1 Overview

1.1 Economic Review

As the economy moved into the second quarter of FY19, the effects of macroeconomic stabilization measures taken since December 2017 have started to unfold. Specifically, monetary policy tightening, exchange rate adjustments, reduction in PSDP spending and regulatory measures have impacted domestic economic activity. This is reflected in a contraction in LSM growth, decline in imports and moderation in the fixed investment component of private sector credit. The underperformance of major *kharif* crops added to this slowdown. Nonetheless, inflation continued to increase mainly due to cost factors and some persistence in underlying demand.

In particular, during Q2-FY19 CPI inflation on YoY basis attained the highest level in 17 consecutive quarters. This trajectory was largely dictated by its core component, non-food non-energy (NFNE), which further gathered momentum as the pass-through of exchange rate depreciation and second round impact of high oil price accentuated its already elevated level. Moreover, persisting high level of fiscal deficit continued to undermine efforts to contain domestic demand.

Table 1.1: Economic Indicators

	FY18	H1-FY18	H1-FY19
	Growth rate (percent)		
LSM[a]	5.0	6.6	-1.5
CPI (period average YoY)[a,1]	3.9	3.8	6.0
Private credit (flow)[b]	14.9	5.7	9.5
Money supply (flow)[b]	9.7	2.3	3.6
Exports[a]	13.7	10.9	1.9
Imports[a]	14.9	18.0	-2.6
FBR tax revenue (billion Rs)[c]	3,844.0	1,722	1,795
Exchange rate (+app/-dep%)[b]	-13.7	-5.0	-12.5
	million US dollars		
SBP's liquid reserves (end-period)[b]	9,789	14,107	7,199
Workers' remittances[b]	19,623	9,745	11,030
FDI in Pakistan[b]	3,092	1,633	1,319
Current account balance[b]	-18,989	-8,353	-7,615
Fiscal balance (% of GDP)[d]	-6.6	-2.2	-2.7

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.

Indeed, the fiscal deficit continued to stay high despite a sharp cut in development spending since the beginning of FY19. While revenue collection declined, current expenditures increased substantially. Rising interest rates and exchange rate depreciation are contributing to the sharp increase in the latter; whereas, a slowdown in economic activity took a toll on the former despite some compensation from higher inflation and exchange rate adjustments. The resulting financing of the budget deficit fell mostly on borrowing from the central bank, as the government resorted to limited external borrowing.

In the external sector, exchange rate depreciation and other regulatory measures have resulted in some improvement in the current account deficit (CAD) during H1-FY19. While the balance on trade in goods and services stagnated at last year's level, the sharp increase in workers' remittances was key in curtailing CAD which improved by 8.8 percent (YoY)[1]. However, net financial inflows were lower than last year in the wake of absence of sovereign debt issuance, lower short-term borrowing, drop in FDI, and continued outflow of equity investments. Therefore, SBP's FX reserves declined by US$ 2.7 billion during H1-FY19, and the PKR depreciated by 12.5 percent against the US dollar.

Taking stock of the evolving developments in the economy, most importantly the high level of fiscal and current account deficits, it is evident that measures addressing structural issues are needed. In order to improve productivity and increase exports, investment in human capital and technology is required. This strategy is long term but its impact on total factor productivity (TFP) is exponential. It will not only attract FDI in Pakistan but with strategic diplomatic efforts, more skilled labor can be sent abroad. In both cases, much needed foreign inflows would materialize. Likewise, the ongoing focus of both the government and SBP to improve financial inclusion, particularly in the context of supporting SMEs and low cost housing sector, can result in better income distribution and an improvement in effectiveness of monetary policy. Lastly, the government's focus on revenue related measures is timely; however, over-reliance on the withholding mode of income tax regime for shoring up tax revenue needs to be rationalized. Unless such measures to facilitate structural transformation are taken, the Pakistan economy will continue to experience business cycles of shorter durations.

1.2 Executive Summary

Real Sector

Economic activities in H1-FY19 remained constrained. This is evidenced by the decline in the performance of the industrial sector, as explained by contraction in LSM particularly in Q2-FY19, and lower production of major crops in the agriculture sector. The slowdown in both the commodity producing sectors is broad based and it is affecting the services sector as well.

[1] CAD has further improved in January 2019. On cumulative basis, it has narrowed down by 16.8 percent during Jul-Jan FY19.

The industrial sector is facing the brunt of the slowdown in both public and private consumption. LSM contracted by 1.5 percent during H1-FY19 relative to a healthy growth of 6.6 percent in H1-FY18. The slowdown in LSM became more pronounced in Q2-FY19 as it declined by 2.4 percent compared to a growth of 3.7 percent in Q2-FY18. Sharp decline in PSDP spending and uncertainties in the property market are impacting the cement and steel sectors, while lower sugar production amid inability in offloading accumulated stocks has dampened the food sector's growth. The lacklustre performance of the textiles sector indicates some moderation in domestic demand. The automobiles sector's growth remained positive, but much lower than the last year's level during the first half. This trend is mainly attributed to the sharp increase in car prices and borrowing costs along with the decline in rural demand for tractors and motorcycles. However, a partial downside impact cannot be ruled out due to the restriction on non-tax filers to buy a car, that has recently been reversed in the Finance Supplementary (Second Amendment) Act, 2019.

In the agriculture sector, during the first half of FY19 there has been a broad based decline in production of major *kharif* crops mainly due to water shortages. Cotton crop is affected the most as according to official estimates[2] its production has remained short by 25 percent from its target. At the start of the *rabi* season, water shortages and weak fertilizer offtake due to its higher price has led to contraction in area sown under wheat. With additional area available to them, farmers have been inclined to utilize it for cultivation of minor crops, as per the historical trend. Furthermore, predictive indicators such as credit disbursements show that livestock sector's growth is going to remain largely intact.

The performance of the services sector is also witnessing moderation as depicted by limited data available by the first half of FY19. Declining trend in performance of commodity producing sector, together with slowdown in imports, has affected the wholesale segment. Similarly, a declining trend in commercial vehicles sales and POL sales shows that growth in the transport sector has also moderated. Lastly, even though the finance segment witnessed an increase in deposits and bank profitability, some deterioration in asset quality has been observed as NPLs rose on a YoY basis while infection ratio of the sugar sector deteriorated sharply.

Inflation and Monetary Policy

Macroeconomic challenges in the form of rising inflationary pressures, elevated levels of twin deficits and low foreign exchange reserves led the Monetary Policy

[2] Pakistan Cotton Crop Assessment Committee.

Committee (MPC) to further increase the policy rate by 150 basis points in November 2018.

Average headline CPI inflation rose to 6.5 percent during Q2-FY19 – the highest quarterly inflation since Q1-FY15, when global crude oil prices were around US$ 100 per barrel. Whereas, the increase in inflation is more pronounced in its core component (NFNE)[3]. Upward revision in the prices of natural gas by the government has alone contributed around 1.0 percentage point in the recent surge in inflation. In addition, pressure on prices in non-food non-energy component of CPI was further fuelled by pass through of exchange rate depreciation on inflation. Food inflation, on the other hand, continued to stay muted during Q2-FY19, with a notable decline in prices of perishables offsetting the double-digit hikes in prices of cigarettes, meat and chicken.

As for the private sector credit, an additional uptake of Rs 570.4 billion has been observed during H1-FY19, compared to Rs 296.3 billion in the same period last year. This trend is largely due to the rising cost of imported inputs and higher energy prices on account of PKR depreciation and liquidity constraints owing to a higher level of unsold inventories (in POL, steel, autos, fertilizers, electronics and sugar sectors) along with circular debt in the energy sector. While non-manufacturing businesses have curtailed further expansion, few industries, such as power, cement and textile sectors, continued to borrow for capacity additions.

Since SBP financed most of the budgetary borrowings, commercial banks had sufficient liquidity to cater to the private sector's credit needs, sometimes extending incremental loans at sub-Kibor rates during Q2-FY19 as well. This is because most of the government debt is now accumulated in the short-run with large maturities in every auction. The commercial banks were hesitant to completely roll over these maturities close to the upcoming monetary policy decisions in anticipation of further increases in the policy rate. These dynamics made public debt management challenging while posing higher re-pricing risks for the government.

In overall terms, the significant rise in both the budgetary borrowings and private sector credit led to a steep increase in the net domestic assets (NDA) of the banking system during Q2-FY19, which more than offset the decline observed in net foreign assets (NFA) as the external situation of the economy continued to weaken. As a result, reserve money growth reached 3.1 percent during HI-FY19 as compared to 0.3 percent during the same period last year.

[3] Increased by 8.2 percent during Q2-FY19 on YoY basis.

Fiscal Sector

The growth in revenue generation recorded further moderation in the second quarter of FY19. This, along with persistent increase in current expenditures, resulted in a broad-based deterioration of fiscal indicators. For example, the overall fiscal deficit increased to 2.7 percent of GDP, up from 2.2 percent in the same period of last year. Similarly, a sharp growth in current expenditures led to a significant increase in the revenue deficit, which increased to 1.7 percent of GDP in H1-FY19 from 0.5 percent last year. At the same time, the primary deficit increased to 0.4 percent of GDP in H1-FY19 from 0.1 percent last year.

The decline in revenue collection has been driven by a slowdown in tax revenue growth and decline in non-tax revenues. The deceleration in tax revenue is largely due to stagnant growth in direct and sales taxes. While the moderation in economic activity resulted in an overall deceleration in tax growth, exchange rate depreciation partially helped to shore up revenues through import-stage taxes. The non-tax revenue declined significantly during H1-FY19, primarily on account of lower SBP profits due to revaluation of liabilities.

Expenditure growth further decelerated during Q2-FY19, mainly due to a sharp cut in development expenditures. Development spending declined both at federal and provincial level, while current expenditure growth was higher at federal level on account of both higher interest payments and defence related spending. Specifically, the growth in interest payments on domestic debt was a result of re-pricing of domestic debt mainly because of increase in interest rate during Q2-FY19. Meanwhile, external debt servicing was higher largely due to PKR depreciation.

External Sector

The high CAD is mainly a result of a 5.0 percent growth in the merchandize trade deficit, which partially offset the notable improvements in the services account and workers' remittances. Higher international oil prices during most of the period has been the key factor behind rising trade deficit, as they pushed the six-month energy import payments up by 26.7 percent to an all-time high level of US$ 8.0 billion. The higher prices completely offset the impact of a drop in quantum imports of both crude oil and POL products, and also played a dominant role in pushing up the LNG imports during the period.

On an overall basis, energy import payments have completely offset the impact of a decline in non-energy import payments during H1-FY19. A sizable cut in development spending and the general slowdown in economic activity reduced the country's demand for imported construction-related items, like iron and steel, and construction machinery. Support also came from soft international palm oil prices, and the continued and expected drop in imports of CPEC-related power generation and electrical machinery. Furthermore, regulatory measures and the PKR depreciation contributed to a decline in multiple non-essential consumer imports, such as CBU cars, and dry and fresh fruits.

The export situation is also presenting a challenge, with cumulative receipts stagnating at US$ 11.8 billion during H1-FY19, that is, a growth of 0.1 percent as compared to 11.3 percent during H1-FY18. The economic slowdown in key European markets, such as Germany and France, is a major concern, as these countries are among the top destinations for Pakistan's textile exports. Even though Pakistan's textile exports to the EU rose in quantum terms, the exporters were fetching lower unit prices owing to strong competition from Bangladesh and China. Competition from China also played a role in subduing Pakistan's non-basmati rice exports to major African markets, and offset the healthy quantum-led growth in basmati exports recorded during H1-FY19. Meanwhile, the withdrawal of export subsidies on sugar and wheat (in Q1 and Q2 respectively) contributed to dwindling exports of both commodities.

A part of the merchandize trade deficit has been offset by a 16.8 percent reduction in the services deficit, with lower freight imports and a hefty decline in FX purchases by residents going abroad playing a key role. Workers' remittances posted a healthy growth of 13.2 percent during H1-FY19, with the US, UK and Malaysia figuring prominently. Continued strong growth in these economies, along with rollback of previous restrictions on correspondent banking (in case of UK), led to higher remittances from the two economies.

1.3 Economic Outlook

Real GDP growth during FY19 is likely to moderate significantly, mainly due to slowdown in the growth of the agriculture sector and stabilization measures taken to preserve macroeconomic stability. This is in line with a further contraction in LSM during Q2-FY19. Moreover, given that public development spending, a key driver for private sector industrial

Table 1.2: Key Macroeconomic Targets and Projections

		FY19	
	FY18	**Target[1]**	**SBP Projections**
		percent growth	
Real GDP	5.2	6.2	3.5 - 4.0
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	25.5 - 27.0
Imports (fob)	56.0	58.5	54.0 - 56.0
		percent of GDP	
Fiscal deficit	6.6	4.9	6.0 - 7.0
CAD	6.1	4.0	4.5 - 5.5

Data source: [1] Ministry of Finance and Planning Commission activities, is unlikely to pick up anytime soon, the full year outlook for manufacturing activities remains subdued. Furthermore, private consumption is going to remain lower due to tighter monetary policy and pass through of exchange rate depreciation that has resulted in both higher energy prices and core inflation. In addition, the prospects for the upcoming wheat crop remain subdued in terms of growth. All these aspects are going to constrain the services sector in the coming months as well. Therefore, SBP has revised down its projection for real GDP growth during FY19 by 0.5 percent to 3.5-4.0 percent (**Table 1.2**)

Regarding price pressures, inflation is expected to remain high in H2-FY19. This is due to the second round impact of recent exchange rate depreciations, an upward adjustment in gas and electricity prices and higher budgetary borrowing from SBP. However, the lagged impact of policy rate increases would be instrumental in keeping demand pressures in check. Acknowledging these risks, SBP continues to project average CPI inflation at 6.5-7.5 percent for the full year.

As noted earlier, the primary deficit has increased further while there has been a sharp reduction in development expenditures in order to improve the fiscal position. This situation has become more challenging as the growth in current expenditure inched up to 17.3 percent during the first half as compared to 13.5 percent last year. On the contrary, revenue collection has contracted by 2.4 percent during the same period as compared to the growth of 19.8 percent last year. Since there is limited room to curtail government expenditures in the coming months, it is the growth in revenues that would be instrumental in determining the overall fiscal position for FY19. Incorporating the performance of revenue collection during the second half in the last four years, SBP projects fiscal deficit to further deteriorate by 0.5 percent of GDP, which brings it close to the same level as in FY18.

As for the external sector, while the CAD has improved by USD 1.7 billion during the first seven months of FY19, it is still high at USD 8.4 billion. Some improvement is expected to continue in the remaining months as imports are likely to contract further on account of moderating domestic demand and relatively low international oil price as compared to that at the beginning of FY19.[4] However, merchandize exports are expected to miss the target due to waning demand in certain export destinations. Additionally, this is compounded by the competitive pressures in the international arena and the lack of diversified and higher value

[4] International price of Brent crude was about USD 75 per barrel in July 2018. It dropped to about USD 57 per barrel in December 2018. The World Bank projects the international oil price to remain around USD 67 per barrel on average during 2019 and 2020.

added products that can effectively utilise the export quotas allowed under specific trade agreements.

Meanwhile on the external financing front, the efforts of the government have started to materialize in the shape of bilateral inflows from Saudi Arabia, UAE and China. Some of these inflows have already been realized, while rest are due in H2-FY19. Along with the Saudi deferred oil payment facilities, these inflows have an important role in meeting the external financing gap for FY19; thereby, relieving pressure on the foreign exchange reserves and mitigating volatility in the FX market.