1 Overview

Midway through the fiscal year 2017-18, prospects for Pakistan's economy surpassing last year's growth rate appear strong. Inflation remained low and fiscal position consolidated on the back of a rebound in revenue collection. However, risks to overall macroeconomic stability have increased due to widening imbalances in country's balance of payments.

Table 1.1: Selected Economic Indicators

	H1-FY17	H1-FY18[P]
	growth rate (percent)	
LSM [a]	4.0	5.5
CPI (period average) [a]	3.9	3.8
Private sector credit[1, b]	8.1	5.7
Exports (customs) [a]	-4.0	11.0
Imports (customs) [a]	9.8	18.1
Tax revenue [c]	6.2	16.4
Development spending [c]	16.7	23.4
Exchange rate (+app/-dep) [b]	+0.2	-5.0
	million US dollars	
SBP's liquid reserves (end-period) [b]	18,272	14,107
Workers' remittances [b]	9,505	9,746
FDI in Pakistan [b]	1,421	1,496
Current account balance [b]	-4,660	-7,920
	percent of GDP	
Fiscal balance [c]	-2.5	-2.2
	Interest rates	
Spread b/w avg. ONMMR and PR	0.06	0.06
Weighted average lending rate	7.2	7.2

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

ONMMR: Overnight money market rates; PR: Policy rate

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

The persistent vibrancy in domestic economic activities explained much of these imbalances, as an improved performance by all the major sectors pushed up the import demand. In particular, large-scale manufacturing (LSM) growth touched a 4-year high during H1-FY18, as upbeat demand for consumer durables and construction inputs induced manufacturing firms to flex their capacities (**Table 1.1**). Agriculture too is expected to perform well, as a number of major crops gained from both an increase in area under cultivation as well as improving yields.

While the economy continued to benefit from higher development spending by the government, accommodative monetary policy and progress on CPEC-related projects, an added impetus to growth came from the consolidation in global economic recovery. A consistent increase in retail spending in the US and EU was particularly helpful, as it fed the export prospects of emerging market economies (EMs), including Pakistan's. Importantly also, an increase in China's industrial growth – for the first time after 2010 – sent positive signals to other integrated EMs. Meanwhile in the Middle East, the non-oil GDP – and therefore jobs – began to recover modestly, as repercussions from the political disturbances in this region are yet to play out.

These global developments had multiple spillover effects on Pakistan's economy. On the positive side, the export growth stretched its eight-month-long unbroken run into December. Not only did this provide stimulus to production and investment activity in key exporting sectors, it also lent some support to the country's stressed balance of payments, and especially, its outlook over the medium term. Similarly, workers' remittances not only stabilized, but recorded a modest growth, on the back of higher inflows from the UK, US and Dubai.

On the flip side, the recovery in the global economy triggered buoyancy in the commodity market – oil prices rallied to a 3-year high as OPEC members exercised more disciplined production cuts amid rising demand. Industrial metal prices too surged steeply as demand outpaced supplies. These developments had two major implications for Pakistan. First, domestic fuel prices increased steadily, as the government passed on the impact of rising global prices to domestic consumers. Although its impact on headline inflation was diffused almost completely by falling domestic prices of food commodities, inflation expectations crept up. Nonetheless, SBP's full-year inflation forecast stayed below the target level of 6 percent, and this assessment primarily guided the Monetary Policy Committee's (MPC) decision to keep interest rates unchanged in its November review.

Second, the increase in commodity prices (especially oil) put upward pressure on imports, which were already strong on the back of domestic demand. Although the import growth subsided as the year progressed, payment volume was large enough to offset the export and remittance gains; the resultant deficit in the current account was too large to be financed by private and official financial inflows. With the payment burden falling increasingly on the country's FX reserves, sentiments turned further against the PKR, leading to an increase in FE-25 deposits and high kerb premium through most of the period. The issuance of the Eurobond and Sukuk in December helped contain the reserves depletion to some extent, but the size of these flotations was still insufficient to placate the interbank foreign exchange market. Consequently, the Pak rupee depreciated by 4.4 percent in December 2017.

This suggests that if the rising trend in global commodity prices continues, it would become important to manage the cost-push risk factors for the economy; that is, imported inflation and the dispersal of high fuel cost across different goods and services. Insulating the economy from these pressures is imperative, especially at this stage of the business cycle when fresh productive capacities in numerous industries (cement, steel, power, construction, automobiles) are soon to be commissioned.

That said, the domestic demand would be the swing factor in shaping up the overall macroeconomic outlook over the medium-term, especially from the perspective of external imbalances. On this front, the current trends lead to mixed assessment. For instance, while the government's development spending in H1-FY18 was higher than last year, the overall fiscal deficit has been well contained. Lower budgetary borrowings, coupled with a lower offtake of private credit, contributed to a slowdown in the growth in money supply. Importantly, core inflation, which reflects the underlying demand pressures in the economy, stabilized in H1-FY18 after increasing steadily over the past seven quarters.

In contrast, the consumption demand looks strong. Although recent consumer confidence surveys have spelled out some weakening in current and expected economic conditions, the hard data still reflects exuberance. Production as well as import of major consumer items – automobiles and electronics – have posted strong growth on the back of rising farm incomes, easy credit conditions, and continued inflow of workers' remittances.

On balance, it can be expected that though import volumes are likely to stay at an elevated level, the import growth may taper further going forward. Machinery imports have already subsided, and given the government's recent decision of banning new power projects in the country, the import of power generating machinery is not likely to surge again – in fact, these imports have already posted a fall of 18.5 percent (YoY in Jul-Feb FY18) as per the customs records.

In case of exports, two recent developments are important. First, the EU has extended the GSP Plus status (which has proved quite helpful in propelling exports to this bloc over the past three years) for Pakistan for the next two years, upon the country satisfactorily meeting the implementation of 27 core conventions. The second silver lining is the announcement of additional incentives by the government under the "Duty Drawback of Taxes Order 2017-18". Half of the drawbacks announced for exporters under this order are performance-based; whereas, 2 percent additional drawback is announced for exports to non-traditional markets.

These concessions notwithstanding, Pakistan's export industry needs to break from the past and fix its long-standing structural constraints. The overall policy mix also needs to be tilted in favour of export expansion; not only would this require eliminating the anti-export bias from our industrial policy, and reducing the cost of doing business, but would also require aligning the incentive structure in favour of exporting business. In this respect, the downward revision of property valuations in January 2018 is not an optimal step; phenomenal capital gains in property investments with minimal tax burden are one of the major reasons behind the diversion of investible funds away from more productive sectors, especially exporting. Moreover, the recent reversal of tighter import regulations for used car dealers, and duty exemptions on imported steel items (also produced locally) for certain CPEC-related projects, runs counter to the purpose of achieving external sector stability.

In the short run, however, the government should complement the needed fundamental policy changes with stop-gap measures, to prevent a further drawdown in official FX reserves– while gross liquid reserves have already fallen to less than three months of the country's import bill, unencumbered reserves are even less. Some steps have been taken to contain import growth (e.g., imposition of regulatory duties and LC margins on consumer imports), but their scope and depth need to be increased to ensure quick and effective results. That said, given the expected volume of current account deficit in coming months along with size of maturing loans, it has become imperative for the government to ensure that estimated official inflows for the remaining part of the year are realized.

Debt sustainability issues may prop up going forward, and this brings into equation the need for a sustainable stream of FX earnings in the future, as well as the increase in country's debt repayment capacity. The latter ultimately hinges upon a perceptible improvement in the country's tax base, and decisive actions to address critical issues like falling number of direct tax payers, recurring circular debt, and costly support price mechanism in the commodity market.

In the larger scheme of things, Pakistan's economy has reached a familiar juncture; the brewing BoP problem warrants concerted and timely measures to preserve the macroeconomic stability and growth momentum. If the economy regains its balance, fundamentals are strong enough to push it towards a high growth path.

1.1 Review of H1-FY18

Real Sector

Real GDP growth is expected to surpass last year's decade-high growth rate of 5.3 percent. While all the major *kharif* crops performed well, wheat production came under pressure due to non-availability of sufficient water, and a reduction in area under cultivation as compared to last year. Similarly, on the industrial front, LSM growth decelerated to 1.6 percent during Q2-FY18 relative to a healthy 9.9 percent growth achieved in the first quarter. This was mainly on the back of delayed commencement of sugarcane crushing.

Barring sugar, however, the performance of the industrial sector was encouraging, with a fairly broad-based sense of optimism. The overall LSM growth during H1-FY18 (5.5 percent) was appreciably higher than that observed during the corresponding period last year (4.0 percent). Increased consumer spending led to a strong showing by durables such as automobile and electronics, while the ongoing infrastructure and construction activities stimulated the allied sectors of cement and steel. Encouragingly, various industrial players across different sectors are investing in capacity expansions and product diversification.

The services sector, meanwhile, is expected to match its last year's impressive performance, based on an analysis of the leading indicators pertaining to the period under review. Improved performance of the commodity producing sectors, coupled with increasing import quantums, would benefit the *wholesale* subsector, while a rise in sales of commercial vehicles, together with higher credit offtake, indicates optimism of the *transport* sector players. Similarly, rising teledensity and increasing gross margins of telecom operators suggest that the communications segment is off to a healthy start as well. Lastly, the double-digit growth in assets and deposits of the banking sector would help strengthen the value addition of finance and insurance sub-sector.

Inflation and Monetary Policy

On average, food inflation kept the overall inflation low despite pressures arising from consumer spending and higher oil prices in the country. Inventories of key food items like wheat, sugar and pulses kept the prices of these commodities low, whereas favorable adjustment in the duty structure of cigarettes led to a sharp fall in its price. Meanwhile, core inflation remained higher on average in H1-FY18, compared to the same period last year due to a continuous increase in education and healthcare costs. However, its pace has stabilized in recent months.

The Monetary Policy Committee (MPC) during the second quarter deliberated on inflation trends and especially SBP's projections that suggested a below-target CPI inflation for the year. However, the committee identified some factors, such as expectations of an uptick in inflation and external sector vulnerabilities, that would be critical going forward. Taking stock of the situation, the MPC decided to keep the policy rate unchanged in November 2017.

Meanwhile, the private sector continued its borrowing from scheduled banks for long-term projects, albeit at a lower pace. The expansion in fixed investment loans remained lower as maturing investment projects in power, construction and cement sectors have reduced the demand for additional borrowings. In contrast, the slowdown in working capital requirements came from a subdued activity in sugar and urea sectors, as manufacturers were struggling with large unsold stocks.

The slowdown in private credit caused a significant deceleration in net domestic assets (NDA) of the banking system. This trend in NDA was reinorced by a decline in government borrowing from the banking system, which was an outcome of both a contained fiscal deficit, as well as increased recourse to external financing. In effect, a part of the decline in NDA was offset by a proportionate increase in the net foreign assets (NFA) of the banking system. In overall terms, broad money supply (M2) witnessed a 9-year low expansion of Rs 336.4 billion during H1-FY18, compared to an increase of Rs 645.9 billion in the corresponding period last year.

Fiscal Sector

The growth in revenue collection outpaced the increase in expenditures in H1-FY18, resulting in a broad-based improvement in fiscal indicators. The overall fiscal deficit was contained at 2.2 percent of GDP, down from last year's level of 2.5 percent. The revenue deficit also declined from 0.8 percent of GDP to 0.4 percent and the primary deficit was further contained to 0.1 percent of GDP during H1-FY18 as compared to 0.5 percent last year.

The growth in revenue collection was broad based, reflected in both direct and indirect taxes. A growing economy – as evidenced by the rise in corporate profitability and higher salary income, along with the surge in the volume of transactions – contributed to higher direct tax collection. Similarly, the increase in imports provided an opportunity for the government to raise revenue from imported goods. The growing sales volumes, in addition to inching up of international POL prices, led to higher sales tax revenues.

The non-tax revenues also rebounded during H1-FY18 after contracting sharply last year. The sharp recovery was broad based with a surge in receipts from property and enterprise, civil administration as well as other miscellaneous receipts. The growth was led by higher SBP profit, mainly on account of revaluation gains, along with an increase in the government's borrowing from the central bank last year. Moreover, the high-volume OMO injections for liquidity management also contributed to higher SBP profit.

On the expenditure side, an elevated debt stock increased mark-up expenditures. Moreover, the ongoing efforts to improve security provision and public safety were further beefed up to create an environment conducive for economic growth and investment. As for the development mandate, infrastructure development and social uplift remained key priority areas for both federal and provincial governments, as they leveraged on improving energy conditions.

Notwithstanding the lower fiscal deficit, public debt increased by Rs 1.4 trillion during H1-FY18, significantly higher than the increase observed in the corresponding period of FY17. Within public debt, major increase came from external component, caused by (i) higher external borrowing; (ii) the revaluation losses due to PKR depreciation against US$; and (iii) appreciation of other currencies against US$. In case of domestic debt, almost the entire volume of incremental debt was against short-term instruments, as there was a net retirement of long-term debt during the period.

External Sector

While the real sector of the economy presents an encouraging picture, the external account remained a cause of concern from the macroeconomic stability standpoint. Despite the much-needed recovery in exports, Pakistan's balance of payments continued to reel under the pressure of surging imports. The current account deficit increased to US$ 7.9 billion in H1-FY18, from US$ 4.7 billion in the same period last year. Higher financial inflows compared to last year, albeit welcome, proved insufficient to rein in the decline in the country's FX reserves.

On the export front, Pakistan's half-yearly growth in exports encouragingly returned to the double-digit territory for the first time since H2-FY11. The broad-based nature of the export growth provides further reassurance; not only did textile exports post healthy numbers, outbound shipments of food and manufactured items also increased by sizable magnitudes. Going forward, a continuously strengthening global economy, recent PKR depreciation, and supportive government policies are likely to support export growth.

Imports surged to US$ 28.7 billion in H1-FY18 (customs records), fuelled by rising global oil prices and vibrant domestic consumption. Besides machinery imports (which, in contrast to its strong growth trend of the past couple of years, posted a YoY decline of 2.9 percent), almost all the major commodity groups exhibited high growth. Transport-related imports spiked by 43.0 percent, petroleum by a third, and those of the metal group by 30.9 percent.

The resultant worsening in the trade account was only partly offset by the rise in workers' remittances. The decline in inflows from Saudi Arabia, Pakistan's largest remittances corridor, has been offset by higher inflows from the advanced western economies. Going forward, as policies in the Kingdom become more stringent for foreign workers, remittances from this corridor are expected to remain under pressure. However, the recently announced schemes of 'Asaan Remittance Account' and the use of m-wallets for remittance delivery are likely to improve the inflow of worker remittances, particularly in far-flung areas with limited financial infrastructure.

With a drop in private and official financial inflows, the burden of financing the current account fell on country's FX reserves. The maturing external debt obligations and the consequent drop in the FX reserves during H1-FY18 made it inevitable for the country to resort to the international capital market. Consequently, Pakistan floated a Eurobond and Sukuk for a cumulative US$ 2.5 billion in December 2017.

1.2 Outlook

Important developments have taken place since the last presentation of the macroeconomic outlook. First, the PKR depreciated by 4.4 percent in December 2017. Second, the MPC in its 4th policy review of the fiscal year, in January 2018, decided to increase the policy rate, after keeping it unchanged for more than six quarters.

Table 1.2: Key Macroeconomic Targets and Projections

	FY17	FY18	
		Target[4]	SBP Projection[2]
		percent growth	
Real GDP[1]	5.3	6.0	5.0 – 6.0
CPI (average)[1]	4.2	6.0	4.5 – 5.5
		billion US$	
Remittances[2]	19.3	20.7	19.5 - 20.5
Exports (fob)[2]	21.9	23.1	24.1 – 24.6
Imports (fob)[2]	48.6	48.8	53.4 – 54.3
		percent of GDP	
Fiscal deficit[3]	5.8	4.1	5.0 – 6.0
Current a/c deficit[2]	4.1	2.6	4.0 – 5.0

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

The MPC's decision was taken to dispel the possible impact of rising oil prices and PKR depreciation on domestic inflation. The switch in the monetary policy stance can potentially induce corporates to practice more conservative leveraging. Encouragingly though, private credit has recovered strongly from mid-January 2018 onwards, and has increased by Rs 167.9 billion since then.[1] In the corresponding period of FY17, credit expansion was quite subdued (Rs 60.3 billion). Sugar industry dominated this borrowing spree as they belatedly initiated the sugarcane crushing.

Despite this activity, expectations are that the full-year growth in sugar production will remain lower compared to the previous season. Still, the overall LSM numbers may be stronger than last year on the back of expected buoyancy in consumer durables and construction-allied industries. In contrast, agriculture

[1] Between 12th January and 16th March 2018.

growth is likely to remain lower than last year, as well as the target set for FY18. This assessment is primarily based on an expected shortfall of 2.5 million bales in cotton production, as well as below-target area under wheat cultivation. In this context, GDP growth is likely to remain slightly below the target of 6 percent (**Table 1.2**).

The assessment on fiscal accounts is largely unchanged. The overall fiscal deficit is likely to exceed the target for FY18, despite an improvement in revenue growth. This is primarily due to the continued momentum in development spending as well as an increase in the debt servicing cost. The overall current expenditures are also likely to remain high because of expected election-related spending.

On the external front, the strengthening demand for imported products in western markets, along with the PKR depreciation and the government's policy support for exporters, are all positive signs. Following a healthy 16.4 percent growth in the month of February 2018, the cumulative export growth in Jul-Feb FY18 has reached 11.7 percent. If exports continue to grow at the same pace for the remaining months, the target of US$ 23.1 billion can comfortably be surpassed.

As for imports, there has been an uptick in the growth during February 2018. It is important to note that almost 62.5 percent of the YoY increase was due to energy products, which basically represented the impact of oil price rally throughout H1-FY18. A higher energy bill, coupled with a steady increase in the import of steel and textile inputs, more than offset a decline in the import of machinery, food items and completely built units of passenger cars during the month.

In this context, it was of some relief that the 7-month long oil price rally came to an end in February 2018, when the commodity shed some 11 percent of its value. Encouragingly, the outlook of global oil prices looks much stable now as the rapid increase in shale production by the US is likely to outweigh the anticipated pick-up in global oil demand. If these expectations materialize, then at least the price component of Pakistan's energy bill may be less of a concern going forward.

From inflation perspective also, the stability in the global oil market will be crucial. Since end-December 2017, the government has increased domestic petrol prices by Rs 11 per litre (13.7 percent) to pass on the impact of the high import cost as well as the PKR depreciation. Though underlying inflation has stabilized, and the headline inflation is low (and falling, as suggested by 4-month low inflation recorded in February 2018), upward pressures coming from fuel costs are hard to ignore.