1 Overview

1.1 Economic Review

The overall macroeconomic environment remained challenging during the first quarter of FY19. The foremost concern was the steep rise in global crude prices, which not only reinforced the already strong underlying inflationary pressures in the economy, but also eclipsed emerging improvements in the external sector. Moreover, uncertainties lingered with regard to the needed balance of payments (BoP) support on account of a political transition underway. Fiscal pressures also remained intact as expenditure rigidities allowed only a limited room for the government to maneuver. Responding to these challenges, the new political regime immediately announced cuts in development spending, partially reversed tax relief measures, and also explored avenues to bridge the external financing gap. While the ongoing macroeconomic stabilization process would continue at least over the short term, it has now become important to urgently initiate and expedite the needed structural reforms in the economy.

Table 1.1: Economic Indicators

	FY18	Q1-FY18	Q1-FY19
	Growth rate (percent)		
LSM[a]	5.4	9.9	-1.7
CPI (period average YoY)[a,1]	3.9	3.4	5.6
Private credit (flow)[b]	14.9	-0.7	2.1
Money supply (flow)[b]	9.7	-0.6	0.2
Exports[a]	13.7	10.5	4.2
Imports[a]	14.9	21.4	-0.04
FBR tax revenue (billion Rs)[c]	3,844.0	765.0	832.3
Exchange rate (+app/-dep%)[b]	-13.7	-0.5	-2.2
	million US dollars		
SBP's liquid reserves (end-period)[b]	9,789	13,857	8,409
Workers' remittances[b]	19,623	4,790	5,420
FDI in Pakistan[b]	3,092	765	439
Current account balance[b]	-18,989	-3,761	-3,622
Fiscal balance (% of GDP)[d]	-6.6	-1.2	-1.4

Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance
[1] YoY growth in the average of CPI index for the quarter.

Setting the direction and pace of the reforms is important not just to address the recurring macroeconomic imbalances, but also to push the economy's productivity frontier. In effect, this can help preserve growth, particularly at the juncture where the economy has begun to lose momentum (**Table 1.1**). In fact, large-scale manufacturing (LSM) contracted for the first time in over 7 years during Q1-FY19. The broad-based nature of this contraction suggested that the impact of exchange rate depreciation and stabilization measures (including a sharp cut in PSDP spending, increase in interest rates, and the imposition of regulatory duties) had begun to materialize. Furthermore, important budgetary measures such as the imposition of a ban on property and car purchases by non-filers restricted the activity in these sectors. The agriculture sector also under-performed, as lower-than-average

rainfall in the country aggravated the prevailing water shortages. Resultantly, *kharif* crops were cultivated over a lesser area compared to last year, leading to a decline in crop harvests.

Notwithstanding the slowdown in economic activities, SBP shored up its stabilization efforts and tightened the monetary policy further during the quarter. In each of the two policy decisions that were held during the quarter, the Monetary Policy Committee increased the policy rate by 100 basis points. These decisions were guided primarily by the prevalence of high twin deficits as well as the increased likelihood of headline inflation surpassing the annual target of 6 percent. While demand pressures remained strong, core inflation continued to trend upwards also as the second-round impact of higher fuel prices and exchange rate depreciation began to seep into the broader economy.

The increased raw-material prices and capital outlay also meant that the credit appetite of the private sector was strong, despite a slowdown in the overall economic activity. The impact of input prices (especially cotton and crude oil) on the overall credit off-take can also be seen from the near doubling of average loan size in Q1-FY19 compared to the same period last year. This implies that a substantial part of the higher off-take during the quarter was price driven. From banks' perspective, the price effect was a favorable development, since it led them to temporarily readjust their asset portfolios away from government papers in anticipation of further interest rate hikes.

This development can be attributed to the government's consistent rejection of high-rate bids in primary auctions, contrary to market expectations of inflation trajectory and interest rates. The behavioral interplay between banks and the government continued to complicate debt and monetary management. From the debt management's perspective, the consistent shortening of the maturity profile raised refinancing and rollover risks for the government; and from the monetary management's perspective, the near-flattening of the yield curve and excessive government borrowings from SBP posed major challenges. The absence of long-term benchmark rates amid excess liquidity in the interbank market (due to heavy retirements by the government) did not allow a complete transmission of changes in the monetary policy to the retail lending rates.

From the government's standpoint, avoiding an increased mark-up was intended to contain the overall fiscal deficit, especially at a time when the stock of public debt had reached a record high. Importantly, interest payments (debt servicing) were already the single-largest expense incurred by the government in FY18,

eating up 33.6 percent of the country's tax revenues. In Q1-FY19, these payments were 13.9 percent higher compared to the same period last year.

Although other expenditures remained subdued, especially PSDP that dropped by 45.5 percent over last year, the fiscal deficit stayed at a high level. This was mainly because revenue collection could not keep pace with growing current expenditures. Thus, the overall fiscal deficit reached Rs 541.7 billion in Q1-FY19 – almost Rs 100 billion higher than in Q1-FY18. Unlike the past few years, the bulk of the financing burden did not fall on the domestic banking system as domestic non-bank sources provided sufficient funding to the government. External funding was also available that made up for 38.9 percent of the total fiscal deficit.

Importantly, the latter also supported the country's external sector. The overall current account deficit declined slightly for the first time in over two years, but stayed at an elevated level in Q1-FY19. The persistence of a large deficit owed primarily to the worsening terms of trade: while export growth slowed down from 12.4 percent last year to only 3.8 percent in Q1-FY19, a sharp increase of 50.9 percent in global crude prices pushed up the import bill. In fact, the increase in oil payments was large enough to offset a combined gain from a decline in non-energy imports, exports growth, and a healthy increase in workers' remittances. With FDI falling 42.6 percent YoY, official borrowings played an important role in plugging the gap. Still, the reserves drawdown continued, and the level at end September 2018 was not sufficient to cover 2 months of the country's import bill.

In this context, although the economy is responding to stabilization measures taken over the past few months, the persistence of near-term challenges to the economy (low FX reserves and rising inflation) does not allow for any policy complacency to set in. Importantly, the domestic demand has witnessed moderation during Q1-FY19 relative to last year, but compared to recent averages, major indicators still reflect vibrancy. As mentioned earlier, the disaggregated analysis of core inflation also suggests contribution from both demand- and supply-side factors.

Therefore, it appears that the country would continue to move along the macroeconomic adjustment path for some time. However, in order to revert to a stable macroeconomic environment, it is equally important to address the policy uncertainties and spell out a clear path of economic reforms going forward. The most immediate requirement is to secure frontloaded BoP support that can lift some pressure from FX reserves as well as the Pak rupee. The confidence of consumers and businesses alike, which had improved sharply soon after the

elections, seems to have tailed off in the most recent surveys on account of rising cost pressures and an uncertain outlook. Furthermore, since the new government has hinted at major revisions in investment and industrial policies, investors (especially foreign investors) seem reluctant to take long-term positions.

These developments run the risk of intensifying the impact of stabilization measures on broad economic activity. However, it is important to note that the government has initiated important reforms in the fiscal sector that can later be built upon to alleviate the structural deficit. For instance, policymaking power has been taken from the FBR, to be shifted to an independent authority. The FBR will be focusing solely on tax administration and collection. Furthermore, efforts are underway to ensure access to third-party data to have information on potential high net-worth individuals.

Moreover, taking an initial step towards reforming the real estate sector, the government has notified the establishment of the Directorate General of Immovable Properties, with the mandate ranging from conducting survey-based market valuations, to establishing linkages with provincial revenue & excise authorities. This is a major initiative, which along with the increased inter-provincial co-ordination, can potentially help reduce prevailing distortions in the economy's incentive structure and also improve revenue collection (**Special Section 1**). With regards to the energy sector, the government has approved an upward revision in gas prices in order to alleviate the financial burden of gas distribution firms.

In sum, while efforts are underway to regain macroeconomic stability, the concurrent progress towards reforms is welcome. It is now important to deepen and accelerate the pace of reforms within the fiscal and energy sectors, and also spread the process across other sectors of the economy. The objective should be to rationalize the economy's incentive structure; enhance ease of doing business via embracing technology and simplifying procedures; and improve public financial management and governance. Putting right policies in place is critical, even if it takes time, to get the economy out of the boom and bust cycle. This is important also to benefit on the productivity front, in order to push the growth momentum forward. At this point, when the country's growing labor force has to be productively engaged, the country cannot afford to get caught up again in a low growth-high inflation equilibrium.

1.2 Executive Summary

Real Sector

After achieving a 13-year high growth of 5.8 percent in FY18, Pakistan's economy is showing signs of moderation. Both the agriculture and industrial sectors have underperformed during Q1-FY19 relative to the same period last year. Within the agriculture sector, preliminary estimates indicate that the production of all major *kharif* crops remained lower compared to the last season. This decline can be attributed primarily to an alarming water availability situation, particularly in Sindh, which led to a 7.7 percent decline in the total area under production. Furthermore, crop yields also suffered due to subdued fertilizer offtake amidst rising prices of both urea and DAP.

The LSM sector, meanwhile, contracted by 1.7 percent during Q1-FY19, after experiencing healthy growth of 9.9 percent during Q1-FY18. Noticeably, the production of construction-allied and consumer durable segments, which were the major drivers of growth last year, decelerated on a YoY basis. In overall terms, the interplay of supply- and demand-side dynamics disrupted the growth momentum of the sector. While the supply-side was affected by rising energy and raw material prices, the slowdown in demand stemmed from a decline in PSDP spending and the imposition of a ban on non-filers from purchasing vehicles.

The underperformance of the commodity-producing sector, alongside a slowdown in import quantum, is expected to have a spillover impact on the services sector. In particular, the *wholesale and retail trade* segment may experience a slowdown on the back of lackluster industrial activity and weakening imports. Similarly, transport activities may also be relatively subdued, as indicated by the declining sale of commercial vehicles and POL sales.

Inflation and Monetary Policy

With underlying inflationary pressures remaining strong and the twin deficits staying at elevated levels, monetary policy continued to move along the adjustment path. During both the Monetary Policy Committee (MPC) meetings that were held during the quarter, the policy rate was raised by 100 basis points each.

Average inflation during Q1-FY19 increased to 5.6 percent – the highest quarterly growth since Q1-FY15. While underlying inflationary pressures remained strong, the second-round impact of higher fuel prices and exchange rate depreciation further shored up the NFNE component of CPI. Food inflation, though remaining somewhat stable during the quarter, also saw its contribution rise to the overall

inflation, as the prices of major items such as wheat flour, tomato and fresh vegetables normalized after experiencing declines last year.

As for the private credit, strong expansion was observed during Q1-FY19 in contrast to the net retirements witnessed in the same quarter last year. This was primarily due to buoyant supply-side conditions in the interbank market. In particular, a sizable amount of banks' investments in government papers was maturing during the quarter, which the banks were not keen on rolling over in anticipation of a further increase in the interest rates. In overall terms, the government retired Rs 1.4 trillion to the commercial banks during Q1-FY19. Even after accounting for mop-ups in the open market operations, the net liquidity condition was such that the banks comfortably catered to credit demand from both public sector enterprises (PSEs) as well as the private sector without unwarranted pressures on the overnight rates. In fact, a negative deviation of 8 bps on average between the overnight rates and the policy rate persisted during the quarter.

In contrast, credit demand conditions were relatively downbeat during the quarter on account of increased borrowing costs as well as the overall slowdown in economic activity. This was evident from a sharp decline in the number of loan applications received by the banks during the quarter. Under such circumstances, the competition across banks for securing credible projects got intense, which restrained a strong pass-through of changes in the policy rate on retail lending rates; the latter increased by only 75 bps during the quarter.

As for the financing categories, the activity in working capital loans was more prominent since rising commodity prices and input costs increased the financing requirements of the corporate sector. The strongest impact was seen in the case of loans taken by petroleum refineries and thermal power producers. In contrast, a slower offtake was visible in the fixed investment category. Given the completion of several early harvest projects under the CPEC, some moderation was to be expected. However, anecdotal evidence also suggests that the corporate sector waited for an expected policy shift with respect to investment and trade, before it could realign its business strategy with the exchange rate movements, rising fuel costs and interest rate trajectory. Similarly, consumer financing also suffered a deceleration, as budgetary measures (such as the imposition of a ban on non-filers from purchasing new vehicles) and upward revisions in car prices following PKR depreciation reduced the demand for auto-financing.

In contrast to last year, both private and public sector borrowing contributed to an increase in the net domestic assets (NDA) of the banking system. However, the impact of rising NDA on broad money (which rose by Rs 26.6 billion during Q1-

FY19) remained subdued because of a net contraction in the net foreign assets (NFA) of the banking system as the country's overall external situation worsened.

Fiscal Deficit and Debt

The fiscal deficit widened to Rs 541.7 billion during Q1-FY19, compared to Rs 440.8 billion during the corresponding period last year. This increase came on the back of a steep rise in current spending (mainly debt servicing and defence), which more than offset marginal gains in the revenue collection.

The consolidated revenues grew by 7.5 percent during the quarter; however, this pace was lower than the 18.9 percent uptick witnessed during Q1-FY18. The slowdown in revenue growth was attributed to: (i) a sharp reduction in the GST rate on petroleum products in July 2018; (ii) the impact of income tax incentives announced by the outgoing government in the Budget 2018-19; (iii) lower collection of withholding tax against PSDP-related contracts; and (iv) an overall slowdown in the economy, especially in construction-allied sectors, which led to lower collections from cement and steel sales. The non-tax revenues, on the other hand, grew by a significant 11.6 percent.

On the expenditure front, a sharp decline in development expenditures led to overall growth slowing to 11.0 percent during Q1-FY19 from 13.5 percent during Q1-FY18. This improvement was offset by an 18.1 percent increase in current spending, on the back of higher interest payments and defense related spending. Provincial current expenditures also grew by 21.9 percent, as spending towards general public services, public order, and educational affairs increased.

The resultant higher fiscal deficit was financed through increased government borrowing from both domestic and external sources. In case of domestic sources, the government borrowed significantly from SBP to retire its bank debt; at the same time, reliance on non-bank sources (money market funds, pension funds, and corporates) also remained higher than last year. In case of public external debt, major contribution came from higher bilateral borrowings. In overall terms, Pakistan's gross public debt reached Rs 25.8 trillion by end-September 2018, compared to Rs 25.0 trillion by end-June 2018.

External Sector

Q1-FY19 was the eighth consecutive quarter in which the country's exports rose on a YoY basis. This development, coupled with a healthy uptick in workers' remittances, led to a slight narrowing of the current account deficit. However, the level of the deficit remained worrisome, as rising oil prices resulted in the quarterly import bill crossing US$ 4.0 billion mark for the first time since Q1-

FY15. With foreign investments declining on a YoY basis, and external borrowing by the private sector remaining subdued, the financial inflows proved insufficient. Resultantly, the pressure on the balance of payments continued to mount, with the country's FX reserves declining by US$ 1.4 billion and the PKR depreciating by 2.2 percent during the quarter.

As for exports, the growth rate dropped from double digits to 3.8 percent during Q1-FY19. This was primarily because of a sharp slowdown in textile exports, as plummeting unit prices for most products almost entirely offset the impact of higher quantum. However, there was the 29.2 percent rise in food exports, particularly of wheat and sugar.

On the other hand, the import bill growth stagnated during the quarter, as non-energy imports declined by a hefty 18.7 percent compared to Q1-FY18, the first such contraction in four quarters. This was principally because of a decline in machinery imports, as public sector development spending slowed and early-harvest CPEC projects neared completion. Energy imports, however, almost completely offset this decline, as a rise in international oil prices drove import payments upward by 20.9 percent. As a result, the trade deficit widened by 7.3 percent on a YoY basis; however, this expansion was much lower than the 38.6 percent YoY uptick noted in Q1-FY18.

Workers' remittances observed a healthy growth of 13.2 percent, as inflows from both GCC and non-GCC countries grew. The improving macroeconomic conditions in the UK and the US, besides the seasonal inflows, supported the remittances in Q1-FY19.

On the financing front, the major challenge in plugging the current account gap was the near-completion of several early harvest projects under CPEC, which led to a 42.6 percent YoY contraction in FDI and partially caused a drop in external borrowing by the private sector (mainly the power sector firms). Apart from CPEC-related inflows from China, no major activity was observed in FDI. As for portfolio investment, net *outflows* accelerated in Q1-FY19, as foreign selling from local bourses doubled compared to last year. This performance was very much in line with the trends in other emerging markets that are also facing selling pressures in the wake of monetary tightening by the US Fed and the resultant portfolio realignment by global fund managers. Under such circumstances, the burden of arranging BoP financing fell heavily on official sources. Here, too, projected inflows from IFIs could not materialize and Pakistan counted increasingly on government-to-government funding arrangements, in addition to drawing drown its FX reserves to plug the payments gap.

1.3 Economic Outlook

The policy environment through the rest of the year is likely to center around achieving macroeconomic stability. SBP has already increased the policy rate by another 150 bps in November 2018, in order to check inflationary pressures and rising inflationary expectations. SBP's inflation forecast for the full year stands at 6.5 to 7.5 percent (**Table 1.2**), which takes into account the impact of revisions in gas tariffs and the second-round impact of exchange rate depreciation. Similarly, fiscal policy has been recalibrated to work in tandem with the stabilization objective since the formation of the new government. In particular, it has cut budgeted development expenditures for FY19 and has partially reversed the tax relief measures that were announced earlier; as mentioned before, these measures had contributed to lower revenue mobilization during Q1-FY19.

Table 1.2: Key Macroeconomic Targets and Projections

	FY18	FY19	
		Target[1]	**SBP Projections**
		percent growth	
Real GDP	5.8	6.2	4.0 – 4.5
CPI (average)	3.9	6.0	6.5 – 7.5
		billion US dollars	
Remittances	19.6	21.2	20.5 – 21.5
Exports (fob)	24.8	27.9	27.0 – 28.0
Imports (fob)	55.8	58.5	56.0 – 57.0
		percent of GDP	
Fiscal deficit	6.6	4.9	5.5 – 6.5
Current a/c deficit	6.1	4.0	4.5 – 5.5

Data source: [1] Ministry of Finance and Planning Commission

Thus, with the policy focus now tilted predominantly towards macroeconomic stabilization, the 6.2 percent target for real GDP growth seems unachievable. *Kharif* crops have already underperformed, and given the persistent water shortages across the country, the overall crop sector is unlikely to rebound in the rest of the year. Therefore, the overall contribution of agriculture in GDP growth would largely depend upon the performance of the livestock sub-sector. Similarly, in case of LSM, the construction-allied industries will continue to give a subdued performance as the government is likely to contain its development spending. Consumer industries would also feel the brunt of reduced demand, as purchasing powers are hit by rising inflation, increasing interest rates and adverse currency movements.

As for the external sector, the most important development has been the bearish spell in the global crude market that began in early October and ran through the rest of Q2-FY19. Oil prices have fallen by a quarter during this period and reached a year-low level of US$ 54 per barrel. This will lift some pressure from Pakistan's oil import bill in at least the second quarter of the year.

In the case of non-energy imports, the current slowdown may continue going forward amidst weakening domestic economic activity, exchange rate depreciation and increase in import duties. At the same time, exports may gain from exchange rate depreciation and increase in consumer spending in the advanced economies, but their momentum could possibly be weakened by rising cost pressures. Still, the estimates for overall foreign exchange earnings are on the higher side, as workers' remittances are projected to sustain a high growth. Resultantly, the overall current account deficit is expected to narrow down to 4.5-5.5 percent of GDP, from 6.1 percent in FY18.

Financing of the current account might improve going forward as there is an expectation of receiving higher foreign exchange inflows from both private and official sources during the second half of FY19. In particular, recent bilateral arrangements, including the deferred oil payments facility, are likely to be available from January 2019 onwards. Not only would this bolster the country's foreign exchange reserves, but also ease pressures in the domestic foreign exchange market. Thus, continuing with a right mix of policies and sufficient BoP support, the country is expected to revert to a stable macroeconomic environment over the medium term.