1 Overview

Real GDP growth has maintained its upward trajectory and increased to a decade-high of 5.3 percent in FY17. Some of the other macroeconomic indicators, such as subdued inflation, investment growth, and rising private sector credit, also showed an encouraging picture. However, decline in exports is overshadowing the otherwise reviving economic activity.

The revival in agriculture during FY17 is especially notable. This was supported by favorable policy measures, including subsidy on fertilizer, reduction in sales tax on tractors, and increased access to finance. Better agriculture had, in turn, positive spillover for trade and manufacturing sectors. Further, PSDP and CPEC-related activities also continued to boost construction related industries, such as cement and steel.

Table 1.1: Selected Economic Indicators

		FY15	FY16	FY17
Growth rate (percent)				
Real GDP[1]	Jul-Jun	4.1	4.5	5.3
Agriculture	Jul-Jun	2.1	0.3	3.5
Industry	Jul-Jun	5.2	5.8	5.0
o/w LSM	Jul-Jun	3.3	2.9	4.9
Services	Jul-Jun	4.4	5.5	6.0
Real fixed investment[1]	Jul-Jun	15.8	6.7	8.3
CPI (period average)[a]	Jul-Mar	5.1	2.6	4.0
Private sector credit [b]	Jul-Mar	5.7	8.1	9.9
Money supply (M2)[b]	Jul-Mar	5.7	6.0	5.9
Exports [b]	Jul-Mar	-3.8	-9.4	-1.3
Imports [b]	Jul-Mar	-0.1	-4.9	14.1
Tax revenue –FBR [c]	Jul-Mar	12.7	17.7	8.2
Exchange rate (+app/-dep%)[b]	Jul-Mar	-3.1	-2.8	-0.01
billion US dollars				
SBP's reserves (end-period) [b]	Mar	11.6	16.1	16.5
Worker remittances [b]	Jul-Mar	13.6	14.4	14.1
FDI in Pakistan [b]	Jul-Mar	0.8	1.4	1.6
Current account balance [b]	Jul-Mar	-2.0	-2.4	-6.1
percent of GDP[1]				
Fiscal balance[d]	Jul-Mar	-3.8	-3.5	-3.9
Current account balance	Jul-Mar	-1.0	-1.1	-2.5

1: Provisional numbers for FY17.
Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Federal Board of Revenue; and [d] Ministry of Finance

The overall improvement in business sentiments along with supportive policies (historic low interest rate, high infrastructure spending and better law and order) has encouraged a number of firms to pursue expansion plans. This was reflected in a significant surge in private sector credit off-take during FY17, with a sizable share of fixed investment loans. At the same time, a hefty increase in machinery imports was also noted.

While the imports of machinery, raw material and other capital goods bode well for the growth potential of the country, these could not be financed completely from non-debt creating FX inflows, like exports, remittances, and FDI. And while

the country continued to enjoy IFI support and access to international capital markets, these inflows were not sufficient to finance the higher current account deficit. As such, SBP's FX reserves declined from US$ 18.1 billion as on end-June 2016 to US$ 15.3 billion on 9th June, 2017.

As the country has adequate level of FX reserves, despite some decline, there are no immediate concerns over its external position. However, going forward, it is imperative to exploit all sources of FX inflows – most importantly exports – in order to comfortably finance the rising import demand. Pakistan's exports have been afflicted by a number of structural, institutional and entrepreneurial gaps, which have constrained the country's competitiveness for the last many years.[1] The government has announced an incentive package for exporters. Moreover, general interest rates for businesses and special rates for export re-finance are at historic low. The private sector has the opportunity to fully benefit from these conditions by modernizing its business processes, investing in research and development, improving human capital, seeking international certifications, and meeting quality standards as expected by foreign consumers.

Low tax collection is another challenge faced by the economy. Some tax measures, like differential tax structure for filers and non-filers can potentially increase the tax base; however, recent fiscal incentives for investment, exports and domestic production have led to deceleration in tax collection.[2] While importance of such fiscal relief measures to support growth cannot be overemphasized, concerted efforts are required to further improve efficiency of the tax system.

Both these challenges, i.e., decline in exports and below target tax collection, are impacting two key macroeconomic balances – current account and fiscal. In order to maintain the growth momentum and hard-earned economic stabilization, these balances need to be kept at sustainable levels. For this purpose, both the public and private sectors have to play their roles: public sector through consistent and well thought policies; and private sector by enhancing its efficiencies.

1.1 Economic review

Real sector

Pakistan's economy grew by 5.3 percent in FY17, up from 4.5 percent growth

[1] See SBP Staff Notes 02/17 and Special Section 3 of SBP Annual Report FY15 for detailed discussions on structural issues affecting exports.

[2] For instance, tax relief on fertilizer and pesticides, zero-rating and duty drawback for exporters, sales tax exemptions on import of new machinery and raw material for textiles, and tax incentives to new energy projects.

recorded in FY16. This acceleration was achieved on the back of a strong performance of agriculture and services sectors, which grew by 3.5 percent and 6.0 percent respectively in FY17, compared with 0.3 percent and 5.5 percent last year.

The rebound in agriculture was primarily driven by five major crops (i.e. rice, cotton, sugarcane, wheat, and maize), which posted a growth of 3.5 percent, after declining 5.0 percent last year. The bumper crops of sugarcane, maize and cotton compensated for low growth in rice and wheat production.[3] The growth in livestock value added has also increased during the year. However, the performance of minor crops remained slightly lower as compared to the last year (see **Chapter 2** for detail).

The industrial sector posted a growth of 5.0 percent during FY17, compared with 5.8 percent last year. This moderation came mainly from decline in growth rates of *mining and quarrying* and *electricity and gas* sub-sectors. Against this, the large-scale manufacturing sector (LSM), a key contributor to industry, grew by 4.9 percent during FY17, compared to 2.9 percent last year.

The improvement in LSM growth was contributed by a wide range of industries, including sugar, cement, steel, pharmaceuticals, electronics, and heavy vehicles (like tractors and buses). At a broader level, support to the sector emanated from: (i) burgeoning domestic demand; (ii) sizable credit off-take; (iii) increased government development spending; (iv) improved law and order situation; (v) adequate availability of raw materials; and (vi) ease in energy supplies.[4]

The higher growth in agriculture and industry also had a positive impact on the performance of the services sector, with *wholesale and retail trade* a key beneficiary. In addition, growth of *finance and insurance* also went up, mainly due to high growth in deposits and advances of the banking sector. Meanwhile, the value addition in *general government services* remained low as compared to last year due to a smaller increase in wages and salaries.

Inflation and monetary policy

CPI inflation remained quite stable in the first two quarters of FY17, but picked up gradually in the third quarter. The average inflation during Jul-Mar FY17 was 4.0 percent, compared with 2.6 percent in the same period last year. However, it is

[3] The growth of five major crops during FY17 has been recorded as: wheat (0.5 percent), maize (16.3 percent), rice (0.7 percent), sugarcane (12.4 percent) and cotton (7.6 percent).
[4] Total power generation in the country increased by 3,166 GWh in Jul-Mar FY17 (source: NEPRA).

still significantly lower than the annual target of 6.0 percent. Some of the uptick in inflation was a result of partial pass-through of the increase in international oil prices to domestic POL prices; a surge in global prices of some key food commodities (like palm oil); increase in medicine prices; and upward revision in education fees (see **Chapter 3** for detail).

This gradual uptick in inflation along with external imbalances had a bearing on the monetary policy decisions during Jul-Mar FY17. Keeping in view the delicate balance between macroeconomic risks and ongoing growth momentum, the policy rate was kept unchanged at 5.75 percent throughout the year FY17. The low interest rate and benign business environment (as manifested by the country's better risk perception), stimulated demand for credit by the private sector, which reached Rs 438.6 billion during Jul-Mar FY17, against Rs 323.4 billion in the same period last year. Also, the increase in credit remained broad-based, with firms borrowing heavily to finance their capital expenditure: fixed investment loans accounted for 42 percent of the total increase in credit to private businesses in Jul-Mar FY17.[5] The demand for working capital loans also accelerated due to high input prices and greater availability of raw materials (e.g., sugarcane and cotton). In addition, to capitalize on the available commodity surplus and exporting opportunities, trade-related borrowings also went up during the period.

The uptick in credit off-take, along with budgetary borrowings, led to increase in NDA of the banking system. The government borrowed primarily from SBP and made retirements to commercial banks – the only exception was the third quarter when commercial banks participated actively in PIB auctions of government securities. In addition, credit to PSEs (especially energy-related) increased sharply, mainly to settle payables.[6] As a result, the expansion in the net domestic assets (NDA) of the banking system stood 75 percent higher than the expansion seen last year. However, this increase in NDA was offset by a decline in the net foreign assets (NFA) of the banking system, which led to a marginally lower growth in M2 during Jul-Mar FY17, compared with the last year.

On the supply side, banks had sufficient liquidity available for private sector lending during Jul-Mar FY17, on the back of high deposit mobilization and lower government borrowing from commercial banks. Moreover, a better outlook in terms of investment opportunities and gains in asset quality also played a part in encouraging banks to expand their credit portfolios.

[5] Over 90 percent of the increase in fixed investment loans by textiles was under SBP's long term financing facility for export oriented projects.
[6] See **Chapter 3** for more detail.

Fiscal operations

The fiscal deficit stood at 3.9 percent of GDP during Jul-Mar FY17, compared with 3.5 percent in the corresponding period last year. This was despite a surplus of Rs 227.6 billion provided by provinces during this period. In fact, revenue collection could not buoy up with the growing economic activities and fiscal needs. Particularly, FBR taxes showed a growth of 8.2 percent in Jul-Mar FY17, which was half the growth observed last year. Non-tax revenues also declined, mainly on account of lower receipts under Coalition Support Fund and SBP profit.

Encouragingly, the expenditure side of fiscal operations remained well-managed. While the growth in current expenditure declined during Jul-Mar FY17 (to 5.8 percent, against 6.5 percent last year), the government managed to maintain a double digit growth in development expenditures. The current expenditure were contained despite a significant increase in defense and security-related expenses.

Gross public debt rose to Rs 20.9 trillion as on end-March 2017, showing an increase of Rs 1.2 trillion during Jul-Mar FY17. A large part of this increase came from domestic borrowing, while increase in external debt remained moderate.

The debt & liabilities stock increased by US$ 595.6 million during Jul-Mar FY17 and reached US$ 62.0 billion. This lower accumulation in external debt took place on the back of revaluation gains (US$ 1.5 billion) and increased repayments made during the period (see **Chapter 4** for detail).

External sector

The current account deficit reached US$ 6.1 billion during Jul-Mar FY17 on the back of a large trade deficit and slowdown in remittances. The trade deficit swelled due to a decline in exports (-1.3 percent) and a sharp increase in imports (14.1 percent), which mainly consisted of capital goods and raw materials.

The increase in imports can be explained by continued power and infrastructure development, expansion plans of a number of industries, and increase in manufacturing activities. On the other hand, the decline in exports is mainly attributed to lower quantums despite recovery in global commodity prices (cotton and rice) during Jul-Mar FY17 (see **Chapter 5** for detail).

On the financing side, official external inflows in Jul-Mar FY17 (project, non-project and commercial loans, and sovereign bonds) stood around the same level as last year – indicating that IFIs and international capital markets are still supportive of Pakistan and comfortable with its growth trajectory (see **Chapter 5** for detail). Besides, both FDI and FPI inflows increased during the period. In

addition to China, a significant amount of FDI also came from other countries through merger and acquisition transactions in food and electronics.[7]

However, these inflows were not sufficient to fully offset the widening in the current account gap. As a result, SBP's liquid FX reserves declined from US$ 18.2 billion by end-December 2016 to US$ 16.5 billion by end-March 2017.[8] However, the reserves adequacy indicators are still comfortable at this level: SBP's liquid FX reserves are sufficient to finance over four months of import of goods.

1.2 Economic outlook

Pakistan's macroeconomic indicators continue to improve and solidify grounds for a sustained upward growth trajectory. In particular, key constraints impeding the economy from achieving high growth – i.e. power supply and security situation – are gradually getting better. In this backdrop, the government envisages a higher real GDP growth of 6.0 percent for FY18, compared to 5.3 percent recorded in FY17.

Inflation is expected to remain within the target of 6 percent amidst some pick up on the back of recovery in global prices of oil and other commodities, and push from domestic demand factors. Meanwhile, the credit expansion is likely to maintain its pace with better prospects for investment and business activities.

The FY18 budget has set a fiscal deficit target of 4.1 percent of GDP for the year. This will be supported by 14 percent growth (Rs 4 trillion) in FBR tax revenues. Along with continuing some of the relief measures, the budget has also introduced a number of measures to achieve this enhanced revenue target. On expenditure side, while containing current expenditure, the budget has created substantial space for development spending; the PSDP for the next year is budgeted at Rs1 trillion, which is 40 percent higher than revised estimates of Rs715 billion for this year.

On the external front, the positive spillover of recovery in the global economy, particularly advanced economies, offers healthier trade prospects. Pakistani exports could also benefit from this evolving dynamic, if the exporters are able to diversify their products at competitive prices. The Annual Plan FY18 projects

[7] Pakistan received FDI inflows from the Netherlands (US$ 465.6 million) and Turkey (US$ 133.1 million) during Jul-Mar FY17. In the same period, FDI from China amounted to US$ 594.8 million.
[8] During this period, Pakistan also repaid US$ 500 million of SAFE China Deposits.

exports to grow by 6.8 percent, with impetus coming from removal of supply-side bottlenecks and a better performance by the industrial sector.

The import bill is likely to rise by 7.6 percent (according to the Annual Plan FY18) due to surge in demand for machinery and equipment. However, the impact of such imports on the external balance would remain muted due to availability of financing from IFIs and other bilateral sources.

In sum, the growth prospects of Pakistan's economy from FY18 onwards would largely hinge upon planned infrastructure projects and capacity expansion by industries. In order to make these plans a success story, enhanced coordination amongst all public sector institutions would be more crucial. Also, continuity and consistency in policies, especially those related to investment and industry, would be necessary to ensure sustainability of the growth momentum.