THE STATE OF PAKISTAN'S ECONOMY

Second Quarterly Report
for the year 2017-18 of the
Board of Directors of State Bank of Pakistan

State Bank of Pakistan

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1 Overview

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

Table 1.1: Selected Economic Indicators

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

[P] Provisional. [1]Percent change in December over June.
ONMMR: Overnight money market rates; PR: Policy rate
Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Ministry of Finance.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

1.1 Review of H1-FY18

Real Sector

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

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

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

Inflation and Monetary Policy

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

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

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

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

Fiscal Sector

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

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

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

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

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

External Sector

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

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

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

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

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

1.2 Outlook

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

Table 1.2: Key Macroeconomic Targets and Projections

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

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

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

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

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

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

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

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

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

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

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

2 Real Sector

2.1 Overview

Preliminary information on major sectors of the economy indicates that GDP growth in FY18 will surpass last year's level. The prospects of achieving the 6 percent growth target set for the year, however, appear less likely. This assessment stems from unfavorable developments in Q2-FY18, which led to a loss of some of the momentum achieved during the first quarter. On the agriculture front, lower-than-targeted wheat crop may eclipse the healthy performance of *kharif* crops, while the latest cotton arrival figures also point towards a downward revision.[1] Meanwhile, the growth in large-scale manufacturing (LSM) decelerated to 1.6 percent during Q2-FY18 against a strong 9.9 percent growth witnessed in the preceding quarter.

Delays in sugarcane crushing – despite a record harvest – overshadowed the otherwise broad-based growth in the sector. This is evident from the fact that the LSM growth excluding sugar, at 4.5 percent in Q2-FY18, was higher than the 3.6 percent growth recorded in Q2-FY17. Consumer durables and construction-allied industries continued to benefit from higher retail spending and infrastructure activities in the country. Hence, the overall LSM growth improved to 5.5 percent in H1-FY18 as compared to 4.0 percent during H1-FY17.

The services sector, meanwhile, is expected to maintain last year's growth momentum, based on encouraging trends in the leading indicators, especially those related to *wholesale & retail trade* and *transport & communication.*

2.2 Agriculture

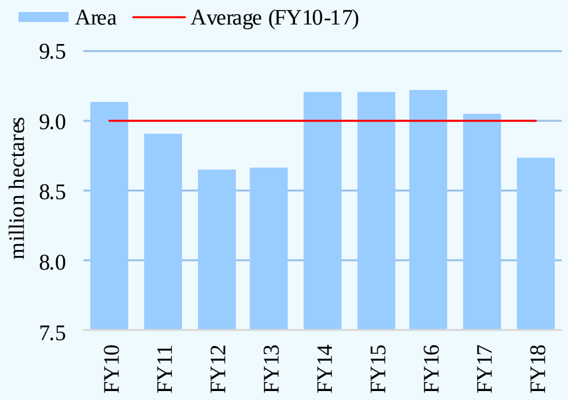
Major *kharif* crops, such as sugarcane and rice, surpassed their targets for FY18, while cotton crop managed to exceed last year's production level. Higher yields, attractive output prices, and supportive government policies, largely explain the healthy output of *kharif* crops. The overall performance of the crop sector, however, will depend on the outcome of *rabi* crops, especially wheat.

Given its dominant share (57 percent) in agriculture, the performance of livestock would determine the overall growth of the sector. In this regard, the sector would benefit from increased focus of provincial governments on feeding, animal

[1] Cotton production may remain below 12 million bales during FY18 – lower than the revised estimate of 12.6 million cotton bales. However, it will surpass last year's level of 10.7 million bales.

management, and genetics. Moreover, a strong performance of the crop sector during the last couple of years has stimulated investment in livestock, which is expected to continue during FY18 as well.

Figure 2.1: Area under Wheat Crop

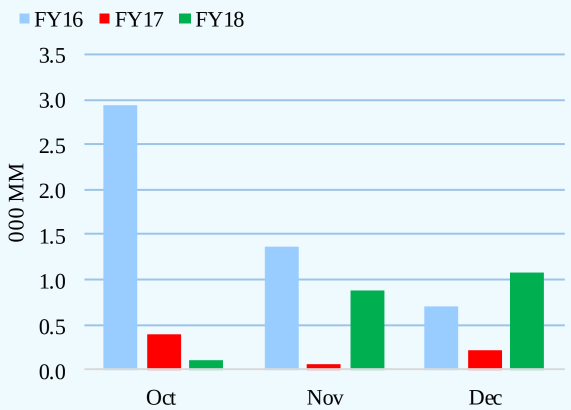


Data source: Pakistan Bureau of Statistics

Wheat

The government has set the wheat production target at 26.5 million tons for FY18 from an area of 8.9 million hectares. The achievement of this target would largely depend on improvement in yield, as the targeted area under the crop was set 2.2 percent below last year's level of 9.1 million hectares.

Figure 2.2: Aggregate Rainfall

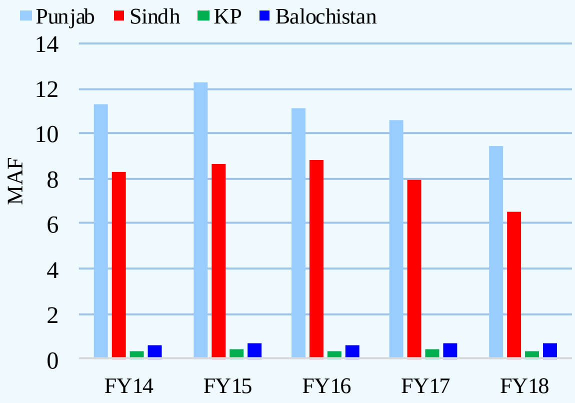


Data source: Indus River System Authority (IRSA)

Initial estimates reveal that the area under cultivation declined by 3.5 percent YoY to 8.7 million hectares (**Figure 2.1**). One of the reasons for the decline in area was the shortage of water both in rain-fed as well as irrigated areas. Rain-fed areas, which account for 14 percent of the area under wheat, and 6 percent of the total output, came under strain due to a prolonged dry spell witnessed in the month of October 2017. However, growers in these areas received some respite from higher rainfall in the subsequent two months as compared to corresponding months last year (**Figure 2.2**). Moreover, in the irrigated plains, water supply in Q2-FY18 was 16.5 percent lower than the average supply recorded over the last five years (**Figure 2.3**).[2]

[2] See, Chapter 7 of Annual Report FY17 of SBP that presents a detailed analysis of the issues regarding water sustainability in Pakistan.

Figure 2.3: Irrigation Water (Oct-Dec)



Data source: SUPARCO

Another reason for the decline in area under wheat was the delay in harvesting of the sugarcane crop in most of the areas. The prolonged standoff between sugar mills and sugarcane growers over procurement prices continued deep into the *rabi* season FY18, which left relatively less land for wheat sowing.

On the other hand, the required increase in yields to compensate for the area losses may also not be realized. Reaching the FY18 wheat production target would now require a 6.4 percent YoY increase in yield. This seems unrealistic, as the highest rate of yield improvement that the country achieved during the previous 5 years, was only 2 percent.

In any case, the country is expected to produce another surplus wheat crop, which is a consequence of high domestic support prices. On one hand, this policy has kept wheat profitability intact, thereby encouraging growers to invest in fertilizer, seeds and pesticides; on the other hand, back-to-back bumper crops in the last four years have resulted in a build-up of stockpile.

Furthermore, the export subsidy has not helped offload stocks due to high price differential (domestic wheat costs US$ 300 per ton whereas the international variant is available at US$ 180). Another bumper crop on the global front is expected to keep downward pressure on the international prices of the commodity.

In the wake of high procurement costs, and an inability to offload stocks under the subsidy scheme, the country needs to rationalize its support pricing policy, while also keeping in view the growers' interest (**Chapter 3**). This would encourage crop substitution, reduce fiscal cost, and make the domestic commodity more competitive in the international market.

Input availability

The country faced acute water shortages during the *rabi* season. Water availability remained 12.7 percent lower in Q2-FY18 as compared to Q2-FY17, and 16.5 percent against the average observed during the last five years.[3] This is mainly attributed to lower snowfall in the northern parts of the country, along with below-average rainfall in the Indus Basin.

The current scenario further stresses the need for adoption of a comprehensive National Water Policy, one that emphasizes the building up of additional storages, developing water-saving technology, revamping the water-pricing mechanism, and enhancing institutional capacity.[4] Beside this, special focus is also required to manage demand in order to deal with future shortages.[5]

In terms of fertilizer application, although the offtake of urea and DAP declined by 16.2 percent and 19.7 percent YoY, respectively, in Q2-FY18, this was mainly due to a strong base effect. Based on anecdotal evidence, dealers across the country had made heavy purchases last year following the announcement of various incentives by the government. These included: (i) Rs 156/ bag subsidy on urea; (ii) reduction in sales tax from 17 percent to 5 percent; and (iii) voluntary price reductions by fertilizer manufacturers. These measures had inflated the offtake numbers in H2-FY17. Barring comparison from last year, fertilizer offtake during H1-FY18 is broadly in line with past trend (i.e. the average during the first half of FY14-FY16).

Credit disbursement to agriculture exhibited a YoY growth of 43.2 percent in H1-FY18, following a 22.0 percent rise witnessed during H1-FY17. This improvement appears to have come from the supply side: alongside commercial banks, disbursements by microfinance banks/institutions continued to rise after their inclusion in the targeted credit regime, which aims to cater to the needs of small-scale farmers.

2.3 Large Scale Manufacturing (LSM)

LSM suffered a two-month consecutive contraction during November and December 2017, which dampened the momentum achieved during Q1-FY18; resultantly, the growth decelerated to only 1.6 percent during Q2-FY18, compared to a healthy start of 9.9 percent growth during the first quarter.

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[3] This figure is for irrigation water availability for all provinces, as reported by the Indus River System Authority.

[4] The first draft of the National Water Policy was developed in 2003 and still awaits approval by the Senate.

[5] Chapter 7 of Annual Report FY17 of SBP presents a detailed analysis of the issues regarding water sustainability, while highlighting the policy initiatives required in this regard.

Three factors mainly explain this deceleration: (i) a decline in sugar production due to delays in crushing; (ii) the government's decision to temporarily shut down furnace oil based power plants, which led to subdued refining activities in November and December; and (iii) lower availability of piped gas to small-scale fertilizer manufacturers, which resulted in plant closures.

Production declines in the aforementioned industries more than offset the strong performances of construction-allied and consumer durable segments during the quarter. Sustained progress on infrastructure projects (under both CPEC and PSDP), as well as robust consumer spending, helped these segments continue their growth momentum.

Table 2.1: YoY Growth in LSM

percent

	Weight	H1-FY17	H1-FY18	Q2-FY17	Q2-FY18
LSM	70.3	**4.0**	**5.5**	6.0	1.6
Textile	20.9	0.2	0.6	0.5	0.2
Cotton yarn	13.0	0.4	0.1	0.5	0.1
Cotton cloth	7.2	0.2	0.0	0.3	0.1
Jute goods	0.3	-38.6	62.7	-23.9	39.9
Food	12.4	6.5	-0.3	12.7	-8.8
Sugar	3.5	52.4	-37.3	52.4	-37.3
Cigarettes	2.1	-31.0	69.8	-17.7	52.3
Vegetable ghee	1.1	1.7	-3.0	4.2	-14.9
Cooking oil	2.2	-1.3	4.6	-2.8	0.0
Soft drinks	0.9	17.8	11.5	16.8	26.2
POL	5.5	-1.3	8.1	0.8	2.8
Steel	5.4	15.6	37.1	18.2	28.1
Non-metallic	5.4	9.3	10.2	10.8	8.5
Cement	5.3	9.5	10.3	11.1	8.5
Automobile	4.6	6.6	21.9	10.2	15.4
Jeeps and cars	2.8	-2.7	27.0	-2.1	22.8
Fertilizer	4.4	3.5	-9.8	0.6	-14.0
Pharmaceutical	3.6	8.1	3.6	9.2	5.5
Paper	2.3	12.0	8.8	13.9	8.1
Electronics	2.0	15.5	50.5	16.1	8.2
Chemicals	1.7	-3.3	-0.4	-0.4	-6.4
Caustic soda	0.4	-6.3	16.6	11.0	15.2
Leather products	0.9	-20.8	-5.9	-24.3	-11.4
Excl. sugar and fertilizer	*62.3*	*2.7*	*8.4*	*3.8*	*5.8*

Data source: Pakistan Bureau of Statistics

On the whole, the YoY LSM production was up by 5.5 percent during H1-FY18, relative to the 4.0 percent growth witnessed during H1-FY17 (**Table 2.1**).

Auto Sector

Automobile production rose to a record high during H1-FY18, despite domestic capacity constraints; the aggregate production improved by 21.9 percent in H1-FY18 compared to 6.6 percent during the same period last year (**Table 2.2**).[6]

Increased demand for passenger cars can largely be explained by rising incomes, upsurge in popularity of online ride hailing services, and easy access to affordable

[6] By working overtime during working days and utilizing off days as well, the sector operated beyond 100 percent capacity for the second quarter running.

bank finance. The vibrancy in this market allowed car manufacturers to pass on the impact of rising assembling costs to consumers without taking a perceptible hit on their sales. Moreover, as availability of adequate public transport lags behind the requirements of the growing population, online ride hailing platforms are gaining traction. This has particularly benefitted the 800-1000cc passenger car segment; the category contributed almost half of the growth in the passenger car segment. Despite historic production, there was significant appetite for imports of both new and used vehicles.

Table 2.2: Vehicles Production and Sales

	H1-FY17		**H1-FY18**		**Growth (percent)**	
Units	Production[1]	Sales[2]	Production	Sales	Production	Sales
Jeeps and cars	90,443	86,106	114,821	110,238	27.0	28.0
Trucks	3,806	3304	4,514	4,252	18.6	28.7
Buses	669	577	409	310	-38.9	-46.3
LCVs	12,548	11,427	14,907	13,909	18.8	21.7
Farm tractors	21,336	20,933	32,614	32,310	52.9	54.3
Motorcycles & three-wheelers	1,189,808	789,733	1,387,240	941,238	16.6	19.2

Data source: PBS[1]; PAMA[2]

The production of sports utility vehicles (SUVs) rose from only 221 units in H1-FY17 to 7,034 units in H1-FY18, driven mainly by the introduction of a new model late last year. The popularity of this budget model can be traced to customers' preference for sturdy vehicles and additional seating capacity.[7] The current performance of the budget SUV shows that the market is eager to absorb such vehicles.

In addition to passenger cars, the demand for light commercial vehicles (LCVs) also remained strong. The production of these vehicles rebounded by 18.8 percent in H1-FY18 after declining 41.4 percent in H1-FY17. Moreover, the surge in the production of trucks continued as it registered an increase of 18.6 percent in H1-FY18 on top of 63.6 percent increase in the same period last year. The uptick in production and sales of commercial vehicles highlight the growing transportation and economic activities in the economy.

As for the tractors, improved purchasing power in rural areas on the back of healthy cash crops, coupled with a continuation of lower sales tax, led to a

[7] This variant's ability to navigate difficult terrains, especially unpaved roads in rural areas, also contributed to its popularity.

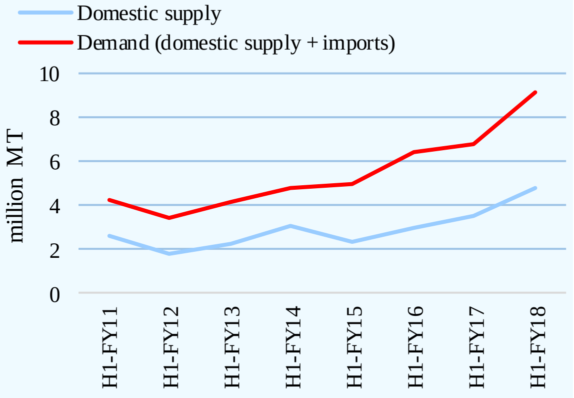
sizeable surge in the sales for tractors (54.3 percent).[8] Motorcycle sales, meanwhile, continued on their upward trajectory; growing middle class incomes mainly drove this growth (19.2 percent YoY).

Steel

The demand for steel products remained strong during H1-FY18, as public sector infrastructure projects and private investment in housing schemes picked up pace. Additional stimulus came from increasing raw material requirements by two- and three-wheeler manufacturers, as bike sales continued to rise substantially in the country. On the supply side, adequate availability of electricity enabled the producers to utilize their capacities optimally during the period. This favorable interplay of demand and supply resulted in steel production growing by 37.1 percent in H1-FY18 after growing 15.6 percent during the corresponding period of FY17.

However, similar to automobiles, the current pace of growth in domestic steel supply lags behind the fast growing demand; this has led to an increase in imports to cover the shortfall (**Figure 2.4**). Keeping in view the demand-supply gap, the large-scale producers are investing further in capacity expansions.[9] They have started integrating their operations vertically to benefit from economies of scale and lower tax levies.

Figure 2.4: Demand and Supply of Finished Steel Products



Data source: Pakistan Bureau of Statistics, SBP

Furthermore, some big players are introducing new products to cater to the diverse needs of various infrastructure projects.[10] Since additional capacities are expected to come on-line during H2-FY18, domestic supplies are likely to increase further; this will help reduce the country's dependence on finished steel imports.

That said, in contrast to large-scale producers, the small/medium scale producers are not able to take advantage of the buoyant steel demand in the country. Their

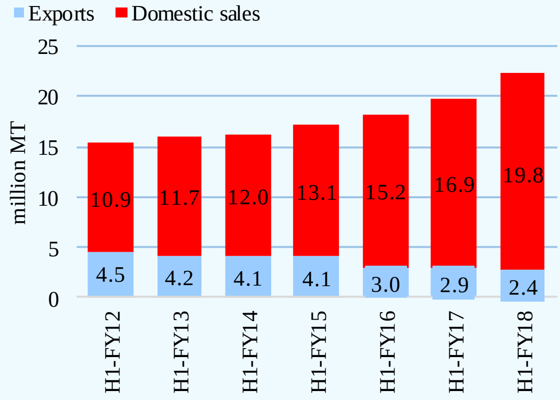
[8] The momentum in tractor sales is expected to continue going forward, given the tractor subsidy scheme announced by the Sindh government worth Rs 2.0 billion.

[9] Investments worth around US$ 112 million by big players (such as International Steel, Amreli Steel, Aisha Steel, and Mughal Steel) will lead to cumulative capacity expansion of 53.0 percent.

[10] For example, Mughal Steel is investing in the production of shockproof steel pipes.

inability to operate at economies of scale makes it difficult for them to lower their overhead cost in the face of high electricity tariffs and increased taxation charges (due to multiple agents in the value chain). Resultantly, the group faces tougher competition from imports relative to the larger manufacturers. These mechanics governing the operational feasibility of small players in the market highlight the fragmented nature of the steel industry.

Figure 2.5: Cement Dispatches



Data source: All Pakistan Cement Manufacturers Association

Cement

Like steel, domestic infrastructure investments by both public and private sectors continued to stimulate the cement industry. Contrary to steel, however, the increasing demand has largely been met by indigenous sources, as the industry has the requisite raw material along with capacity to cater to the growing needs of the economy. Resultantly, domestic sales posted an impressive YoY growth of 17.4 percent in H1-FY18, compared to 11.1 percent in H1-FY17, as capacity utilization reached 95 percent. Cement exports, on the other hand, fell by 17.3 percent on a YoY basis during H1-FY18 (**Figure 2.5**).[11]

The industry is benefiting from economies of scale due to higher capacity utilization. Furthermore, manufacturers have been investing aggressively in capacity expansions (by adding about 60 percent additional operational capacity) over the past few years, in anticipation of strong domestic demand. Most of the projects are expected to be completed within the next two years.

Chemicals

The performance of chemicals industry remained subdued during H1-FY18; a marginal contraction of 0.4 percent was witnessed after a 3.3 percent decline in the same period last year. Robust growth in construction activities resulted in an impressive uptick in cement and steel industries, the chemical counterparts could

[11] The domestic market has been able to absorb 89.2 percent of the output, leaving a marginal surplus for export.

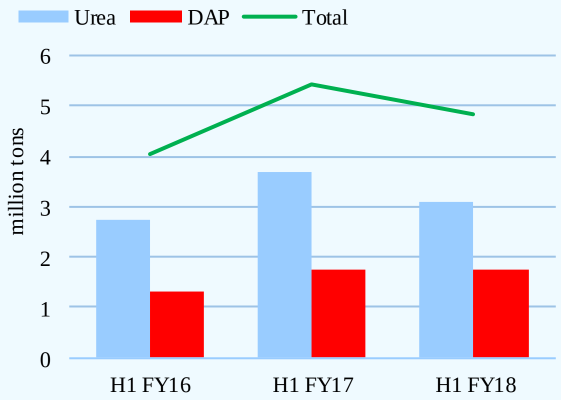
not take advantage. For instance, domestic production of paints and varnishes declined by more than 16 percent, while the increased demand for these products was largely met by imports that more than doubled during H1-FY18. Multiple factors constrained their operations, such as the influx of cheap imported products, dependence on imported raw materials, and high cost of doing business.

For other chemicals, domestic demand also remained strong. Sensing a sustainable rise in economic activities and improved availability of electricity, leading chemical producers are investing in capacity expansions for the production of caustic soda, soda ash and PVC.[12]

Fertilizer

The fertilizer sector exhibited a downturn during H1-FY18 as its production contracted by 9.8 percent, against a 3.5 percent growth witnessed in the same period last year (**Figure 2.6**). Two factors affected the production of fertilizer: (i) diversion of domestic piped natural gas (PNG) supplies away from small-scale urea producers; and (ii) financial infeasibility of operations under costly imported RLNG, especially for the smaller players, which led to a contraction in their activities.[13]

Figure 2.6: Trends in Fertilzer Offtake



Data source: National Fertilizer Development Centre

The price differential between RLNG and concessional feedstock natural gas is around ten-fold: it is costing manufacturers Rs 1,300 per MMBTU to procure RLNG, while the rate fixed for PNG supply for feedstock operations is only Rs 123 per MMBTU.

Here, it is important to recall that enhanced availability of gas and higher profitability (owing to extensive subsidies) were the most important drivers of

[12] Leading chemical producers - Engro Polymer and Chemicals and ICI Pakistan - are spending about US$ 190 million to enhance their respective plant capacities by over 50 percent.

[13] In particular, Fatimafert, Pak Arab Fertilizer (urea) and Agritech Fertilizer companies in Punjab with cumulative capacity of 0.9 million tons had shut down production due to divergence of domestic gas and increase in RLNG prices.

fertilizer production during FY17. Capacity utilization of the small-scale plants had improved to 83.6 percent in H1-FY17 from the average of 22.2 percent witnessed during the past five years. Their share in total urea production had also risen to 12 percent in H1-FY17, compared to the average of 3.8 percent during the previous five years. However, since the start of FY18, these players have faced a severe shortage of PNG, which resulted in an almost complete closure of operations in H1-FY18.

POL Products

Petroleum products registered a growth of 8.1 percent during H1-FY18 compared to a contraction of 1.3 percent in H1-FY17. On the face of it, the higher growth in H1-FY18 looks appreciable; however, keeping in view the 47 percent increase in the sector's aggregate operational capacity during the period under review, this performance appears underwhelming.

The industry was not able to utilize the added capacity, and its output fell significantly, following the government's decision to shut down furnace oil (FO) based power plants in November 2017. This month-long suspension cut down the demand for furnace oil and as a result, domestic refineries had to reduce their throughputs. In early December, however, the government reversed its earlier decision and again allowed the use of domestically produced furnace oil for power production.

Electronics

Higher income levels, urban migration, younger demographics and offering of easy installment plans by retailers have all meant strong demand for electronics in the country. The sector posted an impressive growth of 50.5 percent in H1-FY18, which was significantly higher than last year's growth of 15.5 percent. The performance was all the more impressive given the slack noted at the start of the year and an increase in prices of raw materials (steel, iron and copper).

Electric motors, transformers and air conditioners were the key contributing products, posting growth of 167.9, 51.7, and 32.4 percent, respectively. While the motors segment benefited mainly from improved reporting measures put in place by the data-collecting agency, increased investments in the electricity distribution network by the government led to a surge in the growth of transformers. AC manufacturers, on the other hand, continued to increase the production of their invertor variants following healthy sales last summer. Going forward, robust demand is expected to remain an integral driver of consumer durables, including electronics.

Food

Food, the second largest sector in LSM, recorded a marginal contraction of 0.3 percent in H1-FY18 against a growth of 6.5 percent during the same period last year. Contraction in sugar production, the most dominant sub-sector, mainly overshadowed the healthy performance of other segments like cigarettes, edible oil and soft drinks.

Slower start to the crushing season due to disputes over pricing and closure of some mills resulted in a 37.3 percent YoY decline in sugar production in H1-FY18. Although the country is expected to witness a record sugarcane harvest of 82.1 million tons in FY18, last year's crushing level seems unlikely to be achieved.[14]

On the other hand, cigarette production witnessed a major turnaround in H1-FY18, with its production expanding sharply by 69.8 percent compared to a contraction of 30.9 percent seen during the same period last year. The government's clampdown on counterfeits, smuggling, and tax evasion helped enhance the share of formal producers in the market.

Edible oil production, meanwhile, also showed some recovery, growing 4.6 percent after contracting 1.3 percent during H1-FY17. The slump in global palm oil prices at the start of the fiscal year had induced domestic players to import the raw material at a discount compared to last year. This resulted in bulk manufacturing by the producers.

Leather

Leather manufacturing continued on its declining trend and suffered a contraction of 5.9 percent during H1-FY18 on YoY basis. Alongside subdued external demand, the industry is facing pressure from regional competitors, who are focusing on high value-added products. Pakistan's leather industry, on the other hand, is lagging behind in terms of product diversification and value addition. **Box 2.1** details some of the challenges faced by the sector and the steps required to address the aforementioned worrisome trend.

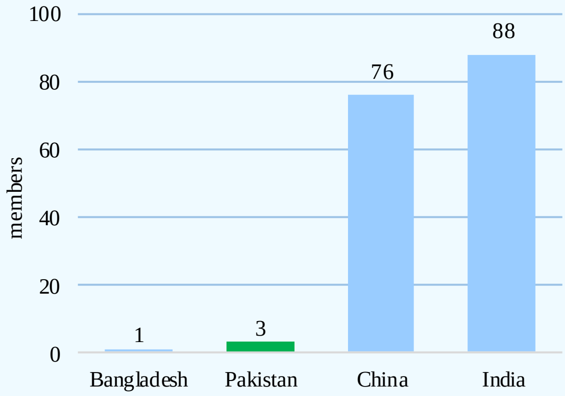
Box 2.1: LWG and Export Potential of Valued Added Leather Products

The Leather Working Group (LWG) is a multi-stakeholder international platform, comprising retailers, manufacturers, chemical companies, and other related parties involved in the global leather industry. Its aim is to ensure and promote environmental-compliance in the production of leather

[14] FY17 was an exceptional year in which around 97 percent of the sugarcane crop was used for sugar production. This was substantially higher than the historical average of around 76 percent.

commodities to be traded around the world. Increasingly, top retailers and brands are relying on LWG to import leather intermediates and finished goods.

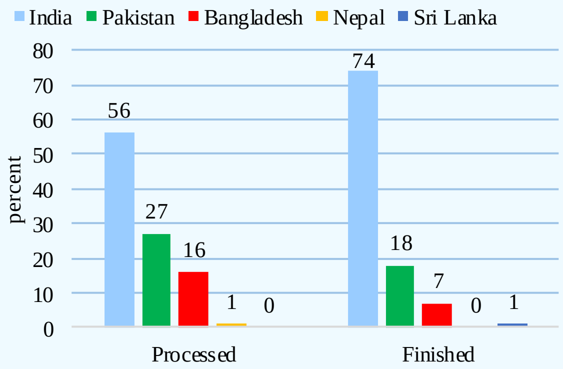
Figure 2.1.1: LWG Memberships - Regional Comparison



Data source: Leather Working Group

LWG members are required to follow certain quality and treatment standards so as to limit environmental degradation. Currently, only three manufacturers from Pakistan are LWG members. The figure is substantially lower than the registered members in regional competitors such as China (76 members) and India (88) (**Figure 2.1.1**). Indeed, this is not a satisfactory state of affairs and requires immediate attention of both the manufacturers and the policymakers to jointly put concerted efforts to solidify the country's place in the high value segment of the global supply chain.

Figure 2.1.2: Share in Region's Leather Exports by Type



Data source: ADB's Report on South Asia Leather Trade (December, 2017)

Non-compliance with the LWG's environmental standards is hindering the potential induction of domestic manufacturers into the global platform. For example, upgradation of non-conforming treatment facilities of some manufacturers in the Korangi industrial area of Karachi will enable them to become part of the group.[15]

Alongside LWG compliance, top retail brands also require products to undergo extensive laboratory testing to ensure the quality of the leather used. These tests are quite expensive. The local manufacturers used to get 75 percent rebate on these tests during 2009-2012. However, in the policy adopted by the government for the period 2012-2015, this rebate clause was removed, thereby impacting industry's cost margins. Besides these factors, the already high cost of doing business and inefficient raw material procurement systems are leading to domestic players to being priced out by other regional players in various international expos and trade fairs.[16] For example, during the

[15] This is a general problem faced by leather manufacturers in Pakistan. In this regard, the government intensified its efforts to address this issue by providing 25 percent matching grant to eight leather manufacturers for the upgradation of their treatment plants under the Strategic Trade Policy Framework.

[16] Refer to "Box 2.2: Why is the Leather Industry Underperforming?" in the SBP's Annual Report for 2016-17 on the State of Pakistan's Economy.

LineApelle fair held in Italy during October 2017 (in which 22 Pakistani firms participated), and the All China Leather Exhibition held in September 2017 (with 6 Pakistani participants), Pakistani leather manufacturers concluded business deals worth US$ 11 million and US$ 5.3 million, respectively. However, the trade predominantly involved selling intermediate items to other countries for further value addition (most notably to China for the production of shoes, garments, and handbags). Adding to this trend, local players are increasingly vying to tap the growth of Bangladesh's leather exports by selling raw material and intermediate items to Bangladeshi exporters.

According to a recent ADB report,[17] Pakistan's share in South Asia's total leather exports of processed and finished products is 27 percent and 18 percent, much lower than that of India (**Figure 2.1.2**).[18] However, the same study notes that Pakistan has the potential to enhance its intra-regional trade by around US$ 90 million annually if it diversifies its product portfolio and streamlines the industry's tariff structure.

With an appropriate mix of policy support, adequate funding for laboratory testing, and presence of more domestic players in the LWG, the local industry will be able to increase its share in the global high-end leather sector.

2.4 Services

The performance of the commodity-producing sectors continued to have a positive spillover on services. Resultantly, the sector managed to maintain its upward momentum during the second quarter, as all the leading indicators showed improvement during H1-FY18 compared to the same period last year (**Table 2.3**). *Wholesale and retail trade*, the largest subsector, looks poised to benefit from: (i) improved performance of LSM during H1-FY18 as compared to H1-FY17; (ii) continuous rise in import quantums; (iii) healthy *kharif* production; and (iv) a

Table 2.3: Services Sector Indicators

	H1-FY17	H1-FY18
Wholesale and Retail (18.5%)		
Credit offtake for the sector- flow (Rs bln)	27.9	44.7
Imports (Rs trillion)	2.5	3
LSM (YoY growth)	4.0	5.5
Petrol and diesel sales (million MT)	7.5	8.5
Agri credit (gross disbursements –Rs bln)	301.7	431.9
Transport, Storage and Communication (13.3%)		
Credit offtake for the sector - flow (Rs bln)	-2.4	17.2
POL sales to transport sector (million MT)	7.0	7.9
Commercial vehicle sales (000 units)	22.4	25.8
Cellular density (%)	72.4	72.7
Broadband users (million)	44.6	50.5
Finance and Insurance (3.4%)		
Assets (Rs billion)	15,831	18,342
Deposits (Rs billion)	11,798	13,012
Return on assets (after tax)	1.3%	0.9%
Return on equity (after tax)	14.4%	11.5%
Profit after tax (Rs billion)	190	158
General Government Services (7.6%)		
Expenses on general government and defense (Rs billion)	1,359.1	1,515.3

Note: Values in parenthesis indicate contribution to GDP in FY17
Data sources: SBP, PBS, OCAC, PAMA, PTA and MoF

[17] Source: "Intraregional Trade in Leather and Leather Products in South Asia: Identification of Potential Regional Supply Chains" (December, 2017), Asian Development Bank.
[18] If China is added to the mix, the situation becomes further discouraging for Pakistan, considering that China is the largest leather exporter in the world (India is the ninth largest).

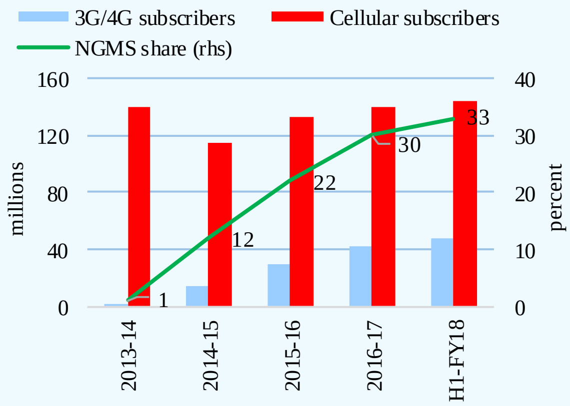
build-up in consumer demand. Furthermore, credit off-take by the subsector increased to Rs 44.7 billion during the period under review (against Rs 27.9 billion during H1-FY17), which indicates growing business confidence of market players.

In the transport sector - in which *road transport* is the biggest segment - the developments so far present a positive picture. Commercial vehicle sales grew by 15 percent, while LCV and truck sales continued on their growing momentum as well. Overall, the uptick in POL sales to the transport sector (by around 13 percent), along with higher credit off-take by the sector relative to last year, indicates that businesses are optimistic.

The communication sector continues to benefit from increasing teledensity in the country. An interesting development is that, as of end-December 2017, one third of cellular subscribers in the country are on NGMS (Next Generation Mobile Service) networks (**Figure 2.7**). Moreover, these mobile broadband subscribers have grown to constitute over 95 percent of the total active broadband base in the country (**Figure 2.8**). This shows the benefits of the introduction of 3G/4G services in the country, which have been widening the general public's access to digital networks. In line with these developments, profit margins of the cellular industry also increased during the period under review.

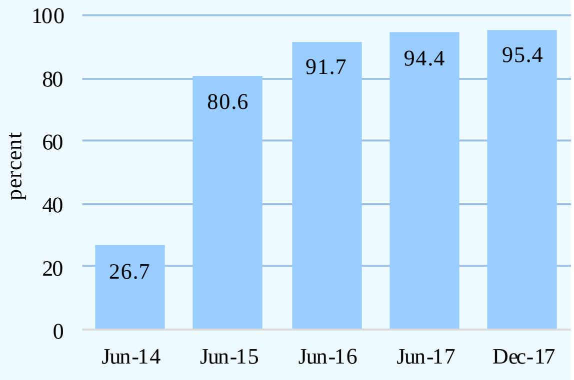
Such an increased access to digital platforms can help enhance financial inclusion in

Figure 2.7: Cellular Broadband Subscribers



Data source: Pakistan Telecommunication Authority

Figure 2.8: Share of 3G/4G in Total Broadband Subscribers in Pakistan



Data source: Pakistan Telecommunication Authority the country by modernizing payment systems and stimulating e-commerce. Keeping in view the possibilities of development that digital platforms provide, and the role that the telecom sector can play in this regard, the federal government recently released its Digital Pakistan Policy 2017 to tap this growing potential in an effective and planned manner (**Box 2.2**).

In the *finance and insurance* sub-sector, while the prevailing low interest rates continue to affect the profitability of the banking sector, the double-digit YoY growth in both assets and deposits would help strengthen the sector's value addition. Overall, the services sector is expected to match its last year's performance, based on the leading indicators available as of end-December 2017.

Box 2.2: Tripartite Digital Evolution - The Envisioned Way Forward
Mobile phone penetration and broadband subscriptions are on the rise in Pakistan. Keeping in view the growing importance of cellular operators, software developers, and emerging FinTech firms, the government revamped its digital policy in 2017. The basic objectives are: (i) to harness the rapidly expanding telecom network to reduce regional digital disparities; (ii) to help modernize the procurement and payment systems in the economy and make them efficient (by increasing financial inclusion through alternative and innovative channels); and (iii) to improve access to health and education facilities in remote and underserved areas of the country (via mobile internet).

The avenues where the telecom, software, and FinTech players are envisioned to triangulate their efforts to generate value addition in the economy include the following:

- **E-Governance:** The government envisages to make the databases of various ministries and commissions inter-compatible with each other. Alongside that, cloud-computing facilities will be introduced to make centralized information more accessible and secure via "G-cloud" servers (**Table 2.2.1**). Secondly, digital mechanism is being employed for procurement of goods and services by the public sector. Lastly, m-government applications are being designed to make government services accessible to cellular subscribers via the internet.
- **E-Agriculture:** A dedicated online information portal is being constructed to improve awareness among the farming and livestock communities about modern and innovative production methodologies.[19] Furthermore, software developers are being tapped to revamp the Geographical Information Systems (GIS) to enhance monitoring and encourage sustainable cultivation. Lastly, FinTech firms will devise digital modes of procurement and marketing through the internet. To make this transition smoother, regional language support and IT skill development trainings are some of the facilities that will be offered to the growers.
- **E-Health:** Improved access to adequate health facilities is one of the primary objectives of the health policy of any country. In this regard, initiation of remote advisory facilities (especially in rural areas) via the internet, coupled with m-Health mobile applications to centralize and integrate patient records and data handling, are currently underway in Pakistan. Alongside that,

[19] The private sector has already initiated such endeavors (mAgri, Telnor's project in association with DFID, is a notable example).

collaboration of mobile wallet providers is being sought to smoothen payment settlement operations on the digital front.

- **E-Energy:** Cellular operators and utility players will jointly harness the power of 3G/4G connections to develop consumer portals for effective provision of utility services (such as bill payments and complaint lodging). Besides that, digitally connected "smart" grids are being designed to analyze the supply-demand dynamics on a real-time basis, and to furnish demand forecasts for the Discos to better manage electricity consumption.
- **E-Commerce**: The government is planning to triple the e-commerce market size by 2020. Efforts will be undertaken on all fronts (financial awareness and inclusion, digital interoperability of payment system providers, and establishment of a centralized payment gateway system) to achieve this objective.[20]

Table 2.2.1: Plausible Interplay of Cellular Operators, IT/Software firms, and FinTech

	Cellular and Broadband Operators	IT Firms	FinTech
E-Governance	1. Providing access to data centers 2. Enabling real-time usage of cloud computing 3. Education portal and apps (m-education)	1. Data center clusters 2. Integration of head and tail systems with the centralized database 3. G-Cloud provision for security and resilience	1. E-procurement in all areas of public sector 2. Collection of fees, taxes, etc. from general public
E-Agriculture	1. Real-time monitoring via GIS 2. Access to information portals 3. Dissemination of material from institutions to farmers	1. Building Information Portal 2. Revamping GIS 3. IT skill-building and trainings, etc.	1. Payment operations 2. Sales and marketing 3. Procurement of third party products by farmers
E-Health	1. Accessing information via apps 2. Real-time usage of and provision of data to, the centralized database. 3. m-Health mobile apps	1. Centralized database	1. Payment facilities
E-Energy	1. Accessing consumer portals 2. Running "smart" grids 3. Real-time data to help in demand forecasting 4. Complaint registrations	1. Building smart grids to better manage consumption 2. Platform for data gathering to enable forecasting by Discos	1. Utility bill payments 2. Procurement facilities

Reference: Digital Pakistan Policy, 2017.

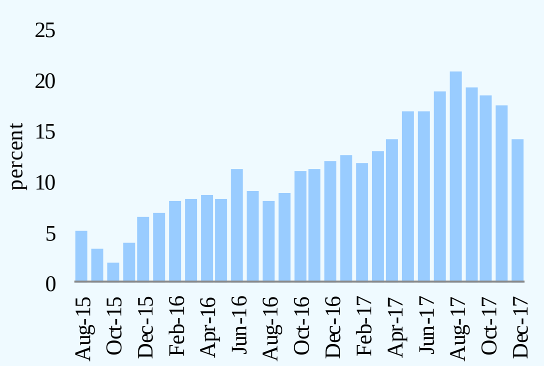
[20] For more information, refer to the Special Section 2 tilted "Online Payment Platforms in Pakistan – A Case of B2C E-Commerce" in the State Bank of Pakistan's First Quarterly Report for FY18 on the State of Pakistan Economy.

3 Inflation and Monetary Policy

3.1 Overview

With the arrival of the financing season of the year, credit momentum began to weaken. Although the private sector continued to pursue fresh additions in capacities during Q2-FY18, it scaled down its borrowings from the banking system for both operational and capital expenditures (**Figure 3.1**). The broad-based moderation in fixed investment loans was particularly notable, as it coincided with a weakening in machinery imports. Some tapering was expected with early harvest projects maturing under the CPEC, as well as scheduled repayments associated with earlier capex in manufacturing, power and construction sectors; however, anecdotal evidence suggests that a few long-term projects were postponed just because corporates got increasingly apprehensive about the general elections later this year, the PKR's trajectory, and the increasing fuel cost.

Figure 3.1: Trend in YoY Growth of Private Sector Credit

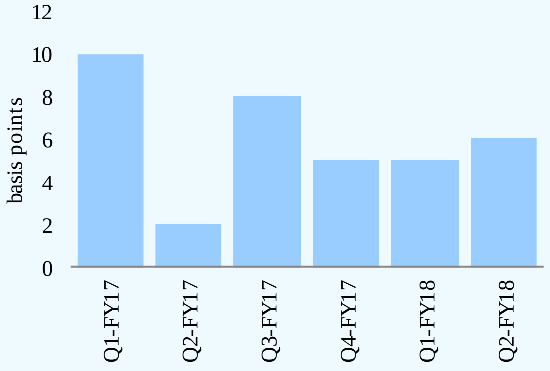


Data source: State Bank of Pakistan

As for working capital loans, inventory build-up in sugar and fertilizer sectors caused the slowdown. Despite subsidy-induced exports of sugar in Q2-FY18, no respite was seen in its stockpile; sugar mills limited their purchases of sugar cane, and hence borrowings. Similarly, a glut in the fertilizer sector, coupled with the closure of some medium-sized units due to unavailability of cheap feedstock, dampened the industry's appetite for fresh borrowing during the review period. The retirements in these two industries more than offset the strong credit expansion in textiles, cement, rice processing and commerce sectors.

Nearly all the banks faced a slowdown in aggregate loan expansion. Despite this, liquidity conditions in the interbank market were relatively tight during Q2-FY18: not only was the upward deviation of overnight rates from the policy rate higher than in Q2-FY17 (**Figure 3.2**), but the commercial banks' resort to SBP's reverse repo facility was also more frequent.[1] These trends were anomalous also because banks received refinancing for nearly a quarter of their loan expansion from SBP.[2] Two factors basically explain this:

Figure 3.2: Quarterly Deviation of Weighted Average Overnight Repo Rates from the Policy Rate



Data source: State Bank of Pakistan

(i) Unlike FY17 when the government relied primarily on SBP funding for budgetary requirements, it opted to borrow from scheduled banks in H1-FY18 and retired some of its SBP debt. During Q2-FY18, the government's borrowing from scheduled banks clocked in at Rs 136.5 billion, which took the cumulative recourse to Rs 334.4 billion in H1-FY18 (**Table 3.1**); and

(ii) FX injections in the interbank drained significant amount of PKR liquidity from the market in Q2-FY18. The volume of these injections was particularly elevated during the month of December 2017, following the exchange rate adjustment in the interbank.

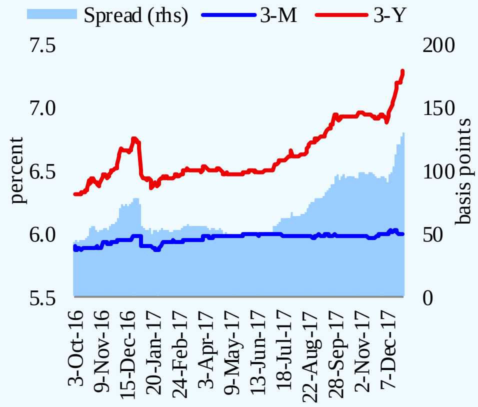
In order to alleviate the ensuing liquidity pressures, SBP stepped up its interventions in the interbank market via open market operations. Outstanding injections rose to Rs 1.6 trillion by the end of December 2017; a more notable development was during the quarter, it surpassed Rs 2 trillion – a level unprecedented before Q2-FY18.

With pressures coming on the overnight repo rates, the benchmark 6-month KIBOR and weighted average lending rates (WALR) also inched up during the quarter (**Figure 3.3b**). However, this upward movement in major interest rates was more of a reflection of expectations of a policy rate increase than just liquidity constraints. Ever since the import pressure started using up the country's FX reserves, the market's expectations for interest rates bottoming out had taken

[1] Commercial banks utilized the SBP window on 9 days during Q2-FY18, borrowing to the tune of Rs 263.3 billion; in comparison, they had utilized this facility on 6 days and borrowed Rs 65.6 billion in Q2-FY17.
[2] SBP refinancing volume, as percent of total private credit expansion, rose to 22.8 percent in Q2-FY18, compared to 13.8 percent in the same period last year.

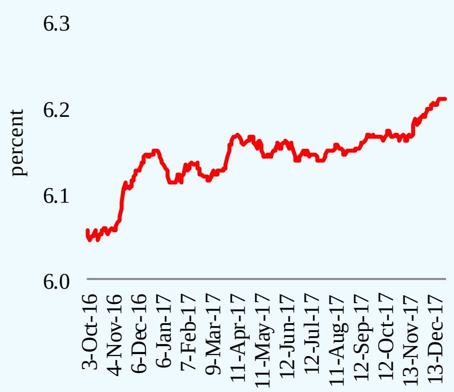
hold. In Q2-FY18 also, banks' appetite for longer tenor instruments remained non-existent and the secondary market yield spread widened further (**Figure 3.3a**). In fact, the PKR depreciation during the second week of December 2017 strengthened these expectations, as evident from a steep rise in the yield spread from there onwards.

Figure 3.3a: Rising Secondary Market Yield Spread



Data source: State Bank of Pakistan

Figure 3.3b: 6-month KIBOR*



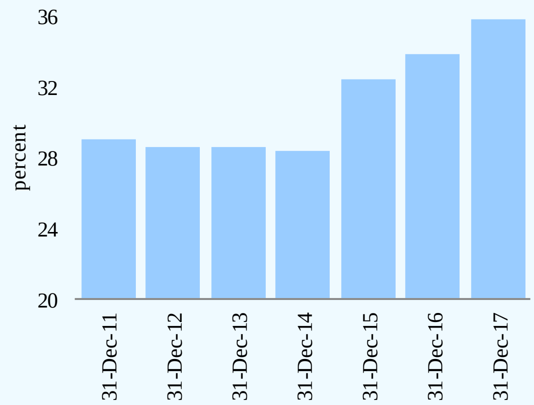
*3-day moving average

As for the policy rate, the monetary policy committee (MPC) met in November 2017. The committee deliberated on SBP's internal projections, which indicated that the inflation forecast for FY18 was within target, whereas the GDP forecast was falling just a little short. However, inflation expectations were getting stronger given the imposition of regulatory duties, and pass-through of rising international oil prices to domestic market. The situation on the external front was not comfortable either, as imports were not likely to recede, and their growth was estimated to surpass the combined increase in exports and remittances. Therefore, on balance, the nine-member MPC unanimously decided to keep the policy rate unchanged in November 2017 – a contrast to the previous two reviews of September and July 2017, when reducing the policy rate was also voted for.

3.2 Monetary Aggregates

Broad money witnessed a 9-year low expansion of Rs 336.4 billion during H1-FY18, compared to an increase of Rs 645.9 billion in the corresponding period last year **(Table 3.1)**. This modest growth was attributed to: (i) a sharp fall in net foreign assets (NFA) of the banking system, despite the support it received from the issuance of Euro and Sukuk bonds, and (ii) lower expansion in net domestic assets (NDA) compared to last year, explained by subdued growth in both private sector credit and budgetary borrowings. As far as the liability side is concerned, the overall slowdown in M2 was reflected both in currency in circulation and bank deposits; that said, the currency to deposit ratio continued to inch up for the third consecutive year (**Figure 3.4**). This basically suggests that the repercussions of the imposition of withholding tax on non-cash banking transactions (via Finance Bill 2015) still persist.

Figure 3.4: Currency to Deposit Ratio



Data source: State Bank of Pakistan

Table 3.1: Key Monetary Indicators

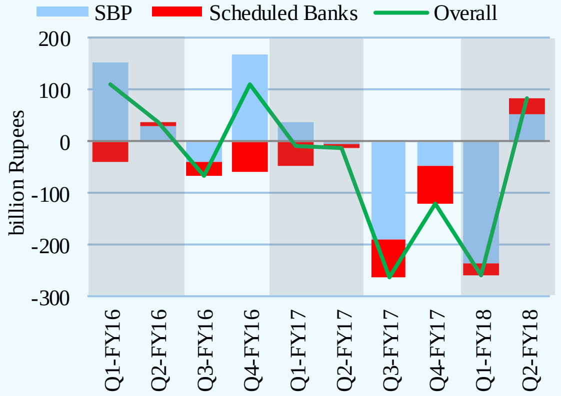
flow in billion Rupees	FY17			FY18		
	Q1	**Q2**	**H1**	**Q1**	**Q2**	**H1**
Reserve money	237.5	26.5	264.1	-134.7	151.5	16.8
M2	29.6	616.2	645.9	-88.4	424.8	336.4
NFA	-8.4	-12.2	-20.6	-258.6	84.2	-174.4
SBP	38.0	-3.4	34.6	-237.1	50.6	-186.5
Scheduled banks	-46.4	-8.7	-55.2	-21.5	33.6	12.1
NDA	38.1	628.4	666.5	170.2	340.6	510.8
Budgetary borrowings*	299.6	107.5	407.1	408.2	-76.5	331.8
SBP	567.7	324.9	892.6	210.3	-213.0	-2.7
Scheduled banks	-268.1	-217.4	-485.5	197.9	136.5	334.4
Private sector credit	-124.1	484.8	360.7	-37.4	333.7	296.3
PSE credit	24.5	58.5	83.0	5.1	60.9	66.0
Commodity operations	-30.7	-52.1	-82.8	-36.3	21.8	-14.6

*on cash basis;
Data source: State Bank of Pakistan

Net foreign assets (NFA)

Following a 5-quarter-long contractionary spell stemming from widening current account deficit and external debt repayments, the NFA of the banking system posted a small recovery in Q2-FY18 (**Figure 3.5**). This trend reversal was attributed entirely to the issuance of Euro and Sukuk bonds, which replenished SBP's NFA in December 2017. Meanwhile, the NFA of scheduled banks increased by Rs 33.6 billion, compared to a contraction of Rs 8.7 billion in the corresponding quarter last year. This improvement primarily reflects a drop in the outstanding position of commercial banks' borrowings from abroad.

Figure 3.5: Quarterly Flows in Net Foreign Assets



Data source: State Bank of Pakistan

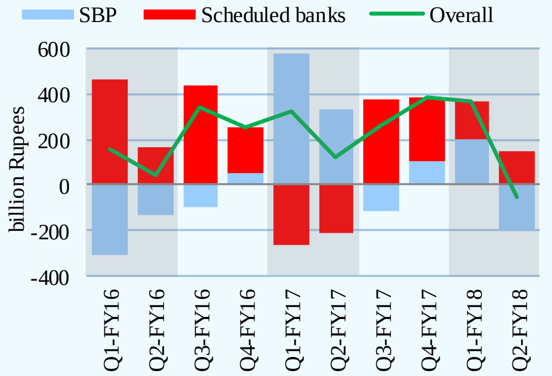
Net Domestic Assets (NDA)

NDA witnessed significantly lower expansion during the first half of the current fiscal year as compared to the same period last year. This slowdown was concentrated in Q2-FY18, when the availability of external funding reduced budgetary dependence on domestic sources, and the private sector's appetite for bank funding also remained low.

Budgetary borrowings

During H1-FY18, budgetary borrowings from the banking system remained significantly lower compared to last year **(Figure 3.6)**. This decline was evident primarily in the second quarter, when the availability of external funding allowed the government to retire some of its domestic debt – mainly to SBP.

Figure 3.6: Composition of Quarterly Budgetary Borrowings from the Banking System



Data source: State Bank of Pakistan

As for its borrowings from scheduled banks, these continued to pile on for the 4th quarter in a row during Q2-FY18; this was quite unlike last year when the government borrowed from SBP and retired scheduled banks' debt. Given the perception that interest rates had bottomed out, banks' appetite for T-bills remained strong, as evident by the amount offered in auction biddings (**Table 3.2**). This allowed the government to meet its pre-auction targets.

Table 3.2: Auction Profile of Government Securities*

billion Rupees	T-bills			PIBs		
	Target	Offered	Accepted	Target	Offered	Accepted
			In gross terms			
Q1-FY17	1,450.0	3,066.0	1,763.9	300.0	980.8	646.3
Q2-FY17	1,300.0	1,710.6	1,099.6	200.0	234.6	-
Q1-FY18	3,900.0	4,511.2	4,406.3	300.0	104.1	55.6
Q2-FY18	3,600.0	4,586.5	3,601.2	200.0	54.3	-
			Net of maturity			
Q1-FY17	272	1,887.9	585.9	-1,127.3	-431.9	-781.0
Q2-FY17	241.6	652.2	41.2	200.0	234.6	-
Q1-FY18	218.5	829.7	724.8	-296.6	-489.6	-541.0
Q2-FY18	-5.0	981.5	-3.8	200.0	54.3	-

*In face value. 'Offered' columns contain competitive bids only. 'Accepted' columns contain all acceptances (i.e. including non-competitive and special auction).
Data source: State Bank of Pakistan

Moreover, the market players were keen only on 3-month T-bills.[3] To put this into perspective, no bid was received for 6- and 12-months T-bills in the 20-Dec-2017 auctions. In particular, such a disinterest in longer tenor instruments was last recorded in the auction held on 16-Oct-2013. It would appear that the PKR depreciation in December 2017 added to inflation expectations and an anticipation of impending monetary tightening, as indicated by a spike in the secondary market yield spread.

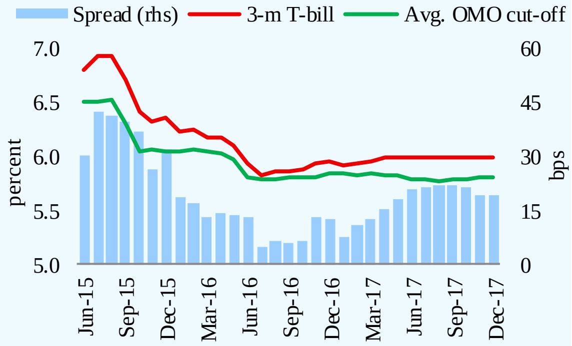
From commercial banks' profitability perspective also, reliance on 3-month T-bills was a viable short-term strategy. This was because the average spread between the 3-month T-bill and the cut-offs of OMO injections, which had squeezed considerably during the first half of FY17, posted a steady increase from H2-FY17 onwards (**Figure 3.7**). On average, this spread stood at 21 basis points in H1-FY18, compared to only 8 basis points in H1-FY17.

Meanwhile, PIB auctions remained dull across the board, regardless of tenor (i.e. 3-, 5- and 10-year). All three auctions during the quarter were scrapped amid relatively low participation; this was the general pattern of PIB auctions for the fifth consecutive month in a row as of December 2017.

[3] Three-month T-bills accounted for nearly 93 percent of offers and 92 percent of accepted bids, as a proportion of offers and acceptances against all tenors during Q2-FY18.

Commodity operations
Retirements by government procurement agencies to commercial banks shrank to Rs 14.6 billion in H1-FY18 compared to Rs 82.8 billion last year (**Figure 3.8**). Lower retirements were particularly visible in case of wheat, which has a share of 86.5 percent in the outstanding stock of commodity finance.

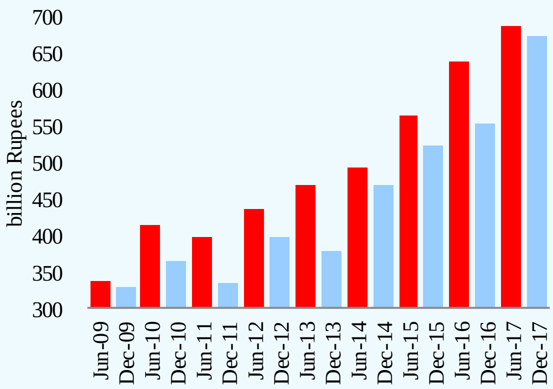
Figure 3.7: Spread between 3-month T-bill and OMO*



*Weighted average yield of T-bill auctions and cut-off of OMO injections

Data source: State Bank of Pakistan

Figure 3.8: Trend in Outstanding Commodity Loans



Data source: State Bank of Pakistan

The stock of hypothecated wheat has increased by 26.6 percent on YoY basis as of December 2017 compared to 8.7 percent last year, and is likely to inch up further in the following months, since harvesting typically begins in March. Due to excess supply in the domestic market and a significant price differential compared to private suppliers, government procurement agencies are finding it difficult to offload their stocks. At the same time, wheat export remains a big challenge due to low international wheat prices vis-à-vis domestic prices.

Among the procurement institutions, the Punjab Food Department deals with largest volumes and its borrowings constitute more than half of the outstanding commodity finance. So far in FY18, the department has incurred Rs 16 billion mark-up cost (at 6.3 percent interest rate), which is likely to increase to Rs 21 billion for the full year. Similar to other provincial food departments, this is a major fiscal expense over and above the subsidy expense, which the Punjab Food Department is burdened with. Importantly, this is not the only one: in addition to mark-up cost, procurement departments are also spending heavily on storage-related expenses. This department has an operational storage capacity up to 1.7

million MT, but due to difficulties in offloading stocks over the last couple of years, it is currently carrying 5.6 million MT of wheat. To accommodate this stock, the department has acquired open spaces as well as rental silos to store the commodity with minimum wastages. Other expenditures are also significant, including procurement of packaging bags; transportation cost from farms to storage areas; taxes and duties on physical inputs such as tents and coolers at the storage site; handling charges; bank commissions; salaries of chowkidars and storekeepers etc.

The bottom line is that the current mechanism of support prices and commodity operations requires a significant reorientation. As a result of these, Pakistan's wheat has become one of the most expensive in the world; moreover, the aggregate fiscal cost of these operations has also escalated due to the inability of the procurement agencies to break even and the resultant stuck-up bank liabilities. The government must hold strategic reserves of important cereals, and take necessary steps to ensure food security in the country, but perhaps more focus is needed on the production front; i.e., increasing yields, enhancing competitiveness, volatility in global prices, and improving farmers' adaptation and mitigation responses to climatic changes and volatility in commodity prices.

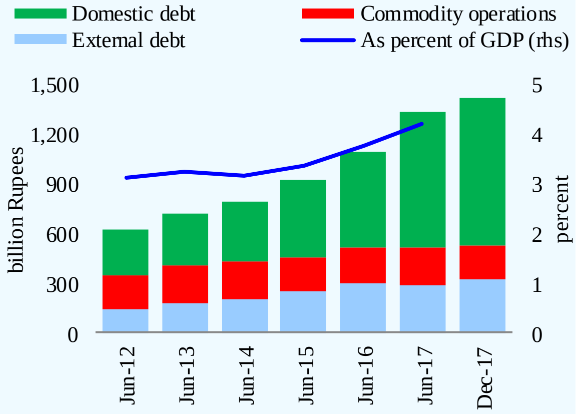
Credit to PSEs

During Q1-FY18, credit offtake by PSEs remained on the lower side due to a major one-off retirement by PSO. However in Q2-FY18, the credit offtake by PSEs grew by Rs 60.9 billion, as compared to Rs 58.8 billion during the same period last year. Similar to the past couple of years, the bulk of these borrowings was associated with energy-related entities. For instance, Sui Southern Gas Company Limited is in the process of building a LNG pipeline from Karachi to Lahore as part of the third regasification (RLNG III) project. The project has an estimated cost of Rs 64.9 billion, which the corporation is mobilizing from domestic banks against government guarantees.

In addition to these, the oil sector also increased its borrowings from domestic banks: (i) Parco took a dollar-denominated loan to settle its oil L/C, and (ii) PSO borrowed again from banks to compensate for growing receivables from its major consumers.

It must be noted that PSEs have been borrowing quite aggressively over the past couple of years, during which the stock of PSE credit has doubled (**Figure 3.9**). The size of PSE debt and liabilities as percent of GDP has surpassed 4 percent. Moreover, these loans constituted nearly 16.9 percent of total non-government credit at end December 2017, and as such, these enterprises have become systemically important for the domestic banking industry. In addition to infrastructure spending, rising volume of circular debt in the energy sector also explains the continued expansion in PSE credit. Nonetheless, as highlighted in some of our earlier reports, most of the enterprises already have sizable amount of funds available as deposits with commercial banks; if utilized efficiently, these would significantly reduce the additional burden of financing cost.

Figure 3.9: Trend in PSEs' Debt and Liabilities

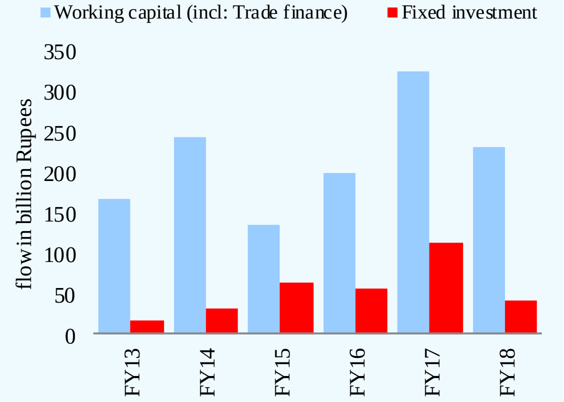


Data source: State Bank of Pakistan

3.3 Credit to Private Sector

Credit to private sector grew by Rs 296.3 billion in H1-FY18, compared to Rs 360.7 billion in the same period last year. The entire slowdown was evident in business loans, as consumer financing recorded a marginal increase.

Figure 3.10: Loans to Private Sector Businesses in Q2



Data source: State Bank of Pakistan

Fixed investment loans

The capex drive in the domestic industrial sector entered its 13th quarter, albeit at a much reduced pace, during Q2-FY18. Maturing investment projects in power and construction sectors have reduced the demand for additional borrowings. This led to a significant decline in the offtake of fixed investment loans (especially in Q2-FY18), which was a major driver of the overall credit flows over the past 3 years (**Figure 3.10**). Furthermore, anecdotal evidence suggests that due to political uncertainity and FX strains in the economy, businesses have adopted a wait-and-see approach and postponed some of their projects.

The power sector retired Rs 6.2 billion during Q2-FY18, compared to a net offtake of Rs 23.4 billion last year. This behavior was also consistent with the YoY fall in the import of power machinery in Q2-FY18. [4]

In contrast, construction allied sectors are progressing more assertively as demand prospects are still upbeat. The case in point is cement and steel sectors. In case of cement, although the sector borrowed additional Rs 3.0 billion in Q2-FY18, it was half the amount it had borrowed in the same period last year (**Table 3.3**). This trend is primarily explained by the fact that almost half of the manufacturing firms are already in a mature stage of capacity expansions. It is expected that 14.2 million MT additional capacity (30 percent addition) will come online by end FY18, whereas another 9.9 million MT will be commissioned by end FY19. At such advanced project stages, it is not surprising to see limited requirement for fresh borrowings.

Table 3.3: Loans to Private Sector Businesses in Q2

flow in billion Rupees	**Total loans**		**Working capital***		**Fixed Investment**	
	FY17	**FY18**	**FY17**	**FY18**	**FY17**	**FY18**
Total	436.6	273.4	323.7	231.5	112.9	41.8
Manufacturing	287.9	183.1	237.5	161.7	50.3	21.4
Textiles	123.0	131.3	103.5	103.1	19.5	28.3
Rice processing	39.7	51.5	39.1	51.0	0.6	0.5
Cement	14.1	15.1	8.0	12.0	6.2	3.0
Machinery and equipment	2.0	5.4	2.6	4.5	-0.5	0.9
Edible oil and ghee	6.7	1.0	6.8	2.2	0.0	-1.2
Fertilizers	-3.4	-29.8	2.3	-25.4	-5.8	-4.5
Sugar	39.8	-36.6	31.7	-33.1	8.1	-3.6
Commerce and trade	28.9	39.6	26.0	34.3	2.9	5.3
Transport, storage and communications	2.8	13.5	1.0	1.5	1.8	12.0
Electricity, gas and water supply	47.6	12.4	26.2	13.7	21.3	-1.2
Production, trans. & distrib. of electricity	45.9	2.5	22.6	8.7	23.4	-6.2
Manufacturing and distribution of gas	1.6	9.9	3.7	4.9	-2.1	5.0
Building construction	4.9	3.7	0.9	3.8	3.9	-0.1
Infrastructure construction	12.0	-0.3	5.2	0.5	6.8	-0.9
Agriculture and forestry	-0.1	2.9	4.4	-1.5	-4.5	4.4
Mining and quarrying	7.0	0.5	-0.4	1.3	7.4	-0.8

* includes trade financing
Data source: State Bank of Pakistan

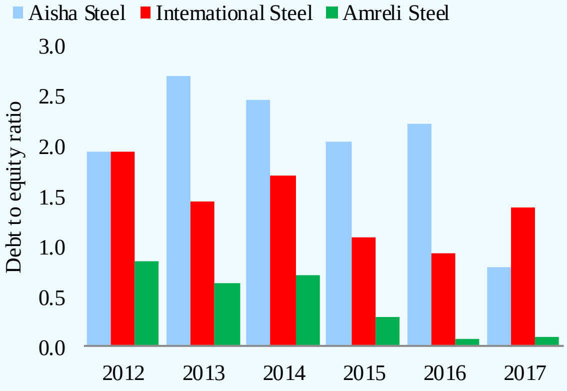
That said, borrowing needs in the sector will remain strong going forward, as major cement manufacturers are expected to invest in cleaner production

[4] According to PBS, the import of power machinery declined by 36.1 percent in Q2-FY18 compared to an increase of 78.6 percent respectively in Q2-FY17.

techniques. The sector has lately started facing stringent regulatory controls due to environmental concerns; provincial governments as well as environment protection agencies are discouraging installation/expansion of production capacities to contain carbon emissions.[5] Therefore, it is becoming increasingly important for firms to embrace more energy-efficient technologies, and use less carbon-intensive (fossil) fuels.

The case of steel is also peculiar. This sector has been adding capacities over the past few quarters as the demand from the domestic construction industry remained strong. However, the sector is relying increasingly on internal funds for capacity additions, instead of getting support from the banking system. Furthermore, major steel players are tapping the equity market to fund their expansion (**Figure 3.11**).

Figure 3.11: Trend in Debt to Equity Ratio of Selected Steel Manufacturers in Pakistan



Data source: Financial statements of companies

In contrast to the above, textiles was the only major manufacturing sector that availed higher fixed investment loans. The sector borrowed more than half of the total fixed investment loans made to private businesses in Q2-FY18. This was in line with the growth in textile exports, as the sector positioned itself to tap the recovery in major markets like the EU. In this regard, SBP's refinancing facilities such as LTFF were quite instrumental. For the past couple of years, textile benefited from attractive rates on SBP's refinance schemes, as the outstanding portfolio of textile under LTFF loans more than tripled between July 2015 and December 2017. While demand has played its part, higher fixed investment loans to textile sector can also be associated with inclination of commercial banks to

[5] As per industry sources, Lucky Cement – the Karachi-based largest producer in the country – was unable to get a mining lease in Punjab. The firm is still seeking the Punjab government's approval for greenfield expansion of 2.3 MT per annum. Moreover, due to continued delay of the project, the firm is planning to expand its existing plant at Pezu, KP. Similarly, Maple Leaf Cement has held back construction work on a new 7,300 tpd line following an order issued by Punjab's Environmental Protection Agency (EPA) in December 2017. However, later in January 2018, the Lahore High Court put aside the EPA order in favor of the firm.

supply more credit to the sector, given the improved credit risk profile of the sector.[6]

Inventory build-up of sugar and urea suppressed working capital loans
The slowdown in LSM during the second quarter of the year, mainly explains lower offtake of working capital loans.
The decline in sugar production significantly contributed to lower working capital requirements of the sector in Q2-FY18, as compared to the same period last year. A bumper sugarcane crop, coupled with a strong offtake in FY17, enabled the sector to produce a record amount of sugar in the year. However, from January 2017 onwards, international as well as domestic prices of the commodity have consistently declined, which resulted in build-up of excess stock in the domestic economy.[7] In order to cope with the situation, the government allowed subsidy on the commodity's export; this propelled sugar exports to 0.4 million MT in Q2-FY18.[8] However, this was not sufficient, as another record high sugarcane production this year would further boost existing stocks.

Importantly, the policy of support prices has created market frictions. Majority of sugar mills have resisted buying sugarcane from growers at government-determined prices. As a result, most mills started the crushing season with a delay of 15 to 30 days than its typical starting period in November. The late crushing cycle resulted in a net retirement of Rs 33.1 billion of working capital loans in Q2-FY18, compared with offtake of Rs 31.7 billion in the same period last year. This was also reflected in a 37.3 percent YoY decline in sugar production in Jul-Dec FY18.

Similarly, surplus inventory of urea created a glut, as the nutrient's offtake declined significantly in the current Rabi season.[9] Moreover, unavailability of cheap gas feedstock resulted in closure of some fertilizer units during the review

[6] Infection ratio of textile sector has declined from 26.0 percent in December 2015 to 18.5 percent (provisional) in December 2017.
[7] According to industry sources, total available sugar stock surpassed 8.1 million tons, compared to annual domestic demand of 5.1 million tons. A surplus stock of around 3 million tons resulted in supply glut after completion of the crushing season of FY17.
[8] In October, 2017, the government allowed sugar mills to export 0.5 million MT sugar and announced a freight subsidy of Rs 10.70/kg on a sliding scale basis. Then in December 2017, the government allowed export of an additional 1.5 million MT of sugar. For details, see EPD Circular Letter No. 20 of 2017 and EPD Circular Letter No. 23 of 2017.
[9] As per NFDC, fertilizer offtake decreased by 17.6 percent YoY in Q2-FY18, compared with a rise of 15.8 percent in the same period last year.

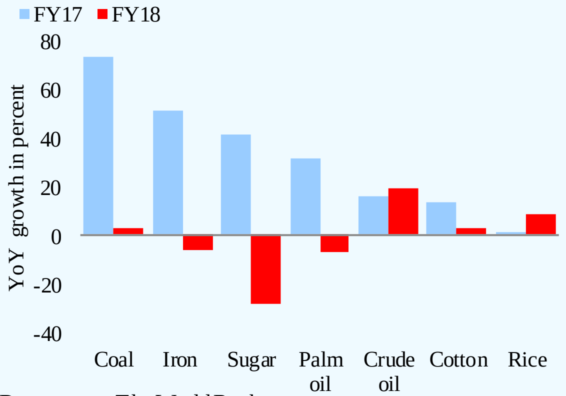
period.[10] The sector retired Rs 25.4 billion of working capital loans in the quarter, compared to a net offtake of Rs 2.3 billion in the same period last year.

Trends in commodity prices during FY18 affected financing requirements

During Q2-FY17, the growth in private credit was attributed to both a sharp jump in input prices (e.g., cotton, coal and palm oil) as well as increased activity in the industrial sector. This year, however, while the activity remained robust, the increase in input prices was modest (**Figure 3.12**).

For instance, despite the double-digit growth in exports and firms' increased procurement of cotton, the textiles sector's demand for working capital loans remained unchanged; this was explained primarily by the fact that cotton prices remained stable. Specifically, cotton prices were up by 13.6 percent YoY last year, which had pushed up the overall financing needs of textile firms; this year, the increase in cotton prices moderated to only 3.2 percent. Similarly in case of cement, the growth in credit offtake would have been much higher, if coal prices had increased at last year's pace. The overall activity in the sector sustained an upbeat momentum this year as evident in higher sales (**Chapter 2**).

Figure 3.12: Trend in Global Prices of Selected Commodities during Q2



Data source: The World Bank

Table 3.4: Consumer Financing

flow in billion Rupees	Q1		Q2		H1	
	FY17	**FY18**	**FY17**	**FY18**	**FY17**	**FY18**
Total	20.3	18.4	13.5	17.1	33.8	35.5
House building	1.8	6.3	2.9	6.1	4.7	12.4
Car financing	5.7	11.2	9.9	9.6	15.7	20.7
Credit cards	1.5	1.6	1.3	2.5	2.8	4.1
Consumer durables	-0.1	-1.5	0.8	3.5	0.7	2.0
Personal loans	11.4	0.8	-1.5	-4.6	9.9	-3.8

Data source: State Bank of Pakistan

Consumer financing

Banks continued to expand their consumer loan portfolio during H1-FY18. Most segments recorded robust expansion; however, the slowdown in car financing during Q2-FY18 (**Table 3.4**) stemmed from the issue of timely delivery of locally

[10] According to industry sources, gas from LNG (at Rs 1300/MMBTU) is not feasible compared to rates for natural gas (Rs 123/MMBTU). Therefore, some fertilizer firms closed their plants (with a capacity of 0.9 million MT per year) in Q1-FY18.

assembled cars, as banks focused more on clearing the delivery backlog of existing customers than catering to the demand of new customers. Among other segments, housing finance took the lead, as banks diversified their portfolios in favor of high yielding assets.

3.4 Inflation

CPI inflation remained at 3.8 percent during the first half of FY18 as compared to 3.9 percent during H1-FY17 (**Table 3.5**). The decline in food inflation helped contain the headline numbers at low level, even though fuel prices rebounded. Meanwhile, with a continuous increase in education and healthcare costs, core inflation remained higher on average in H1-FY18, compared to the same period last year. Its pace has nonetheless slowed in recent months.

Table 3.5: Average CPI Inflation and Contribution

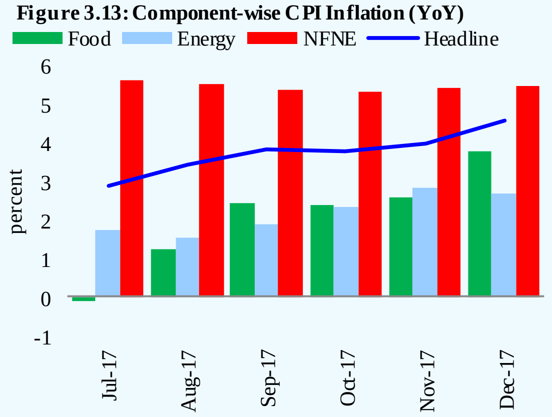
percent		Growth in FY17			Growth in FY18			Contribution in H1	
	Wt	**Q1**	**Q2**	**H1**	**Q1**	**Q2**	**H1**	**FY17**	**FY18**
Overall CPI	**100.0**	**3.9**	**3.9**	**3.9**	**3.4**	**4.1**	**3.8**	**3.9**	**3.8**
Food *of which*	**37.5**	**4.0**	**3.6**	**3.8**	**1.2**	**2.8**	**2.0**	**1.6**	**0.8**
Cigarettes	1.4	17.8	15.3	16.5	-16.4	-17.2	-16.8	0.4	-0.4
Pulses	1.1	23.8	13.0	18.1	-17.5	-20.4	-18.9	0.3	-0.3
Sugar	1.0	7.1	15.8	11.3	-17.5	-20.4	-18.9	0.1	-0.2
Fresh vegetables	1.7	19.5	19.2	19.4	-5.7	-1.4	-3.6	0.4	-0.1
Tomato	0.4	21.1	-25.4	-5.7	-12.9	75.9	27.7	0.0	0.1
Onion	0.5	-31.6	-50.1	-41.9	63.6	165.9	112.4	-0.3	0.5
Rice	1.6	-7.8	0.4	-3.9	13.7	14.3	14.0	-0.1	0.2
Meat	2.4	4.4	3.8	4.1	7.0	7.5	7.3	0.1	0.2
Milk fresh	6.7	4.1	3.7	3.9	3.7	3.9	3.8	0.3	0.3
Non Food *of which*	**62.5**	**3.7**	**4.1**	**3.9**	**5.0**	**5.0**	**5.0**	**2.3**	**2.9**
House rent	21.8	5.8	6.7	6.2	7.2	6.5	6.8	1.1	1.3
Education	3.9	8.3	11.3	9.8	10.1	12.1	11.1	0.4	0.5
Drug medicine	1.3	5.0	8.4	6.7	18.6	15.2	16.8	0.1	0.2
Motor fuel	3.0	-10.4	-7.9	-9.2	7.2	10.9	9.1	-0.2	0.2

Data Source: Pakistan Bureau of Statistics and SBP calculations

Food inflation recovered from a very low level

The fiscal year started with food inflation (YoY) for July 2017 at the lowest ever level (-0.1 percent) since the rebasing of the CPI index in FY08. Cigarette prices – having a 3.7 percent share in the food index – fell by an unprecedented 16.1 percent YoY during the month, and played a crucial role in lowering the food inflation in the month. Inventories of sugar, pulses and wheat in the country also contributed in keeping the inflation at low level. Their combined impact was strong enough to offset a higher level of non-food inflation stemming from strong domestic demand as well as a sharp increase in motor fuel prices. However, as the year progressed, food inflation crept up steadily as supply disruptions of key vegetables (tomatoes and onion) started to hit – by end-December, the level of food inflation came closer to the non-food inflation (**Figure 3.13**). This increase notwithstanding, the average food inflation in Q2-FY18 was 0.6 percentage points lower than the same period last year.

Figure 3.13: Component-wise CPI Inflation (YoY)

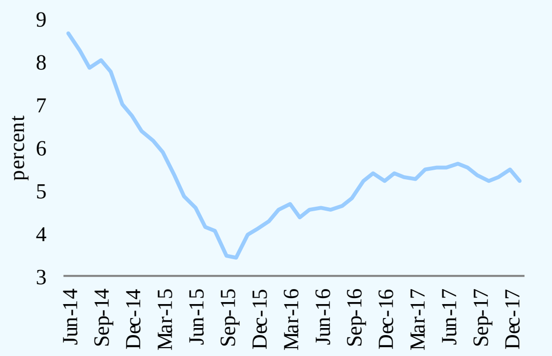


Data source: Pakistan Bureau of Statistics

Core inflation tapered

Core inflation, which was increasing steadily since September 2015, stabilized in H1-FY18 (**Figure 3.14**). The average non-food-non-energy inflation clocked in at 5.4 percent in Q2-FY18, which was slightly lower than 5.5 percent in Q1-FY18. Nonetheless, it is expected that the second-round impact of rising fuel prices and PKR depreciation will be felt on this component of CPI going forward.

Figure 3.14: NFNE Index (YoY growth)

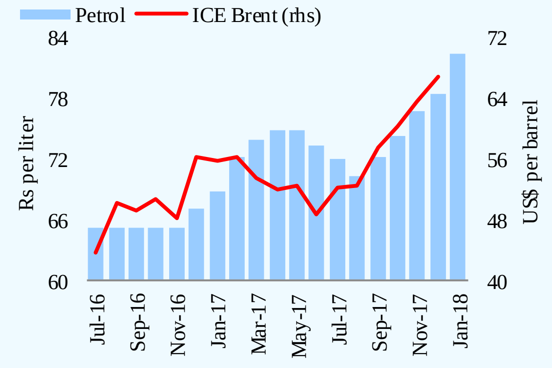


Data source: Pakistan Bureau of Statistics

Global oil prices and the pass-through on domestic fuel

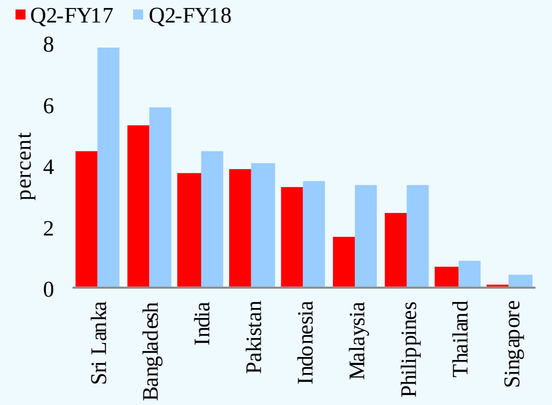
As shown in **Figure 3.15**, crude oil prices have risen steeply since June 2017, reflecting: more disciplined cuts by OPEC (mainly Saudi Arabia) and Russia; strong global demand; decline in crude stockpiles; and

Figure 3.15: Trend in International and Domestic Oil Prices



Data source: Pakistan Bureau of Statistics and World Bank uncertainty associated with protests in Iran (**Box 3.1**). Meanwhile, the pass-through of the increase in international oil prices to domestic consumers has been quite frequent this year. The government incrementally increased domestic petrol prices by a cumulative Rs 16.6 per liter during Sep-Feb FY18. Apart from Pakistan, a number of emerging market economies felt the burden of this global rally, as reflected in higher inflation in Q2-FY18 compared to last year (**Figure 3.16**).

Figure 3.16: Inflation in Pakistan and Regional Economies

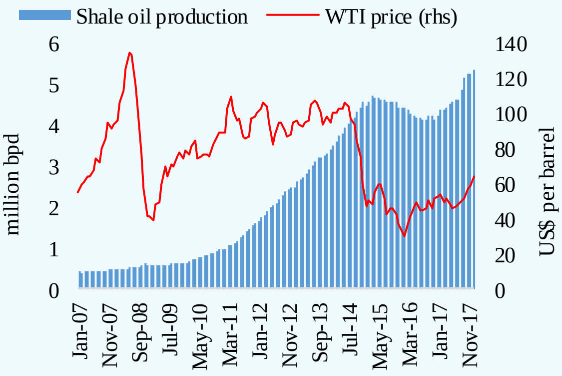


Data source: Haver Analytics

Box 3.1: Current Trends and Developments in the Global Oil Market

The global oil market has undergone significant structural changes over the past few years. Technological advancements – particularly in the shape of improved drilling techniques – have had a significant impact on supply-side dynamics of crude oil. For instance, shale oil producers in North America have posted nearly a fourfold increase in their output in the past 10 years; this has contributed to a global oil glut in recent years as the US' reliance on imported crude oil has declined drastically (**Figure 3.1.1**).[11] Likewise, geopolitical tensions, especially in oil and gas producing regions (MENA and Eastern Europe), and removal of economic sanctions on Iran, have exerted significant and often contrasting forces on crude oil prices. As a result, the global oil prices have remained fairly volatile over the past few years.

Figure 3.1.1: Impact of Oil Prices on Shale Oil Production



Data source: Energy Information Administration (EIA), Bloomberg

It is important to recall here that the oil price crash that began in the second half of 2014, was mainly triggered by OPEC's decision of not cutting its crude output in the wake of lower demand from major consumers like the US (on the back of increase in shale oil production), and China (which has

[11] The US is the largest consumer of crude oil in the world, accounting for a fifth of global oil consumption in 2015 (source: EIA). Reduced demand for imported oil by the country naturally creates a demand-supply imbalance in the global oil market.

already built up sizable reserves of the commodity in recent years). Consequently, within a short span of six months, oil prices plunged by almost 56 percent.[12]

Due to this abrupt price adjustment, US shale oil producers were forced to abort their least productive wells; this led to a decline in shale output, just as envisaged by the OPEC. However, as it turned out, many shale companies continued to bring efficiencies into their processes, which helped to lower their breakeven price of oil and allowed them to survive in the under-US$ 50 price environment.

In its December 2015 meeting, OPEC reiterated its decision against production cuts, believing that the market should be left to correct itself. This led further to a fall in crude prices: in January 2016, oil prices dropped to a 13-year-low of US$ 27 per barrel. However, the prolonged spell of low oil prices had a serious impact on the fiscal positions of oil-exporting economies, particularly those in the Middle East. After much internal debate, OPEC members (and Russia) finally decided in December 2016 to cut their oil production (Saudi Arabia and Russia agreed to the bulk of these cuts). Besides, US shale producers – though not completely knocked out of the market by lower prices – had nonetheless significantly reduced their output **(Figure 3.1.1**). As a result of this dual supply-side squeeze, global oil prices that started to rise steadily from early 2017 got more traction from May 2017 onwards, when the impact of OPEC's supply cut began to be felt – just as cartel members that were earlier not complying with prescribed cuts began to follow them more closely.

Table 3.1.1: New-well Oil (Primarily Shale) Production Per Rig (bbl per day)

Region	Jan-16	Jan-18	% Change	Share*
Permian	498.6	627.6	25.8	44%
Eagle Ford	1,105.0	1,230.9	11.4	19%
Bakken	687.7	1,383.6	101.2	18%
Niobrara	869.5	1,120.8	28.9	9%
Anadarko	310.5	387.2	24.7	7%
Appalachia	101.4	143.7	41.7	2%
Haynesville	28.3	24.8	-12.3	1%

* share in total shale output as of Jan 2018
Data source: Energy Information Agency

Since October 2017, a separate set of factors fueled a further increase in crude oil prices. These include: (i) persistent fall in Venezuela's oil production; (ii) upbeat global economic growth forecasts; a fall in crude inventories in the US and other OECD countries (indicating strong economic turnaround); (iii) extreme winters in the US, which led to an increase in demand for oil for heating purposes; and (iv) OPEC's monitoring committee meeting held in January 2018 in which a few members insisted on extending production cuts beyond current expiration.[13] This increase in global oil prices has implications for shale oil producers as well: those productive wells that had gone out of production became feasible again and went online.

Average Brent crude oil prices have recently softened from US$ 70.5 per barrel to US$ 63. A correction was due since rising oil prices have not only revived shale production, but producers have surpassed their previous output levels. Interestingly, not only are current prices quite favorable for shale companies, but a significant increase in their productivity has helped them slash their break-even wellhead prices even further (**Table 3.1.1**).

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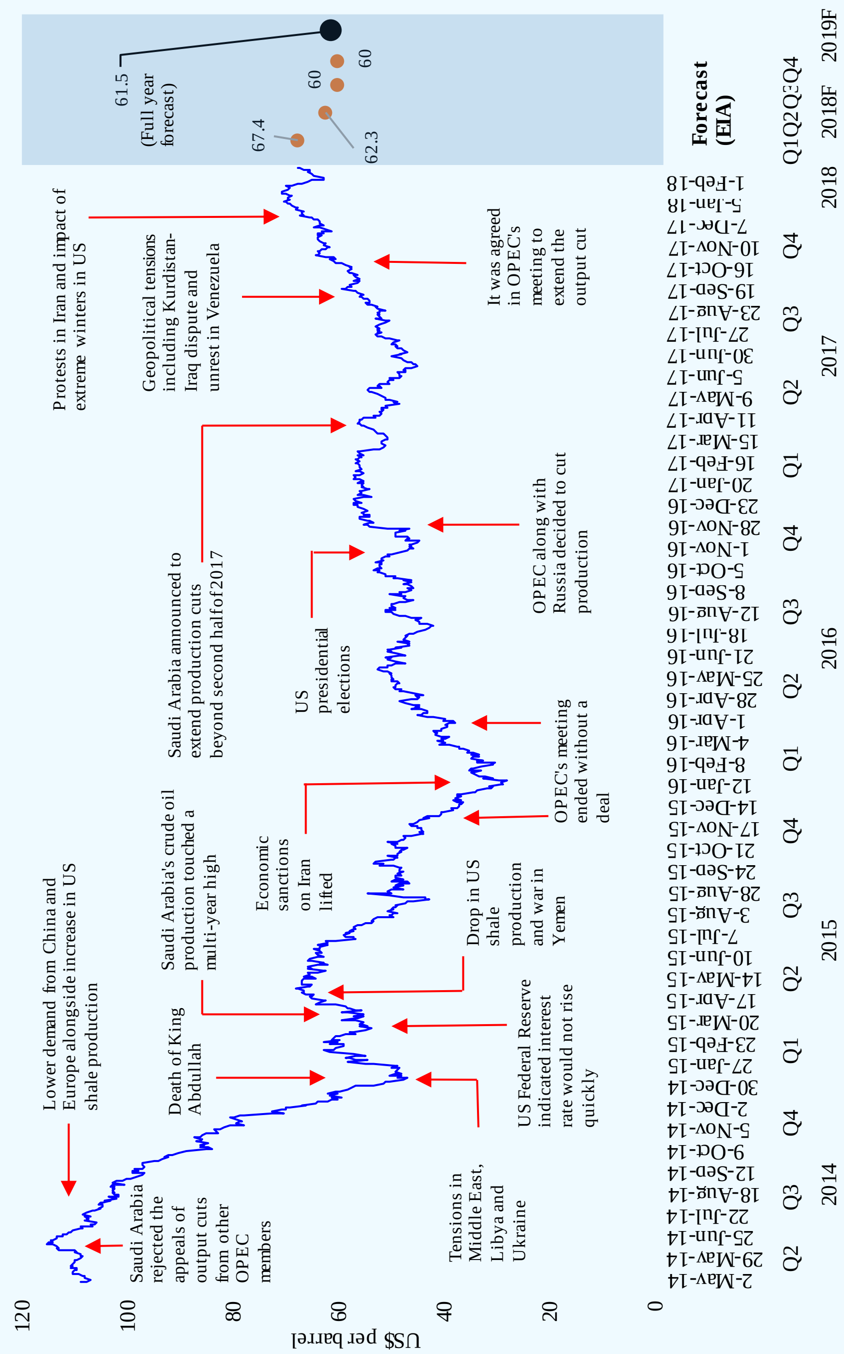
[12] Brent spot price fell from US$ 114 per bbl in June 2014 to US$ 47 per bbl in January 2015.
[13] Joint OPEC-Non-OPEC Ministerial Monitoring Committee (JMMC) was established in Nov 2016 to monitor the compliance and developments in global oil market. Initially, supply cuts were agreed upon for six months starting January 2017. On 25th May 2017, cuts were extended for another nine months commencing 1st July 2017. On 30th Nov 2017, it was agreed to extend the cuts up to December 2018.

Going forward, the expectations of an increase in supply from non-OPEC member countries would help relieve short-term upward pressure on crude prices. Importantly, total US crude oil production on average remained 9.3 million bpd in 2017; this is expected to jump to 10.6 million bpd in 2018, according to EIA estimates. To put this in perspective, OPEC, along with a few other major oil-producing countries, have agreed to a cut of 1.8 million bpd of oil, whereas the US' production is expected to increase by nearly 1.3 million bpd. Consequently, the EIA expects Brent prices to remain around USD 60 per barrel by the end of 2018 (**Figure 3.1.2**).

Figure 3.1.2: Brent Historical Prices and Forecast



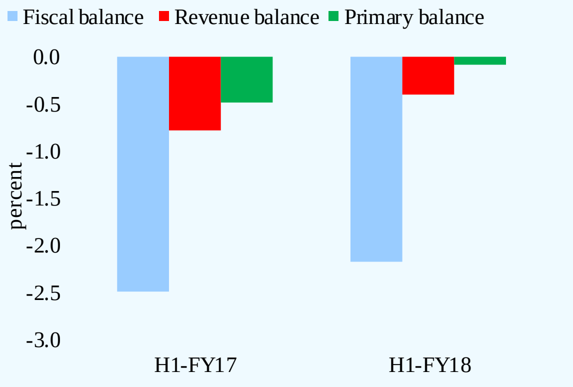
Data source: Bloomberg and EIA

4 Fiscal Policy and Public Debt

4.1 Overview

The growth in revenue collection continued to outpace expenditure for the second consecutive quarter in Q2-FY18. This helped in containing fiscal deficit to 2.2 percent of GDP during H1-FY18, slightly lower than 2.5 percent recorded in the same period last year. Other indicators of fiscal performance also showed a marked improvement over the last year: the revenue deficit declined to 0.4 percent of GDP in H1-FY18 from 0.8 percent last year, and primary deficit fell to 0.1 percent in H1-FY18 compared to 0.5 percent in last year **(Figure 4.1)**.

Figure 4.1: Fiscal Balance Indicators (percent of GDP)



Data source: Ministry of Finance

This across-the-board improvement in the fiscal indicators was primarily due to a strong growth in revenue collection. Both tax and non-tax revenue contributed to acceleration in growth in revenue collection. The rebound in tax collection particularly reflects expansion in economic activity and strengthening of domestic demand. The surge in imports and sale of consumer durables, along with increase in regulatory duties as well as higher international commodity prices, have contributed considerably to indirect taxes. In the same vein, higher growth in withholding taxes and upward revision in government employees' salary has pushed up direct tax collection.

Meanwhile the non-tax revenues also recovered strongly during H1-FY18, led by higher SBP profit, dividends, and mark-up income. While increase in dividend income is consistent with the overall expansion in economy, higher mark-up income is the result of increase in federal government lending to PSEs. The increase in SBP profit mainly reflects its liquidity operations in the interbank market and government borrowing from central bank in FY17. Moreover, transfer of revaluation gains accumulated during the last year added to higher SBP profit during H1-FY18.

Though slower than revenue growth, the consolidated federal and provincial expenditures grew sharply compared to last year. Mainly reflecting government compulsion to complete most of infrastructure and social uplift projects before the elections, the development spending continue to build on its last year's robust growth. Also, the current expenditures grew much more sharply in H1-FY18, more than twice the growth observed last year. Servicing of public debt and continued efforts to improving security and public safety to create conducive environment for growth and investment accounted for a major chunk of the increase in current expenditures (**Table 4.1**).

Table 4.1: Summary of Fiscal Operations
billion Rupees

		Actual		% of GDP	
	Budget FY18	**H1-FY17**	**H1-FY18**	**H1-FY17**	**H1-FY18**
A. Total revenue	6,167.2	1,990.6	2,384.7	6.2	6.6
Tax revenue	4,912.5	1,741.2	2,026.9	5.5	5.6
Non-tax revenue	1,254.7	249.4	357.8	0.8	1.0
B. Total expenditure	7,646.8	2,789.7	3,181.0	8.8	8.9
Current	5,393.9	2,241.6	2,545.2	7.0	7.1
Interest payments	*1,363.0*	*647.4*	*751.4*	2.0	2.1
Defence	920.2	*336.3*	*393.4*	1.1	1.1
Development	2,265.2	497.4	613.9	1.6	1.7
Net lending	-12.3	-6.4	2.0	0.0	0.0
C. Statistical discrepancy	0.0	57.2	19.9	0.2	0.1
Fiscal balance (A-B-C)	-1,479.6	-799.1	-796.3	-2.5	-2.2
Revenue balance	773.3	-251.0	-160.5	-0.8	-0.4
Primary balance	-116.6	-151.7	-44.9	-0.5	-0.1
Financing	1,479.5	799.1	796.3	2.5	2.2
External sources	511.4	240.9	384.1	0.8	1.1
Domestic sources	968.1	558.2	412.2	1.8	1.1
Banks	390.1	407.1	331.8	1.3	0.9
Non-bank	528.0	151.1	80.4	0.5	0.2
Privatization	50.0	0.0	0.0	0.0	0.0
% Growth					
Total revenue		-0.7	19.8		
Tax revenue		6.2	16.4		
Non tax revenue		-31.8	43.4		
Total expenditure		10.7	14.0		
Current		6.5	13.5		
Development		16.7	23.4		

Data source: Ministry of Finance

The resulting fiscal deficit was financed through a combination of external and domestic sources. The former dominated as the requirement for financing of enlarged current account deficit necessitated more reliance on the external loans. In particular, the issuance of Eurobonds and Sukuks complemented somewhat slower multilateral loans. In case of financing from domestic sources, government shifted its borrowing from SBP to scheduled banks. In the last year, government had borrowed heavily from SBP and retired its borrowing, mostly long-term, to scheduled banks.

Thus, most of the accumulation in overall public debt stemmed from external loans. Besides, revaluation losses due to strengthening of major international currencies against Dollar, as well as depreciation of Rupee, also added on to the external debt in local currency terms.

4.2 Revenue

The total revenue collection surged by 19.8 percent during H1-FY18 against a decline of 0.7 percent in H1-FY17. The acceleration in revenue growth was also fairly broad-based with strong showing by both tax and non-tax revenues. Also, robust growth in federal revenue was supplemented by a healthy growth in provincial tax and non-tax revenue.

<u>FBR taxes</u>

FBR tax collection grew by 16.9 percent during H1-FY18 compared to 7.4 percent growth last year. The acceleration in growth was despite higher tax refunds, especially to exporters. The refunds grew by 27.0 percent to Rs 76.1 billion in H1-FY18, compared to Rs 59.9 billion in the same period last year.

Table 4.2: FBR Tax Collection
billion Rupees

		Collections		% growth	
	Budget FY18	**H1-FY17**	**H1-FY18**	**H1-FY17**	**H1-FY18**
Direct taxes	1,594.9	591.5	663.5	9.4	12.2
Indirect taxes	2,418.1	880.8	1,058.1	6.1	20.1
Customs duty	581.4	218.0	281.5	22.6	29.2
Sales tax	1,605.2	577.4	686.5	-0.2	18.9
FED	231.5	85.4	90.1	15.9	5.5
Total taxes	**4,013.0**	**1,472.3**	**1,721.7**	**7.4**	**16.9**

Data source: Federal Board of Revenue

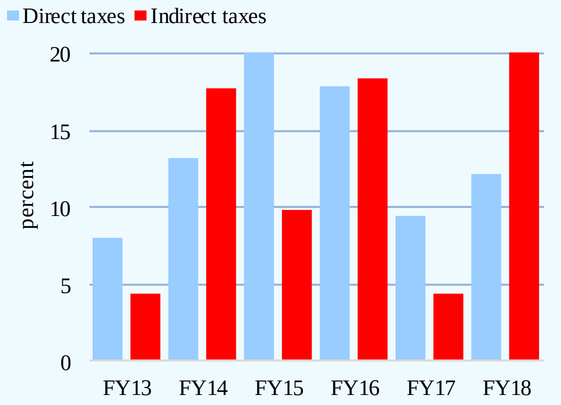
Both the direct and indirect taxes contributed to growth in FBR taxes. Yet, the proportionate increase was higher in case of indirect taxes than from direct taxes. Imposition of regulatory duty at the time of rising import and increase in prices of petroleum products, particularly boosted tax collection from indirect sources.

Moreover, strong domestic demand together with an increase in the general income level in the economy, resulted in higher direct tax collection **(Table 4.2)**.

Direct taxes

The direct taxes grew by 12.2 percent during H1-FY18, compared to 9.4 percent growth in H1-FY17. A higher growth in direct taxes was mainly on account of a sharp growth in withholding taxes and a rise in salaries of government employees also contributed to increase in direct tax collection.[1] Moreover, introduction of risk-based audit improved efficiency of audit cases along with generation of some additional revenue. Yet, the growth in direct tax collection was significantly lower compared to growth in indirect tax collection **(Figure 4.2)**.

Figure 4.2: Growth in Direct and Indirect Taxes during H1

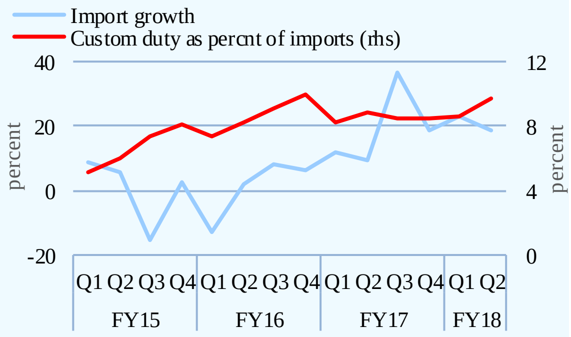


Data source: Federal Board of Revenue

Indirect taxes

The indirect tax collection grew by 20.1 percent during H1-FY18, compared to a subdued growth of 6.1 percent in last year. This sharp growth was an outcome of both an expansion in custom duty collection as well as a rebound in sales tax collection. The custom duty collection grew by 29.6 percent, on top of 22.6 percent growth in H1-FY17, which can be traced to increase in regulatory duty on a number

Figure 4.3: Imports and Custom Duty Collection



Data source: Federal Board of Revenue and Pakistan Bureau of Statistics

[1] The salary income was increased by 10 percent by the Federal; Punjab; KP and Balochistan governments while it was raised by 15 percent by the government of Sindh; (Source: budget documents).

of non-essential consumer items, which was primarily aimed at curtailing imports to address external sector imbalance **(Figure 4.3)**.

The recovery in sales tax collection was even sharper, rising by 18.9 percent during H1-FY18 against a decline of 0.2 percent in the same period of last year. The surge in sales tax collection can be attributed to increase in the prices of petroleum products in line with trends in international market and higher sales volume. Moreover, increase in the overall sales activity commensurate with the growing economy is evident from higher consumption of cement, steel, automobiles, electronics, etc.

In contrast to acceleration in growth of customs and sales tax, the collection from federal excise duty grew by only 5.5 percent in H1-FY18, compared to a 15.5 percent growth in the corresponding period of last year. This slowdown can be attributed to a fall in revenue collection from cigarettes by 11.8 percent, despite a substantial increase in cigarette production. The sudden fall in FED collection from cigarettes was an outcome of a reduction in tax rate on lower tier brands.[2]

Going forward, the pace of FBR tax collection observed in H1-FY18 needs to be enhanced further in H2-FY18 to achieve the FY18 target of Rs 4,013 billion. This would require FBR revenue to grow roughly by 22 percent in the second half of FY18, compared to 16.9 percent realized in first half of the year.

Non-tax revenue

The non-tax revenue also bounced back, growing by 43.4 percent during H1-FY18 compared to a sharp decline of 31.8 percent in the same period of last year (**Table 4.3**). The recovery in non-tax revenue was broad-based, with major contributions coming from higher SBP profit, mark-up income, dividends and PTA

Table 4.3: Non-tax Revenues
billion Rupees

	Budget	Actual	
	FY18	**H1-FY17**	**H1-FY18**
Mark-up (PSEs & others)	96.0	8.9	13.9
Dividends	93.3	12.2	19.2
SBP profits	260.0	87.8	125.2
Defense (incl. CSF)	141.8	4.6	6.1
Profits post office/PTA	11.3	0.6	8.6
Royalties on gas & oil	58.5	24.4	26.6
Passport & other fees	28.0	7.1	7.5
Discount retained	10.0	3.6	4.1
Windfall levy	8.0	0.5	0.8
Other	547.8	99.7	145.8
Total non-tax revenue	**1,254.7**	**249.4**	**357.8**

Data source: Ministry of Finance

[2] Effective from 1st July 2017, duty structure on cigarettes was revised by FBR in which duty on lower tier cigarettes was reduced to Rs 800 per thousand cigarettes (Source: SRO 407(I)/2017).

profit. Higher dividend income and PTA profits are consistent with growth in corporate profitability in an expanding economy.

Higher SBP profit reflects government's increased recourse to SBP borrowing during FY17, higher OMO injections in FY18, and transfer of last year's revaluation gains. Similarly, increased lending to PSEs fetched higher markup/dividend income. Moreover, rise in passport fee income reflects increase in number of people availing this facility to travel abroad for study, work and leisure trips. In the backdrop of recovery in international petroleum prices, royalty on oil and gas escalated. Likewise, revenues from windfall levy and discount retained on crude oil also inched up.

Table 4.4: Analysis of Fiscal Spending
billion Rupees

	Actual		Growth	
	H1-FY17	**H1-FY18**	**FY17**	**FY18**
Current expenditures	**2,241.6**	**2,545.2**	**6.5**	**13.5**
Federal	1,473.5	1,656.0	2.6	12.4
of which				
Interest payment	647.4	751.4	2.4	16.1
(i) Domestic	587.7	678.0	1.7	15.4
(ii) Foreign	59.8	73.5	9.3	23.0
Defense	336.3	393.4	10.9	17.0
Public order and safety	51.4	59.5	9.5	15.8
Others	438.4	451.6	-3.4	3.0
Provincial	768.1	889.3	15.0	15.8
Development expenditures	**497.4**	**613.9**	**16.7**	**23.4**
PSDP	445.7	558.8	17.9	25.4
Federal	198.3	242.1	27.2	22.1
Provincial	247.4	316.8	23.5	28.0
Others (including BISP)	51.7	55.0	7.1	6.5
Net lending	**-6.4**	**2.0**	252.4	-131.4
Total expenditure*	**2,732.6**	**3,161.1**	**8.1**	**15.7**

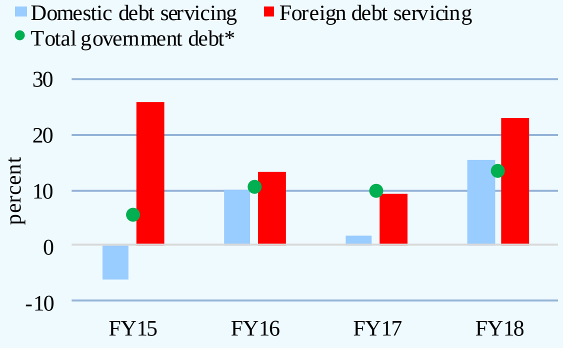
* Excluding statistical discrepancy
Data source: Ministry of Finance

4.3 Expenditures

The consolidated fiscal spending rose by 15.7 percent during H1-FY18, almost twice the growth in the corresponding period of last year. The growth in both current and development spending accelerated during the first half of FY18. While development spending grew both at federal and provincial levels, the acceleration in current expenditure was almost entirely due to faster increase in federal current expenditures (**Table 4.4**).

The federal current expenditures grew by 12.4 percent as compared to 2.6 percent increase recorded in the similar period of last year. This increase was largely due to higher interest payments, both on domestic and external debt (**Figure 4.4**). Increase in interest payments despite continuation of low interest rate environment, in fact, reflects the impact of rising debt stock as well as depreciation of PKR against US dollar. Moreover, spending on defence and public order and safety also rose sharply during H1-FY18 compared to last year.

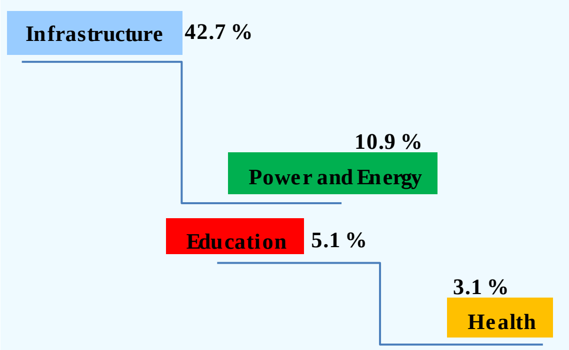
Figure 4.4: Growth in Government Debt and Markup Payments during H1



* As per FRDLA
Data source: Ministry of Finance and State Bank of Pakistan

The development spending continued to maintain its upward momentum, rising by 23.4 percent during H1-FY18 compared to 16.7 percent in last year. This is largely attributed to 25.4 percent increase in releases under PSDP. The spending consideration at the federal level was more tilted towards infrastructure and energy sectors, especially delivering on its commitments under CPEC (**Figure 4.5**). This indicates government's continued focus on developing infrastructure and providing base for sustainable growth, going forward.

Figure 4.5: The Development Concerns at Federal Level during H1-FY18 (as percent of total PSDP)



Data source: PSDP releases as on 29-12-2017, Planning Commission of Pakistan

4.4 Provincial Fiscal Operations

The provinces posted a surplus of Rs 203.9 billion – about 59 percent of the target of Rs 347.3 billion for the year – during H1-FY18. The major contribution to this surplus came from Punjab, followed by Sindh and Balochistan; the surplus of KP almost halved in H1-FY18 compared to last year. The higher provincial surplus was a result of a considerable increase in the provincial revenue (**Table 4.5** and **Figure 4.6**).

Table 4.5: Provincial Fiscal Operations during Jul-Dec
billion Rupees

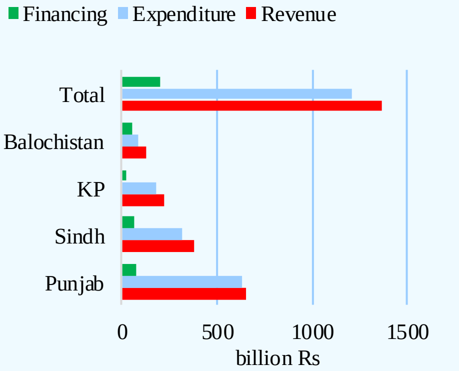
	Punjab	Sindh	KP	Balochistan	Total	Growth
FY18						
A. Total revenue	649.2	374.8	218.1	121.7	1,363.8	28.2
Provincial share in federal revenue	533.2	276.5	176.8	107.3	1093.8	26.1
Provincial revenue (I+II)	113.1	80.7	36.0	11.1	240.9	33.0
I. Taxes	91.8	72.2	8.4	4.0	176.4	21.1
II. Non-tax revenue	21.3	8.5	27.6	7.1	64.5	82.3
Fed loans and transfers	2.8	17.6	5.3	3.4	29.1	82.5
B. Total expenditure	636.7	319.5	176.4	80.4	1,213.1	18.7
Current	422.3	263.3	135.2	75.5	896.3	15.7
Development	214.4	56.2	41.2	4.9	316.8	28.0
Gap (A-B)	12.5	55.3	41.6	41.3	150.8	257.5
Financing* (overall balance)	**-69.5**	**-60.7**	**-21.0**	**-52.7**	**-203.9**	**125.2**
FY17						
A. Total revenue	503.5	293.5	159.6	107.6	1,064.2	1.3
Provincial share in federal revenue	410.4	220.6	136.8	99.4	867.1	-0.1
Provincial revenue (I+II)	83.9	67.8	24.5	5.0	181.1	17.9
I. Taxes	71.4	64.3	7.0	3.0	145.7	19.1
II. Non-tax revenue	12.4	3.5	17.5	2.0	35.4	13.2
Fed loans and transfers	9.3	5.1	-1.7	3.3	15.9	-45.5
B. Total expenditure	490.2	263.2	193.6	75.0	1,022.0	14.1
Current	348.6	210.8	146.6	68.6	774.6	15.0
Development	141.7	52.4	47.0	6.3	247.4	11.4
Gap (A-B)	13.3	30.2	-34.0	32.6	42.2	-72.8
Financing* (overall balance)	**32.9**	**-37.4**	**-49.6**	**-36.4**	**-90.6**	**-56.6**

Negative sign in financing means surplus.
Data source: Ministry of Finance and SBP calculations

The total provincial revenue grew by 28.2 percent during H1-FY18 as compared to a meager 1.3 percent growth reported in last year. This improvement is attributed to increase in federal transfers, bolstered by an impressive growth in FBR tax collection, and provinces' own tax revenue (**Figure 4.7**). The provinces' own tax revenue continued to build on expanding coverage of general sales tax on services (GSTS), increasing by 33 percent during H1-FY18 compared to 17.9 percent growth last year.

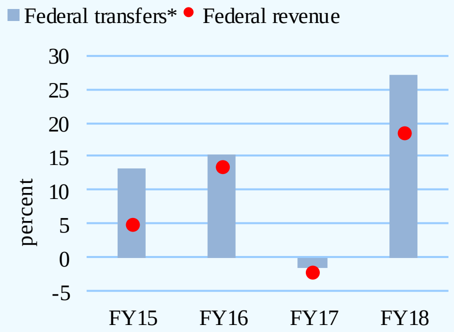
Improved economic activity had a spillover effect on provinces' own revenue collection as well. Besides collection from sales tax on services, provinces saw an encouraging growth in excise and stamp duties, followed by property and motor vehicle taxes.

Figure 4.6: Provincial Fiscal Position during H1-FY18



Data source: Ministry of Finance

Figure 4.7: Growth in Federal Transfers to Provinces and Federal Revenue during H1



*Provincial share in federal revenue and federal loans/grants

Data source: Ministry of Finance and SBP calculations

The provincial non-tax revenue also grew sharply by 82.3 percent during H1-FY18. This mainly came from KP with Rs 27.6 billion, out of which Rs 18.2 billion was received under *profits from hydroelectricity*. Moreover, non-tax revenue of Punjab also almost doubled to Rs 21.3 billion during H1-FY18.

Higher revenue collection created more fiscal space for provincial spending, which is reflected in 18.7 percent increase in provincial expenditure during H1-FY18, compared to 11.4 percent last year. Most of the increase in spending during H1-FY18 was meant for development purposes, as growth in current expenditures was slightly higher compared to last year.

However, the province-wise analysis shows that growth in provincial development spending was primarily due to Punjab, as the other three provinces reported either a negligible growth or decline. Therefore, provinces spent only Rs 316.8 billion during H1-FY18 out of total PSDP allocation of Rs 1,112 billion given in provincial Annual Development Programs (ADPs).[3] Since most of the development functions have been devolved to provinces after 18th Amendment, provinces need to set a road map for the effective allocation of resources in view of new opportunities such as CPEC.

[3] Source: Public Sector Development Programme 2017-2018, Planning Commission, Ministry of Planning, Development and Reform.

Table 4.6: Pakistan's Public Debt Profile
billion Rupees

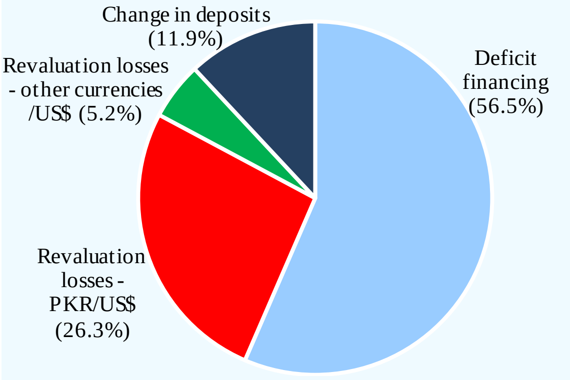
	End period stocks		Share in total		Flow			
					H1		FY18	
	Jun-17	Dec-17	Jun-17	Dec-17	FY17	FY18	Q1	Q2
Gross public debt	21,408.7	22,820.8	100.0	100.0	595.6	1,412.1	651.2	761.0
Government domestic debt	14,849.2	15,437.4	69.4	67.6	566.7	588.2	526.3	61.9
Government external debt	5,918.7	6,692.5	27.6	29.3	43.0	773.8	111.1	662.7
Debt from the IMF	640.8	690.9	3.0	3.0	-14.1	50.1	13.8	36.4
Total debt of the government*	19,635.4	20,879.3	-	-	562.5	1,243.9	558.8	685.1

*Gross public debt minus government deposits with the banking system.
Data source: State Bank of Pakistan

4.5 Public debt

The budget deficit in the face of widening current account deficit necessitated more external borrowing during H1-FY18 compared to last year. However, domestic borrowings also increased slightly during the period.[4] As a result, Pakistan's public debt stock rose by 6.6 percent during H1-FY18, reaching Rs 22.8 trillion as of end-December 2017 (**Table 4.6**).

Figure 4.8: Composition of Change in Gross Public Debt during H1-FY18



Data source: State Bank of Pakistan

The increase in external debt signifies both higher borrowings and revaluation losses due to PKR depreciation against US dollar as well as appreciation of other currencies against US dollar (**Figure 4.8**). It is worth noting that PKR depreciation increases the rupee value of external debt, but does not add to foreign currency liability of the country (**Box 4.1**). In case of domestic debt, the government borrowed over and above its budgetary needs and built up its deposits with the banking system.

[4] Despite lower fiscal deficit in nominal terms, the increase in domestic debt was reflected in build-up of government deposits with the banking system, which increased to Rs 168.3 billion during H1-FY18, compared with only Rs 33.1 billion same period last year.

Domestic debt

Domestic debt increased by Rs 588.2 billion during H1-FY18, slightly higher than the level observed in the same period last year. Most of the increase in domestic debt was concentrated in the first quarter of FY18, since the government borrowing needs from domestic sources shrank in the second quarter due to increased borrowings from external sources (**Figure 4.9**). Moreover, almost the entire increase in domestic debt came from short-term debt, as there was net retirement of long-term debt during the period.

Table 4.7:Absolute Change in Government Domestic Debt

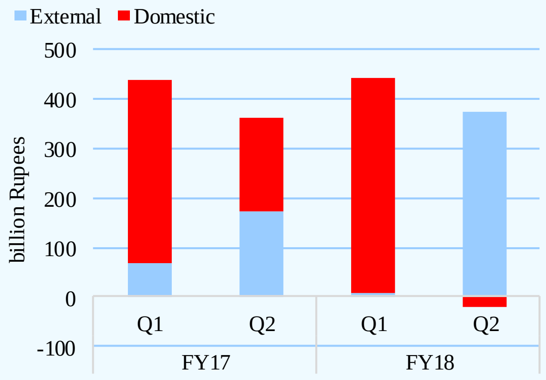
billion Rupees

	FY17	FY18	FY18	
	H1		Q1	Q2
Government domestic debt	**566.7**	**588.2**	**526.3**	**61.9**
Permanent debt	-720.2	-495.4	-510.5	15.2
Of which				
PIBs	-780.9	-541.0	-541.0	0.0
Prize bond	60.7	45.6	30.4	15.2
Floating debt	1236.2	1038.2	1017.8	20.4
Of which				
MTBs	631.0	747.7	745.9	1.8
MRTBs	817.8	83.2	271.9	-188.7
Outright basis by SBP	0.0	207.3	0.0	207.3
Unfunded debt	50.7	45.1	19.0	26.1
Foreign currency loans	0.0	0.2	0.0	0.2

Data source: State Bank of Pakistan

Similar to H1-FY17, the government continued to rely on short-term borrowings from scheduled banks (**Table 4.7**). With the expectation of monetary tightening that prevailed throughout the first half, the banks' interest in PIB auctions was almost non-existent. In absolute terms, banks offered only Rs 158.4 billion in PIB auctions during H1-FY18 compared to Rs 9.1 trillion offered in T-bills auctions. Within T-bills, around 85.6 percent of the offers were for 3-month T-bills only.

Figure 4.9: Financing of the Budget Deficit



Data source: Ministry of Finance

Given the market sentiments, the government managed to meet most of its financing requirements from the external sources, and the rest almost entirely from 3-month T-bills. As an outcome, the share of 3-month T-bills in total outstanding T-bills reached 62.6 percent in December 2017 from 32.8 percent in June 2017 (**Figure 4.10**).

Fund mobilization through NSS

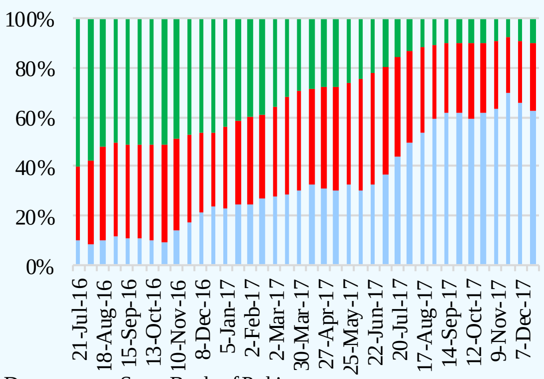
Net investments in national saving schemes saw an expansion of Rs 46.4 billion during H1-FY18, lower than the increase seen in the same period last year (**Table 4.8**). This was primarily because the profit rates on these schemes have remained unchanged since February 2017.

In fact, the rate on most NSS schemes is linked with rates on similar tenor PIBs, determined in the primary auctions. As the government rejected most of the bids in PIB auctions since February 2017, the NSS rates have remained essentially unchanged since then. As a result, institutional investors shifted their investment to PIBs in the secondary market where returns are still relatively higher (**Figure 4.11**). This was particularly reflected in a major outflow from medium-tenor schemes (like SA, SSC etc.), eligible for institutional investment whereas other major scheme recorded increase during H1-FY18.

Public external debt

Pakistan's stock of public external debt increased by US$ 4.3 billion during first half of FY18, reaching US$ 66.9 billion as of end-December 2017 (**Table 4.9**).

Figure 4.10: Tenor-wise Share in Outstanding T-bills



Data source: State Bank of Pakistan

Table 4.8: Receipts under NSS Instruments*

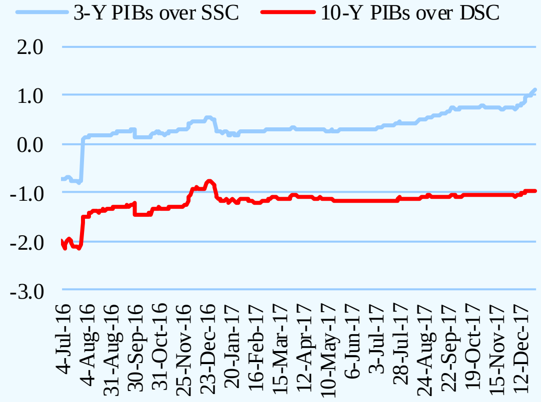
billion Rupees

	H1-FY16		H1-FY17		H1-FY18	
	Gross	**Net**	**Gross**	**Net**	**Gross**	**Net**
DSC	13.3	1.1	25.2	13.4	27.6	6.1
SSC	87.1	4.9	41.1	-5.2	91.0	-25.5
RIC	35.3	-5.3	24.8	-15.9	43.2	5.1
BSC	80.3	39.5	75.5	31.2	73.3	21.2
SSA	77.1	25.3	38.0	18.2	164.5	29.4
SA	93.4	0.4	107.5	0.9	126.1	0.9
Others	25.5	11.4	25.8	10.3	30.5	9.1
Total	412.1	77.2	338.0	52.8	556.2	46.4

*excludes short-term savings certificates

Data source: Central Directorate of National Savings

Figure 4.11: Term Premuim-PIBs over NSS



Data source: MUFAP and CDNS

Table 4.9: Public External Debt & Liabilities
billion US$

	Stock		Flows			
			H1		FY18	
	Jun-17	Dec-17	FY17	FY18	Q1	Q2
Public external debt & liabilities	66.1	70.5	0.1	4.4	0.9	3.5
Public external debt (i+ii)	62.5	66.9	0.2	4.3	0.9	3.5
i) Govt. debt	56.4	60.6	0.4	4.2	0.8	3.4
Of which;						
Paris club	12.0	11.9	-1.1	-0.1	0.1	-0.2
Multilateral	27.6	27.9	-0.7	0.3	0.3	0.0
Other bilateral	5.8	6.5	0.7	0.7	0.4	0.2
Euro/Sukuk bonds	4.8	7.3	1.0	2.5	0.0	2.5
Commercial loans (LT)	4.8	5.3	1.0	0.5	-0.1	0.6
ii) IMF	6.1	6.3	-0.1	0.1	0.1	0.0
iii) Foreign exchange liabilities	3.6	3.7	-0.1	0.1	0.0	0.0

Data source: State Bank of Pakistan and Economic Affairs Division

Despite higher repayments, the increase in external debt was largely due to US$ 2.5 billion mobilized through Euro bond/Sukuk issuance and borrowings from commercial banks during the period.

In addition, strengthening of other currencies against US dollar resulted in US$ 669.3 million as revaluation losses. Specifically, the Dollar weakened against Euro and SDR by 4.9 percent and 2.3 percent respectively, which added significantly to dollar value of Pakistan's external debt.

Table 4.10: External Loan Disbursement during H1
million US$

	FY17	FY18	Absolute change
ADB	674.6	443.3	-231.3
IDA	72.3	132.3	60.0
IDB	30.2	55.4	25.2
IBRD	127.5	86.7	-40.8
IDB (short term)	212.4	695.2	482.8
China	848.0	506.9	-341.1
Japan	42.8	47.4	4.6
Euro/Sukuk bond	1,000.0	2,500.0	1,500.0
Commercial banks	900.0	1,164.0	264.0
Others	45.1	0.0	-45.1
Total	3,952.9	5,692.2	1,739.3

Data source: Economic Affairs Division

Gross loan disbursements increased by 44 percent during H1-FY18. Around two-thirds of the inflows came from bond issuance and the government borrowings from the foreign commercial banks (**Table 4.10**). In addition to commercial borrowings, the support from the multilateral donors came largely for energy and infrastructure projects. Within bilateral loans, major inflow came from China, meant for infrastructure projects under CPEC.

It is worth noting that the Euro/Sukuk bonds issuance was oversubscribed by more than US$ 8 billion. The investor base was also quite diversified; with 44 percent from Europe, 24 percent from Asia, 20 percent from North America, 8 percent Middle East and 12 percent from other regions. Encouragingly, the rate of return on 10-year bonds was lower compared with fixed rate bonds issued during last 10 years (**Table 4.11**). This development bodes well in terms of lengthening the maturity profile, cost effectiveness and the interest rate risk on external debt portfolio.

Table 4.11: Sovereign Eurobonds Issued by Pakistan
Value in million US$

	Tenor	Value	Interest rates
FY14	5 years	1,000	7.25%
	10 years	1,000	8.25%
FY15	5 years	1,000	6.75%
FY16	10 years	500	8.25%
FY17	5 years	1,000	5.5%
FY18	5 years	1,000	5.625%
	10 years	1,500	6.875 %

Data source: Economic Affairs Division

The servicing of public external debt was US$ 720.2 million higher during H1-FY18 compared to the same period last year (**Table 4.12**). The main servicing burden was due to repayment to the foreign commercial (bank) loans that reached around US$ 537.4 million during H1-FY18. In addition, the repayment to Paris club and other multilateral donors also increased significantly during the period.

Table 4.12: Servicing of Public External Debt during H1 (Principal + Interest)
million US$

	FY17	FY18	Change
Government debt	1,479.7	2,198.6	718.9
Of which			
Paris club	250.6	416.4	165.8
Multilateral	787.5	831.3	43.8
Other bilateral	200.7	198.0	-2.6
Euro/Sukuk bonds	169.4	171.3	1.9
Commercial loans	21.4	537.4	516.0
IMF	37.3	60.7	23.4
External liabilities	32.6	10.5	-22.1
Total	**1,549.6**	**2,269.7**	**720.2**

Data source: State Bank of Pakistan

Box 4.1: Depreciation and Public Debt

Typically, public debt is issued to finance the fiscal and current account deficits. Within public debt, the external debt is contracted in different currencies and then converted into US$ and then to PKR for the reporting purposes. Thus, any movement in the international currencies (in which debt is contracted) and PKR vis-à-vis US$ can change the dollar and PKR value of external debt respectively. On the contrary, the domestic debt does not carry currency risk.

In Dollar terms, Pakistan's public external debt stood at US$ 66.9 billion as of end December 2017, registering a growth of 6.9 percent over June 2017. In Rupee terms, however, the debt increased by 12.6 percent to reach at Rs 7.3 trillion as of end December 2017 (**Table 4.1.1**). The difference in growth primarily reflects the impact of PKR depreciation during the first half of FY18.

As of end December 2017, Pakistan's public debt amounted to Rs 22.8 trillion, of which around Rs 15.4 trillion is denominated in local currency. This means around two-third of the public debt is not prone to any currency risk. On the other hand, the PKR depreciation against US$ increased the PKR value of the external debt; however, this has not added to foreign currency liability of the country.

Table 4.1.1: Growth in Stock of Public External Debt

	Dec-13	Jun-14	Dec-14	Jun-15	Dec-15	Jun-16	Dec-16	Jun-17	Dec-17
Billion US$	47.5	51.5	50.4	51.0	53.4	57.8	58.0	62.5	66.9
Growth (%)	*-1.4*	*8.4*	*-2.0*	*1.1*	*4.7*	*8.2*	*0.4*	*7.8*	*6.9*
Billion PKR	5,017.3	5,084.7	5,064.2	5,187.6	5,596.1	6,050.8	6,079.6	6,559.4	7,383.4
Growth (%)	*5.2*	*1.3*	*-0.4*	*2.4*	*7.9*	*8.1*	*0.5*	*7.9*	*12.6*

Data source: State Bank of Pakistan

The impact of depreciation on government accounts is realized when the repayment of external debt is actually made. Here, it is also important to highlight that the entire amount of debt does not mature on the same day; rather, it becomes due over a period of time. Usually countries with higher short-term debt suffer most from the exchange rate depreciation, only when creditors refuse to roll over the debt while reserves are also insufficient to cover the debt maturities. In case of Pakistan, the short term external debt accounts for only 1.7 percent of total public external debt, of which around 80 percent is IDB short-term financing for oil imports. Moreover, Pakistan's short term debt is equivalent to 8 percent of country' FX reserves, which provides sufficient liquidity buffer in case of any repayment difficulties.

The available literature on public debt sustainability suggests that the depreciation could have both negative and positive impact on debt sustainability. Once currency depreciates, servicing cost increases and that has the negative balance sheet impact on public debt. At the same time, the depreciation increase the price competiveness, boosts net exports, government revenues and hence has a positive income effect on GDP.

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5 External Sector

5.1 Overview

Pakistan's balance of payments position remained under stress in H1-FY18, as the rise in imports overshadowed a healthy turnaround in FX receipts from exports and workers' remittances.[1] The current account deficit widened to US$ 7.9 billion in the period (from US$ 4.7 billion in H1-FY17), and could not be completely financed by the surplus in the financial account. As a result, SBP's liquid FX reserves fell by US$ 2.0 billion in the first half to US$ 14.1 billion by end-December 2017. The PKR also remained under pressure, depreciating by a cumulative 5.0 percent during the period (**Table 5.1**).

Table 5.1: Summary of Pakistan's External Sector

million US$

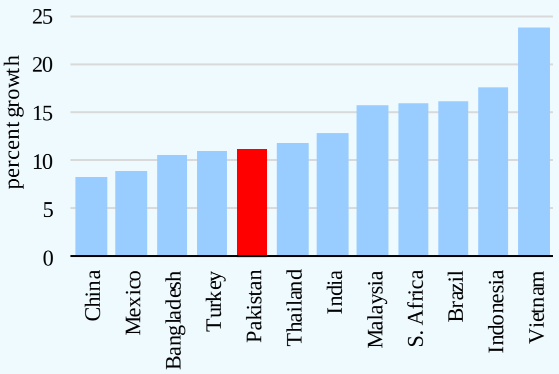
	Q2		*Change in Q2*		H1		*Change in H1*	
	FY17	**FY18**	**FY17**	**FY18**	**FY17**	**FY18**	**FY17**	**FY18**
Current account balance	-3,023	-4,374	-1,108	-1,351	-4,660	-7,920	-2,164	-3,260
Trade balance	-6,077	-7,371	-1,035	-1,294	-11,342	-14,643	-1,543	-3,301
Exports	5,577	6,131	112	554	10,629	11,795	-154	1,166
			(2.1)	*(9.9)*			*(-1.4)*	*(11.0)*
Imports	11,654	13,502	1,147	1,848	21,971	26,438	1,389	4,467
			(10.9)	*(15.9)*			*(6.7)*	*(20.3)*
Oil imports	2,649	3,385	578	737	4,998	6,330	214	1,332
Non-oil imports	9,005	10,117	569	1,112	16,973	20,108	1,175	3,134
Services balance	-1,099	-1,405	-36	-306	-2,256	-2,672	-815	-416
Primary income balance	-1,426	-1,489	185	-63	-2,418	-2,511	342	-93
Secondary income balance	5,579	5,891	-222	312	11,356	11,906	-148	550
Worker's remittances	4,765	4,955	43	190	9,505	9,746	-183	241
Financial account balance	-2,798	-4,730	-453	-1,932	-4,730	-6,364	-710	-1,634
FDI in Pakistan	998	795	259	-203	1,421	1,496	174	75
FPI in Pakistan	625	2,446	796	1,821	743	2,320	523	1,577
Eurobond/Sukuk	1,000	2,500	1,000	1,500	1,000	2,500	500	1,500
FX loans (net)	1,668	1,962	-966	294	2,880	2,575	-617	-305
IMF	0	0	-500	0	102	0	-1029	-102
SBP's liquid FX reserves	18,272	14,107	-220	250	18,272	14,107	129	-2,038
Exchange rate (PKR/USD)*	104.6	110.4	0.02	-4.54	104.6	110.4	0.2	-5.0

*(+)ve change shows appreciation, while (-)ve change reflects depreciation in percentage terms.
Figures in parenthesis represent growth rates.
Data source: State Bank of Pakistan

[1] Though the growth in imports is slowing down on a quarterly basis, the absolute increase in the import bill is the key driver of the current account deficit.

The country's exports posted a double-digit growth for the first time since the second half of FY11 (**Table 5.1**). A number of factors contributed to this trend reversal. The recovery in advanced economies from the latter half of 2017, with the US experiencing one of the fastest quarterly growth rates in the last three years, boosted demand for products exported by emerging economies, including Pakistan (**Figure 5.1**). Besides, the OECD economies also witnessed higher GDP growth in the third quarter of 2017. Furthermore, the recovery in global commodity prices pushed up export prices of non-basmati rice, manufactured products such as cotton yarn, hosiery, bedwear, readymade garments, and leather, and of petroleum products.

Figure 5.1: Export Performance of Developing Economies (Jul-Dec FY18)



Data source: Haver

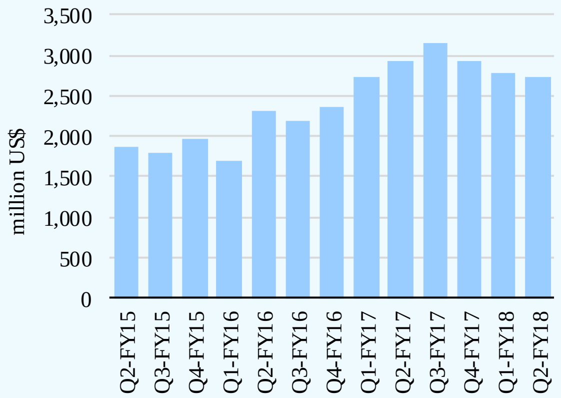
Second, the incentives announced by the government in FY17 for promoting exports may start giving results.[2] Under the Prime Minister's package announced for exporters in FY17, the government allowed duty drawback of up to 7.0 percent on the export of garments, home textiles, processed fabric, *greige* fabric and yarn manufacturing meant for export. The government also announced exemptions for the textile industry on the import of raw material (customs duty), and textile machinery (sales tax). In the presence of GSP Plus status, these incentives may have catalyzed the exports in H1-FY18, specifically to the European market.

However, as mentioned earlier, the import of goods and services continued to remain at an elevated level in absolute terms in H1-FY18. This time, the recovery in global commodity prices, specifically oil, mainly contributed to the payment burden. Almost 56.0 percent of the increase in the import of POL products in H1-FY18 came due to higher prices, with the rest of the increase driven by higher consumption, augmented by increased economic activity in the domestic economy.

[2] Last year, the government announced exemption from sales tax on the purchase of raw materials for five major export-oriented sectors: textiles, leather, sports goods, surgical goods and carpets.

Besides POL, increased demand for motorcars, palm oil, pesticides, chemicals, plastic materials, and iron and steel scrap contributed to the surge in non-oil imports. At the same time, it seems that the CPEC related projects are progressing to advanced stage, as suggested by the slowdown in machinery imports (**Figure 5.2**).

Figure 5.2: Pakistan's Machinery Imports



Data source: Pakistan Bureau of Statistics

Meanwhile, a welcome rebound was noted in workers' remittances during the period. Higher inflows from western economies, specifically the UK and the US, offset declining inflows from Saudi Arabia (KSA) - Pakistan's largest remittance corridor. As policies in the KSA are becoming more stringent for foreign workers, a further slowdown in inflows from KSA cannot be ruled out, at least in the short term (**Box 5.1**).

In the financial account, overall FDI went up slightly, driven mostly by significant Chinese investment under CPEC. Meanwhile, the participation of foreign investors in the domestic equity market also remained subdued, mainly due to prevailing expectations of a PKR depreciation through most of H1-FY18. Nonetheless, Pakistan was able to tap the international capital market and floated a Eurobond worth US$ 1.5 billion and a Sukuk worth US$ 1.0 billion in December 2017 at favorable rates.

The sovereign debt issuance, along with other official borrowings (from commercial, bilateral and multilateral sources) helped slow down the decline in official FX reserves, *albeit* partially, to US$ 2.0 billion in H1-FY18. Due to strong pressure on reserves, PKR depreciated by 4.4 percent against the USD in December 2017. Though this depreciation might help FX receipts from exports and foreign equity investors, other structural bottlenecks, such as high cost of doing business and higher export concentration towards the textile sector, need to be addressed. Promoting Pakistan's business friendly image at the global level will be key in this context.

5.2 Current account

The current account deficit rose by almost 1.7 times on YoY basis to US$ 7.9 billion in H1-FY18. In addition to a sharp increase in the trade deficit, higher profit repatriation by multinational companies operating in Pakistan, dented the growth in worker remittances and contributed to the rising current account gap.

Workers' Remittances

After declining last year, worker remittances rose by 2.5 percent and reached US$ 9.7 billion during H1-FY18 (**Table 5.2**). The increase in inflows was more pronounced in Q2-FY18 with a growth of 4.0 percent.

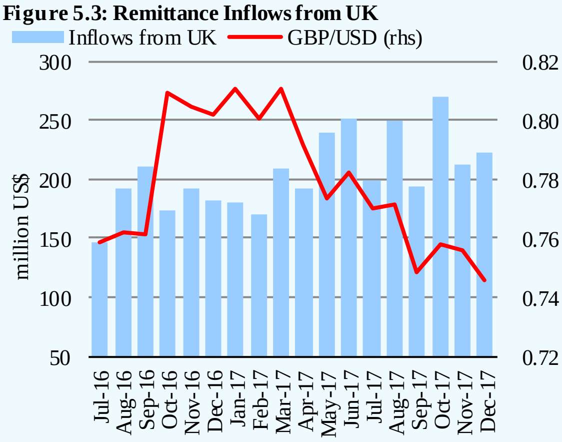
Table 5.2: Workers' Remittance Flows to Pakistan (million US$)

	FY17			FY18			% share in H1		Growth in
	Q1	Q2	H1	Q1	Q2	H1	FY17	FY18	H1-FY18
Total	**4,740**	**4,765**	**9,505**	**4,790**	**4,955**	**9,745**	**100**	**100**	**2.5**
GCC	2,975	3,052	6,027	2,869	2,951	5,820	63	60	-3.4
Saudi Arabia	1,324	1,411	2,735	1,228	1,303	2,531	29	26	-7.5
UAE	1,076	1,061	2,137	1,078	1,083	2,161	22	22	1.1
Other GCC	576	580	1,156	563	565	1,129	12	12	-2.3
UK	550	548	1,098	643	707	1,350	12	14	23.0
USA	613	559	1,172	626	655	1,281	12	13	9.3
Other countries	603	605	1,208	652	642	1,294	13	13	7.1

Data source: State Bank of Pakistan

The shares of both the US and the UK in remittances to Pakistan have increased this year. Healthy economic activity in the US and low unemployment have likely supported the growth in inflows from this corridor (**Figure 5.3**). Furthermore, a sharp depreciation of the US Dollar against the British Pound inflated the dollar value of the remittances originating from the UK.

Figure 5.3: Remittance Inflows from UK



Data source: State Bank of Pakistan

On the contrary, the share of Saudi Arabia in total inflows in H1-FY18 declined from last year; this trend is expected to continue going forward as well due to a tough regulatory climate for migrant workers in the kingdom (**Box 5.1**).

Box 5.1. Recent Important Changes in Employment and Residency Policies in Saudi Arabia
Saudi Arabia has introduced a number of economic reforms to cope with the low oil price environment. These reforms have the potential to bring important change in remittances to Pakistan, at least in the short run. The most important is the job nationalization drive, which aims to replace expatriate workers with Saudi citizens.

The key measures under job nationalization program are as follows.

- From July 2017, the Saudi government imposed a new tax of SAR 100 per dependent per month on expatriates and their dependents. This tax is expected to increase gradually every year until 2020. The tax amount has doubled to SAR 200 from January 2018, and will increase to SAR 300 in 2019 and to SAR 400 by 2020.

- From January 2018, the tax rate of SAR 200 per foreign employee per month has been increased to SAR 300 on private companies, hiring equal number of expatriates and Saudi workers. This rate will increase to SAR 500 per employee per month in 2019 and to SAR 700 in 2020.

- Companies employing more foreign workers than Saudi nationals are required to pay SAR 400 per employee per month in 2018. This tax is expected to increase to SAR 600 in 2019 and SAR 800 in 2020. Generally, the additional tax for hiring more foreign workers used to be waived in the past. However, no waiver is allowed under the new tax regime.

- Saudi Arabia, along with the United Arab Emirates, has introduced Value Added Tax (VAT) at the rate of 5.0 percent from January 2018. The VAT has been imposed on most wholesale and retail sales, including on food consumed at restaurants. This tax is likely to increase the cost of living for unskilled lower income foreigners in KSA and UAE. Saudi Arabia generally hires semi-skilled or unskilled labor from Pakistan. The VAT, being regressive in nature, is expected to affect the savings of the unskilled labor force, which will force them to send lower amounts back home.

- Lastly, the Saudi government has removed the driving ban for women from September 26, 2017. From Pakistan's perspective, this step will have repercussions, as the demand for foreign drivers is likely to decrease, going forward.

Though the taxes discussed above affect all expatriates equally, the imposition of levy on dependents and higher taxes on the companies employing foreign workers will affect the skilled and high skilled workers the most; these are the jobs for which Saudi citizens prefer competing with foreigners. Therefore, a large number of people with 'white collar' jobs will be forced to either send their families back home or quit their jobs permanently and return to Pakistan. Not surprisingly, remittances inflows from Saudi Arabia declined by 7.5 percent in H1-FY18.

This decline in inflow may become stronger going forward, after the imposition of VAT from January 01, 2018 in both KSA and UAE.

Yet, inflows are expected to recover from other GCC countries, particularly Qatar, Bahrain and Oman. These GCC members have publicly announced a temporary deferment of the VAT.

Moreover, recent policy initiatives undertaken in Pakistan, in the form of the Asaan Remittance Account and the promotion of home remittances through m-wallets, may boost remittances in the future **(Box 5.2)**.

Box 5.2. Pakistan's Initiatives to Promote Home Remittances through Banking Channels
Pakistan launched two major schemes in December 2017. SBP, in collaboration with the Pakistan Remittance Initiative (PRI), launched the Asaan Remittance Account. Meanwhile the government, in cooperation with SBP and the financial industry, launched a scheme for promotion of remittances through m-wallets.

The key feature of the 'Asaan Remittance Account' is that it can be opened in any scheduled bank through a simplified procedure. Similar to the 'Asaan Account' launched by SBP in 2015, the one-page account opening form for the 'Asaan Remittance Account' asks for basic customer information only. The customer due diligence and other controls specified for 'Asaan Account' are applicable on the opening of the Asaan Remittance Account as well. This initiative aims to encourage beneficiaries to receive remittances in a secured banking environment instead of over-the-counter cash they receive through traditional sources.

The key feature of the m-wallet scheme is that the beneficiaries will be able to withdraw cash from ATMs, bank branches or from hundreds of thousands of branchless banking agents. Moreover, they will be able to make digital payments, for example pay utility bills, by using their m-wallets. This initiative aims to increase financial inclusion in the country, besides enhancing the pace and reducing the cost of remittance delivery.

The above two schemes are expected to improve the inflow of worker remittances, besides promoting financial inclusion, particularly in far-flung areas with limited financial infrastructure.

5.3 Financial account

The surplus in the financial account rose to US$ 6.6 billion in H1-FY18 from US$ 4.7 billion in H1-FY17. This improvement can mainly be traced to the floatation of Sukuk and Eurobond worth US$ 2.5 billion in December 2017; these issuances significantly boosted FPI inflows during the period. FDI also registered a marginal increase in the first half of the year.

Foreign direct investment

Net FDI rose by 5.3 percent in H1-FY18 over last year, despite a substantial increase in inflows from China (**Table 5.3**). FDI from China mainly arrived in the power and construction sectors.

China's share in the country's net FDI more than doubled from 28.0 percent in H1-FY17 to 71.8 percent this year. In particular, Q2-FY18 witnessed the second highest quarterly inflows of US$ 536.0 million that Pakistan has received from China, after US$ 724.7 million received in Q4-FY14 **(Figure 5.4)**.

Besides power and construction, firms in exploration and production (E&P) and financial sector also attracted FDI, though their quantums remained relatively moderate.

Table 5.3: Sector-wise Net FDI in Pakistan

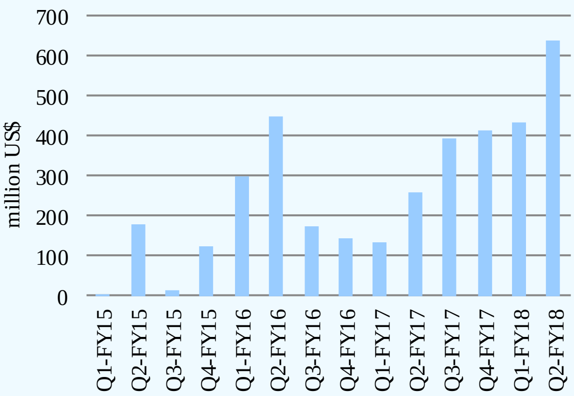
(million US$)

	FY17		FY18		H1		Change in
	Q1	Q2	Q1	Q2	FY17	FY18	H1-FY18
Total	**423.4**	**998.1**	**699.9**	**794.6**	**1,421.5**	**1,494.4**	**72.9**
Construction	31.4	52.4	123.6	226.1	83.8	349.7	265.9
Power	121.3	217.9	239.6	382.0	339.2	621.6	282.4
Financial business	60.1	53.8	121.5	67.5	113.9	189.0	75.1
Telecommunications	4.5	-56.1	55.8	-84.9	-51.6	-29.1	22.5
Oil & gas explorations	34.9	45.5	53.3	54.5	80.4	107.8	27.5
Electronics	4.4	134.4	6.2	8.7	138.8	14.9	-124
Food	10.3	488.9	4.0	16.4	499.2	20.4	-478.9
Others	156.6	61.2	95.7	124.3	217.8	211.6	-6.2

Data source: State Bank of Pakistan

Nonetheless, the stagnation in FDI calls for a more concerted policy effort. Though improved power supply and law and order situation have provided some comfort to the business community, a lot remains to be done to advance the business friendly image of Pakistan among foreign investors.[3]

Figure 5.4: Net FDI Inflows from China



Data source: State Bank of Pakistan

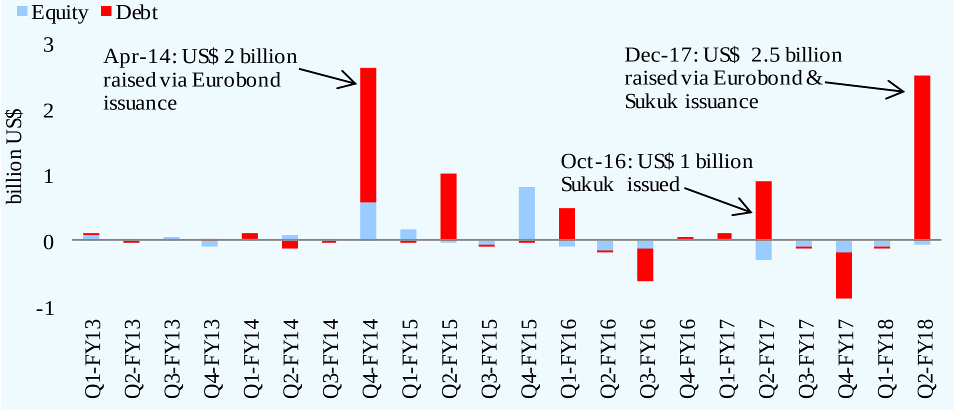
Foreign portfolio investment

Official flows continued to dominate foreign portfolio investment in H1-FY18. Inflows of US$ 1.0 billion via Sukuk and US$ 1.5 billion via Eurobond were realized in the second quarter. These inflows not only offset outflow of foreign funds from the domestic equity market, but also helped the government retire some of its external commercial

[3] In the World Bank's Doing Business 2018 ranking of 190 economies, Pakistan stood at 147th position, only above Bangladesh (177) and Afghanistan (183) among regional peers. Regional countries such as Bhutan (75), India (100), Nepal (105), Maldives (136), and Sri Lanka (111) all fared better than Pakistan.

borrowings **(Figure 5.5)**.

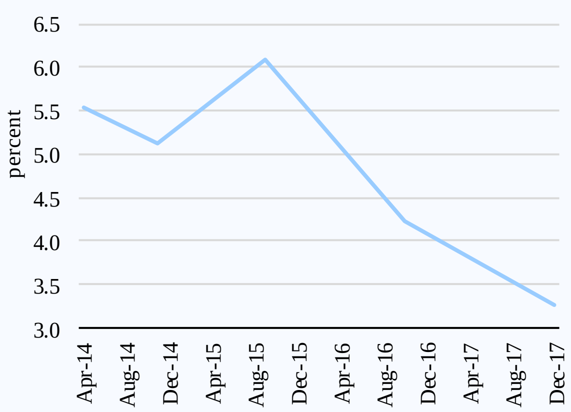
Figure 5.5: Foreign Portfolio Investment in Pakistan



Data source: State Bank of Pakistan

More importantly, the risk premium attached by investors on the 10-year Sukuk bond dipped to a recent low of 3.3 percent from a high of 6.1 percent asked by investors for the Eurobond issued in September 2015 (**Figure 5.6**).[4] This shows that foreign investors were highly confident about the performance of Pakistan's economy.

Figure 5.6: Risk Premium on Eurobond/Sukuk Floatation



Data source: Bloomberg and SBP calculations

As for private flows, the downward trend witnessed in some of the Asian equity markets during Q2-FY17 was reversed in Q2-FY18, as foreign selling pressure in anticipation of Fed rate hike and uncertainty over the new US administration eased **(Table 5.4).** However, neither China nor Pakistan benefitted from this trend reversal in portfolio inflows.

[4] Risk premium is the difference between the market yield on the 10-year Eurobond/Sukuk on the date of floatation and the monthly average of 10-year US Treasury rates. Where the 10-year bond is unavailable, the risk premium is calculated using the 5-year paper. Information of 10-year Sukuk is used for calculating the December 2017 risk premium.

Specifically in China, where Shanghai Composite Index (SCI) tumbled by over 3.0 percent during the second half of November 2017, the outflow was triggered by the structural reforms undertaken by the Chinese government to deleverage its state enterprises.

Table 5.4: Performance of Major Asian Equity Markets
(growth in percent)

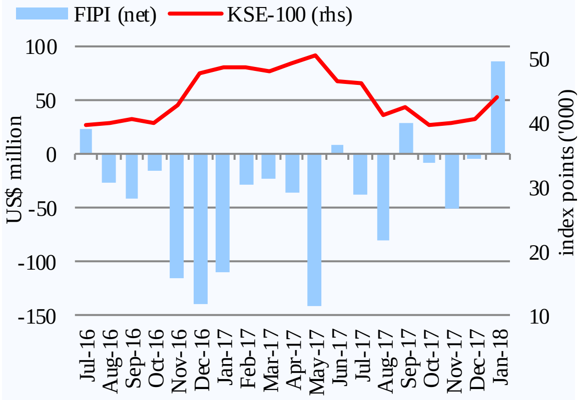
	FY17				FY18	
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**
India	5.1	-5.4	13.2	3.8	3.2	8.4
Indonesia	6.9	-1.3	5.1	4.7	1.2	7.7
Thailand	2.6	4.0	2.1	0.0	6.2	4.8
Pakistan	5.0	19.0	-2.3	-5.6	-8.6	2.9
Malaysia	-0.1	-0.7	6.0	1.4	-0.5	2.3
China	2.6	3.3	3.8	-0.9	4.9	-1.2

Data source: Bloomberg

By contrast, in Pakistan, active participation by local investors brought a revival in PSX performance, which after declining since Q3-FY17, posted 2.9 percent YoY growth in Q2-FY18 **(Table 5.4)**.

More recently in January 2018, foreigners purchased US$ 86 million worth of Pakistani stocks, reversing a prolonged spell of either equity sell-off or tepid foreign buying **(Figure 5.7)**.

Figure 5.7: Foreign Investment in Pakistani Equities



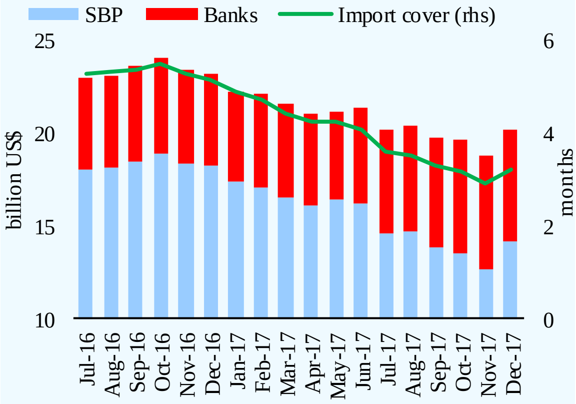
Data source: NCCPL, Pakistan Stock Exchange

Besides attractive valuation, two factors explain this recent surge in portfolio inflows. First, the successful raising of US$ 2.5 billion through the international capital market at relatively low risk premium showed the confidence of foreign fixed income investors on Pakistan's growth prospects; this may have inspired equity investors to follow the trail. Second, market information confirms that foreign funds were holding back in anticipation of a PKR depreciation, ever since the short-lived adjustment in the PKR-USD parity in July 2017, and the continually widening current account deficit. When the PKR–USD parity finally adjusted in December 2017, foreign portfolio investors gained some comfort and re-entered the Pakistani equity market.

5.4 Reserves and Exchange Rate

The higher current account deficit amid insufficient financial inflows meant that the payments gap had to be met by reserve drawdown: SBP's liquid FX reserves fell by US$ 2.0 billion in H1-FY18. The drop was sharper in the first five months of FY18, when official reserves decreased by US$ 3.5 billion (**Figure 5.8**). The issuance of US$ 2.5 billion worth of Eurobond and Sukuk partially slowed this drawdown, with SBP's reserves ending December 2017 at US$ 14.1 billion.

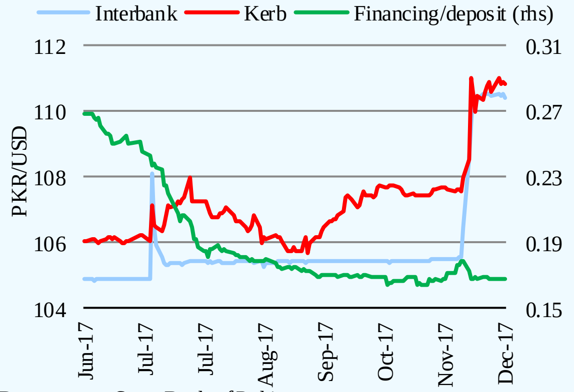
Figure 5.8: Pakistan's FX Reserves



Data source: State Bank of Pakistan

Contrary to the pressure on SBP's reserves, the commercial banks' reserves in H1-FY18 increased by US$ 812.1 million. Anecdotal evidence suggests that retail investors and the general public, in anticipation of a PKR depreciation, purchased dollars from the kerb market and deposited them in foreign currency accounts.

Figure 5.9: USD-PKR Exchange Rate Movements and FX Market Activity



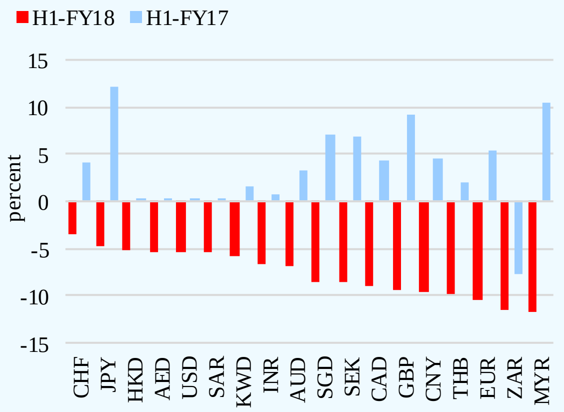
Data source: State Bank of Pakistan

The deposits under these accounts grew by 4.9 percent in H1-FY18.[5] Moreover, FE-25 financing declined by 26.0 percent during July-November 2017, indicating that private businesses stayed away from FX borrowing to avoid exchange rate risk. Consequently, the FE-25 financing to deposit ratio declined sharply by 30.2 percent **(Figure 5.9)**.

[5] FE-25 deposits increased by 6.0 percent between July and November, 2017.

Nevertheless, following the PKR's 4.4 percent depreciation against the US Dollar in December 2017, market expectations of a further currency adjustment dissipated; as a result, the kerb premium almost disappeared by end-2017 **(Figure 5.9).** Notably, the PKR depreciation came at a time when most currencies of developed and developing economies were strengthening against the US Dollar **(Figure 5.10)**.

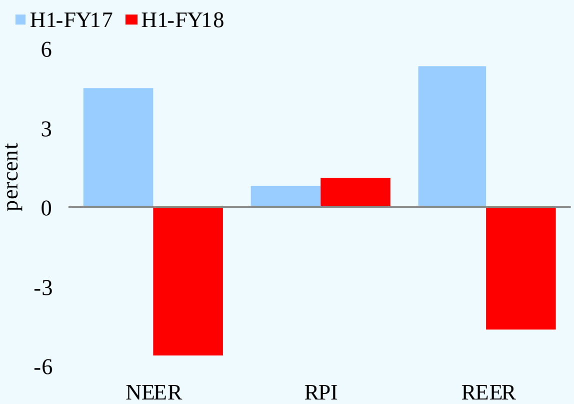
Figure 5.10: Movement of PKR Against Major Currencies



Data source: State Bank of Pakistan

Meanwhile, in line with the significant depreciation against most important currencies, Pakistan's nominal effective exchange rate (NEER) depreciated by 5.7 percent during H1-FY18. The real effective exchange rate (REER), on the other hand, depreciated by 4.6 percent, driven mainly by NEER; this suggests that the Rupee's competitiveness in real terms *viz-a-viz* currencies of other trading partners has improved **(Figure 5.11)**.

Figure 5.11: Trend in Pakistan's NEER, RPI and REER



Data source: State Bank of Pakistan

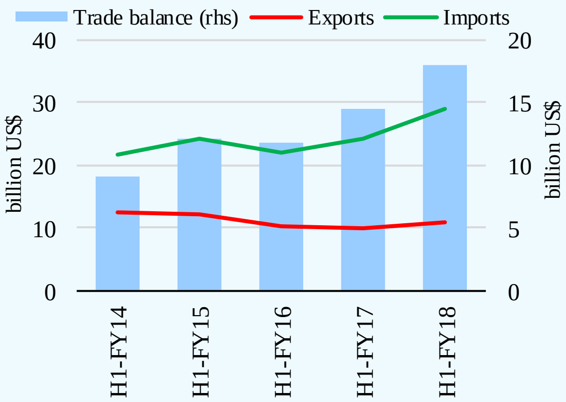
5.5 Trade Account[6]

The trade deficit widened by 23.0 percent YoY to US$ 17.7 billion in H1-FY18. A strong recovery in exports was not sufficient to offset the rise in imports, which increased to US$ 28.7 billion **(Figure 5.12)**. The uptick in exports, which started in Q4-FY17, gathered steam on the back of strong performances by textiles, rice

[6] The analysis is based on the provisional data provided by Pakistan Bureau of Statistics. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*. To understand the difference between these two data series, please see Annexure on data explanatory notes.

and manufactured items. On the other hand, recovering global oil prices and burgeoning domestic demand in the transport sector played a key part in pushing up imports in H1-FY18.

Figure 5.12: Pakistan's Trade Performance



Data source: Pakistan Bureau of Statistics

5.5.1 Exports

Pakistan's exports staged a comeback with a growth of 11.0 percent in H1-FY18. The recovery was broad-based, with textiles (up 8.1 percent), food (17.0 percent), and manufactured items (11.3 percent) figuring prominently (**Figure 5.12**). The rising exports suggest that the easing of some structural barriers, such as energy supply and security situation, have finally started to benefit key exporting industries.

On the demand side, a synchronized upswing in the global economy is translating into consistently strong demand from traditional western markets. Pakistani exports, particularly of rice, made significant inroads into new markets in the OECD countries.

<u>Textile</u>

Textile exports rose 8.1 percent to US$ 6.6 billion in H1-FY18, and accounted for 60.5 percent of overall exports during the period **(Table 5.5)**. Globally, higher commodity prices along with robust demand from the EU and the US are sustaining the growth momentum, which started from Q3-FY17. Specifically in the presence of the GSP Plus status and the depreciation of US Dollar (and PKR) against the Euro provided much needed impetus to Pakistan's exports to the EU market.

Supplementing favorable demand-side conditions, the recent heavy import of machinery by the textile industry, availability of cheap credit, disbursement of sales tax refunds, and broadening of the scope of the export package announced in FY17, all contributed to higher textile exports in the period.

Table 5.5:Export of Major Items during Jul-Dec
(Values in million US$; growth in percent)

		Quantum			Values		
	Units	**FY17**	**FY18**	**YoY growth**	**FY17**	**FY18**	**YoY growth**
Food group		-	-	-	**1,653.7**	**1,934.4**	**17.0**
Rice	000 MT	1,660.0	1,796.5	8.2	712.8	849.7	19.2
a) Basmati	000 MT	190.3	183.4	-3.6	177.1	195.1	10.2
b) Others	000 MT	1,469.7	1,613.1	9.8	535.7	654.6	22.2
Fish and fish prep.	000 MT	66.9	79.5	18.8	183.5	200.6	9.3
Fruits	000 MT	295.5	220.9	-25.2	198.1	180.5	-8.9
Meat and meat prep.	000 MT	30.3	26.9	-11.2	104.4	147.4	41.2
Textile group		-	-	-	**6,146.6**	**6,642.5**	**8.1**
Raw cotton	000 MT	20.9	32.2	54.1	35.9	53.3	48.5
Cotton yarn	000 MT	230.9	256.2	10.9	657.2	661.5	0.7
Cotton fabrics	M SQM	1,006.1	1,015.8	1.0	1,067	1,066.9	0.0
Hosiery (knitwear)	000 DZ	51,163.0	52,908.0	3.4	1,177.6	1,334.8	13.3
Bedwear	000 MT	178.1	185.5	4.2	1,058.5	1,124.4	6.2
Towels	000 MT	91.1	101.1	10.9	380	385.6	1.5
Readymade garments	000 DZ	16,589	18,776.0	13.2	1,100.1	1,249.5	13.6
Synthetic textiles	M SQM	65.1	143.1	119.6	83.5	148.0	77.4
Petroleum group		-	-	-	**89.3**	**163.6**	**83.1**
Solid fuel incl. naphtha	000 MT	46.6	58.8	26.1	15.6	23.3	48.9
Other manufactures		-	-	-	**1,529.1**	**1,701.4**	**11.3**
Leather manufactures		-	-	-	260.5	265.3	1.8
Foot wear	000 pair	4,682.0	4,473.0	-4.5	46.9	50.0	6.7
Pharmaceuticals	000 MT	5.5	5.3	-2.6	109.4	103.0	-5.8
Electric fans	000 No.	535.0	452.0	-15.5	10.2	9.5	-7.6
Cement	000 MT	2,802.4	2,360.4	-15.8	145.6	118.6	-18.6
Others		-	-	-	**475.6**	**539.3**	**13.4**
Total exports		-	-	-	**9,894.4**	**10,981.2**	**11.0**

Data source: Pakistan Bureau of Statistics

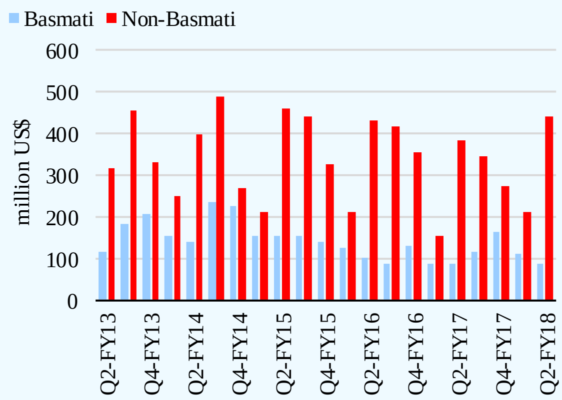
Specifically, in December 2017, the government extended the purview of the export package unveiled earlier by announcing an additional 2.0 percent duty drawback on exports to non-traditional markets. Moreover, the reimbursement of 50.0 percent of the duty drawback amount under the export package scheme was exempted for exporters demonstrating an increase in their foreign sales. The remaining 50.0 percent reimbursement was allowed upon posting an increase of more than 10.0 percent.[7]

Resultantly in H1-FY18, textile exports benefitted from both increased prices and higher quantum sales. Among different segments, the surge in quantum exports of cotton yarn and readymade garments was particularly impressive. Significant increases were also observed in quantum exports in the case of bed wear, knitwear and raw cotton items. On the other hand, the price effect was more dominant in knitwear. **(Table 5.5)**.

<u>Rice</u>

Among food items, non-basmati rice exports recovered from a disappointing performance last year, and grew by 21.7 percent in H1-FY18 (**Figure 5.13**). This can be attributed to a variety of factors, specifically efforts of rice exporters to adopt enhanced processing quality techniques, better marketing strategies (to increase their share in existing markets), and exploring new markets. Consequently, Pakistan's rice exports to the Middle East, Australia, Canada and Europe increased significantly.

Figure 5.13: Pakistan's Rice Exports



Data source: Pakistan Bureau of Statistics

A notable push to non-basmati rice exports came from Bangladesh. Pakistan's exports to the South Asian neighbor in H1-FY18 increased nearly ten-fold and crossed US$ 5.0 million. The demand from Bangladesh is likely to stay strong as the country is reeling from floods that damaged local crops, and led domestic prices to reach a record high.[8] Meanwhile, Pakistan's export of basmati rice increased by 10.2 percent.

H1-FY18 also saw a healthy growth in the export of chemicals and pharmaceutical, 'medical & surgical instruments' and cutlery items. Moreover,

[7] Notification No. 1(42-A)TID/17-TR-II, Ministry of Textile & Commerce (Textile Division), Islamabad.

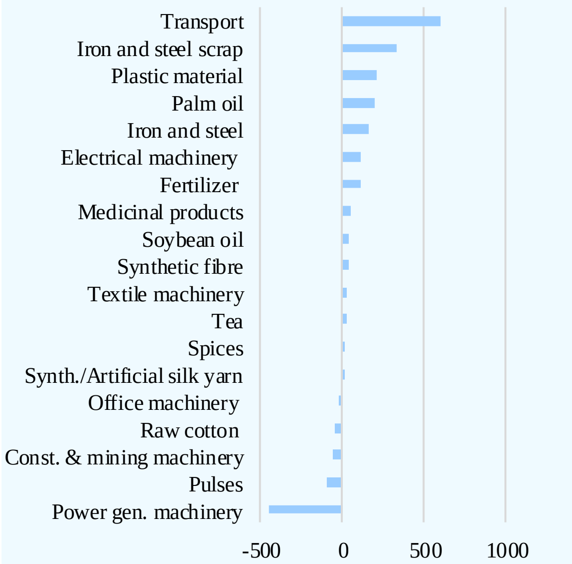
[8] According to FAO, Bangladesh's rice imports jumped from 0.1 million tonnes in 2016 to 2 million tonnes in 2017. Moreover, in November 2017, the government announced purchase of 300000 tonnes of rice, at USD 464 per tonne, up from USD 393 per tonne offered a year earlier.

keeping in view the sugar surplus in the country, the government lifted the export ban and announced a subsidy; this led to sugar exports of nearly half a million tonnes (leading to FX earning of US$ 118.5 million).[9]

5.5.2 Imports

Imports surged by 18.1 percent to reach US$ 28.7 billion in Jul-Dec FY17. Transport group recorded the highest increase of 43.0 percent, followed by petroleum, metal and food groups, whose imports rose by 33.4 percent, 30.9 percent and 13.2 percent, respectively. Machinery imports reversed their recent rising trend and recorded a YoY decline of 2.9 percent in H1-FY18 (**Figure 5.14**).

Figure 5.14: Major Non-oil Imports during Jul-Dec FY18
(Absolute YoY change in million US$)



Data source: Pakistan Bureau of Statistics

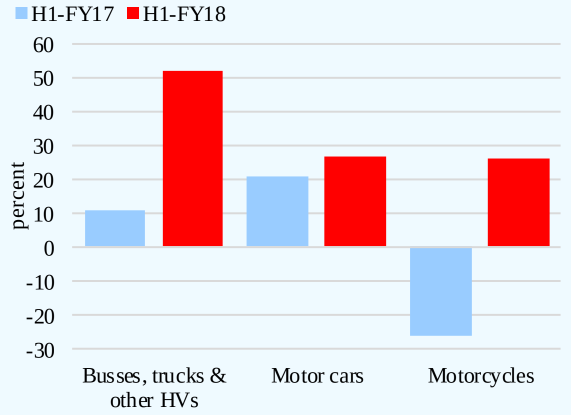
<u>Transport</u>

Transport imports increased by 43.0 percent in H1-FY18, compared to a rise of 6.2 percent recorded in the same period last year. Import of parts and accessories for local assembly of commercial and private vehicles (CKD/SKD) remained strong. Within this, the import of 'buses, trucks & other heavy vehicles' rose by 39.5 percent, and motor cars and motor cycles increased by 27.0 and 26.0 percent, respectively.

The significant growth in the import of auto parts corresponded with strong sales of locally assembled vehicles **(Chapter 2).** Besides, surging imports of these items points to carmakers' expectations of sustained high demand going forward, as the industry tends to import kits and accessories on the basis of advance booking orders.

[9]The Economic Coordination Committee (ECC) allowed the export of 1.5 million tonnes of sugar with a subsidy of Rs 10.70 per kilogram in late November 2017.

Figure 5.15: Disaggregated Growth in Import of CKD/SKD



Data source: Pakistan Bureau of Statistics

Within Completely Built Units (CBU), motor car imports increased by 64.1 percent on YoY basis to US$ 275.8 million during Jul-Dec 2017 (**Figure 5.15**). Passenger vehicles, including motor cycles, are witnessing a burgeoning demand due to growing ride-hailing business in the country and a sharp rise in auto financing by commercial banks (**Chapter 3**).

The commercial import of CBUs is allowed only under personal baggage, gift scheme and transfer of residence scheme. As most motor cars are imported under the transfer of residence scheme, in October 2017, the government imposed mandatory requirement of paying duties and taxes in foreign currency through account of the sender of the car. However, these mandatory requirements were withdrawn on 23rd February 2018.[10]

The October 2017 measure was unable to dent the bullish sentiment in the imported car market. In fact, car imports under CBU jumped by 64.1 percent YoY in H1-FY18. The import of commercial vehicles in CBU, on the contrary, has started declining; went down by 29.6 percent YoY during H1-FY18.

<u>POL</u>

Petroleum group imports rose by 29.0 percent YoY to US$ 5.6 billion in H1-FY18, from US$ 4.4 billion in the same period last year. The price impact proved relatively stronger in case of POL imports, accounting for 66.4 percent of the YoY increase in the first half. On the other hand, the growth in quantum was moderate, increasing by 9.7 percent YoY in H1-FY18.

A sharp rise in the demand for crude oil and HSD was noted, in contrast to a sharp fall of 18.8 percent in volumetric imports of furnace oil (**Table 5.6**). While crude oil imports surged on the back of an increase in the country's oil-refining capacity, HSD and petrol imports rose on account of stronger demand from the transport sector.

[10] Through Commerce Division's SRO 126(1)/2018

The fall in furnace oil imports can be attributed to the government's policy decision, announced on October 27 2017, to close less-efficient power plants in a phased manner and to convert furnace oil-based plants to gas.[11] As a result, electricity generated through furnace oil dropped by 1,444 GWh in H1-FY18. On the other hand, gas based power plants, on the back of 71.2 percent increase in the RLNG imports, produced 2,940 GWh of additional electricity in H1-FY18 as compared to last year (**Table 5.7**).

Table 5.6: Quantum Import of Major POL Items in H1

	Quantity (000' tonnes)			**Growth** (percent)	
	FY16	**FY17**	**FY18**	**FY17**	**FY18**
HSD	1,306.8	1,837.2	2,103	40.6	14.5
Furnace oil	3,000.2	3,632.1	2,950.5	21.1	-18.8
Crude oil	4,640.1	4,261.1	5,135.5	-8.2	20.5
Petrol	2,068.7	2,558.9	2,688.7	23.7	5.1
Other	58.5	61.2	117.6	4.7	92.2

Data source: OCAC

Table 5.7: Power Generation by Source (GWh)

Fuel Source	**H1-FY17**	**H1-FY18**	**Abs Change**
Hydro	19,654	18,069	-1,585
Gas	15,016	17,956	2,940
Furnace oil	15,541	14,097	-1,444
Coal	37	3,883	3,846
Nuclear	2,507	4,355	1,849
Others	717	1,930	1,213
Total	**53,473**	**60,291**	**6,819**

Data source: NEPRA

Interestingly, the composition of Pakistan's energy imports is changing, with a tremendous increase in coal and RLNG imports. **Box 5.3** further discusses the changing composition of Pakistan's energy imports.

Box 5.3: Changing Composition of Pakistan's Energy Imports

Pakistan's energy mix has observed significant changes in recent years. From being predominantly oil-based, the economy's fuel choices have now spread to coal and liquefied natural gas. These developments are welcome from both diversification point of view, as well as from lowering the overall energy cost.

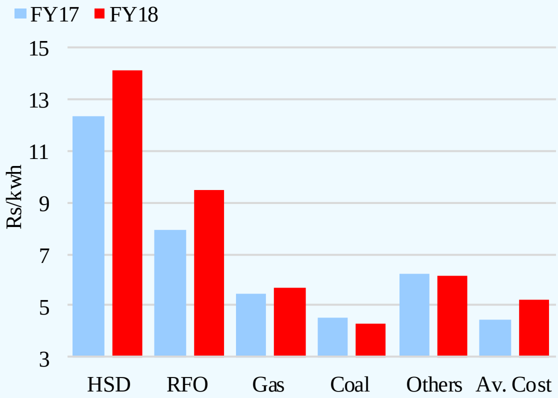
Table 5.3.1: Coal Based Power Plants under CPEC

Serial No	**Project description**	**Capacity (In MW)**	**Project status**
1	Sahiwal Plant, Punjab	1,320	Operational
2	Engro Thar Block II	660	In progress
3	Port Qasim Karachi	1,320	In progress
4	Gwadar, Pakistan	300	In progress
5	SSRL Thar Coal	1,320	In progress
6	CPHGC, Hub Balochistan	1,320	In progress
7	Rahimyar Khan	1,320	In progress
8	Muzaffargarh, Punjab	1,320	To be initiated
Total installed capacity planned		**8,880**	

Data source: Planning Commission (http://cpec.gov.pk/energy)

[11] Prime Minister Office's press release, October 27, 2017, available at: http://pmo.gov.pk/press_release_detailes.php?pr_id=2065

Figure 5.3.1: Comparison of Cost by Generation Source



Data source: National Electric Power Regulatory Authority

In H1-FY18, Pakistan imported coal and related products worth US$ 500.4 million, which was double the imports of only US$ 255.2 million in H1- FY17. This surge was primarily driven by coal-based Sahiwal power plant of 1,320 MW capacity, which was completed under the CPEC. **Table 5.3.1** shows that almost seven coal based power projects, of a total 8,880 MW installed capacity, are envisaged under CPEC, of which only one is currently operational. Therefore, going forward, the country's coal imports will rise significantly when all these plants become operational.

As coal-based power generation is cheaper compared to furnace oil or LNG, it is likely to get a higher place in the 'Operational Merit Order' if the current price scenario continues (**Figure 5.3.1**). This is evident from the increase in power generation from coal to 3,883 GWh in H1-FY18 from a meager 37.0 GWh in H1-FY17. If this trend continues, the overall power generation cost is expected to decline going forward. From competitiveness perspective, these developments are welcome provided the environmental concerns are taken care of.

Palm oil

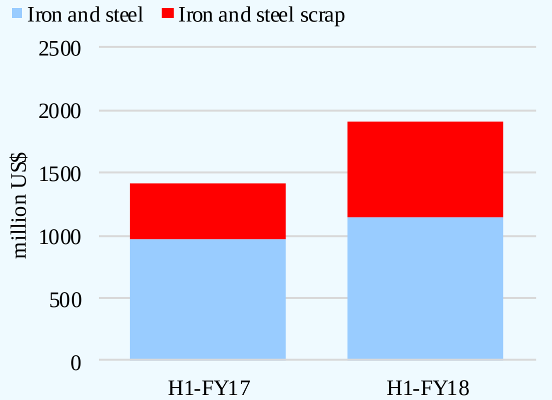
The country's palm oil imports crossed the US$ 1.0 billion mark in H1-FY18, primarily due to a volumetric increase of more than 168.6 thousand MT over the corresponding period of last year. Higher quantums accounted for nearly 71.0 percent of the increase in palm oil imports during the period. Appreciation in Malaysian Ringgit and increased demand from non-traditional segments (such as tea whitener) contributed to the 23.0 percent YoY increase in the palm oil imports.

Among other food items, soybean oil imports grew by 76.2 percent in the period. Soybean production in major producing countries, such as Brazil and Argentina, increased significantly, bringing international price of this commodity down. The lower price, in turn, induced importers to substitute other soft oils such as canola and sunflower with soybean, thereby pushing up its imports.

Iron and Steel

Within the metal group, steel imports rose by 16.8 percent on YoY basis to US$ 1.1 billion. A more pronounced increase was witnessed in the import of iron and steel scrap, which went up by 76.0 percent to US$ 777.3 million in H1-FY18 (**Figure 5.16**). The imposition of regulatory and anti-dumping duties on finished products, along with growing demand from construction and transport sectors, are the prime reasons behind elevated scrap imports.

Figure 5.16 : Pakistan's Iron and Steel Imports



Data source: Pakistan Bureau of Statistics

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:

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

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

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

Where I_t is consumer price index in t^{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;[1] 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.

[1] 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

AC	Air Conditioners
ADB	Asian Development Bank
ADP	Annual Development Programs
AED	United Arab Emirates Dirham
ATM	Automated Teller Machine
AUD	Australian Dollar
BBL	Barrel
BISP	Benazir Income Support Program
BoP	Balance of Payments
BPD	Barrels Per Day
BSC	Behbood Savings Certificates
CAD	Current Account Deficit/ Canadian Dollar
Capex	Capital Expenditures
CBU	Completely Built Unit
CDNS	Central Directorate of National Savings
CHF	Confoederatio Helvetica Franc (Swiss Franc)
CKD	Completely Knocked Down Unit
CNY	Chinese Yuan
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
DAP	Diammonium Phosphate
DFID	Department for International Development
DSC	Defense Savings Certificates
EIA	Energy Information Administration
EPA	Environmental Protection Agency
EPD	Exchange Policy Department
EU	European Union
EUR	Euro
FAO	Food and Agriculture Organization
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FIPI	Foreign Investors Portfolio Investment

FO	Furnace Oil
FPI	Foreign Portfolio Investment
FX	Foreign Exchange
FY	Fiscal Year
GBP	Great Britain Pound
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIS	Geographical Information Systems
GSP	Generalized System of Preferences
GSTS	General Sales Tax on Services
GW	Giga Watt
H	Half year
H1	First Half
HKD	Hong Kong Dollar
HSD	High Speed Diesel
HV	Heavy Vehicle
IBRD	International Bank for Reconstruction and Development
ICE Brent	Intercontinental Exchange Brent Oil
ICI	Imperial Chemical Industries
IDA	International Development Association
IDB	Islamic Development Bank
IMF	International Monetary Fund
INR	Indian Rupee
IT	Information Technology
JMMC	Joint OPEC-Non-OPEC Ministerial Monitoring Committee
JPY	Japanese Yen
Kg	Kilogram
KIBOR	Karachi Interbank Offered Rate
KSA	Kingdom of Saudi Arabia
KSE	Karachi Stock Exchange
KWD	Kuwaiti Dinar
L/C	Letter of Credit
LCV	Light Commercial Vehicles
LNG	Liquefied Natural Gas

LSM	Large Scale Manufacturing
LTFF	Long Term Financing Facility
LWG	Leather Working Group
M2	Broad Money
MENA	Middle East and North Africa
MMBTU	Million British Thermal Units
MoF	Ministry of Finance
MPC	Monetary Policy Committee
MT	Metric Tons
MTBs	Market Treasury Bills
MUFAP	Mutual Funds Association of Pakistan
M-Wallet	Mobile Wallet
MYR	Malaysian Ringgit
NCCPL	National Clearing Company of Pakistan Limited
NDA	Net Domestic Assets
NEER	Nominal Effective Exchange Rate
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Assets
NFDC	National Fertilizer Development Corporation
NFNE	Non-Food-Non-Energy
NGMS	Next Generation Mobile Services
NSS	National Savings Certificates
OCAC	Oil Companies Advisory Committee
OECD	Organization for Economic Cooperation and Development
OMOs	Open Market Operations
OPEC	Organization of Petroleum Exporting Countries
PAMA	Pakistan Automotive Manufacturers Association
PARCO	Pak Arab Refinery Limited
PBS	Pakistan Bureau of Statistics
PIB	Pakistan Investment Bond
PKR	Pakistan Rupee
PNG	Piped Natural Gas
POL	Petroleum, Oil, and Lubricants
PRI	Pakistan Remittance Initiative

PSDP	Public Sector Development Programme
PSEs	Public Sector Enterprises
PSO	Pakistan State Oil
PTA	Pakistan Telecommunication Authority
PVC	Polyvinyl Chloride
Q1	First Quarter
Q2	Second Quarter
REER	Real Effective Exchange Rate
Repo	Repurchase Agreement
RFO	Residual Fuel Oil
rhs	Right Hand Side
RIC	Regular Income Certificates
RLNG	Re-gasified Liquefied Natural Gas
RPI	Relative Price Index
Rs	Rupees
SA	Savings Account
SAR	Saudi Arabian Riyal
SBP	State Bank of Pakistan
SDR	Special Drawing Right
SEK	Swedish Krona
SGD	Singapore Dollar
SKD	Semi Knocked Down Unit
SRO	Statutory Regulatory Order
SSA	Special Savings Account
SSC	Special Saving Certificates
SSRL	Sino-Sindh Resources Limited
SUV	Sports Utility Vehicle
T-Bill	Treasury Bill
THB	Thai Baht
UAE	United Arab Emirates
UK	United Kingdom
US	United States
US$	United States Dollar
USD	United States Dollar

VAT	Value Added Tax
WALR	Weighted Average Lending Rates
Wt	Weight
WTI	West Texas Intermediate
YOY	Year-on-year
ZAR	Zuid Afrikaanse Rand (South African Rand)