1 Overview

Towards the end of FY19, the challenges to the macro-economy have continued to persist. Specifically, during Jul-Mar FY19, fiscal deficit further deteriorated and while the current account gap relatively improved, its sustainability remained a concern. Meanwhile, CPI inflation averaging at 6.8 percent in the first 9 months of FY19 has already exceeded its 6.0 percent target for the current fiscal year. Furthermore, as per provisional national income accounts, GDP growth moderated to 3.3 percent in FY19. Thus far, these trends have yet again exposed Pakistan's structural deficiencies and its vulnerabilities to the buildup of external and internal deficits (**Table 1.1**).

Table 1.1: Selected Economic Indicators

		FY17[F]	FY18[R]	FY19[P]
Growth rate (percent)				
Real GDP	Jul-Jun	5.2	5.5	3.3
Agriculture	Jul-Jun	2.2	3.9	0.8
Industry	Jul-Jun	4.6	4.9	1.4
o/w LSM	Jul-Jun	5.6	5.1	-2.1
Services	Jul-Jun	6.5	6.2	4.7
CPI (period average)[a]	Jul-Mar	4.0	3.8	6.8
Private sector credit [b]	Jul-Mar	9.9	9.1	10.2
Money supply (M2)[b]	Jul-Mar	5.9	4.8	5.1
Exports [b]	Jul-Mar	-0.1	11.9	-1.3
Imports [b]	Jul-Mar	14.7	18.8	-3.7
Tax revenue –FBR [c]	Jul-Mar	7.5	16.2	2.8
Exchange rate (+app/-dep%)[b]	Jul-Mar	0.0	-9.2	-13.7
Policy Rate [b]	Mar	5.75	6.0	10.75**
ONMMR (end-period) [b*]	Mar	5.7	5.7	10.0
billion US dollars				
SBP's reserves (end-period) [b]	Mar	16.5	11.6	10.5
Worker remittances [b]	Jul-Mar	14.1	14.8	16.1
FDI in Pakistan [b]	Jul-Mar	2.0	2.6	1.3
Current account balance [b]	Jul-Mar	-8.0	-13.6	-10.3
percent of GDP[1]				
Fiscal balance[d]	Jul-Mar	-3.9	-4.3	-5.0
Current account balance	Jul-Mar	-2.6	-5.7	-4.7
Investment	Jul-Jun	16.2	16.7	15.4

P=Provisional; F= Final; R=Revised
* Overnight Money Market Rate
** Effective from April 01, 2019
[1] Provisional numbers for FY19
Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Federal Board of Revenue; and [d] Ministry of Finance

The moderation in GDP growth is partly a result of policy induced, demand-management measures, initiated since January 2018, to contain the buildup of inflationary pressures and rising twin deficits. These policy actions led to contraction in LSM, which was further entrenched by regulatory measures. At the same time, adverse developments such as water shortages and high input costs undermined the agriculture sector performance. In the meantime, less tangible factors such as uncertainty regarding decision on the IMF program for BoP support hampered business sentiments as reflected in the IBA-SBP Business Confidence Survey result of April 2019. These developments also contributed to a slowdown in private sector credit during the third quarter of FY19.

The overall economic slowdown, along with specific import compression measures, led to a sizeable contraction in country's import bill. Exports managed to post a sizable growth in quantum terms; however, this recovery was not sufficient to offset the adverse price effect stemming from lower unit values. Nonetheless, improvement in trade deficit coupled with healthy growth in workers' remittances resulted in reduction in current account deficit from US$ 13.6 billion in Jul-Mar FY18 to US$ 10.3 billion in Jul-Mar FY19. However, slowdown in FDI inflows kept the external financing requirements at elevated levels. Thus, while the realized bilateral inflows from friendly countries did provide some support to foreign exchange reserves, its adequacy is still below the three-month of import coverage and the overall BoP position remained weak.

In the same vein, fiscal indicators have continued to deteriorate in the first nine months of FY19 despite a steep cut in development expenditures by 34.0 percent. At the same time, interest rate hikes and exchange rate depreciations accentuated the rigidities in the current expenditures. Making things worse, revenue mobilization remained weak due to stagnant tax revenues and steep fall in non-tax revenues. These trends are largely attributed to slowdown in economic activity and lack of tax effort both at provincial and federal level. As a result, the fiscal deficit increased to 5.0 percent of GDP; notably, the primary deficit has risen to 1.2 percent of GDP, which suggests that the debt servicing ability has deteriorated sharply and the country would be requiring more debt to service its current debt.

Despite several rounds of policy rate hike, a cumulative increase of 500 bps since January 2018, inflation has rather stubbornly kept an upward trajectory. Although demand-pull pressures have lessened in intensity towards the end of FY19, the Non-Food Non-Energy component continued to climb. This is because its major impetus came from cost-push factors, including the second round impact of exchange rate deprecation and increase in energy prices. Furthermore, food inflation that had remained benign over the past five years posted a sharp increase in Q3-FY19 due to supply-side bottlenecks.

In spite of being in stabilization phase led by demand management policies for the last sixteen months, three challenges still stand out in Pakistan's economy. First, external sector remains vulnerable. Second, fiscal consolidation remains elusive. Third, inflation continues to attain higher plateaus. This basically suggests that current stabilization agenda needs to be reinforced with deep rooted structural reforms.

The reforms in fiscal sector are particularly long awaited especially with respect to broadening the tax base, reduction in untargeted subsidies, withdrawal of discretionary tax exemptions and privatization/restructuring of loss making PSEs. These reforms are challenging to implement and thus demand serious realization and commitment. A cross cutting area is energy, where a massive overhaul is required across the entire value chain in terms of pricing, governance, management of circular debt and handling mechanism of IPPs (See **Special Section 1**).

As for the balance of payments, role of private sector would be equally important as of the government in terms of reducing the structural deficit. The government has to provide affordable infrastructure, competitive markets, skill development and business facilitation. The private sector, on the other hand, has to focus on adoption of innovation and technology to improve product and market diversification.

1.1 Executive Summary

Real Sector

The pace of economic growth slowed down considerably during FY19. This was mainly in response to the policy measures taken to curb the twin deficits. These measures affected the performance of the industrial sector and dampened manufacturing activities in the country. Meanwhile, water- and weather-related concerns, in tandem with the higher cost of major inputs, took a toll on crop production. The weak showing by the commodity-producing sectors also constrained the output of the services sector.

Industrial output moderated on the back of a cut in PSDP outlays, amid tightening in monetary policy, currency depreciation, and imposition of regulatory measures. Within industry, there were notable declines in LSM, construction, and mining and quarrying segments. Specifically, LSM posted a broad-based 2.9 percent decline during Jul-Mar FY19, compared to a 6.3 percent growth recorded during the same period last year; nearly all the leading sectors contracted during the review period (**Chapter 2**).

Meanwhile, the agriculture sector’s subdued growth can be traced to a noticeable contraction in the crop sector, particularly important crops. Sugarcane and cotton crop outputs declined by 19.4 percent and 17.5 percent respectively. This recent stagnancy in agricultural output makes it pertinent to highlight the urgent need for boosting agriculture productivity in the medium term while population growth remains high. In this context, **Special Section 2** highlighted the state of food security in Pakistan. However, the silver lining during FY19 was the livestock segment, which maintained its growth momentum from last year and ultimately pushed the agriculture sector's overall growth marginally into positive territory.

On the other hand, the services sector lost some of its growth momentum from last year, registering a growth of 4.7 percent during FY19 as compared to 6.2 percent in FY18. In particular, growth in wholesale and retail trade – a heavyweight segment with inherent linkages to the commodity-producing sectors – more than halved as compared to FY18. The slowdown in imports played a role in the lower growth of the retail trade segment.

In sum, the dominance of the services sector within the economy relative to industry and agriculture, continued to grow during FY19. If left unchecked, the evolving dynamics of domestic consumption relative to production can further exacerbate the gap between demand and supply, necessitating either higher imports or lower exportable surplus in the future. Clearly, neither of these outcomes is desirable from the external sector's stability perspective, and calls for the adoption of structural transformation at the earliest, to ensure a more balanced growth path of the economy.

Inflation and Monetary Policy

The headline CPI inflation rose steeply from 6.0 percent in H1-FY19 to 8.3 percent in the third quarter. Cost-push factors were mostly responsible: (i) managing the high level of twin deficits necessitated upward adjustments in administered prices (of mainly petrol, gas and electricity), which not only directly inflated CPI's energy component (and by extension, transport services), but also escalated manufacturing cost; (ii) the impact of a sharp increase in the rupee-dollar parity was felt across a number of items within the CPI basket; and (iii) supply-side constraints and higher transportation costs led to a surge in food prices (these prices had remained low and stable over the past 5 years). Furthermore, house rents posted a sharp YoY increase during Q3-FY19 due to base effect – quarterly revision in house rents was unusually modest in Q3-FY18.

As a result, inflationary pressures were broad-based – 72 percent of the items within the CPI basked recorded inflation of more than the 6 percent target rate, whereas 31.5 percent of the items recorded double-digit inflation. Importantly, the persistence of the large twin deficits weighed heavily on the near- to medium-term inflation outlook. Moreover, further adjustments in energy tariffs as well as continued pressures on the exchange rate also meant that cost pressures were not likely to dissipate. Therefore, the Monetary Policy Committee decided to continue with monetary tightening, and increased the policy rate by a cumulative

75 bps during the review period, taking the cumulative adjustment since the beginning of the recent tightening cycle to 500 bps by end of Q3-FY19.

On the monetary policy implementation front, voluminous budgetary transactions in the banking system complicated liquidity management during the third quarter. In particular, commercial banks continued to eye higher cut-offs in auctions of government securities, and were not willing to roll-over maturing debt at prevailing rates. As a result, the government had to borrow excessively from the SBP to finance the fiscal deficit and to repay commercial banks' debt. On aggregate, the government retired Rs 2.0 trillion to banks during Q3-FY19 – a record-high level for any quarter. To absorb the excess liquidity from the market and to keep overnight rates close to the policy rate, the SBP had to conduct 52 OMOs (mop-ups only) during the quarter.

The entrenched liquidity surpluses in the interbank market can also be explained by the weakening momentum of private sector credit in the wake of unfavorable macroeconomic conditions. After posting a sizable expansion in the preceding quarter, credit offtake suddenly and sharply slowed down to just Rs 41.1 billion in Q3-FY19, as compared to Rs 177.4 billion in the same period last year. The slowdown in the working capital component was more pronounced, as scheduled retirements by textile and fertilizer manufacturers largely offset fresh borrowings by sugar, dairy and beverages sectors. Among non-manufacturers, power generating firms also made net retirements during Q3-FY19, as their cash flows improved after the issuance of Rs 200 billion Sukuk by the government.

In overall terms, the subdued budgetary and private sector borrowings led to a containment in the growth of net domestic assets of the banking system during Q3-FY19. This more than offset the improvement in the net foreign assets and credit to PSEs during the quarter. As a result, the pace of monetary expansion (M2) slowed down to 1.4 percent during the quarter, as compared to the growth of 3.6 percent in H1-FY19 and 2.5 percent in Q3-FY18. While this slowdown conforms to the ongoing stabilization measures and may help rein in excess demand in the economy, the composition of M2 is worrisome.

Around 88 percent of the M2 growth during Q3-FY19 came from currency in circulation, as a substantial weakening was observed in deposit mobilization during the quarter. While the pace of deposits mobilization has remained underwhelming ever since the government had imposed withholding tax on non-filers for non-cash banking transactions, the trend in Q3-FY19 was quite concerning, as deposit growth fell to only 0.2 percent, from 1.8 percent in Q3-FY18. Furthermore, the currency to deposit ratio on average touched 39.6 percent during the quarter. The rise in mark-up rates on NSS instruments, overall macroeconomic uncertainty, rising inflation, and expectations of further exchange rate depreciation, all extended the weak growth in bank deposits.

Fiscal Sector

The cumulative fiscal deficit during Jul-Mar FY19 stood at 5.0 percent of GDP, much higher than the deficit of 4.3 percent recorded in the same period last year. Most of the deterioration was recorded in the third quarter, when the deficit reached 2.3 percent of GDP; it is worth noting that the deficit during the H1-FY19 had amounted to 2.7 percent.

A steep fall in non-tax revenues and a slowdown in tax revenue led the overall revenue collection to stagnate at last year's level. The FBR's taxes grew by only 2.8 percent in Jul-Mar FY19, compared with double-digit growth of 16.2 percent recorded during the same period last year. Meanwhile, the non-tax revenues were lower mainly due to fall in SBP profits and delay in transfer of hydel profits to the provinces.

Within FBR taxes, sales and direct tax collection declined during Jul-Mar FY19 due to a cut in PSDP spending, as well as the impact of measures like suspension of tax on mobile phone top-ups and lowering of tax rates on salaries and POL products. Meanwhile, a double-digit growth in customs and excise duties supported overall revenue growth. The higher revenue from this segment was in response to the hiking of regulatory and excise duties on various products, including cigarettes, as well as the exchange rate deprecation during the period.

On the expenditure front, the cumulative growth stood at 8.0 percent during Jul-Mar FY19, against 16.0 percent last year. The slowdown in growth primarily came from cuts in PSDP spending, both at the federal and provincial levels, as current expenditures grew at a much higher rate (17.7 percent) than they had in the same period last year (13.0 percent). The increase in current expenditures stemmed from higher interest payments and security-related expenses during the period.

The resulting higher fiscal deficit was mainly financed through borrowing from the SBP, and non-bank and external sources. In particular, financing from non-bank sources was almost four times higher than last year, with the NSS being the primary source of increase. At the same time, external sources financed around 27 percent of the fiscal deficit, as the country received significant bilateral and commercial loans.

In addition to the higher fiscal deficit which increased financing needs, revaluation losses owing to the PKR's depreciation against the US dollar also contributed significantly to the rise in public debt. During Jul-Mar FY19, public debt rose by Rs 3.6 trillion and reached Rs 28.6 trillion by end-March 2019.

External Sector

The external account continued to improve as the year progressed, with the current account deficit in Q3-FY19 falling to a two-year low to US$ 2.0 billion. Contractions in import payments for both goods and services were the primary factors, and were supported by a decent growth in worker remittances. These factors cumulatively offset the higher primary income deficit and a decline in export receipts. As a result, the current account deficit for Jul-Mar FY19 declined 23.9 percent to US$ 10.3 billion.

As the year went on, the merchandize import payments further dropped with tapering demand for imported power generation and electrical machinery, following the conclusion of early harvest CPEC projects. Furthermore, purchases of aircraft and related parts from abroad that inflated last year's imports, normalized this year. Meanwhile, the overall slowdown in economic activity in the wake of macro adjustment policies and regulatory measures curbed the import demand for raw materials for construction and auto industries. Also, quantum-led drops in import payments for both POL products and crude oil in the third quarter pulled down energy imports for the first time since Q1-FY17. The lower energy purchases, along with declining non-energy imports, led overall import payments to decline 16.4 percent in Q3-FY19.

Both domestic and international factors were responsible for the subdued export performance. For exports of major textile products like knitwear and readymade garments, the slowdown in export growth was primarily due to a decline in their dollar-denominated unit prices, as their quantum exports rose significantly (**Chapter 5**). Besides, higher domestic demand for value addition and lower cotton yarn demand from China suppressed yarn exports to China. The phasing out of export subsidies on sugar and wheat from Q2 onwards made their exports unviable. Moreover, lower production of cotton and fertilizer not only crippled their export prospects, but instead necessitated hefty imports.

Meanwhile, workers' remittances have risen significantly in the year, with most of the increase coming from the US and the UK. The Pakistan Remittance Initiative (PRI) has intensified its efforts by launching advertisement campaigns in local and destination specific foreign media to encourage overseas Pakistanis to remit through legal channels. Besides this, strong real GDP growth, coupled with rising wages in advanced economies, have boosted inflows from the US and the UK.

However, despite the higher remittances and the resultant reduction in the current account gap, the size of the deficit is still quite large. And this gap could not be filled by foreign investment. As a result, the country had to resort to bilateral and commercial sources for external financing; most of these inflows were realized in the third quarter. Yet, given the elevated CAD and the precarious FX reserves position, these inflows proved insufficient to completely calm down FX market sentiments. As a result, the PKR depreciated 13.7 percent against the US dollar during Jul-Mar FY19.

1.2 Economic Outlook

With stabilization policies in place and the economy moving along the reforms agenda, the country's macroeconomic indicators are expected to slowly revert to a stable trajectory. In this process, however, the real GDP growth is likely to remain contained.

In particular, adjustment on the fiscal side has yet to get underway. Related to this, the revenue measures announced in FY20 Federal Budget are likely to keep disposable incomes and domestic demand under check. Amid such conditions, the industrial growth is not expected to rebound notably next year. Having said that, some support to the GDP growth can possibly come from strong prospects in the agriculture sector, where there is a potential for higher output if the impact of constraints affecting area under cultivation and yields is managed effectively. Early investments in agriculture and SEZs under the CPEC and higher outlay of next year's PSDP can also have a positive impact on GDP growth in FY20.

As for the current account, the government is projecting the deficit to reduce further in FY20, on the back of an expected better export performance, containment of import payments and continued momentum in workers' remittances. However, downside risks persist in the wake of a slowdown in global economy, attributed to escalated trade war between US-China and uncertainty in Europe. Under these circumstances, increasing exports to the traditional markets may prove challenging. On the financing side, the initiation of the IMF Extended Fund Facility program would help assuage the overall external sector concerns.

Finally, despite monetary tightening, the government is projecting CPI inflation to be higher in FY20. This outlook is largely explained by supply-side factors, such as the upward adjustments in domestic energy prices and recent episodes of PKR depreciation along with their second-round impact, which are likely to increase the cost of production and doing business. Additional impact is likely to come from various taxation measures taken in the FY20 Federal Budget and the risk arising from any volatility in the international oil prices.