.60	0.68
Paper	2.3	-15.6	5.7	-0.64	0.19
Electronics	2.0	-8.2	14.5	-0.14	0.22
Chemicals	1.7	10.8	-2.7	0.27	-0.07
Caustic soda	0.4	26.1	-6.3	0.11	-0.03
Leather products	0.9	6.2	-18.9	0.12	-0.38
LSM excl. sugar	66.8	4.4	2.6	--	--

Source: Pakistan Bureau of Statistics

(2) In the textile sector, the recovery in global commodity prices (particularly cotton) and the recently announced export package are positive developments. But fully capitalizing on these favorable developments would require a well-

Going forward, 1,320 MW coal fired power projects at Sahiwal and the 118 MW Port Qasim power project in Karachi would further ease the energy constraints.

[9] Several indicators show rising consumer demand in the country, like: (i) a rise in consumer financing; increase in the sale of consumer durables (automobiles, electronic goods); sharp growth in fuel consumption, etc. Furthermore, the IBA-SBP Consumer Confidence Index (CCI) recorded its highest-ever level of 174.9 points in January 2017, showing an increase of 17 points from July 2016.

[10] During H1-FY17, the manufacturing sector availed Rs 82.7 billion in fixed investment loans, against Rs 21.8 billion in the same period last year.

[11] Some of these include: withdrawal of the increase in Federal Excise Duty on cigarettes (announced in the federal budget FY17, which led to a decline in production during Q1-FY17); and the lifting of a temporary ban on jute exports by Bangladesh (which had adversely affected the local jute industry). Similarly, the post-Apna Rozgar Scheme drag on car production would fade away after February 2017 (as car production under this scheme had continued till February 2016).

[12] While several firms in cement, steel, automobiles and beverages industries have already planned capacity expansions, it may take time for them to materialize.

thought out strategy and concerted efforts to resolve the endemic issues afflicting the sector;[13] and

(3) Global prices of key raw materials are increasing, which may squeeze margins for manufacturing firms in cement, automobiles, and cooking oil/ghee sectors (**Table 2.3**).

Table 2.3: Key International Raw Material Prices

		Change over (percent)		
Commodities	**US$***	**3-months**	**6-months**	**12-months**
Coal (mt)	87.2	28.9	45.2	76.9
Palm oil (mt)	711.8	2.8	21.8	36.7
Soya bean Oil (mt)	800.3	10.7	19.5	18.2
Cotton (lb)	71	3.1	8.3	8.7
Copper (mt)	251	12.9	12.3	16.1
Steel (lb)	633	27.6	2.9	61.9
Iron (mt)	79.7	40.7	41.0	101.4
Rubber (kg)	200	43.9	54.8	69.9
Crude oil				
Brent (bbl)	52.6	16.8	19.0	43.9
WTI (bbl)	54.9	21.5	22.9	47.5
Arabian light (bbl)	52.6	23.3	21.6	56.4

* As of 31st December, 2016

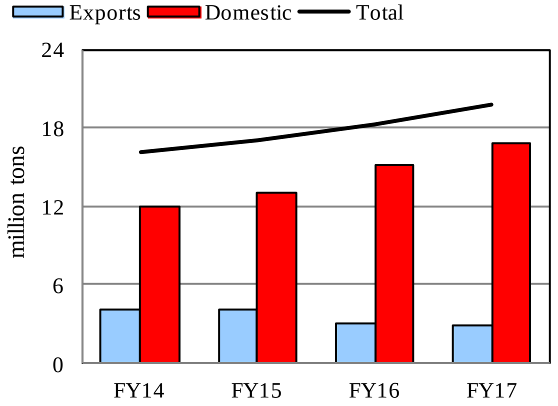
Source: Bloomberg, IMF and WB

Sectoral review

Cement

The growth in cement production increased to 9.5 percent during H1-FY17 from 7.1 percent in H1-FY16. This was mainly a result of robust domestic demand, as exports to Afghanistan fell due to strong competition from cheaper Iranian cement and some supply-related issues (**Figure 2.3**).[14] During H1-FY17, overall cement sales grew 8.7 percent and reached a record level of 19.8 million metric tons.[15]

Figure 2.3: Cement Sales (Jul-Dec)



Source: All Pakistan Cement Manufacturers Association

[13] Efforts are needed to address the issues, like low investment on R&D, product development, innovation, branding and tapping of new markets; lack of skill upgradation and resulting low labor productivity; use of obsolete technology; and high export concentration in low value added products.

[14] Due to implementation of border management system and some other issues, the resultant delays in transportation of cement (which has limited shelf life) has forced Afghan buyers to switch to Iranian cement.

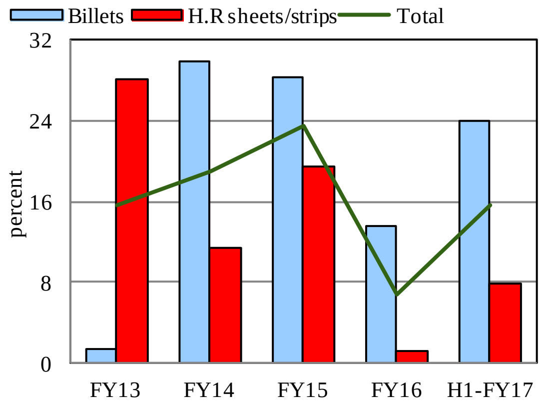
[15] Domestic sales recorded a double-digit growth of 11 percent and reached 16.9 million tons in H1-FY17. Cement exports, on the other hand, declined by 4 percent during this period.

The sizable domestic demand actually allowed manufacturers to enhance their capacity utilization to over 80 percent. The resulting economies of scales also improved their margins. The outlook of the industry appears encouraging, as many cement producers have announced capacity expansions in anticipation of firm demand (from private housing schemes, rising development spending and increased focus on CPEC-related projects).[16]

Steel

Robust construction activities in the country also led to an increase in demand for steel and allied products. The production of steel grew by 15.6 percent during H1-FY17 (**Figure 2.4**). More importantly, this growth was achieved despite the dumping of cheaper Chinese imports (which squeezed margins for the local industry).

Figure 2.4: Trend in Private Steel Production



Source: Pakistan Bureau of Statistics

That said, the industry gained some comfort when a recovery in global prices offered local players a room to increase their prices as well.[17] At the same time, improved energy supply helped the industry improve its capacity utilization.

Expecting strong domestic demand going forward, the industry is gearing up for expansions as well. For example, some large steel producers are doubling their production capacities, in addition to diversifying their energy mix and minimizing their dependence on imported raw materials. The outlook for the local industry has further improved following the imposition of anti-dumping duties on imports of steel products from China.[18]

[16] The establishment of the proposed infrastructure finance bank (in partnership with international financial institutions to finance mega infrastructure projects in the private sector) could prove instrumental in ensuring the sustainability momentum of construction activities in the country.

[17] Following rising international prices, domestic steel prices also increased by Rs 3,000-5,000 per ton.

[18] In February 2017, the National Tariff Commission (NTC) imposed anti-dumping duties on imports of steel products (galvanised steel coils and sheets), in the range of 6 percent to 40.5 percent. Other countries have also imposed anti-dumping and countervailing duties on steel imports from China.

Automobiles

The automobile sector registered a YoY growth of 6.7 percent in H1-FY17, compared to an increase of 32.4 percent in the corresponding period last year. Higher production of vehicles under the Apna Rozgar Scheme last year explains this slowdown in growth.[19] Adjusting for this scheme, the auto industry showed a reasonable growth of 11.0 percent YoY during H1-FY17 (**Table 2.4**). This was largely enabled by higher sales of commercial vehicles (i.e., tractors, trucks and buses).

Table 2.4: Vehicles Production and Sale

					%Growth			
	H1-FY17		H1-FY16		H1-FY17		H1-FY16	
Units	**Output**	**Sale**	**Output**	**Sale**	**Output**	**Sale**	**Output**	**Sale**
Passenger Cars	90,222	85,901	92,514	89,824	-2.5	-4.4	48.0	53.0
Exc. Apna Rozgar Scheme	79,803	76,288	72,847	70,308	9.5	8.5	31.5	35.1
Trucks	3,806	3,304	2,326	2,194	63.6	50.6	31.8	34.7
Buses	669	577	499	451	34.1	27.9	65.8	76.9
LCVs, Vans & Jeeps	12,548	11,427	21,423	21,474	-41.4	-46.8	144.6	164.2
Exc. Apna Rozgar Scheme	2,829	2,533	2,552	2,522	10.9	0.4	20.0	39.9
Farm Tractors	21,336	20,933	13,064	12,375	63.3	69.2	-45.9	-40.7
Motorcycles & Three-Wheelers	790,240	789,879	657,283	651,338	20.2	21.3	86.2	84.1

Source: Pakistan Automotive Manufacturers Association

The robust growth in tractors was mainly due to an improvement in the purchasing power of growers due to better prices of rice and cotton; cash disbursement on account of kissan package; subsidy on basic inputs like fertilizer; and a reduction in sales tax on tractors. Similarly, the production of trucks and buses segment has responded to expansion in road infrastructure, and growing trade and economic activities.

Going forward, the industry is also expected to benefit from the launch of new models (e.g. Celerio, Alto 660cc, Revo, Fortuner, Ciaz and Vitara) by existing manufacturers; the revival of dormant players Kia Motors and Hyundai; and the entry of new players.

Steel manufacturers have also been able to persuade China to cut down its production. As a result, Chinese steel exports fell during CY-16, providing support to prices in the international market.

[19] The effect of the Apna Rozgar Scheme, which had inflated last year's growth number for the passenger car segment, is going to end in February 2017. This will help normalize the segment's growth going forward.

Fertilizer

The buildup of large urea inventories last year took its toll on domestic production this year, as output grew by 3.5 percent during H1-FY17, significantly lower than the 15.1 percent rise witnessed in H1-FY16.

Despite some recovery in sales during Q2-FY17 (due to lower prices), urea stocks were still quite elevated at about one million tons by end-December 2016.[20] Going forward, domestic demand is expected to remain strong in response to the government's decision to maintain subsidy on fertilizer.[21] Moreover, production would also benefit as the industry is getting adequate gas supplies.

Pharmaceuticals

The pharmaceutical industry continued its growth momentum from last year, rising by 7.9 percent during H1-FY17. A number of factors helped the industry's growth, like price hikes last year; a decline in raw material costs (due to the euro's depreciation); and ongoing consolidation in the sector.[22,23] Multiple factors, including the current state of health facilities and the government's increased focus on the sector; higher population growth; more clarity after the drug pricing policy; and the launch of new products (like the dengue vaccine) can further fuel the industry's growth.

Electronics

This segment witnessed a sharp turnaround during H1- FY17, recording a growth of 14.5 percent, against a contraction of 8.2 percent during the same period last year. Consumer durables like refrigerators (up 25.0 percent) and deep-freezers (up 54.4 percent) mainly contributed to this improved performance.

Further rise in energy supply in the coming months, increase in consumer financing in a low interest rate environment, better market access for the rural population, expansionary plans of leading players, and foreign investment, all indicate a sustainable trajectory for the industry's growth going forward.[24]

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[20] Urea inventories reached 1.3 million tons by end-September 2016.

[21] Although the government has allowed the export of 0.3 million tons of urea in FY17, its higher cost makes exports challenging: domestic prices are still at a premium of 6 percent to international prices).

[22] ICI Pakistan Limited is in the process of acquiring the assets of Wyeth Pakistan Limited, a multinational pharmaceutical company operating in Pakistan since 1949. And Martin Dow Ltd has acquired the Pakistani operations of Merck KGaA.

[23] The gross margins for the industry crossed 30 percent in H1-FY17 (source: listed companies' financial reports).

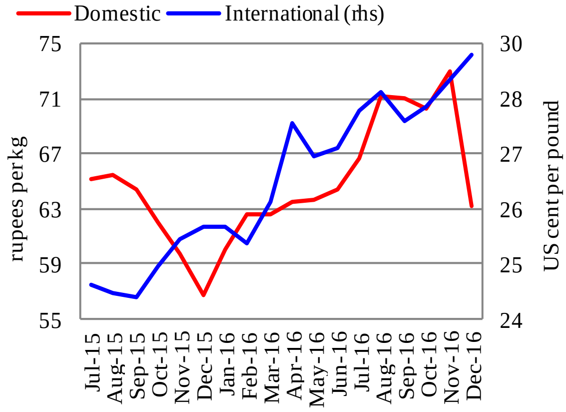
[24] Turkish firm Arcelik has recently acquired the home appliance company Dawlance Pakistan for US$258mn.

Food

During H1-FY17, the food sector grew by 6.9 percent, after contracting by a marginal 0.1 percent in H1-FY16. While cigarette-manufacturing continued to decline (in response to the levying of FED in the FY17 budget), a sharp increase in sugar production supported the overall growth in the food industry.

A better sugarcane crop, and rising domestic prices of sugar, led to an increase in cane crushing.[25] In addition, the government has allowed the export of 0.225 million tons of sugar.[26] These exports have now become increasingly feasible, given the rise in global sugar prices during H1-FY17 (**Figure 2.5**). In addition, manufacturers have increased their focus on power generation through by-products (mainly bagasse and ethanol).

Figure 2.5: Trend in Sugar Prices



Source: Pakistan Bureau of Statistics and World Bank

The soft drink category grew by 18.8 percent during H1-FY17 – higher than the average growth of 16 percent realized in the last five years. A major soft drink firm recently made a US$ 200 million investment to expand its production and distribution capacities. On the other hand, volatility in international cooking oil prices and the drive against hazardous and low quality oil, constrained the production of vegetable ghee and cooking oil.

Textile

The growth in the textile industry remained subdued at 0.1 percent during H1-FY17, compared to 1.0 percent in the corresponding period last year. The export decline and structural bottlenecks constrained the performance of the sector. While the government has recently announced a generous export package for the

[25] While sugarcane output is likely to reach an all-time high of 71 million tons, domestic sugar prices have risen by 11 percent YoY during Jul-Jan FY17.

[26] An inter-ministerial committee would meet in the first week of every month to review the price and stock/export situation of sugar. In case domestic prices exceed their level on December 15, 2016, the committee would recommend to the ECC to stop further exports of the commodity.

sector, it would take some time to make a significant impact on the sector's performance.

Other sectors

During H1-FY17, POL products witnessed a decline of 1.3 percent, compared to an increase of 6.8 percent in H1-FY16. The impact of the policy shift towards upgraded quality petroleum products is holding back growth in this sector. Wood, engineering, and leather industries are finding it difficult to compete with cheap imported products.

2.4 Services

As evident from the partial information available so far, the performance of the services has largely remained on track. For example, the expected recovery in agriculture, steady growth in large-scale manufacturing and strong growth in imports, all suggest an encouraging outlook for *wholesale and retail trade* – the largest subsector in services.

Similarly, in the transport segment, the demand for buses and trucks surged by 27.9 and 50.6 percent in H1 FY17 over the same period in the previous year; this partially offset the impact of culmination of the Apna Rozgar Scheme. At the same time, fuel consumption increased sharply in the country: sale of petrol increased by 20.1 percent YoY in H1-FY17, whereas diesel uptake grew by 15.1 percent – both of these suggest an uptick in commercial activities in the country.

On the other hand, most indicators related to the communications remained subdued, with the exception of the subscription base for 3G/4G services (which increased by 27 percent during H1-FY17). Furthermore, consolidated accounts of PTCL show higher net losses (Rs 1.5 billion) during the period, compared to Rs 1.3 billion last year. This was mainly due to losses posted by PTCL's cellular subsidiary, and additional costs incurred from the voluntary separation scheme.

Within *finance and insurance*, the profits (before tax) of the banking sector remained lower than the last year (**Table 2.5**). That said, advances to the private sector have recovered strongly this year.

Table 2.5: Performance of the Banking Sector (Jul-Dec)

million rupees

	2015	2016
Profit/loss before tax	157.8	151.8
Investments(net)	671.6	-312.2
Advances(net of provision)	263.7	319.0
Deposits	419.3	773.7

Source: State Bank of Pakistan

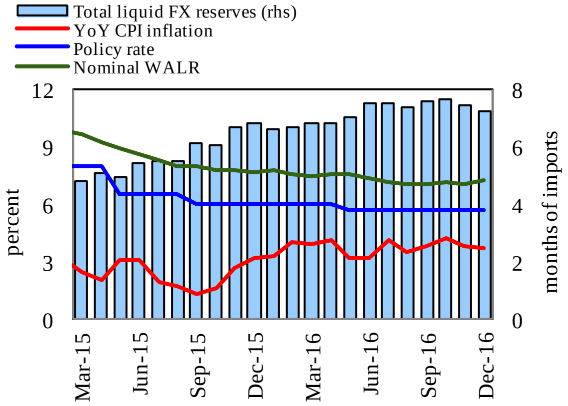
Therefore, in overall terms, we expect the services sector to grow at the same pace as last year.

3 Inflation and Monetary Policy

3.1 Policy review

With the uptick in global commodity prices amid healthy domestic demand, some of the macroeconomic indicators began to change course. Import payments have particularly been rising with the start of FY17, which resulted in the near-doubling of the current account deficit during the first half.[1] The average CPI inflation also remained higher in H1-FY17 compared to the same period last year, as the impact of the commodity slump gradually fizzled out (**Figure 3.1**).[2] Nonetheless, the inflation has been stable over the past one year, oscillating within a narrow range. Finally, aside from good performances by few sectors, the overall LSM growth remained low during the initial months of FY17.[3]

Figure 3.1: Key Policy Indicators



Source: State Bank of Pakistan

These divergent trends in important indicators were challenging for monetary policy decision-making – especially for the one due in November 2016. A rate cut could have supported the sluggish activity in the LSM – the fact that external pressures had been (and still seem) manageable and the increase in CPI inflation subdued, this policy option could not be disregarded altogether.[4] However, from the macroeconomic stability standpoint, it seemed prudent not to discount the emerging import pressures while pushing for higher growth. Thus, with a close

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[1] The current account deficit increased from US$ 1.9 billion in H1-FY16 to US$ 3.6 billion in H1-FY17.

[2] The average IMF commodity price index during Oct-Dec 2016 was 12.9 percent higher than the same period last year. In contrast, this index had posted a decline of 33.2 percent YoY during Oct-Dec 2015.

[3] Here it is important to point out that after recording a low growth during Jul-Oct 2016 (2.0 percent YoY), LSM rebounded strongly by an average 7.7 percent during Nov-Dec 2016 on YoY basis.

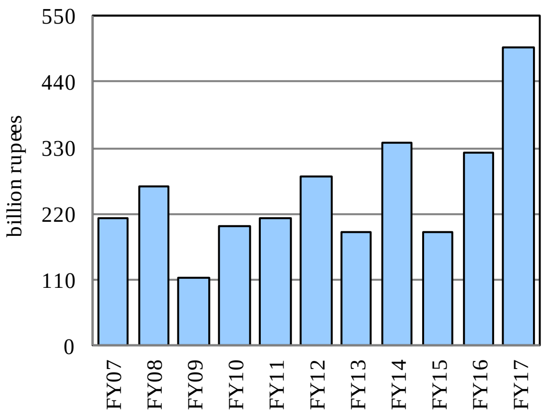
[4] Despite a significant increase in the current account deficit during H1-FY17, pressures on the overall external sector are contained, as there were sufficient volume of FX loans and FDI.

voting of 6:4 in favor of status quo, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 5.75 percent.[5]

The MPC's decision basically prolonged the spell of historic-low interest rates in the country.[6] It also signaled the committee's comfort over the short-term macroeconomic outlook. The outcome was naturally positive. Corporate customers, positioning earlier in response to favorable business environment only gradually, borrowed aggressively in the months of November and December 2016, prompted by the initiation of fresh credit cycle with the arrival of *kharif* crops. Consumer loans also picked up as banks strategized to readjust their asset portfolios in favor of high-earning segments.

As a result, the overall credit to private sector posted an unprecedented increase of Rs 499.3 billion during Q2-FY17 (**Figure 3.2**); even after adjusting for the price level, this flow was a ten-year high. In addition to favorable policy environment, this also represented: (i) higher cotton prices and recovery in value-added textile exports YoY in Q2-FY17, which increased working capital requirements of textile firms (**Chapter 5**);[7] (ii) high PSDP expenditures that triggered activity in cement, real estate and construction sectors;[8] and (iii) the uptick in CPEC-related activity in the energy sector. Therefore, it was not surprising to see a fairly large volume of loans extended under both the fixed investment as well as working capital categories (**Section 3.3**).

Figure 3.2: Credit to Private Sector (Oct-Dec)



Source: State Bank of Pakistan

[5] SBP's last policy rate cut (of 25 bps in May 2016) brought the cumulative decline in interest rates from November 2014 onwards to 425 bps. By the time for next policy decision (i.e., in March 2017), this would be one of the longer time periods during which SBP has kept the policy rate unchanged.
[6] Prior to the ongoing spell of low interest rates in the country, one has to go back to before May 1972 to identify a period where the policy rate was maintained below 6 percent.
[7] Global cotton prices rose 13.6 percent in Q2-FY17, compared to 1.2 percent in Q2-FY16. Similarly, domestic cotton prices rose 15.3 percent YoY during Q2-FY17.
[8] PSDP expenditures stood at Rs 445.7 billion in H1-FY17, representing an increase of 17.9 percent over the same period last year.

This unusually large volume of private credit off-take constituted the bulk (over 80 percent) of monetary expansion during Q2-FY17 (**Table 3.1**). The rest was mostly contributed by budgetary borrowings, the volume of which was quite modest in comparison to the preceding quarter. Not only was the overall deficit slightly lower during the quarter, but the higher availability of external financing moderated funding pressure on the banking sector.[9] Within the banking sector, the government continued with its Q1-FY17 borrowing mix; i.e., mobilizing funds only from SBP and making retirements to commercial banks. Its impact on the reserve money growth was neutralized by unwinding of outstanding OMO injections (**Section 3.2**). Some downward pressure on reserve money also came from a fall in SBP's NFA during the quarter.

Table 3.1: Monetary Aggregates

flows in billion Rupees

	FY16			FY17			Jan-Dec	
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**	**2015**	**2016**
Reserve Money	342.1	-7.8	334.3	237.5	26.5	264.1	696.5	761.3
M2	119.8	360.0	479.7	29.6	616.2	645.9	1,352.4	1,708.8
NFA	111.6	39.0	150.6	-8.4	-12.2	-20.6	321.5	23.7
SBP	150.9	28.8	179.7	38.0	-3.4	34.6	353.9	165.5
Scheduled banks	-39.3	10.2	-29.1	-46.4	-8.7	-55.2	-32.4	-141.8
NDA	8.2	321.0	329.2	38.1	628.4	666.5	1,031.0	1,685.1
Budgetary borrowings*	139.4	43.9	183.3	299.6	107.5	407.1	872.6	1,010.9
SBP	-304.4	-124.8	-429.2	567.7	324.9	892.6	-450.1	847.0
Scheduled banks	443.8	168.7	612.5	-268.1	-217.4	-485.5	1,322.6	164.0
Credit to Private sector	-25.7	321.4	295.7	-115.6	499.3	383.7	261.2	534.4
Other items (net)	-140.1	22.9	-117.2	-152.7	10.4	-142.4	-152.5	-95.3

* on cash basis

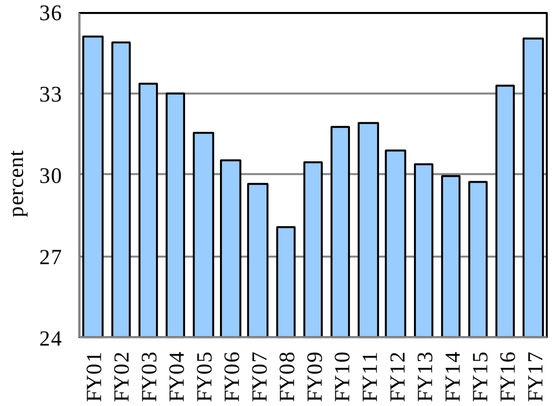
Source: State Bank of Pakistan

Therefore, the reserve money growth was only 0.6 percent in Q2-FY17, helping contain the cumulative growth in H1-FY17 to 6.6 percent – much lower than the 10.6 percent growth realized in H1-FY16. The overall M2 growth still fell short, despite a sizable expansion in the second quarter. The money multiplier continued its downward trajectory throughout H1-FY17, as public preference tilted further towards cash holding. As shown in **Figure 3.3**, the currency-to-deposit ratio, which spiked right after the imposition of withholding tax on banking transactions

[9] The overall fiscal deficit during Q2-FY17 was Rs 361.2 billion, which was 17.5 percent lower than the deficit incurred in Q1-FY17. While external resources financed only 15.7 percent of the deficit in Q1-FY17, these were sufficient to make up for 47.6 percent of the total deficit in Q2-FY17.

in early FY16, reached to a 16-year high during H1-FY17 – close to the level last seen in H1-FY01.[10]

Figure 3.3: Average Currency-to-Deposit Ratio (July-Dec)

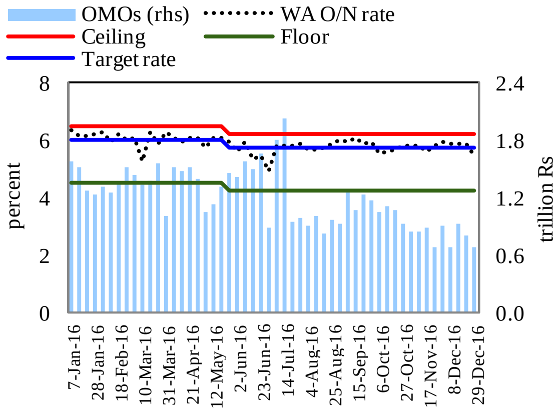


Source: State Bank of Pakistan

3.2 Money market developments

The policy rate remained unchanged throughout H1-FY17, and liquidity conditions in the interbank market eased further as the government continued to borrow from SBP. These were particularly helpful in the second quarter that marks the initiation of the credit cycle. The ease in liquidity conditions was reflected in multiple indicators: (i) the decline in overnight rates, which stayed on average just 1 basis point above the target rate during Q2-FY17 (**Figure 3.4**);[11] (ii) a steady fall in the outstanding level of OMO injections, which declined from Rs 1,147 billion at end-September to Rs 800 billion by end-December 2016; and (iii) limited use of the SBP's reverse repo facility by commercial banks.[12] Furthermore, with respect to long term rates, the 6-month KIBOR remained fairly stable – at around 6.1 percent – during H1-FY17.

Figure 3.4: SBP Interest Rate Corridor and OMOs



Source: State Bank of Pakistan

[10] Specifically, the average currency-to-deposit ratio during H1-FY17 rose to 35.0 percent.
[11] This compares to an upward deviation of 10 bps of the overnight rate from the target rate during the preceding quarter.
[12] Banks availed SBP's reverse repo facility only 6 days during Q2-FY17, compared to 10 days in the previous quarter. In terms of volume, commercial banks' borrowing from the SBP window amounted to Rs 65.6 billion during Q2-FY17, against Rs 503.9 billion during the previous quarter.

Notwithstanding this comfort in the interbank market, commercial banks' participation in the auctions of government papers was subdued during Q2-FY17 (**Table 3.2**). Unlike the first quarter, when the government (in gross terms) raised more than twice the combined targeted amount of Rs 300 billion, all PIB auctions during Q2 were scrapped. Not only were the offered volumes quite modest in comparison to targets, the rates quoted by commercial banks were also on a higher side. Given these conditions, and the fact that the government had sufficient funding available from other resources (SBP, external and domestic non-bank), the government rejected all the bids for PIBs during the quarter.

Table 3.2: Auction Profile of Government Securities*

billion Rupees

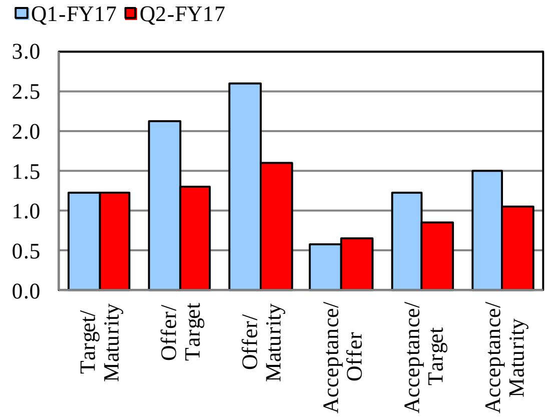
	T-bills			PIBs		
	Target	Offered	Accepted	Target	Offered	Accepted
Gross						
Q1-FY16	1,200.0	1,387.0	1,321.2	200.0	808.2	218.3
Q2-FY16	1,225.0	2,060.9	1,014.0	150.0	447.0	182.9
Q1-FY17	1,450.0	3,066.0	1,763.9	300.0	995.3	678.5
Q2-FY17	1,300.0	1,695.8	1,099.6	200.0	234.6	-
Net of maturities						
Q1-FY16	337.4	524.4	458.6	36.7	644.9	55.0
Q2-FY16	78.6	914.5	-132.4	150.0	447.0	182.9
Q1-FY17	272.0	1,887.9	585.9	-1,127.3	-431.9	-748.8
Q2-FY17	241.6	637.4	41.2	200.0	234.6	-

*includes non-competitive and special auction (in face value)

Source: State Bank of Pakistan

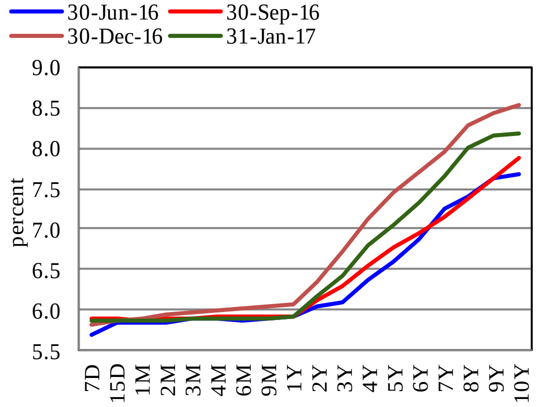
The pattern of low participation and high bid rates witnessed in PIB auctions was mirrored in T-bill auctions as well. Commercial banks placed bids amounting to 1.3 times the government's target in Q2-FY17, compared to more than double the target in the previous quarter (**Figure 3.5**). That said, unlike PIB auctions, the government met about 85 percent of the T-bill auction targets.

Figure 3.5: Key Ratios of T-bills Auction



Source: State Bank of Pakistan

Figure 3.6: PKRV Yield Curve



Source: State Bank of Pakistan

The first outcome of the PIB and T-bill auctions was a collective funding shortfall of about Rs 400 billion for the government, which it duly plugged via borrowings from SBP.[13] The second notable impact was a steepening of the longer segment of the yield curve (> 1 year maturity), especially between end-September and end-December (**Figure 3.6**).[14] This indicated the market's anticipation of a rise in inflation, and a possible bottoming out of policy rate – thereby increasing the term premium. Commercial banks' bidding behavior in the auctions of government papers – i.e., relatively greater inclination for T-bills over PIBs – is consistent with this line of reasoning. Nonetheless, as the actual inflation consistently turned out to be lower than market expectations (especially in November and December 2016), some correction in the longer segment of the yield curve was observed during January 2017.

3.3 Monetary aggregates

While most of the developments in monetary aggregates have already been discussed in **Section 3.1**, a few additional insights are being presented here:

(i) NFA of the banking system declined for the second consecutive quarter in FY17, which is in sharp contrast to the rise observed in the comparable quarters of FY16. Importantly, the stock of NFA of scheduled banks that turned negative back in May 2016, continued to decline further. This mainly represented higher FX liabilities incurred by some of the foreign banks operating in the country;

(ii) Credit to public sector enterprises (PSEs) increased by Rs 60.0 billion during H1-FY17. This increase is mainly attributed to financing raised for the completion of Neelum-Jhelum Power Project; back in June 2016 also,

[13] The government borrowed Rs 893 billion from SBP during H1-FY17, of which Rs 325 billion was during Q2-FY17.
[14] PKRV interest rates of less than one year tenor did not shift because these are more sensitive to changes in policy rate and overnight rate: the policy rate remained unchanged, and the overnight rate remained close to the target rate in the period under consideration.

the company had issued Rs 100 billion sukuk to get around financial constraints in the timely completion of the project;

(iii) The retirements under commodity loans in H1-FY17 were more than double the same in H1-FY16.[15] Higher retirements were primarily evident in two commodities: fertilizer and wheat. In the case of fertilizer, the government's subsidy program led to a higher off-take of both urea and DAP during *kharif* 2016; this enabled the Trading Corporation of Pakistan to settle its dues with commercial banks.

As for wheat, although the procurement agencies were able to retire more to commercial banks compared to last year, the outstanding stock of loans as well as the unsold stocks of wheat still remains high. Given the surplus availability of wheat in the country, the government (while maintaining the wheat support price at Rs 1,300 per 40 kg) took certain measures in FY17 to do away with the high level of unsold stocks. Firstly, it gave an extension (up to March 15, 2017) on the subsidy of US$ 120 per tons on the export of wheat, and increased the limit of export under the scheme by 400,000 tons to 1.3 million tones. Secondly, it raised the regulatory duty on wheat import further to 60 percent in H1-FY17, to avoid the building up of a glut-like situation in the market.[16]

3.4 Credit to private sector

The business climate in the country has been favorable for the last few years, on the back of stable macroeconomic environment, better energy and security conditions, and the initiation of mega projects in the country. While this continued to have a positive bearing on credit off-take in H1-FY17, further impetus to credit demand came from: (i) lagged impact of reduction in policy rate in May 2016; (ii) higher PSDP expenditures and CPEC related investments in the country, which triggered activity in construction and transport industries; and (iii) a recovery in input prices – especially cotton and coal – which supplemented the demand for working capital loans in sectors like textile and cement.

However, the swing factor in Q2-FY17 was the favorable supply-side conditions, as the government continued to make retirements to commercial banks, leaving them with sufficient resources to meet the funding needs of the private sector. In addition, deposit growth also remained slightly higher than last year; during Q2-

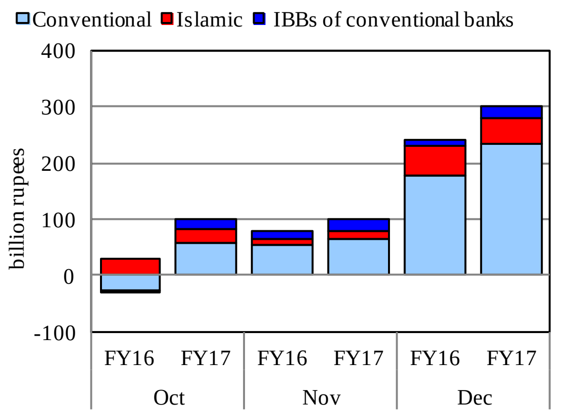
[15] Specifically, net retirements during H1-FY17 amounted to Rs 82.8 billion, compared to net retirements worth Rs 41.8 billion during H1-FY16.

[16] Back in Q4-FY16 also, the government had increased the regulatory duty from 25 percent to 40 percent.

FY17, total deposits with banks grew by 6.0 percent, compared to 5.3 percent in the comparable quarter last year.

The net result of these demand- and supply-factors was the significant increase in private sector borrowing during Q2-FY17. The increase in credit was evident in both working capital and fixed investment categories, and originated primarily from conventional banks (**Figure 3.7**).[17] The increase was particularly strong in the last week of December, when banks reported to have lent out Rs 229.9 billion to the private sector. However, the caveat came in the *first week* of January 2017, when Rs 111.5 billion was subsequently retired.[18]

Figure 3.7: Credit to Private Sector (Flows, by Type of Bank)



Source: State Bank of Pakistan

Manufacturing credit picked up despite slowdown in LSM

Within loans to private sector businesses, manufacturing firms accounted for 68.5 percent of the credit availed during Q2-FY17 (**Table 3.3)**. As is customary, textile units were amongst the large borrowers, with demand driven primarily by a pickup in cotton prices as well as an increase in textile exports – both in terms of quantum and value.[19]

By contrast, rising volumes – rather than prices – helps explain the higher credit demand by the sugar sector. The area dedicated to the sugarcane crop, as well as subsequent production – particularly in Punjab – exceeded the annual target for

[17] Particularly, energy and construction sectors continued to have high share in credit for fixed investment in FY17; moreover, cement, textile and food products & beverages also followed suit in the year despite having marginal credit availed for this purpose in FY16.
[18] Some commercial banks seem inclined to make temporary placements in the form of credit during the last week of the calendar and fiscal year – promptly followed by substantial retirements the next week.
To be precise, the first week refers here to the week extending from 30-Dec-16 to 6-Jan-17.
[19] Domestic cotton prices rose 15.3 percent YoY during Q2-FY17. For details of increase in quantum and value of textile exports during Q2-FY17, please see **Chapter 5**.

FY17.[20] As a result, demand for credit during the crushing season was also higher compared to last year.

Table 3.3: Loans to Private Sector Businesses (flows during Q2)
billion Rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY16	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**
Total loans to private businesses	255.7	420.2	149.9	279.3	56.4	94.3	49.4	46.6
1) Manufacturing	192.5	287.9	125.6	195.9	12.7	50.3	54.2	41.6
a) Textiles	91.3	123.0	66.2	84.5	4.3	19.5	20.8	19.0
Spinning, weaving, finishing	70.0	104.3	52.7	74.3	2.9	18.7	14.4	11.2
b) Food products & beverages	53.9	91.7	31.6	67.8	5.8	13.6	16.6	10.3
Rice processing	27.4	39.7	17.3	32.3	0.9	0.6	9.2	6.8
Sugar	10.4	39.8	3.9	26.9	5.2	8.1	1.3	4.8
c) Cement	0.7	14.1	1.4	5.4	-2.2	6.2	1.5	2.6
d) Chemicals	17.1	10.0	14.6	11.6	-0.1	-0.3	2.5	-1.2
Man-made fibers, other products	0.9	5.1	1.0	2.2	-0.1	2.6	0.0	0.3
Fertilizer	4.3	-3.4	6.7	5.3	-4.8	-5.8	2.4	-2.9
2) Electricity, gas & water supply	26.5	38.0	12.0	25.4	16.2	11.8	-1.7	0.9
3) Commerce and trade	23.2	28.1	24.3	23.2	-1.5	2.9	0.4	2.0
Retail trade	11.2	13.8	14.2	9.9	-4.1	1.9	1.1	2.0
Wholesale and commission trade	10.8	14.5	9.4	13.7	2.1	1.1	-0.6	-0.3
4) Construction	23.2	16.9	8.2	6.3	11.6	10.8	3.5	-0.1
5) Real estate, renting, business activity	8.8	12.1	6.7	7.2	2.4	5.6	-0.3	-0.6
6) Transport, storage/communication	12.8	2.5	-0.8	1.4	14.0	1.5	-0.3	-0.4
7) Agriculture	15.1	-6.5	14.2	-2.5	0.2	-4.5	0.7	0.6

Source: State Bank of Pakistan

Working capital demand from the cement sector traces its origin to higher production and local dispatches, on account of increased domestic construction activity as mentioned earlier. In addition, anecdotal evidence indicates that some major cement manufacturers are also gearing up for expansion, which explains the demand for fixed investment loans by the sector.

To sum up, sectors like sugar and cement availed significantly higher credit in the current period; this uptick is consistent with their stronger, individual contributions within LSM.[21]

[20] The frequent distress faced by cotton crop in past seasons and high support prices for sugarcane fixed by the government over the past several years made sugarcane a safer and more remunerative option for growers, leading to an increase in the area under the crop. For details, see **Chapter 2** in SBP's First Quarterly Report for FY17 on The State of Pakistan's Economy.

Energy sector's borrowing saw a shift in composition

While the borrowing for power projects last year had primarily been composed of long-term loans (classified as fixed investment), H1-FY17 saw a shift towards short-term (working capital) borrowing.[22]

It is also worth mentioning that import of power generating and electrical machinery amounted to Rs 276.3 billion during H1-FY17, while gross disbursement of fixed investment loans to the energy sector amounted to only Rs 101.2 billion in the same period. This implies that a large portion of machinery imports are not being financed by bank credit.[23] By contrast, the demand for working capital credit from energy firms appears to have increased on account of rising operational costs (purchase of various fuels), since the machinery already imported last year would now be in use.

Table 3.4: Consumer Financing
flows in billion Rupees

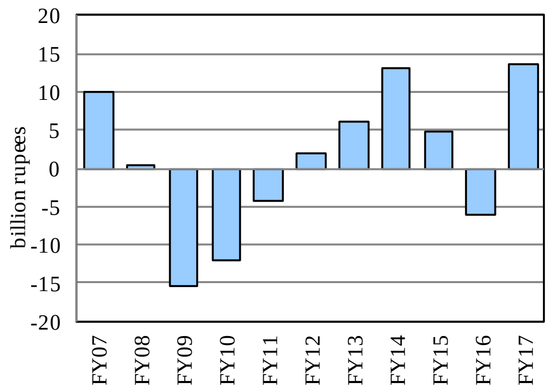
	Full-year		Jul-Dec		
	FY15	**FY16**	**FY15**	**FY16**	**FY17**
Total	32.0	25.5	13.1	9.9	37.6
Auto	21.0	26.8	8.2	11.8	15.7
Personal	9.1	-11.3	4.9	-6.0	13.7
House building	0.9	7.9	0.2	2.7	4.7
Credit cards	1.1	1.7	-0.1	0.8	2.8
Consumer durables	-0.1	0.4	-0.1	0.5	0.7

Source: State Bank of Pakistan

Consumer financing remained strong

Consumer financing posted an increase of Rs 37.6 billion during H1-FY17 (**Table 3.4**). Auto finance continued to be the dominant segment, while personal loans showed a pickup. The net credit off-take of Rs 13.7 billion of personal loans witnessed in H1-FY17 is the highest half-year figure in about a decade (**Figure 3.8**).

Figure 3.8: Personal Loans (Flows during H1)



Source: State Bank of Pakistan

[21] LSM grew by 3.9 percent during H1-FY17, as compared to the same growth witnessed in the H1-FY16 (see **Chapter 2 on Real Sector**).
[22] Specifically, fixed investment net credit off-take for electricity, gas and water supply was Rs 18.7 billion during H1-FY16, compared to Rs 22.5 billion in H1-FY17, whereas the corresponding working capital off-take rose from Rs 3.2 billion in H1-FY16 to Rs 17.7 billion in H1-FY17. Thus, despite the marginally higher fixed investment off-take in the current period in Rupee terms, the share of these long-term loans in total credit off-take declined considerably.
[23] For further discussion on machinery imports data, see **Box 5.1** in **Chapter 5**.

3.5 Inflation

Average CPI inflation rose to 3.9 percent in H1-FY17, from 2.1 percent in H1-FY16 (**Table 3.5**). This rise was mainly due to (i) fewer supplies of fresh vegetables;[24] (ii) a visible recovery in global prices of food commodities such as palm oil, rice and sugar;[25] (iii) the impact of taxation measures in Federal Budget for 2016-17 on various items such as cigarettes, powdered milk, stationery items and cement; and (iv) gradual build-up of domestic demand as evident in rising core inflation, especially non-food-non-energy (NFNE).

Table 3.5: CPI Inflation
percent

					Core	
	Overall	**Food**	**Non-Food**	**Energy**	**NFNE**	**Trimmed**
FY16						
Q1	1.7	0.3	2.7	-3.7	3.9	2.8
Q2	2.5	1.8	3.0	-1.2	3.8	2.8
H1	2.1	1.0	2.9	-2.5	3.8	2.8
Q3	3.8	3.3	4.1	1.7	4.5	3.5
Q4	3.5	3.0	3.9	0.1	4.5	3.7
FY17						
Q1	3.9	4.0	3.7	-1.6	4.6	3.6
Q2	3.9	3.6	4.1	-2.1	5.2	3.8
H1	3.9	3.8	3.9	-1.8	4.9	3.7

Source: Pakistan Bureau of Statistics and State Bank of Pakistan

Importantly, the combined impact of these factors on overall CPI would have been higher if not for the continued YoY fall in prices of motor fuel and transport services in the quarter.[26] Moreover, stability in the PKR in Q2-FY17 also played a role in taming inflation. The H1 inflation of 3.9 percent YoY is quite below the target of 6.0 percent set in the Annual Plan for 2016-17.

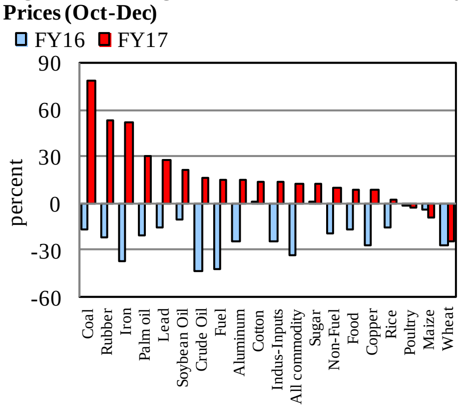
Stepping back, the prices of fresh vegetables remained high in both the quarters of H1-FY17; it posted the highest increase of 19.2 percent in Q2-FY17 among the 20 heaviest items in the CPI basket. This is in comparison with only 1.9 percent increase during the same period last year. Not only did the dry weather affect the domestic production of certain vegetables (especially garlic and turnip), but the crackdown on informal trade also disrupted imported supplies.[27] Nonetheless,

[24] Fresh vegetables mainly include peas, chilies, garlic, ginger, carrots, cucumbers, turnips, cauliflower, spinach, lemon/limes, etc. These do not include potatoes, tomatoes and onions, the price data for which is reported separately.
[25] The rise may also be attributed to the base effect, as the price of few heavy weight items in CPI that fell sharply last year, either increased during Q2-FY17 (cooking oil/ghee, and rice) or posted a marginal decline (motor fuel) during Q2-FY17.
[26] These two have a combined weight of 5.7 percent in the overall CPI.
[27] For instance, cauliflower, spinach, and lemon & limes imports dropped to 1.9, 0.2, and 2.6 metric ton in Jul-Oct FY17, from 2.1, 1.0 & 5.1 metric ton, respectively in the same period last year.

compared to Q1-FY17, when the increase in vegetable prices was broad-based, it was concentrated in few items during Q2-FY17.[28]

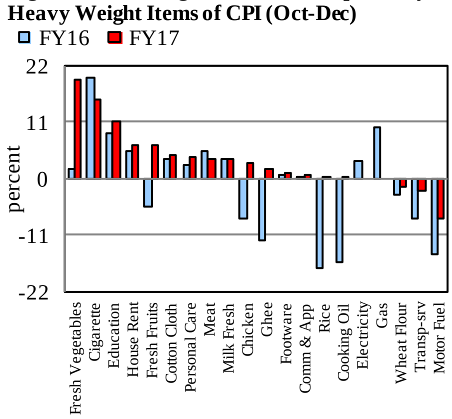
Meanwhile, global prices of a number of edible commodities recovered in Q2-FY17 (**Figure 3.9**), and have recently started influencing domestic inflation **(Figure 3.10**). Specifically, the trend of falling domestic prices of rice, cooking oil, ghee, and sugar till Q1-FY17, reversed during Q2-FY17. Moreover, due to imposition/enhancement of taxes in the Federal Budget for 2016-17, many consumer items (such as cigarettes, powdered milk, and stationary items) also contributed to pushing up inflation.[29] Cement prices also increased as the government changed the modalities in duty structure.[30]

Figure 3.9: Changes in Selected Global Commodity Prices (Oct-Dec)



Source: International Monitoring Fund

Figure 3.10: Changes in Prices of Top Twenty Heavy Weight Items of CPI (Oct-Dec)



Source: Pakistan Bureau of Statistics

Apart from these items, prices of health and education services recorded significant increases of 8.1 and 11.3 percent in Q2-FY17, compared with only 2.7 and 8.8 percent respectively in Q2-FY16. Price of health services and related items rose mainly due to upward revision in medicine prices following the approval of Drug Regulatory Authority of Pakistan (DRAP).[31] In case of

[28] In Q1-FY17, most of the fresh vegetables like brinjal, bottle gourd, okra, tinda, turai, karaila, chilies (green) and garlic recorded more than 20 percent inflation. However, in Q2-FY17, a number of vegetables recorded a sharp fall in prices like bottle gourd, lady finger/okra, peas, tinda, turai, karaila, arvi, carrot and ginger, whereas garlic and turnip recorded 66.5 and 22.3 percent inflation, respectively.
[29] For instance cigarettes and cement recorded inflation of 15.3 and 5.2 percent in Q2-FY17, compared with 19.8 and -1.2 percent in Q2-FY16, respectively.
[30] For details see **Chapter 3** in SBP's First Quarterly Report for FY17.
[31] Via S.R.O. 628 (I)/2016 dated July 22, 2016, DRAP, Ministry of National Health Services, Regulations and Coordination.

education, the increase mostly represents an early revision of educational fees in FY17 compared to FY16.[32] These changes also fed into the steady rise in core inflation: NFNE rose to 5.2 percent in Q2-FY17 compared to an average of 4.5 percent in the previous three quarters.

The only group whose prices fell in Q2-FY17 was transport.[33] This represented the lagged impact of the fuel price cuts announced by the government in Jan-Mar 2016.[34] However, the seven-month stability in POL prices came to an end when the government eventually lifted petrol and diesel prices in December 2016.[35] Its impact on CPI inflation will be reflected in subsequent months.

Outlook

The OPEC agreement to cut output in the later part of Q2-FY17 caused a rising trend in crude oil prices, as these have recovered by 25.0 percent between November 2016 and February 2017.[36] As anticipated, the government has partially passed on its impact to domestic consumers from mid-January 2017 onwards.[37]

The following factors may contribute to domestic inflation during the remaining months of FY17:

i) Global commodity and oil prices are expected to move in upward direction, which will be affecting domestic inflation.
ii) The construction component of WPI is showing a robust increase recently, which may transmit to wages and prices of construction items in CPI. [38] Moreover, as construction cost is reflected in house rent, an upward revision

[32] In FY16, education fees were revised upward in Q3, whereas in FY17, these were increased in Q2.
[33] Transport group prices fell by 3.3 percent for Q2-FY17, compared with 8.6 percent in Q2-FY16.
[34] The government had slashed petrol and diesel prices by a cumulative Rs 13.5 and 12.5 per liter, respectively during Jan-Mar 2016.
[35] In December 2016, the government announced Rs 2 and Rs 2.70 per liter increase in prices of petrol and high speed diesel, respectively – this is the first increase since April 2016. A month earlier, OMCs had increased the price of HOBC following the deregulation of the market of this fuel.
[36] Saudi Arabian light oil was traded at US$ 43 and US$ 45.4 per barrel on the eve of US elections on November 8, 2016, and November 30, 2016 – the day OPEC agreed on the production cut. On March 6, 2017, its trading was averaged at US$ 54.2 per barrel.
[37] From mid January to 1st March 2017, the government has increased petrol and high speed diesel prices on four occasions, cumulatively by Rs 6.7 per liter and Rs 6.8 per liter, respectively. Furthermore, price of CNG has also gone up by Rs 1.7 per kg during Jan-Feb 2017, following the deregulation of CNG sector in December 2016 (vide Ministry of Petroleum and Natural Resources notification no. CNG-7(9)/16-Price, dated December 16, 2016).
[38] Construction input items of WPI include glass sheets, other glass articles, ceramics & sanitary, bricks blocks & tiles, cement, steel bars & sheet and pipe fittings.

in house rent index – the largest component of CPI, may also put upward pressure in the CPI inflation.

iii) On the flip side, recent rains will likely improve supply conditions of wheat and perishables food items, which will help mitigate inflationary pressures.

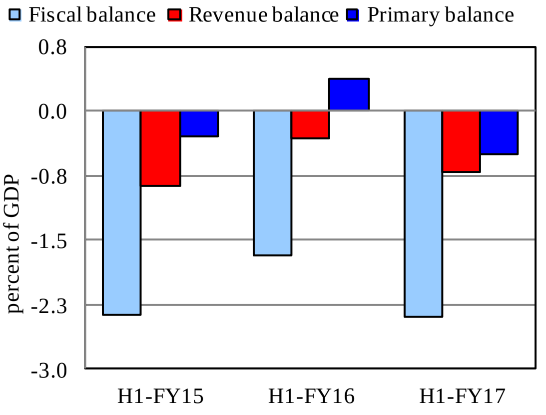
Thus, on balance, we expect the annual CPI inflation to remain close to 4 percent during FY17.

4 Fiscal Policy and Public Debt

4.1 Overview

Increase in development and security related expenditures amid a decline in revenue collection, has led to an increase in the fiscal deficit to 2.4 percent of GDP in H1-FY17 from 1.7 percent in the corresponding period of last year. The primary balance turned into a deficit of 0.5 percent of GDP in H1-FY17, from a surplus in FY16 **(Figure 4.1)**.

Figure 4.1: Fiscal Indicators



Source: Ministry of Finance

A sharp contraction in non-tax revenues, mainly on account of non-realization of Coalition Support Fund (CSF) and lower SBP profits dragged down the growth in total revenues during H1-FY17.[1] Moreover, despite higher collection in Q2-FY17, the growth in tax revenues remained lower than envisaged at the start of the fiscal year. This slowdown was broad-based, as the growth in both direct and indirect taxes was almost half their respective growth rates observed in the last year.

Here, it must be acknowledged that the slowdown in tax revenue collection is partly due to several tax incentives announced to promote investment and boost economic activity in the country; this includes the reduction in the corporate tax rate. Besides, in the wake of recently announced incentives – especially the export package and the tax exemptions for some CPEC-related projects – accelerating revenue collection during the remaining part of FY17 may also be challenging.[2]

[1] However, US$ 550 million were received under CSF in Q3-FY17.

[2] Under Prime Minister Package of Incentives for Exporters, the government: (i) allowed duty draw back up to 7.0 percent on the export of garments, home textiles, processed fabric, Greige fabric and yarn manufacturing cum exporters units (vide ministry of textile SRO No. 1(42) TID/17-RDA); (ii) exempted custom duty on import of raw material for textile (vide FBR S.R.O. No. 39(I)/2017); and, (iii) exempted sales tax on import of textile machinery (vide. FBR S.R.O. No.36 (I)/2017). Similarly,

On the expenditure side, due to higher security-related spending to further improve the overall law and order situation in the country, the trends in current expenditure observed in Q1-FY17 could not be sustained into Q2-FY17. Encouragingly, despite the fiscal strain, development spending was not compromised during the period (**Table 4.1**).

Similar to Q1-FY17, the government largely financed the fiscal deficit in the second quarter by borrowing from SBP, while making retirements to commercial banks. Moreover, sizeable financing was available from external and non-bank sources during H1-FY17. Interestingly, despite the higher fiscal deficit, the pace of accumulation of public debt remained lower than the last year. This reflects drawdown in government's deposits with the banking system, and revaluation gains on external debt.

4.2 Revenues

The total revenue collection declined by 0.7 percent during H1-FY17 after recording an increase of 14.6 percent in H1-FY16. This decline mainly stemmed from a 31.8 percent fall in non-tax revenues (on account of non-realization of CSF in H1-FY17, lower SBP profit, and decline in dividend income). Encouragingly the pace of tax collection recovered in the second quarter from Q1-FY17, though the cumulative growth in tax revenues remained considerably lower at 6.2 percent in H1-FY17 as compared to the 20.4 percent YoY increase realized last year (**Table 4.1**).[3] The slowdown largely came from the FBR's tax collection as provincial tax collection grew by 19.1 percent during H1-FY17, on top of 28.8 percent growth recorded in the last year.

<u>FBR taxes</u>

The growth in FBR's tax collection remained subdued at 7.0 percent during H1-FY17, against a robust 17.0 percent increase recorded in the corresponding period last year **(Table 4.2).** The recovery in direct taxes in Q2-FY17 was partially offset by a slowdown in indirect tax collection.

On the surface, the broad-based deceleration in both direct and indirect tax collection can be interpreted as an unintended consequence of fiscal measures to

vide FBR S.R.O. No.735 (I)/2016, Chinese construction companies were allowed income tax exemption under some CPEC projects.

[3] Tax collection grew by 8.2 percent in Q2-FY17, compared to the 3.2 percent increase recorded in Q1-FY17.

Table 4.1: Summary of Fiscal Operations

		Actual		% of GDP*	
	Budget	**H1-FY16**	**H1-FY17**	**H1-FY16**	**H1-FY17**
A. Total revenue	5347.0	2,004.9	1,990.6	6.8	5.9
Tax revenue	4,306.0	1,639.1	1,741.2	5.5	5.2
Non-tax revenue	1,041.0	365.9	249.4	1.2	0.7
B. Total expenditure	6,623.0	2,520.1	2,789.7	8.5	8.3
Current	5,198.0	2,104.4	2,241.6	7.1	6.7
Interest payments	*1,360.0*	*632.4*	*647.4*	2.1	1.9
Defence	860.2	303.3	336.3	0.5	1.0
Development	1,435.0	426.2	497.4	1.4	1.5
Net lending	-10	-1.8	-6.4	0.0	0.0
C. Statistical discrepancy	0	-8.6	57.2	0.0	0.2
Fiscal balance (A-B-C)	-1,276.0	-515.2	-799.1	-1.7	-2.4
Revenue balance	149.0	-99.5	-251.0	-0.3	-0.7
Primary balance	84.0	117.2	-151.7	0.4	-0.5
Financing	1,276.0	515.2	799.1	1.7	2.4
External sources	234.0	203.2	240.9	0.7	0.7
Domestic sources	1,042.0	311.9	558.2	1.1	1.7
Banks	453.0	183.3	407.1	0.6	1.2
Non-bank	539.0	128.7	151.1	0.4	0.5
Privatization	50.0	0.0	0.0	0.0	0.0
% Growth					
Total Revenue		14.6	-0.7		
Tax revenue		20.4	6.2		
Non tax revenue		-5.7	-31.8		
Total Expenditure		5.0	10.7		
Current		5.8	6.5		
Development		32.6	16.7		

* Targeted GDP for FY17
Source: Ministry of Finance

support investment and economic activity in the country.[4, 5] It also highlights the continuing structural weaknesses in the tax system, which currently is narrowly

[4] The government offered tax incentives to the agriculture sector through sales tax exemption on pesticide and fertilizer. Similarly, five major exports-oriented sectors – textile, leather, surgical and sports goods, and carpets – were allowed zero-rating facility. In addition, petroleum prices were subsidized to provide relief to consumers. Moreover, customs duty on the import of raw cotton, staple, nylon and acrylic fibers was exempted (vide S.R.O. No. 39(I)/2017), and sales tax exemption was allowed on the import of new textile machinery (under SRO No.36 (I)/2017).

[5] Similarly, lower petroleum prices during the period have led to a decline in sales tax collection. An increase in FED on cigarettes resulted in increased usage of smuggled cigarettes (as also reflected in 31 percent decline in its production during H1-FY17) and a decrease in tax collection.

based and skewed towards indirect taxes. However, the government has taken a number of measures to improve the taxation structure, as a part of the continuous reforms agenda, encompassing both policy and administrative dimensions. Such efforts will go a long way in improving the country's tax system in years to come.

Table 4.2: FBR Tax Collection
billion rupees

	Budget FY17	Collections H1		% growth H1	
		FY16	**FY17**	**FY16**	**FY17**
Direct taxes	1,558.0	540.8	586.4	17.8	8.4
Indirect taxes	2,063.0	830.1	880.9	16.4	6.1
Customs duty	413.0	177.9	218.0	31.5	22.6
Sales tax	1,437.0	578.5	577.5	12.6	-0.2
FED	213.0	73.7	85.4	15.2	15.9
Total taxes	3,621.0	1,370.9	1,467.3	17.0	7.0

Source: Federal Board of Revenue

Direct taxes

Enabled by a sharp recovery in Q2-FY17, direct tax collection grew by 8.4 percent during H1-FY17; however, it still remained lower than the 17.8 percent increase recorded in H1-FY16.[6] It is worth mentioning that some slowdown in direct taxes was expected on account of reduction in the corporate tax rate. The other main factor was a decline in commercial banks' profits, and a moderate pace of increase in corporate profitability.[7]

Within the direct taxes, the growth in withholding tax (WHT), which accounts for 67 percent of direct taxes, decelerated to 10 percent in H1-FY17 from 20.0 percent in the last year. Similarly, growth in voluntary tax payments (with a 28 percent share) fell to 6.6 percent in H1-FY17 from 21.0 percent increase in the last year. Collection on demand was the only component that rebounded sharply, growing by 32.2 percent during H1-FY17 after declining 27.7 percent last year.[8] However, its share in direct taxes is only 5 percent.

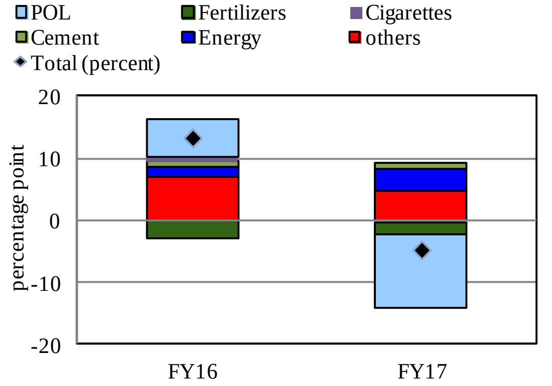
Indirect taxes

The growth in indirect tax collection in Q2-FY17 (at 1.6 percent) could not maintain the pace observed in the first quarter (12.2 percent). As a result, the half-

[6] Direct tax collection increased by 17.2 percent year-on-year in Q2-FY17 against a decline of 2.5 percent in Q1-FY17.
[7] However, corporate profitability seems to have recovered in the second quarter of FY17.
[8] This sharp increase can be attributed to the introduction of risk based audit, with audit of individuals more likely to evade taxes.

yearly growth fell to 6.1 percent from 16.4 percent last year. The major drag came from a decline in sales tax collection, which was partially offset by a steady growth in customs duty and federal excise duty.

Figure 4.2: Contribution in Growth of Domestic Sales Tax Collection (Jul-Dec)



Source: Federal Board of Revenue

Sales tax collection, which accounts for 66 percent of indirect taxes, declined marginally by 0.2 percent during H1-FY17. The disaggregated analysis shows that drag was due to sharp decline in domestic sales tax collection by 4.7 percent. However, most of this was offset by a 3.7 percent increase in sales tax collection on imports. Major revenue spinners, including POL, fertilizer, and natural gas contributed to decline in domestic sales tax collection (**Figure 4.2**).[9] These more than offset higher sales tax collection from electrical energy and cement sectors. Improved electricity generation and steady growth in cement sales – reflecting ongoing work on several CPEC projects – led to higher collection from these segments.

The decline in collection from fertilizer was due to reduction in sales tax under the package announced for farmers last year under the agriculture package. Related to this, the decline in collection from natural gas was due to reduction in prices of the natural gas for feedstock.[10] In addition, an increase in FED on cigarettes resulted in loss of revenue from sales tax through lower sales of locally manufactured cigarettes.

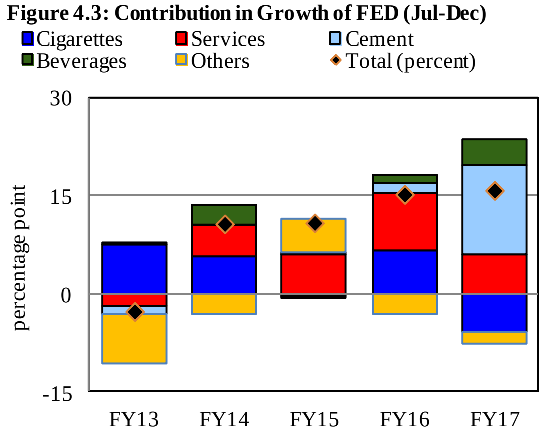
[9] The decline in sales tax collection from petroleum can be traced to the government's decision to keep fuel prices unchanged by absorbing the increase in international prices. This dented tax revenues through two ways: (a) lower revenues from the change in sales tax structure of POL from fixed rate to ad valorem (lower price means low revenues); and (b) lower revenues due to the decrease in sales tax rates.

[10] In April 2016, OGRA reduced feedstock prices for fertilizer manufacturers to Rs 123 per MMBTU from Rs 200, and it reduced fuel prices for electricity firms to Rs 400 from Rs 600 per MMBTU in December 2016.

Collection from customs duty grew by 22.6 percent during H1-FY17 compared to the 31.5 percent growth realized during the previous year. This sustained increase in customs duty was a natural outcome of the substantial increase in imports: both due to higher demand for machinery and raw materials and the increase in global commodity prices, mainly oil and cotton. Although the government announced some tax exemptions on CPEC-related machinery imports, its impact was not significant given the overall import volume.[11,12] Therefore, customs duty continues to remain a dependable source of revenue generation. Further, changes in tariff structure (especially for higher slabs) and an increase in rates for iron and steel also resulted in higher custom duty collection.[13,14]

FED collection grew by 15.9 percent during H1-FY17 compared to 15.2 percent growth in the last year (**Figure 4.3**). This steady increase was mainly contributed by higher production of cement and beverages.[15]

Figure 4.3: Contribution in Growth of FED (Jul-Dec)



Source: Federal Board of Revenue

As mentioned earlier, the increase in the FED rate on cigarettes reduced the demand for locally manufactured sticks and simultaneously boosted that for non-taxed/smuggled brands; ultimately collection from cigarettes (which constitutes around one third of overall FED collection), declined by 13.3 percent during H1-FY17. In response,

[11] The value of import (PBS) has grown by around 10 percent during H1-FY17. Specifically, import of machinery increased by 40.8 percent YoY in H1-FY17.

[12] Federal budget for FY17 reduced the custom duty on import of machinery and raw materials from 5 to 3 percent.

[13] In the Federal budget for FY17, the number of custom duty slabs was reduced to 4 from 5: (i) 2 percent and 5 percent slabs were merged into a new 3 percent slab; (ii) 10 and 15 percent slabs were replaced with new 11 and 16 percent slabs; and (iii) the 20 percent slab was kept unchanged.

[14] FBR vide S.R.O. No. 614(I)/2016 withdrew exemptions on the import of articles of iron and steel.

[15] Specifically, collection from cement grew 16.2 percent to Rs 28.6 billion during H1-FY17. Besides higher production, it also reflects the change in duty structure. In the budget FY17, the FED rate of 5 percent on retail cement prices was replaced with a fixed rate of Re 1/kg. Moreover, collection from beverages increased by over 40 percent (an outcome of both an increase in the FED rate and production). Similarly, collection from air travel services increased by 28.6 percent.

FBR started a crackdown against illicit cigarettes to harness the true revenue potential from this source.[16]

Non-tax revenues

Non-tax revenues declined by 31.8 percent during H1-FY17 compared to a fall of 5.7 percent recorded in the last year. This sharp decrease was broad-based except for increase in mark-up income, passport fee and others. As mentioned earlier, non-receipt of CSF in H1-FY17 remained the major drag, while SBP profit and dividend income also remained considerably lower as compared to last year (**Table 4.3**).

Table 4.3: Non-tax Revenues

billion rupees

	Budget FY17	Actual H1	
		FY16	FY17
Mark-up (PSEs & others)	81.1	2.2	8.9
Dividends	85.0	31.4	12.2
SBP profits	280.0	122.6	87.8
Defense (incl. CSF)	171.0	78.2	4.6
Profits from post office/PTA	81.0	5.3	0.6
Royalties on gas & oil	43.0	31.5	24.4
Passport & other fees	25.0	6.2	7.1
Discount retained on crude oil	10.0	4.2	3.6
Windfall levy	10.0	1.4	0.5
Other	254.9	82.8	99.7
Total non-tax revenue	**1,041.0**	**365.9**	**249.4**

Source: Ministry of Finance

SBP profit declined by 28.4 percent in H1-FY17 due to lower interest rates and reduced stock of government borrowing from SBP during the previous two fiscal years.[17] Similarly, market reports suggest that some Public Sector Enterprises (PSEs) reported decline in their profits during the first two quarters of FY17, leading to lower dividend income for the government.

4.3 Expenditures

Consolidated fiscal spending grew sharply by 10.7 percent during H1-FY17 compared to the 5.0 percent growth realized in previous year. This acceleration in expenditure growth was mostly due to 6.5 percent increase in current expenditures, which account for 80 percent of total expenditures. Development spending also increased but at a lower rate of 16.7 percent relative to the 32.6 percent increase witnessed in last year.

The higher growth in current expenditures was largely due to an increase in spending on defense and maintenance of public order and safety. On an

[16] FBR constituted a joint committee to curb the manufacturing/trading of illicit cigarettes in its 2nd Chief Commissioner Conference held on 6th January 2017 (Source: http://download1.fbr.gov.pk/Docs/20171271511821401DecisionsTakenRegardingTobaccoSector.pdf)

[17] During FY15 and FY16, government had retired Rs 434 billion and Rs 475 billion respectively.

encouraging note, the rise in interest payments was contained to just 2.4 percent during H1-FY17, against an increase of 10.4 percent seen in H1-FY16 (**Table 4.4**). The moderate increase in interest payments (despite lower interest rates) was due to elevated debt stocks during the period.

A break up of Public Sector Development Program (PSDP) reveals that infrastructure development, power generation, and social sector remained the top priority of the federal government during H1-FY17. In this regard, Rs 80.1 billion were released for the construction of roads and highways, Rs 54.3 billion for power related projects; and Rs 14 billion for the development of railways. Apart from this, Rs 20.8 billion were spent on development of special areas including AJK, Gilgit-Baltistan and FATA; another Rs 42.6 billion was released for the rehabilitation of temporarily displaced persons and Rs 20 billion for achieving Sustainable Development Goals (SDGs).[18]

Table 4.4: Fiscal Spending During H1
billion rupees

	Actual		% Growth	
	FY16	**FY17**	**FY16**	**FY17**
Current expenditures	**2104.4**	**2241.6**	**5.8**	**6.5**
Federal	1436.7	1473.5	3.7	2.6
Interest payment	632.4	647.4	10.4	2.4
Defense	303.3	336.3	-8.0	10.9
Public order and safety	47.0	51.4	7.3	9.4
Others	454.0	438.4	3.3	-3.4
Provincial	667.7	768.1	10.7	15.0
Development expenditures	**426.2**	**497.4**	**32.6**	**16.7**
PSDP	378.0	445.7	40.3	17.9
Federal	155.8	198.3	24.1	27.3
Provincial	222.1	247.4	54.3	11.4
Others (incl. BISP)	48.2	51.7	-7.3	7.2
Net lending	**-1.8**	**-6.4**	**-118.8**	**256.9**
Statistical discrepancy	**-8.6**	**57.2**	**-110.6**	**-765.1**
Total expenditure	**2520.2**	**2781.8**	**5.0**	**10.7**

Source: Ministry of Finance

4.4 Provincial fiscal operations

The overall provincial surplus reached Rs 90.6 billion in H1-FY17 -approximately one-fourth of the full-year target of Rs 339 billion; this was down sharply from the surplus of Rs 208.6 billion that the provinces had provided in H1-FY16 (**Table 4.5**). The YoY decline in the consolidated provincial surplus in H1-FY17 was due to a deficit of Rs 32.9 billion shown by Punjab; simultaneously, Sindh and KPK also posted lower surpluses as compared to last year.

[18] Source: PSDP 2016-17, status of releases as on 06-01-2017, Ministry of Planning, Development & Reform. The sum of these numbers may not tally with the PSDP data shown in Table 4.4, which also includes provincial PSDP (for which breakup is not available).

Table 4.5: Provincial Fiscal Operations
billion rupees

	Punjab	Sindh	KPK	Balochistan	Total
H1-FY17					
A. Total revenue	503.5	293.5	159.6	107.6	1064.2
Share in federal revenue	410.4	220.6	136.8	99.4	867.1
Taxes	71.4	64.3	7.0	3.0	145.7
Non-taxes	12.4	3.5	17.5	2.0	35.4
Federal loans and transfers	9.3	5.1	-1.7	3.3	15.9
B. Total expenditure	490.2	263.2	193.6	75.0	1022.0
Current	348.6	210.8	146.6	68.6	774.6
Development	141.7	52.4	47.0	6.3	247.4
Gap (A-B)	13.3	30.2	-34.0	32.6	42.2
Financing (overall Balance)	**32.9**	**-37.4**	**-49.6**	**-36.4**	**-90.6**
H1-FY16					
A. Total revenue	496.8	293.0	165.0	96.2	1051.0
Share in federal revenue	415.6	227.1	140.0	85.4	868.1
Taxes	60.7	53.9	6.0	1.8	122.4
Non-taxes	15.7	2.5	10.9	2.1	31.3
Federal loans and transfers	4.7	9.5	8.1	6.9	29.2
B. Total expenditure	453.8	215.6	148.6	77.8	895.8
Current	312.4	178.7	116.5	66.0	673.7
Development	141.4	38.8	32.1	11.8	224.1
Gap (A-B)	43.0	77.4	16.4	18.4	155.2
Financing (overall Balance)	**-36.0**	**-88.9**	**-62.0**	**-21.7**	**-208.6**

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

On the revenue side, provincial collections increased by 17.2 percent on account of gradually rising collection from sales tax on services, followed by stamp duty and motor vehicle tax. Against expectations, collection from property taxes decreased by 6.8 percent, taking hit from property tax collection in Punjab. Relatively subdued market activity following the revision in property valuation rates could be a possible cause of this decline.

On the expenditure side, a major reason for the reduction in the provincial surplus was a sharp 15 percent increase in spending by provinces in H1-FY17; this was particularly true for Sindh and KPK. In addition, spending on ongoing infrastructure development projects increased by 10.4 percent. On the contrary, Balochistan posted a higher surplus due to lower development spending.

4.5 Public debt

Despite a higher fiscal deficit, the pace of public debt accumulation slowed down in H1-FY17 compared to the last year. Encouragingly, this slowdown was broad-based and largely driven by net retirements during Q2-FY17 (**Table 4.6**). The decline in external debt was mainly due to revaluation gains, while drawdown in government deposits with the banking system helped to contain its borrowing from domestic sources in the second quarter.

Table 4.6: Pakistan's Public Debt Profile
billion rupees

	Stock		Share in total		Flow			
					H1		FY17	
	Jun-16	Dec-16	Jun-16	Dec-16	FY16	FY17	Q1	Q2
Gross Public debt (FRDLA definition)*	1,9676.7	20,272.2	100.0	100.0	1,095.5	595.5	866.1	-270.6
Govt. domestic debt	13,625.9	14,192.6	69.2	70.0	687.1	566.7	759.8	-193.2
Govt. external debt	5,417.7	5,460.7	27.5	26.9	303.0	43.0	97.3	-54.4
Debt from the IMF	633.1	619.0	3.2	3.1	105.5	-14.1	8.9	-23.0
External liabilities	377.1	365.0			2.2	-12.2	-1.1	-11.1
Net public debt**	17,823.2	18,385.7			706.3	562.4	458.0	103.6

*Fiscal Responsibility and Debt Limitation Act, 2005 (FRDLA) was amended in June 2016 to define "Total Public Debt" as "The debt of the government serviced out of consolidated fund and debts owed to International Monetary Fund (IMF)".
**Gross public debt minus government deposits with the banking system.
Source: State Bank of Pakistan

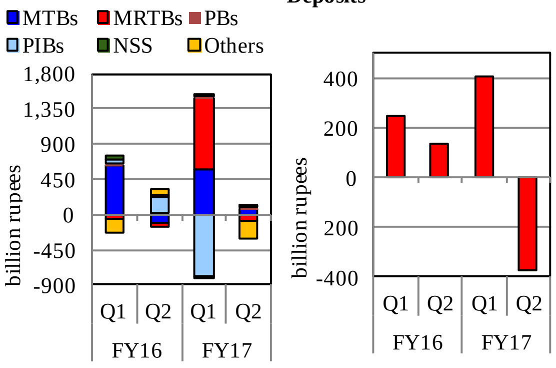
<u>Domestic debt</u>

Domestic debt increased by Rs 566.7 billion in H1-FY17, lower than the accumulation of Rs 687.1 billion witnessed in the same period last year. The entire increase came from short-term debt, as there was net retirement of long-term debt during the period.

Unlike Q1-FY17, when the government had mobilized substantial funding through T-bills and made hefty retirements of PIBs, Q2-FY17 witnessed only a marginal increase in the stock of T-bills and almost no change in PIBs. Moreover, the government retired maturing Sukuk of Rs 212 billion and MRTBs worth Rs 94.1 billion, which led to an overall decline in the domestic debt. To meet its budgetary requirements, the government utilized its deposits with the banking system. As evident in **Figure 4.4**, these declined by

Figure 4.4: Change in Domestic Debt

Change in the Government Deposits



Source: State Bank of Pakistan & Central Directorate of National Savings

Rs 374.2 billion during Q2-FY17, after rising by Rs 407.3 billion in Q1-FY17.

The bidding pattern of government securities in Q2-FY17 suggests that banks were expecting an increase in interest rates in view of the YoY increase in inflation and the widening of the current account deficit. In this backdrop, banks offered only Rs 234.6 billion in PIBs in Q2-FY17, compared with Rs 1.7 trillion offered for T-bills in the same period (**Table 4.7**). Within T-bills, around two-third of the amount was offered in 3-month tenor.

Table 4.7: PIB and T-bills Auction Profile*

billion rupees

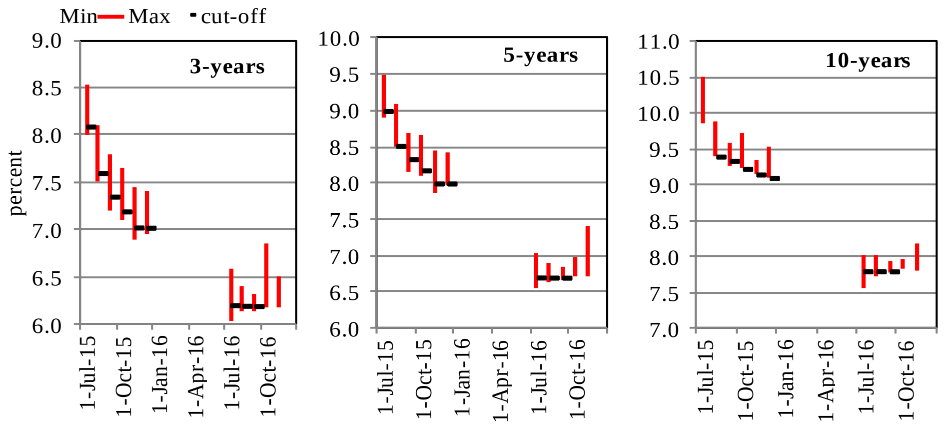
	Target	Offer	Accepted	Maturity**
Q1-FY17				
T-bills	1,450.0	3,065.9	1680.4	1,178.0
PIBs	300.0	995.3	678.5	1683.9
Total	**1,750.0**	**4,061.2**	**2358.9**	**2,861.9**
Q2-FY17				
T-bills	1,300.0	1,695.8	1048.4	1,058.4
PIBs	200.0	234.6	0	35.5
Total	**1,500.0**	**1,930.4**	**1048.4**	**1,093.9**
Grand total H1-FY17	**3,250.0**	**5,991.6**	**3407.3**	**3,955.8**

* Face value and competitive bids only; ** Principal plus coupon payments for PIBs

Source: State Bank of Pakistan

Understandably, the minimum rate asked by banks in the two auctions conducted in Q2-FY17 was higher than the last cut-off rates (**Figure 4.5**). Any acceptance in these PIB auctions may have signaled a reversal in long-term interest rates, which, in turn, would have had implications for the market's short-term interest rate expectations.

Figure 4.5: Bid-pattern in PIB Auction



Fund mobilization through NSS

Unfunded debt, mainly comprising National Savings Schemes (NSS), continued to slide in H1-FY17 (**Table 4.8**), as returns offered on most of the instruments remained relatively lower than in previous years**.** In H1-FY17, the government mobilized Rs 338 billion in gross terms through NSS, substantially lower than the Rs 412 billion realized in H1-FY16.

An instrument-wise breakup shows that Behbood Saving Certificate (BSC) was the major contributor. This is understandable, as this scheme not only offers relatively higher returns but is also exempted from withholding tax and Zakat deduction.

Table 4.8: Receipts under NSS Instruments
billion rupees

	H1-FY15		H1-FY16		H1-FY17	
	Gross	**Net**	**Gross**	**Net**	**Gross**	**Net**
DSC	23.7	8.6	13.3	1.1	25.2	13.4
SSC	124.0	28.0	87.1	4.9	41.1	-5.2
RIC	85.3	40.3	35.3	-5.3	24.8	-15.9
BSC	68.0	26.5	80.3	39.5	75.5	31.2
SSA	96.9	54.6	77.1	25.3	38.0	18.2
Others	107.6	9.6	119.0	11.8	133.4	12.2
Total	505.4	167.5	412.1	78.9	338.0	53.8

Source: Central Directorate of National Savings (CDNS)

Among other schemes, DSC attracted higher inflows during the period, partly due the higher returns it offers over longer tenor.[19] While the government frequently revised DSC rates down to align them with the relevant rates on PIBs, these are still higher than market return on longer tenor PIBs.

Public external debt & liabilities

In H1-FY17, Pakistan's external debt growth slowed considerably, primarily due to currency revaluation gains. Therefore, external debt increased merely by US$ 129.8 million despite the government availing a cumulative US$ 2.7 billion from Sukuk bond, commercial borrowings, and loans from China (**Table 4.9**).

Table 4.9: Pakistan's Public External Debt & Liabilities
million US$

					H1	
	Jun-15	**Dec-15**	**Jun-16**	**Dec-16**	**FY16**	**FY17**
Public external debt	54,673.6	56,985.4	61,356.7	61,486.5	2,312.8	129.8
Government debt	46,861.2	48,375.6	51,713.7	52,098.7	1,514.4	385.1
IMF	4,103.0	4,988.6	6,043.0	5,905.6	885.6	-137.3
External liabilities	3,709.4	3,621.2	3,600.0	3,482.1	-88.2	-117.9

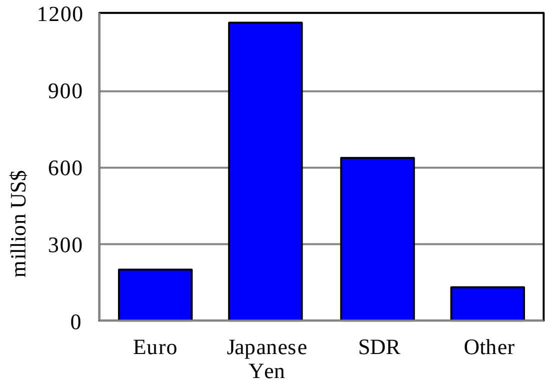
Source: State Bank of Pakistan

The impact of fresh external borrowing was largely offset by revaluation gains of approximately US$ 2.1 billion during H1-FY17. Out of this, the major

[19] DSC offers low return in initial five years and higher return in the final five years

contribution came from depreciation of Japanese Yen against the US Dollar (**Figure 4.6**).

Figure 4.6: Currency Revaluation Gains During H1-FY17



Source: Economic Affairs Division

While inflows from multilateral institutions declined in H1-FY17, the government borrowed substantially from commercial banks. In addition to US$ 1.0 billion raised through Sukuk, the government also borrowed US$ 900 million from foreign commercial banks (**Table 4.10**). Besides, disbursements from China increased by US$ 286 million over last year, and reached US$ 848 million in H1-FY17. This occurred in tandem with a pick-up in CPEC-related economic activities in the country.

Table 4.10: External Loan Disbursement

million US$

	H1-FY16	H1-FY17	Absolute Δ
ADB	607.4	674.6	67.2
IDA	594.9	72.3	-522.6
IDB	39.3	30.2	-9.1
IBRD	36.2	127.5	91.3
IDB (short term)	378.5	212.4	-166.1
China	556.4	848.0	291.6
Japan	26.5	42.8	16.3
Euro/Sukuk bond	500.0	1000.0	500.0
Commercial banks	956.1	900.0	-56.1
Others	91.9	45.1	-46.8
Total	**3787.2**	**3952.9**	**165.7**

Source: Economic Affairs Division

The government's increased reliance on commercial borrowings shows its inclination to benefit from the prevailing low interest rate environment in the global financial market. Particularly, the bonds issuance in recent years, not only curtailed the overall debt servicing cost, but also created a benchmark for future sovereign issuance (**Box 4.1**).

Box 4.1: Improving Pakistani Bond Yields in the International Market

Before FY14, Pakistan was largely relying on domestic borrowings to meet its budgetary requirements. With the implementation of critical reforms under the IMF's Extended Fund Facility (EFF), the confidence of investors in general and lenders in particular improved. Along with the revival of multilateral and bilateral flows, the country issued sovereign bonds of longer maturities, worth a cumulative US$ 4.5 billion (**Table 4.1.1**).

Out of the total, US$ 3 billion are of 10-year maturity, while the rest are of 5-year maturity. All the bonds have bullet repayment features and were oversubscribed at the time of issuance. The coupon payments on each bond are made semi-annually and the coupon rates vary according to global conditions, maturity, and the country's economic situation and the credit rating at the time of issue.

Table 4.1.1: Sovereign Bonds Issuance

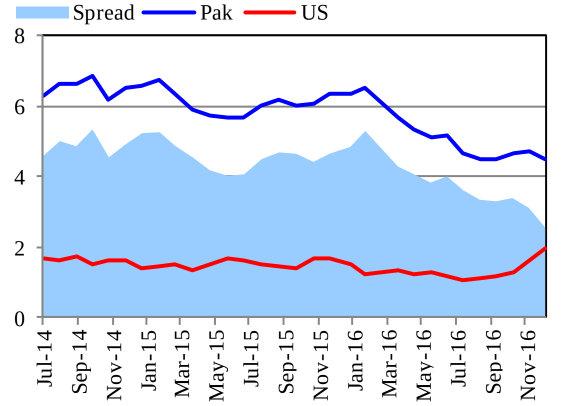
value: million US$, yield in percent

Issue Year	Bond	Tenor	Maturity	Value	Yield at issue	Yield at 31 December 2015	Yield at 31 December 2016
FY14	Euro	5- years	Apr-19	1000	7.3	6.2	4.7
	Euro	10- years	Apr-24	1000	8.3	7.8	6.7
FY15	Sukuk	5- years	Dec-19	1000	6.8	6.2	4.5
FY16	Euro	10- years	Sep-25	500	8.3	7.8	6.8
FY17	Sukuk	5- years	Oct-21	1000	5.5		5.0

Source: Bloomberg

While the coupon on sovereign bonds is fixed, the price in the secondary market fluctuates with market conditions, like the current interest rate, market liquidity, issuer country's outlook and the maturity of bond. After issuance, Pakistani bonds are being traded at a higher price than the issuance price and their yields have fallen accordingly (**Figure 4.1.1**).

Figure 4.1.1: 5-Y Pak Bond Yield vis a vis US Treasury



Source: Bloomberg

What are the factors behind the falling bond yields?

- After the global financial crises of 2008, international bond issuances rose significantly. While developed countries were lowering interest rates to boost aggregate demand, investors were in search of high yield assets. At the same time, a number of advanced economies were in turbulence; this resulted in a shift in investors' capital from advanced to developing economies.
- These developments resulted in availability of ample liquidity in the international capital market, and spurred investors to go for relatively riskier asset classes.[20] As a result, many developing countries tapped international capital markets to benefit from the low interest rate environment.
- In Pakistan's case, the improvement in credit rating also helped mobilize resources at relatively lower rates. **Table 4.1.2** shows that the credit rating agencies upgraded the

[20] Sovereign debt issuances declined significantly during the financial crisis, when investors preferred to stay away from risky assets.

country's sovereign rating, reaching B3 and B by Moody's and S&P respectively.[21] The oversubscription in almost all bond issues suggests that the country has secured a minimum credit rating required for investors' comfort; this also paved the way for future bond issuances.

- The country's macroeconomic fundamentals improved under the IMF's EFF. In particular, improvement in the fiscal and external accounts and low inflation promoted investor confidence and led to lowering of yield on the sovereign bonds.

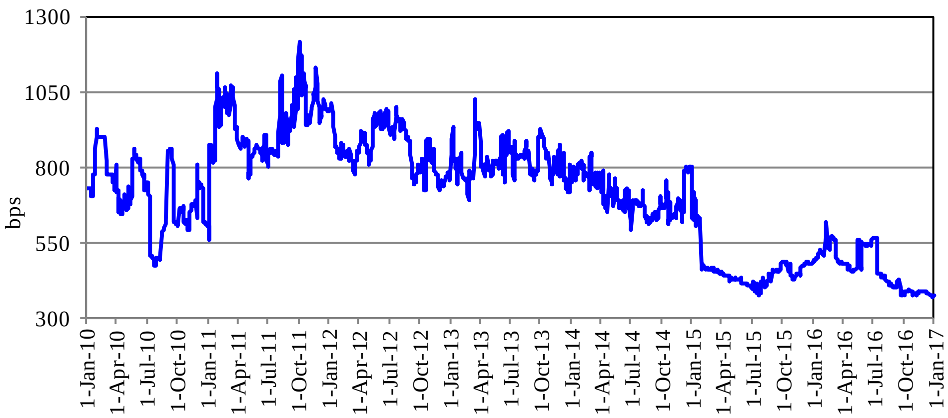
Table 4.1.2:Pakistan's Sovereign Ratings

Date	Rating	Outlook
Moody		
27-Apr-16	B3	Stable
11-Jun-15	B3	Positive
25-Mar-15	Caa1	Positive
14-Jul-14	Caa1	Stable
25-Nov-13	Caa1	Negative
S&P		
30-Oct-16	B	Stable
5-May-15	B-	Positive
1-Aug-13	B-	Stable

Source: Bloomberg

Credit default swap (CDS) , another measure of the country's default risk, also fell significantly (**Figure 4.1.2**).[22] Importantly, Pakistan's CDS stood at 368 bps in January 2017, down from a peak of 1,219 bps in 2011.[23] As mentioned earlier, turbulence in some European countries and ample liquidity due to quantitative easing by the US resulted in an overall decline in CDS. However, a slight uptick in the CDS was observed during the second half of FY16, when the US Fed increased its federal funds rate.

Figure 4.1.2: CDS for Pakistan



Source: Bloomberg

[21] Since the credit rating agencies assess the current economic health and future prospects of a country, an upgrade sends a positive signal to investors.
[22] A credit default swap (CDS) is a financial swap agreement that the seller will compensate the buyer in the event of a loan default.
[23] Our analysis of CDS focuses on 5-year CDS, the most liquid part of the market.

These are the welcome developments in the context of new issuance in the international market. However, the changing trends in international capital markets could have some implications in future. For instance, the recent tightening of monetary policy in US might affect prices of the sovereign bonds. This could also lead to increase in yield on current issues and thus, may affect the terms of new bond issuances.

5 External Sector

5.1 Overview

A sizable increase in import payments in H1-FY17, alongside non-receipt of Coalition Support Fund (CSF) and a fall in exports and remittances, led to a significant widening in the current account deficit.[1] In nominal terms, the import bill surged by US$ 1.2 billion in H1-FY17; of this, non-oil imports contributed a major share of US$ 995 million (**Table 5.1**). That said, oil payments – which had been declining for eight consecutive quarters – reversed trend in Q2-FY17, and tacked onto an already elevated non-oil bill. Resultantly, the quarterly current account deficit (CAD) rose to US$ 2.2 billion in Q2-FY17, bringing the cumulative deficit for H1-FY17 to US$ 3.5 billion.[2]

Table 5.1: Summary of Pakistan's External Sector

million US$

	Q2			H1		
	FY16	**FY17**	*Abs. change*	**FY16**	**FY17**	*Abs. change*
Current account balance	-1,286	-2,234	-948	-1,865	-3,527	-1,662
Trade balance	-4,609	-5,707	-1,098	-9,361	-10,809	-1,448
Exports	5,463	5,527	64	10,776	10,534	-242
Imports	10,072	11,234	1,162	20,137	21,343	1,206
POL (incl. LNG)	2,071	2,649	578	4,784	4,998	214
Non-oil	8,001	8,588	587	15,353	16,348	995
Services balance	-915	-821	94	-1,275	-1,731	-456
CSF	0	0	0	713	0	-713
Worker remittances	4,722	4,760	38	9,688	9,458	-230
FDI in Pakistan	575	806	230	978	1,081	103
FPI in Pakistan	-172	626	798	217	744	527
Eurobond/Sukuk	0	1,000	1,000	500	1,000	500
FX loans (net)	1,982	710	-1,272	2,710	1,521	-1,189
IMF	500	0	-500	952	102	-850
SBP's FX reserves (end-period)	15,884	18,272	2,388	15,884	18,272	2,388

Source: State Bank of Pakistan

Fortunately, sufficient financial inflows (mainly from government borrowings and FDI inflows) were available;[3] these helped finance the higher CAD. Resultantly,

[1] However, US$ 550 million were received under CSF in Q3-FY17.

[2] A similar trend was visible in case of full calendar year. The current account deficit increased to US$ 4.9 billion in CY-2016, from US$ 2.1 billion during CY-2015.

[3] Two major foreign acquisitions of local companies (one partial and one complete) were completed during Q2-FY17, leading to a net inflow of US$ 587.7 million into the country. This pushed up net FDI inflows during the quarter to US$ 806 million, against US$ 575 million in Q2-FY16.

the overall external balance remained in surplus in H1-FY17, with SBP's FX reserves rising by US$ 129 million during the period to US$ 18.3 billion. This, in turn, facilitated SBP in effectively managing sentiments in the interbank market in the wake of a widening current account gap: the PKR/USD parity remained virtually unchanged at 104.6 at end-September and end-December 2016, and fluctuated between 104.5 and 104.9 during the period. During H1-FY17, the rupee appreciated by a nominal 0.2 percent against the greenback.

Meanwhile, the rise in overall import payments was mainly driven by higher purchases of fuel and capital equipment. This is understandable, given that Pakistan is transitioning from a low-growth to higher growth phase, and is addressing supply-side bottlenecks in energy and infrastructure. This indicates strong positive impact on broader economic activities.

For instance, quantum imports of all POL products (particularly HSD and petrol), have recorded significant growth this year (**Table 5.2**), indicating strong transport sector activity (**Chapter 2**). This has also corresponded with a hefty increase in imports of buses and heavy commercial vehicles.[4]

Table 5.2: Pakistan's Import of Petroleum Products (H1)

	Quantity in 000 MT			% Growth	
	FY15	**FY16**	**FY17**	**FY16**	**FY17**
High speed diesel	1,548.8	1,306.8	1,837.2	-15.6	40.6
Furnace oil	3,210.1	3,000.2	3,733.6	-6.5	24.4
Crude oil	3,941.8	4,640.1	4,261.1	17.7	-8.2
Motor spirit	1,300.1	2,068.7	2,526.4	59.1	22.1
Others	32.4	58.5	61.2	80.6	31.7
Total	10,032.2	11,074.2	12,419.5	10.4	12.1

Source: Oil Companies Advisory Council

Similarly, an increase in power generation from furnace oil in H1-FY17 led to higher imports of the fuel.[5] Meanwhile, according to customs data, the rise in imports is mainly driven by power generation machinery (**Section 5.5**); a strong pick-up in fixed income loans by the power sector was also noted in H1-FY17 (**Chapter 3**).[6] These trends support our view of higher infrastructure development-led economic growth and active energy management in the country.

[4] Import payments for buses, trucks and other heavy vehicles (both CKDs and CBUs) rose by a sizable 186.7 percent (US$ 244 million) to US$ 344.1 million in H1-FY17. To put this in context, heavy vehicle imports contributed 18.6 percent to the overall *rise* in Pakistan's import bill in the period. While the higher import of buses might partly be a result of efforts to meet pent-up demand for public transportation, purchases of commercial vehicles reflect a general increase in intra-country trading activities (partly stimulated by CPEC-related projects).
[5] Of the 2,153 GWh *increase* in power generation during H1-FY17, 1,172 GWh came from furnace oil (source: National Electric Power Regulatory Authority).
[6] According to customs data compiled by PBS, power generation machinery contributed 38.4 percent (or US$ 816 million) to the overall increase in imports during H1-FY17. On the other hand, as per

Nonetheless, in the external sector, the real challenge emerges from the financing standpoint. Up till Q1-FY17, the savings on oil import payments had been offsetting rising non-oil imports and partially compensating for declining exports. This, coupled with growing remittances (till FY16), had been providing adequate FX cover to the external account and indirectly contributing to reserve accretion. However, as mentioned earlier, this comfort has now started to diminish. Moreover, Pakistan's import bill may further increase with the surge in oil prices following the supply cut agreement between Opec and key non-Opec members in December 2016.

To somewhat ease the pressure on the import bill, SBP, on its part, imposed a requirement of 100 percent cash margin on the import of over 400 mainly consumer items in February 2017.[7] This is expected to create some financing space for the import of growth-inducing capital goods and raw materials.[8] That said, we recognize that such regulatory measures can, at best, provide limited relief to the rising import bill. For medium- to long-term stability of the external account, it has become ever-more critical to boost FX receipts from exports and foreign investment.

In case of exports, the recovery in international cotton prices has yet to translate into higher unit values for Pakistan's high value-added textile exports.[9] However, on an encouraging note, exports of high value-added textile products, like readymade garments and bedwear items, have risen in H1-FY17; this increase has been entirely driven by higher quantums (**Figure 5.1**), indicating that these Pakistani products are in demand in key export markets. More importantly, Pakistan's share in the European Union's textile market has gone up during Jul-Dec FY17, at the expense of major exporters like India and China (**Section 5.5**). Helped along by rising exports of some clothing and home textile items, and of non-traditional items like seafood, fruits and plastic, overall export receipts grew by a marginal 1.2 percent in Q2-FY17 – finally breaking the spell of 10 quarters of successive YoY declines.

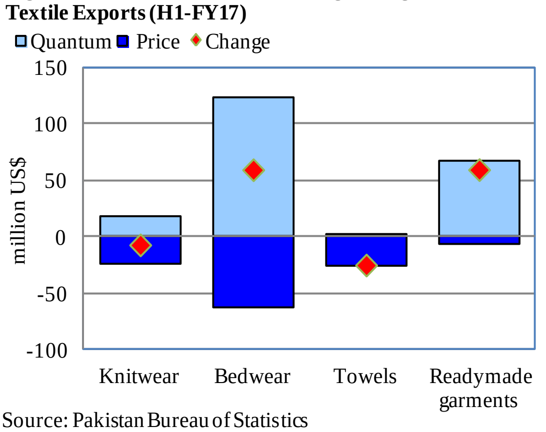
SBP data, import of these items actually *declined* (by 0.4 percent, or US$ 2.1 million) during the same period. For a discussion on this discrepancy between SBP and PBS import data, see **Box 5.1**.

[7] Vide BPRD Circular No. 2 of 2017. Major import items on which margin requirements have been imposed include motor vehicles (both CBUs and CKDs), cell phones, cigarettes, jewellery, cosmetics and personal care items, home appliances, and arms and ammunition.

[8] Between end-September and end-December 2016, SBP's liquid FX reserves declined by US$ 220 million.

[9] After bottoming out in March 2016, international cotton prices have been rising consistently (**Chapter 3**). Average global cotton prices during H1-FY17 were almost 13 percent higher than the same period last year (source: World Bank).

Figure 5.1: Breakdown of YoY Change in High Value -Added Textile Exports (H1-FY17)



Source: Pakistan Bureau of Statistics

As such, there are some positive trends that need to be sustained. In this context, we believe that the government's recently announced export package might ease cash-flow constraints for major exporting sectors, particularly textiles. With regards to attracting foreign investment, the Automotive Development Policy 2016-2021 seems to be having the intended effect: multiple foreign carmakers have shown interest in stepping into the Pakistani market and forming joint ventures with local conglomerates. Therefore, other sector-specific industrial policies (like that for agri-businesses, including meat and dairy, and for SMEs, like those engaged in manufacturing surgical goods, etc), can be explored to fully harness the export potential from non-traditional product categories, and simultaneously make them attractive for foreign investors.

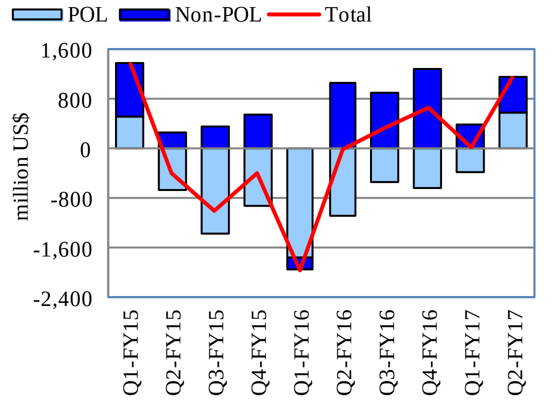
In sum, maintaining the external sector stability – achieved over the past three years – will ultimately be contingent on the country generating sufficient FX earnings to finance the growth-induced rise in the import bill. For this, the recent positive trends in exports and foreign investment need to be sustained, with policy support provided where necessary. In the interim period, SBP's FX reserves (at end-December 2016) are sufficient to finance over five months of the country's projected merchandise imports.

5.2 Current account: *Rising oil payments further inflate trade deficit*

In a span of three years – i.e. from Q1-FY15 to Q1-FY17 – the cumulative decline in the country's oil payments amounted to US$ 7.3 billion. This decline was almost entirely driven by the dramatic fall in oil prices, as quantum POL imports have been generally increasing during the period (**Table 5.2**). This essentially provided room for the country to finance rising non-oil imports (including that of power generation and construction-related machinery for CPEC projects), without exerting any pressures on the external account (**Figure 5.2**).

But with oil payments rising in Q2-FY17 on a YoY basis for the first time from Q1-FY15 onwards, the overall import bill swelled 11.5 percent to US$ 11.2 billion in the quarter. Even though exports reversed their multi-year declining trend and rose 1.2 percent (to US$ 5.5 billion), this uptick was insufficient to offset the rise in the import bill. As a result, the trade deficit widened by 23.8 percent to US$ 5.7 billion in Q2-FY17 – the second-highest quarterly trade gap.[10] This brought the half-year trade deficit to US$ 10.8 billion (against US$ 9.4 billion in H1-FY16), and pushed up the current account deficit to around US$ 3.5 billion.

Figure 5.2: YoY Change in Import Payments



Source: State Bank of Pakistan

Encouragingly, the services account posted an improved picture in H1-FY17, after excluding CSF inflows.[11] Major impetus came from telecom services, whose exports grew 59.4 percent YoY to US$ 255 million during the period. The primary income account also improved, mainly due to lower profit repatriations by oil & gas firms.

Meanwhile, worker remittances weakened in H1-FY17, with inflows dropping 2.4 percent YoY to US$ 9.5 billion. So far, the drop has been noted from all major corridors (i.e. the Gulf, US and UK). However, the decline was concentrated in the first quarter, as inflows grew by a meagre 0.8 percent in Q2-FY17.

5.3 Financial account: *Inflows up on rising FDI, commercial borrowings*

A pick-up in foreign investment inflows (both public and private) and continued bilateral and multilateral funding, were able to finance the growing current account gap in H1-FY17. Most of the activity took place in the second quarter, in

[10] The highest quarterly trade deficit was recorded in Q1-FY15 (at US$ 6.1 billion). Despite a drop in oil payments at the time, overall imports had surged on the back of higher imports of other food items (like lentils and oilseeds etc, owing to crop losses due to floods), iron and steel, and telecom equipment (as firms upgraded their infrastructure following the issuance of 3/4G licenses).

[11] After excluding CSF, the services account deficit narrowed by US$ 279 million YoY in H1-FY17. The country received US$ 713 million in CSF in H1-FY16, and did not receive any amount under this head in H1-FY17.

which major FX receipts for SBP included: (i) US$ 1.0 billion from a Sukuk; (ii) US$ 382.2 million in loans from China; and (iii) US$ 333.4 million in Asian Development Bank funding.[12] These brought the gross official financial inflows during H1-FY17 to US$ 4.1 billion – around 52.6 percent of the budgetary estimate of US$ 7.8 billion for the full fiscal year.[13]

In addition to these official inflows, the country's FX reserves also benefitted from the completion of two major corporate acquisitions/partial stake sales; these contributed a cumulative US$ 587.7 million to net FDI inflows of US$ 806 million in Q2-FY17.[14] These receipts proved critical in maintaining the country's FX reserves position during the period under review.

Foreign direct investment: Pakistan finally getting a slice of global M&A activity

At the global level, the recent surge in foreign investment has been dominated by mergers and acquisitions (M&A), with overall greenfield investments growing at a much slower pace.[15] However, Pakistan seemed to be missing out from this trend earlier on.

This dynamic seems to have changed in FY17. Multiple M&A deals have been concluded (and still others announced), indicating that professionally managed and innovative Pakistani firms are now *also* on the screens of foreign investors looking to gain a foothold into this 194-million strong market.[16, 17] Importantly, foreign investment from countries other than China is now also trickling into the country, reflecting investors' favorable outlook about country's growth prospects.

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[12] The loan disbursement figures for China and ADB for Q2-FY17 are net of retirement, and based on Economic Affairs Division data.

[13] According to FY17 budgetary estimates, the government is targeting to raise US$ 1.75 billion from Eurobond and Sukuk, and US$ 2.0 billion from commercial borrowings. During H1-FY17, the government issued a US$ 1.0 Sukuk and raised US$ 900 million in gross commercial loans.

[14] The country received US$ 127.7 million in November 2016 when a Turkish firm acquired a privately held Pakistani home appliances company. In December, a Dutch food conglomerate completed its purchase of a majority stake in a Pakistani food processing company for US$ 458 million.

[15] For instance, in 2015, global cross-border M&A deals had grown by a sizable 66.9 percent to US$ 721 billion. In contrast, announced greenfield investments had risen by a much smaller 8.0 percent to US$ 766 billion (source: World Investment Report 2016, United Nations Conference on Trade and Development).

[16] In addition to the two acquisition deals in food processing and electronics sectors that were completed in Q2-FY17, M&A activity is also visible in the power, automobile, and pharmaceutical industries.

[17] Economic Survey of Pakistan 2015-16 (Statistical Appendix, Table 1.1) has projected Pakistan's population at 193.6 million.

Meanwhile, FDI from China is not just limited to power and infrastructure projects anymore: Chinese firms have either concluded or are in the process of striking deals in industries as varied as financial services (Pakistan Stock Exchange), glass manufacturing, and packaging materials. From a medium- to long-term perspective, it is reasonable to expect positive spillover of these M&A transactions to extend beyond the arrival of FX inflows only, and lead to improvements in corporate productivity and efficiency; skill and technology transfer; introduction of innovative products; and opening up of new markets for exportable products. Most importantly, these deals offer opportunities for aspiring Pakistani manufacturers to get a foothold into the cut-throat global value chain. However, this will only be possible if foreign companies invest in exporting sectors of the economy, instead of attempting to just cater to rising domestic demand in the country.[18]

Helped along by the stake sales of the food and electronics companies, net FDI inflows into the country grew 10.4 percent YoY to US$ 1.1 billion in H1-FY17.[19] After excluding these acquisition proceeds, net FDI was down 49.7 percent YoY in the first half of the year. Inflows from China dropped 54.0 percent to US$ 204 million; a corresponding decline of 53.8 percent was noted in foreign investment flowing into the power sector (which amounted to US$ 211 million). The decline in Chinese investment so far this fiscal year is somewhat intriguing, as it does not seem to resonate with the extent of visible, on-the-ground CPEC-related activities in the country, particularly in the power sector (**Box 5.1**).

Box 5.1. Financing of CPEC imports: Addressing gaps in data

In Pakistan, data regarding the import of goods is compiled by two different government bodies. One is the Pakistan Bureau of Statistics (PBS), which compiles data reported by customs authorities (which record imports when the goods physically cross the country's border). The other is SBP, which receives data from commercial banks when importers make payments against letters of credit (L/Cs). Due to a variety of factors (like imports on deferred payments, freight and insurance, etc), there is a natural discrepancy between the two datasets. Deferred payments, for instance, result in a time lag between the recording of imports by customs and their reporting to SBP. Besides, there are certain items, like gold, and vehicles (under the baggage scheme) etc., for which the payment burden does not fall on the interbank market.

Usually, for any period, import data recorded by PBS tends to be higher than that available with SBP: the 10-year average difference between the two (for July-December) is US$ 1.6 billion. However, this difference has widened considerably from FY15 onwards, and touched an unprecedented US$ 3.0 billion in Jul-Dec FY17 (**Figure 5.1.1**).

[18] For details, please see Special Section titled "Why have Pakistan's exports stagnated?" in SBP's *Annual Report on the State of Pakistan's Economy for 2014-15*.

[19] Here, it must be pointed out that after excluding re-invested earnings, net FDI recorded a much higher YoY growth of 62.2 percent in H1-FY17.

Moreover, a large share of this discrepancy can be explained by the surge in import of power generation machinery, which is being recorded by customs but is not fully visible in import financing data available with SBP (**Figure 5.1.2**). The gap in import data for power generation equipment also widened dramatically to US$ 1.1 billion in H1-FY17, from the previous 10-year's average of just US$ 193 million. Since most power sector activity in the country is taking place under the CPEC umbrella, it is highly probable that the widening gap between the two import datasets is linked with the CPEC accord (signed in April 2014).

Figure 5.1.1: Gap between PBS & SBP imports data (Jul-Dec)

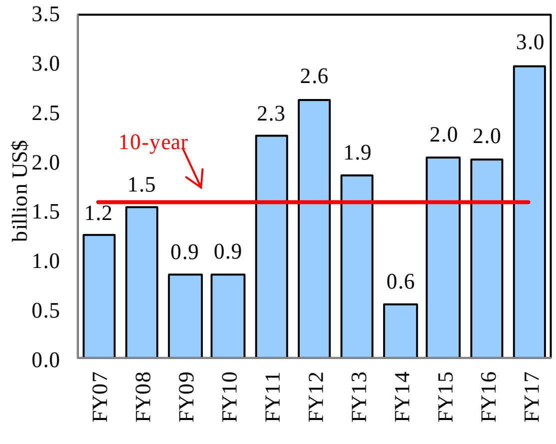
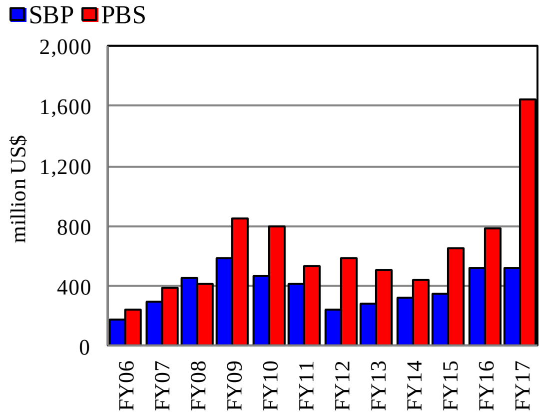


Figure 5.1.2: Import of Power Generating Machinery Reported by Different Sources (Jul-Dec)



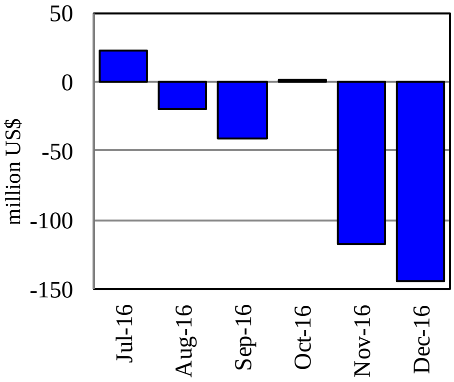
Typically, banks report import financing data to SBP after importers make payments against L/Cs. However, that appears not to be the case with imports of power generation machinery over the past two and a half years: there has been a relatively minor increase in these imports based on L/C-level data provided by commercial banks to SBP. Hence, it appears that the *bulk* of these machinery imports are being financed from outside the Pakistani banking channel. This is also supported by the absence of any outsized pressure in the interbank (which would have been a near certainty if the import bill had grown by a further US$ 3.0 billion in Jul-Dec FY17, as per PBS data, without a commensurate increase in financing flows).

This difference indicates that capital equipment imports into the country, FDI and loans from China are not being fully captured in BoP data. For its part, SBP has enhanced reporting requirements for commercial banks regarding foreign currency accounts maintained with them by corporate entities operating in the country. Through EPD Circular Letter No. 14 (issued on December 7, 2016), SBP directed commercial banks to clearly specify whether each project/company maintaining a special FCY account with them, is part of CPEC or not. Moreover, banks have also been instructed to clearly specify the nature of each FX transaction conducted in these accounts (like import payments, loan disbursements and repayments, repatriation of dividends, disinvestment of foreign investment, and issuance of bonus shares, etc.). This will help clarify whether the financing of CPEC-related capital imports is coming in the form of loans (both from commercial and/or foreign sponsors), and equity investment (in cash or kind).

SBP is also coordinating with other government departments (including the Ministry of Finance, the Planning Commission and the Board of Investment) to timely update the data for import financing for CPEC with that of loan and FDI inflows from China. Once this happens, figures for both imports and loans/FDI in SBP's balance of payments data may be revised upwards significantly in the future. While this will inflate the trade and current account deficits (due to recording of higher imports) *ceteris paribus*, it will be netted out through an equal increase in loans and/or FDI in the financial account – leaving zero net impact on the country's reserves position for that period.

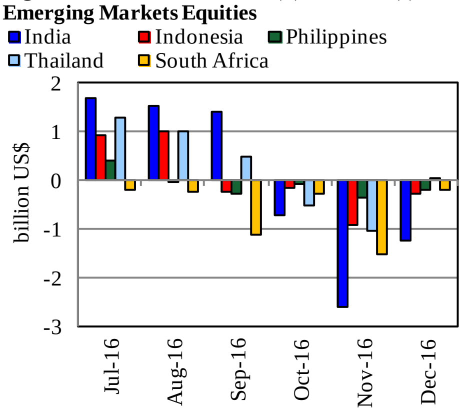
<u>Foreign portfolio investment: Public inflows offset equity sell-off by foreigners</u>
Public flows dominated foreign portfolio investment in H1-FY17 of US$ 745 million. Major impetus came from the issuance of a US$ 1.0 billion Sukuk by the government in October 2016. This was instrumental in offsetting an increase in capital outflows from the local equity market; a trend that gathered pace in Q2-FY17 (**Figure 5.3a**). More than anything else, this sell-off by foreign investors seems to have been sparked by exogenous factors, and has affected multiple emerging markets (EMs) alike (**Figure 5.3b**).

Figure 5.3a: Foreign Investors' Net Buying(+)/Selling(-) in Pakistan Stock Exchange



Source: National Clearing Company of Pakistan Ltd

Figure 5.3b: Net FPI Inflows (+)/Outflows (-) in Emerging Markets Equities



Source: Bloomberg

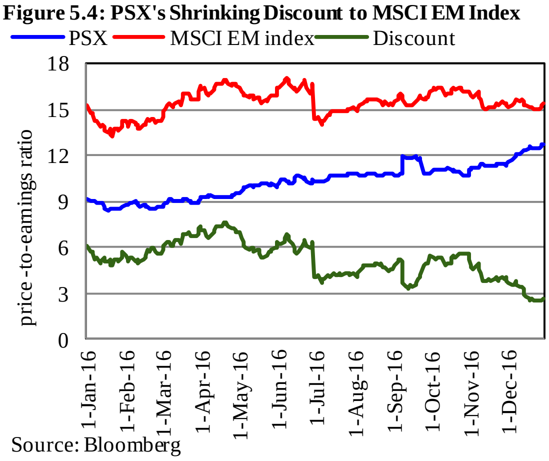
Anticipating the second interest rate hike by the US Fed in a 12-month period, foreign funds seemed to have started offloading emerging market equities from September 2016 onwards. Yet, the outcome of the US presidential elections in early November 2016 apparently accelerated this sell-off, even before the Fed got round to raising the federal funds rate (in December). Global funds started factoring in rising inflation in the US in the future (as the new administration promised to ease the regulatory climate, significantly cut corporate taxes, and boost infrastructure spending); the thinking went that these steps would lead to rising price levels, and ultimately lead the US central bank to further tighten monetary policy. This led investors to shun safe havens (particularly US

Treasuries and gold) and riskier EM assets alike;[20] instead, they started piling into US equities, playing on the deregulation and infrastructure-development themes.[21]

However, with EMs across the board facing capital outflows, local institutional and retail investors embarked on a significant buying spree at the Pakistan Stock Exchange (PSX) over the past year, and easily absorbed the equity sell-off by foreign investors. As a result, the PSX-100 index was among the top five equity markets in the world in CY-2016, giving out a healthy 45.7 percent return in the year.

However, the resultant hike in the index's valuation might restrain foreign funds – that were earlier attracted by the PSX's wide price-to-earnings (p/e) discount over the MSCI EM Index (**Figure 5.4**) – from venturing heavily into Pakistani stocks.[22]

Figure 5.4: PSX's Shrinking Discount to MSCI EM Index



Source: Bloomberg

5.4 Exchange rate

Unlike H1-FY16, the PKR remained stable against the greenback during H1-FY17. In fact, it has appreciated by 0.2 percent, after depreciating 2.8 percent during the same period last year. Against the Japanese yen (JPY), the PKR appreciated by 13.9 percent YoY in H1-FY17, after depreciating 4.2 percent in the

[20] In fact, 10-year US Treasury yields surged from 1.83 percent on November 7 and reached 2.44 percent by end-December 2016 (source: Bloomberg), as investors demanded higher premium on longer-tenured bonds to offset any erosion in their value due to rising inflation in the US in the future. Since the 10-year US Treasury yield is one of the benchmarks used in pricing long-term fixed income instruments across the globe, a continual surge in this rate might pose a dilemma for EMs like Pakistan that are looking to issue dollar-denominated sovereign bonds in international capital markets.

[21] Between November 7 and December 31, 2016, the Dow Jones Industrial Average surged 8.2 percent to 19,762.6 points (after hitting its all-time high of 19,974.6 points on December 20), while the broader S&P 500 rose 5.0 percent to 2,283.8 points (source: Bloomberg). Though the market rally was broad-based, stocks of financial services firms, in particular, performed quite well (on expectations that the new administration will considerably loosen the Dodd-Frank financial sector reforms, leading to healthy industry profits).

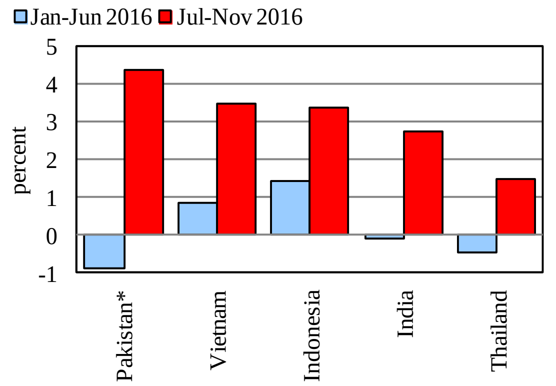
[22] Specifically, the PSX's (p/e) discount to the MSCI Emerging Markets Index has shrunk from 6.1 at the start of CY-16 to 2.6 by year-end.

same period last year. Volatility in global commodity prices helped strengthen the safe haven currency (JPY) against multiple currencies during H1-FY16.

This time around, the US dollar posted significant gains on account of two major events: a) the US presidential elections in November 2016 pushed the dollar up on expectations that the newly elected president's administration may boost the domestic economic growth with fiscal stimulus; and b) the Fed rate hike in December 2016 further augmented the gains, pushing down the advanced currencies like euro and Japanese yen.[23]

In real terms, major Asian currencies, while remaining relatively stable during the first six months of CY-2016, started to appreciate since July 2016; the PKR was no exception (**Figure 5.5**). After depreciating 0.9 percent during the first six months of CY16, the rupee appreciated by 4.4 percent during July-November 2016 in real terms. Currencies of other EMs, like Vietnam, Indonesia, India and Thailand, have also appreciated in real terms during this period.

Figure 5.5: REER Appreciation (+)/ Depreciation (-) of Some Asian Currencies



Source: Haver Analytics, *State Bank of Pakistan

5.5 Trade account[24]

The trade deficit widened by 21.9 percent to US$ 14.5 billion in H1-FY17, as imports picked up pace substantially and the export slowdown continued. The increase in imports was mainly driven by the rise in machinery and petroleum imports: while machinery had pushed up overall imports in Q1-FY17, POL contributed significantly to the overall increase in imports during Q2-FY17 (**Table 5.3**). Basically, the rising share of capital goods – like machinery, electrical machinery, energy related products, aluminum alloys, etc – in overall

[23] The dollar index (which measures the greenback's strength against the basket of major currencies) reached a 14-year high level of 103 in December 2016.

[24] 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.

imports reflects a pro-growth change in the country's import composition. Higher investment in power, infrastructure and construction will not only boost economic activities, but also help address energy shortage in the country.

Table 5.3: Foreign Trade
billion US$

		Exports	Imports	Trade deficit
Q1	FY16	5.1	10.6	5.5
	FY17	4.7	11.7	7.0
Q2	FY16	5.2	11.6	6.4
	FY17	5.2	12.7	7.5
H1	FY16	10.3	22.2	11.9
	FY17	9.9	24.4	14.5
% Growth				
Q1	FY16	-14.3	-14.9	-15.5
	FY17	-9.3	10.0	28.1
Q2	FY16	-14.8	-1.0	13.8
	FY17	1.4	9.8	16.6
H1	FY16	-14.5	-8.2	-1.9
	FY17	-3.9	9.9	21.9

Source: Pakistan Bureau of Statistics

Exports

Though exports dropped 3.9 percent in H1-FY17 (against a drop of 14.5 percent in H1-FY16), this was mainly due to a 9.3 percent decline observed in the first quarter of the year. Exports grew by a marginal 1.4 percent in Q2-FY17, as a recovery in international prices of some textile products and an increase in demand for Pakistani textiles in the EU, boosted textile exports by 3.4 percent in the quarter. Within textile exports, items that exhibited improvements included readymade garments and bedwear. Moreover, exports of some non-traditional items, like fish, fruits, spices, tobacco, plastic, and naptha etc. also increased.

Table 5.4: Textile Exports
million US$

	Values				% Growth			
	Q1-FY16	Q2-FY16	Q1-FY17	Q2-FY17	Q1-FY17	Q2-FY17	H1-FY16	H1-FY17
Total	**3,220.8**	**3,039.0**	**3,018.3**	**3,136.1**	**-6.3**	**3.2**	**-9.1**	**-1.7**
Cotton	55.5	16.1	17.5	18.4	-68.5	14.3	-37.0	-49.9
Yarn	383.0	318.2	307.0	347.5	-19.9	9.2	-29.3	-6.7
Cotton fabric	561.0	549.4	547.6	502.8	-2.4	-8.5	-10.2	-5.4
Other textile materials	132.6	155.2	131.3	141.8	-1.0	-8.7	-15.4	-5.1
Synthetic textile	75.7	72.3	39.7	60.6	-47.6	-16.1	-21.8	-32.2
Knitwear	630.4	561.1	592.3	592.0	-6.0	5.5	-3.7	-0.6
Bed wear	514.4	482.7	528.9	527.7	2.8	9.3	-7.1	6.0
Towels	214.5	190.6	178.6	201.4	-16.7	5.6	6.4	-6.2
Readymade garments	506.1	534.0	524.4	575.3	3.6	7.7	3.4	5.7
Other made up articles	147.7	159.4	151.1	168.7	2.3	5.9	-2.5	4.2

Source: Pakistan Bureau of Statistics

Textile

While textile exports dropped 1.7 percent in H1-FY17 to US$ 6.2 billion (after declining 9.1 percent in the same period last year), the contraction was mainly observed in Q1-FY17, as textile shipments rebounded in Q2-FY17. Encouragingly, this increase emanated from both low and high value added categories (**Table 5.4**).

The appreciable 13.6 percent YoY recovery in international cotton prices during Q2-FY17 likely contributed to a significant YoY increase of 14.3 and 9.2 percent YoY respectively in cotton and cotton yarn exports. In case of readymade garments, export values benefitted from a price increase as well as higher quantums.

Pakistan's performance in the key EU market is particularly noteworthy. The country mainly exports readymade garments, knitwear and bedwear to the bloc, which has the highest share in the country's textile exports. While the EU's overall clothing imports declined during Jul-Dec FY17, Pakistan was among those few countries whose textile exports to the bloc increased during the period. In fact, Pakistan (along with Bangladesh and Vietnam) was able to increase its share in the EU's textile market during the period (**Table 5.5** & **5.6**). This indicates that at least some Pakistani exporters are effectively utilising the duty-free access to the EU market that Pakistan currently enjoys under the GSP Plus scheme, without cutting back supplies to other markets.

Table 5.5: EU Import of Clothing from Major Countries (Jul-Dec)

million US$

	Value		% Growth		% Share	
	FY16	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**
China	19,147	17,665	-13.4	-7.7	40.2	38.0
Bangladesh	7,527	8,041	4.3	6.8	15.8	17.3
India	2,480	2,413	-7.8	-2.7	5.2	5.2
Vietnam	1,767	1,789	5.0	1.2	3.7	3.8
Pakistan	1,289	1,365	4.4	5.9	2.7	2.9
Total	**47,618**	**46,484**	**-7.6**	**-2.4**	**100.0**	**100.0**

Source: Eurostat

However, uncertainty prevails in the US market, as the country's overall as well as textile imports have declined in the period.[25] Pakistan's textile exports to the country declined in both values and quantums during H1-FY17.[26]

[25] The US' import of textile and apparel declined by 0.7 percent YoY in terms of quantum and 9.0 percent in value during Jul-Dec FY17 (source: Office of Textiles and Apparel, US Department of

Table 5.6: EU Import of Home-Textile from Major Countries (Jul-Dec)
million US$

	Value		% Growth		% Share	
	FY16	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**
China	2,137	2,122	-7.0	-0.7	41.0	40.4
Bangladesh	176	183	-17.4	3.7	3.4	3.5
India	596	585	-10.5	-1.9	11.4	11.1
Vietnam	111	118	-10.5	6.2	2.1	2.3
Pakistan	813	865	-5.5	6.4	15.6	16.5
Total	**5,210**	**5,250**	**-8.3**	**0.8**	**100.0**	**100.0**

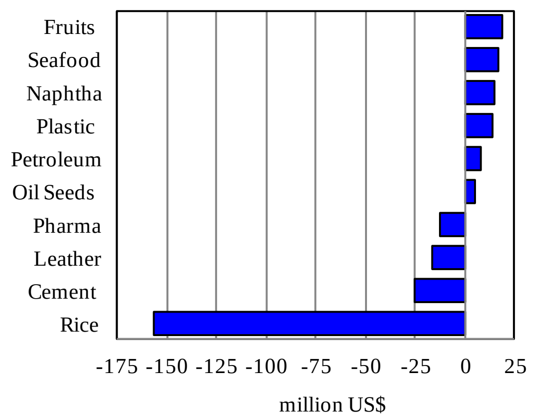
Source: Eurostat

With the recent recovery in international cotton prices, Pakistani textile exporters have a chance to increase their earnings by streamlining their operations and becoming more cost-effective. In this backdrop, the rise in the import of textile machinery during H1-FY17 is a promising sign. Furthermore, the recently announced export package (including an increase in rebate on FOB values) should ease exporters' cash-flow constraints. The relaxation in customs duty and sales tax on the import of cotton, man-made fibre (rather than polyester) and textile machinery, should all provide some relief to textile exporters dependent on imported raw materials.

Non-textile items

Within non-textile items, exports of seafood, fruits, naphtha and other POL products, and plastic increased during H1-FY17, whereas shipments of major products like rice (both basmati and non-basmati), cement, leather and pharmaceuticals declined in the period (**Figure 5.6**).

Figure 5.6: YoY Change in Non-Textile Exports in H1-FY17



Source: Pakistan Bureau of Statistics

Encouragingly, export of *fish and fish preparations* grew 10.3 percent YoY to US$

Commerce). Moreover, the US's overall imports declined by 0.3 percent YoY in Jul-Dec FY17 (source: International Trade Center).

[26] Pakistan's textile and clothing exports to the US market declined 8.8 percent in quantum terms and 10.7 percent in value during Jul-Dec FY17 (source: Office of Textiles and Apparel, US Department of Commerce)

183.5 million in H1-FY17, compared to US$166.3 million in the same period last year. This growth can be traced to: (i) a rise in shipments to China, Malaysia, and UAE; and (ii) a phenomenal volumetric increase in exports of salmonidae, crabs, shrimps and squids. Meanwhile, the surge in global oil prices during the period has arguably made it feasible for local refineries to start exporting *naphtha and other POL products* again.

Among major export items, shipments of both *basmati and non- basmati rice* varieties declined 18.0 percent YoY during H1-FY17. This mainly represented a shift in the demand from key markets like Saudi Arabia, UAE, and Philippines, etc away from Pakistani rice, to other countries. An additional factor was the second successive good rice harvest in Africa, which kept a lid on import demand from the region.

Lastly, *cement* exports continued on their downward trend, with most of the 14.4 percent YoY decline in H1-FY17 coming from two markets – South Africa and Afghanistan. A slight consolation was continued strong demand for Pakistani cement from India; this partially offset the declines witnessed in the two other major markets.[27]

Imports

Imports registered a growth of 9.9 percent YoY in H1-FY17, with a large share of the increase coming from machinery and POL items, followed by food, transport and metals (**Table 5.7**).

Table 5.7: Import of Major Categories (Jul-Dec)

million US$

	values			% growth	
Items	**FY15**	**FY16**	**FY17**	**FY16**	**FY17**
Food group	2,810.1	2,626.6	2,865.1	-6.5	9.1
Palm oil	*953.4*	*829.9*	*843.7*	*-12.9*	*1.7*
Pulses	*187.2*	*268.8*	*371.2*	*43.6*	*38.1*
Others	*1,669.5*	*1,527.9*	*1,650.3*	*-8.5*	*8.0*
Machinery group	3,644.0	4,023.5	5,669.2	10.4	40.9
Power gen.	*658.1*	*790.2*	*1,680.4*	*20.1*	*112.6*
Textile	*211.8*	*232.4*	*258.8*	*9.7*	*11.3*
Construction	*132.5*	*161.9*	*250.7*	*22.2*	*54.8*
Electrical	*594.3*	*892.4*	*959.7*	*50.2*	*7.5*
Others	*2,047.3*	*1,946.7*	*2,519.7*	*-4.9*	*29.4*
Transport group	1,290.5	1,322.3	1,406.9	2.5	6.4
Petroleum group	6,946.9	4,488.6	5,002.7	-35.4	11.5
Petroleum prod.	*4,304.8*	*2,704.4*	*3,205.7*	*-37.2*	*18.5*
Crude oil	*2,642.1*	*1,476.2*	*1,165.6*	*-44.1*	*-21.0*
L.N.G	-	*228.1*	*511.7*		*124.4*
Textile group	1,249.3	1,558.1	1,364.4	24.7	-12.4
Agri & chem group	3,842.4	3,768.3	3,594.3	-1.9	-4.6
Metal group	1,798.3	1,906.8	1,960.3	6.0	2.8
Miscellaneous group	2,563.6	2,467.9	2,489.0	*-3.7*	*0.9*
Total Imports	**24,145.1**	**22,162.1**	**24,351.9**	**-8.2**	**9.9**

Source: Pakistan Bureau of Statistics

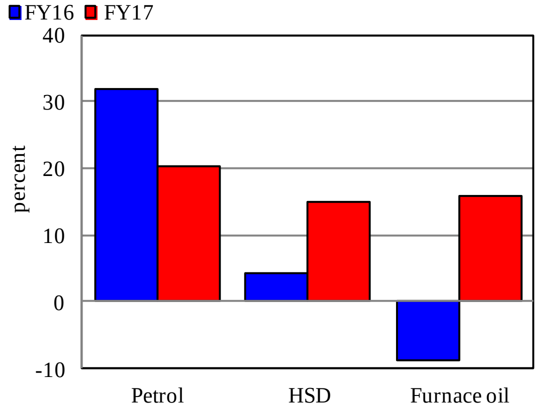
[27] Quantum cement exports to Afghanistan and African countries (mainly South Africa) declined by a cumulative 402,000 MT during Jul-Dec FY17, whereas shipments to India rose by 295,000 MT in the same period (source: All Pakistan Cement Manufacturer Association).

POL imports rising on higher quantums

Petroleum imports grew by 11.5 percent YoY during H1-FY17. This increase was driven primarily by higher volumetric imports of furnace oil and high-speed diesel (HSD), as a result of higher demand from power and transportation sectors respectively. Rising imports of power generators also contributed to the increase in demand for HSD.[28]

It might also be recalled that the impact of the policy shift towards high quality petrol (92 RON) has led to higher imports of petrol (**Figure 5.7**), as local refineries struggle to upgrade their existing set-ups to comply with new product standards in the interim period; this has also contributed to lesser crude oil imports, and lower domestic production of POL products during the period (**Chapter 2**).

Figure 5.7: YoY Growth in POL Quantum Sales (Jul-Dec)



Source: Oil Companies Advisory Council

Machinery and transport imports up on strong economic activities

Vibrant domestic construction, progress on mega infrastructure projects, and CPEC-related economic activities, all contributed to a surge in demand for machinery and commercial vehicles during H1-FY17. Machinery imports posted a significant increase of 40.9 percent during H1-FY17 and reached US$ 5.7 billion – almost 23.2 percent of the total import bill. Moreover, machinery items contributed a massive 73.3 percent to the increase in total imports in the six-month period. Within machinery, imports of power generation, textile and construction-related machinery increased during the period, while that of telecom equipment declined (**Table 5.7**).

Surge in global commodity prices boosts food imports

A visible recovery in global prices of food items, particularly palm oil, inflated the food import bill. Average international palm oil prices during H1-FY17 were 28.1 percent higher than their level in the same period last year.[29] Pakistan's palm oil imports rose 29.0 percent YoY in Q2-FY17, after declining 17.8 percent in Q1-

[28] During Jul-Oct FY17 (latest data available), the country imported 15,250 diesel generators of varying capacities, against 6,995 units in the same period last year.

[29] Source: World Bank

FY17. Lower domestic production necessitated higher imports of certain perishable commodities, like garlic, tomatoes and other vegetables etc (which are classified under "other food items"). However, tea was an exception, as the decline in its import was entirely due to lower international prices; its quantum imports increased slightly during the period.

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:

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

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

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

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 auctions 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) **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
AJK	Azad Jammu and Kashmir
AML	Anti-Money Laundering
APCMA	All Pakistan Cement Manufacturers Association
APML	Asian Precious Minerals Limited
bbl	Billion Barrels
BISP	Benazir Income Support Programme
BPRD	Banking Policy & Regulations Department
bps	Basis Points
BSC	Bahbood Savings Certificate
CAD	Current Account Deficit
CBU	Complete Built Up
CCI	Consumer Confidence Index
CDNS	Central Directorate of National Savings
CDS	Credit Default Swap
CFT	Combating the Financing of Terrorism
CPEC	China-Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
CY	Calendar Year
DAP	Diammonium Phosphate
DRAP	Drug Regulatory Authority of Pakistan
DSC	Defence Savings Certificate
ECC	Economic Coordination Committee
EFF	Extended Fund Facility
EM	Emerging Markets
EPD	Exchange Policy Department
EU	European Union
FAO	Food and Agriculture Organization
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty

FO	Furnace Oil
fob	Free on Board
FRDLA	Fiscal Responsibility And Debt Limitation Act
FX	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
GST	General Sales Tax
GWH	Gigawatt hours
H1	First Half
HOBC	High Octane Blending Content
HSD	High Speed Diesel
IBA	Institute of Business Administration
IBRD	International Bank for Reconstruction and Development
IDA	International Development Assistance
IDB	Islamic Development Bank
IMF	International Monetary Fund
IRSA	Indus River System Authority
JPY	Japanese Yen
KIBOR	Karachi Inter Bank Offer Rate
KP	Khyber Pukhtunkhwa
LNG	Liquefied Natural Gas
LSM	Large Scale Manufacturing
M & A	Mergers & Acquistions
M2	Broad Money Supply
MMBTU	Million British Thermal Units
MPC	Monetary Policy Committee
MRTBs	Market related Treasury Bills
MSCI	Morgan Stanley Capital International
MT	Metric Tons
MTO	Money Transfer Operators
MW	Mega Watt
NDA	Net Domestic Assets

NFA	Net Foreign Assets
NFDC	National Fertilizer Development Centre
NFNE	Non-Food Non-Energy
NSS	National Savings Scheme
NTC	National Tariff Commission
OGRA	Oil & Gas Regulatory Authority
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PBS	Pakistan Bureau of Statistics
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
PM	Prime Minister
POL	Petroleum, Oil and Lubricants
PSDP	Public Sector Development Programme
PSEs	Public Sector Enterprises
PSX	Pakistan Stock Exchange
PTCL	Pakistan Telecommunication Company Limited
Q2	Second Quarter
RD	Regulatory Duty
rhs	Right Hand Side
Rs	Rupees
RON	Research Octane Number
SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
SUPARCO	Pakistan Space and Upper Atmosphere Research Commission
T-bills	Treasury Bills
UAE	United Arab Emirates
UK	United Kingdom
USD	US Dollar
WB	World Bank
WHT	Withholding Tax
WPI	Wholesale Price Index
WTI	West Texas Intermediate
YoY	Year on Year