

# **THE STATE OF PAKISTAN'S ECONOMY**

**First Quarterly Report  
for the year 2019-20 of the  
Board of Directors of State Bank of Pakistan**



**State Bank of Pakistan**

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# 1 Overview

## 1.1 Economic Review

During the first quarter of FY20, Pakistan's economy moved progressively along the adjustment path. So far, the policy mix appears adequate to address the macroeconomic imbalances and push the economy towards stability.

In terms of policies, a number of developments were important. First, the macroeconomic stabilization process picked up momentum with the initiation of the IMF's Extended Fund Facility program. While the SBP continued to keep the monetary policy consistent with the medium-term inflation target, consolidation efforts were also visible on the fiscal front, both on the revenue and expenditure sides. Second, the system of a market-based exchange rate was implemented, to which the interbank foreign exchange market – barring initial edginess – adjusted relatively well. Third, the government abided by its commitment to avoid deficit monetization, including rollover of SBP debt, which is instrumental for ensuring effective monetary management. Fourth, the government actively pursued documentation efforts,

including asset revaluations, tight financial scrutiny, and the introduction of structured mechanisms to formalize businesses' value-chains.

While the success of documentation measures hinges upon the policy consistency and would manifest in revenue mobilization over the medium term, the payoff from the ongoing stabilization efforts has become visible in the form of declining twin deficits (**Table 1.1**). Specifically, the current account deficit (CAD) in Q1-FY20 fell to less than half of last year's level. This improvement came on the back of significant import

**Table 1.1: Economic Indicators**

	FY19	Q1-FY19	Q1-FY20
	<u>Growth rate (percent)</u>		
LSM <sup>a</sup>	-3.4	-0.6	-5.9
CPI (period average YoY) <sup>a,1</sup>	7.3	5.6	11.5
Private credit <sup>b</sup>	11.6	2.1	-0.3
Money supply <sup>b</sup>	11.3	0.1	0.6
Exports <sup>a</sup>	-1.1	4.2	2.5
Imports <sup>a</sup>	-9.9	-0.04	-20.9
Policy rate spread (basis points) <sup>2</sup>	-6.6	-5.9	-11.9
FBR tax revenue (billion Rs) <sup>d</sup>	3,828.5	832.3	959.1
Exchange rate (+app/-dep%) <sup>b</sup>	-24.1	-2.2	2.4
	<u>million US dollars</u>		
SBP's liquid reserves (end-period) <sup>b</sup>	7,280.4	8,408.7	7,936.6
Workers' remittances <sup>b</sup>	21,838.6	5,557.6	5,478.1
FDI in Pakistan <sup>b</sup>	1,668.0	559.4	542.1
	<u>percent of GDP</u>		
Current account balance <sup>b</sup>	-4.9	-5.5	-2.3
Fiscal balance <sup>c</sup>	-8.9	-1.4	-0.7
Primary balance <sup>c</sup>	-3.5	-0.1	0.6

<sup>1</sup>YoY growth in the average of CPI index (old base) for the quarter (2007-08=100). <sup>2</sup>Difference between SBP's policy rate and overnight rate

Data sources: <sup>a</sup> Pakistan Bureau of Statistics; <sup>b</sup> State Bank of Pakistan; <sup>c</sup> Ministry of Finance; and <sup>d</sup> Federal Board of Revenue

compression and the ongoing shift towards renewables and indigenous coal in the energy mix, whereas volumetric gains were also visible in the country's exports. Thus, with the payments gap narrowing in the interbank, the available financial inflows helped the SBP accumulate foreign exchange reserves.

On the fiscal front, the improvement came from a healthy growth in both tax and non-tax collections and containment in current spending, both at the federal and provincial levels. As a result, the overall fiscal deficit remained lower as compared to the same period last year, and the primary balance recorded a surplus for the first time in 7 quarters.<sup>1</sup> Importantly, development expenditures recorded a sharp rise of 30.5 percent in Q1-FY20.

However, despite these stability gains, the overall confidence among businesses and consumers remained weak, as they struggled to preserve their purchasing powers and dealt with operational constraints stemming from the adjustment process. For consumers, the increase in inflationary pressures in the economy (especially food items) was particularly disconcerting, as it impacted their real incomes. This high inflation outcome was driven largely by the pass-through of the exchange rate depreciation, correction in energy prices, shortage of food items, and revenue measures taken by the government. For businesses, perceptions about the current economic conditions remained below the threshold level (index value below 50, which represents prevalence of more negative views than positive views), as depicted in the IBA-SBP survey waves of August and October 2019. In addition to the government's revenue measures and tight credit conditions, this may also reflect the impact of the FBR's instructions to businesses to record CNIC numbers of buyers and suppliers while filing sales tax returns.

While large businesses (especially export-oriented and import-competing industries) remained bullish on fundamentals, they refrained from taking a long-term view. This cautious behavior, coupled with tapering demand and the compression of unregistered businesses – which dominate the network of dealership and wholesale infrastructure of registered firms – reinforced the economic slowdown. On the whole, a number of industries within the large-scale manufacturing (LSM) struggled with inventory build-ups amid rising input costs during the quarter. With gross margins squeezed and financing costs rising, firms scaled back their operations to save their bottom lines from dropping further. As a result, a contraction was observed in a majority of LSM sub-sectors.

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<sup>1</sup> The primary balance refers to the fiscal position after adjusting for the impact of interest payments.

From the policy perspective, it is important to continue with the adjustment process despite weakening economic activity, as well as the visible stability gains in terms of the falling twin deficits. The policy continuation is warranted given the lingering vulnerabilities in the economy and the chronic nature of the structural weaknesses. In this regard, three aspects are important. First, most of the improvement in the current account has come from a reduction in the country's import bill; exports have yet to contribute significantly, as healthy quantum gains are not supported by price trends. Furthermore, while the drawdown in foreign exchange reserves has been reversed, the overall reserves position remains below the comfort level (in terms of import coverage).

Second, the announced documentation-related measures must be implemented in order to bring the needed diversification in the revenue base. This is important to rebalance the country's fiscal revenue structure, which is currently over-reliant on very few sectors. Specifically, tax collection is concentrated in industry-related revenues, as agriculture and services sectors under-contribute compared to their respective shares in GDP. Furthermore, a disproportionately large contribution from import-related collections makes Pakistan's taxation system excessively vulnerable to business cycles and overall import trend.

Third, managing food prices has lately become challenging. It is important to note here that the impact of the aforementioned one-off factors is likely to dissipate going forward. However, supply-management issues, such as weak governance in commodity procurement agencies, hoarding practices and regional trade bottlenecks, may potentially perpetuate food inflation going forward. This runs the risk of undermining the impact of softening demand pressures in the economy, as reflected in the somewhat stabilizing core inflation.

Keeping these challenges in view, it is vital that the government continues to address the underlying structural vulnerabilities and put the economy on a balanced and sustainable growth trajectory. Furthermore, there is a need to build on gains on the ease of doing business front, which requires not just the capacity development in key public institutions, but also a continuous dialogue with relevant stakeholders to ensure smooth implementation. Side by side, it is equally important for firms to leverage on the facilitative policies, particularly the export promotion incentives, and gain a foothold in the global value chains (GVCs); this would not only align our product mix with trends in global demand, but also put the exports on a sustainable growth path (**Special Section 1**).

## **1.2 Executive Summary**

### ***Real Sector***

Following the modest GDP growth of 3.3 percent last year, the government set a 4.0 percent growth target for FY20. This recovery was premised on a better performance by the agriculture and industrial sectors, whereas the target for the services sector was similar to the growth observed a year earlier. However, based on the sluggish start during the first quarter, it appears that achieving the annual targets for agriculture and industry may prove to be challenging.

In the agriculture sector, revised estimates for the *kharif* season suggest that the production of important crops is likely to fall short of targets for FY20. Specifically, untimely rains and pest attacks held back the cotton output to some extent. For sugarcane, the experience of farmers in the previous *kharif* season, when they were unable to realize expected returns on the crop, led to a fall in area under cultivation. In contrast, rice crop delivered a strong showing during the review period, as it comfortably surpassed the annual target for FY20. This can be linked to greater export potential of basmati and non-basmati varieties, which encouraged growers to apportion a greater area to rice cultivation as compared to last year.

As for industry, the decline in LSM deepened during Q1-FY20. The impact of macroeconomic stabilization policies and the second-round impact of exchange rate depreciation contributed to both supply-side pressures (expensive inputs) and lower demand (marginal growth in real incomes) for domestic industries. With the increase in financial and operational costs, a number of industries, including steel, automobiles, chemicals and cement, cut their production. Furthermore, the government's policy to shift away from furnace oil for power generation forced local refineries to scale back their operations. In contrast, previous corrections in the exchange rate helped export-oriented industries, as reflected in the relatively better performance of textiles and leather. Meanwhile, fertilizer production benefited from improved supply of natural gas.

In the services sector, trends in proxy indicators – like the decline in LSM and imports, and lower sectoral credit offtake compared to Q1-FY19 – suggest that *wholesale and retail trade* activities were relatively subdued. Similarly, in case of *transport, storage and communication*, commercial vehicle sales and POL sales to the transport sector both declined during the first quarter. By contrast, higher commercial bank profits during Q1-FY20 over last year may bode well for the full-year prospects of the *finance and insurance* segment. The improvement in banks' earnings primarily reflects the impact of rising interest rates and banking spreads, which increased their net interest incomes.

### ***Inflation and Monetary Policy***

In its July 2019 decision, the Monetary Policy Committee (MPC) raised the policy rate by 100 basis points. This decision took into account the imminent pressures on inflation, stemming from: (i) the announcement of a substantial increase in gas tariffs (up to 168 percent) from July 2019 onwards; (ii) revenue measures announced in the budget 2019-20; and (iii) the pass-through of the impact of exchange rate depreciation towards the end of FY19. As the quarter progressed, these pressures began to manifest in the inflation numbers. The headline CPI inflation recorded a broad-based increase of 11.5 percent during the quarter – the highest quarterly inflation since Q4-FY12. Importantly, the contribution of core inflation remained more or less unchanged at last year’s level, which indicated softening demand pressures in the economy amid the ongoing macroeconomic stabilization efforts. However, the increase in food and energy inflation pushed up the overall inflation.

Energy prices posted the steepest rise of 32.5 percent during the quarter, with the upward revision in gas prices alone contributing 1.6 percentage points to the headline inflation. Food inflation rose to 11.8 percent during Q1-FY20, as the exchange rate depreciation increased the cost of imported products (such as pulses and vegetables) and also escalated transportation costs. Revenue measures also contributed, as traders/manufacturers passed on the impact of higher federal excise duty (FED) on cigarettes and edible oil, and increased sales tax on sugar, to end-consumers. Since these pressures were already taken into account in the July 2019 decision, the MPC decided to keep the policy rate unchanged in its September meeting.

The overall growth in money supply (M2) stood at 0.6 percent in Q1-FY20, compared to only 0.1 percent last year. The entire increase in M2 stemmed from a surge in net foreign assets (NFA) of the banking system, reflecting the improvement in the country’s balance of payments and the receipt of the first tranche of the IMF’s EFF program – this is the first time that the IMF’s lending for balance of payments support will also be utilized by the government to finance the budget deficit. In contrast to NFA, the net domestic assets (NDA) of the banking system contracted, as the increase in net budgetary borrowings (on accrual basis) was more than offset by credit retirement by the private sector and a decline in other items net (reflecting an increase in the SBP’s profit).

Within the budgetary borrowings, a clear shift was observed, with the government borrowing heavily from commercial banks to retire its SBP debt. This was unlike last year, when the government had borrowed heavily from the SBP to retire its commercial bank debt. This shift was attributed to two factors. First, the

government strictly adhered to its commitment of not resorting to deficit monetization. Second, the commercial banks' own appetite for investing in government papers remained strong, as they expected interest rates to have plateaued. Moreover, they also remained averse to private sector lending.

With regards to private sector credit, a general slowdown in the manufacturing and commercial activities resulted in significantly lower credit appetite of businesses. This, coupled with higher interest rates, led firms in a number of sectors to deleverage, whereas fresh applications for working capital finance also decreased notably. In cumulative terms, private businesses retired Rs 85.4 billion loans, compared to an offtake of Rs 99.0 billion during Q1-FY19.

### ***Fiscal Sector and Debt***

Fiscal indicators recorded a marked improvement in Q1-FY20. A strong growth in revenue collection and containment of current expenditures helped reduce the fiscal deficit to 0.7 percent of GDP (the lowest in 15 quarters), compared to a deficit of 1.4 percent last year. The revenue deficit also contracted sharply, whereas a surplus was recorded in the primary balance after a gap of 7 quarters.

The consolidated revenues grew by 35.1 percent during the quarter, with both tax and non-tax revenues contributing almost equally. This growth in revenues was possible on the back of tax measures announced in the budget for the year 2019-20. For instance, the preferential tax treatment was eliminated for certain sectors (e.g. sugar, steel and edible oil) and the zero-rating regime for five export-oriented sectors (textile, leather, carpets, sports goods and surgical goods) was ended. Similarly, measures such as the increase in the sales tax rates, especially on petroleum products and sugar, upward revision in income tax rates for both salaried and non-salaried persons, reinstatement of withholding tax and sales tax on mobile top-ups, increased excise duty on cement and cigarettes, and upward adjustment in power tariffs, also contributed significantly to the higher revenue collection in Q1-FY20. The growth in non-tax revenues remained strong as well, largely due to a sharp rise in the SBP's profit and partial collection of the much-awaited renewal fee of GSM licenses.

At the same time, the growth in total expenditures decelerated to 8.0 percent in Q1-FY20 from 12.1 percent in the same period last year. Unlike last year, when a sharp cut in development spending (mainly PSDP) drove the trajectory of overall expenditures, containment of current spending explained the overall slowdown in total expenditures in Q1-FY20. Both interest payments (on cash basis) and defence-related expenditures recorded lower growth compared to Q1-FY19. This

created room to increase development expenditures (especially PSDP) by 30.5 percent, without undermining the overall fiscal consolidation efforts.

Despite lower financing needs and stable exchange rate, the pace of debt accumulation increased further in Q1-FY20. While the government strictly adhered to its commitment to avoid deficit monetization, it continued to build up its deposits with the banking system (cash buffers) to ensure smooth debt management going forward. The pace of external debt accumulation in Q1-FY20 was relatively slower compared to Q1-FY19 in the wake of revaluation gains due to depreciation of other currencies against the US dollar and higher debt repayments.

### ***External Sector***

The balance of payments continued to improve during Q1-FY20. Led by a sharp decline in the import bill, the current account deficit decreased to less than half of the level witnessed during Q1-FY19. With the receipt of the first EFF tranche and the increase in foreign portfolio investment (FPI), the current account gap was easily plugged by the available financial flows. These inflows also helped the SBP to increase its foreign exchange reserves by US\$ 656.2 million and reduce its net forward liabilities by US\$ 1.3 billion during the quarter. The Pak rupee appreciated by 2.4 percent against the US dollar during Q1-FY20.

Import payments fell by a sharp 22.7 percent, with energy imports contributing almost one-third to the overall decline. As mentioned earlier, the shift away from furnace oil and towards indigenous coal reduced the import demand for both these commodities. Furthermore, lower international prices allowed the country to import more petrol and LNG, without pushing up their import payments. The demand for non-energy imports also remained subdued in response to inventory build-up from last year (in case of DAP fertilizer, palm oil and automobiles) and a slowdown in industrial activity (iron and steel).

On the export front, volumes of a number of products rose substantially, but earnings recorded only a marginal increase. This signifies pressures on unit values stemming from slumping commodity prices, and cutthroat competition amid economic slowdown in the major destinations. These factors have suppressed export earnings of other emerging markets as well, but the impact on Pakistan's unit prices was more pronounced. This suggests that the currency adjustment has enabled Pakistani exporters to undercut their competitors without giving up much on their margins (in Pak rupee terms).

In response to these dynamics, the trade deficit fell to its lowest level in over three years. However, workers' remittances posted a decline of 1.4 percent YoY during the quarter, mainly due to tight employment conditions in the Gulf Cooperation Council (GCC) countries. Lower remittances from these countries more than offset the increase in inflows from the UK, EU and the US.

On the financing side, FPI flowed into government securities (T-bills and PIBs) after a gap of over two years, as investors responded to the continued increase in reserve buffers; sustainability of the exchange rate regime; and the comfort offered by the inception of the IMF program. However, FDI remained almost stagnant, with a steep decline recorded in inflows to the construction and power sectors owing to the completion of various CPEC projects. This was partially offset by a one-off inflow into a telecom firm for renewal of the GSM license fee.

### **1.3 Economic Outlook**

The current account balance is expected to improve over the projections presented in the Annual Report for 2018-19.<sup>2</sup> This mainly reflects a more-than-expected contraction in imports. With the industrial sector under stress, its demand for imported raw material is expected to stay low. Commodity prices are also subdued, amid the slowdown in the world economy and the absence of key triggers (resolution of the US-China trade dispute and Brexit). On the flip side, the tepid global growth outlook and commodity prices may also weigh on both exports and remittances. Nonetheless, any negative impact on these earnings would be more than offset by the reduction in import payments. On balance, therefore, the current account deficit for FY20 is likely to stay within the range of 1.5 – 2.5 percent of GDP.

However, the performance of the commodity producing sectors is likely to remain subdued. In case of agriculture, targets for the overall crop sector may not be achieved, as the production of both cotton and sugarcane is estimated to remain lower than in FY19. The industrial sector is also expected to remain under stress. The latest LSM estimates for October 2019 show an 8.0 percent decline on a year-on-year basis, steeper than the 5.9 percent decline recorded in Q1-FY20. Nonetheless, the export-oriented industries continue to perform better. Also, the government's decision to postpone regulatory actions for businesses for implementation of the CNIC restriction up till February 2020 (and also, axle load

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<sup>2</sup> In fact, the current account recorded a surplus for the first time in 50 months, in October 2019. After adjusting for CSF inflows, the current account had last recorded a surplus 59 months back. During Oct-Nov FY20, the current account deficit was recorded at US\$ 249 million, which was down 89.8 percent from the same period last year.

management), may ease manufacturers' operational constraints to some extent.<sup>3</sup> In view of these developments, achieving the real GDP growth target of 4 percent appears unlikely.

In case of inflation, pressures are expected to recede in the second half of the fiscal year, in light of a continued softness in domestic demand (which is expected to keep core inflation in check), and stability in the exchange rate on the back of improving CAD and financial inflows. For the full-year, the SBP estimates average headline CPI inflation to stay within the range of 11 – 12 percent. This forecast is subject to upside risks in the form of a reversal in global crude prices, exchange rate depreciation and increased budgetary borrowings.

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<sup>3</sup> To curb overloading of vehicles, the government had put limits on axle load on motorways and national highways effective from June 1, 2019. However, this limit was postponed for one year on a major motorway (sources: NHA press release dated May 22, 2019 and PM office press release dated October 27, 2019).

## 2 Real Sector

### 2.1 Overview

The slowdown in real GDP growth last year was generally attributed to the policy measures taken to manage twin deficits. As a result, along with curtailed domestic demand and significant import compression, the industrial sector (especially manufacturing) came under strain. Also, costlier inputs and water shortages dented agriculture output, especially of important crops. Since industrial and agricultural output are linked to important services,<sup>1</sup> the deceleration in growth of both had led to a moderation in services sector growth in FY19 as well.

At the start of FY20, the government had set GDP growth target of 4.0 percent for the year. The achievement of this target crucially depends on the performance of the agriculture and industrial sectors, which are targeted to grow by 3.5 percent and 2.3 percent

**Table 2.1: Real Sector Performance and FY20 Target**

	FY18 <sup>R</sup>	FY19 <sup>P</sup>	FY20 <sup>T</sup>
1. Commodity-producing	4.4	1.1	2.9
A. Agriculture	3.9	0.8	3.5
o/w: Important crops	3.5	-6.5	3.5
B. Industry	4.9	1.4	2.3
o/w: LSM	5.1	-2.0	1.3
2. Services	6.2	4.7	4.8
GDP	5.5	3.3	4.0

R=revised; P=provisional; T=target  
Data source: Planning Commission

respectively (**Table 2.1**). In this regard, while the output of important *kharif* crops is expected to remain below target, there is some improvement over the last year. Meanwhile, the performance of the LSM sector in Q1-FY20 is indicative of the contraction in industrial activity.

In the agriculture sector, targets for important *kharif* crops are likely to be missed. While cotton production was hurt by pest attacks and untimely rains, sugarcane farmers cultivated less area this year, as they were not able to generate expected earnings on their investments last year. On the other hand, rice production grew appreciably, with the impetus coming from both higher demand from the Middle East and the EU and better international prices. However, it is worth highlighting that despite an improvement in water availability and higher use of other inputs, crop yields have remained low, pointing towards structural shortcomings in the sector, such as the use of older varieties of seed, low level of farm mechanization, soil erosion, etc.

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<sup>1</sup> Such as wholesale and retail trade and transportation, storage and communication.

In the industrial sector, the contraction in LSM during Q1-FY20 was broad-based, with the automobile, petroleum and construction-allied firms particularly feeling the pinch from the economic downturn. Meanwhile, the rest of the LSM sector faced supply constraints stemming from expensive inputs, implementation of stabilization and revenue measures and lower domestic demand. Furthermore, the textile industry is bracing for a shortfall in cotton production in FY20 and would have to rely on imports to meet the demand from the value adding export industry. On the positive side, fertilizer and electronics have provided some relief, as the output of these industries has risen on account of better natural gas supply and high demand for water extraction equipment respectively.

As for the services sector, *wholesale and retail trade* appears to be off to a slow start, based on an assessment of proxy indicators such as the decline in LSM and imports, and lower sectoral credit offtake as compared to last year. Similarly, lower commercial vehicle sales and POL sales to the transport sector may reflect broadly sluggish activity in the *transport, storage and communication* segment. Regarding *finance and insurance*, higher quarterly profits for commercial banks compared to Q1-FY19 may represent a silver lining.

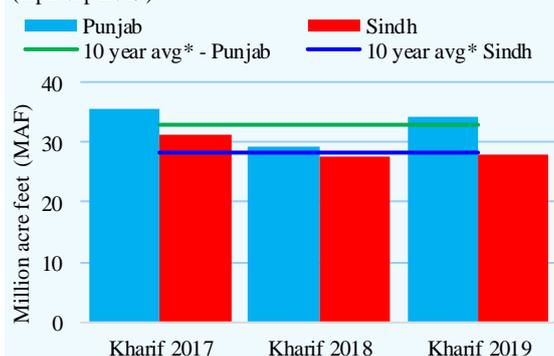
## 2.2 Agriculture

The major *kharif* crops presented a mixed picture during Q1-FY20, based on preliminary estimates. The outcomes for the rice and maize crops were broadly favorable. However, the revised estimate for cotton crop was significantly below the annual target as well as last year's level. In addition, early estimates of a 3.8 percent decline in the area under cultivation for sugarcane crop suggest that its performance may remain subdued. On overall basis, there are accentuated downside risks in reaching the targeted growth of 3.5 percent for agriculture during FY20, particularly given the gradually declining yields of almost all major crops.

### Inputs

The availability of canal water in Punjab improved considerably as compared to the last *kharif* season (**Figure 2.1**). In Sindh's case, canal water availability remained similar to the last season,

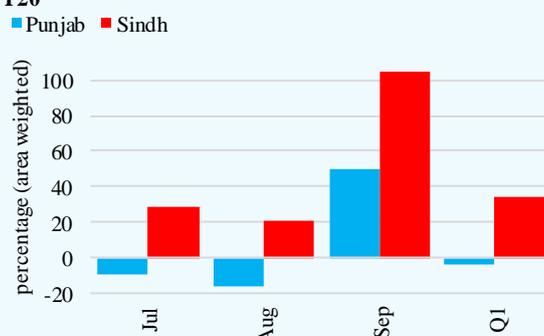
**Figure 2.1: Canal Water Withdrawals for Kharif**  
(Apr-Sep 2019)



\* Average of actual utilization  
Data source: Indus River System Authority

as well as the 10-year average for the province. However, the overall water availability in the province improved due to ample rainfall, which helped alleviate the drought-like condition observed last year. Still, some shortage of irrigation water was recorded during the important stages of the cotton crop’s development, which contributed to depressed yields in the province (Figure 2.2).<sup>2</sup>

**Figure 2.2: Departure of Rainfall from Normal\* during Q1-FY20**



\* Normal refers to area-weighted rainfall during 1981-2010  
Data source: Pakistan Meteorological Department

Fertilizer offtake during the *kharif* 2019 was higher compared to last year. Specifically, urea and DAP offtake rose by 4.7 percent and 8.1 percent, compared to declines of 10.7 percent and 9.6 percent recorded in the last season respectively.

In addition, there was an uptick in agriculture credit, with disbursements during Q1-FY20 up 24.1 percent compared to last year (Table 2.2). Despite some deceleration, 19.5 percent of the agriculture credit disbursement target set by the government had been achieved by end-September 2019, which was higher than the 17.0 percent progress made in the comparable period last year. In the non-farm sector, the growth in credit for poultry enterprises occurred in tandem with an increase in input prices, and also coincided with the launch of the Prime Minister’s backyard poultry initiative.

**Table 2.2: Agriculture Credit Disbursements (Jul-Sep)**

	Rupees (billion)			Growth (percent)	
	FY18	FY19	FY20	FY19	FY20
<b>Farm sector</b>					
A. Production	57.5	82.4	103.8	43.3	26.0
Co-operate farm	2.6	26.7	27.0	926.9	1.1
B. Development	3.3	6.0	9.3	81.8	55.0
Tractor	1.1	1.0	0.7	-9.1	-30.0
C. Total farm sector (A+B)	60.8	88.4	113.1	45.4	27.9
<b>Non-farm sector</b>					
Livestock/dairy	41.2	61.5	77.8	49.3	26.5
Poultry	24.7	26.6	64.3	7.7	141.7
Other	29.1	35.7	8.1	22.7	-77.3
D. Total non-farm sector	95.0	123.7	150.2	30.2	21.4
<b>Total agri (C+D)</b>	<b>155.9</b>	<b>212.1</b>	<b>263.3</b>	<b>36.0</b>	<b>24.1</b>

Data source: State Bank of Pakistan

<sup>2</sup> Source: MNFSR press release dated December 19, 2019.

Elsewhere in the farm sector credit, disbursements to corporate farmers remained high for the second year running. That said, in terms of rupee amount, the credit availed for production purposes constituted the bulk of disbursements to the farm sector, and its significant growth could partially be attributed to the rising cost of production. Increase in prices of agricultural inputs such as fertilizer<sup>3</sup>, diesel<sup>4</sup> (for water extraction, tube wells and farm machinery) and tractors affected the on-farm expenditure of growers.

### Crop Production

#### Cotton

Cotton production in the country, estimated at around 9.45 million bales, fell well short of the annual target (**Table 2.3**),<sup>5</sup> with both Sindh and Punjab posting lower output than last year. Adverse weather played an important role in the crop's performance. Harsh temperatures during key stages of the crop's development – including a 2-5 degree Celsius increase in September 2019 as compared to earlier years – put cotton under severe stress. In addition, the crop's performance was also impacted by an outbreak of whitefly pests and a pink bollworm attack (which lowered the boll weight).

Table 2.3: Cotton Crop Estimates

	FY20			Growth in %		
	FY18	FY19	Target	FY20 <sup>P</sup>	FY19	FY20
<b>Area ('000 hectares)</b>						
Punjab	2,053	1,888	2,145	1,860	-8.0	-1.5
Sindh	612	448	640	615	-26.8	37.3
Pakistan	2,700	2,373	2,895	2,513	-12.1	5.9
<b>Production ('000 bales)</b>						
Punjab	8,077	6,826	7,900	6,671	-15.5	-2.3
Sindh	3,776	2,938	4,600	2,680	-22.2	-8.8
Pakistan	11,946	9,861	12,720	9,451	-17.5	-4.2
<b>Yield (Kg/hectares)</b>						
Punjab	669	615	626	610	-8.1	-0.8
Sindh	1,049	1,115	1,223	741	6.3	-33.5
Pakistan	753	707		639	-6.1	-9.5

Data source: Cotton Crop Assessment Committee; Federal Committee on Agriculture; PBS; SBP calculations

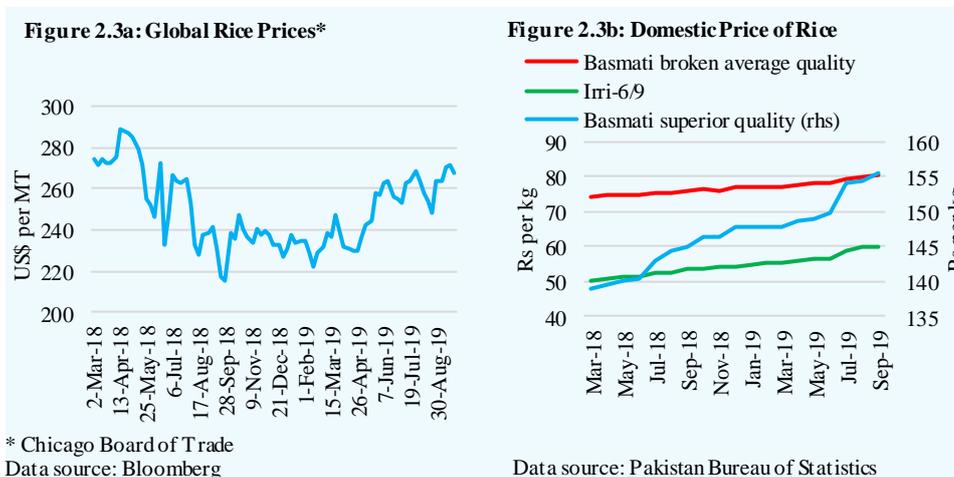
#### Rice

Rice production grew by 6.9 percent and comfortably surpassed the annual target during the FY20 *kharif* season, as the area dedicated to the crop increased substantially (**Table 2.4**). To some extent, the impetus came from an uptick in global prices for rice compared to the same period last year (**Figure 2.3**). It is worth mentioning that exports of both basmati and other varieties of rice nearly doubled during Q1-FY20 compared to a year earlier (for details, see **Chapter 5**).

<sup>3</sup> The average price of urea rose by 18.0 percent in Q1-FY20 compared to previous period.

<sup>4</sup> The average price of diesel in Q1-FY20 registered increase of 16.0 percent over last year.

<sup>5</sup> The annual target for cotton was 12.72 million bales according to the Pakistan Central Cotton Committee, and 15.0 million bales according to the Annual Plan 2019-20.



That said, there appeared to be some room for improvement in rice cultivation in Sindh.

While the area under rice rose substantially, the corresponding increase in output was relatively lower. This could partly be traced to a decline in the yield for the province compared to a year earlier.

### Sugarcane

According to preliminary estimates, sugarcane production in the country is likely to decline during FY20 as compared to last year (Table 2.5).<sup>6</sup> The output may largely mirror the pattern of area under cultivation, with yields remaining roughly similar to FY19. Specifically, a decrease in the area dedicated to the crop may result in a corresponding fall in output in Punjab, the country's largest sugarcane-producing region, for the second season in a row. Pricing disputes and delayed payments to sugarcane growers by sugar mills in successive seasons during the last few years, have made the farmers less inclined to grow sugarcane

Table 2.4: Rice Crop Performance

	FY20			Growth in %		
	FY18	FY19	Target	FY20 <sup>P</sup>	FY19	FY20
<b>Area ('000 hectares)</b>						
Punjab	1,841	1,904	1,869	2,029	3.4	6.6
Sindh	828	690	770	780	-16.7	13.1
Pakistan	2,901	2,810	2,877	3,036	-3.1	8.1
<b>Production ('000 tons)</b>						
Punjab	3,898	3,979	4,000	4,267	2.1	7.2
Sindh	2,851	2,571	2,710	2,746	-9.8	6.8
Pakistan	7,450	7,202	7,432	7,701	-3.3	6.9
<b>Yield (kg/hectare)</b>						
Punjab	2,117	2,090	2,140	2,103	-1.3	0.6
Sindh	3,441	3,725	3,519	3,519	8.2	-5.5
Pakistan	2,568	2,563	2,583	2,536	-0.2	-1.0

P = provisional

Data source: MNFSR and Federal Committee on Agriculture

<sup>6</sup> Some revised numbers in Table 2.5 may vary from the provisional numbers published in the Annual Development Plan 2019-20 and Economic Survey 2018-19.

until the issues are resolved.

That said, a marginal decline in sugarcane production may not be a major cause for concern since output was already in surplus relative to domestic consumption. Moreover, in the past, sugar export tended to be uncompetitive without subsidies. Therefore, some rebalancing in terms of the reduction in cultivated area under sugarcane crop is optimal.<sup>7</sup>

**Table 2.5: Early Estimates of Sugarcane Crop Performance**

	FY18	FY19	Target	FY20 <sup>P</sup>	Growth (percent)	
					FY19	FY20
<b>Area ('000 hectares)</b>						
Punjab	859	711	753	661	-17.3	-7.0
Sindh	333	280	310	287	-16.1	2.7
Pakistan	1,342	1,102	1,179	1,060	-17.9	-3.8
<b>Production ('000 tons)</b>						
Punjab	55,068	44,906	44,906	42,218	-18.5	-6.0
Sindh	20,612	16,691	18,339	16,985	-19.0	1.8
Pakistan	82,128	67,174	68,702	64,771	-18.2	-3.6
<b>Yield (kg/hectare)</b>						
Punjab	64,107	63,194	59,636	63,846	-1.4	1.0
Sindh	61,898	59,724	59,158	59,157	-3.5	-1.0
Pakistan	61,198	60,960	58,271	61,103	-0.4	0.2

P = provisional

Data source: MNFSR, FCA, and SBP calculations

### 2.3 Large Scale Manufacturing

Performance of LSM dipped further as economic downturn deepened. The sector witnessed decline of 5.9 percent in Q1-FY20 YoY, compared to a 0.6 percent drop during the same period in FY19 (Table 2.6). This contraction was broad-based. Construction-allied industry, petroleum and automobile industries continued on their downward trajectory, while fertilizer and electronics posted positive performances. Production of urea increased on the back of resumption of natural gas supplies to smaller units. The electronics sub-sector grew at the back of the robust demand for electric motors.

The overall downtrend can be explained by the macroeconomic stabilization policies. Contractionary monetary and fiscal policies and realignment of the exchange rate, which resulted in the sharp Pak rupee depreciation in June FY19, helped set the tone for the industry at the beginning of FY20. These developments affected the cost structure of the industrial sector in general, and particularly for industries relying more on imported inputs. Furthermore, in order to anchor inflation expectations, the SBP jacked up the policy rate by 100 bps in Q1-FY20 to 13.25 percent; the highest level since October 2011. On the demand side, low growth outcome is resulting in nominal wages not rising in line with higher level of inflation as compared to the previous few years, hurting the purchasing power

<sup>7</sup> It is also worth mentioning that provinces had been previously encouraged to devise their own strategies to lower the area dedicated to sugarcane, given that its production is highly water-intensive and water scarcity is already an issue in certain regions of the country. For details, refer to the minutes of the 11th meeting of the FCA for *rabi* season 2018-19.

of consumers. The increase in operational and financial costs amid low demand hampered the performance of the industrial sector during the period under review.

The trend in monthly LSM growth (12-month moving average) also remained largely subdued. Nonetheless, there is a slight improvement in this trend on 3-month moving average basis. **Figure 2.4** shows that the seasonal dip has decreased in intensity in Q1-FY20 compared to the same period in the last two years. However, it is hard to pin down if the LSM growth has bottomed out from this recent trend.

In addition to the policy measures, certain regulatory measures also helped contain excess demand in the economy. First, increase in additional customs duty increased the cost of production for some industries. Second, the introduction of statutory requirement to record CNIC number of purchaser for transactional purposes also unsettled businesses. The government’s measures to bring more people under the tax net during the economic downturn has negatively affected business sentiments.

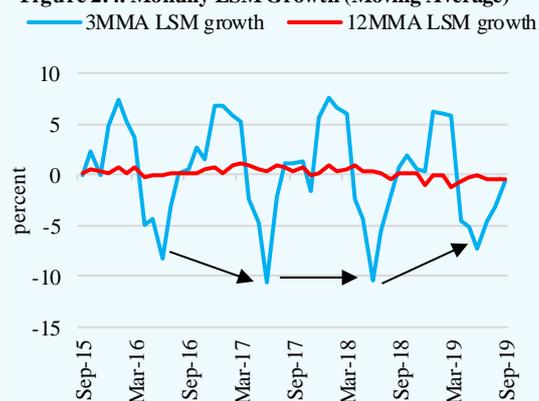
**Table 2.6 : YoY Growth in LSM (Q1)**

growth in percent, contribution in percentage points

	wt.	YoY Growth		Contribution to growth	
		FY19	FY20	FY19	FY20
<b>LSM</b>	<b>70.3</b>	<b>-0.6</b>	<b>-5.9</b>		
Textile	20.9	-0.2	0.2	0.0	0.0
Cotton yarn	13.0	0.0	0.2	0.0	0.0
Cotton cloth	7.2	0.1	0.1	0.0	0.0
Jute goods	0.3	-8.1	-14.8	0.0	0.0
Food	12.4	1.5	-8.0	0.2	-1.2
Cigarettes	2.1	4.4	-34.5	0.1	-0.7
Vegetable ghee	1.1	2.8	1.7	0.0	0.0
Cooking oil	2.2	5.7	-0.8	0.2	0.0
Soft drinks	0.9	-6.7	-8.0	-0.3	-0.3
POL	5.5	-5.4	-14.5	-0.4	-1.0
Steel	5.4	-2.9	-17.0	-0.2	-0.8
Non-metallic minerals	5.4	0.1	-0.9	0.0	-0.1
Cement	5.3	0.1	-1.5	0.0	-0.2
Automobile	4.6	-1.2	-34.1	-0.1	-2.8
Jeeps and cars	2.8	4.7	-38.6	0.2	-1.7
Fertilizer	4.4	-4.8	15.9	-0.3	0.9
Pharmaceutical	3.6	-4.8	-11.9	-0.4	-1.0
Paper	2.3	3.9	-2.0	0.1	-0.1
Electronics	2.0	16.9	5.5	0.5	0.2
Chemicals	1.7	-6.7	-8.9	-0.2	-0.2
Caustic soda	0.4	17.2	-21.4	0.1	-0.1
Leather products	0.9	0.5	4.2	0.0	0.1

Data source: Pakistan Bureau of Statistics

**Figure 2.4: Monthly LSM Growth (Moving Average)**



Data source: Pakistan Bureau of Statistics

Also, the imposition of FED on certain products, such as automobiles and cigarettes, adversely affected the output of these industries.

### Automobile

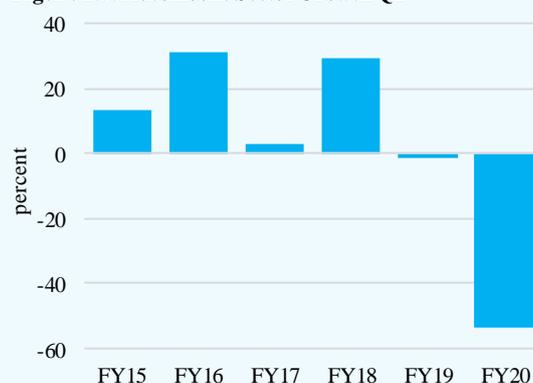
The output of the automobile sector contracted sharply by 34.1 percent in Q1-FY20, on top of a 1.2 percent dip recorded in the same period last year (**Figure 2.5**).

Segment-wise production data shows that the decline was broad-based (**Table 2.7**).

This decline can be explained by further increase in automobile prices in the country, as a result of: (i) the pass-through of 6.0 percent depreciation of Pak rupee in the month of June 2019; (ii) imposition of FED to the tune of 2.5, 5.0 and 7.5 percent on cars below 1000 cc, between 1001 and 2000 cc, and above 2000 cc

respectively (**Figure 2.6**); and (iii) increase in the rate of additional customs duty on automobile parts.<sup>8</sup> This increase in vehicle prices came at a time when real wages of prospective customers were also subdued. Furthermore, prevailing high level of interest rates deterred consumers from availing financing facilities. This behavioral shift is evident from net retirements of Rs 1.9 billion recorded under auto-finance during Q1-FY20 as opposed to Rs 5.0 billion uptake in Q1-FY19. This also contributed to a subdued demand for automobiles during the quarter.

**Figure 2.5: Automobile Sector Growth Q1**



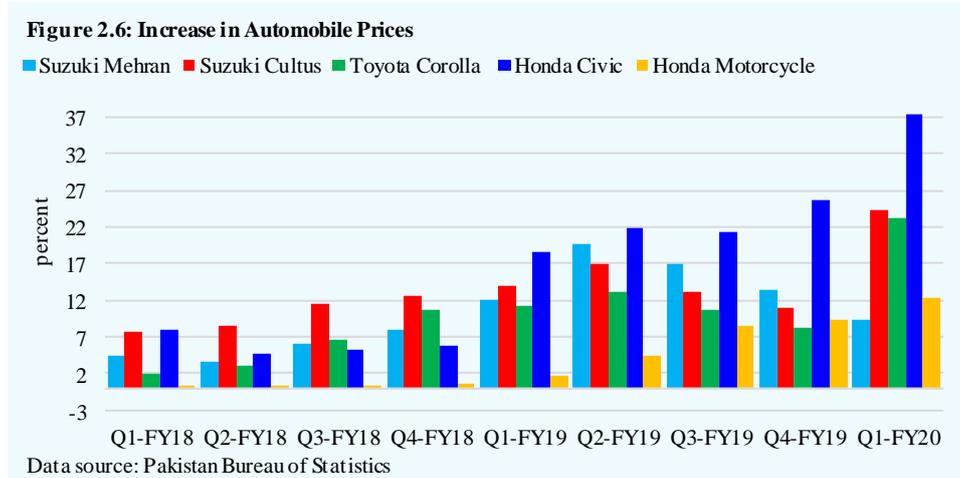
Data source: Pakistan Bureau of Statistics

**Table 2.7: Automobile Sector Production during Q1**

	Growth (percent)			
	FY19	FY20	FY19	FY20
All Cars	53,258	33,122	8.0	-37.8
<800 cc	12,854	11,817	8.5	-8.1
between 800-1000 cc	13,515	9,524	3.9	-29.5
>1000cc	26,889	11,781	10.0	-56.2
Sports utility vehicles	2,147	867	-22.5	-59.6
Light commercial vehicles	11,947	8,570	-6.3	-28.3
Trucks	2,049	799	-16.4	-61.0
Buses	281	157	-4.4	-44.1
Tractors	13,939	9,589	-10.8	-31.2
Motorbikes	456,521	370,771	-2.6	-18.8

Data source: PAMA

<sup>8</sup> FBR SRO 670(I)/2019 dated 28<sup>th</sup> June, 2019.



It is important to note that new assemblers have already started their production activities, especially in the car segment. However, these newcomers as well as the incumbents face a testing period as the economy is going through a low economic growth phase. In order to integrate these entrants in the domestic market and also to insulate the automobile industry from the excessive effects of economic cycles and import compression, a number of structural improvements are needed. These include: (i) increasing the localization content in automobile assembling; (ii) providing a level-playing field in the sector by doing away with protective policies; and (iii) addressing market frictions in the auto financing business.

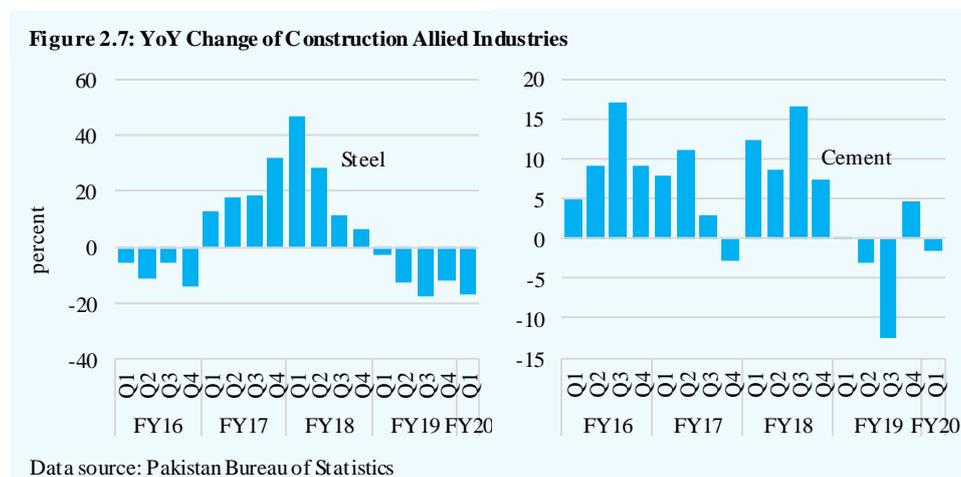
### ***Construction Allied Industries***

The downward trend in construction-allied industries became more pronounced in Q1-FY20 (**Figure 2.7**).

#### Cement

The cement industry's output declined by 1.5 percent in Q1-FY20 compared to marginal growth last year, as captured by LSM data. This outcome is owed mostly to subdued domestic demand although there are some signs of improvement since September FY20. On the other hand, exports of clinker helped offset a substantial portion of losses but were not enough to turn the overall output growth to positive in this quarter.

According to the All Pakistan Cement Manufacturers Association (APCMA), cement exports rose by 17.6 percent in Q1-FY20 compared to 30.8 percent growth



last year.<sup>9</sup> As exports to India tapered, exports of the finished commodity to Afghanistan and clinker to mainly African countries rose sharply, to the benefit of local producers. In particular, exports of clinker, which grew 121.9 percent over last year, provided much needed boost to a sector that has undertaken extensive capacity enhancement in the last few years, and added over 20.0 percent to the overall capacity in just the past two years (Table 2.8).

**Table 2.8: Cement Dispatches and Growth**

		Dispatches (million tons)		Growth (percent)	
		Domestic	Export	Domestic	Export
FY18	Q1	9.0	1.3	21.6	-13.3
	Q2	10.7	1.1	12.6	-15.4
	Q3	11.4	1.0	17.5	11.1
	Q4	9.9	1.3	8.8	44.4
FY19	Q1	9.1	1.7	1.1	30.8
	Q2	10.6	1.7	-0.9	54.5
	Q3	9.8	1.6	-14.0	60.0
	Q4	10.9	1.4	10.1	7.7
FY20	Q1	9.1	2.0	0.0	17.6

Data source: All Pakistan Cement Manufacturers' Association

Meanwhile, domestic cement sales remained dull as public and private spending on infrastructure and housing remained subdued. High cost of construction deterred real estate developers. In addition, large-scale developers, who rely on bank borrowing to fund their operations, held back their investment owing to the increase in financing costs.

### Steel

The steel industry's downtrend continued, with output contracting 17.0 percent in

<sup>9</sup> However, this is in contrast with the PBS' exports data, which shows a 5.2 percent YoY decline in quantum cement exports in Q1-FY20.

Q1-FY20. The production of billets, mostly used in construction activities, declined by around one-third as compared to Q1-FY19. As mentioned earlier, the high cost of construction is the primary cause of this performance.

In addition, the PKR depreciation just before the start of the year, higher financing costs, and lower utilization levels have led to higher costs for the industry's larger players, and also played a role in constraining the producers' pricing power. As demand subsided owing to higher prices, the profitability margins of the industry squeezed as well.

### Food

The food sector's growth continued to remain negative due to weak performances of cigarettes, soft drinks and cooking oil segments. The increase in FED on cigarettes and uncertainty regarding the imposition of an additional tax on sugary soft drinks, affected the industry. Cooking oil processing declined as production of its close substitute (ghee) registered an increase. This is mainly due to the significant drop in the import price of palm oil (major input for ghee production) prices compared to soybean, which is a major raw material for cooking oil.

### Cigarette

The output of the cigarette industry declined by 34.5 percent during Q1-FY20 as compared to a positive growth of 4.4 percent in the corresponding period last year. The primary reason was the significant increase in FED rates on two tiers and elimination of the third tier of locally produced cigarettes (**Table 2.9**).

Timeline	Tier	(Price=P in PKR/1000 cigarettes)	FED
Jun-16	Tier 1	> 4000	3436
	Tier 2	< 4000	1534
May-17	Tier 1	> 4500	3740
	Tier 2	2925 < P < 4500	1670
	Tier 3	< 2925	800
Apr-18	Tier 1	> 4500	3964
	Tier 2	2925 < P < 4500	1770
	Tier 3	< 2925	848
Sep-18	Tier 1	> 4500	4500
	Tier 2	2925 < P < 4500	1840
	Tier 3	< 2925	1250
Jun-19	Tier 1	> 5960	5200
	Tier 2	< 5960	1650

Data source: Federal Board of Revenue

The increase in FED had negative implications for the growth of the formal cigarette industry, as it pushed consumers towards cheaper alternatives, in the shape of illicit products that remain out of the tax net. These include both locally produced counterfeits and those smuggled from abroad. In order to curb the prevalence of illegal products in the market, the government has developed a track and trace program that would track these products and penalize the illegal chain of tobacco dealers in the black market.

### ***Petroleum***

The POL industry registered a double digit contraction of 14.5 percent in Q1-FY20, which was deeper than the drop of 5.4 percent recorded last year. The shift in power generation away from furnace oil has reduced the fuel's demand and affected the industry's output. Some oil refineries are still weighing the possibility of installing diesel hydro desulphurization units that would allow them to increase their production of other POL products. However, for the time being, refineries are facing excess capacities.

### ***Textile***

The mismatch between production and export volume data for the textile sector has widened further. Domestic textile output data (as reported in LSM) is skewed towards firms making primary products; these firms exhibited insipid performance during Q1-FY20 which is reflected by the marginal growth of 0.2 percent over Q1-FY19. However, export volumes of apparel, for instance, have risen sharply during the period, supported by the realignment of the exchange rate with market fundamentals. As highlighted in previous SBP reports as well, the detailed analysis of these two datasets points toward some transition in the textile sector, from low value added (yarn and fabric) products to higher value added products (such as apparel).

This transition is a welcome boost for the industry, as firms continue to make inroads into the European and the US markets. This positive outcome, while not entirely visible in production (LSM) data, is the result of the industry regaining competitiveness after the exchange rate depreciation. To further support this, some of the large industry players have increased their capacity utilization levels as well.

### ***Fertilizer***

The fertilizer sector's output expanded sharply by 15.9 percent in Q1-FY20 in contrast to a decline recorded last year. The impetus came from small as well as large urea producers, which led to a record high first quarter urea production. The output of small urea units expanded considerably,<sup>10</sup> whereas large producers also scaled up their operations by another 2.5 percent in Q1-FY20 (against a growth of 2.3 percent in the previous period), as shown in **Figure 2.8**. At this rate, the country is set to produce surplus urea for FY20.

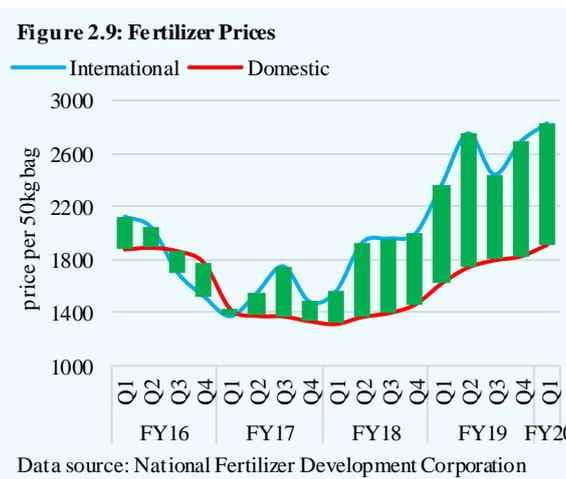
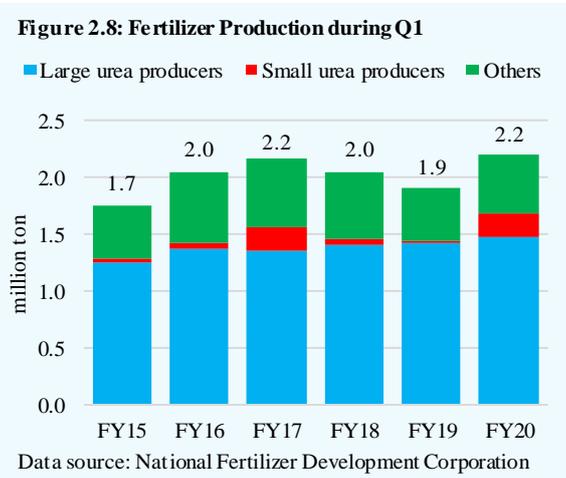
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<sup>10</sup> It is pertinent to recall that last year, these units had remained shut during the time due to non-availability of natural gas, a critical input, at economically feasible rates. For details, see Chapter 2 in the SBP's State of the Economy Report for Q1-FY19.

The country’s absorption capacity for urea is around 6 million tons in a typical year. With production outstripping demand, the surplus supply would need to be offloaded in the international markets. The global urea prices have risen by around 19.7 percent since Q1-FY19, creating potential for the producers to export the commodity at favorable rates. The fertilizer’s average domestic price was Rs 1,911 per 50-kilogram bag during Q1-FY19, while international prices averaged Rs 2,821. The sizeable price differential means that the producers can earn substantial returns on their excess stock (**Figure 2.9**).

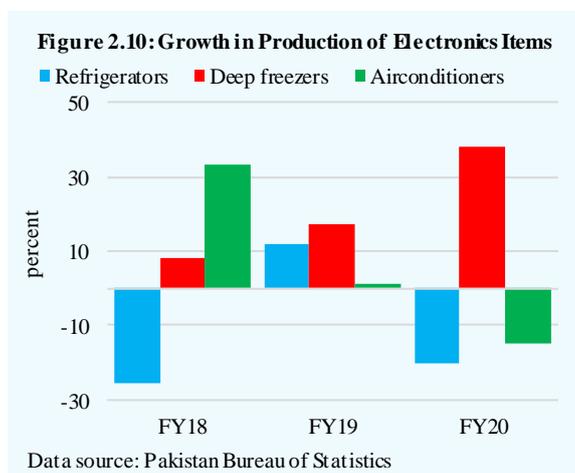
However, this export opportunity has arisen due to subsidies provided by the government to the fertilizer plants. Before making allowances for export, the government needs to recoup as much of the cost subsidy as possible. Otherwise, it makes no economic sense to subsidize consumption of fertilizer for foreign users.

Production of other fertilizers (which included DAP, NPK and SSP) also witnessed significant recovery during Q1-FY20 after 3 years of contraction. The higher production reduced the need for fertilizer imports; in fact, fertilizer (DAP) was one of the largest contributors to the decline in overall imports in the quarter (**Chapter 5**).



### Electronics

The output of the electronics industry grew by 5.5 percent during Q1-FY20 as compared to the growth of 16.9 percent in the corresponding period of FY19. The major driver was the electric motor segment, which saw its growth reach 9.8 percent, against the rise of 28.8 percent recorded during Q1-FY19. One possible reason is that domestic consumers have turned away from imported motors after the exchange rate depreciation, and have started to prefer relatively cheaper domestic alternatives. The inclusion of a motor assembling firm in the LSM data is somewhat helpful in pinning down this uptick in growth.



Meanwhile, the increase in electricity tariffs and the Pak rupee depreciation had some bearing on a few consumer durables, such as air conditioners and refrigerators (**Figure 2.10**). The rise in electricity rates increased the operating costs, while the Pak rupee depreciation increased the production costs of these import-intensive products.

### 2.4 Services

The services sector's growth target of 4.8 percent for FY20 is only marginally higher as compared to the actual growth realized last year (**Figure 2.11**). Moreover, it is fairly low compared to the annual targets in the previous five years.

To some extent, the near-term outlook of the services sector depends on the performance of its largest segment, *wholesale and retail trade*, which is



inherently linked to the commodity-producing sectors. On this note, LSM declined during Q1-FY20 (**Table 2.10**). Imports were also expected to remain on the lower side as long as macroeconomic stabilization policies remain in place. In addition, various traders' associations observed countrywide strikes during the first quarter to protest against certain documentation measures being pursued by the government; these tensions persisted till end-October 2019, when an agreement was finally reached. Taking all these factors into account, it was hardly a surprise that credit offtake to wholesale and retail traders saw a significant decline during Q1-FY20 compared to last year.

**Table 2.10: Selected Services Sector Indicators (Q1)**

	FY19	FY20
<b>Wholesale and Retail Trade (18.9%)</b>		
Sectoral credit off take*- flow	-4.9	-43.8
Imports (billion US\$ )	14.2	11.5
LSM (YoY growth)	-0.6	-5.9
Agriculture credit	212.1	263.3
<b>Transport, Storage and Communication (12.9)</b>		
POL sales to transport sector	3.6	3.4
Commercial vehicle sales	11,219	5,000
Cellular teledensity (%)	73.2	76.8
Broadband users (million)	61.6	74.0
<b>Finance and Insurance (3.5%)</b>		
Assets (billion Rs)*	18,118	21,655
Deposits (billion Rs)*	13,603	14,945
Profit after tax (billion Rs)	34.8	37.3
Infection ratio	8.0	8.9
<b>General Government Services (8.4%)</b>		
Expenses on general govt & defense*** (Rs billion)	932.8	1,009.3

Note: Values in brackets are sectoral shares in GDP, as of FY19.

\* With adoption of ISIC-4 classification by SBP, the *wholesale and retail trade* and *transport, storage and communication* categories have been modified. Thus, one-to-one mapping of sectoral credit offtake numbers may not be possible in each case

\*\* Stocks, as of end-September 2019

\*\*\*Only Federal Government

Data source: SBP, PBS, OCAC, PAMA, PTA and MoF

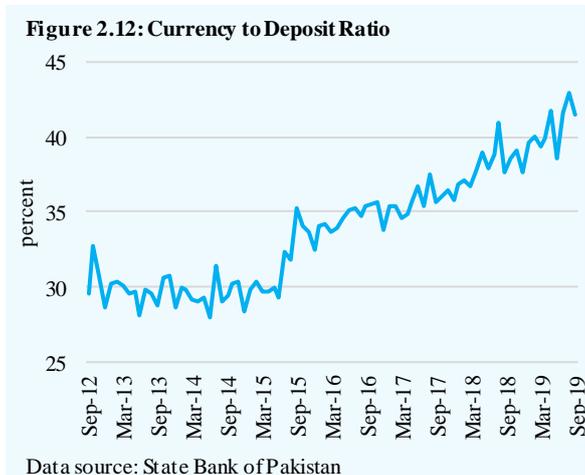
Among the *transport, storage and communication* segment indicators, there was a sharp dip in commercial vehicle sales, which more than halved compared to last year. Besides, POL sales to the transport sector were also lower during Q1-FY20. Furthermore, the proposed implementation of axle load controls faced resistance from the business community and transporters. Ultimately, in late October 2019, the government postponed the axle load implementation for a year.

Regarding the *finance and insurance* segment, the profit after tax of commercial banks showed some improvement in Q1-FY20 compared to the same quarter last year. To some extent, this may be attributed to higher net interest income. At the same time, a rising infection ratio and higher quantum of NPLs may keep the upside potential somewhat in check.

It is worth noting that there continues to be an excessive reliance on cash holdings, indicated by the persistently high currency- to-deposit ratio (**Figure 2.12**). The secular rise in cash holdings can mainly be traced to the introduction of

withholding taxes on banking transactions by the government in FY16. In addition to the lingering impact of this move, the higher inflation since FY19 may also have influenced the people's preference to keep greater cash holdings for transactions. That said, certain measures proposed by the SBP may induce a gradual shift in the public's preference away from cash-based transactions in favor of digital payments, as envisioned in the National

Payment Systems Strategy (NPSS) introduced in November 2019.<sup>11</sup> The entry of more players into the payments space, including fintechs, may drive more innovation and financial inclusion, ultimately bringing more vibrancy to the *finance and insurance* sector.



<sup>11</sup> The details of the NPSS may be accessed at SBP's website.

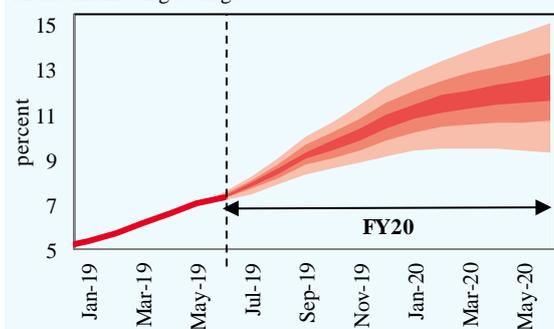
## 3 Inflation and Monetary Policy

### 3.1 Overview

By the start of FY20, the macroeconomic stabilization measures taken over the past year and a half had largely succeeded in reining in demand pressures in the economy. However, inflation proved difficult to deal with, especially given: (i) rising cost pressures emanating from the exchange rate depreciation and the rationalization of energy prices; (ii) a large fiscal deficit last year and its financing through central bank

borrowing; and (iii) a steep rise in food inflation in the fourth quarter. Headline CPI inflation touched a higher plateau in every successive quarter of FY19, reaching 8.9 percent in April-June 2019. For FY20, the SBP's projections at the start of the year (July 2019) clocked in at an elevated range of 11-12 percent. Not only was this range higher than previously projected (Figure 3.1), but it was also in excess of the medium-term target of 5-7 percent.

**Figure 3.1 : CPI Inflation Projections (July 2019 forecast)**  
12-month moving average

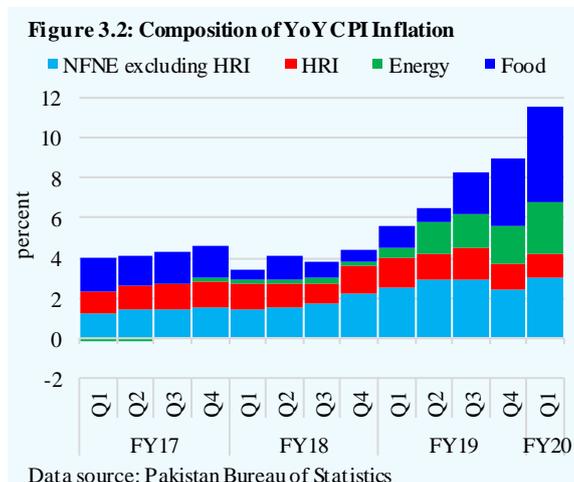


\*Probability distribution of risks around the average forecast. Shades indicate various levels of confidence interval. Data source: SBP staff estimates

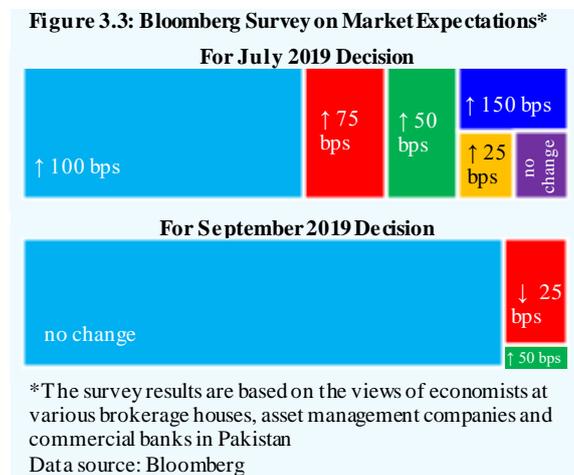
These projections were premised entirely on the additional pressures emanating from: the OGRA's approval of up to a 168 percent hike in gas tariffs (effective from July 2019); several tax rationalization measures rolled out in the Budget 2019-20; and the expected pass-through of the exchange rate depreciation that took place towards the end of FY19. Although these measures were to bring about just a one-time surge in prices, these could also potentially reinforce inflation expectations. Moreover, further adjustment in the real interest rate was warranted to anchor the inflation expectations around the medium-term inflation target. Therefore, when the Monetary Policy Committee (MPC) met in July 2019, it raised the policy rate by 100 basis points.

As the quarter progressed, the upward pressures on inflation began to materialize. The steepest jump was recorded in the energy price index, reflecting the impact of a sharp increase in natural gas tariffs – this alone contributed 1.6 percentage points

to the overall inflation during the quarter (**Figure 3.2**). The pass-through of the June 2019 exchange rate depreciation also had an impact. Not only did it push up fuel prices (and consequently transport fares), but it also reinforced the prevailing input cost pressures. Meanwhile, immediate price increases of a number of items was noted in the wake of tax rationalization measures: (i) the imposition of federal excise duty shored up retail prices of cigarettes, edible oil/ghee, cement, steel and cars; (ii) the end of zero-rating regime for the textile industry pushed up clothing prices, as producers passed on the impact of the applicable general sales tax (GST) to end-consumers; and (iii) the end of the reduced GST regime on sugar partially contributed to the increase in its retail prices. The impact of these budgetary adjustments was visible in a steep 2.3 percent month-on-month inflation recorded in July 2019.

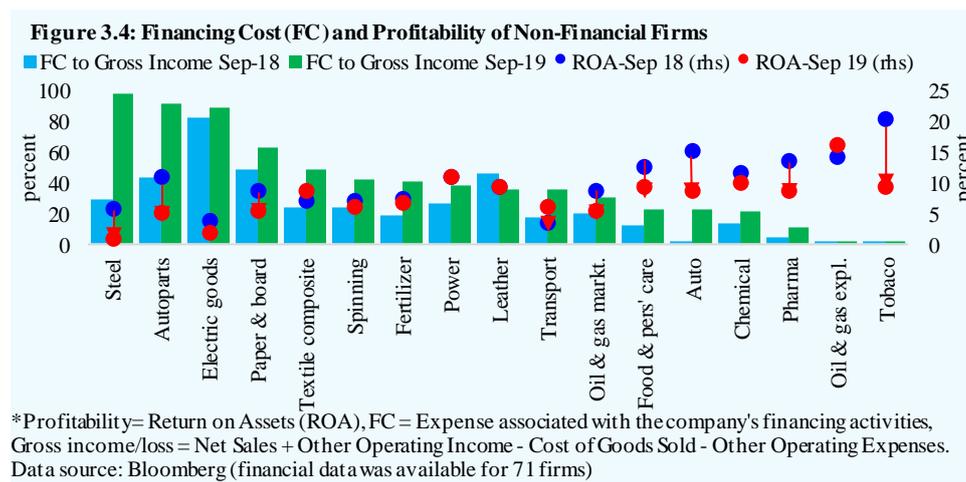


In subsequent months also, the course and the magnitude of headline inflation remained broadly in line with the SBP's earlier projections. Importantly, the improvement in the balance of payments (that led to stability in the market-based exchange rate), and the government's adherence to fiscal discipline, were both helpful in subduing the potential upside risks to inflation. As a result, the SBP's inflation projections in September 2019 remained more or less unchanged from July 2019. Keeping in view these developments, the MPC decided to keep the policy rate unchanged in its September 2019 decision.



The decision did not come as a surprise for the interbank market, as the expectations for further monetary tightening had subsided to a large extent after the July 2019 decision. Surveys of bank treasuries and fund managers explicitly reflected expectations that interest rates had peaked out (**Figure 3.3**). These expectations were also visible from the growing demand for longer tenor government papers in the primary market, and the yield spreads turning negative in the secondary market. In fact, banks were keenly observing the improvement in the fiscal position and the visible shift in the budgetary financing pattern away from banking sources (towards non-bank sources). Therefore, banks overbid in most auctions of government papers and locked in their available liquidity in long-term fixed-income assets.

As for private businesses, maintaining the interest rates at the elevated level meant they had to put up with the prevalent tight financial conditions. While credit demand was already weak due to thin activity in the manufacturing sector, most businesses avoided bank borrowing even to finance their short-term liquidity needs. Last year, cash flow constraints arising from inventory build-up and rising input costs had pushed many firms towards excessive leveraging; but with the weighted average lending rates hovering at 7 and a half year high levels in Q1-FY20, it had become difficult for firms (except for steel and car manufacturers) to viably meet their liquidity needs through bank borrowings. Financing cost had started eating up on firms' gross margins, which were already under stress owing to weak demand conditions (**Figure 3.4**). Therefore, a number of sectors preferred to deleverage; also, fewer requests were placed with banks for fresh working capital facility. In overall terms, Q1-FY20 saw net retirements of Rs 16.9

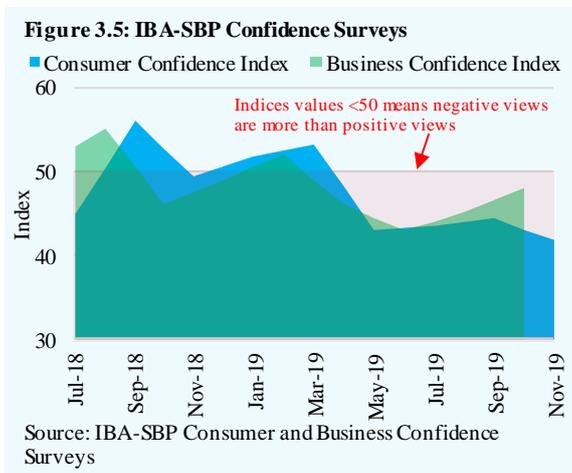


billion of private sector credit. Fixed investment also remained subdued as the overall confidence among businesses and consumers remained weak (Figure 3.5).

### 3.2 Monetary aggregates

Broad money expanded by Rs 105.2 billion during Q1-FY20, compared to Rs 22.4 billion last year (Table 3.1). Unlike the trend in the past 3 years, the entire increase this year stemmed from an improvement in net foreign assets (NFA) of the banking system, reflecting the improvement in the country's balance of payments and the receipt of the first tranche of the IMF's EFF program.

Here, it is important to mention that this is the first time that the IMF's lending for balance of payments support will also be utilized by the government to finance its budget deficit (therefore, it will be treated as a liability of the government, not of the central bank).<sup>1</sup> In contrast to NFA, the net domestic assets (NDA) of the banking system contracted, as the increase in net budgetary borrowings (on accrual basis) was more than offset by credit retirement by the private sector and a sharp increase in the SBP's profit (which caused a decline in other items net).



**Table 3.1: Monetary Aggregates in Q1<sup>P</sup>**

	billion Rupees			
	Abs. change in stocks		Growth rate in percent	
	FY19	FY20	FY19	FY20
M2 (A+B)	22.4	105.2	0.1	0.6
A. NFA*	-148.5	260.4	-71.3	17.3
B. NDA	171.0	-155.3	1.1	-0.8
Budgetary borrowing**	84.6	156.0	0.9	1.3
SBP	1,518.3	-1,586.9	42.0	-23.7
Scheduled banks	-1,433.7	1,742.9	-24.8	35.5
Commodity operations	-10.8	-15.6	-1.3	-2.1
Private sector	127.9	-16.9	2.1	-0.3
PSEs	60.7	-2.0	5.8	-0.1
Other items net	-91.8	-276.0	-8.9	-25.0
Reserve money	-31.0	-207.4	-0.6	-3.2

<sup>P</sup>: Provisional

\* Outstanding stock at end June 2019 was Rs -1,507.1 billion and at end Sep 2019 was Rs -1,246.6 billion.

\*\* These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in Table 4.1.

Data source: State Bank of Pakistan

<sup>1</sup> Hence, this amount will not be netted out from foreign exchange reserves to calculate the SBP's NFA.

On the liability side, currency in circulation grew at a five-quarter high rate of 5.8 percent during Q1-FY20. With commercial bank deposits falling by 1.4 percent, the overall currency-to-deposit ratio jumped to an all-time high of 42.0 percent (on average) during Q1-FY20. In addition to the prevailing high level of inflation, this trend can be attributed to growing apprehensions of businesses and households over increased financial scrutiny in the country. Over the past three years, businesses had already preferred out-of-bank settlements to avoid withholding taxes on banking transactions. But now, with increased use of data on deposits and banking transactions by tax authorities (to identify high net-worth individuals and unregistered businesses), the preference for cash-based settlements has grown even more. In addition, it also appears that tight financial conditions may have induced firms and households to tap their savings held in the form of bank deposits (**Table 3.2**).

**Table 3.2: Change in Sector Wise Deposits in Q1\***

	Percent		Rs billion	
	Share in June 2019		FY19	FY20
Total	100.0		1.6	-193.4
<i>of which:</i>				
<i>I. Government</i>	14.8		-48.0	-88.9
<i>II. Non-financial PSEs</i>	6.1		24.8	42.0
<i>III. Non-bank FIs (NBFIs)</i>	3.2		13.8	27.1
<i>IV. Private sector</i>	21.5		-60.5	-135.6
<i>V. Personal</i>	49.2		106.0	-29.1
a. Salaried persons	12.4		34.2	-29.3
b. Self employed	21.4		11.1	-14.6
c. Other personal	15.5		60.8	14.9
<i>VI. Other</i>	0.5		-4.2	-30.3

\*From July 2019 onwards, SBP has adopted ISIC 4.0 classification, therefore, sectoral figures for FY19 and FY20 may not be fully comparable.

Data source: State Bank of Pakistan

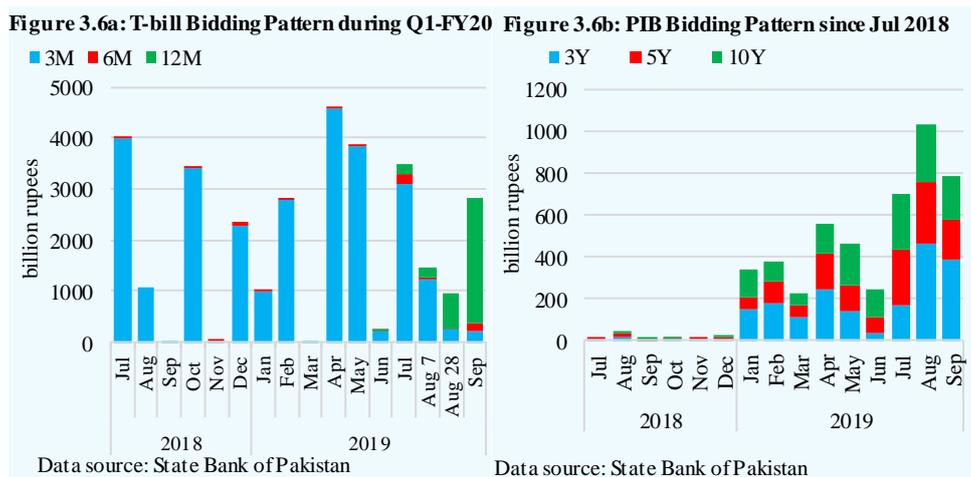
### ***Budgetary Borrowings***

The fiscal deficit nearly halved during the quarter and there was an uptick in financing from non-bank sources. Therefore, the government's appetite for bank financing remained subdued compared to last year. Even though, on accrual basis, net budgetary borrowings from the banking system remained higher than last year, this was entirely on account of a sharp increase in the SBP's accrued interest income.<sup>2</sup> This increase was a result of: (i) higher stock of government borrowing at end-June 2019 compared to end-June 2018; (ii) higher level of interest rates; and (iii) the impact of term premium and a change in the interest payment cycle resulting from the debt re-profiling exercise at end-June 2019 (involving the

<sup>2</sup> Accrued interest income is a sub-component of budgetary borrowings in the monetary survey. However, when calculating budgetary borrowings on cash basis, the accrued income is not included. In Q1-FY20, the government's net retirements to the SBP stood at Rs 1.6 trillion on accrual basis and Rs 1.8 trillion on cash basis.

replacement of T-bills with long-term PIBs). Adjusting for the accrued interest income, the government's net retirements to SBP stood at Rs 1.8 trillion, which more than offset its Rs 1.7 trillion net borrowing from commercial banks. In overall terms, the government retired Rs 123.0 billion to the banking system in Q1-FY20 on cash basis.

Within the banking system, a clear shift was observed in the source of the budgetary financing. Unlike last year, when the government had borrowed heavily from the SBP to retire commercial bank debt, it borrowed heavily from commercial banks this year to retire the SBP debt. This shift can be traced to two major factors. First, the government had committed not to borrow from the SBP to finance its deficit under the EFF program. This commitment was limited not just to achieving zero quarterly borrowings, but also to refrain from rolling over the maturing SBP debt. Second, the commercial banks' own appetite for investing in government papers remained strong. In particular, their expectations of interest rates had peaked out, which led them to lock available liquidity in longer tenor



government securities. This change in the market's expectations was also quite visible in the bidding pattern in primary auctions, which clearly reflected banks' preference for longer tenor securities (Figure 3.6a and b).

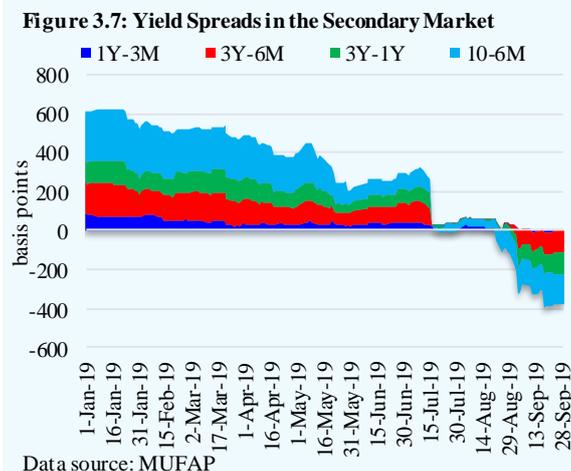
**Table 3.3: PIB Auction Summary (Fixed rate)**  
in billion rupees

	Target	Maturity	Offered*	Accepted
<b>Fixed Rate</b>				
Q1-FY20	325.0	275.9	2,521.2	963.5
Q1-FY19	150.0	461.1	65.2	20.6

Data source: State Bank of Pakistan

In case of PIBs, the banks' active participation was evident from the start of FY20. Since the first PIB auction was held after the 100 bps rate hike in July 2019, the

market viewed that as the ideal time for placing funds in long-term bonds. In nearly all the subsequent auctions also, banks' offers widely surpassed the targets set by the government (**Table 3.3**); on aggregate, the offers in PIB auctions during the quarter stood at an all-time high. But relatively limited acceptances left nearly Rs 1.5 trillion worth of demand unmet.



Keeping in view such a high demand from scheduled banks, the government leveraged its position by slashing the cut-off rates by 75 bps, 130 bps and 145 bps for 3 year, 5 year and 10 year PIBs, respectively, during Q1-FY20. In the secondary market also, yield spreads turned negative, as the demand-supply gap of long-term bonds edged up (**Figure 3.7**). In addition to the market's view on interest rates, banks' expectations of subdued future supplies of long-term bonds, further strengthened the demand for these instruments. Specifically, with the improvement in tax collection and the overall fiscal position, along with estimates of higher external financing through the rest of the year, it was understandable for banks to anticipate a thin supply of PIBs in subsequent months.

A similar behavior was observed in T-bill auctions. Until the first auction of August 2019, banks bid for the shorter tenor securities, i.e., the 3m T-bill. However, banks' behavior changed in all the subsequent auctions, and they started bidding heavily in the 12m paper. In overall terms, the government mobilized Rs 1.8 trillion in excess of maturities from T-bills (**Table 3.4**).

**Table 3.4: T-bill Auction Summary**

	Target	Offered	Accepted
<i>in gross terms</i>			
Q1-FY20	6,800.0	8,715.7	6,995.4
Q1-FY19	5,450.0	5,119.0	4,687.0
<i>net of maturity</i>			
Q1-FY20	1,620.4	3,536.1	1,815.8
Q1-FY19	-210.6	-541.6	-973.6

Data source: State Bank of Pakistan

With heavy bank participation in the auction of government securities amid deposit withdrawals, the interbank market witnessed bouts of liquidity drains during Q1-FY20. This strain was partially relieved by net retirements by the private sector, PSEs and the government's commodity procurement agencies. To

further ease the liquidity conditions, the SBP scaled up its injections in the interbank market; the average outstanding OMO size soared to Rs 1.3 trillion during Q1-FY20, compared to Rs 1.0 trillion last year and *negative* Rs 247.4 billion (net absorption) in the preceding quarter.

At the same time, there were multiple instances where the average deviation of overnight rates plunged more than 100 basis points *below* the policy rate (Figure 3.8). This was primarily because the SBP refrained from conducting frequent mop-ups, and left the market to settle on its own, based on expected outflows.

This increased the commercial banks' recourse to the floor facility, placing Rs 537.3 billion during Q1-FY20, compared to only Rs 146.5 billion a year earlier (Table 3.5).<sup>3</sup> As a result, the weighted average overnight rates plunged on multiple occasions.

### Commodity operations

Commodity operations recorded a relatively higher net retirement in Q1-FY20 than last year. This was mainly driven by wheat, as other commodities, such as fertilizer and sugar, recorded higher offtake during the quarter (Table 3.6). In case of wheat, better liquidity conditions of major procurement

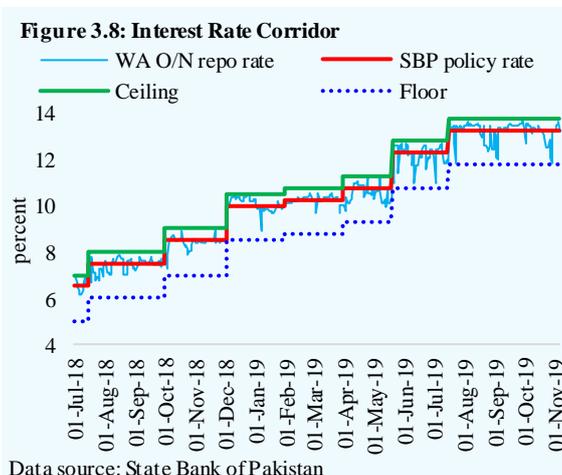


Table 3.5: Summary of Repo Market

	Q1-FY19	Q1-FY20
Volume ( in billion rupees)		
Mop up	-2,402.0	-308.8
Injections	12,825.9	19,673.1
Floor	-146.5	-537.3
Ceiling	491.9	515.0

Data source: State Bank of Pakistan

Table 3.6: Commodity Financing in Q1

	flow in billion rupees	
	FY19	FY20
Wheat	-12.4	-18.5
Rice	0.0	-0.8
Fertilizer	0.6	1.8
Sugar	0.9	1.9
Cotton	0.0	0.0
<b>Total</b>	<b>-10.8</b>	<b>-15.6</b>

Data source: State Bank of Pakistan

<sup>3</sup> During Q1-FY20, 46 counters had resorted to the SBP's floor facility, compared to only 17 during the same period last year.

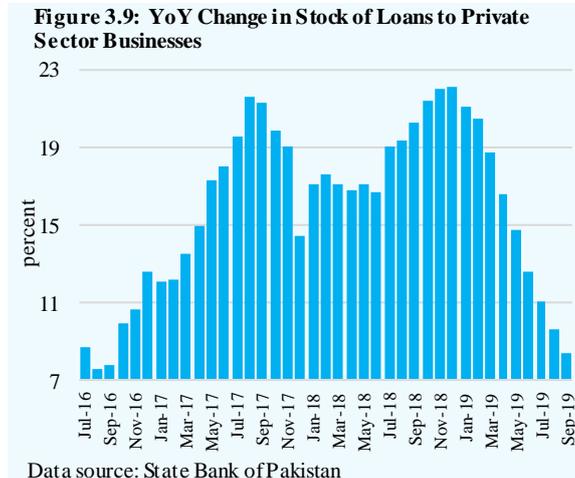
agencies helped them retire a higher volume of bank debt. These agencies were able to scale up their releases of the commodities amid the prevailing shortages and price pressures in the market.

### 3.3 Credit to Private Sector

The weakening in the private credit momentum, which had started from the third quarter of FY19, persisted in Q1-FY20.

In overall terms, private businesses retired Rs 85.4

billion loans during the quarter, as compared to offtake of Rs 99.0 billion in Q1-FY19 (**Figure 3.9**).



The underlying dynamics of private sector credit were consistent with the overall macroeconomic situation. The downtrend in manufacturing activity, which constitutes the bulk of demand for bank credit, deepened further in Q1-FY20, as stabilization measures and regulatory changes weighed heavily. In particular, cost-push pressures, coupled with revenue-enhancing measures, led to price increases of various items, which induced consumers to reduce spending on luxuries (such as cars and appliances). This led to inventory build-ups and generated cash flow problems in the associated industries. Moreover, notwithstanding some recent improvement in the construction sector, the overall sentiment in the construction-allied industries remained downbeat. While firms had been facing tepid demand conditions since last year and initially managed their liquidity problems by further leveraging, the resultant increase in their financing costs and the rising trajectory of interest rates dissuaded them from pursuing this strategy in Q1-FY20.<sup>4</sup>

As a result, the overall demand for working capital loans remained subdued during the quarter. This was also reflected in a 6.5 percent YoY reduction in the number of applications received for working capital loans by banks.

<sup>4</sup> The incremental weighted average lending rate rose to 13.6 percent in Sep-2019 from 8.4 percent in Sep-2018.

**Borrowing for fixed investment purposes increased**

Fixed investment loans increased by Rs 14.6 billion during the quarter, as textiles and power sectors undertook capex and cellular firms borrowed long to pay for the renewal fees for GSM licenses.

Textile firms continued to position themselves to benefit from the market-based exchange rate regime, concessionary market access to the EU under the GSP-Plus, and lately, of imposition of tariffs on China's textile exports to the US (**Chapter 5**). The industry invested Rs 8.1 billion in importing machinery during the quarter; these purchases were financed primarily by the SBP's subsidized LTFF facility— LTFF constituted around 94 percent of the offtake during the quarter.

**Table 3.7: Loans to Private Sector Businesses Q1\***  
flow in billion rupees

	Total Loans		Working Capital**		Fixed Investment	
	FY19	FY20	FY19	FY20	FY19	FY20
<b>Private Sector Businesses</b>	<b>99.0</b>	<b>-85.4</b>	<b>64.1</b>	<b>-100.0</b>	<b>34.9</b>	<b>14.6</b>
Manufacturing	50.5	-50.7	30.2	-46.5	20.3	-4.3
Sugar	-21.9	-42.7	-32.3	-36.9	10.4	-5.9
Rice processing	-23.4	-21.6	-23.7	-21.7	0.3	0.1
Vegetable and animal oils & fats	12.1	-12.8	11.8	-12.2	0.2	-0.5
Fertilizer	-7.4	-19.2	-2.9	-16.5	-4.5	-2.7
Paper & papers products	4.1	-4.8	5.1	-2.7	-1.0	-2.1
Electrical equipment	-7.3	-6.2	-9.1	-3.1	1.9	-3.1
Textiles	29.6	6.6	29.4	-2.0	0.2	8.6
Refined petroleum	20.1	-4.1	22.0	-2.9	-1.9	-1.1
Cement, lime and plaster	17.4	-1.8	6.6	1.4	10.8	-3.2
Other food manufacturers		17.2		15.7		1.5
Iron & steel	11.3	15.8	8.8	11.9	2.5	3.9
Motor vehicles	9.9	30.7	8.7	29.4	1.3	1.3
Power generation, transmission and distribution	36.1	9.6	35.7	3.8	0.5	5.8
Wholesale and retail trade	-4.9	-42.0	-5.1	-36.8	0.1	-5.3
Mining and quarrying	2.0	-5.0	-2.4	-5.8	4.3	0.9
Construction	5.7	-17.1	3.6	-19.0	2.1	1.9
Agriculture, forestry and fishing	-2.2	-0.8	0.5	0.6	-2.8	-1.3
Real estate activities	8.4	5.3	5.3	-0.2	3.1	5.6
Transportation and storage	6.0	4.6	2.2	5.4	4.0	-0.8
Telecom	1.5	24.4	2.7	-0.4	-1.0	24.8

\* The sector wise numbers for FY19 and FY20 may not be fully comparable, as the flows for Q1-FY19 are based on ISIC 3.1 whereas the flows for Q1-FY20 are based on ISIC 4.0 classification.

\*\*includes trade financing

Data source: State Bank of Pakistan

On the other hand, the increase in long-term loans in the power transmission and distribution segments reflected borrowing by CPEC-related coal-based projects.

In one case, the borrowing was to expedite work on a 660MW project, which is expected to commence operation by March 2021. In another case, a major IPP is in the process of growing its portfolio in various power projects; this raised its long-term financing requirement during the quarter.

In addition to these two sectors, some activity was also recorded in the steel sector. It is important to highlight that the existing south-based key players are focusing on increasing their footprint in the northern region of the country, apart from vying for market share in non-construction segments, such as the home appliance and the auto sectors. Steel firms are establishing dedicated service centers to capture the potential demand from these segments. Besides this, some firms are also investing in BMR activities, such as upgrading their furnaces.

***Working capital loans recorded net retirements***

Working capital recorded a net retirement of Rs 100.0 billion in Q1-FY20, compared to an increase of Rs 64.1 billion last year (**Table 3.7**). The retirements were broad-based across major manufacturing sectors, such as refined petroleum, sugar, rice processing, fertilizers, and textiles. Here it is important to qualify that textile businesses retired Rs 2.0 billion of working capital loans, but a closer look into the data suggests that the export-oriented firms borrowed Rs 14.8 billion under the Export Finance Scheme.

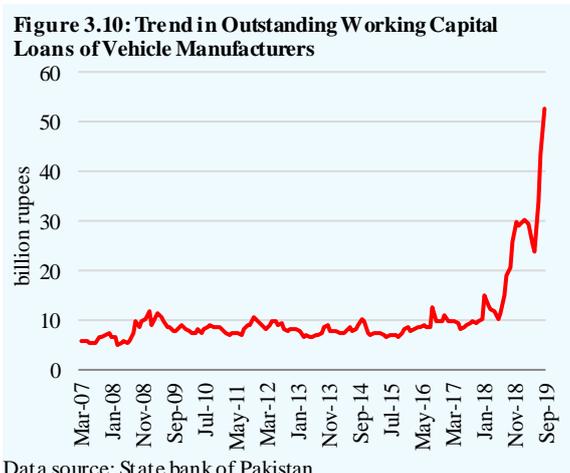
Only three sectors took out more working capital loans during the quarter; these included FMCGs, automobiles and steel. In the case of FMCGs and steel, the impact of rising input costs and weakening demand put them in a tight spot. Liquidity concerns were more intense in the steel sector, as the subdued construction activity in the country did not allow firms to pass on the impact of costly imported steel scrap, high energy prices and rising transportation costs (due to axle load limits). Furthermore, anecdotal evidence suggests that firms were facing operational constraints, as their unregistered dealers had apprehensions with respect to the CNIC condition.

In case of automobiles, local assemblers had raised their prices several times since the beginning of FY19, citing the currency depreciation, the imposition of FED on various car models and additional customs duty on parts. However, the rising prices of cars, coupled with increasing cost of borrowing and maintenance, has priced out many buyers from purchasing vehicles and led to inventory build-up with dealers and assemblers. It is important to mention that car assemblers typically finance their working capital from customer prepayments and do not rely much on bank borrowing for operational needs; however, the inventory build-up has squeezed their cash flows and led them to borrow heavily from banks during

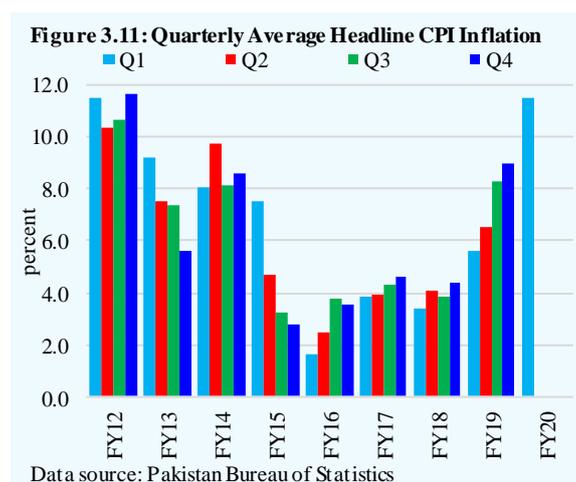
Q1-FY20 (Figure 3.10). In addition to carmakers, other segments of the industry, such as tractor, two/three wheeler and truck manufacturers, also took out short-term loans to manage their liquidity constraints.

### 3.4 Inflation

Extending the steep upward trend persistent since the beginning of FY19, the average headline CPI inflation reached 11.5 percent in Q1-FY20. Not only this level was double the inflation observed in the same quarter last year, it was also the highest level of quarterly inflation since Q4-FY12 (Figure 3.11). In terms of dispersion, the increase in inflation was broad-based, as around 64 percent of the total items posted higher inflation during Q1-FY20 as compared to last year. Moreover, around 40 percent of the total items registered double-digit inflation during the quarter.



Data source: State bank of Pakistan



Data source: Pakistan Bureau of Statistics

Although the inflation during Q1-FY20 represents a sharp deviation from the medium-term target of 5-7 percent, it was not entirely unanticipated. First, the exchange rate depreciation towards the end of FY19 was expected to have a second-round impact on a number of items in Q1-FY20. Second, up to 168 percent increase in gas prices, as notified by Oil and Gas Regulatory Authority (OGRA), was expected to inflate energy prices from July 2019 onwards.<sup>5</sup> And

<sup>5</sup> According to the OGRA's notification, dated June 29, 2019, gas tariffs for slab using 201-300 mmbtu/month was raised up to 168 percent. For consumers using 51-100 and 101-200 mmbtu/month of gas, tariffs were raised by 136.2 and 109.5 percent respectively. Together, these three slabs constitute over half of the total gas consumption in domestic sector.

third, the revenue-led fiscal consolidation measures – including the imposition of FED, end of zero-rating regime for export-oriented industries and reduced GST regime for sugar – announced in Budget 2019-20 were anticipated to bring about a steep surge in retail prices of a number of food and non-food items (**Box 3.1**).

**Box 3.1: Zero-rating Regime Ended for Export Oriented Industries**

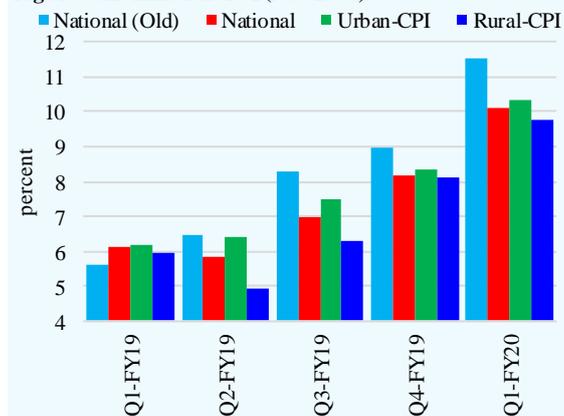
On 29<sup>th</sup> June, 2019, the zero-rated regime for the five major export-oriented sectors (textiles, carpets, leather, sports and surgical instruments) – granted under SRO 1125 dated 31<sup>st</sup> December 2011 – was rescinded after the issuance of SRO 694 (I)/2019. The government restored the standard GST rate of 17 percent on inputs and products of export-oriented sectors. The GST rate on local supplies of finished articles of textile and leather and finished fabric was also raised to 17 percent.

Previously, the industry players pertaining to these sectors were paying sales tax at zero-rate on 128 items to be used as industrial inputs. In addition, the SRO allowed registered manufacturers in these sectors to avail electricity and gas at zero percent sales tax. Furthermore, a tax of 5.0 percent was applicable if the produced items were sold to retailers or end-consumers domestically. Lastly, registered persons who were solely or otherwise engaged in retailing activities of these goods were paying 5.0 percent sales tax on their retail sales and were entitled to input tax adjustment.

However, according to the tax authorities, the provisions were at times being misused. In particular, the benefits were being availed by some manufacturers who sold a significant part of their finished products in the domestic market instead of exporting. Furthermore, the reduced rates were also hurting the government’s revenue collection. This prompted the government to rescind the SRO 1125.

The strongest impact of these measures was visible on the food group, which was already struggling with rising transportation costs, crop damages, limited regional trade, hoarding practices and commodity-management issues. The other major contributor was the energy group, which recorded the highest level of inflation in at least a decade. Finally, the contribution of non-food-non-energy (NFNE) remained more or less at last year’s level. This

**Figure 3.12: Inflation-YoY (New Base)**



Data source: Pakistan Bureau of Statistics

was despite the continued increase in input prices (including transportation cost), the pass through of the exchange rate depreciation, and the impact of revenue measures – especially in case of construction material and clothing. This signifies that the macroeconomic stabilization measures (including the increase in interest

rates and realignment of the exchange rate with fundamentals) that were taken to alleviate domestic demand pressures, have proved largely effective.

An important development during Q1-FY20 was the completion of the rebasing exercise of CPI by the Pakistan Bureau of Statistics (**Box 3.2**). While it will take some time to collect the price information at a granular level under the new base, preliminary assessment suggests that the trends are quite similar to those noted under the old base. For instance, national level inflation edged up to 11.4 percent in September 2019 on YoY basis as compared to 5.4 percent last year (**Figure 3.12**). In case of old base (2007-08=100), the (urban) inflation increased to 12.6 percent in September 2019 compared to 5.1 percent last year. Disaggregated analysis reveals that inflation in urban areas remained more pronounced as compared to rural areas, and was predominantly driven by highly volatile food inflation.

**Table 3.8: Average CPI Inflation and Contribution - Q1**  
inflation in percent, contribution in percentage point

	Weight	Inflation		Contribution	
		FY19	FY20	FY19	FY20
<b>Overall CPI</b>	<b>100.0</b>	<b>5.6</b>	<b>11.5</b>	<b>5.6</b>	<b>11.5</b>
<b>Food of which</b>	<b>37.5</b>	<b>2.7</b>	<b>11.8</b>	<b>1.1</b>	<b>4.7</b>
Cigarette	1.4	0.6	37.9	0.0	0.7
Wheat flour	4.2	3.9	9.7	0.2	0.4
Chicken	1.4	-6.4	34.5	-0.1	0.3
Onion	0.5	-25.0	72.6	-0.2	0.4
Potato	0.5	-19.8	24.6	-0.1	0.1
Sugar	1.0	-3.3	33.5	0.0	0.3
Pulses	1.1	-11.3	19.2	-0.1	0.2
Vegetable ghee	2.1	3.0	13.6	0.0	0.2
<b>Non Food of which</b>	<b>62.5</b>	<b>7.6</b>	<b>11.3</b>	<b>4.5</b>	<b>6.8</b>
Fuel	3.0	25.7	23.1	0.5	0.6
Transport services	2.7	14.4	7.4	0.3	0.2
Clothing & footwear	7.6	6.5	8.2	0.5	0.7
Education	3.9	13.7	6.4	0.6	0.3
Household equipment	4.2	6.1	10.7	0.3	0.5
House rent	21.8	7.6	6.2	1.5	1.2
Recreation	2.0	6.7	8.0	0.1	0.1
Construction index	0.9	9.4	12.3	0.1	0.1
Motor vehicle	0.7	10.7	19.7	0.1	0.1
<b>NFNE</b>	<b>53.5</b>	<b>7.7</b>	<b>8.0</b>	<b>4.0</b>	<b>4.2</b>

Data source: Pakistan Bureau of Statistics

### ***Food remained the dominant source of inflation***

Food inflation, after rising steeply in H2-FY19, clocked in at 11.8 percent during Q1-FY20 (**Table 3.8**). This rise was a major factor contributing to weak

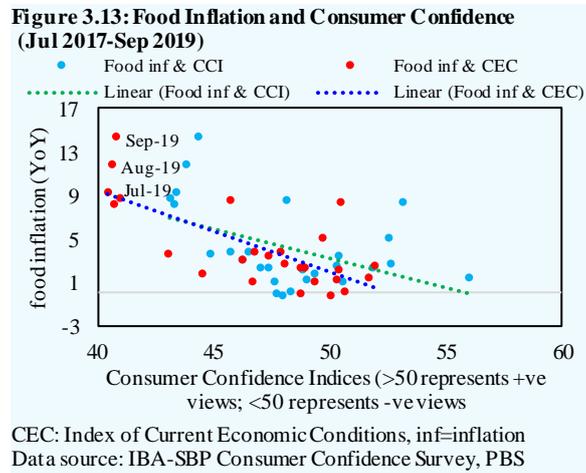
consumer confidence (**Figure 3.13**). In addition to the broad-based impact of increased transportation cost on account of fuel inflation and implementation of the axle load management policy, this pressure can be traced to:

**Revenue-enhancing fiscal measures**

As mentioned earlier, revenue measures in the Budget 2019-20 caused a significant increase in retail prices of a number of food items. For instance, upward revision in cigarette prices was attributed primarily to the imposition of FED in the Budget 2019-20.<sup>6</sup> It is important to note here that cigarettes single handedly contributed almost 0.7 percentage points to food inflation during the quarter.

Similarly, the increase in retail prices of edible oil and ghee products mainly reflected the increase in FED rate from 8.0 percent to 17.0 percent.<sup>7</sup> Edible oil refineries were also putting up with rising international prices of palm oil and soybean since the beginning of FY20: international palm oil prices were 6.8 percent higher in September 2019 as compared to June 2019, whereas prices of soybean increased by 4.3 percent in the same period.<sup>8</sup>

Moreover, double-digit inflation in sugar can partially be attributed to a steep rise in the rate of sales tax from 8 percent to 17 percent. In addition, anecdotal evidence suggests that rising sugar prices in the country, also reflect the persistence of collusive behavior and hoarding practices across the distribution chain. Official estimates of demand-supply conditions in the market support this view: the Ministry of Industries and Production has estimated available stocks in



<sup>6</sup> The FED was increased to Rs 5,200/1,000 sticks from Rs 4,500/1,000 sticks if the on-pack printed retail price exceeds Rs 5,960. Likewise, if the on-pack printed retail price is less than Rs 5,960, the FED was increased to Rs 1,650/1,000 sticks from Rs 1,840/1,000 sticks (for price between Rs 2,925 to Rs 4,500) and Rs 1,250/1,000 sticks (for on-pack printed prices less than 2,925). Source: SRO 608(I)/2019 dated 29<sup>th</sup> June 2019.

<sup>7</sup> In the budget FY20, it was proposed to increase the rate of FED to 17 percent on edible oils/ghee/cooking oil and do away with Rs 1 per kg tax in lieu of value addition tax and concessional rates on edible seeds.

<sup>8</sup> Data source: IMF

the country at over 2 million tons during the first week of October 2019; this seems sufficient, keeping in view the monthly demand of 0.4 million tons and given the expected start of the new crushing season from the next month.

#### Supply disruptions

Pressures on prices of some perishable food items emanated from supply disruptions in the form of crop damages, the impact of depreciation on imported food items, and non-tariff barriers on the import of vegetables and other food items. In particular, unfavorable weather this year has caused sizable losses in the minor crop sector. Therefore, reliance on imported food stuff increased, but at elevated prices due to the impact of Pak rupee depreciation. For instance, the double-digit inflation in pulses (barring gram), can be attributed to a production shortfall as well as a 12.2 percent increase in the rupee unit value of imports.<sup>9</sup> In case of chicken also, the impact of the Pak rupee depreciation appears strong, as it escalated imported feed prices. As per anecdotal evidence, poultry dealers were facing financial losses for some time as they were unable to completely pass on the impact of feed cost to their retail prices.

Furthermore, crop damages and supply constraints in regional economies (traditional suppliers) have also made it difficult to alleviate price pressures in the local market. For instance, heavy rains caused significant damages to onion harvest in Sindh, and delayed arrivals from Baluchistan. But similar damages were recorded in India also, which is one of the largest onion producers in the region. With supplies shrinking from India, most buyers (including Pakistan, Bangladesh and Nepal) started importing from China; naturally, an abrupt increase in demand pushed up prices of Chinese onions as well. It is worth noting that onion prices contributed 0.4 percentage points to the overall increase in food prices in Q1-FY20, and this trajectory is likely to stay north until the summer harvest arrives.

Also, in case of some food items, plugging the demand-supply gap via imports was itself difficult this year due to prevailing regulatory restrictions (non-tariff barriers). Commercial food importers have been complaining of delays in the issuance of import permits and valid phytosanitary certificates before they could place orders. Moreover, importers are also raising concerns with respect to lack of quarantine department staff at the borders to allow no-objection certificates for importing commodities into the country. These problems particularly affected the

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<sup>9</sup> Pulses imports stood at 251.8 thousand MT in Q1-FY20 compared to 285.9 thousand MT in the same period last year.

import of fresh vegetables in the country, which resulted in an 11.4 percent inflation during the quarter.

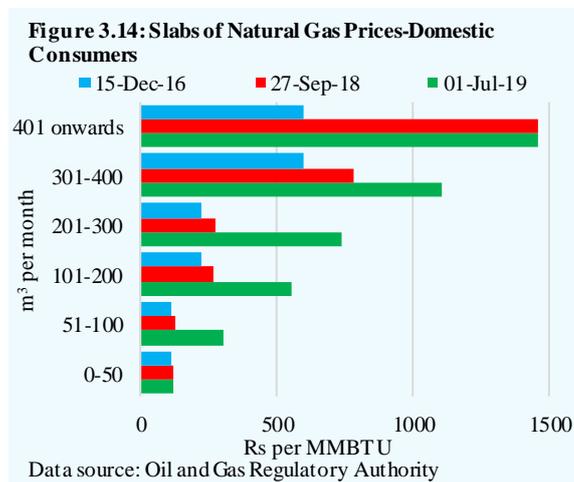
**Commodity management**

Wheat prices edged up further in Q1-FY20, after rising steeply in the fourth quarter of FY19. As mentioned in SBP’s Annual Report for 2018-19, this increase predominantly reflects administrative weaknesses in commodity management, instead of just demand-supply dynamics.

Despite a good crop this year (though short of target) and carry-over stocks from previous years, the public procurement agencies were not able to control a consistent increase in wheat (and therefore, flour) prices. From time to time, procurement agencies were advised by the Economic Coordination Committee (ECC) to release sufficient amounts of wheat in the market to stabilize prices. It also imposed a ban on the commodity’s exports during the quarter. However, these measures could not arrest the rising price trend, probably in the presence of hoarding practices in the open market.

**Administered energy inflation continued with the upward trajectory**

In an attempt to adhere to the objective of eliminating energy sector losses on a sustainable basis, the government has committed to increase administered fuel prices to reflect purchase prices.<sup>10</sup> The decision further escalated the underlying inflationary pressures in the economy as the energy index rose 32.5 percent during Q1-FY20, compared to a 6.5 percent increase recorded last year. Inflation in gas alone has contributed 1.6 percent to the headline inflation, constituting 59.0 percent of energy inflation. This was in response to a revision in natural gas prices by Oil and Gas Regulatory Authority (OGRA) for various consumers, effective from July 1, 2019 (**Figure 3.14**). This measure was taken to address the concern of



<sup>10</sup> The sector was advised to initiate a comprehensive pricing structure that was reflective of its costs, in order to eliminate the process of circular debt accumulation.

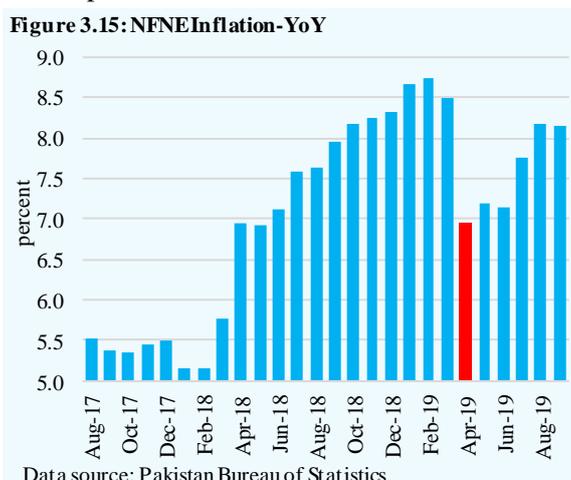
emerging arrears in the gas sector, coming mostly from delays in tariff notifications and rising technical losses. Moreover, certain amendments in the OGRA Act are on the cards, which are meant to ensure regular and timely notification of end-consumer tariffs.

Motor fuel prices grew by 23.1 percent during the quarter under review. However, inflation in this segment was slightly contained as compared to last year on account of stable international oil prices.

Electricity inflation registered an 11.3 percent rise during the quarter, led by heavier rise in prices for slabs over 300 units. It is important to note that the government is committed to improving the pricing structure in the electricity sector by: aligning effective tariffs with those determined by Nepra; removing or minimizing delays in the tariff notifications; adequately budgeting the implicit subsidies provided by the government; and minimizing the technical and distribution losses. The government has already reduced the flow of circular debt by a significant margin during the quarter, and is expected to take the necessary actions to tackle all the major sources of power sector arrears.

**Contribution of core inflation remains unchanged**

The inflationary pressures in the NFNE component started bottoming out in April 2019 on YoY basis (Figure 3.15). However, the implementation of budgetary measures, such as imposition of direct taxes on multiple items, pushed up NFNE inflation during Q1-FY20.



For instance, in case of construction inputs (cement and steel), the impact may be attributed to the pass-through of increase in FED,<sup>11</sup> in addition to rise in energy tariffs. Similarly, motor

<sup>11</sup> In order to simplify the tax regime for steel sector, FED at 17 percent (in sales tax mode) was imposed on billets, ingots, bars, ship plates and other long profiles. Previously, steel sector was subject to fixed sales tax. Specifically, imported scrap was subject to sales tax at Rs 5,600 / MT whereas, for ship-plates obtained from breaking of ship, sales tax was Rs 9300 per MT. In contrast, for ship-breakers, ships imported for breaking was exempted from payment of sales tax. Further,

vehicle prices (in the CPI basket) also increased by 19.7 during the quarter, which the domestic assemblers justified with the imposition of FED on cars, increase in additional customs duties from 2 percent to 7 percent, and the lagged impact of the PKR depreciation.<sup>12</sup> In case of clothing and textiles also, the increase in prices can be attributed to the end of zero-rating regime of sales tax for the sector.<sup>13</sup>

### Box 3.2: Rebasings of Price Indices

In August 2019, the Pakistan Bureau of Statistics (PBS) started publishing a new set of price indices with FY16 as the base year. The weights of consumer items in the new basket have been derived from the Family Budget Survey (FBS) conducted by the PBS in FY16, whereas consumption details have been taken from the Household Integrated Economic Survey (HIES). The salient features of new base data are given below:

- PBS introduced Rural Consumer Price Index (RCPI) and Urban Consumer Price Index (UCPI) for the first time.
- The National Consumer Price Index (NCPI) was also introduced (based on weighted average of RCPI and UCPI).
- The number of commodities included in the new CPI basket have been classified into 12 groups as per a scheme developed by the United Nations, i.e. “Classification of Individual Consumption According to Purpose.
- The total number of items has been reduced in the new base. This is despite the inclusion of some new items (Table 3.2.1).
- **The number of urban cities has also been reduced.** Jhelum, Wazirabad, Muzaffargarh, Mithi and Mardan have been excluded from the sample.
- In the new baskets, **weights have been changed** significantly for some categories. For instance, the overall food group’s weight has been increased mainly on account of the rise in weight of *hotel and restaurant*. On the other hand, weight of the *housing group* has been decreased significantly (Table 3.2.2)
- Different weights are assigned to the urban and rural baskets along with different basket (Table

Table 3.2.1: Comparison of New and Old Base

	Base year 2015-16	Base year 2007-08
	<b>Urban</b>	
No. of cities	35	40
No. of markets	68	76
No. of items	356	487
No. of commodities	94	89
No. of groups	12	12
	<b>Rural</b>	
No. of rural areas	27	Nil
No. of markets	27	Nil
No. of items	244	Nil

Data source: Pakistan Bureau of Statistics

steel industry of tribal areas was also exempted from payment of sales tax. Whereas, FED on cement has been increased to Rs 2 per kg from Rs 1.5 per kg earlier.

<sup>12</sup> FED on the following slabs has been introduced: 2.5 percent for cars from 0 to 1,000 cc, 5 percent on cars from 1,001cc to 2,000 cc, and 7.5 percent on cars over 2,000 cc.

<sup>13</sup> The government restored the standard GST rate of 17 percent on inputs and products of export-oriented sectors, i.e. textile, leather, carpets, sports goods and surgical goods. The GST rate on local supplies of finished articles of textile and leather and finished fabric was also raised to 17 percent.

3.2.3).

- New indices are computed on the basis of **weighted geometric mean of prices**, as per best international practices; the old base was computed using the arithmetic mean.<sup>14 15</sup>
- **Consumption quintiles have been introduced** instead of income quintiles, as it is difficult to extract income information from consumers.
- **Consumer-weighted approach has been introduced** to compute gas prices and electricity prices.
- **Electronic data collection** (Android based) has been introduced for the first time in the history of PBS.

**Table 3.2.2: CPI Major Indices**

	Old	New
General (Overall)	100.0	100.0
1 Food & non-alcoholic beverages.	34.8	34.6
2 Alcoholic beverages, tobacco	1.4	1.0
3 Clothing & footwear	7.6	8.6
4 Housing, water, gas & other fuel	29.4	23.6
5 Furnished household equipment & maintenance etc.	4.2	4.1
6 Health	2.2	2.8
7 Transport	7.2	5.9
8 Communication	3.2	2.2
9 Recreation & culture	2.0	1.6
10 Education	3.9	3.8
11 Restaurants and hotels	1.2	6.9
12 Miscellaneous goods & services	2.8	4.9

Data source: Pakistan Bureau of Statistics

**Table 3.2.3: Urban and Rural Indices**

	Weights	
	Urban (94 indices)	Rural (89 indices)
1 Food and non-alcoholic beverages	30.42	40.87
2 Alcoholic beverages, tobacco	0.85	1.28
3 Clothing and footwear	8.01	9.48
4 Housing, water, electricity, gas	27.03	18.49
House rent	19.26	8.61
Gas charges	1.08	
5 Furnishing and household equipment	4.09	4.1
Carpets	0.03	
Household servant	0.77	
6 Health	2.31	3.51
Therapeutic appliances & equipment	0.01	
7 Transport	6.14	5.56
8 Communication	2.35	1.99
9 Recreation and culture	1.73	1.38
10 Education	4.88	2.13
11 Restaurants and hotels	7.41	6.19
12 Misc. goods and services	4.77	5.02

Data source: Pakistan Bureau of Statistics

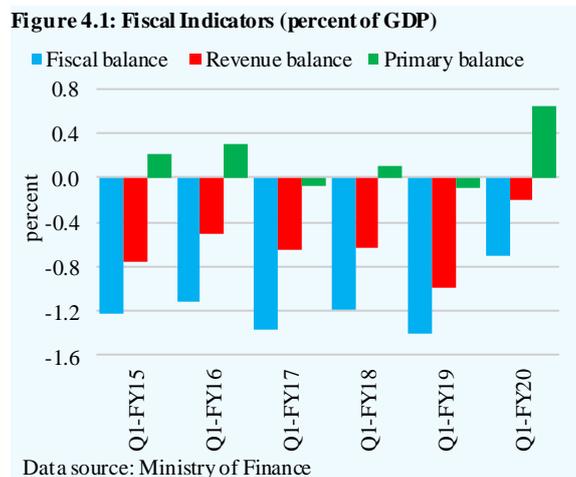
<sup>14</sup> As per the previous method, PBS used to collect 4 quotations for a commodity in a market and then take a simple average. Now, it collects 3 quotations in urban areas and 2 in rural in order to calculate the geometric mean.

<sup>15</sup> The geometric mean accounts for the economic substitution behavior of consumers relatively better. Consumers do, to some degree, insulate themselves from the impact of higher prices by adjusting their spending to relatively lower priced goods or services (Kenneth V. Dalton, John S. Greenlees, and Kenneth J. Stewart (1998), Incorporating A Geometric Mean Formula into the CPI, Monthly Labor Review, U.S. Bureau of Labor Statistics).

## 4 Fiscal Policy and Public Debt

### 4.1 Overview

All the fiscal indicators improved at the beginning of FY20. The fiscal deficit reached 0.7 percent of GDP in Q1-FY20, the lowest in 15 quarters. A remarkable turnaround was visible in the primary balance, which posted a surplus, whereas the revenue deficit became almost negligible (**Figure 4.1**). This improvement was made possible through both revenue-enhancing and expenditure-control measures.



On the revenue side, the major thrust came from the reversal of some of the tax concessions given last year. These concessions had included the slash in general sales tax (GST) rates on petroleum products; suspension of taxes on telecom services; increase in the income threshold for income tax collection; and lowering of income tax rates for both salaried and non-salaried persons. Besides, increased excise duty on cement and cigarettes and the upward adjustment in power tariffs were also major contributing factors to the higher revenue collection during Q1-FY20. Further impetus came from the end of the preferential tax treatment for certain sectors (e.g. sugar, steel and edible oil) and the zero-rating regime for five export-oriented sectors (textile, leather, carpets, sports goods and surgical goods). At the same time, non-tax revenues also grew strongly on the back of higher SBP profit and partial realization of the much-awaited renewal fees for GSM licenses.

The government also actively pursued documentation efforts (especially related to asset revaluations), increased financial scrutiny, and introduced structured mechanisms to register businesses' value-chains and curb smuggling practices. All these efforts would be instrumental in attaining the high and sustainable tax revenue growth. As for the current year, the first quarter revenue growth lagged behind the target as revenue collection from imports remained subdued.

On the expenditure side, a broad-based containment in current spending was witnessed during Q1-FY20 (Table 4.1). A sharp contraction was visible in *other expenditures*, such as education, economic affairs, health, housing, environment, recreation and culture. Furthermore, interest payments, defence expenditures, public order and safety and provincial current spending all decelerated from last year. Importantly, the government did not resort to the usual practice of cutting development expenditures to achieve fiscal consolidation, as these recorded a sharp rise in Q1-FY20.

**Table 4.1: Summary of Fiscal Operations**

billion rupees

	Actual			Growth	
	Q1-FY18	Q1-FY19	Q1-FY20	Q1-FY19	Q1-FY20
<b>A. Total revenue</b>	<b>1,025.1</b>	<b>1,102.1</b>	<b>1,489.1</b>	<b>7.5</b>	<b>35.1</b>
Tax revenue	911.4	975.2	1,142.9	7.0	17.2
Non-tax revenue	113.7	126.9	346.1	11.6	172.8
<b>B. Total expenditure</b>	<b>1,465.9</b>	<b>1,643.8</b>	<b>1,775.1</b>	<b>12.1</b>	<b>8.0</b>
Current	1,240.5	1,479.9	1,582.2	19.3	6.9
<i>Interest payments</i>	<i>445.4</i>	<i>507.1</i>	<i>571.7</i>	13.9	12.7
Development	189.9	109.2	142.5	-42.5	30.5
Net lending	0.9	-0.3	4.7		
<b>C. Statistical discrepancy</b>	<b>34.6</b>	<b>54.9</b>	<b>45.8</b>		
<b>Fiscal balance (A-B-C)</b>	<b>-440.8</b>	<b>-541.7</b>	<b>-286.0</b>		
Revenue balance*	-215.4	-377.8	-93.1		
Primary balance**	4.6	-34.6	285.7		
<i>Financing</i>	440.8	541.7	286.0		
External sources	7.9	210.8	166.5		
Domestic sources	432.9	330.9	119.5		
Banks	408.1	92.5	-123.0		
Non-bank	24.5	238.4	242.5		
<b>As percent of GDP</b>					
Total revenue	3.0	2.9	3.4		
Tax revenue	2.6	2.5	2.6		
Non-tax revenue	0.3	0.3	0.8		
Total expenditure	4.3	4.3	4.0		
Current	3.6	3.9	3.6		
Development	0.6	0.3	0.3		

\*Revenue balance is total revenue less current expenditures. \*\*Primary balance is fiscal balance excluding interest payments.

Data source: Ministry of Finance

Despite lower financing needs and the appreciation of Pak rupee against the US dollar, the pace of public debt accumulation increased in Q1-FY20. While the government adhered to zero borrowing from the central bank, it continued to strategically build up its deposits with the banking system to create cash buffers

for managing the revenue-expenditure gap in the absence of a major and residual source of financing. The resultant rise in the domestic debt was large enough to offset the decline in the rupee value of the government’s external debt. The dollar value of external debt in Q1-FY20, on the other hand, grew at a slower pace as compared to the same period last year. This deceleration was largely attributed to the revaluation gains due to depreciation of other currencies against the US dollar and higher debt repayments.

#### 4.2 Revenues

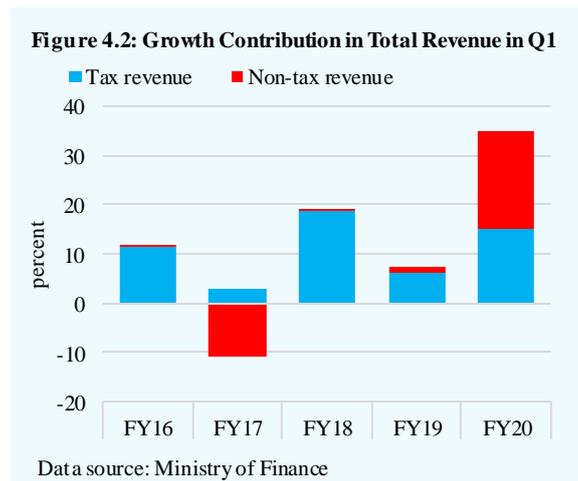
Total revenue collection recorded an impressive increase of 35.1 percent in Q1-FY20 against the 7.5 percent growth observed in Q1-FY19. Tax and non-tax revenues contributed almost equally to this growth (Figure 4.2).

##### **FBR taxes<sup>1</sup>**

The overall FBR taxes grew 15.2 percent in Q1-FY20, compared to the 8.8 percent rise noted in Q1-FY19 (Table 4.2).<sup>2</sup> This higher growth can

be attributed to: (i) an increase in sales tax rates; (ii) reinstatement of taxes on telecom services; (iii) an upward revision of tax rates on various salary slabs; (iv) increase in interest rates and higher tax on profit on debt;<sup>3</sup> (v) upward revision in the federal excise duty (FED) rates; and (vi) the abolishment of the zero rating regime on five export-oriented sectors. In addition to these measures, the impact of higher inflation also boosted revenue mobilization.

Despite this improvement, the FBR managed to achieve only 17.3 percent of the annual target of Rs 5,555.0 billion for FY20.<sup>4</sup> This means that tax revenues



<sup>1</sup> The analysis in this section is based on data received from FBR.

<sup>2</sup> The latest data on fiscal operations released by MoF depicts a growth of 15.9 percent in FBR tax revenue.

<sup>3</sup> Tax rates (in percentage terms) on three slabs of income from profit on debt were raised from 10, 12.5 and 15.0 percent to 15.0, 17.5 and 20.0 percent, respectively, in the FY20 budget.

<sup>4</sup> Note that the indicative target for FBR taxes has been revised down to Rs 5,238.0 billion for FY20 (source: IMF Country Report No. 19/380, December 2019).

would require a substantially higher growth in the remaining 9 months of the year to achieve the full year target.<sup>5</sup> Moreover, import-related taxes, representing nearly half of FBR taxes, would remain under stress due to the ongoing declining trend in imports. Dutiable imports, in particular, declined sharply in Q1-FY20.

**Table 4.2: FBR Tax Collection**

billion rupees

	Budget FY20*	Q1			Growth (%)		
		FY18	FY19	FY20	Q1-FY18	Q1-FY19	Q1-FY20
<b>Direct taxes</b>	2,081.9	282.9	298.5	349.2	21	5.5	17
<b>Indirect taxes</b>	3,473.1	482.1	533.8	609.9	22.5	10.7	14.3
Customs duty	1,000.5	128.9	156.5	155.2	27.8	21.5	-0.8
Sales tax	2,107.7	314.4	335.1	404.7	20.2	6.6	20.7
FED	364.8	38.8	42.1	50	25	8.5	18.7
<b>Total taxes</b>	<b>5,555.0</b>	<b>765</b>	<b>832.3</b>	<b>959.1</b>	<b>22</b>	<b>8.8</b>	<b>15.2</b>
<b>Percent of GDP</b>	<b>12.6</b>	<b>2.2</b>	<b>2.2</b>	<b>2.2</b>			

\* Budget in Brief, Ministry of Finance

Data source: Federal Board of Revenue and Ministry of Finance

Encouragingly, the fiscal authorities have introduced some initiatives to facilitate business and individual tax payers and to broaden the tax base. For instance, in order to provide hassle-free refunds to exporters, the FBR has introduced the Fully Automated Sales Tax e-Refund (FASTER) system for tackling refund claims within 72 hours. The FBR has also launched a mobile application, "FBR Tax Asaan," to facilitate taxpayers in paying sales tax and claiming refunds. In addition, video tutorials are prepared and uploaded online to guide taxpayers in filing their income tax returns. These efforts to simplify and streamline the taxation mechanism have also contributed to the improvement in Pakistan's ranking in the World Bank's Ease of Doing Business: the digitization of tax collecting procedures was cited as one of the drivers of the improvement in the country's ranking. In addition, the government has continued its drive to increase documentation in the economy. However, businesses are resisting some of these documentation measures, such as the CNIC condition on business-to-business (B2B) and business-to-consumer (B2C) transactions.

### Direct Taxes

Direct taxes, having a share of 36.4 percent in FBR taxes, recorded a sizeable growth of 17.0 percent in Q1-FY20, compared to the rise of 5.5 percent in the

<sup>5</sup> Given the revised target of Rs 5,238.0 billion, a collection of around Rs 475.0 billion would be required in each month of the remaining FY20. This does not compare favorably with the average 5-year monthly collection of around Rs 300 billion in the last 9 months of a fiscal year.

same period last year. Withholding taxes (WHT), having a major share in direct taxes, grew by 19.8 percent to Rs 256.5 billion during the quarter, in contrast to a decline of 4.6 percent last year (Table 4.3).<sup>6</sup>

In addition, an increase of Rs 44.6 billion in voluntary payments was also noted, owing to an increase of Rs 24.8 billion in advance taxes. Some of the rise in voluntary payments may also be attributed to the Amnesty Scheme announced in FY19. However, collection on demand contracted by 48.2 percent to Rs 5.8 billion in Q1-FY20 compared to 11.3 billion last year. The rise in withholding taxes mainly came from the increase in collection following the upward revision in salary slabs, which added Rs 10.0 billion to the withholding taxes.<sup>7</sup>

**Table 4.3: Break-up of Direct Tax Collection during Q1**  
billion rupees

			Abs. Change	
	FY19	FY20	FY19	FY20
<b>I. Collection on demand</b>	<b>11.3</b>	<b>5.8</b>	<b>-0.1</b>	<b>-5.4</b>
<b>II. Voluntary payments</b>	<b>64.8</b>	<b>109.4</b>	<b>-1.4</b>	<b>44.6</b>
<b>III. Withholding taxes</b>	<b>214.2</b>	<b>256.5</b>	<b>-10.4</b>	<b>42.3</b>
Imports	57.3	50.7	6.3	-6.6
Exports	7.4	9.6	1.1	2.3
Contracts	49.2	51.0	-7.8	1.8
Salary	15.4	25.4	-11.3	10.0
Interest & securities	14.0	29.8	1.9	15.8
Cash withdrawal	8.9	4.3	1.8	-4.6
Dividends	8.6	13.0	-1.2	4.4
Electric bills	9.3	11.4	3.4	2.1
Telephone	1.9	12.6	-10.2	10.7
Others	42.2	48.8	5.7	6.6
<b>Net direct taxes</b>	<b>298.5</b>	<b>349.2</b>	<b>15.7</b>	<b>50.7</b>

Data source: Federal Board of Revenue

The collection from interest and securities in withholding taxes increased to Rs 29.8 billion during Q1-FY20 from Rs 14.0 billion in Q1-FY19, as interest rates and tax rates on profit on debt both increased. The reinstatement of taxes on telecom services led to a higher tax collection of Rs 12.6 billion in Q1-FY20.<sup>8</sup> With filers getting exemption, the withholding tax on cash withdrawals dropped sharply to almost half of the amount collected last year.

#### Indirect taxes

Indirect taxes, having a share of 63.6 percent in FBR taxes, grew by 14.3 percent during Q1-FY20 on top of the 10.7 percent growth observed during Q1-FY19.

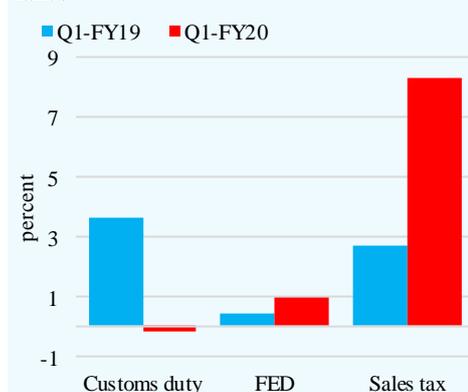
<sup>6</sup> Withholding taxes had a 73.4 percent share in overall direct taxes in Q1-FY20.

<sup>7</sup> Collection from salaries grew 64.7 percent in Q1-FY20, as compared to a decline of 42.3 percent recorded last year.

<sup>8</sup> Salaries, interest and securities, and telephone together contributed 26.4 percent to the overall withholding taxes.

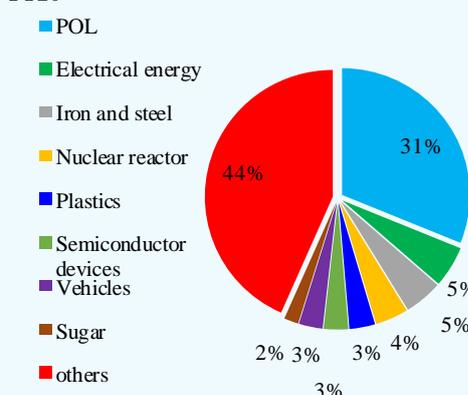
This was primarily owing to the 20.7 percent growth in sales tax to Rs 404.0 billion, as compared to the 6.6 percent growth recorded last year. Sales tax, constituting around 66.0 percent of indirect taxes, contributed 8.4 percent out of the 15.2 percent growth in the FBR taxes (**Figure 4.3**).

**Figure 4.3: Growth Contribution of FBR's Indirect Taxes**



Data source: Federal Board of Revenue

**Figure 4.4: Contribution in Sales Tax during Q1-FY20**



Data source: Federal Board of Revenue

The major contribution to the increase in sales tax came from POL products (**Figure 4.4**).

This is explained by the hike in prices and sales tax rates on most of the petroleum products (**Table 4.4**).<sup>9</sup> The increased sales tax rate on motor spirit (petrol), contributed the most to the rise in collection from POL products.

Without POL, the indirect taxes recorded a growth of 12.9 percent in Q1-FY20 as compared to 16.7 percent last year.

Another major contributor to the higher sales tax was electrical energy; collection from this segment grew 69.3 percent to Rs 22.0 billion, as compared to a decline of 1.3 percent in the corresponding period of last year. This was due to the upward price adjustments in tariffs during Q1-FY20. Furthermore, with the abolishment of preferential treatment for the sugar industry, collections from this

**Table 4.4: Sales Tax Rates on POL (percent)**

	Q1-FY19*	Q1-FY20
Petrol	11	17
High speed diesel	23	17
Kerosene	8	17
Light diesel oil	4	17

\*Effective rates for Q1-FY19, calculated on basis of weighted average formula

Data source: Federal Board of Revenue

<sup>9</sup> The prescribed (exclusive of sales taxes) prices of petrol and high speed diesel increased from Rs 84.8 and Rs 85.9 per liter in Q1-FY19 to Rs 95.1 and Rs 106.9 in Q1-FY20, respectively.

sector also recorded an increase of Rs 7.7 billion from Rs 3.9 billion during Q1-FY19. Similarly, the collection from sales tax on textile products also increased to Rs 2.1 billion as compared to Rs 0.6 billion last year, on back of the elimination of zero-rating regime for the sector.

In contrast to sales tax, collections from customs duty, the second major component of indirect taxes, declined by 0.8 percent in Q1-FY20, as compared to the 5-year average growth of 19.7 percent. This decline was attributed primarily to a sharp contraction in imports during the quarter. Specifically, the dutiable imports (in rupee terms) declined by 6.8 percent during Q1-FY20, against a rise of 23 percent in the corresponding period of last year. The collection from vehicles declined by 32.0 percent to Rs 16.8 billion in Q1-FY20 against 0.8 percent rise in Q1-FY19. The demand for imported vehicles was affected by higher prices and stringent documentation requirements that raised the transaction costs. Meanwhile, the growth in duty-free imports (in rupee terms) almost doubled in Q1-FY20.

On the other hand, the collection from FED improved due to the upward revision in the excise duty rate (**Table 4.5**). Overall FED collections increased by 18.7 percent to Rs 50 billion in Q1-FY20, compared with a rise of 8.5 percent last year. Collections from cement, cigarettes and beverages contributed to the higher growth in FED this year.

#### **Non-tax revenues**

Non-tax revenues grew by a significant 172.8 percent to Rs 346.1 billion during Q1-FY20, as compared to an increase of 11.6 percent recorded in the same period last year (**Table 4.6**). The major contributors to the higher non-tax revenue were SBP profit (Rs 185 billion) and partial realization of the GSM license renewal

**Table 4.5: Upward Revision in FED in Budget 2019-20**

	Q1-FY19	Q1-FY20
Beverages/Aerated waters	11.5%	13.0%
Cement	Rs 1.5 per kg	Rs 2 per kg
	Rs 4,500 per	Rs 5,200 per
Cigarettes	1,000 sticks	1,000 sticks
	Rs 4.9 per	Rs 10 per
Natural gas	MMBTU	MMBTU

Data source: Budget Speech 2019-20

**Table 4.6: Non-tax Revenues (consolidated)**

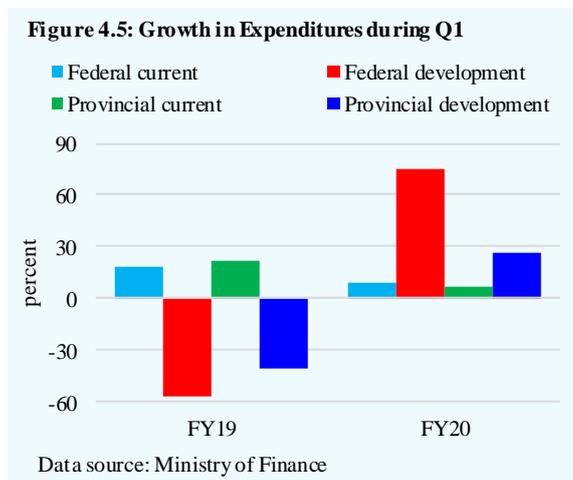
billion rupees	Q1-FY19	Q1-FY20
Mark-up (PSEs and others)	1.2	3.3
Dividends	4.5	1.7
SBP profit	50.7	185.0
Defence	2.4	2.6
Profits PTA/post office	6.1	71.8
of which GSM renewal fee	-	70.0
Royalties on gas and oil	23.6	23.8
Passport and other fees	3.3	6.2
Discount retained on crude oil	3.1	3.7
Windfall levy against crude oil	2.1	2.0
Others	29.9	46.0
<b>Total non-tax revenue</b>	<b>126.9</b>	<b>346.1</b>

Data source: Ministry of Finance

fees (amounting to Rs 70.0 billion).<sup>10</sup> The SBP accrued higher profit this year primarily on account of both higher stock of government securities and interest rates, apart from the appreciation of the Pak rupee in Q1-FY20.

### 4.3 Expenditures

Total expenditures decelerated to 8.8 percent during Q1-FY20 as compared to 11.0 percent in Q1-FY19. This was largely achieved by a containment in current expenditures, both at the federal and provincial levels (**Figure 4.5**). In particular, provincial current spending and defence expenditures both slowed down. In addition, a decline was also seen in *other expenditures*, such as education, economic affairs, health, housing, environment, recreation and culture.



The growth in defence spending and public order decelerated substantially during Q1-FY20, reflecting improved security conditions in the country. In addition, there was a slight decline in the growth of interest payments, despite growing debt levels and higher interest rates. This slowdown can be explained by the change in the payment structure of central bank debt that was re-profiled to longer maturities; thus, a part of the payments accrued in Q1-FY20 will be paid over the next quarters.<sup>11</sup>

In contrast to large cuts in development expenditure last year, these expenditures witnessed a sharp rise in Q1-FY20, which is partly explained by decelerating current expenditures and partly motivated by government's preference to support growth and employment in the country. Importantly, the contributions were made by both the federal and provincial governments (**Table 4.7** and **Figure 4.5**).

<sup>10</sup> Source: Pakistan Telecommunication Authority (<https://www.pta.gov.pk/en/media-center/single-media/pta-receives-over-rs-70-billion-against-license-renewal-fee-040919>).

<sup>11</sup> In June 2019, the government converted the stock of short-term MRTBs held by the SBP into long-term PIBs of various maturities. Since 70 percent of the MRTBs were converted into 10-year PIBs with floating rates (benchmarked with the 6-month T-bill rate), the coupon payments would be made bi-annually.

**Table 4.7: Analysis of Fiscal Spending**

billion rupees, growth in percent

	Q1			Abs. change	Growth		
	FY18	FY19	FY20		FY18	FY19	FY20
<b>Current expenditures</b>	<b>1,240.5</b>	<b>1,479.9</b>	<b>1,582.2</b>	<b>102.2</b>	<b>15.9</b>	<b>19.3</b>	<b>6.9</b>
<i>Federal o/w</i>	846.4	999.3	1,069.7	70.5	11.7	18.1	7.1
Interest payment	445.4	507.1	571.7	64.6	7.5	13.9	12.7
Defence	181.9	219.4	242.6	23.2	20.1	20.6	10.6
Public order and safety	27.9	32.7	33.3	0.6	16.2	17.1	1.9
Others	191.2	240.1	222.1	-18.0	13.8	25.5	-7.5
<i>Provincial</i>	394.1	480.7	512.4	31.8	25.9	22.0	6.6
<b>Development expenditures</b>	<b>189.9</b>	<b>109.2</b>	<b>142.5</b>	<b>33.3</b>	<b>-0.6</b>	<b>-42.5</b>	<b>30.5</b>
PSDP	165.0	106.6	142.4	35.8	-1.3	-35.4	33.6
Federal	69.5	50.9	71.8	20.9	8.4	-26.8	41.1
Provincial	95.4	55.7	70.6	14.9	-7.4	-41.6	26.7
Others (including BISP)	24.9	2.6	0.1	-2.5	3.9	-89.5	-96.0
<b>Net lending</b>	<b>0.9</b>	<b>-0.3</b>	<b>4.7</b>	<b>4.9</b>	-	-	-
<b>Total expenditure*</b>	<b>1,431.3</b>	<b>1,588.9</b>	<b>1,729.3</b>	<b>140.4</b>	<b>13.5</b>	<b>11.0</b>	<b>8.8</b>

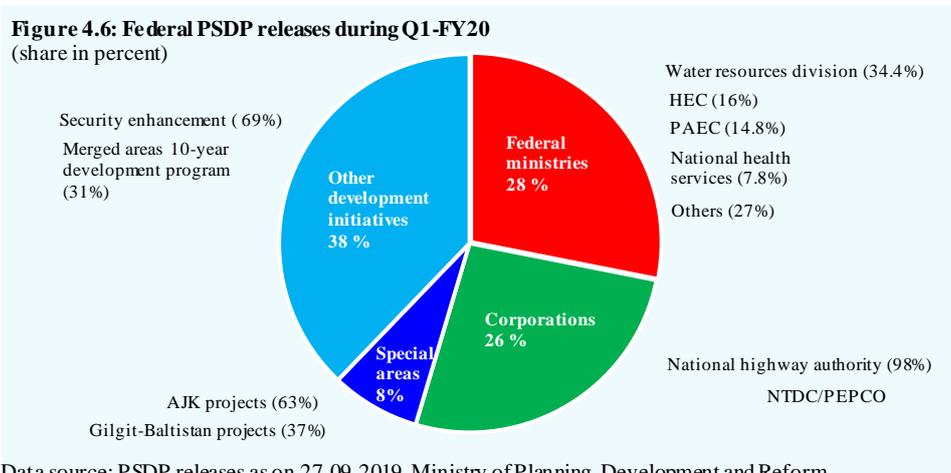
\* Excluding statistical discrepancy

Data source: Ministry of Finance

Within the federal PSDP, the ministries received the highest share (28 percent) followed by corporations (26 percent) such as the National Highway Authority (NHA), National Transmission and Dispatch Company (NTDC), and Pakistan Electric Power Company (PEPCO); this shows that development concerns were tilted towards infrastructure and energy-related spending. In addition to the usual projects, the budget FY20 also emphasized welfare and tourism projects, and the 10-year development plan for the former FATA, which was merged with KP under the 25<sup>th</sup> amendment (**Figure 4.6**).

In July 2019, the government announced a strategy for release of funds for FY20.<sup>12</sup> In order to achieve better public financial management, the government allocated a fixed percentage of releases for both current and development expenditure in a quarter-wise release plan. Accordingly, it was decided that 20 percent of the funds would be released in Q1 and Q2 each, and the remaining would be equally divided in Q3 and Q4. Despite a substantial rise in development expenditure during Q1-FY20, the federal PSDP expenditures were recorded at 13.3 percent of the overall annual budgeted PSDP.

<sup>12</sup> For details, see the Office Memorandum No. F.4 (I), B&A/ 2019-20 (Ways and Means)/35 dated 15<sup>th</sup> July 2019, Government of Pakistan, Finance Division on subject Policy/strategy for release of funds – financial year 2019-20 (<https://www.pc.gov.pk/uploads/psdp/Release2019-20.pdf>).



Data source: PSDP releases as on 27-09-2019, Ministry of Planning, Development and Reform

#### 4.4 Provincial Fiscal Operations

The total provincial revenues (including federal transfers) grew by a slight 0.5 percent during Q1-FY20, against a 36.9 percent growth recorded last year (**Table 4.8**). The provinces' own revenues posted an impressive growth of 31.3 percent as compared to a decline of 9.7 percent in Q1-FY19. This improvement mainly came from the non-tax revenues, which grew by 111.8 percent to Rs 30.9 billion during the period; provincial tax revenues also increased by 17.9 percent, compared to a meagre 2.0 percent growth last year.

Further analysis shows that both direct and indirect sources of provincial taxes accounted for this growth during Q1-FY20. The biggest collection was from the general sales tax on services, followed by stamp duties, property tax, and motor vehicles. Moreover, the increase in non-tax revenue was mainly on the back of *profits from hydroelectricity* from KP and Punjab.

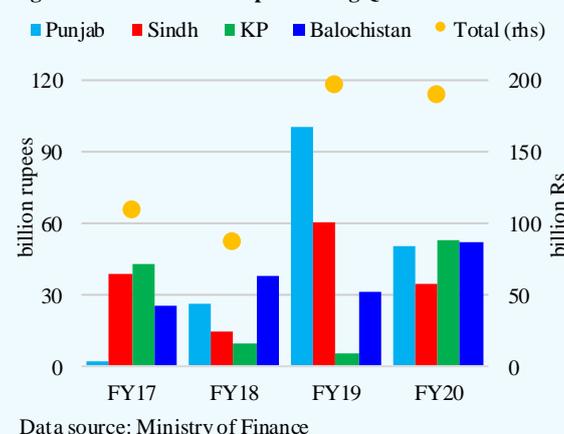
Despite higher growth in federal revenues, the NFC transfers to the provinces declined to Rs 612.5 billion during Q1-FY20 from Rs 662.9 billion last year. However, federal loans and grants, especially for development purposes, rose to Rs 43.2 billion, almost double from last year's level of Rs 21.1 billion. The annual target of provincial surplus was set at Rs 423.0 billion for FY20; the provinces achieved 44.7 percent of this target by posting a combined surplus of Rs 189.0 billion during Q1-FY20. KP registered the highest surplus, followed by

**Table 4.8: Provincial Fiscal Operations during Q1**  
billion rupees and growth in percent

	Punjab	Sindh	KP	Balochistan	Total	Growth
<b><i>FY20</i></b>						
A. Total revenue	365.8	198.6	140.8	85.9	791.1	0.5
Provincial share in federal revenue	293.5	145.0	97.0	76.9	612.5	-7.6
Provincial revenue (I+II)	71.9	46.2	13.4	4.0	135.5	31.3
I. Taxes	52.1	43.7	5.5	3.2	104.5	17.9
II. Non-tax revenue	19.8	2.4	7.9	0.8	30.9	111.8
Fed loans and transfers	0.4	7.4	30.4	5.0	43.2	104.4
B. Total expenditure	290.4	163.0	87.1	48.6	589.1	9.0
Current**	247.7	147.3	78.7	44.9	518.5	6.9
Development	42.7	15.8	8.4	3.7	70.6	26.7
Gap (A-B)	75.4	35.5	53.7	37.3	202.0	-18.1
<b>Financing* (overall balance)</b>	<b>-49.9</b>	<b>-34.5</b>	<b>-52.7</b>	<b>-51.8</b>	<b>-189.0</b>	<b>-4.0</b>
<b><i>FY19</i></b>						
A. Total revenue	390.6	209.4	116.0	71.2	787.2	36.9
Provincial share in federal revenue	325.8	163.4	107.7	65.9	662.9	54.6
Provincial revenue (I+II)	51.0	43.0	5.9	3.2	103.2	-9.7
I. Taxes	42.6	39.9	4.1	2.0	88.6	2.0
II. Non-tax revenue	8.5	3.1	1.8	1.3	14.6	-46.7
Fed loans and transfers	13.7	3.0	2.3	2.1	21.1	-34.6
B. Total expenditure	264.1	145.3	86.6	44.6	540.6	9.7
Current**	233.8	132.2	75.8	43.1	484.9	21.9
Development	30.3	13.1	10.8	1.5	55.7	-41.6
Gap (A-B)	126.5	64.1	29.4	26.7	246.6	200.4
<b>Financing* (overall balance)</b>	<b>-100.0</b>	<b>-60.5</b>	<b>-4.9</b>	<b>-31.4</b>	<b>-196.7</b>	<b>128.2</b>

\*Negative sign in financing means surplus. \*\* Current expenditure data may not match with those given in Table 4.7 as numbers reported here includes the markup payments to federal government.  
Data source: Ministry of Finance and SBP calculations

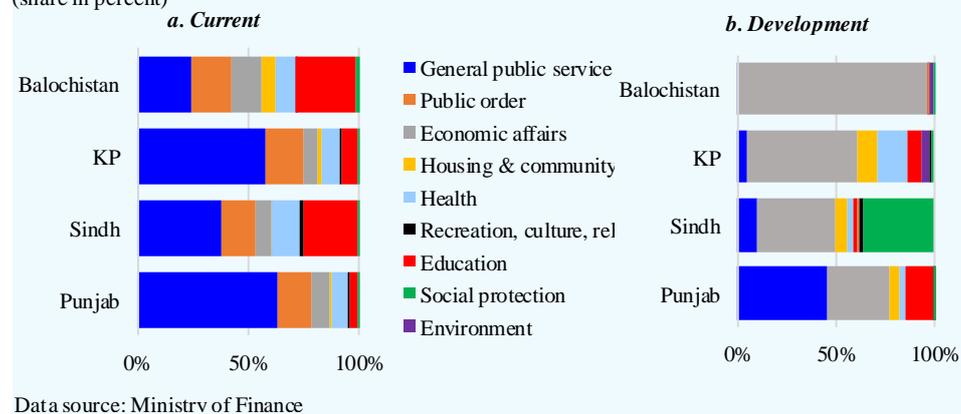
Balochistan; the surpluses of both these provinces grew sharply from the corresponding period last year. However, the surplus recorded by Punjab halved from last year, whereas that of Sindh was also lower as compared to Q1-FY19; this was due to lower revenue collection in both provinces, along with a relatively higher growth in expenditures during the period (**Figure 4.7**).

**Figure 4.7: Provincial Surplus during Q1**

### Provincial expenditures

The total provincial spending growth decelerated to 9.0 percent during Q1-FY20 as compared to 9.7 percent growth last year, with current expenditures playing a major role. The current provincial spending grew by 6.9 percent as compared to the 21.9 percent growth recorded in the previous year, and remained skewed towards general public service, public order, health and education (**Figure 4.8a**). The deceleration in current expenditures created some fiscal space for the provincial development expenditures, which increased by 26.7 percent during Q1-FY20 in contrast to a decline of 41.6 percent last year. The higher spending was mainly recorded for economic affairs, which includes agriculture, food, construction, and transport (**Figure 4.8b**).

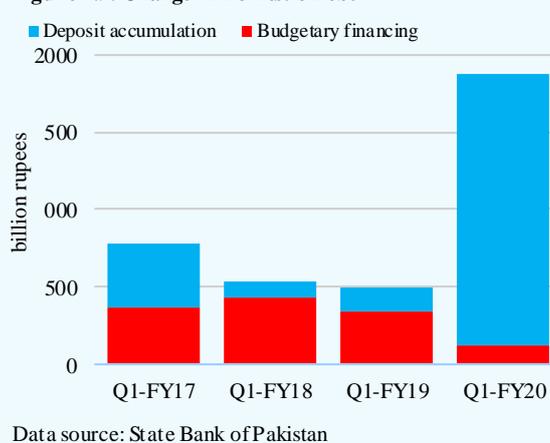
**Figure 4.8: Provincial Spending Priorities during Q1-FY20**  
(share in percent)



### 4.5 Public debt

Public debt increased by Rs 1.5 trillion during Q1-FY20, as compared to an increase of Rs 0.8 trillion in the same period last year (**Table 4.9**). This rise was mainly attributed to an increase in the domestic debt, which more than offset the decline in the rupee value of external debt.

**Figure 4.9: Change in Domestic Debt**



### Domestic debt

The pace of domestic debt accumulation accelerated sharply during Q1-FY20 – to Rs 1.9 trillion – and was almost four times higher than in Q1-FY19. Although the financing needs were lower than last year, the government continued to build up strategic cash buffers in the form of deposit accumulation (**Figure 4.9**). The need for these cash buffers emerged as the government adhered to zero fresh borrowing from the central bank. These deposits would facilitate the government to manage its debt obligations more smoothly in the absence of a major source of financing.

**Table 4.9: Pakistan's Public Debt Profile**

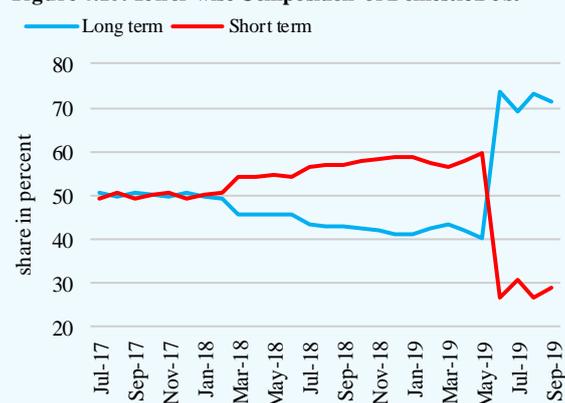
	Stocks				Flows	
	June-2018	Sep-2018	June-2019	Sep-2019	Q1-FY19	Q1-FY20
<b>Public debt</b>	<b>24,952.90</b>	<b>25,783.40</b>	<b>32,707.9</b>	<b>34,240.60</b>	<b>830.6</b>	<b>1,532.70</b>
Government domestic debt	16,416.30	16,919.80	20,731.80	22,649.90	503.6	1,918.10
Government external debt	7,795.80	8,122.90	11,055.10	10,598.00	327.1	-457.1
Debt from the IMF	740.8	740.7	921	992.7	-0.1	71.7
<b>Memorandum Items</b>						
Total debt of the government*	23,024.0	23,692.0	29,520.7	29,300.0	668.0	-220.7
Govt. deposits with banking system	1,928.9	2,091.4	3,187.2	4,940.6	162.5	1,753.4

\* FRDLA definition

Data source: State Bank of Pakistan

The maturity structure of the additional domestic debt was almost equally balanced between short-term and long-term securities during Q1-FY20. It is important to highlight that the overall share of short-term debt has declined substantially since June 2019, when the government re-profiled its short-term debt into long-term debt (**Figure 4.10**). Consequently, the re-pricing and roll-over risks have also significantly declined.

**Figure 4.10: Tenor-wise Composition of Domestic Debt**



Data source: State Bank of Pakistan

The government's borrowing from non-bank sources amounted to Rs 342.8 billion in Q1-FY20, compared to Rs 242.0 billion during the same period last year (**Table**

**4.10).** Non-banks preferred investing in T-bills and also PIBs. Net mobilization from National Saving Schemes (NSS) also increased significantly during the period under review, due to higher profit rates and some possible switchover from the discontinued Rs 40,000 denomination prize bonds towards various NSS instruments.<sup>13</sup>

**Table 4.10: Non-bank Holding of Domestic Debt**  
flow in billion rupees

	Q1-FY19	Q1-FY20
T-bills	146.4	204.3
Other securities	38.7	154.8
Prize bond	42.1	-152.3
NSS	10.5	137.7
<b>Total</b>	<b>242.0</b>	<b>342.8</b>

Data source: State Bank of Pakistan

### External debt & liabilities

The external debt & liabilities increased by US\$ 0.5 billion compared to an increase of US\$ 0.9 billion during the same period last year (**Table 4.11**). The improvement in the current account balance, revaluation gains due to the depreciation of major currencies against the US dollar, and higher external debt servicing (both principal and interest payments) are major factors which explain the slowdown in accumulation of the external debt. Nonetheless, the first IMF tranche of almost US\$ 1 billion, and fresh disbursements of bilateral loans by China and multilateral loans by the ADB and the IDB, increased the stock of external debt during the period under review.

Meanwhile, revaluation gains due to the depreciation of major currencies against the US dollar reduced the dollar value of the country's external debt by roughly US\$ 0.7 billion during Q1-FY20. More than one half of these gains were due to the US dollar's appreciation against the Special Drawing Rights (SDR) during the period.<sup>14</sup>

Foreign investors (mainly from the US and the UK) took keen interest in government securities during Q1-FY20, as they made investments worth US\$ 0.3 billion in T-bills (**Figure 4.11**). This investment was an outcome of the continued

<sup>13</sup> It must be recalled that to enhance documentation of the economy, the government notified the withdrawal of Rs 40,000 denomination national prize bonds from circulation on 24<sup>th</sup> June 2019. The holders of these prize bonds were given three options: (i) conversion to premium prize bonds; (ii) replacement with special savings certificate/defense savings certificates; or (iii) encashment at face value (transfer of proceeds to the bond-holder's bank account). As highlighted in SBP's Annual Report of FY19, evidence suggests that many bond-holders preferred to substitute these bonds with NSS.

<sup>14</sup> External debt denominated in SDR constitutes around 27 percent of the country's external debt stock. The SDR depreciated by 1.9 percent against the US dollar in Q1-FY20.

**Table 4.11: Pakistan's External Debt and Liabilities**  
billion US\$

	Stock				Flow	
	June-18	Sep-18	June-19	Sep-19	Q1-FY19	Q1-FY20
A. Government debt	64.1	65.4	67.8	67.8	1.3	0.0
<i>Of which</i>						
Paris club	11.6	11.5	11.2	11	-0.1	-0.2
Multilateral	28.1	27.6	27.8	28	-0.5	0.2
Other bilateral	8.7	10.8	12.7	12.8	2.1	0.1
Bonds	7.3	7.3	6.3	6.3	0	0
Commercial loans	7.5	7.2	9	8.3	-0.3	-0.7
Multilateral (ST)	1	0.9	0.8	0.9	-0.1	0.1
B. Debt from IMF	6.1	6	5.6	6.4	-0.1	0.8
C. Foreign exch. liabilities	5.1	5	10.5	10.4	-0.1	-0.1
<b>1. Public external debt</b>	<b>75.4</b>	<b>76.3</b>	<b>83.9</b>	<b>84.5</b>	<b>0.9</b>	<b>0.6</b>
<b>2. PSEs debt</b>	<b>2.7</b>	<b>2.7</b>	<b>4</b>	<b>3.8</b>	<b>0</b>	<b>-0.2</b>
<b>3. Banks debt</b>	<b>4.4</b>	<b>4.5</b>	<b>4.7</b>	<b>4.5</b>	<b>0.1</b>	<b>-0.2</b>
<b>4. Private sector debt</b>	<b>9.2</b>	<b>9.3</b>	<b>10.4</b>	<b>10.8</b>	<b>0.1</b>	<b>0.4</b>
<b>5. Intercompany debt</b>	<b>3.6</b>	<b>3.3</b>	<b>3.3</b>	<b>3.3</b>	<b>-0.3</b>	<b>0.0</b>
<b>External debt &amp; liabilities</b>	<b>95.2</b>	<b>96.1</b>	<b>106.3</b>	<b>106.9</b>	<b>0.9</b>	<b>0.6</b>

Data source: State Bank of Pakistan and Economic Affairs Division

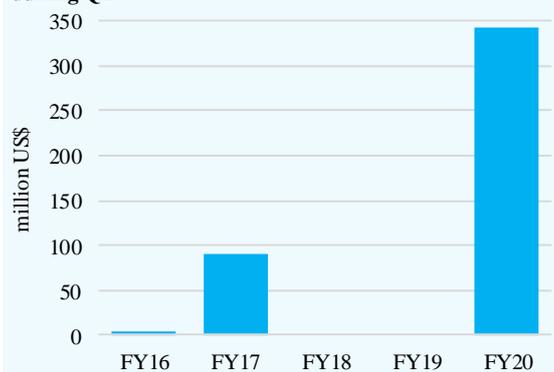
improvement in the country's BoP position and reserve buffers; sustainability of the exchange rate regime; and the comfort offered by the inception of the IMF program (**Chapter 5**).

External loan disbursements more than doubled in Q1-FY20 over the same period last year. Specifically, disbursements from commercial banks, ADB and IDB increased considerably. Most of these disbursements were for financing purposes (non-project based).

Pakistan's external debt servicing amounted to US\$ 3.0 billion during Q1-FY20, up from US\$ 2.5 billion during Q1-FY19. Principal and

interest payments were both higher during the period under review, with debt

**Figure 4.11: Foreign Investment in Government Securities during Q1**



Data source: State Bank of Pakistan

servicing of commercial loans almost five times higher as compared to last year. Similarly, interest payments on bilateral and commercial loans increased considerably in Q1-FY20 over the corresponding period of last year (**Table 4.12**).

**Table 4.12: Public External Debt Servicing during Q1**

million US\$

	<b>FY19</b>	<b>FY20</b>	<b>Change</b>
<i>Principal</i>			
I. Total debt (a+b+c+d)	1,902.1	2,275.3	373.2
a. Government debt	1,374.5	1,923.9	549.4
Paris club	25.1	28.2	3.2
Multilateral	412.2	420.1	7.9
Other bilateral	139.8	174.3	34.5
Commercial loans/credits (LT)	200.0	945.0	745.0
Short term	597.5	356.3	-241.2
b. IMF	83.9	164.8	80.9
c. PSEs debt	90.1	54.2	-35.9
d. Private debt	352.6	131.0	-221.6
<i>Interest</i>			
II. Total debt (a+b+c+d)	552.0	798.0	246.0
a. Government debt	360.2	482.6	122.4
Paris club	6.3	6.7	0.4
Multilateral	113.9	120.8	7.0
Other bilateral	98.9	163.5	64.4
Euro/Sukuk bonds	32.7	32.7	0.0
Commercial loans /credits(LT)	90.2	141.6	51.4
Multilateral (ST)	13.6	8.0	-5.6
b. IMF	35.7	43.7	8.0
c. PSEs debt	44.5	50.4	5.9
d. Private debt	58.9	151.0	92.1
<b>Total (I+II)</b>	<b>2,454.1</b>	<b>3,073.7</b>	<b>619.2</b>

Data source: State Bank of Pakistan

## 5 External Sector

### 5.1 Overview

The improvement in Pakistan's balance of payments that began in FY19, gained further momentum in Q1-FY20, as the current account deficit (CAD) shrank to less than half of the level seen last year. The initiation of the IMF program and receipt of the first tranche not only helped plug the current account gap, but also restored confidence among foreign investors, leading to a trend reversal in portfolio investment during the quarter. The lower financing needs, coupled with the available inflows, reversed the recent trend of reserves drawdown, and led SBP's liquid foreign exchange reserves to rise by US\$ 656 million in the quarter (**Table 5.1**).

**Table 5.1: Pakistan's Balance of Payments**  
million US\$

	Q1- FY19	Q1- FY20	Change
<b>Current account balance</b>	-4,287	-1,572	2,715
Trade balance	-8,382	-5,021	3,361
Exports	5,893	6,010	117
Imports	14,275	11,031	-3,244
Services balance	-1,076	-1,201	-125
Primary income balance	-1,121	-1,485	-364
Secondary income balance	6,292	6,135	-157
Workers' remittances	5,557	5,478	-79
<b>Capital account balance</b>	106	105	-1
<b>Financial account balance</b>	-2,899	-1,885	-1,014
Direct investment inflow	559	541	-18
Portfolio investment inflow	-185	344	529
Net incurrence of liabilities	2,282	840	-1,442
General government	1,878	1,092	-786
Banks	89	-517	-606
Other sector	314	262	-52
<b>Change in SBP's liquid reserves*</b>	-1,357	656	-
<b>PKR app(+)/dep(-) in percent</b>	-2.2	2.4	-

\*between end-June and end-Sep  
Data source: State Bank of Pakistan

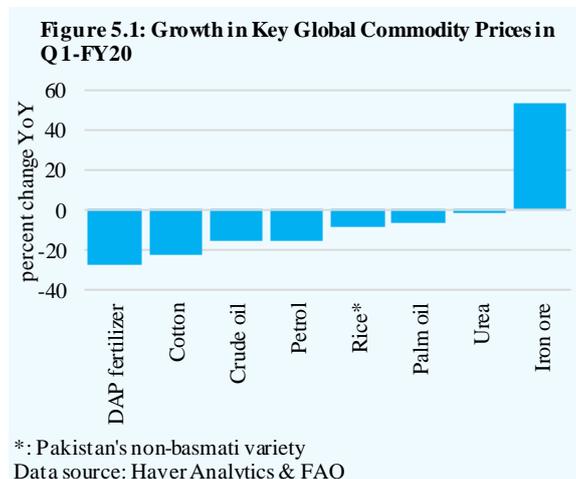
This outcome reflects the impact of the Pak rupee adjustment and other macroeconomic stabilization measures taken over the past year and a half, which have led to a considerable contraction in import demand; in fact, import payments recorded their largest drop in a decade in Q1-FY20. Quantum-led import declines were observed across all product categories, and were complemented by lower international prices of most of Pakistan's principal import commodities (**Figure 5.1**).

The energy group figured prominently contributing almost one-third to the overall import decline, with lower quantum playing a more dominant role.<sup>1</sup> Here, three

<sup>1</sup> Of the US\$ 3.2 billion decline in overall import payments in Q1-FY20, US\$ 1.2 billion drop was noted in energy imports.

factors stand out. First, the country's energy mix shifted in favor of hydropower and indigenous coal-based generation in Q1, which led to an ease in the import demand for furnace oil and LNG. Second, HSD sales weakened due to the slowdown in trade-related commercial transport activity, thereby reducing its import demand. And third, lower international prices allowed the country to import petrol and LNG, without

pushing up the import payments. Meanwhile, demand for non-energy imports also tapered, amid inventory build-up from last year (in case of DAP fertilizer and palm oil), and reduced demand for raw materials from sectors facing the brunt of macro adjustment policies, i.e. the automobile and allied industries.



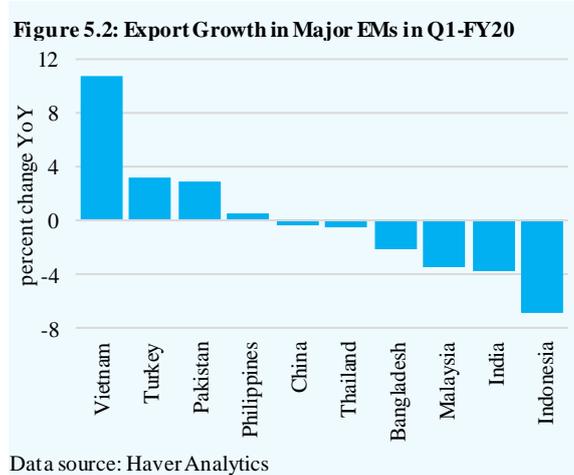
While the lower current account gap and the initiation of the Saudi oil facility reduced the payments pressure in the interbank, financial flows via foreign portfolio investment (FPI) increased during the quarter.<sup>2</sup> The recovery in FPI can be traced to investors' confidence about the sustainability of the market-based exchange rate system; continued improvement in the country's BoP and reserve buffers; and the comfort offered by the inception of the IMF program.

Notwithstanding the continued CAD reduction and the available financing, concerns linger over the external account sustainability. First, even though the official reserves have stabilized and inched up in Q1-FY20, the reserves adequacy is still below benchmarks in terms of import coverage.<sup>3</sup> This leaves the external account vulnerable to unfavorable trends in the global market.

<sup>2</sup> Import payments for crude oil purchased under the Saudi oil facility will come due 12 months after the purchase. While this mechanism eases the payment pressure in the interbank market, it has a zero net effect on the BoP and the reserves position. In the current account, the relevant payment amount is recorded under imports, and the same amount is included in the short-term loan disbursements to the general government.

<sup>3</sup> SBP's FX reserves amounted to US\$ 7.9 billion by end-September 2019, up from US\$ 7.3 billion at end-June. In terms of reserves adequacy, the import cover improved from 1.7 months to 1.9 months during this period.

Second, export earnings remained weak, mainly due to lower unit values amid a slowing global economy, slumping commodity prices and cutthroat competition in the major destinations. While the first two factors have suppressed export earnings of other emerging markets as well (Figure 5.2), the impact on Pakistan’s unit prices was more pronounced (Section 5.5). This suggests that the currency adjustment has enabled



Pakistani exporters to undercut their competitors and increase their market share by shipping higher quantities, without giving up on their margins (in Pak rupee terms). While this strategy is viable from the industrial activity standpoint, it is undermining the country’s foreign exchange receipts.

Third, FDI has yet to pick up in response to the stabilization of the economy and the certainty afforded by the IMF program, as investors have adopted a wait-and-see approach. FDI during Q1-FY20 was driven by a one-off cash infusion into a telecom company for a license purchase, with all other sectors receiving lower investment. Similarly, workers’ remittances have also declined, with the global economic slowdown and the challenging employment situation in the GCC hampering flows to Pakistan as well as other major recipient countries.

The above trends suggest that the improvement in balance of payments came largely from imports. Given the consequences of the macroeconomic adjustment policies on growth and investment, it is imperative that the country’s foreign exchange earnings via exports and FDI pick up, to allow financing space for essential imports.

While the macro adjustment policies have created some challenges for the exporting industries (such as an increase in raw material costs), official support provided some cushion. For instance, SBP’s trade refinancing schemes, available at attractive rates and steps taken by the Board of Investment and the FBR to streamline corporate registrations and tax payments have already led to improvement in the country’s ease of doing business ranking (Box 5.1). That said,

the focus should be now on shoring up the gains and instilling a sense of policy stability, which could help the investors to take long-term investment decisions.

### 5.2 Current Account

The current account deficit narrowed by US\$ 2.7 billion and reached US\$ 1.6 billion in Q1-FY20 (**Figure 5.3**).

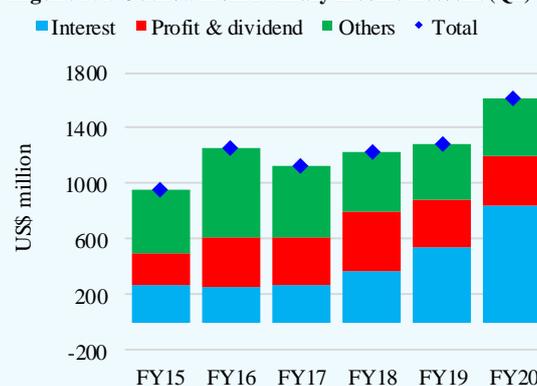
Almost the entire improvement came from the drop in import payments. Both lower quantum and unit prices were responsible for the import compression, though quantum played the dominant role. In case of exports, however, lower unit values dominated, partially offsetting the impact of significant volumetric growth in a number of major export products.

**Figure 5.3: Current Account Deficit**



At the same time, the higher primary income and services deficit, and the decline in remittances, contributed negatively to the current account. The outflows from the primary income account rose by US\$ 321 million to US\$ 1.6 billion in Q1-FY20 (**Figure 5.4**). This was mainly due to higher interest payments on external debt, as profit repatriation on foreign investments almost stagnated at last year's level. The higher interest payments mainly reflect the impact of the increase in the public external debt stock over the past few years in response to the persistent twin deficits.<sup>4</sup>

**Figure 5.4: Outflow from Primary Income Account (Q1)**



#### Workers' remittances

In Q1-FY20, remittances declined by 1.4 percent on YoY basis, compared to a significant 14.7 percent growth recorded during the same

<sup>4</sup> The country's external debt and liabilities increased by 12.9 percent during the last three years.

period last year. The drop in inflows from the GCC, especially the UAE, was mainly responsible for the overall decline in remittances (**Table 5.2**).

Remittances from the UAE declined 7.2 percent in Q1-FY20, mainly due to the challenging employment situation in the country, as remittance outflows from UAE to other major recipients also declined.<sup>5</sup> Anecdotal evidence also suggests that a significant number of workers have returned from the UAE.<sup>6</sup>

Interestingly, the growth in inflows from other main sources, such as the UK, USA and the EU, remained positive, despite an overall global economic slowdown in 2019.<sup>7</sup>

This slowdown has impacted remittance flows to other large recipient countries, including India, as well; these countries are projected to observe a sharp deceleration in remittance growth during CY2019 (**Figure 5.5**).

As per the World Bank's estimates, Pakistan fares well compared to these countries, as the remittances growth is expected to decline only by 2.6 percentage points in CY2019. This relatively better outlook likely reflects the ongoing efforts by the Pakistan Remittance Initiative (PRI) and the government to enhance remittances through formal channels into the country. For instance, the PRI has aided the Pakistan Post and the National Bank of Pakistan to jointly enhance their

**Table 5.2: Country-wise Remittances (Jul-Sep)**

million US\$				
	FY19	FY20	Change	
USA	862.8	911.7	48.9	
U.K.	810.2	814.4	4.2	
GCC countries	3,017.6	2,928.0	-89.6	
Saudi Arabia	1,263.2	1,269.4	6.2	
UAE	1,227.5	1,139.2	-88.3	
Other GCC countries	527.0	519.4	-7.5	
EU countries	165.8	169.6	3.9	
Malaysia	395.2	405.1	9.9	
Norway	11.4	9.2	-2.2	
Switzerland	8.7	4.1	-4.6	
Australia	57.9	49.7	-8.2	
Canada	52.6	42.6	-10.0	
Japan	4.4	6.2	1.8	
Other countries	171.0	137.5	-33.5	
<b>Total</b>	<b>5,557.6</b>	<b>5,478.1</b>	<b>-79.5</b>	

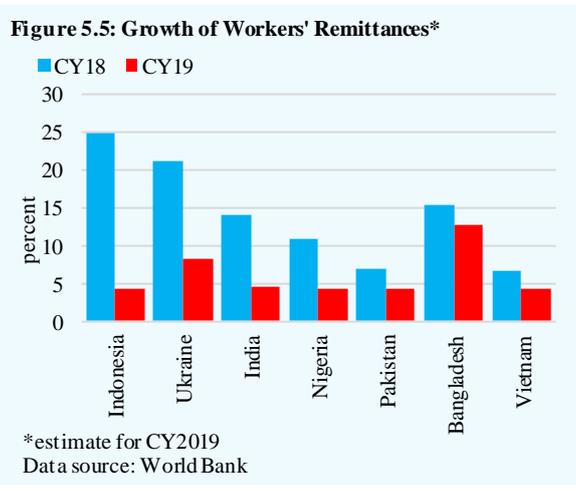
Data source: State Bank of Pakistan

<sup>5</sup> The overall remittance outflow from the UAE declined by 11.7 and 4.2 percent YOY respectively during Jan-Mar and Apr-Jun 2019. This trend is in line with the slowdown in employment in the country (Source: Quarterly Economic Reviews, Central bank of UAE).

<sup>6</sup> According to the Bureau of Emigration and Overseas Employees, the number of Pakistanis going abroad for work increased by 3.7 percent during January to September 2019, over the same period last year. Here, it is important to mention that no official data is available on the number of Pakistanis returning from abroad.

<sup>7</sup> The IMF estimates the global economic growth to slow down to 3 percent in 2019 from 3.8 percent in 2017- the lowest level since the global financial crisis (source: IMF WEO, October 2019).

tie-ups with 41 money transfer operators in the UAE and Saudi Arabia during the current year. Also, under the “foreign remittance initiative” project, families of Pakistani workers can receive remittances from 240 branches of Pakistan Post for free. Other incentives include the exemption from WHT on bank accounts fed with remittances, and the reimbursement of marketing charges to exchange companies and banks.



### 5.3 Financial Account

During Q1-FY20, inflows in the financial accounts were dominated by the public debt flows. Higher portfolio investment in T-bills; borrowing from the IMF; and the commercial borrowings have pushed up the gross disbursements during the period. These inflows were more than sufficient to finance the current account deficit and the debt amortization during the quarter, keeping the country's foreign exchange reserves on a high growth trajectory.

#### *Foreign direct investment*

Net FDI into Pakistan during Q1-FY20 remained almost stagnant at last year's level (**Table 5.3**). All major sectors recorded lower inflows, except for telecom, textiles and the electric machinery. Specifically, major declines were seen in the construction and power sectors, reflecting the completion of the first phase of CPEC-related projects in the country. Meanwhile, the food sector also witnessed outflows, as some food conglomerates operating in Pakistan repatriated their retained earnings to their parent companies.

In contrast, the telecom sector fetched around half of the net FDI during the quarter, as a cellular company received funds from its parent company to pay a license renewal fee. In addition, inflows under electrical machinery mainly reflect a US\$ 50.0 million investment by a Chinese company for ongoing work on a CPEC-related power transmission project.

Importantly, the net FDI would have declined more sharply, if the one-off inflow into the telecom sector had not materialized this year. Besides lower gross

inflows, the country has seen divestments from multiple sectors, especially food, power and financial businesses. Cognizant with the issues related to ease of doing business, the government has taken several measures to create a business friendly environment in the recent years. These efforts have contributed to an improvement in the country’s ranking in the World Bank’s latest Ease of Doing Business 2020 report (**Box 5.1**)

**Table 5.3: Sector-wise Net FDI inflow in Q1**  
million US\$

	FY18	FY19	FY20	Change
Construction	125.3	180.3	5.2	-175.1
Power	426.3	92.4	0.9	-91.5
Financial business	190.1	39.8	24.9	-14.9
Exploration & prod.	83.3	74.1	34.1	-40.0
Electrical machinery	0.8	5.2	64.8	59.6
Pharmaceuticals	0.8	29.2	16.5	-12.7
Transport equipment (Automobiles)	1.4	27.7	24.3	-3.4
Textiles	10.8	12.4	16.9	4.5
Food	0.8	14.2	-17.9	-32.1
Telecommunications	62.8	-54.2	246.4	300.6
Others	116.6	137.9	125.9	-12.0
<b>Total</b>	<b>1,019</b>	<b>559</b>	<b>542</b>	<b>-17</b>

Data source: State Bank of Pakistan

**Box 5.1: Ease of Doing Business Report 2020 and Pakistan’s Ranking**

In the Doing Business 2020 report, Pakistan’s rank has improved by 28 notches, to 108 position among 190 countries (**Figure 5.1.1**). A number of recent policy initiatives by the government have helped Pakistan secure a place among the top 10 countries with the most improved business climate.

This progress has been achieved by bringing improvements in six key areas: starting a business, dealing with construction permits, getting electricity, registering property, paying taxes, and trading across border (**Table 5.1.1**). In this regard, the following efforts are worth noting:

- The government has made it easier to start a business by introducing a one-stop registration system, replacing several forms of incorporation.
- The approval process for getting a construction permit has been restructured to make it easier; regularity in inspection of the building quality has also been ensured.
- The government has initiated service delivery timeframes for getting electricity by introducing an online portal for new applications.
- Changes in the electricity tariff have been made more transparent to the ease of the business community.
- In the area of taxes, online payment modes have been introduced for value added tax and corporate income tax. Furthermore, the corporate income tax rate has been reduced.

**Figure 5.1.1: Overall Ease of Doing Business Ranking for Selected Countries in 2019**



Data source: World Bank

- The process of registering a property has been simplified by allowing its execution at the office of the Sub-Registrar. Moreover, steps are taken to increase the transparency in the land administration system.
- Trading across borders has been made easier by integrating the Web-Based One Customs (WeBOC) electronic system. Moreover, coordinated joint physical inspections at the port by various agencies has been facilitated.

Furthermore, the government has formed a steering committee, the Pakistan Regulatory Modernization Initiative (PRMI), which is mandated to improve regulations and develop the regulatory system on modern lines to facilitate the businesses. This will improve trading across borders by reducing customs-related processing time and the number of hours required to prepare import/export documents via electronic document exchange.

**References:**

Doing Business Report 2020, World Bank  
IMF Staff Report, July 2019

**Foreign portfolio investment**

After a gap of almost two years, foreign portfolio investment witnessed a trend reversal, with the country receiving US\$ 344.5 million inflows in Q1-FY20, against an outflow of US\$ 185.2 million recorded in the same period last year.

Almost the entire investment in T-bills and PIBs came from investors in the UK and the US. This increase in portfolio flows can be attributed to investors' confidence about the sustainability of the market-based exchange rate system; continued improvement in Pakistan's reserves buffers; and the comfort provided by the initiation of the EFF program. It is also important to note that while the interest rate differential had been higher in the past as well, Pakistan's

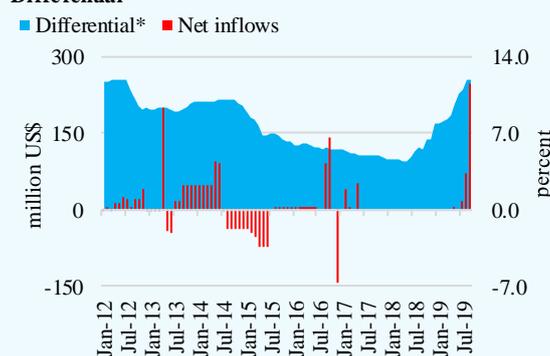
**Table 5.1.1: Ease of Doing Business Indicators Scores\***

	2017	2018	2019	2020
Starting a business	76	77	82	89
Dealing with construction Permits	54	51	52	66
Getting electricity	43	43	43	64
Paying taxes	47	46	47	53
Registering property	38	39	43	49
Trading across borders	64	67	67	69

\*0=lowest performance to 100= best performance

Data source: World Bank Group

**Figure 5.6: Portfolio Investment in T-bills and Interest Rate Differential**



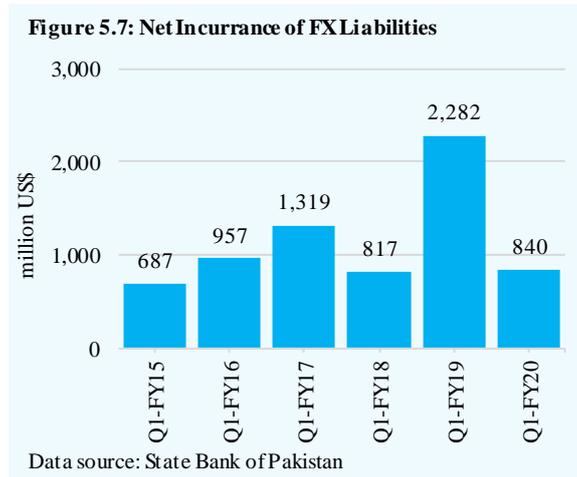
\* T-bills vs US Security

Data source: State Bank of Pakistan and Bloomberg

debt market was unable to attract significant interest from foreign investors (Figure 5.6).

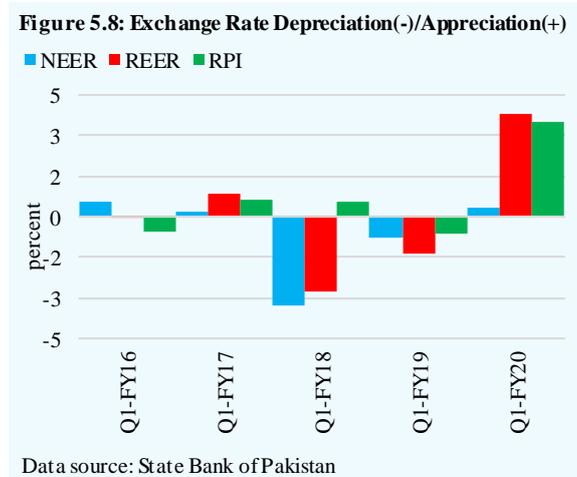
**Net incurrence of liabilities**

The net inflow of foreign exchange liabilities amounted to US\$ 840 million in Q1-FY20, down by 63.2 percent from the same quarter last year (Figure 5.7). While the commercial banks retired US\$ 517 million, the government borrowing was also significantly lower than last year. In gross terms, the government received three times higher inflows during the quarter, however, significant loan amortizations left the net borrowing to a lower level. The major inflows came from the IMF (US\$ 991.4 million), ADB and the foreign commercial banks.



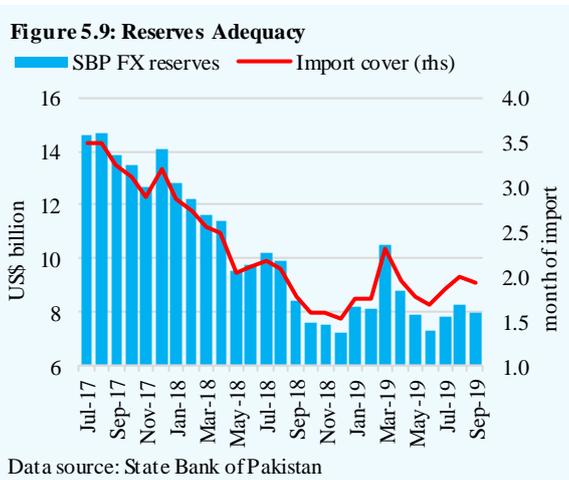
**5.4 Exchange Rate and Reserves**

The improvement in current account, along with sufficient availability of external financing led to reserve build-up during the quarter. This resulted in a 2.4 percent appreciation of the Rupee vis-a-vis US dollar in Q1-FY20; in contrast to last year, when the rupee had depreciated 2.2 percent.



In contrast, currencies of Pakistan’s major trading partners, including China, depreciated significantly against the US dollar during Q1-FY20. Particularly, the Chinese yuan, having 29.1 percent share in Pakistan’s NEER basket, depreciated by 3.1 percent during the period. The slide in the yuan and other major currencies added further to effective appreciation in the Pak rupee.

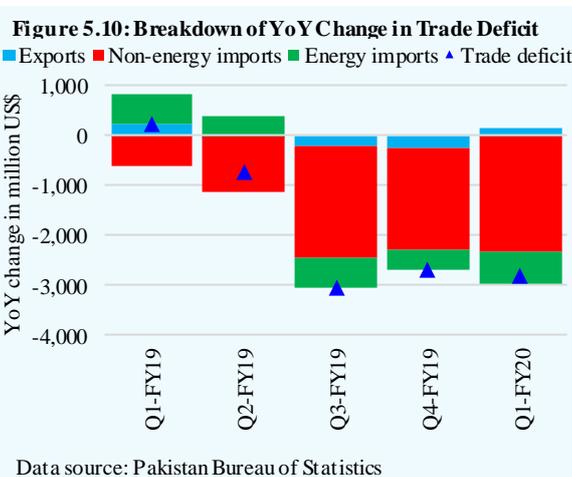
The average Nominal Effective Exchange Rate (NEER) during September 2019 recorded an appreciation of only 0.3 percent compared to June 2019 (Figure 5.8). However, the surging inflation in Pakistan relative to its trading partners pushed up the Relative Price Index (RPI) by 3.5 percent. This resulted in a 3.8 percent increase in the Real Effective Exchange Rate (REER).



In case of foreign exchange reserves, the sharp decline in imports, along with the revival in portfolio and IFI financing, contributed towards the reserve build-up. The country's foreign exchange reserves increased by US\$ 751 million in Q1-FY20 compared to a fall of the US\$ 1.4 billion in the same period last year. A major share of this increase was observed in the SBP's reserves, which improved by US\$ 656.2 million in Q1-FY20 to US\$ 7.9 billion by end-September (Figure 5.9). As a result, Pakistan's reserves adequacy levels also improved during the period.

### 5.5 Trade account<sup>8</sup>

The trade deficit declined by a sizable 35.3 percent YoY to US\$ 5.7 billion in Q1-FY20, after dropping by 2.5 percent in the same quarter last year. An across-the-board decline in imports, led by lower quantum and complemented by declining global commodity prices, offset a YoY slowdown in export growth (Figure 5.10).<sup>9</sup>



<sup>8</sup> This analysis is based on customs data provided by the Pakistan Bureau of Statistics, and may not tally with the payments record data reported in Sections 5.1 and 5.2.

<sup>9</sup> International oil prices were, on average, 16.1 percent down in Q1-FY20 as compared to Q1-FY19, whereas palm oil prices were 6.8 percent lower in the same period.

As a result, the trade deficit fell to its lowest level in over three years.

### Exports

Pakistan's exports rose 2.5 percent to US\$ 5.5 billion in Q1-FY20, after rising by 4.2 percent in the same period last year. The slowdown in growth originated almost entirely from the POL group, which dragged down relatively broad-based and decent rebound in exports of other products, particularly rice, apparel, fruits and vegetables, and meat (**Table 5.4**).

### Textile exports

Textile exports rose 2.9 percent to US\$ 3.4 billion in Q1-FY20; the growth was higher than the 0.6 percent increase recorded in Q1-FY19. This mainly reflected a trend reversal in readymade garments, whose export values had declined last

year and rose by double digits this year. While the drag from lower unit prices – which had pulled down apparel exports throughout last year – is now tapering off (**Figure 5.11**), the unit prices are still exerting downward pressure on export values of multiple textile items, including apparel, yarn and fabric.

In terms of demand, while the growth in the US' quantum apparel imports in the full first quarter of FY20 was similar to last year, monthly data shows solid growth in July and August, followed by a decline in September 2019.<sup>10</sup> This decline mainly came from China: September marked the first time that China's apparel exports to the US started attracting additional tariffs. The import growth

**Table 5.4: Pakistan's Major Exports during Q1**  
million US\$

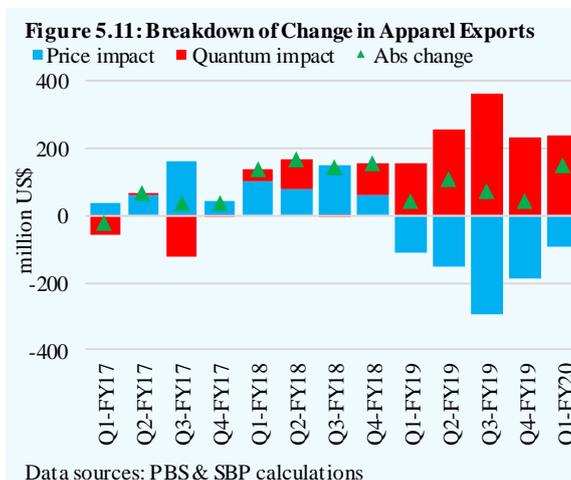
	FY19	FY20	Abs. change	Quant. impact	Price impact
<b>Food group</b>	<b>864.0</b>	<b>984.3</b>	<b>120.2</b>	-	-
Basmati rice	132.2	196.3	64.2	94.6	-30.5
Non-basmati	180.0	274.3	94.3	91.7	2.6
Wheat	92.8	11.0	-81.8	-83.1	1.3
Sugar	55.6	42.8	-12.8	-22.4	9.6
Fruits & veg.	132.8	148.2	15.4	12.9	2.5
Meat & prep	46.7	70.6	23.9	20.2	3.7
<b>Textile group</b>	<b>3,275.3</b>	<b>3,371.7</b>	<b>96.3</b>	-	-
Raw cotton	7.0	10.8	3.8	5.5	-1.8
Cotton yarn	313.7	297.2	-16.5	21.6	-38.1
Cotton fabrics	529.1	499.4	-29.7	67.4	-97.0
Apparel	1,300.0	1,446.0	146.0	238.6	-92.6
Bedwear	584.0	601.0	17.1	110.9	-93.9
Towels	184.4	180.7	-3.8	-3.6	-0.2
<b>POL group</b>	<b>145.8</b>	<b>62.3</b>	<b>-83.6</b>	<b>-65.7</b>	<b>-17.8</b>
Crude oil	76.2	37.5	-38.7	-30.6	-8.1
POL products	45.9	9.6	-36.3	-34.9	-1.4
<b>Other manuf.</b>	<b>828.9</b>	<b>804.4</b>	<b>-24.5</b>	-	-
Leather tanned	61.6	51.9	-9.7	-9.2	-0.4
Leather manufactures	119.0	131.5	12.5	7.4	5.0
Plastic	78.6	77.1	-1.5	17.4	-18.9
Pharma	49.4	55.6	6.2	17.0	-10.8
Cement	77.6	66.8	-10.8	-4.1	-6.7
<b>Total exports</b>	<b>5,373.9</b>	<b>5,509.8</b>	<b>135.8</b>	-	-

Data source: Pakistan Bureau of Statistics and SBP calculations

<sup>10</sup> The US' quantum apparel imports grew 2.2 percent YoY in Q1-FY20, against the growth of 2.3 percent recorded in Q1-FY19 (source: US Office of Textile and Apparel).

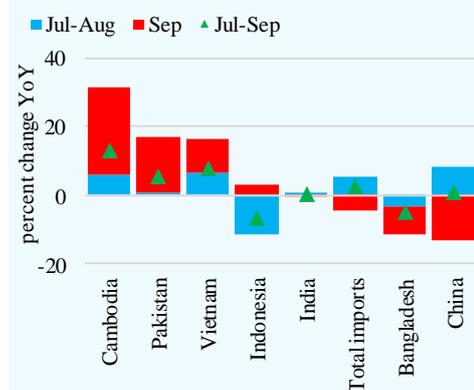
in July and August was also mainly driven by China, as American importers accelerated their purchases from May onwards (in anticipation of higher tariffs) and pulled back imports from other suppliers (Figure 5.12a).<sup>11</sup> The higher imports in Jul-Aug also led to rising inventories with clothing and retail stores (Figure 5.12b), and reduced the need for imports in September. Then in September, a shift towards

low-cost producers was also witnessed, as quantum imports from Cambodia, Vietnam and Pakistan recorded sizable growth. These changing dynamics present an opportunity for Pakistani exporters to capture China's share in the US' cotton-centric garment market. Pakistan also has the low-cost advantage, given the extent of the Pak rupee's adjustment against the US dollar over the past year and a half, which has allowed exporters to keep their unit prices in control (Table 5.5), without taking a hit on their margins in rupee terms.



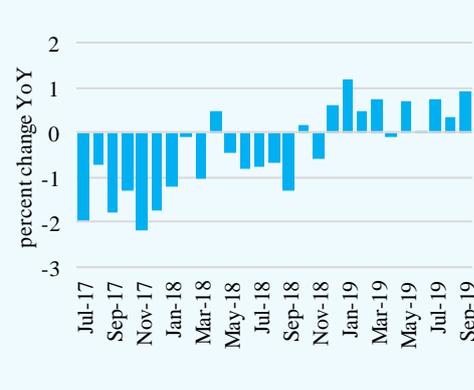
Data sources: PBS & SBP calculations

Figure 5.12a: Growth in US' Quantum Apparel Imports in Q1-FY20



Data source: US Office of Textile & Apparel

Figure 5.12b: Growth in Inventories at US Clothing & Accessories Stores



Data source: US Census Bureau

<sup>11</sup> American importers were warned of the impending tariff hike back in May 2019, when the US government released a list of 3,805 Chinese products that would potentially attract additional tariffs. This list included 646 apparel products, and tariffs on 568 of them were raised on September 1, 2019. Source: US Office of the Trade Representative (<https://ustr.gov/issue-areas/enforcement/section-301-investigations/section-301-china/300-billion-trade-action>).

That said, Pakistani exporters will face stiff competition from Vietnam, whose exporters are already well-connected with the US' apparel supply chain and have emerged as one of the largest beneficiaries of the US-China trade dispute. However, the unit prices of Vietnam's exporters are now also rising, due to rising labor costs as well as a stable exchange rate; this may erode Vietnam's export competitiveness in relative terms. For Pakistan, utilizing this opportunity will hinge on sustained investments and improvements in the product composition and quality, as so far exporters are targeting to increase their market share by simply undercutting unit prices in US dollar terms, without sacrificing their margins in rupee terms.

**Table 5.5: Growth in US's Apparel Import Unit Values & USD's YoY App(+)/Dep(-) against EM Currencies**

Percent change	Unit Values		USD's App/Dep	
	FY19	FY20	FY19	FY20
Pakistan	1.7	1.2	18.0	27.0
Bangladesh	2.1	7.0	3.4	0.6
India	2.7	3.7	8.9	0.4
China	0.0	-4.1	1.9	3.1
Cambodia	6.1	2.6	-0.3	0.4
Indonesia	3.3	4.2	9.5	-3.3
Vietnam	2.1	6.1	2.2	0.0
World	1.1	0.8	1.5*	3.2*

\*Change in Dollar Index

Data source: OTEXA and Bloomberg

**Table 5.6: Growth in EU's Apparel Imports from Major Countries during Q1**

	Quantum		Value		Unit Values*		Currency**	
	FY19	FY20	FY19	FY20	FY19	FY20	FY19	FY20
Pakistan	4.9	5.2	3.5	4.2	-1.3	-1.0	16.3	21.9
India	-5.9	2.2	-4.7	2.7	1.2	0.5	7.9	-4.1
China	-11.2	-1.1	1.3	1.1	14.0	2.3	1.0	-1.4
Bangladesh	7.9	-1.1	7.5	5.5	-0.3	6.6	2.6	-3.9
Cambodia	11.7	-8.2	11.9	-2.0	0.2	6.7	-1.1	-4.3
Turkey	8.1	6.3	3.5	7.6	-4.2	1.3	59.4	-4.1
World***	-0.9	-0.6	4.6	4.0	5.6	3.4	-1.1	-4.4

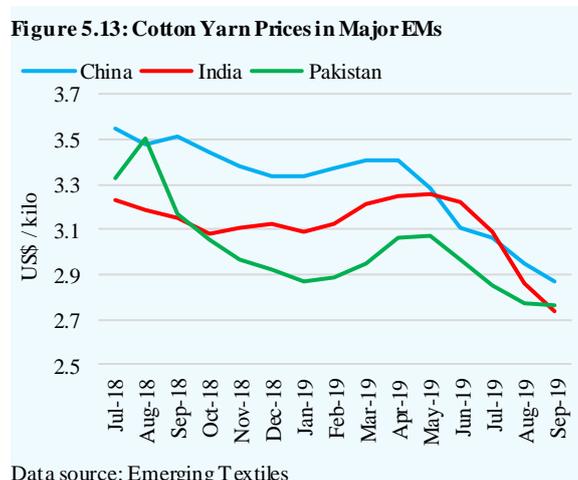
\*In euros \*\*Euro's YoY app(+)/dep(-) against respective currencies \*\*\*Euro against US\$

Data source: Eurostat, Bloomberg and SBP calculations

Similarly, in the EU, Pakistan's export unit prices were also lower than last year; in fact, Pakistan was the only major supplier whose unit prices to the bloc declined during Q1-FY20 (**Table 5.6**). With the euro weakening against EM currencies, the EU's import demand from high-cost suppliers was especially impacted.

In Pakistan's case, two factors stood out. First, the euro has been depreciating against currencies of all major exporting EMs for the past 2-4 quarters on YoY basis – with the exception of the Pak rupee, against which it has appreciated consistently since Q4-FY18. This has made the EU's imports from other EMs relatively more expensive than from Pakistan. And second, Pakistan continues to enjoy concessionary market access to the bloc under the GSP Plus. Due to these

two factors, Pakistani exporters fetched lower unit prices, while shipping higher quantities. In the low value added segment, Pakistan's export values of cotton yarn and fabric declined on YoY basis, with lower unit prices offsetting higher quantum exports for both products. In yarn's case, prices are trending downwards not just for Pakistan, but also for China and India (**Figure 5.13**), reflecting the trend in international cotton prices.



#### Non-textile exports

Non-textile exports grew 1.9 percent YoY to US\$ 2.1 billion in Q1-FY20, against a growth of 10.5 percent recorded in Q1-FY19. The slowdown is mainly due to a 57.3 percent drop in POL exports, with foreign sales of crude oil, POL products and naphtha all declining. While lower international oil prices played a role, quantum exports of the commodities also dropped.

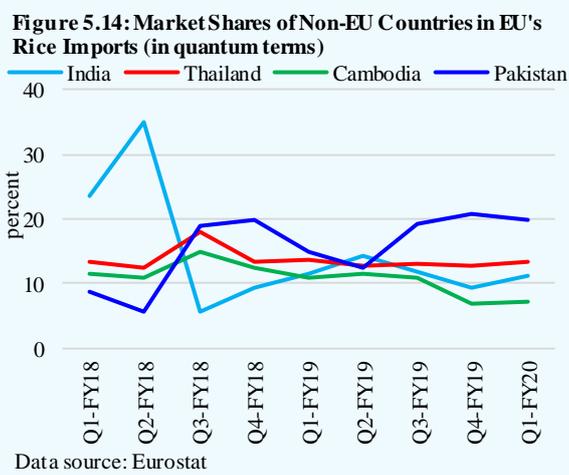
Crude oil exports fell 50.8 percent, with lower quantum explaining 79.1 percent of this decline. A likely reason is a decrease in the exportable surplus of the commodity. Owing to differences in specification and viscosity, refineries are ill-equipped to process locally extracted crude oil. However, owing to financial constraints in the wake of exchange rate losses and high interest rates, a couple of refineries have now started blending locally produced crude oil with imported oil, to reduce their import burden.<sup>12</sup>

In the case of products, the heaviest decline was noted in jet fuel. Jet fuel production had fallen 2.8 percent YoY in Jul-Sep, as refineries curtailed their throughput in response to financial constraints as well as their inability to offload FO stocks to the power sector. Meanwhile, demand-side dynamics for jet fuel were also not ideal: Pakistan typically exports jet fuel to Afghanistan under a government-to-government arrangement. With the gradual withdrawal of allied

<sup>12</sup> For instance, Byco Petroleum mentioned in its Annual Report for 2018-19 that it “has started limited procurement of local crude and has successfully blended it with imported crude oil while retaining product quality and yields”.

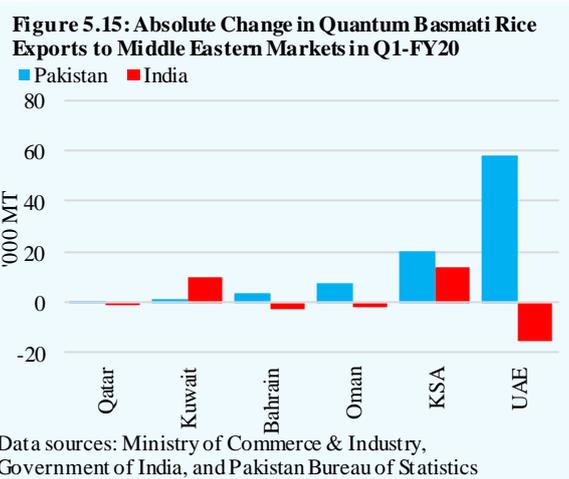
troops from the neighboring country, requirements for fuel items and other logistical services from Pakistan are likely to taper as well.

In contrast to the POL group, overall food exports grew 13.9 percent to US\$ 984.3 million in the quarter, mainly due to a 50.8 percent growth in rice exports. In fact, rice was the single largest contributor to the growth in overall exports, with export values rising to US\$ 470.6 million in Q1-FY20. Exports of both basmati and non-basmati varieties rose substantially, with higher quantum exports entirely offsetting the impact of lower unit prices (as indicated earlier in **Table 5.4**).



In terms of destination, a substantial increase in rice export receipts from the EU, Middle East and African economies was noted. Pakistan's rice exports to European countries have been growing for the past two years now and its share in the EU market has risen ever since India's rice exports to the bloc became restricted over excessive pesticide usage concerns (**Figure 5.14**).

However, Pakistani basmati exporters are now also capturing India's share in the major Middle Eastern markets, with exports rising significantly in quantum terms just as India's are declining (**Figure 5.15**). The largest increase was noted in the UAE, where quantum exports recorded a four-fold increase during Q1-FY20. There are indications that at least part of the rice shipments to the country are being routed to Iran, following the breakdown of oil trade between Iran and India in May-June



2019.<sup>13</sup> Quantum exports to Saudi Arabia also more than tripled, in the wake of marketing efforts by exporters, relatively lower unit prices, and low base effect from last year.<sup>14</sup>

In case of non-basmati rice, exports to traditional African markets, such as Senegal and Mozambique, also rose, as exporters were able to keep their unit prices lower than competitors like India and Thailand. Furthermore, owing to favorable duty structure, Pakistan is now also sending more non-basmati (brown) rice to European countries, like Belgium and the UK, in addition to already strong basmati sales to the bloc.<sup>15</sup>

Among other food items, sugar and wheat exports both fell drastically. It may be recalled that export subsidies were in place for both commodities during Q1-FY19, which led to a high base effect. In case of wheat, even though quantum exports had dwindled sharply after Q1-FY19, rising domestic flour prices<sup>16</sup> led the government to ban the grain's exports in September 2019.<sup>17</sup> As a result, wheat export values dropped 88.1 percent in Q1-FY20. Sugar exports also fell 23.0 percent, with lower quantum exports entirely offsetting an increase in unit prices. Domestic sugar prices were, on average, 33.5 percent higher in Q1-FY20 as compared to last year, incentivizing sugar mills to cater to the local market instead of pursuing exports.<sup>18</sup>

Lastly, exports of fruits and vegetables rose by 11.6 percent YoY to US\$ 148.2 million in the quarter – dwarfing the cumulative exports of protected industries like wheat and sugar. Detailed data indicates that exports of mangoes, potatoes and maize were all higher than last year. The encouraging performance can be traced to trade exhibitions organized by the Trade Development Authority of Pakistan (TDAP) in coordination with diplomatic missions and exporters in central Asian and European countries, like Russia and Germany. Furthermore,

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<sup>13</sup> The US' waivers to a few countries (including India) with extensive trade links with Iran expired in early May 2019 and were not renewed (source: White House statement dated April 22, 2019). India and Iran had a barter-like trading system in place, where India would credit its payments for Iranian oil imports into an INR-denominated bank account in India. Iran would use this account to pay for its imports of mainly food and pharmaceutical items from India.

<sup>14</sup> During Q1-FY20, the average unit price of Pakistan's non-basmati rice was 9.6 percent lower than that of India and 21.0 percent lower than that of Thailand (source: UN FAO).

<sup>15</sup> This rice is then further processed by mills in the region to produce white rice that is commonly used in the western countries.

<sup>16</sup> The price of a 10kg wheat flour bag averaged 11.1 percent higher in Q1-FY20 on YoY basis.

<sup>17</sup> Via Ministry of Commerce SRO No. 1044(I)/2019, dated September 11, 2019.

<sup>18</sup> The domestic prices rose after the GST was increased from 8 percent to 17 percent in the FY20 budget, and amid weak price control mechanisms at the local level. For details, see **Chapter 3**.

meat export values also rose substantially, as the country shipped significantly higher quantum to major Middle Eastern markets, like Saudi Arabia, the UAE and Kuwait.

### Imports

Imports declined by a sharp 20.9 percent to US\$ 11.2 billion in Q1-FY20. An across-the-board decline was noted, with lower quantum imports generally playing a more dominant role (**Table 5.7**). Lower international prices of key commodities, such as crude oil, coal and palm oil, along with inventory build-up last year (in case of DAP fertilizer and CKD kits) also helped curtail import demand this year. In absolute terms, crude oil contributed the most to the decline in overall imports, followed by fertilizer (DAP), coal (classified under 'all other items'), and furnace oil (FO).

### Energy imports

Energy imports dropped 16.2 percent to US\$ 3.2 billion in Q1-FY20 after rising by 19.4 percent in the same quarter last year. The drop mainly reflects lower fuel demand from the transport and power sectors, which led to heavy drops in quantum imports of POL

products like furnace oil (FO) and high speed diesel (HSD). Further support came from international oil and coal prices, which were, on average, 16.1 percent and 10.9 percent lower on YoY basis respectively. The lower unit prices also severely curtailed the growth in LNG import values in the quarter.

**Table 5.7: Pakistan's Major Imports during Q1**  
(million US\$)

Items	FY19	FY20	Abs.	Quantum	Price
<b>Energy group</b>	<b>3,783.5</b>	<b>3,169.7</b>	<b>-613.8</b>	103.1	-716.9
POL prods.	1,595.1	1,319.9	-275.2	112.3	-163.0
Crude oil	1,202.2	823.3	-378.8	-225.6	-153.3
LNG	939.2	965.6	26.4	391.6	-365.2
<b>Agri and chem</b>	<b>2,324.0</b>	<b>1,815.2</b>	<b>-508.9</b>	-	-
Fertilizer	344.2	127.7	-216.5	-174.6	-41.9
Other chem.	1,091.3	926.6	-164.6	-	-
<b>Transport</b>	<b>791.2</b>	<b>538.1</b>	<b>-253.1</b>	-	-
Cars	304.2	189.8	-114.3	-	-
CBUs	87.2	14.7	-72.5	-	-
CKDs	217.0	175.1	-41.8	-	-
Truck & buses	164.4	81.8	-82.6	-	-
Aircraft &	82.9	131.1	48.1	-	-
<b>Metals group</b>	<b>1,307.8</b>	<b>1,005.9</b>	<b>-301.9</b>	-	-
Steel scrap	412.5	388.8	-23.7	-105.4	81.7
Iron & steel	573.5	370.4	-203.0	197.8	-5.2
<b>Food group</b>	<b>1,458.4</b>	<b>1,097.4</b>	<b>-361.4</b>	-	-
Tea	148.3	102.2	-46.0	-31.1	-14.9
Palm oil	485.7	362.4	-123.3	-47.5	-75.8
Soybean oil	22.8	32.1	9.3	12.6	-3.3
Pulses	152.9	118.7	-34.2	-17.7	-16.5
<b>Textile group</b>	<b>676.9</b>	<b>451.3</b>	<b>-225.6</b>	-	-
Raw cotton	65.2	37.4	-27.8	-28.2	0.4
Syn. yarn	153.4	118.5	-34.9	-35.1	0.2
<b>Machinery</b>	<b>2,288.1</b>	<b>2,032.9</b>	<b>-255.1</b>	-	-
Power gen	342.8	312.1	-30.8	-	-
Electrical	460.3	506.2	45.8	-	-
Construction	85.7	33.6	-52.1	-	-
Cell phones	199.2	269.1	69.9	-	-
Other	808.2	551.5	-256.7	-	-
<b>All other items</b>	<b>1,251.2</b>	<b>895.7</b>	<b>-372.6</b>	-	-
o/w Coal	464.5	272.2	-192.3	-83.4	-108.9
<b>Total imports</b>	<b>14,164.8</b>	<b>11,199.2</b>	<b>-2,965.6</b>	-	-

Data source: PBS and SBP calculations

In case of crude oil, imports dropped 31.5 percent to US\$ 823.3 million in the quarter, with the decline mainly reflecting a heavy 18.8 percent drop in import quantum. In fact, quantum import of crude slumped to their lowest level in two years. While the ongoing phasing out of FO from the energy mix continues to strain refineries' throughput and their demand for crude oil, a couple of other factors are also at play.

First, some refineries have cited their inability to obtain forward cover to hedge their exchange rate exposure amid erratic fluctuations in international oil prices as a serious operational constraint; this has led them to book significant exchange losses. Second, a couple of refineries have started blending domestically extracted crude oil with imported oil, as mentioned earlier in the exports section. These factors, in addition to FO-related issues, have led refineries to cut back on crude oil imports.

**Table 5.8: Contributors to Absolute YoY Change in Power Generation during Jul-Sep (GWh)**

Fuel Source	FY18	FY19	FY20
Furnace oil	-242.5	-4,697.5	-1,846.2
Natural gas	2,163.5	-4,318.9	-1,101.3
Hydro	-220.4	462.7	2,700.4
LNG*	0.0	9,405.1	196.2
Coal	1,300.3	2,905.4	1,915.6
Nuclear	866.4	-109.6	185.1
Others	867.2	-66.7	-465.9
<b>Total</b>	<b>4,734.5</b>	<b>3,580.4</b>	<b>1,583.8</b>

\*Generation from LNG till Q3-FY18 was being captured under natural gas. Due to this base effect for Q1-FY18, generation from LNG shows large increase in Q1-FY19.

Data source: NEPRA

In case of POL products, imports declined 17.3 percent to US\$ 1.3 billion in the quarter. FO continued to account for the bulk of this decline, owing to its replacement from the energy mix by LNG, coal, and particularly during Q1, by record hydropower output following ample rainfall in the country (Table 5.8).<sup>19</sup> During Q1-FY20, quantum FO imports fell by a sizable 84.3 percent.

Among other products, import of petrol rose in quantum terms, but its unit prices dropped to the extent that they pulled down overall import values. Petrol sales had risen at a higher rate than last year, and with domestic production declining, the gap had to be met via higher imports. In case of HSD, sales, production and imports all declined in the quarter, in response to lower demand for the fuel from the commercial and heavy vehicle transport segments.

Meanwhile, LNG imports rose 2.8 percent in Q1-FY20, against the much higher increase of 136.3 percent recorded last year. The entire growth in import values

<sup>19</sup> Source: WAPDA press release dated October 3, 2019.

came from the quantum side, as unit prices were down 27.4 percent during the period. The uptick in quantum imports partly reflected higher demand from the power sector, as electricity generation from LNG rose 2.1 percent during the quarter and partially compensated for the lower generation from furnace oil (**Table 5.8**).

Lastly, coal imports dropped by a sharp 41.4 percent YoY to US\$ 272.2 million during the quarter. Quantum imports and unit prices of the commodity were both lower than last year. Demand for imported coal dropped from both the power and cement sectors. In case of power, demand for imported coal dropped as the country began utilizing indigenous coal for electricity generation: a 660MW project using Thar coal began commercial operations in July 2019.<sup>20</sup> Due to this, electricity generation from coal rose 45.3 percent YoY during the quarter, and, like LNG, partially offset the decline in FO-based power generation. Meanwhile, coal import demand from the domestic cement industry also fell, as production dropped 1.5 percent in the quarter, with manufacturers facing uncertain demand dynamics. The lower production reduced their demand for coal, which is a major raw material for the industry.

#### Non-energy imports

Pakistan's non-energy imports declined 22.5 percent to US\$ 8.0 billion in Q1-FY20, after dropping 5.6 percent YoY in Q1-FY19. Unlike last year, the decline this year was fairly broad-based and not just led by machinery group.

The heaviest declines were noted in raw materials and products whose: (i) prices had shot up considerably in the domestic market following the Pak rupee depreciation and regulatory measures (including tariff hikes); and (ii) inventories had built up. These included fertilizer, cars (both CBUs and CKDs), and iron and steel. Furthermore, lower global palm oil prices also contributed to the sizable drop in the commodity's import values.

The largest drop was noted in DAP fertilizer, whose imports declined 72.4 percent during Jul-Sep. The decline came as fertilizer manufacturers continued to draw down existing inventories (which had reached a record high by September 2018), instead of going for additional imports (**Figure 5.16**).<sup>21</sup> Another possible reason was the 8.1 percent rise in average DAP prices, which led to lower demand for the

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<sup>20</sup> The power plant is among the early harvest CPEC projects (source: <https://www.engroenergy.com/businesses/engro-powergen-thar-private-limited-ept/>).

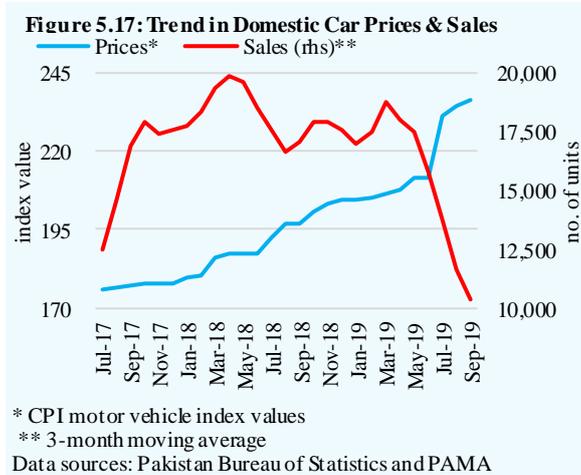
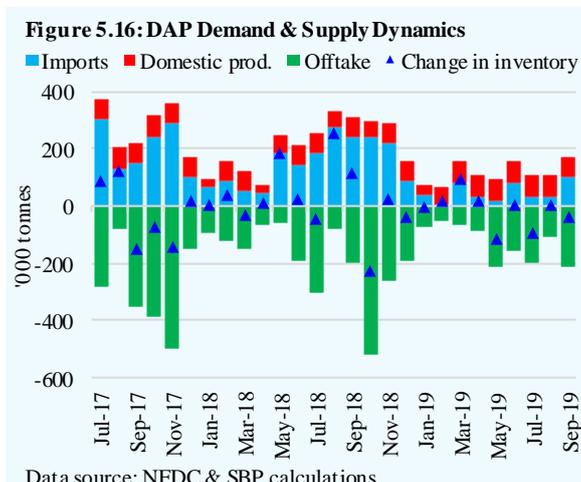
<sup>21</sup> This point was also asserted by the country's largest DAP manufacturer, Fauji Fertilizer Bin Qasim Ltd, in its Annual Report for FY19.

input.<sup>22</sup> The decline in DAP imports was sufficient enough to offset a rise in urea imports in the quarter, and led overall fertilizer imports to drop 62.9 percent YoY.

Among other non-energy products, transport imports dropped by a sizable 32 percent in Q1-FY20, after declining by 17.3 percent in Q1-FY19.

Unlike last year, the decline this year was driven mostly by cars and buses. The significant increase in local car prices – reflecting the cumulative impact of the Pak rupee depreciation, imposition of FED on new car sales and hike in regulatory duties on auto part imports – and the resultant shrinkage in demand, have all contributed to a slump in car sales (Figure 5.17) and led to a build-up of inventory with auto assemblers.

Imports of CBUs fell more drastically than those of CKDs, mainly because CBU imports are now effectively only limited to local auto assemblers, instead of commercial car dealers. After the tightening of regulations governing used car imports last year, CBU imports by car dealers have virtually come to a standstill. Also, unlike imports by car dealers in the past, the CBU units currently imported by auto companies



<sup>22</sup> The higher prices mainly reflect the impact of the Pak rupee depreciation, given that the bulk of local DAP supplies comes from imports as opposed to domestic production. Therefore, while the hike in gas tariffs in July 2019 raised fertilizer manufacturer's production costs, the same has likely played a smaller role in pushing up DAP prices.

tend to be luxurious vehicles with limited demand from a niche clientele.<sup>23</sup> Both these factors have led to a more pronounced decline in CBU imports. For CKDs also, heavier declines in imports were noted for the higher-tier variants (above 1,500cc) than for others.

Meanwhile, imports of raw materials and finished products for the auto and construction-allied industries, such as iron and steel and old ships for shipbreaking, continued on the downward trajectory that had begun last year. Cumulative iron and steel imports (both finished products and scrap) declined 23 percent to US\$ 759.3 million. Within this category, imports of cold steel sheets and varnished sheets, typically used to make car body panels, declined heavily, reflecting lower demand from auto assemblers.

In the food group, imports of palm oil dropped 25.4 percent YoY to US\$ 362.4 million, in response to both lower import quantum and unit prices. The drop in quantum imports is the first since Q3-FY17, and is explained by multiple factors. First, some switching to soybean oil is evident, as quantum imports of that commodity have risen this year. And second, edible oil mills had been stockpiling palm oil throughout last year as international prices had trended downwards and uncertainty abounded about the extent of the ongoing Pak rupee adjustment. That stockpiling activity seems to have ended now, leading to a decline in import demand for the commodity.

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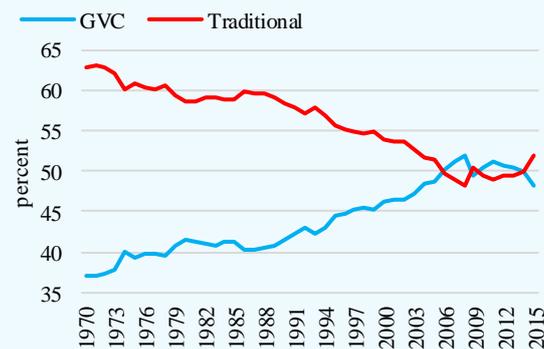
<sup>23</sup> These include high-end sedans and SUVs that are imported by auto companies like Audi (all models), Toyota (Rush, Camry, Land Cruiser) and Honda (Accord). Suzuki's Ciaz, which is also imported as a CBU, is relatively lower priced as compared to the other vehicles cited above. In contrast, vehicles imported by commercial car dealers before tightening of regulations were predominantly in the small engine car category (660-1,000cc).

## Special Section 1: Global Value Chains (GVCs) – Implications for Pakistan

### S1.1 Introduction

Global Value Chains (GVCs) had been the most prominent force behind globalization and world GDP growth during 1995-2008.<sup>1</sup> Over the past two decades, the scale and patterns of global trade have become organized around and governed by the GVCs. This is evident from the fact that GVC-related trade accounts for 48.1 percent of the total global trade (Figure S1.1).

Figure S1.1: Decomposition of International Trade between Traditional Networks and Global Value Chains



Data source: World Bank (2019); Johnson and Noguera (2017)

In light of the above, this section intends to: (i) highlight the importance of GVCs and comment upon the emerging trends with regards to their structure and organization; (ii) present stylized facts about the current position of Pakistan in the GVCs; and (iii) elaborate upon the policy implications and the way forward for the country to enhance its integration with the global production networks. In particular, the section makes the case that without increasing its share in the GVCs, it will be challenging for Pakistan to achieve sustainable export-led growth.

### S1.2 Importance of Global Value Chains

GVCs are enterprise networks in which the production of a certain commodity/service crosses at least one border, and typically many borders, before final assembly or provision. For instance, production design and engineering elements of the iPhone are finalized in the US, while the assembling and packaging is outsourced to countries like China and Vietnam; these, in turn, use components shipped from countries such as South Korea and Japan to produce the final output. The product would then be re-exported to the US (and other destination economies) to be marketed and sold in its final form.

The reason that GVCs have become so important over the past two decades is that they have provided the means for countries to overcome indigenous resource

<sup>1</sup> Source: Measuring and Analyzing the Impact of GVCs on Economic Development, Washington DC, World Bank (2017).

dependency by enabling them to import raw material and intermediate inputs and adding value to them via further processing. This has had a two-fold impact. First, the countries have been able to develop those industries in which they might have a competitive advantage, even if resources for the same were not available domestically at all, or if the local resources were of an inferior quality or in less abundance (*backward integration*). Second, it allows countries to export locally manufactured/processed items in raw or unfinished form (*forward integration*) in which they might not have a competitive advantage over the full value addition cycle. This leads countries that are integrated with the GVCs to achieve sustainable growth patterns in their exports that are also more aligned with the overall global demand.

As mentioned before, GVC participation has allowed many countries to increase their exports, even when local availability for the required resources of production were negligible or absent. For instance, despite having negligible local raw materials (cotton or synthetic fiber), Bangladesh has consistently expanded its garment export base – a process within the overall textile value chain where it had competitive advantage in terms of cheaper labor. This, in turn, led the country to import intermediate goods from economies that had a competitive advantage in producing those (for example, Pakistan and India for fabric and yarn). As Bangladesh's participation in the GVCs rose, it was able to consolidate its presence in Europe and North America's apparel markets.<sup>2</sup> Today, Bangladesh is the second biggest exporter of apparel and clothing accessories in the world, second only to China. It is important to recall here that garments alone account for over 85 percent of Bangladesh's total exports, and have been the major engine of growth for the economy. The increasing integration of its firms with GVCs has thus helped the country become the fastest growing economy in South Asia over the past couple of years.

Vietnam is another success story. In the mobile manufacturing segment, for instance, Vietnam focuses primarily on production of outer structures and final assembling, and imports high-tech components such as semiconductors, displays and turnkeys from countries like the US, Taiwan, Korea and China. Those countries have competitive advantages in producing technology-intensive products

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<sup>2</sup> Alongside integration with the GVCs, factors such as liberal investment and trade policies, focus on addressing structural problems, and overall macroeconomic stability also figured prominently in Bangladesh achieving consistently high export and economic growth. According to the World Bank's Bangladesh Development Update (2019), economic "output growth will be supported by strong macroeconomic fundamentals, faster implementation of public investments in megaprojects, continued movement of labor away from low productivity sectors in agriculture, higher domestic demand aided by remittances, and continued export growth as production shifts from China."

and services (design elements and engineering), while Vietnam has an edge in labor-intensive and scale-based operations, such as assembling and packaging. This led Vietnam to become the third-largest smartphone exporter in the world, and to get highly integrated with Samsung's value chain, producing 40 percent of the firm's mobile devices. Similarly, countries like Taiwan, China and South Korea were able to focus on their core competencies and further solidify their shares in the higher-end stages of the manufacturing chain.

In overall terms, GVCs have therefore resulted in substantial returns for both the advanced and emerging economies, as well as for the firms and the consumers. In developed economies, GVCs provide access to more competitively priced inputs, higher variety of goods and services, and economies of scale. For emerging economies, GVCs are viewed as a fast-track towards industrialization – where countries join existing supply chains instead of building them anew. GVC participation also helps attract more investment in the emerging economies; however, the relationship is not like-for-like, as investments also crucially depend on broader policy and institutional frameworks of an economy.

For firms, the trade, investment and knowledge flows underpinning GVCs provide mechanisms for rapid learning, innovation, and industrial advancement. Meanwhile, productivity rises as businesses relocate the least efficient production stages to concentrate on core activities. Furthermore, as a cost-saving technique, offshoring potentially raises profits that can be utilized for pursuing innovation.

### **S1.3 Restructuring of GVCs and Emerging Opportunities for Pakistan**

While countries like Vietnam and Bangladesh have reaped substantial returns in terms of export and economic growth over the past two decades via participation in the GVCs, Pakistan has been unable to establish a similar presence in the global production and supply networks. However, the following key developments pertaining to GVCs currently underway provide the country with an opportunity to realign its trade activities and improve integration within the existing and emerging global value chains.

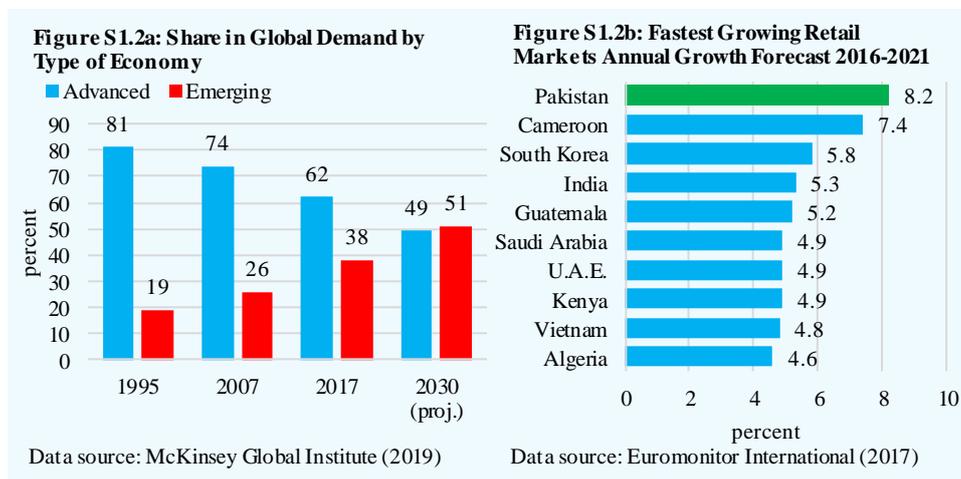
First, the manufacturing activities around the world are becoming more services-oriented. Trade flows in value-added terms reveal that transport logistics, communication, and financial services play important roles in GVCs. Resultantly, the value created by services as intermediate inputs represent over one-third of total GVA of global manufacturing, and services exports figures in gross terms

(43 percent) vastly understate the exports of services in value-added terms (21 percent).<sup>3</sup>

Second, information technologies are undergoing a revolutionary transformation. Businesses and consumers alike are transitioning from the usage of social media, analytics, and cloud computing to areas such as distributed ledger technology, artificial intelligence, reality augmentation, and quantum computing. Together, these developments stand to facilitate and increase the transfer and accessibility of information exponentially, thereby enabling more processes and activities to be fragmented and/or outsourced.

Third, with consumption patterns changing and becoming more personalized, the GVCs are also undergoing a transformation, from mass production towards mass customization. This is resulting in the creation of multiple value chains for similar products, with input materials being sourced from various locations instead of relying on suppliers from a single geographical location. The wage increases in production countries such as China are also pushing firms to relocate to alternate destinations to keep their competitive edge intact.

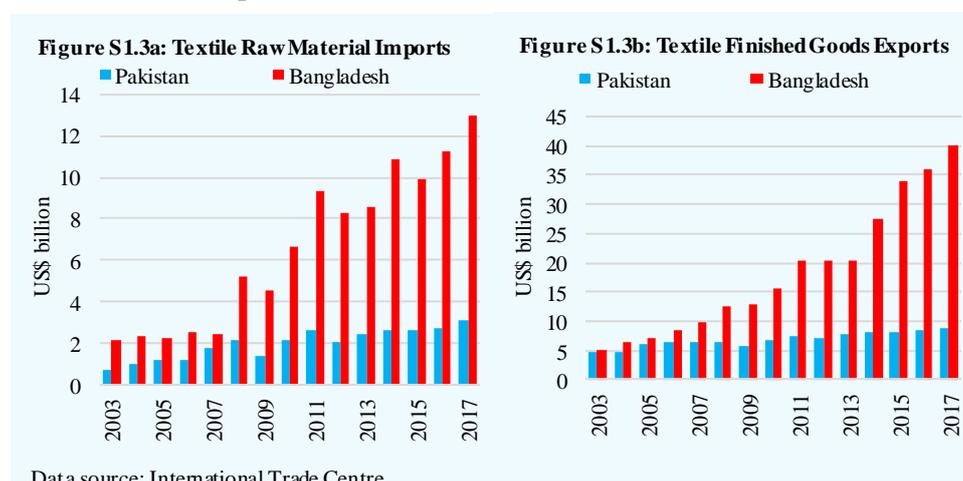
Fourth, the gradual rise in demand in the emerging economies, particularly China and India, is increasing the attraction of such destinations not only as an outsourcing market but also as a selling one. This rerouting of value chains is expected to continue over the next decade and beyond as emerging economies are



<sup>3</sup> OECD. The Future of Global Value Chains – Business as Usual or a New Normal? September 2017.

expected to achieve 50 percent share in total global demand by 2030 fueled by consistently high retail market growth rates (**Figure S1.2**).

Keeping in view these developments, Pakistan must utilize this opportunity and deepen the linkage of its manufacturing activities with the global value chains to steer its exports towards a sustainable growth trajectory, akin to Bangladesh's performance in the textile sector (**Figure S1.3**). In this backdrop, the following sub-section analyzes the potential of Pakistani firms to reorient their businesses within the established chains pertaining to textiles, electronics and ICT sectors. In the long run, the country holds the potential to target even the middle- to higher-end segments of the GVCs, given that the right mix of policies is adopted (discussed in subsequent sub-sections).



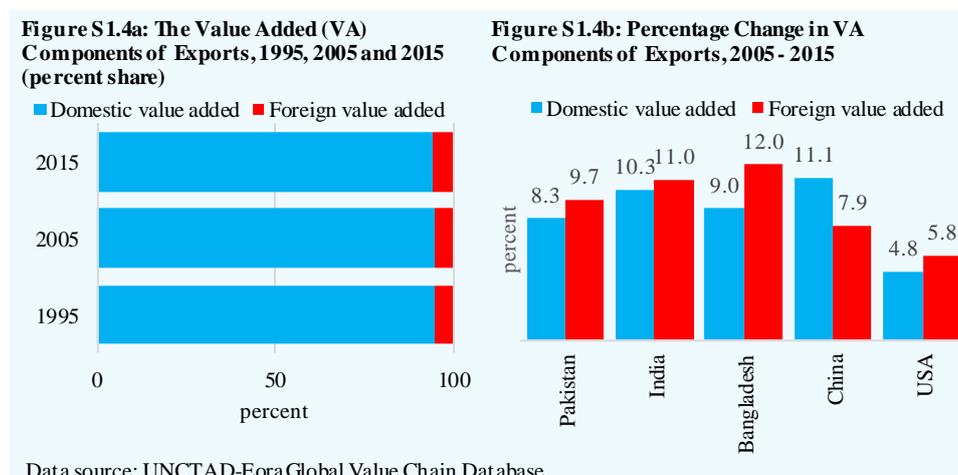
#### S1.4 Where does Pakistan Stand?<sup>4</sup>

At present, Pakistan stands among those economies that could not realize maximum benefits of integrating into GVCs across different sectors. The following stylized facts present the prominent features of the value added content of Pakistan's exports and their level of participation in global production networks.

- The value added profile of Pakistan's exports shows that the country has remained unable to achieve adequate level of foreign value addition to its exports. As shown in **Figure S1.4**, the domestic value-added content (i.e.,

<sup>4</sup> The data referred to in this section has been extracted from the EORA database. Formal citation is: Casella, B.R. Bolwijn, D. Moran and K. Kanemoto (forthcoming). Improving the analysis of global value chains: the UNCTAD-Eora Database. Transnational Corporations 26(3). New York and Geneva: United Nations.

value added of intermediate goods that are produced locally) predominantly constitutes Pakistan's exports. In contrast, the share of foreign value-added content of exports, which corresponds to the value added of inputs that were imported in order to produce intermediate or final goods/services to be exported, is quite small. Furthermore, during the span of 20 years (1995-2015), the share of foreign value added in exports inched up by only 0.7 percentage points.



- This phenomenon is also reflected in the overall composition of GVC participation of Pakistan, which is the sum of backward and forward participation in global exports. The data suggests that the share of backward participation in exports (the share of imported intermediate inputs the country used to produce exports), only reached 5.6 percent in 2015 (**Table S1.1**). This signifies two main characteristics of Pakistan's trade paradigm:
  - i. Exports have been concentrated in low value added products and primary commodities, which do not usually require processing of imported inputs; and
  - ii. The country has imposed strong trade policy distortions in the form of tariff and non-tariff barriers on imports – Pakistan's tariffs on intermediate goods are four times the average in East Asia.<sup>5</sup> This ultimately results in higher production costs for exporting firms and erode their competitiveness in the global market.

<sup>5</sup> World Bank 2020. World Development Report 2020: Trading for Development in the Age of Global Value Chains. Washington DC: World Bank

- In case of forward participation, which reflects the share of intermediate goods in Pakistan’s exports that are used as inputs in exports of other countries, Pakistan’s performance is relatively better. As shown in **Table S1.1**, 27 percent of Pakistan’s exports are used as inputs in exports of other countries. Most of these exports originate from primary agricultural commodities and low-tech manufacturing sectors (such as cotton yarn and fabric), and are shipped to China, Bangladesh and Turkey, which produce and export value-added finished products to high-end garment stores such as Zara, Marks & Spencer and H&M.<sup>6</sup>

**Table S1.1: GVC Participation Index\***

Percentage share in total exports

	Total GVC participation*		Backward participation**		Forward participation***	
	1995	2015	1995	2015	1995	2015
Singapore	80.5	70.7	68.9	57.9	11.7	12.7
Malaysia	65.5	63.3	48.4	35.5	17.1	27.8
UK	52.2	58.9	26	25.3	26.2	33.7
Vietnam	44.9	57.1	27.5	35.6	17.4	21.5
France	49.6	55.9	24.7	28.2	24.9	27.7
Germany	47.3	55.5	24.7	33.2	22.6	22.3
Turkey	43.9	51.8	19.1	28.5	24.8	23.3
Japan	39.1	46.8	9.1	19.4	30	27.5
USA	38.4	44.5	9.3	13	29.1	31.5
China	32.4	42.8	11.6	13.8	20.8	29
India	33.1	40	9.4	14	23.7	26.1
<b>Pakistan</b>	<b>26.7</b>	<b>33.2</b>	<b>4.8</b>	<b>5.6</b>	<b>22</b>	<b>27.6</b>

\* GVC Participation index is a sum of share of backward and forward participation in exports

\*\*Backward participation shows share of imported intermediate inputs the country is using in exports

\*\*\*Forward participation shows share of intermediate inputs the country is exporting to other countries

Data source: UNCTAD-Eora Global Value Chain Database

- During 2000-15, Pakistan could only increase its GVC participation by US\$ 6.7 billion (**Figure S1.5**). The country exhibited the lowest rate of GVC participation as percent of exports in 2015. This shows the low presence of Pakistani companies in the network of coordinated transactions among different layers of firms on a global scale.
- The value-added content of Pakistan’s exports is predominantly concentrated in a single sector – textiles and wearing apparels – which represent 60 percent of domestic value addition in the country’s exports. It has also added the

<sup>6</sup> For instance, the share of Pakistan in overall Bangladesh imports of denim fabric was recorded at 24.7 percent in 2018.

highest content of foreign value addition of 3.8 percent to its exports, in the form of chemical and dyes, high quality cotton, man-made fiber (MMF), etc.

- In 2015, over 50 percent of Pakistan's exports went to five countries: China, USA, Germany, Saudi Arabia and the UK. In addition, most of the exports to these countries were textiles and apparel products, with the highest share of 85.1 percent in total exports to China and the lowest of 48.7 percent in case of Saudi Arabia.

Figure S1.5: Change in Total GVCs -2000-2015 (US\$ billion)



Data source: UNCTAD-Eora Global Value Chain Database

#### Box S1.1: Strategies to Improve Participation of Existing Exporting Sectors in GVCs

In order to increase participation along the GVCs, a low-hanging fruit can be to target sectors where domestic players already have established global relationships, such as textiles and Business Process Outsourcing (BPO). This strategy would not only provide an opportunity to deepen the present relationships, but also allow firms to branch out and diversify both their product base (towards higher value-added items) and geographic sources/destinations. Going forward, however, Pakistan must tap sectors, such as light engineering, appliances manufacturing and services, whose shares in GVC trade are consistently rising.

In light of the above, this section builds upon the prospects of Pakistan's current exporting sectors to engage in the evolving GVCs, using the World Bank and Duke University's Global Value Chains Center studies for exporting sectors including textiles, medical devices and offshore services.<sup>7</sup>

##### a. Textiles

During FY19, Pakistan's apparel exports (comprising knitwear and readymade garments) fetched US\$5.4 billion; exports had risen steadily over the last two decades and grown by nearly 200 percent since FY00. However, the sector could not tap the growing demand in the product categories offering higher unit values, like those based on man-made fiber (MMF); instead, exports are concentrated in cotton-based products, which fetch lower unit prices. Besides, the sector also lacks some vital links in the value addition processes that, if focused upon, could generate more earnings as compared to conventional processes. For instance, firms are clustered around low value stages of Original Equipment Manufacturers (OEMs), and the second tier Cut, Make & Trim providers (CMTs); active participation is missing at the most value added stages of GVCs i.e., Original Brand Manufacturers (OBMs) and Original Design Manufacturers (ODMs). The absence of links with OBMs and ODMs explains the lack of product diversity and upgradation in the country's apparel sector.

<sup>7</sup> This section also draws heavily from discussions with stakeholders in the relevant industries.

Being the world’s 5th largest cotton producer, Pakistan has relatively easier access to a major input for apparel-making, which facilitates backward linkages in the value addition process. In addition, the sector also has a competitive edge over regional peers in the form of: i) low labor wages; ii) GSP+ access to EU markets; iii) domestic ownership of firms and their vertical integration; and iv) an extensive network of supportive institutions at each stage of the value chain.<sup>8</sup> Realizing these benefits, the apparel sector has achieved moderate success in product upgradation: in 2016, the country stood 3rd in unit value associated with denim-trouser export and 6th in terms of quantum exports. Some of the country’s leading firms have started to contribute in the supply chain of global brands such as Target, the Gap, Levi’s, and C&A etc.

**b. Medical Devices**

Pakistan has a long history of exporting surgical instruments, exhibiting an edge in the manufacturing of metallic instruments. Besides low wage labor, established capacities for a wide range of products and a geographically concentrated production hub in a single city – i.e. Sialkot – assists the industry to cater to the growing global demand.<sup>9</sup>

However, Pakistan does not currently have a strong foothold in the medical devices industry. In terms of the sector’s linkages with the GVCs, 98 percent of the local participation is concentrated in the precision metal instruments segment (**Table S1.1.1**). Resultantly, the leading firms (MNEs) that dominate the global medical devices business did not actively invest in Pakistan’s domestic industry, and instead set up their production facilities in Malaysia (Penang), Mexico (Baja California), and the Dominican Republic (Santo Domingo) etc. This MNE investment significantly contributed to the product and process upgradation of local industries in those countries.

**Table S1.1.1: Presence of Pakistan’s Firms in Medical Device GVCs**

Research & development	Component manufacturing	Assembly	Distribution	Marketing & sales	Post-sales services
Prototype	Software dev.	Assembly	Capital equipment	Cardiovascular	Training
Process development	Electronic/elec. comp.	Packaging	Therapeutic devices	Orthopedics	Consulting
Regulatory approval	Precision metal works	Sterilization	Surgical & medical Inst.	General surgery	Complains management
Sustaining eng.	Plastic extrusion		Disposables	Infusion systems	Maintenance/repair
	Weaving knit. text.		Consumables	Others	

Highlighted cells indicate areas where Pakistani firms have a presence in the GVCs  
 Data source: World Bank and Duke University’s Global Value Chains Center

Since Pakistan has basic infrastructure to tap the growing demand in the medical devices industry, diversification and inter-sectoral upgradation in products and processes will be key to increase

<sup>8</sup> The export-oriented sectors in Pakistan, including textiles, are also provided with concessionary borrowing facilities such as SBP’s Export Finance Scheme (EFS) and Long Term Financing Facility (LTFF).

<sup>9</sup> Currently, few firms in the medical device industry have ventured into relatively advanced product markets, such as endoscopic instruments, liposuction accessories, biopsy punches and implantable staples.

**Table S1.1.2: Pakistan's Exports of ICT Services Value Chain**

	In million US\$			CAGR
	FY06	FY10	FY19	(FY06-19) (percent)
<b>a. Information Technology Outsourcing</b>				
Software consultancy services	18.1	31.4	354.6	25.7
Export / Import of computer software	46.7	124.2	279.5	14.8
Other computer services	5.9	29.6	155.0	28.5
<b>b. Knowledge Process Outsourcing</b>				
Research and development services	3.8	5.2	17.3	12.4
Legal services	5.8	18.3	19.0	9.5
Accounting, auditing, bookkeeping, and tax consulting services	17.3	4.0	34.7	5.5
Business and management consulting and public relations services	47.2	87.5	144.8	9.0
Advertising, market research, and public opinion polling	20.0	20.9	108.8	13.9
<b>c. Business Process Outsourcing</b>				
Call centers	0.0	16.6	98.7	NA
<b>d. Vertical Activities</b>				
Financial services	70.1	89.7	107.8	3.4
Insurance and pension services	28.6	41.8	45.0	3.6

Data source: SBP

participation in the GVCs. The current initiatives of setting up SEZs and EPZs (with customary benefits such as tax holidays, duty free exports/imports, equity ownership etc.) may attract leading firms, entailing positive spillover for the local industry. Lastly, product diversification in new segments, such as apparatus used in minimally invasive surgeries, disposable items, medical textile items, therapeutics and implantable devices, may assist the local industry in carving out a sizeable share in the upscale GVCs.

### c. ICT Services

ICT services are one of the most promising areas for Pakistan's future exports. The sector, which was almost non-existent in the early 2000s, grew extensively during the last decade. This is evident from the double-digit growth in exports of segments such as software consultancy services, call centers and other software and computer services during FY06-FY19 (**Table S1.1.2**).

The latest available estimates suggest that in terms of revenues, the market size of global offshoring services ranges from US\$262 billion to US\$1.3 trillion (as of 2017). The global value chain of offshore services has three horizontal segments: Information Technology Outsourcing (ITO), Business Process Outsourcing (BPO) and Knowledge Process Outsourcing (KPO), and a vertical segment that pertains primarily to the financial sector. In terms of magnitude, ITO dominates with 52 percent of total deal values in 2017, followed by KPO with 18 percent share.<sup>10</sup>

In comparison to mature markets like India, Philippines, Sri Lanka, Mexico etc., Pakistan's share in global offshore services exports is minimal, at 0.1 percent. Most of the activities of Pakistan's offshore services firms are concentrated around low value added services in ITO and BPO, which have a cumulative share of 65 percent in total offshore services; very few firms are active in vertical and knowledge process outsourcing.

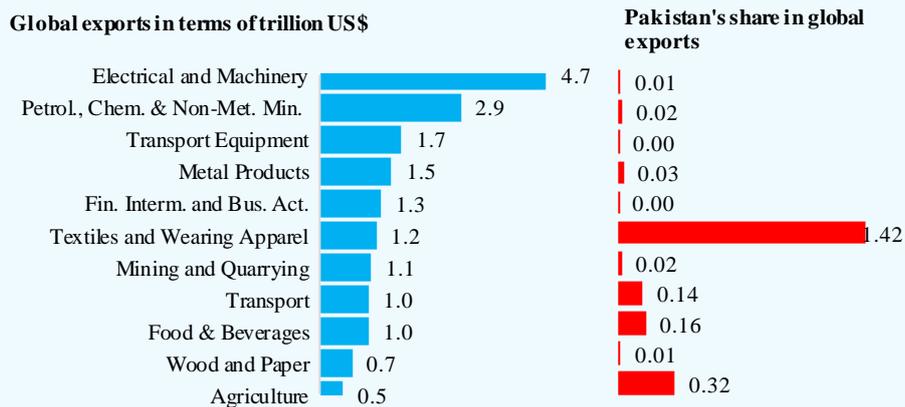
<sup>10</sup> 'Global IT-BPO Outsourcing Deals Analysis,' Annual Analysis for 2017, KPMG (2017).

### S1.5 Policy Implications and the Way Forward

To increase traditional exports, countries have relied on updating their investment policies, signing free trade agreements and bilateral investment treaties with strategic partners, becoming a part of regional trade associations, and loosening FDI and labor regulations, etc. However, a key distinction in terms of GVC exports is that they require liberalization of a country’s import policy, particularly pertaining to raw and intermediate products and services. This is vital to ensure businesses’ participation in both backward and forward value chain processes.

Currently, sectors such as electrical & machinery, petroleum, chemical, mineral, transport equipment, metal products and financial intermediaries & business activities, capture the first five positions in terms of global export revenues. However, Pakistani firms have marginal presence in these sectors at the global level (**Figure S1.6**).

**Figure S1.6: Exports of Major Sectors and Pakistan's Share in Global Exports (2015)**



Data source: UNCTAD-Eora Global Value Chain Database

Given the level of innovation, automation techniques and human skills that some high-tech industries require, it would be challenging for Pakistan to pursue them over the short- to medium-term. As mentioned before, the existing base of infrastructure in the country’s current exporting sectors (textile, leather, and offshore services etc.) may be utilized effectively to tap GVCs in the low value added segments in the first stage. The participating firms may eventually venture into more complex processes, once fully realizing their comparative advantage in the existing products and processes. Furthermore, the importance of human capital development cannot be overstated. Particularly, the labor-intensive and low-skilled manufacturing activities in which Pakistani firms trade the most in the GVCs, are the most susceptible to disruption under the ongoing global automation

and digitization drive. More importantly, if the country aspires to become a noteworthy participant in the high-growth areas such as ICT and financial intermediation services, substantial investment would be required to prepare the workforce for the evolving demands of those industries.

***Designing an adequate and effective institutional framework is necessary to facilitate growth of domestic businesses***

As illustrated in detail in the Annual Report of FY19, a major reason for the constrained investment and business climate in Pakistan is the difference between the *de jure* and *de facto* policy environments for domestic investors.<sup>11</sup> In particular, the existing investment landscape is deficient in terms of facilitation for local businesses, partly due to issues on the contract enforcement and dispute resolution fronts, as well as inadequate guidance and policy communication practices of the relevant supervisory and regulatory government authorities. This results in investors finding it hard to carry out and expand their business activities over the medium- to long-term. The unfavorable tax environment also merits a special mention, with domestic firms facing cumbersome documentation procedures, incidences of corruption, and an overall lack of ease on the tax administration front.

Encouragingly, substantial improvement in the business climate has been observed over the past couple of years. This is evident from the 39 point jump in Pakistan's standing in the World Bank's Ease of Doing Business rankings, from 147<sup>th</sup> in 2017 to 108<sup>th</sup> in 2019. However, it is vital now for the government to ensure that these improvements are not only maintained but also built upon further. Here, emphasis should be on the establishment of clear communication and policy advocacy channels for businesses; enhanced cooperation between federal and provincial authorities to minimize policy uncertainties and complexities; targeted incentive programs for domestic firms showing growth potential as well as integration capability within the GVCs; and a stronger role of the state bodies to lead investments in sectors deemed important for long-term objectives.

***Attracting and integrating with MNEs must be a priority***

It is widely held that a major reason for the increased GVC-related trade activities over the past two decades is the rising popularity of multinational enterprises (MNEs).<sup>12</sup> These corporations, with their dispersed and vertically integrated

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<sup>11</sup> For details, please see Chapter 7 titled "Factors Constraining Investments in Pakistan: Beyond the Macroeconomics" in the SBP's FY19 Annual Report on the State of Pakistan's Economy.

<sup>12</sup> See, for example, Baldwin, R. (2016), *The Great Convergence, Information Technology and the New Globalization*, Harvard University Press and Dicken, P. (2015), *Global Shift: Mapping the Changing Contours of the World Economy*, Seventh edition, Guilford Press, New York.

operational footprints, are particularly important for the developing economies. This is because they provide an opportunity to easily integrate in the already established global production networks. According to recent estimates, MNEs account for around one-third of the global output and 80 percent of total world exports.<sup>13</sup> In particular, of the production by foreign affiliates of MNEs – which grew from US\$ 7 trillion to US\$ 20 trillion between 2000 and 2014 – around 60 percent consists of intermediate goods and services to be used for production of final products across the various GVCs.

Encouragingly, the government has introduced various reforms to improve and broaden the scope of the Board of Investment (BOI) in the areas of grievance handling, dedicated country- and sector-specific task forces, investment tracking services and policy advocacy channels, etc. The efforts on this front have been acknowledged in the World Bank’s Doing Business rankings as well. If such measures are continued, they would attract investors and MNEs into the country going forward.

***Pakistan needs to liberalize its trade policy***

Pakistan was late in initiating trade liberalization policies compared to the regional economies at the start of the century.<sup>14</sup> This had a twofold impact. First, higher tariffs meant that the input costs were higher than for peer economies, resulting in lost competitiveness. Second, by the time the country finally started rationalizing the tariff lines, many of the competitors had already forged international trade relationships with buyers and suppliers; this meant that Pakistan missed the first-mover advantage just when complex GVCs were gaining traction.

While the tariff liberalization process in Pakistan since the start of the 2000s has been substantial, the applied rates are non-uniform across sectors. This has meant that some industries, such as automobile and steel, have continued to enjoy higher protection, which fueled an anti-export bias. The protectionist policy stance is also augmented by the imposition of various regularity duties (RD) on imported items – a measure that was initially adopted as a temporary tool to tackle the balance of payments crisis of FY08, but gained in scope and applicability over

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<sup>13</sup> Cadestin, C., De Backer, K., Desnoyers-James, I., Miroudot, S., Ye, M., & Rigo, D. (2018). Multinational Enterprises and Global Value Chains: New Insights on the Trade-Investment Nexus. OECD Science, Technology and Industry Working Papers, 2018(5), 0\_1-36. The estimates provided in the study were obtained by taking into account the MNEs’ “arms-length” trade (i.e. trade between MNEs and final consumers or non-MNE firms), intra-firm trade (i.e. trade within MNEs between affiliates or with the parent company) and trade between companies that have no ownership link but are associated through franchising, licensing or other forms of contractual relationships.

<sup>14</sup> World Bank. 2006. Pakistan - Growth and Export Competitiveness. Washington, DC.

time as a revenue-generating tool for the government. Hence, there is an urgent need to correct this trend.

According to the World Economic Forum's Competitiveness Index rankings of 2019, Pakistan stands at 138<sup>th</sup> position in terms of *trade openness* out of 141 countries. By contrast, regional competitors such as Vietnam and Bangladesh stand at 91<sup>st</sup> and 119<sup>th</sup> positions, respectively, and fare better in indicators like the prevalence of non-tariff barriers, trade tariff rates, tariff complexity, and border clearance efficiency.<sup>15</sup> Pakistan's ranking is particularly weakened by below-par performance in the *trade tariffs* sub-index, where Pakistan ranks at 139<sup>th</sup> out of 141 economies.

From the policy perspective, the authorities should strive to streamline and rationalize trade tariffs by committing to a minimal and uniform structure in order to encourage export-orientation. Furthermore, policy coordination between the trade policy setting authorities (such as the Ministry of Commerce) and para-tariff implementation bodies (such as FBR) is vital to strike an efficient balance between trade liberalization and the revenue generating objective of the government. This would bring much needed clarity and transparency to the import policy, thereby reducing uncertainty and improving businesses' confidence and access to competitive inputs for value-addition and re-exporting purposes.

***Focus should be on trade logistics and facilitation***

Faster and smoother trade flows are important with regards to conventional trade activities, and they become even more so under the GVC model. Pakistan can vastly improve its trade potential in the GVCs by enhancing the state of trade-related infrastructure and service provision in the country. At present, Pakistan performs poorly amongst selected peer economies in terms of *customs, infrastructure, international shipments and logistics competence, and timeliness* (Table S1.2). Cumbersome documentation requirements, delays in clearance, high port traffic, and poor record of timeliness has led to a fall in the country's ranking in the World Bank's Logistics Performance Index to 122<sup>nd</sup> in 2018, from 110<sup>th</sup> in 2010.

Digitization of customs procedures, liberalizing transport services and further investment in road, railway and port physical infrastructure can go a long way towards addressing this deficit. Add in the changing demand dynamics that call for increased customization and reduced delivery times, and the need for an

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<sup>15</sup> Global Competitiveness Report 2019: *How to End a Lost Decade of Productivity Growth*. World Economic Forum.

efficient logistics and clearance mechanism becomes paramount. In fact, this is primarily the reason many economies are transitioning towards adopting multinational transport corridors to standardize and streamline customs and logistics operations along the value chains. This leads to the next requirement, which is increasing Pakistan’s trade integration with the regional economies.

**Table S1.2: Adjusted Logistics Performance Index Rankings\*# - A Regional Comparison**

	LPI Rank	Customs	Infra-structure	Int. shipments	Logistics	Timeliness	Change in 2018/2010 LPI ranking
China	27	30	24	18	27	29	0
India	42	43	48	38	39	50	3
Vietnam	45	51	54	45	40	47	14
Philippines	64	70	71	39	64	83	-16
Pakistan	95	104	100	79	80	112	-12
Bangladesh	100	120	109	99	94	108	-21

\*The Adjusted LPI combines the four most recent (2012, 2014, 2016 and 2018) LPI surveys to generate a “big picture” to better indicate countries’ logistics performance.

#Ranking out of 163 countries

Data source: World Bank Logistics Performance Index

***Pakistan has to increase trade integration with regional economies to reap welfare and trade gains***

Perhaps the near-absence of regional trade is one of the weakest links in Pakistan’s overall trade dynamics. Other than China, Pakistan’s trade relationships with regional economies are substantially below-par. In particular, the intraregional trade between the South Asian economies, marred principally by chronic geopolitical tensions, has been found to be less than one-third of the potential, with the gap widening each passing year.<sup>16</sup> Not surprisingly, evidence shows that the share of regional GVC trade between South Asian economies in the total global GVC trade has been just 0.8 percent, the lowest between 1990 and 2015, according to the EORA database. For comparative purposes, intra-regional trade of Europe and Central Asia accounts for 43.1 percent of the total worldwide GVC trade. High trade barriers merit a particular mention here. South Asian economies enact trade restrictive policies to a greater extent on their regional counterparts compared to the rest of the world (**Figure S1.7**).

Encouragingly, progress under the China-Pakistan Economic Corridor (CPEC) provides Pakistan with the opportunity to link closely with the Central Asian and

<sup>16</sup> Unlocking the Potential of Regional Economic Cooperation and Integration in South Asia: Potential, Challenges and the Way Forward, SSWA Books and Research Reports, UNESCAP South and South-West Asia Office (2018).

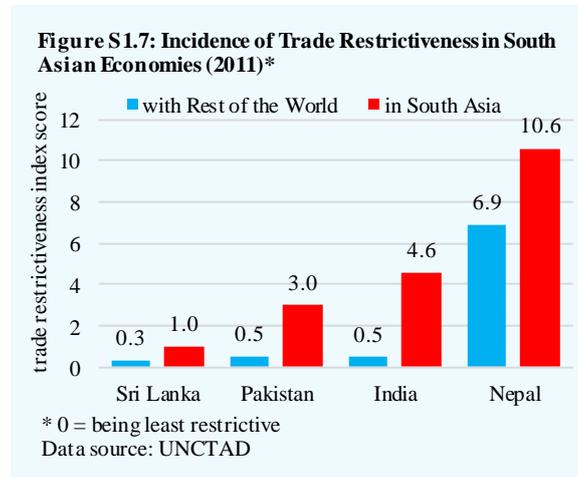
other Belt and Road Initiative (BRI) member states.

However, the South Asian states must also loosen their trade policy stances with respect to each other in order to net substantial welfare and trade gains.

***Finally, the services sector exports of the country must be enhanced***

Although the services sector's share in the country's GDP and labor force has continued to

increase, its exports have not risen commensurately. However, with the *servicification* of the manufacturing sector underway across the globe, the importance of the services sector is rising with respect to the GVCs.<sup>17</sup> In this regard, Pakistan must strive to increase its services exports to improve integration with the global production networks.



Recently, there has been palpable progress on this front. The Ministry of Commerce has recently introduced the draft E-Commerce Policy, while the SBP has released the draft Electronic Money Institutions Guidelines. Both stand to work under the ambit, and complement the associated objectives, of the Digital Pakistan Policy released by the Ministry of IT and Telecom. Likewise, numerous incubators and accelerators are increasingly financing and facilitating startups under the domain of 4IR (cloud computing, data analytics, ICT, 3D-printing, and reality augmentation, etc.). In the medium- to long-term, the direct benefit of such efforts would be an increase in the country's IT exports, while indirectly the focus on technological advancement would result in increasing the productivity and competitiveness of the manufacturing and agricultural products. Both these developments are vital to ensure a sustainable and meaningful integration of the domestic firms in the GVCs going forward.

<sup>17</sup> Raei, F., Ignatenko, A., & Mircheva, B., Global Value Chains: What are the Benefits and Why Do Countries Participate? IMF Working Paper No 19/18 2019.

## Annexure: Data Explanatory Notes

- 1) GDP:** SBP uses the GDP target for the ongoing year, as given in the Annual Plan by the Planning Commission, for calculating the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.
- 2) Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation } (\pi_{\text{Ht}}) = \left( \frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation } (\pi_{\text{YoYt}}) = \left( \frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation } (\pi_{\text{MoMt}}) = \left( \frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where  $I_t$  is consumer price index in  $t^{\text{th}}$  month of a year.

- 3) Change in debt stock vs. financing of fiscal deficit:** The change in the stock of public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing,

whereas borrowing is adjusted for government deposits with the banking system, when calculating the financing data; (ii) changes in the stock of debt also occur due to changes in the exchange rate, which affects the rupee value of external debt, and (iii) the movement of various other cross-country exchange rates also affect the US Dollar rate and, hence, the rupee value of external debt.

**4) Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

*Borrowing from State Bank:* The federal government may borrow directly from SBP either through the “Ways and Means Advance” channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). The Ways and Means Advance is extended for the government borrowings up to Rs 100 million in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum.

*Borrowing from scheduled banks:* This is mainly through the fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs). The Government of Pakistan also borrows by auctions of 3, 5, 10, 15, 20 and 30 year Pakistan Investment Bonds (PIBs). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, public debt, debt servicing, foreign trade, etc., often does not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases are given below:

**(a) Financing of budget deficit (numbers reported by MoF vs. SBP):**

There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

**(b) Foreign trade (SBP vs. PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on exchange record data, which depends on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif).

In addition, the variation in import data also arises due to differences in data coverage; e.g., SBP import data does not include non-repatriable investments (NRI) by non-resident Pakistanis;<sup>1</sup> imports under foreign assistance; land-borne imports with Afghanistan, etc. In export data, these differences emerge as PBS statistics do not take into account short shipments and cancellations, while SBP data does not take into account land-borne exports to Afghanistan, export samples given to prospective buyers by exporters, exports by EPZs, etc.

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<sup>1</sup> The non-repatriable investment (NRI) consists of small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad and the purchases made from the *duty-free shops*.

## Acronyms

ADB	Asian Development Bank
AJK	Azad Jammu and Kashmir
APCMA	All Pakistan Cement Manufacturers Association
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BOI	Board of Investment
BoP	Balance of Payments
BPO	Business Process Outsourcing
bps	Basis points
BRI	Belt and Road Initiative
CAD	Current Account Deficit
CAGR	Compound Annual Growth Rate
CBU	Completely Built Up
CKD	Completely Knocked Down
CNIC	Computerized National Identity Card
CPEC	China–Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
CY	Calendar Year
DAP	Diammonium Phosphate
ECC	Economic Coordination Committee
EFF	Extended Fund Facility
EFS	Export Finance Scheme
EM	Emerging Market
EU	European Union
FAO	Food and Agriculture Organization
FASTER	Fully Automated Sales Tax e-Refund
FATA	Federally Administered Tribal Areas
FBR	Federal Board of Revenue
FCA	Federal Committee on Agriculture
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FMCG	Fast-Moving Consumer Goods

FO	Furnace Oil
FPI	Foreign Portfolio Investment
FRDLA	Fiscal Responsibility and Debt Limitation Act
FX	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GSM	Global System for Mobile
GSP	Generalized System of Preferences
GST	General Sales Tax
GVA	Gross Value Added
GVCs	Global Value Chains
GWh	Gigawatt
HEC	Higher Education Commission
HIES	Household Integrated Economic Survey
HSD	High Speed Diesel
IBA	Institute of Business Administration
ICT	Information and Communications Technology
IDB	Islamic Development Bank
IFI	International Financial Institution
IMF	International Monetary Fund
INR	Indian Rupee
IPP	Independent Power Producers
ISIC	International Standard Industrial Classification
ITO	Information Technology Outsourcing
KERO	Kerosene Oil
KP	Khyber Pakhtunkhwa
KPO	Knowledge Process Outsourcing
LDO	Light Diesel Oil
LNG	Liquefied Natural Gas
LPI	Logistics Performance Index
LSM	Large scale manufacturing
LT	Long-term
LTFF	Long term Financing Facility

LTV	Loan-to-value
MMBTU	Metric Million British Thermal Unit
MMF	Man Made Fiber
MNEs	Multi National Enterprises
MNFSR	Ministry of National Food Security and Research
MoF	Ministry of Finance
MPC	Monetary Policy Committee
MRTBs	Market related Treasury Bill
MT	Metric Ton
MUFAP	Mutual Funds Association of Pakistan
NBFI	Non-Banking Financial Institution
NCPI	National Consumer Price Index
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Asset
NFC	National Finance Commission
NFDC	National Fertilizer Development Center
NFNE	Non-food-non-energy
NHA	National Highway Authority
NPK	Nitrogen, Phosphorus, and Potassium
NPL	Non-performing loan
NPSS	National Payment Systems Strategy
NSS	National Savings Scheme
NTDC	National Transmission and Dispatch Company
OCAC	Oil Companies Advisory Council
OECD	Organization for Economic Co-operation and Development
OGRA	Oil and Gas Regulatory Authority
OICA	Organisation Internationale des Constructeurs d'Automobiles
OMO	Open Market Operation
OTEXA	Office of Textiles and Apparel
PAEC	Pakistan Atomic Energy Commission
PAMA	Pakistan Automotive Manufacturers Association
PBS	Pakistan Bureau of Statistics

PEPCO	Pakistan Electric Power Company
PIB	Pakistan Investment Bond
PKR/Rs	Pakistan Rupee
POL	Petroleum, Oil and Lubricants
PRI	Pakistan Remittance Initiative
PRMI	Pakistan Regulatory Modernization Initiative
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PTA	Pakistan Telecommunication Authority
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
RCPI	Rural Consumer Price Index
RD	Regulatory Duties
REER	Real Effective Exchange Rate
RPI	Relative Price Index
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SRO	Statutory Regulatory Order
SSP	Single Superphosphate
ST	Short-term
SUV	Sports Utility Vehicle
T-bills	Treasury bills
TDAP	Trade Development Authority of Pakistan
UAE	United Arab Emirates
UCPI	Urban Consumer Price Index
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNESCAP	The United Nations Economic and Social Commission for Asia and the Pacific
US\$	US dollar
USA/US	United States of America
WAPDA	Water and Power Development Authority

WeBOC	Web-Based One Custom
WEO	World Economic Outlook
WHT	Withholding tax
WTO	World Trade Organization
YoY	Year on Year