THE STATE OF PAKISTAN'S ECONOMY

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Board of Directors of State Bank of Pakistan

State Bank of Pakistan

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1 Overview

The provisional information presents a mixed picture of Pakistan's economy at the end of Q3-FY18. Maintaining its upward trajectory, the real GDP growth is estimated at a 13-year high of 5.8 percent in FY18, along with a benign inflationary environment. However, deterioration in external balances and high fiscal deficit remains a major source of concern. (**Table 1.1**)

The estimates for FY18 also suggest that compared to FY17 all the three sectors remained vibrant. Agriculture sector on the back of improved cotton crop and record sugarcane is expected to comfortably surpass its growth target for FY18. Industrial sector, reflecting a robust domestic demand, is set to achieve a 10-year high growth. The services sector is estimated to maintain almost its last year growth based on spillover impact of healthy performance by commodity producing sector. In the same encouraging vein, inflation remained within manageable and supportive levels, largely owing to decline in its food component.

Table 1.1: Selected Economic Indicators

		FY16[F]	FY17[P]	FY18[P]
Growth rate (percent)				
Real GDP	Jul-Jun	4.6	5.4	5.8
Agriculture	Jul-Jun	0.2	2.1	3.8
Industry	Jul-Jun	5.7	5.4	5.8
o/w LSM	Jul-Jun	3.0	5.6	6.1
Services	Jul-Jun	5.7	6.5	6.4
CPI (period average)[a]	Jul-Mar	2.6	4.0	3.8
Private sector credit [b]	Jul-Mar	8.1	9.9	9.1
Money supply (M2)[b]	Jul-Mar	6.0	5.9	4.8
Exports [b]	Jul-Mar	13.0	-3.2	13.1
Imports [b]	Jul-Mar	-4.4	18.3	15.9
Tax revenue –FBR [c]	Jul-Mar	17.7	8.6	15.8
Exchange rate (+app/-dep%)[b]	Jul-Mar	-2.8	0.0	-9.2
Policy Rate [b]	Mar	6.0	5.75	6.0
ONMMR [b]	Mar	6.1	5.7	5.7
billion US dollars				
SBP's reserves (end-period) [b]	Mar	16.1	16.5	11.6
Worker remittances [b]	Jul-Mar	14.4	14.1	14.6
FDI in Pakistan [b]	Jul-Mar	1.8	2.0	2.1
Current account balance [b]	Jul-Mar	-3.4	-8.0	-12.1
percent of GDP[1]				
Fiscal balance[d]	Jul-Mar	-3.5	-3.9	-4.3
Current account balance	Jul-Mar	-1.6	-3.5	-5.0
Investment	Jul-Jun	15.7	16.1	16.4

P=Provisional; F= Final.
Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan; [c] Federal Board of Revenue; and [d] Ministry of Finance

The combination of robust economic activity and low inflation had two important implications. First, it boosted confidence in the economy, which along with affordable cost of financing induced firms to borrow substantially. In particular, energy, textiles, and cement sectors focused more on capacity expansion to gear up for growing domestic demand. A healthy rise was also observed in working capital requirements; while the consumer finance posted the highest Jul-Mar flow

during the last 12-years, driven mainly by a surge in auto and housing finance. Ample liquidity in the wake of maturity of government securities also supported this credit off-take.

The second impact relates to increased consumption, which along with recovering oil prices, further inflated the import payments. Higher import bill, despite 10 consecutive months of exports growth and rising workers' remittances, resulted in record widening of current account deficit. Even higher financial inflows from IFIs, bilateral sources, and issuance of sovereign bonds remained insufficient. Thus, the remaining payment gap fell on the country's FX reserves, which fell to only two months of import cover by end-March, 2018. The foreign exchange market also remained volatile and PKR depreciated by 9.2 percent against the US$ during Jul-Mar period of FY18.

These external sector developments started to impact inflation as well. The pass-through of rising global oil prices to domestic fuel prices pushed up the energy component of inflation, as the government passed on its impact to consumers. Similarly, the impact of PKR depreciation started to translate into costly imports and shoring up of inflationary expectations.

On the fiscal side, the healthy growth in revenue could not keep up pace with a sharp rise in fiscal expenditure in the Q3-FY18. Particularly, the development expenditure related to infrastructure and power projects increased sharply, with major contribution coming from provinces. As a result, the fiscal deficit in Q3-FY18 stood higher than corresponding period last year.

To finance the fiscal gap, the government had to rely both on SBP's borrowing and external sources. In particular, the government borrowings from SBP stood at Rs2.2 trillion in Q3-FY18 – the highest level in a quarter. External debt, owing both to higher commercial loans and revaluation impact of the PKR depreciation, also rose considerably.

In short, ensuring the continuity of expansion in economic activities and low inflation would depend on containing of current account and fiscal deficits. As these vulnerabilities are posing challenges to Pakistan's current growth cycle, implementation of both short-term and medium term policies would be crucial in this regard.

In short-term, concerted efforts could be made to rationalize fiscal expenditures given the tax relief measures approved in budget FY19. In the medium term,

reforms would be needed to expand tax base besides enhancing efficiency of the existing system. Simultaneously, there is a need to arrange external financing in the short term. Also, more policy measures are required to contain the widening trade deficit. For this purpose, it is also crucial to resolve structural issues affecting exports competiveness.

Economic Review

Real Sector

The real GDP is estimated to grow by 5.8 percent during FY18, surpassing the decade-high growth of 5.4 percent achieved during FY17. This was achieved on the back of strong performances by agriculture and services sectors, both of which managed to grow at or above their targets.

The agriculture sector grew by 3.8 percent, higher than both the target of 3.5 percent and last year's growth of 2.1 percent. The sector benefitted from a strong showing by livestock and healthy production of major *Kharif* crops such as cotton and sugarcane. This, alongside contributions from cotton ginning segments, more than offset the contraction in wheat harvest due to decline in area under cultivation and lack of water availability.

In services sector, the improvement in *wholesale & retail trade and general government services* helped offset the deceleration in the *finance & insurance* and *transport, storage & communication* segments. Overall, the sector was able to keep its momentum intact and achieve the targeted growth of 6.4 percent during FY18.

The value addition in industrial sector grew by 5.8 percent during FY18 compared to 5.4 percent growth observed during last year. This was achieved on the back of a rise in large-scale manufacturing, coupled with a recovery in mining activities and continued surge in construction activities. However, the deceleration in electricity generation and distribution constrained the overall growth of the industrial sector below the target of 7.3 percent.

Inflation and Monetary Policy

Monetary Policy Committee (MPC) raised the policy rate by 25 basis points to 6 percent in January 2018 – this was the first hike since November 2014. The key factors influencing the MPC's January decision included: (i) PKR depreciation of nearly 5 percent in December 2017; (ii) rising international oil prices; (iii) monetary tightening by other central banks (particularly the US Fed and Bank of England), with its concomitant impact on PKR interest rate differential; and (iv) a possible overheating of the economy as indicated by increased capacity utilization

in a number of industries. Also, the expected rising trend in inflation and aggregate demand remained a consideration. Subsequently, the policy rate was maintained in March 2018.

Given that banks seemed to have already priced in the anticipated uptick in policy rate during Q2-FY18, the January policy rate hike did not trigger a similar upward adjustment in weighted average lending rates (WALR) for the most part. In fact, retail rates moderated slightly during February and March 2018, as banks had ample liquidity at their disposal. This stemmed largely from the banks' reluctance to roll over the bulk of maturing government securities in a perceived rising interest rate scenario. In turn, this liquidity comfort nudged the overnight rates below the policy rate during Q3-FY18.

With the cost of bank financing continuing to be attractive, demand for credit from the private sector remained strong. Furthermore, steady economic activity appeared to help maintain the growth in fixed investment loans, as both manufacturing and non-manufacturing firms (largely cement and textile) borrowed for the long term. As far as working capital loans is concerned, the sugar sector's borrowing was most notable during Q3-FY18, with the crushing season in full swing.

The government's reliance on SBP borrowings increased in Q3-FY18, as banks' participation in government paper auctions stood relatively low in contrast to the first two quarters. SBP lending to the government reached Rs2.2 trillion in the third quarter. This, coupled with high credit off-take and increase in loans to PSEs, led to an upsurge in the NDA of the banking system. However, the M2 growth remained subdued due to a concurrent contraction in NFA.

Fiscal Operations

A sharp increase in expenditures, amid a slower growth in revenue in Q3-FY18, led the fiscal deficit rising to 4.3 percent of GDP during Jul-Mar FY18 compared with 3.9 percent last year, and a full year target of 4.1 percent. The growth in revenue, though remained higher compared to last year, slowed down in Q3-FY18 compared to first two quarters of FY18. On the other hand, growth in expenditures accelerated from 12.4 percent in Q1-FY18 to 23.4 percent in Q3-FY18.

The slowdown in revenue collection was primarily due to direct taxes. More specifically, the drag came from a decline in voluntary payments, while withholding taxes and collection on demand increased considerably compared to last year. The decline in voluntary payments can partially be attributed to

reduction in corporate tax rate and lower bank profitability. Meanwhile, growth in indirect and provincial taxes remained buoyant in line with expanding economic activity, and the pass-through of rise in the oil prices to domestic consumers. The non-tax revenue also recovered strongly, bolstered by a jump in provincial non-tax revenue, higher markup payment, dividend income and PTA /postal service profit.

The acceleration in growth of expenditures was more due to higher provincial spending, with both current and development expenditures growing sharply. The provincial development spending grew by 36.7 percent during Jul-Mar FY18 compared to 13.6 percent in the corresponding period of last year. Growth in federal development spending also remained high, close to 25 percent compared to 28.9 percent in last year. The push has come from urgency to complete the ongoing project before the terms of assemblies came to an end. Similar to growth in development expenditure, major contribution to a sharp increase in current expenditure came from provinces, especially in Q3-FY18. Higher debt servicing and defense spending at federal level and general public services, economic affairs, and public order and safety in case of provinces contributed to the increase in current expenditures.

The resulting higher fiscal deficit was largely financed through borrowing from SBP and external sources. In case of external financing, government heavily relied on commercial loans and sovereign bonds. Moreover, the revaluation losses, resulting from appreciation of major currencies against US$ and the depreciation of rupee against US$ also added significantly to external debt. Overall, these developments led to considerable increase in public debt, with record accumulation in Q3-FY18 since FY14.

External sector

The external account remained under pressure, despite a recovery in exports and remittances. A rebound in global oil prices, together with higher machinery and transport import, exacerbated the trade deficit. This led to the highest current account deficit of US$12.1 billion, the country has seen during Jul-Mar of a fiscal year.

Exports witnessed a broad-based growth of 13.1 percent YoY in Jul-Mar FY18 and reached US$ 17.1 billion. Notably, exports in Q3-FY18 alone recorded a growth of 17.2 percent YoY, the highest growth in Q3 in more than six years. Both traditional and non-traditional exports contributed to this improved performance. Moreover, extension of GSP plus status by EU, additional incentives announced by the government in October 2017 export package, and recovery in global demand also supported the export growth. As regards imports,

the rising global crude oil prices together with lagged impact of machinery import payments have inflated the import bill during Jul-Mar FY18. About 70 percent of the import payments were contributed by three categories namely energy, machinery and metals. However, the recent decline in machinery imports is likely to reduce the payment pressure going forward.

A significant increase in financial inflows on account of a rise in official portfolio investment and loans, and a marginal growth in net FDI could not completely finance current account gap. In this scenario, the country's official reserves depleted by US$ 4.5 billion and reached US$ 11.6 billion by end-March FY18. Consequently, PKR depreciated by 9.6 percent on a cumulative basis during Jul-Mar FY18.

1.2 Economic outlook

The government has set a 6.2 percent real GDP growth target for FY19 largely on the back of accelerating growth momentum of the last few years. Higher PSDP and CPEC spending, a further ease in power supply, and continuation of industrial expansion plans, are other reassuring factors. However, the growing external vulnerability and high fiscal deficit will continue to pose major down side risks to the achievement of this target. Moreover, on the real side, the ongoing dry spell and water shortages may adversely impact the value addition potential of the agriculture sector.

High domestic demand, lagged impact of adjustment in energy prices, and PKR depreciation are likely to contribute to higher CPI inflation in FY19. Smooth supply of staple food items and soft oil price on the other hand could offset these underlying pressures and help keep inflation around the target of 6 percent set for FY19.

The government has set fiscal deficit target at 4.9 percent of GDP for FY19, which is based on a 12.7 percent anticipated growth in FBR tax revenues and a 10.0 percent increase in expenditures, with greater emphasis on current expenditure. While the current budget has reduced tax rates without rationalizing expenditure, achieving the fiscal deficit target in this backdrop appears challenging.

On the external side, the exports growth prospects remains encouraging on the back of PKR depreciation; recovery in global demand; fiscal incentives for exports; ease in power supply; and improved price outlook of rice and cotton in the international markets. Also, the growth in workers' remittances is expected to further gather some pace, partly on account of the steps taken by the government and SBP to attract inflows through the official channels. At the same time, a

deceleration in imports is expected due to proactive monetary management by SBP, PKR depreciation and the continuation of administrative measures to dampen the domestic demand for non-essential import items.

However, the import bill is likely to stay high owing to a notable increase in international commodity prices, especially of oil. This would keep the trade deficit high in FY19 as well. Furthermore, the FDI inflows are expected to remain lower in FY19 than last year as a number of CPEC energy projects are in their advance stages of completion. Therefore, in overall terms, the high current account deficit, together with limited financial inflows, would continue to keep the balance of payments under pressure.

2 Real Sector

2.1 Overview

Provisional estimates put the real GDP growth for FY18 at 5.8 percent, up from 5.4 percent during FY17. This has been the highest growth achieved over the last 13 years, and is close to the overall target of 6 percent set for FY18. A healthy showing by agriculture, a sustained growth in the services, and an uptick in large-scale manufacturing output contributed to this performance.

Table 2.1: GDP and its Components

Share and growth in percent; contribution in percentage points

	Share	Growth			Contri. to growth
		FY17^{R}	FY18^{P}	FY18^{T}	
Agriculture	**18.9**	**2.1**	**3.8**	**3.5**	**0.7**
Of which					
Important crops	4.5	2.2	3.6	2.0	0.2
Livestock	11.1	3.0	3.8	3.8	0.4
Industry	**20.9**	**5.4**	**5.8**	**7.3**	**1.2**
Of which					
Mining and Quarrying	2.8	-0.4	3.0	3.5	0.1
LSM	10.8	5.6	6.1	6.3	0.7
Electricity gen. & dist.	1.8	5.8	1.8	12.5	0.0
Construction	2.8	9.8	9.1	12.1	0.2
Services	**60.2**	**6.5**	**6.4**	**6.4**	**3.8**
Of which					
Wholesale & retail trade	19.0	7.5	7.5	7.2	1.4
Finance & insurance	3.4	10.8	6.1	9.5	0.2
General govt.	7.9	5.9	11.4	3.9	0.9
GDP	**100**	**5.4**	**5.8**	**6.0**	**5.8**
Memorandum item					
Investment-GDP ratio		16.1	16.4		

R: Revised; P: Provisional; T: Target

Data source: Pakistan Bureau of Statistics

The GDP growth was supported by a host of factors, such as: (i) improved energy supply; (ii) supportive policies including low & stable interest rates and fiscal incentives through subsidies, easy credit conditions, and rising PSDP spending; iii) continuation of CPEC related investments & projects, and (iv) favorable export demand. Moreover, the economy received benefits concomitant with improved security and law and order.

On the agriculture front, impetus from livestock segment and substantial improvement in production of cotton and sugarcane crops – the latter experienced another record season - led the sector posting a growth of 3.8 percent, higher than both the last year's 2.1 percent and the targeted growth of 3.5 percent for FY18. Improved quality of inputs like certified seeds and pesticides, increased mechanization, and an uptick in credit disbursement helped to partially offset the negative impact of inadequate water availability and lower fertilizer off-take for crop sector.

The services sector is estimated to have almost achieved its targeted growth of 6.4 percent during FY18 on the back of strong performance by *wholesale & retail*, which benefitted from improvement in commodity-producing segment, a rise in import quantum and *general government services*. However, *finance & insurance* and *transport, storage & communication* experienced deceleration as against growth seen in the last year.

The industrial sector's performance also remained constrained mainly on account of steep deceleration in *electricity and gas generation & distribution.* This deceleration also led GDP growth miss the 6 percent mark, as the services and agriculture sector performed at or above their targeted rates. Encouragingly, improvement in large-scale manufacturing output and a turnaround in *mining and quarrying* helped keep overall growth of the sector at 5.8 percent, which stood higher than last year's performance of 5.4 percent.

The current growth paradigm stems from the strong performance of agriculture and construction (and its allied) sectors – both of these promote employment in the abundant unskilled segment of the country's labor force. A recent World Bank study for South Asia also validates this relationship between GDP growth and job creation in case of Pakistan (**Box: 2.1**).

Box 2.1: Impact of Growth on Job Creation[1,2]

Employment is considered one of the key development indicators of an economy's performance. A recent World Bank's study analyzes empirical relationship between growth and employment for the South Asian economies. According to the report, growing labor force will outpace the population growth in most of South Asia; however, increase in labor force would not be a problem if the economy creates sufficient job opportunities.

In the case of Pakistan, it needs to create around 1.3 million jobs every year to maintain its current employment level. Moreover, in order to achieve this, a certain threshold of economic growth would be required. Empirical evidence on the relationship between growth and employments suggests that every percentage point increase in growth results in creation of 0.2 million jobs. Going by these calculations, Pakistan has to attain annual economic growth of around 6.6 percent to accommodate all of its new job seekers. As the growth momentum has picked up, so has the country's ability to provide more job opportunities.

According to the study, the following factors may also create job opportunities. First, better infrastructure is one of the important ways to promote employment opportunities as it facilitates business activities. In the context of Pakistan, CPEC related infrastructure development is projected to spur business growth, especially with development of Special Economic Zones. Second, more integration with the global markets enhances productivity and thereby real wage rate. Recently,

[1] Source: World Bank Publication, "South Asia Economic Focus, Spring 2018: Jobless Growth".
[2] While the region-centric study suffers from data limitations and equivalence issues, its key takeaways are broadly applicable to Pakistan.

Pakistan's exports have started showing signs of recovery under supportive government policies and recovery in global demand. Last, planned urban development plays an important role in job creation, since metropolitan areas are hubs connecting a country to the outside world and act as engines of its growth. Mega city development projects (especially mass transit) in Pakistan have boosted economic activity and the same is expected after completion of ongoing developmental projects.

In addition to GDP growth, Pakistan can absorb more entrants per unit of growth through two sources. First, a slight change in growth mechanics can spur employment growth. In particular, SME-led growth can provide more employment opportunities than highly capital-intensive large-scale industries. Second, within SMEs, a renewed focus on women entrepreneurial incubators would yield high social welfare returns.[3] Women-led SMEs are more inclined to hire women than men-led ones.[4] A national outreach program to motivate and attract female participation could also unlock a substantial employment potential. Here, the regulatory bodies (SBP, SECP and SMEDA) need to enhance collaboration amongst them to provide a platform for SMEs to grow and expand. Moreover, they may support women-led SMEs to break the glass ceiling.

In this regard, SBP has also announced a policy for promotion of SME Finance in December 2017. The policy has 9 key pillars, which include improving regulatory framework, upscaling of microfinance banks, risk mitigation strategy, simplified procedures for SME banking, program-based lending & value chain financing, capacity building & awareness creation, handholding of SMEs, leveraging technology and simplification of taxation regime. Simultaneously, the SBP SME framework set certain benchmarks for 2020, which include (i) an increase in SME share in private sector credit, from existing 8 percent to 17 percent and (ii) increase in number of borrowers from existing 164,000 to 500,000. These actions are likely to contribute towards employment generation going forwards.

2.2 Agriculture

The agriculture sector experienced a broad-based improvement of 3.8 percent in FY18, comfortably surpassing both the targeted growth of 3.5 percent and last year's performance of 2.1 percent. Important crops posted a growth of 3.6 percent compared to 2.2 percent last year, with notable contributions coming from fisheries and cotton ginning sectors (**Table 2.2**). The crop sector growth is attributed largely to record performance by sugarcane and rice, contributing a share of 15.2 percent and 13.1 percent to the important crop sector. Record production of sugarcane and rice and

Table 2.2 Agriculture Sector Value-addition

Share and growth in percent; contribution in percentage points

	Share	Growth			Contribution to Growth	
	FY18	FY17^{R}	FY18^{T}	FY18^{P}	FY17^{R}	FY18^{P}
Crop Sector	36.9	0.9	-	3.8	0.3	1.4
Important crops	23.6	2.2	2.0	3.6	0.5	0.8
Other crops	10.8	-2.7	3.2	3.3	-0.3	0.4
Cotton ginning	2.5	5.6	6.5	8.7	0.1	0.2
Livestock	58.9	3	3.8	3.8	1.7	2.2
Forestry	2.1	-2.4	10	7.2	-0.1	0.1
Fishing	2.1	1.2	1.7	1.6	0	0
overall	**100**	**2.1**	**3.5**	**3.8**		

Data Source: Pakistan Bureau of Statistics, R: Revised, T: Target, P: Provisional

[3] Female participation in labor force is still low in Pakistan, even by South Asian standards.
[4] Source: "Women-led Businesses", An independent report by BDRC, February 2015.

double-digit growth in cotton, hence more than offset the negative growth shown by wheat and maize (**Table 2.3**).

The improved crop performance, despite a lower availability of certain inputs such as fertilizer and water supply, can be attributed to higher yields on the back of supportive government policies (attractive support prices and subsidies) along with availability of other quality inputs (certified seeds and pesticides) and expansion in agriculture credit.

Table 2.3 Production of Important Crops

million tons; cotton in million bales; growth in percent

	Share in important crops %	Production			Growth	
		FY17	FY18[T]	FY18	FY17	FY18
Cotton	23.3	10.7	13.6	11.9	*7.6*	*11.8*
Rice	13.1	6.8	6.8	7.4	*0.7*	*8.6*
Sugarcane	15.2	75.5	68.5	81.1	*15.3*	*7.4*
Wheat	38.4	26.7	26.5	25.5	*4.1*	*-4.4*
Maize	10.0	6.1	5.6	5.7	*16.4*	*-7.0*

Data Source: Pakistan Bureau of Statistics, T: Target

Crop Sector:

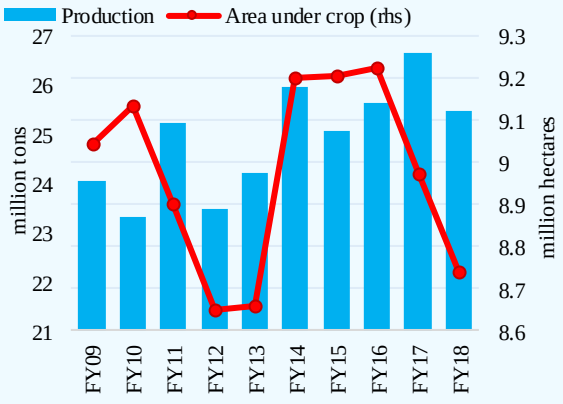
Inputs

A review of major inputs reveals an uptick in agriculture credit, while a reduction in fertilizer off-take and water availability during Jul-Mar FY18. Agriculture credit disbursements increased by 40.8 percent during Jul-Mar FY18 compared to 23 percent growth during the same period last year. Similarly, fertilizer off-take in Jul-Mar FY18 went down by 2.9 percent and 5.2 percent for urea and DAP respectively. Irrigation water availability was also reduced by 6.1 percent in Jul-Mar FY18, compared to same period last year. Decline in fertilizer off-take and water availability was more pronounced in Rabi season, which adversely impacted wheat and maize crops.

Wheat:

Wheat production stood at 25.5 million in FY18, down 4.4 percent from last year, and missing the target of 26.7 million tons set for FY18. According to revised estimates by PBS, FY17 witnessed record wheat production of 26.7 million tons with yield displaying a YoY growth of 6.9 percent compared to FY16. The country was not able to match last year's performance as both area and yield declined in FY18 by 2.7 and 1.8 percent respectively

Figure 2.1: Wheat Production and Area



Data source: Pakistan Bureau of Statistics

(**Figure 2.1**).

Wheat production suffered mainly due to four factors. First, delay in sugarcane crushing led to unavailability of land for wheat cultivation. Second, water availability declined significantly during *Rabi* FY18. This was evident from 14.5 percent lower irrigation flows compared to same period last year. Third, fertilizer off-take remained lower during the season for phosphate nutrient[5], which witnessed a 13.3 percent contraction on a YoY basis. Fourth, higher than normal temperatures in March also adversely impacted the yield of wheat crop in Punjab and Sindh.

Despite contraction in wheat output, FY18 witnessed another bumper crop, which further increased the stockpile. While government agencies are set to procure around 6.9 million[6] tons of wheat this year, the stocks at end April (start of procurement season) are already standing at 6.9 million tons; the estimated wheat stockpiles with government storage houses would easily cross 10 million mark this year.

Some relief to wheat stocks position came from exports during Feb-Mar 2018. In December 2017, the government allowed export of 2 million tons[7] to create room for the next crop until June 2018. Attractive subsidies on 2 million tons of wheat export were offered: US$ 159 per ton by sea and US$ 120 per ton by land.[8] During Feb-Mar 2018, wheat exports achieved 0.3 million tons[9] mark (**Chapter 5).** Exports of wheat provided some respite to local procurement agencies; however, they occurred at a cost to the government in terms of export subsidies to compensate for price differential between domestic and international prices.[10]

Cotton:

According to the latest estimates, cotton production stood at 11.9 million bales during FY18, registering an increase of 11.8 percent over last year, while missing the annual plan's envisaged target of 13.6 million bales. Like wheat harvest, lower cotton production may also be attributed to substitution of area under sugarcane cultivation.

[5] Phosphate is an important nutrient for wheat crop.
[6] Source: Annual Plan 2017-18
[7] The Economic Coordination Committee allowed exports of 1.5 million tons for Punjab and 0.5 million tons for Sindh before June 30 2018.
[8] Source: Ministry of National Food Security and Research.
[9] Wheat exports are to Bangladesh, Indonesia, Vietnam, Oman and Muscat at prices of 185-200$ per ton.
[10] Public expenditure of up to $320 million is expected given the entire amount is exported at the full subsidy.

Supportive pricing policies for wheat and sugarcane have been attractive for growers hence resulting in surplus production of these commodities. Offloading stocks in the global market is hindered by low international prices without hefty subsidies. Hence, excessive stockpiles of wheat and sugar have added a significant financial strain to the government. Current scenario requires price rationalization for crops that sufficiently provide for local consumption and directing resources to other crops. Promotion of oilseeds provides one such crucial avenue given the rise in edible oil import bill (see **Box 2.2**).

Box 2.2: Oilseeds Crops in Pakistan: A Way to Crop Substitution

In spite of being an agrarian economy, Pakistan had to import[11] 2.7 million metric tons of edible oils[12] worth US$ 2.0 billion in FY17 and 2.2 million metric tons worth US$ 1.7 billion in Jul-Mar FY18[13] in order to fulfill the needs of its domestic edible oil industry. Major oilseed's[14] imports stood at US$ 0.8 billion in Jul-Mar FY18 compared to US$ 0.6 billion in the same period in FY17. As per the United States Department of Agriculture report, import of oilseeds is further expected to exceed imported edible oil imports.[15] The country is capable of producing sizeable quantities of oilseeds that will reduce the import bill majorly for oilseeds and partly for edible oil.

Current Scenario: Major oilseed crops in the country are cottonseed, sunflower, rapeseed/mustard and canola[16]. Local oil production on average remained 0.6 million tons during FY08-FY17; whereas the total edible oil availability stood at 3.2 million tons, indicating low quantity produced domestically. Furthermore, the import of seeds for poultry feed manufacturing has been on the rise too[17].

Various policies have led to lower oilseed production besides heavy reliance on imports. Supportive pricing policies for wheat and sugarcane have had a distortionary impact on oilseed production as evident from decline in area under oilseeds (**Fig2.2.1**). Oilseed cultivation is further disadvantaged by absence of adequate machinery[18]and high yielding seed varieties.[19] Furthermore, import supportive policies and free trade agreements for oil imports reduce incentives for local oilseed production. In July 2015, custom duty on soybean seed was reduced to 3 percent compared to 10 percent on soymeal imports (used in poultry feed), hence resulting in increase in imports of soybean seed compared to soymeal. Furthermore, starting July 2014 the sales tax on soybean was reduced to 6 percent compared to 16 percent on canola or sunflower for solvent extractors, resultantly the

[11] These imports form 88 percent of total edible oil supplies. Source: Pakistan Oilseeds Development Board

[12] The figure consists of soybean and palm oil imports.

[13] Source: PBS imports data.

[14] Major oilseed imports consist of soybean, sunflower and canola seed.

[15] Source: GAIN Report, 2018: Oilseeds and Products Annual Islamabad Pakistan.

[16] Source: PARC: Other oilseeds crops include groundnut, sesame, safflower, linseed, jojoba, castor, Salicornia and salvadora.

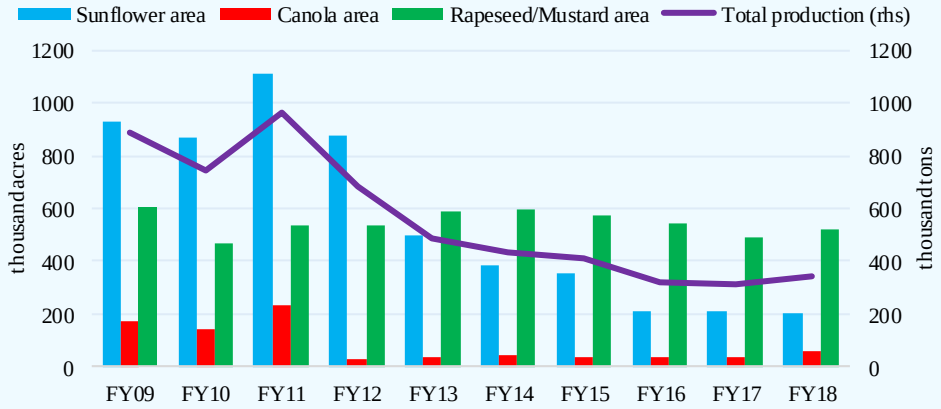
[17] Soybean seed is used to extract protein for soyameal production; a major component of poultry feed.

[18] Proper machinery, which includes planters, harvesters, and seed driers for crops such as canola and sunflower crops, is not available.

[19] In FY08,1.1 million acres was area under sunflower with production of 643,000 tons. In FY17, the area reduced to 0.2 million acres and production to 104,000 tons.

import of soybean for solvent extraction went up from a mere 50,000 thousand tons in FY15 to 640,000 tons in FY17.[20]

Fig 2.2.1 Oilseeds Area & Production



Data source: Pakistan Oilseeds Development Board

Glut of wheat and sugar in the market provides opportunity for oilseed crop promotion to shift farmers focus away from surplus-producing crops.[21]

Required Policy Actions:

- **Oilseed Policy**: The Pakistan Oilseed Development Board needs to develop an Oilseeds Policy for promotion of oilseeds in the country, in collaboration with all stakeholders22 and get it approved by the government at the earliest. In this regard, special focus is required on the demarcation of responsibilities and goals for federal and provincial governments respectively.
- **Production of quality seeds and development of hybrid seeds**: Several projects are already underway to develop quality oilseeds. In this regard, Pakistan Agriculture Research Council (PARC) has developed a hybrid canola seed variety and planted the same in Northern Punjab and KPK. Furthermore, the olive plantations have been initiated in the Potohar valley. Despite this, more focus is still required on production of quality hybrid seeds locally mainly to reduce input costs of ultimate beneficiaries.
- **Incentivizing farmers:** Pricing support or subsidy may be provided to oilseed growers in order to bring their profitability at par with crops, such as wheat. For Rabi crop FY18, the government of Punjab has announced a cash payment of Rs.5000 per acre for upto two acres for sowing of canola and sunflower crops. As a result, the area and production under these crops increased, thereby indicating the significance of maintaining incentives in boosting up oilseeds production.

[20] This is distortionary in a sense that soybean oil extraction ratio is only 17-18 percent, compared to sunflower's 47 percent and rapeseed/canola's 43 percent.

[21] Sugarcane was planted on an area of 1.3 million hectares, with cane production of 81.1 million tons in FY18. This will produce about 6.3 million ton sugar, whereas the country's requirement is around 3.4 million ton (16.3 kg per capita consumption). This means 0.6 million hectares is cropped extra than required which can be used for oilseed cultivation. Source: Pakistan Oilseeds Development Board.

[22] Stakeholders consist of farmers, solvent extractors and poultry feed manufacturers.

- **Tariff rationalization and fixation of quota on imported oilseeds and edible oil:** Tariff on import of oilseeds and edible oil may be rationalized so as to promote domestic oilseed production. Furthermore, quota fixation may be introduced in order to limit oilseeds imports. Especially, the imports of oilseeds and edible oil may be discouraged during the harvesting seasons mainly to protect local oilseed production.

2.3 Industry[23]

Industrial production has witnessed the highest growth in the current fiscal year since FY08. The performance can be traced to noteworthy contributions from construction and manufacturing activities. Public sector development program (PSDP) and CPEC related expenditure have had a spillover impact on manufacturing sub-sectors such as steel, cement and automobiles. All of these industries posted record production numbers.

However, the industry could not achieve the growth target set for FY18 on account of a lower increase in gross value addition (GVA) by *electricity generation and gas distribution*. Higher cost of production due to an uptick in international fuel prices, along with limited revenue growth under an administered pricing mechanism, led to slowdown in GVA of this sector. Further, the closure of inefficient furnace oil based power plants in a phased-manner also contributed to lower GVA. In this backdrop, it could only manage 1.8 percent growth over last year's performance of 5.8 percent, despite an improvement seen in electricity

Table 2.4: YoY Growth in LSM Jul-Mar

percent

		YoY Growth		Contribution in Growth	
	wt.	FY17	FY18	FY17	FY18
LSM	70.3	5.4	5.9		
Textile	20.9	0.8	0.4	0.2	0.1
Cotton Yarn	13.0	0.8	0.1	0.1	0.0
Cotton Cloth	7.2	0.5	0.0	0.0	0.0
Jute Goods	0.3	-7.9	33.4	0.0	0.1
Food	12.4	10.0	2.7	2.2	0.6
Sugar	3.5	29.3	-11.7	2.5	-1.2
Cigarettes	2.1	-42.5	84.9	-0.9	0.9
Vegetable Ghee	1.1	2.3	-1.8	0.0	0.0
Cooking Oil	2.2	1.1	15.6	0.0	0.5
Soft Drinks	0.9	22.2	5.9	0.5	0.2
POL	5.5	-0.3	12.3	0.0	0.7
Steel	5.4	16.6	27.5	0.6	1.0
Non-Metallic Minerals	5.4	7.1	12.1	0.8	1.3
Cement	5.3	7.2	12.2	0.8	1.3
Automobile	4.6	11.4	19.0	0.7	1.3
Jeeps and Cars	2.8	4.7	22.1	0.2	0.7
Fertiliser	4.4	1.3	-8.3	0.1	-0.5
Pharmaceutical	3.6	9.0	4.4	0.7	0.4
Paper	2.3	9.8	9.0	0.3	0.3
Electronics	2.0	18.0	45.2	0.3	0.8
Chemicals	1.7	-2.4	-0.4	-0.1	0.0
Caustic Soda	0.4	-0.6	21.1	0.0	0.1
Leather Products	0.9	-18.8	-9.1	-0.4	-0.1
Excl. Sugar	66.8	3.2	7.9		

Data source: Pakistan Bureau of Statistics

[23] This section is based on actual data up to March 2018. Therefore, number reported in this section would not tally with those presented in Table 1, which are annual estimates.

generation.[24]

Large-scale manufacturing

LSM marginally improved on a YoY basis, growing by 5.9 percent during Jul-Mar FY18, compared to 5.4 percent in the corresponding period last year (**Table 2.4**)[25]. The factors which facilitated LSM growth mainly included: (i) increased capacity utilization due to ease in energy supplies; (ii) high credit off-take owing to low interest rates; (iii) output stimulus in associated industries due to widespread construction activities; and (iv) an improved business environment on the back of CPEC related projects and favorable law and order situation.

Construction allied and consumer durable industries registered a notable growth. However, sugar industry was not able to capitalize on record sugarcane production; in stark contrast to last year, when it was the main driver of LSM growth. Barring sugar, LSM registered remarkable growth of 7.9 percent during Jul-Mar FY18 compared to 3.2 percent during the same period last year. A detailed industry-wise analysis is as follows:

Automobile

The automobile subsector grew by 19.0 percent during Jul-Mar FY18 on top of the 11.4 percent growth witnessed during the same period last year **(Table 2.4)**. A healthy performance by the passenger car and tractor segments, coupled with a rebound in production of light commercial vehicles, contributed to this improved performance (**Table 2.5**).

From the demand side, rising incomes, prevalent low interest rate environment, introduction of new variants, and the widening scope of ride hailing services in major urban areas of the country helped maintain consumers and businesses interest in the passenger car segment high, which had the highest weight in the automobile sector. In response, the industry players resorted to double shifts and continued to invest in various debottlenecking activities[26] during the period to meet the rising demand. The high demand also allowed the manufacturers to pass on impact of the PKR depreciation in the form of increased prices without an adverse impact on sales. High demand facilitated the production of the jeeps and cars to grow by 22.1 percent during Jul-Mar FY18 compared to 4.7 percent growth observed during the corresponding period of last year.

[24] During Jul-Mar FY18, electricity generation increased by 12.9 percent compared to same period last year.

[25] The GDP estimates for FY18 compiled by National Income Accounts are based on projected LSM growth of 6.2 percent.

[26] Indus Motors' debottlenecking has added about 10,000 units annual capacity.

Table 2.5: Automobile production during Jul-Mar

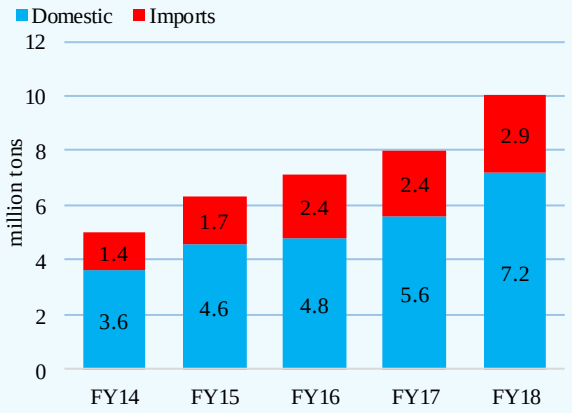
Units	FY16	FY17	FY18	Growth (percent) FY17	FY18
All Cars	**137,067**	**143,317**	**166,166**	**4.6**	**15.9**
Cars <800 cc	53,130	45,390	53,705	-14.6	18.3
Cars between 800-1000 cc	19,139	26,180	38,377	36.8	46.6
Cars >1000cc	64,798	71,747	74,084	10.7	3.3
Trucks	**3,940**	**5,489**	**6,907**	**39.3**	**25.8**
Buses	**746**	**893**	**555**	**19.7**	**-37.8**
Light Commercial Vehicles	**29,529**	**18,637**	**22,605**	**-36.9**	**21.3**
Sports Utility Vehicles	**621**	**812**	**7,034**	**30.8**	**766.3**
Tractors	**21,942**	**37,938**	**52,551**	**72.9**	**38.5**
Motorbikes	**998,040**	**1,211,454**	**1,410,034**	**21.4**	**16.4**

Data source: PAMA

Improved purchasing power in the rural areas on the back of a rise in agriculture output, a rise in agri-lending, and lower sales tax led to strong demand for tractors. This, in turn, contributed to a 38.5 percent growth in tractor production on top of the 72.9 percent increase achieved during Jul-Mar FY17.

LCV sector rebounded strongly in Jul-Mar FY18, growing by 21.3 percent, after contracting 36.9 percent during corresponding period last year.-In the HCV segment, trucks continued on their upward trajectory. Truck production benefitted from pickup in trade activities, alongside various CPEC and public sector led infrastructure projects underway in the country.

Figure 2.2: Supply of Finished Steel Products (Jul-Mar)



Data source: Pakistan Bureau of Statistics, SBP

Steel

The domestic steel industry continued to benefit from a host of factors. Increase in construction activities under PSDP and CPEC, imposition of anti-dumping duty on finished steel products, housing schemes in private sector, and a surge in demand for appliances and automobile drove growth of the industry. The overall increase in steel production stood at 27.5 percent during Jul-Mar FY18 against 16.6 percent growth witnessed during the same period last year (**Figure 2.2**).

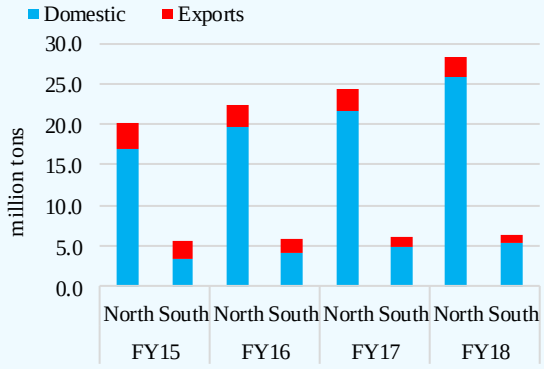
The overall demand for steel outpaced the growth in domestic supplies by a significant margin, which led to continuing reliance on imports to cover the deficit. Resultantly, the country imported 20 percent more finished steel products during the first nine months of FY18 compared to last year. Encouragingly, leading private producers have fast-tracked their expansionary plans (which are expected to come on-line in the next two to three years) to consolidate their market share.

Cement

Cement manufacturing witnessed an increase of 12.2 percent during Jul-Mar FY18 compared to 7.2 percent during the same period last year. Strong local dispatches (which rose by 17.9 percent) enabled this performance. On the other hand, cement exports continued to slide. Exports shrank by a further 8.2 percent in Jul-Mar FY18 in continuation of the contraction of 14.8 percent witnessed during same period last year. This occurred despite a significant rise recorded in shipments to Madagascar, Senegal and Afghanistan during the period (**Figure 2.3**).

Similar to steel, the growth in cement industry is also driven by CPEC related projects, public sector development spending and private housing schemes. Anticipating growing demand in the years ahead, the industry players are investing heavily in capacity expansions, mainly to consolidate their positions in a high margin market.

Figure 2.3: Cement Sales (Jul-Mar)



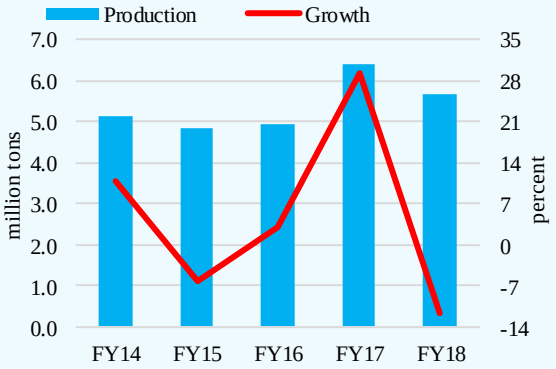
Data source: APCMA

Addition of 3 million tons production capacity so far in FY18 has affected market dynamics of the industry. Analysis of financials of major cement companies reveals that their profitability has gone down by 6 percentage points during the period under review. This is a direct consequence of increased competition and difference in pricing, particularly in the northern parts of the country. This trend is likely to continue until the dust settles on market shares in the wake of expansionary phase (**see *Special Section 1: Cement Industry: Current Dynamics and Future Prospects***).

Food

The food industry grew by 2.7 percent during Jul-Mar FY18 compared to a growth of 10.0 percent during Jul-Mar FY17. Contraction in the production of sugar offset the otherwise appreciable performance of rest of the sector. Cigarette production rebounded, while the edible oil subsector maintained its growing momentum during the period under review.

Figure 2.4: Trend in Sugar Production (Jul-Mar)



Data source: Pakistan Bureau of Statistics

Despite a record crop harvest, the production of sugar industry contracted 11.7 percent during Jul-Mar FY18, after witnessing a 29.3 percent increase during the same period last year (**Figure 2.4**). Start of the crushing period was delayed due to: (i) price disputes between the growers and the millers; and (ii) a court order in Punjab affected the operations of some manufacturers; resulted in below par performance of the industry. However, growth in sugar production gained some momentum during Q3-FY18, following indicative price adjustments in Sindh and the temporary permission by court for relocated sugar mills in Punjab to resume production. Provided that the crushing season continues during Q4-FY18, the industry can be expected to at least match, if not surpass, last year's production level.

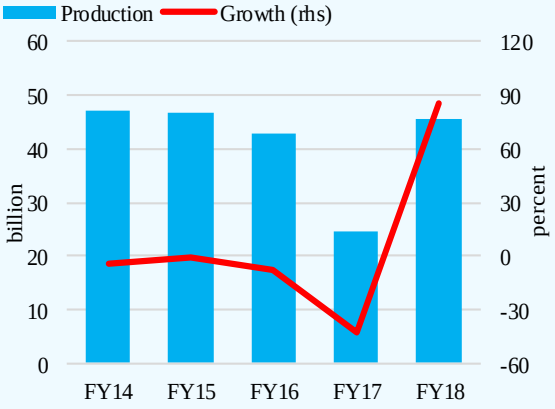
It is pertinent to point out here that domestic breakeven price remained around 30 percent higher than international price.[27] Sitting atop significant stockpile already, surplus production will further add to the sugar reserves during FY18. The federal government announced an export subsidy for sugar to the tune of Rs 10.7 per kilogram and allowed exports of 2.0 million tons of the commodity. Subsequently, the country was successful in offloading around 1 million ton by end March 2018. While this helped reduce the excess reserves, the cost of the subsidy so far has been Rs 10.8 billion during Jul-Mar FY18.

A sharp recovery was witnessed in the production of cigarettes during Jul-Mar FY18 with a growth of 84.9 percent compared to a contraction of 42.5 percent

[27] Ministry of Industries and Production calculated the breakeven price of domestic sugar at US$ 499 per ton.

during the same period last year (**Figure 2.5**). Introduction of a third tier in Federal Excise Duty (FED) and crackdown on illicit trade has proved to be beneficial for the formal cigarette industry. The rebound of formal cigarette industry shows that the government initiatives are working; however, this comes at a social cost.[28] The cigarettes in the third tier are cheaper than they were a year before.[29]

Figure 2.5: Trend in Cigarette Production (Jul-Mar)



Data source: Pakistan Bureau of Statistics

Pharmaceuticals

The pharma sector managed to register growth during Jul-Mar FY18, growing by 4.4 percent in addition to the 9.0 percent growth witnessed during the same period of last year. The government allowed increase in drugs prices in Q3-FY18 under Drugs Pricing Policy which helped boost incomes of pharmaceutical firms.

Meanwhile transformation of public healthcare systems at the federal and provincial levels led to efficient and effective health management. This is evident from the Prime Minister National Health Program and Sehat Sahulut Program in KPK. Such programs have already enrolled millions of people from the targeted lower income group.

Electronics

Improvement in energy supplies and significant demand from the consumers played important role in healthy performance of the electronics sector. It posted a 45.2 percent increase during Jul-Mar FY18 compared to 18.0 percent during the same period last year. Electric motors, electric transformers and air conditioners were the key contributing products.

[28] The three-tier duty structure may bring in revenues but it would escalate health cost for the government in future.

[29] Financials of duopoly of Pakistan Tobacco Company and Philip Moris Pakistan showed combined revenues increased by 31 percent while cost of sales surged by only 13 percent during the first 9 months of FY18 compared to same period last year. The profitability jumped to 254 percent during the same comparison period.

While performance of electric motors improved due to enhanced data coverage of the sector, the government's increased focus on electricity distribution segment resulted in enhancing demand for transformers. Meanwhile, the early onset of summer season, improvement in energy efficiency of air conditioners, stable prices and rising incomes helped appliance producers to cash in on higher demand.

POL

The performance of POL sector, albeit impressive, was not commensurate with the substantial expansion in the industry's operational capacity during the period under review. This was mainly on the back of a month long shutdown of furnace oil based power plants (the biggest consumers of the product) in the country during Q2-FY18; the industry suffered two consecutive months of production contractions on a YoY basis. However, after the relaxation in earlier policy measures on imports and production of furnace oil, the POL sector, rebounded strongly. It posted a healthy overall growth of 12.3 percent during Jul-Mar FY18 compared to a stagnation observed during the corresponding period of last year.

Textile

Textile production remained constrained during the period under review. The sector grew by a marginal 0.4 percent – half the level achieved during the corresponding period last year. However, the industry managed to increase its exports in value terms by 10.8 percent during the first 9 months of FY18.

2.4 Services

The services sector continued on its upward momentum and achieved a growth of 6.4 percent during FY18 on top of the 6.5 percent improvement observed last year. Major thrust came from *wholesale & retail trade* and *general government services*, while *finance & insurance* and *transport, storage & communication* experienced deceleration during the period under review. Overall, the share of services in real GDP has now crossed the 60 percent mark for the first time (**Table 2.6**)

Table 2.6: Performance of the Services Sector

	Share in GDP	Growth (percent)		Contr. to Services Growth	
		FY17[R]	FY18[P]	FY17[R]	FY18[P]
Wholesale and retail trade	19	7.5	7.5	35.7	36.4
Transport, storage and communication	13	4.4	3.6	15.6	12.4
Finance and insurance	3.4	10.8	6.1	9	5.4
Housing services	6.5	4.0	4.0	7	6.9
General government services	7.9	5.9	11.4	11.6	22.3
Other private services	10.4	8	6.1	21	16.5
Services	**60.2**	**6.5**	**6.4**	100	100

Data source: Pakistan Bureau of Statistics

The *wholesale & retail trade* segment was a direct beneficiary of the improved agriculture and manufacturing performances. This, coupled with a continued rise in import quantum, led to the subsector surpassing the growth target of 7.2 percent and witnessing a 12-year high growth of 7.5 percent during FY18.

On the other hand, the slowdown in growth of *transport, storage & communication* continued for the third consecutive year, as the sector posted a growth of 3.6 percent compared to 4.4 percent during FY17. This was mainly on the back of subdued performance of *road transport* and *communication* (**Table 2.7**).

Table 2.7: Transport, Storage & Communication

	GVA (Rs billion)		Growth (percent)	
	FY17^{R}	**FY18^{P}**	**FY17^{R}**	**FY18^{P}**
Railways	1,778	4,755	-74.6	167.4
Water transport	52,415	49,387	13.4	-5.8
Air transport	99,742	110,693	3.6	11.0
Pipeline transport	1,890	1,496	-2.4	-1.4
Communication	262,467	267,734	5.6	2.0
Road transport	1,117,655	1,155,754	4.4	3.4
Storage	398,45	42,953	7.8	7.8
Total	**1,575,792**	**1,632,771**	**4.5**	**3.6**

Data source: Pakistan Bureau of Statistics

On the transport front, the deceleration in *road transport* was in sharp contrast to the increase in cargo handling activities and sales of commercial vehicles witnessed during the period under review. Encouragingly, however, both railways and air transport segment showed significant improvement on a YoY basis, with the former experiencing a turnaround by growing 167.4 percent during FY18 as against the 74.6 percent contraction last year.[30] Going ahead, the growth trend is likely to continue, with Pakistan Railways in the middle of implementing its "Revitalization Strategy" focusing on financial stability and service delivery,[31] and PIA launching a five-year strategic business plan to revamp its services model in the short-to-medium term.

The overall performance of the communications segment suffered as a result of a constrained growth in the profits of PTCL.[32] On a positive note, however, the number of broadband subscribers reached to 59.6 million, an increase of more

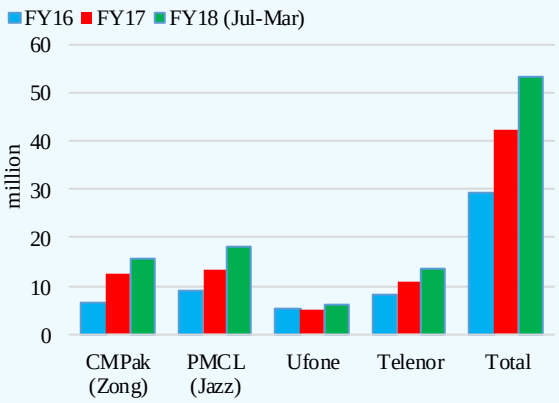
[30] Pakistan Railways witnessed a 26.7 percent increase in gross earnings on a YoY basis during Jul-Dec FY18, as the number of passengers carried, freight carried and freight tonnes earnings improved by 4.7 percent, 55.8 percent and 62.1 percent respectively.

[31] Ministry of Railways launched its Vision 2026 in 2014. The objective was to enhance its share in transportation sector by improving the rail infrastructure and adding new locomotives to its network – 205 wagons were to be imported from China while 595 were planned to be built at home. The first phase of the plan was completed in 2017.

[32] After accounting for the one-off expense booked by PTCL under the voluntary separation scheme introduced by the company for its employees during 2016, profit after tax effectively declined by 30.2 percent during 2017 on a YoY basis.

than 12 million in the first 9 months of the current fiscal year. Cellular network subscriptions were a major contributor in this regard (see **Figure 2.6**). As highlighted before in the SBP reports, the introduction of mobile broadband services has opened the door for digital and financial inclusion in the country. However, there is still a long way to go in terms of enabling an inclusive internet and mobile connectivity environment in the country, given that Pakistan lags behind regional economies in terms of both consumer readiness (inadequate digital literacy and skewed male/female participation ratio), and availability of relevant content (refer to **Box 2.3** for more detail).

Figure 2.6: Trend in 3G/4G Subscriptions



Data source: Pakistan Telecommunication Authority

On the *finance & insurance* side, the deceleration in growth of gross value addition of scheduled banks dragged down the subsector's growth from 10.8 percent last year to 6.1 percent during FY18 (**Table 2.8**). While low interest rates have continued to hurt the profitability margins of commercial banks, it was mainly a slower increase in deposits that affected the output of the sector.[33]

Table 2.8: Finance & Insurance

	Share in FY18	Growth (percent) FY17	FY18
Central Banking	1.9	-11.9	3.6
Other Monetary Intermediation	86.9	10.7	8.8
Scheduled Banks	82.5	9.5	7.2
Non-scheduled Banks	4.4	57.1	52.3
Other Financial Services	1.4	0.8	1.1
Insurance, reinsurance and pension fund	3.7	6.2	2.1
Activities auxiliary to financial services	6.1	24.8	-19.0
Finance and Insurance	**100.0**	**10.8**	**6.1**

Data source: Pakistan Bureau of Statistics

Box 2.3: State of Internet Inclusiveness in Pakistan

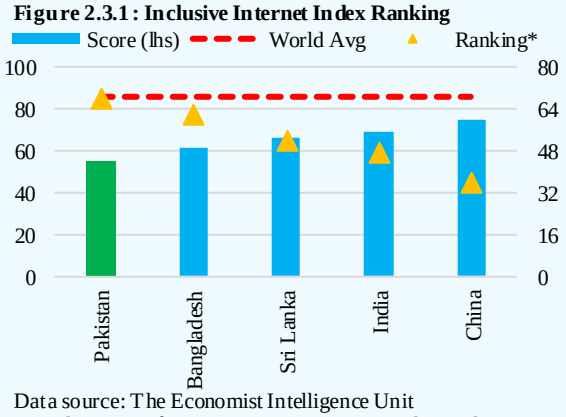
Internet penetration has been rising in Pakistan at an appreciable pace. Ever since the introduction of 3G/4G services, mobile telecom operators have led the exponential increase in broadband subscriptions in the country. This has opened the door for digitization of services provision via broadening the scale of e-commerce, facilitating the dissemination of agricultural knowledge, and enabling online access to various government-to-citizen (G2C) services, etc. However, cross-country

[33] During Jul-Mar FY18, the deposits of the banking sector grew by 4.8 percent compared to the 6.4 percent growth witnessed during the corresponding period of last year.

statistics reveal that there exists ample room of improvement in this regard, not least from the demand side.

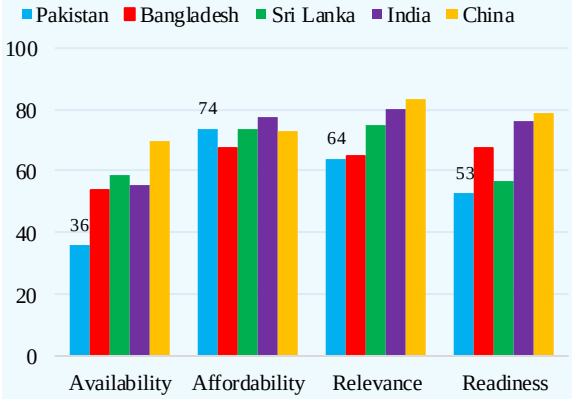
According to The Economist Intelligence Unit's Inclusive Internet Index of 2018, Pakistan ranks 68th in overall terms amongst the 86 countries surveyed, with a mean score of 54.5 relative to the South Asian average of 61 (out of 100) (**Figure 2.3.1**). Among the four dimensions considered for the ranking; namely, *availability*, *affordability*, *relevance*, and *readiness*; the country shows average to poor performance in all of them (**Figure 2.3.2**).

Figure 2.3.1 : Inclusive Internet Index Ranking



Data source: The Economist Intelligence Unit
* Ranking out of 86 countries. Importance in descending order

Figure 2.3.2: Index Score Comparison



Data source: The Economist Intelligence Unit

Under the *availability* dimension, the index compares the performance of the countries across indicators pertaining to infrastructure, electricity, usage, and quality of the internet access provided. The overall ranking of Pakistan is a lowly 77th, owing primarily to the dismal performance in the *usage* criterion. There exists a huge disparity between the number of male and female internet users in the country. In fact, Pakistan ranks lowest worldwide in the gender access parity, with a 266 percent gap in internet access rates and a 121.2 percent gap in mobile ownership in favor of men. This poses a policy challenge in light of currently underway National Financial Inclusion Strategy (NFIS).

On the *customer readiness* front, the poor literacy rate and sub-optimal level of web accessibility leads the country posting second-to-lowest score in the digital *literacy* environment indicator. However, the higher standing in the parameters pertaining to *policy* (owing to concentrated effort of the government in the form of NFIS) and *trust* (in which Pakistan ranks 15th in the world, benefitting from the existence of strong and enabling regulations and safety protocols) helped improve the country's overall dimension ranking somewhat to 68th.

On *affordability* terms,[34] the country sits in the middle of the rankings (43rd), bolstered primarily by the dominant market share of wireless internet providers and the strong level of competition between them (i.e. absence of oligarchy). Pakistan ranks joint-first in the *wireless operators* category, alongside 23 other countries.[35,36] On the consumer side, however, the performance is not at a commensurate level due to high mobile phone procurement cost and substantial pre- and post-paid tariffs.

Lastly, the *relevance* parameter measures the extent of local and relevant content available online to the public. It can be taken as an indicator of ease and usefulness of internet access in a country. Pakistan fares badly compared to regional and worldwide counterparts, with an overall ranking of 70 out of 86. While the amount of local language content is comparable to other developing countries, the absence of adequate domestically produced content (in areas of e-finance, e-health, and e-entertainment facilities) hurts the overall standing of the country. Once again, the lower level of general, and particularly digital and financial, literacy holds the country back.

In overall terms, hence, it is imperative to note that expanding the coverage by improving the digital infrastructure, though beneficial to the overall progress of the country, would not be sufficient unless there is a concurrent focus on demand side factors such as public literacy, gender parity, and specialized content generation and availability. The recently introduced Digital Pakistan Policy 2017 is a welcome development in this regard; however, concentrated and sustained efforts would be required to improve the unsatisfactory performance by Pakistan in terms of inclusive internet accessibility.

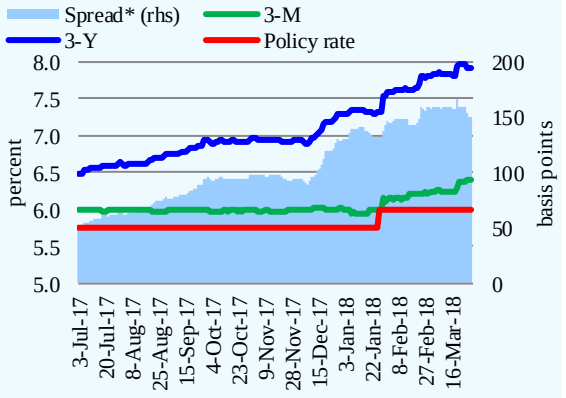
[34] The index measures affordability in terms of the cost of acquiring access to internet with respect to per capita income level of the country, and the level of competition in the internet marketplace (that helps keeps the prices down).
[35] The competitiveness parameter is calculated based on the Hirschman-Herfindahl Index.
[36] However, the absolute score was affected after Warid Telecom merged with Mobilink in mid-2016.

3 Inflation and Monetary Policy

3.1 Overview

The thirteen-quarter long spell of monetary easing that led to a historic low policy rate in the country, came to a close in Q3-FY18.[1] Market players had been anticipating a reversal in monetary policy stance for some time already, as indicated by their subdued participation in auctions of government securities except for the 3-month paper, and the rising secondary market yield spread (**Figure 3.1**).

Figure 3.1: Policy Rate and Secondary Market Yields



*between 3-M and 3-Y secondary market yields
Data source: State Bank of Pakistan

For the MPC, four key developments motivated the January 2018 decision to raise the policy rate by 25 bps: (i) PKR depreciation of nearly 5 percent in December 2017; (ii) rising international oil prices; (iii) monetary tightening by other central banks (particularly Fed and Bank of England), with its concomitant impact on PKR interest rate differential; and (iv) an overheating of the economy as indicated by increased capacity utilization in a number of industries. Thus, in view of the expected rising trend in inflation and aggregate demand, the committee overwhelmingly voted in favor of increasing the policy rate to 6 percent.[2]

The policy rate was kept unchanged when the MPC met again in March 2018. The status quo was considered prudent to allow more time for the full impact of the January rate hike and other policy measures taken by the government and SBP to play out. While inflation forecast was still on a higher side, some comfort came

[1] Monetary easing began in November 2014, when SBP cut the policy rate by 50 bps to 9.5 percent. The historic low policy rate of 5.75 percent was set in May 2016.

[2] MPC's concerns turned out to well-grounded as core inflation did surge to 5.8 percent in March and 6.9 percent in April 2018, even though headline CPI inflation still remained on track to fall within the annual target. The spike in core inflation may have been triggered in part by the two episodes of exchange rate depreciation, as prices of a number of non-food items (particularly those with an import component, like motor vehicles) rose sharply.

from moderation in core inflation from its 5.5 percent average in H1-FY18, to 5.2 percent in Jan-Feb 2018. Moreover, it was expected that the combined impact of the two depreciations on the trade balance would become fully apparent over the next few months, since exchange rate movements tend to be accompanied by a lagged impact and second round effects.

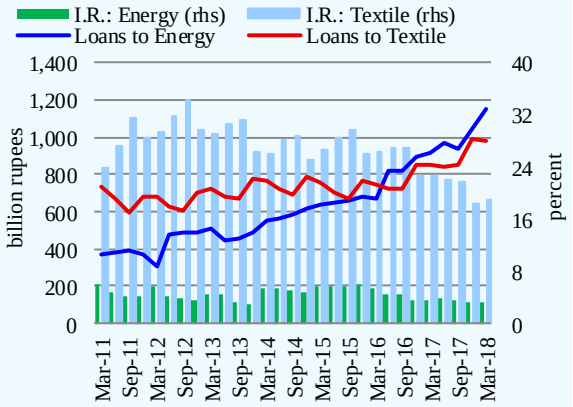
As for the interbank market, it appears that banks had already priced in the expected policy reversal on lending rates offered to their customers. Specifically, weighted average lending rate (WALR) that started inching up from October 2017 onwards, had shown a cumulative increase of 16 bps by end December 2017. Thus, when the policy rate was increased by 25 bps in January 2018, it attracted a muted response from banks; if anything, WALR shed 10 bps (on average) in February and March 2018. This softening of retail rates stemmed from ample liquidity that was available to banks, primarily on account of sizeable maturity of government securities, which they were not keen to roll over in a perceived rising interest rate scenario.[3] To a lesser extent, deposit mobilization during the third quarter was also higher than it had been during Q3-FY17. Importantly, this liquidity comfort played a part in pushing the average deviation of overnight rates from the policy rate into the negative territory (i.e. minus 3 bps) during Q3-FY18.

Thus, with virtually unchanged financing cost for the private sector, credit expansion continued unabated during the third quarter. In fact, growth in private credit during Q3-FY18 was twice that of last year.[4] While borrowing for working capital by the textiles sector was the largest in terms of volume during the quarter, the revival of fixed investment loans was the highlight of the period under review. A number of sectors – manufacturing and non-manufacturing alike – seemed to shrug off some of the hesitancy that appeared to have slightly held back long-term borrowing during the preceding quarter.

Other than interest rates, the steady continuation of economic activity – reflected by promising LSM numbers throughout the quarter – kept the credit demand strong. Additionally, the exchange rate adjustment in December 2017 may have helped ease the perception of an overvalued rupee among certain quarters, especially firms considering long-term fixed investment. Furthermore, the active decision-making by the government also helped subdue the element of uncertainty that had earlier put some businesses in a wait-and-see mode.

[3] Banks' reduced lending to the government ultimately prompted the highest-ever quarterly budgetary borrowing from the central bank.
[4] Credit to private sector grew by 3.2 percent in Q3-FY18 on QoQ basis, compared to 1.6 percent in the same period last year.

Figure 3.2: Infection Ratio (IR) of Energy & Textile Loans



Data source: Financial Soundness Indicators, SBP

A key supporting factor that encouraged banks to cater to financing requirements of the private sector was a steady improvement in perceived credit quality. The overall non-performing loans declined as percent of outstanding loans from 9.9 percent as of March 2017 to 8.3 percent at end-March 2018. The infection ratio was particularly reassuring in the energy sector (under 4 percent, private and public entities combined), where banks' exposure is growing the most.[5] As shown in **Figure 3.2**, the credit quality in energy sector looks much favorable especially when compared with the traditionally largest recipient of bank loans: textiles.

3.2 Liquidity Conditions in the Interbank Market

Liquidity conditions eased up considerably during Q3-FY18. In addition to the downward deviation of overnight rates from the policy rate mentioned earlier, another indicator of liquidity comfort was the reduced need for commercial banks to approach the central bank for support. During Q3-FY18, commercial banks utilized SBP's reverse repo facility on just four occasions, to borrow Rs 59.4 billion; in contrast, eight such instances were documented in the third quarter a year ago that had led to borrowings four times as high (Rs 160.8 billion to be precise).

The easy liquidity conditions mainly stemmed from lower investment in government securities by scheduled banks. While there were sizeable maturities of PIBs and T-bills in the third quarter, scheduled banks' participation in auctions of government securities remained sparse, except for the 3-month paper (**Section 3.4**).[6] The government, therefore, relied on SBP for budgetary borrowings. This was a reversal from the earlier pattern in H1-FY18, when commercial banks had funded budgetary borrowings and the government had retired its SBP debt. To a

[5] Admittedly, a significant portion of this borrowing has been directed towards productive capacity enhancements and increased running costs of operating new power plants. At the same time, some portion of energy sector loans was meant to fulfill liquidity shortages stemming from rising circular debt.

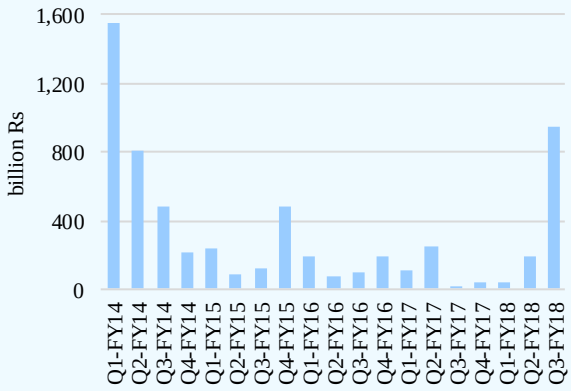
[6] Maturities of government securities amounted to Rs 5.6 trillion during Q3-FY18, comprising Rs 5.1 trillion for T-bills and Rs 526.8 billion for PIBs (principal only; excluding coupon).

lesser extent, some liquidity cushion also came from a minor uptick in deposit generation during the third quarter.[7]

These developments more than offset the liquidity pressure that may have emanated from FX interventions in the interbank, particularly in the aftermath of the December 2017 exchange rate adjustment. Such interventions during Q3-FY18 exceeded the amount observed in the earlier two quarters of the fiscal year. Specifically, the volume of FX injections in January 2018 was the highest monthly injection of FY18 thus far, though it subsequently subsided to an extent in February and March.

In view of the excess liquidity and in keeping with SBP's operational target, the central bank gradually unwound its outstanding stock of OMO injections in the third quarter.[8] The average outstanding OMO position fell to Rs 1.1 trillion during Q3-FY18, from Rs 1.5 trillion in the previous quarter.[9] In fact, the outstanding OMO position was negative Rs 36 billion as of end-March, in sharp contrast to the historic high of Rs 2 trillion that had been touched in Q2-FY18. Furthermore, repo (mop-ups) featured prominently during the third quarter, on a scale not witnessed since Q1-FY14 (**Figure 3.3**).

Figure 3.3: Repo (Mop-up) Acceptances



Data source: State Bank of Pakistan

3.3 Monetary Aggregates

While broad money growth had been subdued during H1-FY18 compared to a year earlier, it picked up during the third quarter (**Table 3.1**). This was due to an increase in net domestic assets (NDA) of the banking system, with the impetus

[7] Total deposits with banks grew by 1.8 percent during Q3-FY18, compared to 0.3 percent in Q3-FY17. That said, deposit generation of 4.8 percent for Jul-Mar FY18 remained lower than the 6.4 percent growth seen in Jul-Mar FY17.

[8] SBP's operational target is to maintain the weekly weighted average overnight repo rate close to the policy rate.

[9] The average outstanding level of OMO injections was Rs 961 billion in Q3-FY17. However, in this instance, Q2-FY18 serves as a better reference point, particularly since the outstanding stock had briefly touched a historic high of Rs 2 trillion in just the previous quarter.

coming from higher budgetary borrowing and private sector credit during Q3-FY18 compared to the third quarter last year.

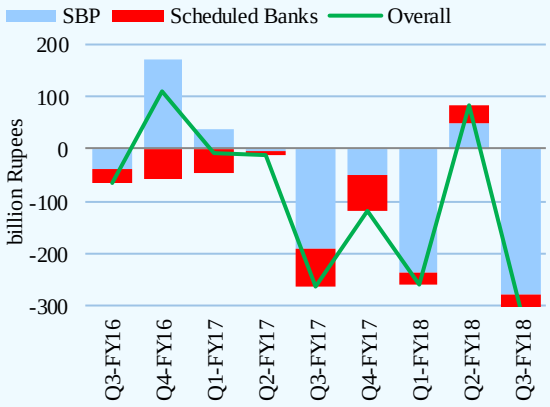
Table 3.1: Monetary Aggregates
flows in billion Rupees

	Q3		Jul-Mar	
	FY17	**FY18**	**FY17**	**FY18**
M2	110.2	366.0	756.1	702.4
NFA	-264.2	-308.6	-284.8	-483.1
SBP	-189.7	-277.8	-155.2	-464.3
Scheduled banks	-74.5	-30.8	-129.7	-18.7
NDA	374.4	674.7	1,040.9	1,185.5
Budgetary borrowing*	287.6	481.8	694.7	813.5
SBP	-100.5	2,162.5	792.2	2,159.9
Scheduled banks	388.0	-1,680.8	-97.5	-1,346.3
Private sector credit	77.9	177.4	438.6	473.7
PSE credit	114.0	107.6	197.0	173.6
Commodity operations	-55.1	-43.9	-137.9	-58.4
Reserve money	50.3	181.6	314.3	198.4
Other items (net) - SBP	337.2	-1,714.7	-432.1	-1,573.5
Reverse repo	298.7	-1,628.5	-408.4	-1,516.4

*On cash basis
Data source: State Bank of Pakistan

At the same time, the net foreign assets (NFA) of the banking system declined. Following a brief respite in Q2-FY18, when the NFA of SBP and scheduled banks had both registered minor recoveries, the indicator fell in the third quarter (**Figure 3.4**). This was because the positive flow in NFA of SBP in the previous quarter owed to a one-off development (i.e. issuance of Eurobond and Sukuk in the international capital market) rather than a sustained trend reversal.

Figure 3.4: Quarterly Flows in Net Foreign Assets



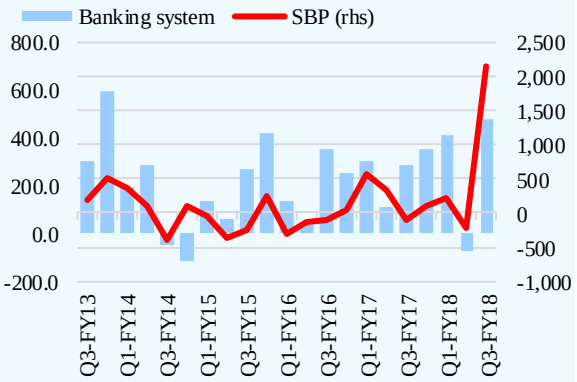
Data source: State Bank of Pakistan

As for reserve money, its growth picked up during the third quarter, primarily because of the elevated budgetary borrowing from SBP.[10] That said, reserve money growth would have been even larger in proportion to the scale of budgetary borrowings from the central bank had it not been partially neutralized by the unwinding of outstanding OMO injections (**Table 3.1**). To a lesser extent, the declining NFA of SBP also contributed to a much contained increase in reserve money.

3.4 Budgetary Borrowings

The government's budgetary borrowings from the banking system took their cue from fiscal developments. During H1-FY18, the fiscal deficit was relatively contained, and sizable external financing was also available in Q2; thus, budgetary borrowings from the banking system during the half as a whole were lower compared to last year. However, as fiscal slippages began to emerge in the third quarter and the buffer provided by Eurobond and Sukuk issuances subsided, the government increasingly tapped the banking system to bridge the shortfall. Moreover, the onus to provide financing fell squarely on SBP (**Figure 3.5**). The central bank lent nearly Rs 2.2 trillion to the government during the third quarter. Not only did this amount represent the highest quarterly borrowing from SBP ever, it also meant that the limit of zero quarterly borrowing from central bank – laid out in SBP Act – was not met.

Figure 3.5: Quarterly Budgetary Borrowing (Flows)
billion Rupees



Data source: State Bank of Pakistan

As mentioned earlier, the government's heavy reliance on SBP borrowing in the third quarter may be attributed in part to banks' lackluster participation in auctions of government securities. The March 2018 PIB auction was the 8th successive such auction to be scrapped amidst low participation by scheduled banks. Furthermore, the disinterest in 6- and 12-month T-bills which had surfaced in the previous quarter continued in Q3-FY18, with either no bid received for these tenors in a majority of the auctions, or the bids placed being rejected since they were on the higher side.

[10] Reserve money grew 3.7 percent in Q3-FY18, compared to 1.2 percent growth in Q3-FY17.

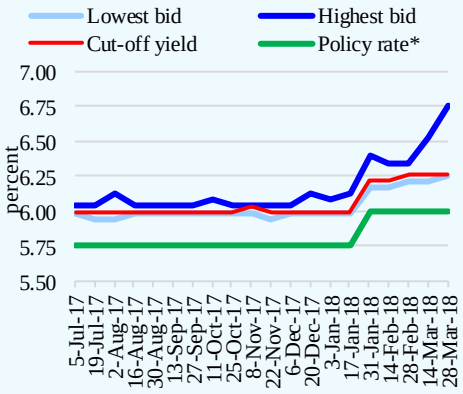
Table 3.2: Tenor-wise Offers and Acceptance in T-Bill Auctions* (Gross)
in billion Rupees

	3-month			6-month			12-month		
	Mat.	Off.	Acc.	Mat.	Off.	Acc.	Mat.	Off.	Acc.
Q1-FY17	267.1	814.5	410.5	400.6	1,378.4	863.4	510.3	873.1	490.1
Q2-FY17	389.7	1,086.2	827.1	441.2	497.2	216.1	227.5	127.3	56.3
Q3-FY17	841.7	1,748.7	1,203.8	863.4	1,972.1	1,391.0	817.1	599.0	369.6
Q4-FY17	1,189.2	1,479.9	1,383.2	216.1	698.2	502.7	266.7	76.4	20.6
Q1-FY18	1,800.4	3,501.6	3,463.1	1,391.0	942.8	895.5	490.1	66.8	47.7
Q2-FY18	3,045.9	4,284.7	3,298.4	502.7	296.8	302.8**	56.3	5.0	0.0
Q3-FY18	3,794.1	5,311.0	4,214.7	895.5	80.3	0.0	369.6	5.3	0.0

* In face value. Mat.= Maturity; Off.= Offered; Acc.= Accepted
Offered columns contain competitive bids only; Accepted columns contain all acceptances
** Consists of Rs 291.8 billion competitive and Rs 11.1 billion non-competitive bids
Data source: State Bank of Pakistan

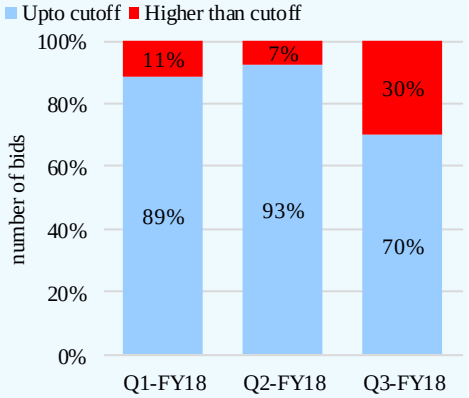
The pattern of offers and acceptances for the 3-month T-bill also presented a striking picture (**Table 3.2**). The gap between net-of-maturity offers and acceptances of the 3-month tenor, which had widened considerably in the second quarter, remained close to Rs 1 trillion even in Q3-FY18. During Q3 in particular, higher bid rates motivated the relatively low acceptance against the shortest tenor (**Figure 3.6**).

Figure 3.6a: Bidding Pattern for 3-month T-Bill



Data source: State Bank of Pakistan

Fig 3.6b: Composition of Bids for 3-m T-bills



Data source: State Bank of Paksitan

Commodity Operations

Commodity financing posted lower retirements during Q3-FY18 compared to the same period last year (**Table 3.3**). This was primarily driven by developments in wheat, which constitutes around 80 percent of the overall lending under commodity operations.

By contrast, sugar and fertilizer witnessed a modest credit expansion during Q3-FY18 compared to the same period last year. This marginal increase was mainly related to finance cost of the outstanding loans against pending subsidies and the commodities procured earlier. In case of sugar, local suppliers demonstrated their reluctance to participate in a tender issued by TCP in January 2018, mainly because of differences over payment terms.

Table 3.3: Commodity Operations
flow in billion Rupees

	Q3		Jul-Mar	
	FY17	FY18	FY17	FY18
Wheat	-56.52	-44.28	-134.33	-55.43
Sugar	0.78	0.30	4.25	-1.82
Fertilizer	0.60	0.08	-5.99	-1.40
Cotton	0.99	1.05	-1.88	0.06
Rice	0.02	0.02	0.06	0.15
Total	-55.11	-43.86	-137.90	-58.44

Data source: State Bank of Pakistan

3.5 PSE Credit

While credit to PSEs experienced a slowdown during Q3-FY18 on YoY basis, its subcomponent of loans remained higher compared to the same period last year (**Table 3.4**). Energy-related PSEs (like PSO, Power Holding Private Limited - PHPL, WAPDA) continued to dominate this segment.

Table 3.4: Credit to PSEs
flow in billion Rupees

	Q3		**Jul-Mar**	
	FY17	**FY18**	**FY17**	**FY18**
Credit	114.0	107.6	197.0	173.6
Loans	76.1	110.4	111.5	212.3
Of which				
Energy related PSEs	51.6	115.7	70.9	166.6
Investment	37.9	-2.8	85.5	-38.7

Data source: State Bank of Pakistan

During the third quarter, WAPDA settled Rs 150 billion outstanding dues of net hydel profit to the governments of Punjab and KP – part of which was financed through borrowings from commercial banks. The government also raised funds through PHPL to settle its dues to IPPs and PSO. Meanwhile, PSO was able to reduce its outstanding receivables from Rs 313 billion to Rs 304 billion during Q3-FY18, mainly on the back of funds received as part of circular debt settlement.[11]

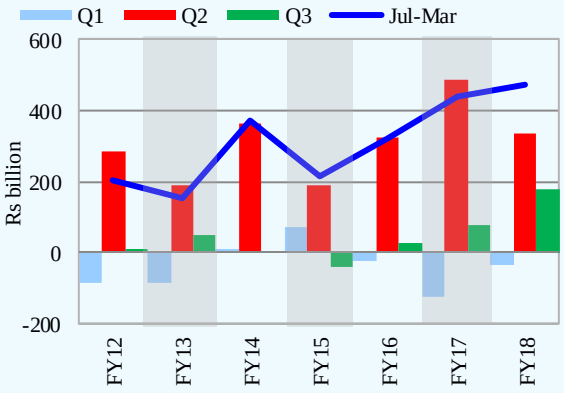
3.6 Credit to Private Sector

The third quarter marked a pickup in fixed investment loans, which was instrumental in pushing overall flows of credit to private sector during the Jul-Mar period beyond the level seen last year (**Figure 3.7**). Specifically, the Rs 77.2

[11] Having said that, PSO's financial woes are still a matter of concern and it is imperative for the company to negotiate with key stakeholders, both on the asset as well as the liability side, in order to smoothly manage payments related to FO and LNG.

billion flow of fixed investment during Q3-FY18 was the highest quarterly flow of the ongoing fiscal year.[12] More broadly, the Jul-Mar FY18 fixed investment lending represented a 12-year high.

Figure 3.7: Quaterly Flows of Credit to Private Sector



Data source: State Bank of Pakistan

The textile sector was the single largest group accounting for long-term loans during Jul-Mar FY18, having taken advantage of SBP's refinance schemes.[13] This development was consistent with the sector's improved performance, as export-oriented firms in particular continued to benefit from the government's export package, as well as a recovery in major markets like the EU to which Pakistan has favorable access via the GSP plus regime.[14]

Apart from textiles, the cement sector also registered noteworthy fixed investment borrowing during Jul-Mar FY18. In fact, the sector's fixed investment loan uptake in the third quarter alone amounted to Rs 16.9 billion, amid reports that some key players remained keen on capacity expansions. Domestic dispatches grew at a robust pace, increasing by nearly 17.9 percent to 31.3 million tons during Jul-Mar FY18.

Meanwhile, the power sector's fixed investment appetite recovered in the third quarter, after a relatively modest offtake in H1-FY18.[15] This included financing for: a gas-fired power plant being developed in the public-private partnership mode in Sindh; a coal-based CPEC power project in Hub; and wind energy projects being set up in Jhimpir by two textile firms.

[12] Fixed investment loans had risen by Rs 56.7 billion and Rs 41.8 billion in Q1-FY18 and Q2-FY18.
[13] Nearly 63 percent of the textile sector's fixed investment borrowing was facilitated by SBP's Long Term Finance Facility during Jul-Mar FY18. To a lesser extent, one-third of the sector's flow of working capital was also financed through the Export Finance Scheme.
[14] For further discussion of the textile sector's borrowing, refer to SBP's Second Quarterly Report for FY18.
[15] The power sector borrowed long-term loans worth Rs 25.3 billion in Q3-FY18, compared to net retirement of Rs 8.9 billion in H1-FY18.

Table 3.5: Loans to Private Sector Businesses in Jul-Mar (Flow, in billion Rupees)

	Total Loans		Working Capital*		Fixed Investment	
	FY17	FY18	FY17	FY18	FY17	FY18
Private Sector Businesses	**382.2**	**417.7**	**221.3**	**242.0**	**160.9**	**175.7**
Manufacturing	259.7	244.1	161.9	158.3	97.8	85.8
of which						
Textiles	87.0	124.2	60.8	89.8	26.2	34.3
Cement	11.7	35.9	2.9	12.5	8.7	23.4
Rice processing	9.4	31.1	8.4	30.3	1.0	0.8
Electrical machinery	6.5	28.2	5.0	25.6	1.5	2.6
Sugar	101.1	25.2	85.5	15.1	15.5	10.1
Edible oil and ghee	-4.5	16.4	-5.0	14.4	0.5	2.0
Iron and steel	0.5	13.9	-0.6	14.9	1.1	-1.0
Bakery etc	0.6	12.9	0.1	9.1	0.5	3.7
Basic chemicals	0.8	12.1	-1.3	9.8	2.2	2.2
Domestic appliances	6.2	10.1	4.8	5.7	1.3	4.4
Fertilizer	-14.7	-69.2	-25.6	-56.1	10.9	-13.1
Electricity, gas and water supply	44.9	66.1	24.1	43.0	20.9	23.1
Production., transmission and distribution of electricity (power sector)	46.1	60.8	24.4	44.4	21.7	16.4
Manufacture of gas; distribution of gaseous fuels through mains	0.7	5.2	1.6	-1.3	-0.9	6.6
Commerce and trade	20.1	38.5	20.3	24.9	-0.3	13.6
Real estate, renting and business activity	7.6	24.3	1.2	9.5	6.4	14.8
Transport, storage and communications	-0.3	19.5	-9.1	-3.5	8.8	22.9
Construction	22.4	13.6	6.6	7.7	15.8	5.8

*includes trade financing

Data source: State Bank of Pakistan

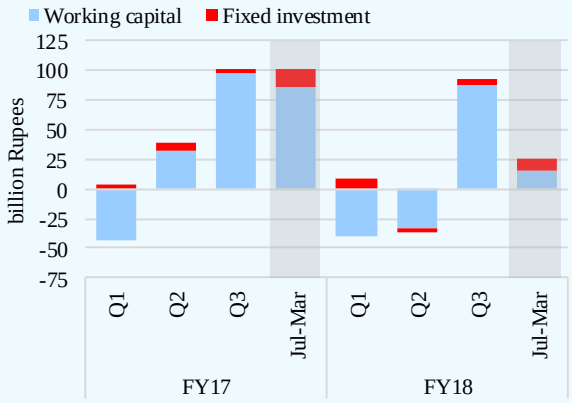
Moving on to working capital loans, the textile sector again accounted for the bulk of these borrowings during Jul-Mar FY18, which were relatively higher compared to last year. This may be attributed to rising export quantums and increased procurement of cotton pushing up the requirement for short-term loans, even though domestic cotton prices continued to remain soft compared to a year earlier.[16] Other sectors that registered notable working capital borrowing during Jul-Mar FY18 included: (i) the power sector, where projects coming online pushed up the financing requirement for fuel purchases; and (ii) rice processing, which saw double digit growth in exports.

That said, during the third quarter only, it was the sugar sector which overwhelmingly drove the off-take for working capital loans. It would appear that

[16] The wholesale price of cotton grew by 5.3 percent in Jul-Mar FY18, compared to 24.3 percent in Jul-Mar FY17.

the delayed onset of the sugarcane crushing season this year primarily explains the disruption in timing of the related credit flows, particularly during Q2 and Q3-FY18 (**Figure 3.8)**. While crushing typically gets underway in November, this year a majority of mills delayed crushing by around 15-30 days. Hence, it is possible that the borrowing cycle may overflow into the fourth quarter as well, such that full year flows to the sugar sector would normalize by the year end. Given that there was a record production of sugarcane this season, there is little reason to suspect that working capital borrowing by the sector would be significantly lower as compared to last year.

Figure 3.8: Loans to Sugar Sector



Data source: State Bank of Pakistan

In contrast, there was no recovery in borrowing activity by the fertilizer sector – neither in terms of short or long-term borrowing, nor in any of the three individual quarters of FY18. In the backdrop was the continuing decline in production, which spilled over to Q3-FY18 as a number of small units remained closed due to unavailability of cheap gas feedstock.[17]

Consumer financing

Consumer financing kept up its growing momentum and rose by Rs 57.2 billion in Jul-Mar FY18, compared to Rs 50.1 billion last year. This is the highest flow in the last 12 years in any Jul-Mar period, and was driven primarily by auto and housing finance (**Table 3.6**).

Table 3.6: Consumer Financing in Jul-Mar

flows in billion Rupees

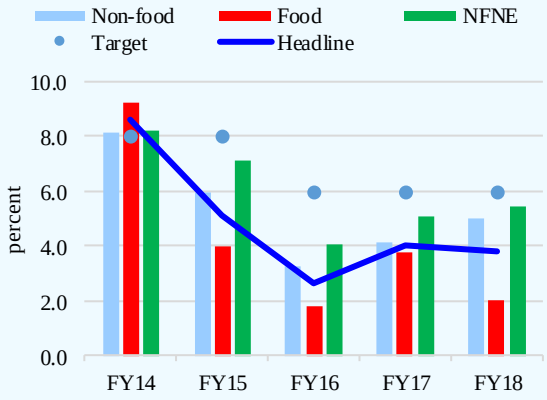
	FY17	FY18
Total	**50.1**	**57.2**
Auto financing	26.2	34.6
House building	8.2	15.1
Credit cards	3.0	4.7
Consumer durables	0.8	1.0
Personal loans	11.9	1.8

Data source: State Bank of Pakistan

[17] Small fertilizer producers could only achieve 9 percent capacity utilization during Jul-Mar FY18, compared to 69 percent utilization in Jul-Mar FY17. In contrast, large fertilizer producers' capacity utilization was around 100 percent in both periods.

That said, it is worth noting that merely eight banks have accounted for around 70 percent of the outstanding auto and housing loans over the last couple of years. The credit card segment is even more concentrated, with only five banks holding nearly 78 percent market share. Given that the per capita income has increased in recent years, banks may benefit by diversifying into these largely untapped segments.

Figure 3.9: Average CPI Inflation (Jul-Mar)



Data source: Pakistan Bureau of Statistics

3.7 Inflation

Rising global commodity prices and strong domestic demand played a key role in determining the trend of domestic prices during Jul-Mar FY18. This was particularly true for non-food inflation, which rose by just under one percentage point YoY; however, its impact was more than offset by a decline in food inflation (**Figure 3.9**). On aggregate, the headline inflation remained lower than last year.

Table 3.7: Average CPI Inflation and Contribution during Jul-Mar

		Growth		Contribution	
	Wt	**FY17**	**FY18**	**FY17**	**FY18**
Headline	**100**	**4.0**	**3.8**	**4.0**	**3.8**
Food	**37.5**	**3.8**	**2.0**	**1.6**	**0.8**
Cigarettes	1.4	15.1	-17.8	0.3	-0.4
Fresh vegetables	1.7	17.9	-3.0	0.3	-0.1
Sugar	1.0	8.3	-18.2	0.1	-0.2
Pulses	1.1	11.9	-17.9	0.2	-0.3
Onion	0.5	-38.1	90.2	-0.3	0.4
Meat & chicken	3.8	2.0	7.4	0.1	0.3
Rice	1.6	-0.6	14.3	0.0	0.2
Milk Fresh	6.7	3.8	3.9	0.3	0.3
Non-food	**62.5**	**4.2**	**5.0**	**2.4**	**3.0**
House rent	21.8	6.4	6.4	1.2	1.2
Education	3.9	10.3	12.1	0.4	0.5
Clothing, shoes	7.6	4.3	4.1	0.4	0.3
Motor Fuel	3.0	-5.7	10.4	-0.1	0.2

Data source: Pakistan Bureau of Statistics

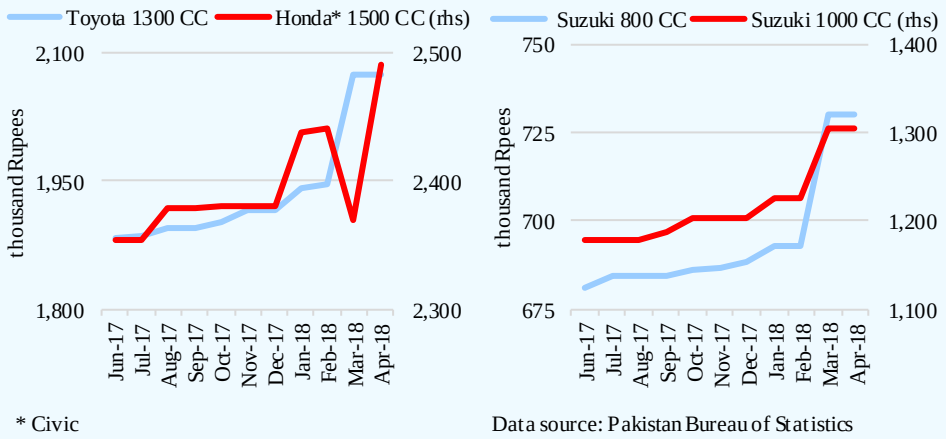
Commodities that showed lower inflation during Jul-Mar FY18 were (a) cigarettes; (b) fresh vegetables; (c) sugar; and (d) pulses (**Table 3.7**). Here, it is important to mention that developments related to these items were actually triggered in Q1-FY18, but continued to subdue CPI inflation until the third quarter. These included: (a) fall in cigarette prices due to a change in the regulatory duty

structure; (b) normalization of fresh vegetable prices as their supplies eased in FY18; and (c) excess supply of sugar and pulses in the country.

Motor vehicle prices spiked during Q3-FY18

Regulatory duty on car imports and a rising Japanese Yen against PKR during Jul-Mar FY18 had a significant impact on car prices in the CPI basket.[18] Car manufacturers raised the prices of several variants that are part of the CPI, and have an import-related component (**Figure 3.10**). Resultantly, the motor vehicle index rose by 5.7 percent during Q3-FY18 against 4.3 percent during the same period last year.

Figure 3.10: Spike in Car Prices



* Civic

Data source: Pakistan Bureau of Statistics

Pass-through of change in global oil prices to domestic POL

Demand and supply-related factors drove up global oil prices at a brisk pace.[19] Resultantly, the government raised domestic fuel prices quite frequently during Jul-Mar FY18 in order to keep them aligned with international prices (**Figure 3.11**). Cumulatively, petroleum prices rose from their lowest level recorded in CPI (in August 2017) to Rs 88.1 per litre, a growth of 26.7 percent.[20] Consequently, the motor fuel index rose by 10.4 percent during Jul-Mar FY18, after declining for previous three consecutive years in the same 9-month period. The impact of this rise also started to spill over to transport services, as the index

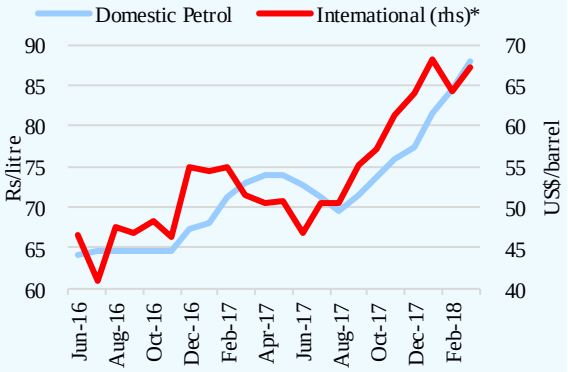
[18] The PKR depreciated by 13.5 percent against Japanese Yen during Jul-Mar FY18.

[19] Average prices of WTI, Brent, Dubai Spot and Saudi Arabian Light increased by 43.1 percent during Jul-Mar FY18. For details, see **Chapter 5**.

[20] Diesel prices were also adjusted, rising by just over 27 percent during the same period. In comparison, international oil prices (average of WTI, Brent, Dubai Spot and Arabia light Spot) increased from its recent trough by registering a 43 percent increase during Jul-Mar FY18.

rose by 1.3 percent during Q3-FY18 against declines in the same periods of FY15-FY17.

Figure 3.11: Domestic and International Oil Prices



* Average of WTI, Brent, Dubai Spot and S Arabia Light
Data source: Bloomberg and Pakistan Bureau of Statistics

Rice prices on a rise despite sufficient supply

In case of rice, its prices have been steadily rising since the beginning of FY18. First, during Jul-Mar FY18, the quantum of rice export rose by about 16.8 percent compared to the same period of FY17. Second, the mid-December 2018 exchange rate depreciation appeared to boost the foreign demand of Pakistani rice. By extension, this enhanced external demand may have played an important role in maintaining the upward trajectory of rice prices.

Regulatory duties affected various CPI items

Alteration in the structure of regulatory duties of cigarettes had prompted an unintended, abrupt fall in prices of cigarette items in the CPI during Q1-FY18.[21] In the third quarter, it was betel nut prices that felt a direct impact of regulatory duties; these prices rose by over five times during Q3-FY18.[22] This can be attributed to three factors, one of which was the FBR's decision to increase the regulatory duty on import of the commodity from 25 percent to 55 percent.[23] Second, attempts to illegally import betel nuts, and that too without proper medical certificate, had been made unsuccessful by customs authorities.[24] Third, there was a crackdown on the sale of the commodity in some parts of the country.[25]

[21] For a detailed analysis of how the altered regulatory duties affected cigarette prices, please refer to SBP's First Quarterly Report on The State of Pakistan's Economy, 2017-18.
[22] While the weight of betel nuts in the CPI is negligible (0.02 percent), such an exponential increase in prices is worth highlighting.
[23] Through S.R.O.1035 (I)/2017.
[24] The Ministry of Commerce requires valid import permit as well as phytosanitary (health) certificate for the import of many food items (Ministry of Commerce, S.R.O. 1076).
[25] For instance, the Punjab Food Authority gave an ultimatum to retailers and wholesalers to stop selling betel nuts and close their respective businesses by 30th April, 2018, before legal action was taken against them.

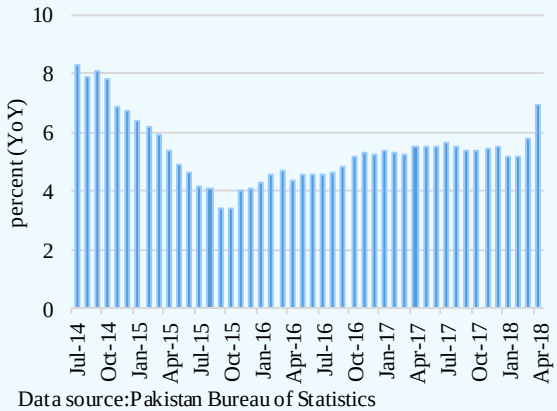
In addition, regulatory duty of 30 percent imposed on maize in October 2017 had an indirect impact on chicken prices. According to the Pakistan Poultry Association (PPA), maize is the key ingredient of poultry feed, having about 60 percent weight. Given that domestic production of maize also remained low, the association holds that regulatory duty on maize has brought about a significant increase in input costs for the poultry producers. In the meantime, these developments appear to have contributed to an 18.4 percent increase in prices of chicken during Q3-FY18; in comparison, they had remained on the lower side during Jul-Mar FY15, FY16 and FY17.

More broadly, the export quantum of meat grew by 3.4 percent during Q3-FY18, compared to a decline of 29.9 percent in Q3-FY17. Thus, the relatively lower supply in the domestic market may partially explain a rise in meat prices, which was the highest during Jul-Mar FY18 compared to similar periods since FY14.[26] Specifically, in case of beef and mutton, the growth in prices almost doubled during the period compared to Jul-Mar FY17.

Core inflation picked up

The non-food non-energy (NFNE) inflation displayed stable YoY growth during H1-FY18 (**Figure 3.12**). It even moderated somewhat in January and February 2018, as: (a) the house rent index witnessed the lowest YoY growth since FY10 in the first 2 months of 2018, and (b) the health index maintained single-digit (less than 5 percent) growth during the same period, compared to more than 12 percent average YoY growth during 2017.[27] [28]

Figure 3.12: Non-Food Non-Energy Index



Data source: Pakistan Bureau of Statistics

However, during March and April 2018, the core index rose to its highest level in 36 months, due to rapid growth in an overwhelming majority of its components.[29] Two points

[26] Meat (mutton and beef) and chicken have a combined CPI share of 3.8 percent.
[27] The house rent index is NFNE's heaviest component, with a 40 percent share.
[28] Average YoY growth in the health index was 8.7 percent during Jan-Apr FY18, compared to 9.9 percent in the comparable period a year earlier.
[29] CPI includes clothing and footwear, construction related indices, motor vehicle and its accessories, mechanical services and education.

are worth highlighting. First, the education index showed a YoY growth of 17.6 percent during March 2018, which is the highest ever since the rebasing of CPI; courtesy of majority of items in the index that showed double-digit growth.[30] Second, due to two rounds of exchange rate depreciation in December 2017 and March 2018, the higher cost of imported items evidently led to a broad-based impact on non-food CPI items.

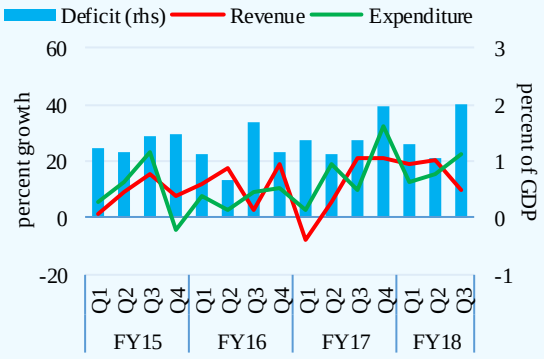
[30] The items include the fee charged by educational institutions in both the public sector (average increase of 25 percent) and private sector (average increase of 15 percent).

4 Fiscal Policy and Public Debt

4.1 Overview

The impressive growth in revenue collection witnessed during the first two quarters could not be sustained in Q3-FY18. Yet, on a cumulative basis during Jul-Mar FY18, it remained considerably higher compared to corresponding period of last year. On the other hand, building on the momentum seen in first two quarters, expenditures grew sharply in Q3-FY18 (**Figure 4.1**).

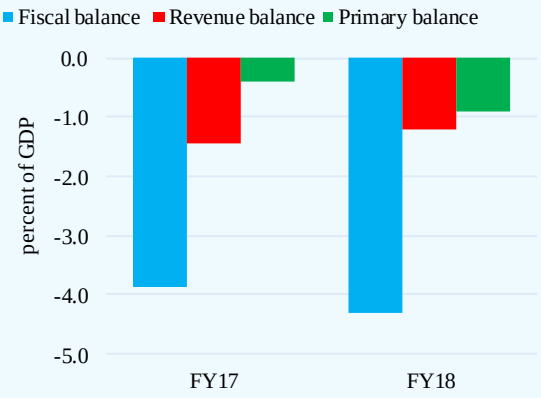
Figure 4.1 : Quarterly Trends in Revenue, Expenditure and Fiscal Deficit



Data source: Ministry of Finance

Together these have resulted in fiscal deficit rising to 4.3 percent of GDP during Jul-Mar FY18, against full year target of 4.1 percent and 3.9 percent deficit recorded in the corresponding period of last year. Similar to overall fiscal balance, the improvement in primary balance could not be sustained either, signifying that the non-interest expenditure grew at a faster pace relative to last year. The improvement in revenue balance, nevertheless, shows that revenue growth still managed to outpace the increase in current expenditures (**Figure 4.2**).

Figure 4.2: Fiscal Balance Indicators During Jul-Mar



Data source: Ministry of Finance, SBP calculations

Thus, acceleration in growth of expenditures was more due to development spending, both at federal and provincial level. The provincial governments in particular, revved up the pace of development spending to fast track completion of the ongoing projects before the term of current assemblies came to an end. The

growth in federal development spending, albeit slightly lower compared to last year, still remained high, above 24 percent (**Table 4.1**).

Table 4.1: Summary of Fiscal Operations (Jul-Mar)
billion rupees

		Actual (Jul-Mar)		% of GDP		FY18		
	Budget FY18	FY17	FY18	FY17	FY18	Q1	Q2	Q3
A. Total revenue	6,167.2	3,145.5	3,650.0	9.8	10.6	1,025.1	1,359.6	1,265.3
Tax revenue	4,912.5	2,694.3	3,076.2	8.4	8.9	911.0	1,115.9	1,049.3
Non-tax revenue	1,254.7	451.2	573.8	1.4	1.7	114.0	243.8	216.0
B. Total expenditure	7,646.8	4,383.6	5,130.9	13.7	14.9	1,465.9	1,715.1	1,949.9
Current	5,393.9	3,605.1	4,075.4	11.3	11.8	1,241.0	1,304.2	1,530.2
Interest payments	*1,363.0*	*1,094.5*	*1,172.8*	3.4	3.4	*445.4*	*306.1*	*421.4*
Defence	920.2	*535.7*	*623.8*	1.7	1.8	*181.9*	*211.5*	*230.5*
Development	2,265.2	803.9	1,042.5	2.5	3.0	220.5	392.5	650.0
Net lending	-12.3	-34.2	9.2	-0.1	0.0	0.9	1.3	7.9
C. Statistical discrepancy	0.0	8.8	3.8	0.0	0.0	4.0	15.9	-16.1
Fiscal balance (A-B-C)	-1,479.6	-1,238.1	-1,480.9	-3.9	-4.3	-440.8	-355.5	-684.6
Revenue balance	773.3	-459.6	-425.5	-1.4	-1.2	-215.9	55.4	-264.9
Primary balance	-116.6	-143.6	-308.1	-0.4	-0.9	4.5	-49.4	-263.2
Financing	1,479.5	1,238.0	1,480.9	3.9	4.3	440.8	355.5	684.6
External sources	511.4	220.2	524.3	0.7	1.5	16.0	368.1	140.2
Domestic sources	968.1	1,017.9	956.6	3.2	2.8	425.0	-12.8	544.4
Banks	390.1	694.7	813.5	2.2	2.4	408.0	-76.2	481.8
Non-bank	528.0	323.2	143.1	1.0	0.4	17.0	63.4	62.7
Privatization	50.0	-	-	-	-	-	-	-
% Growth								
Total Revenue		6.2	16.0			18.9	20.5	9.6
Tax revenue		8.6	14.2			21.4	12.7	10.1
Non tax revenue		-6.2	27.2			2.2	76.8	7.1
Total Expenditure		10.4	17.0			12.8	15.1	22.3
Current		5.8	13.0			15.9	11.4	12.2
Development		14.9	29.7			15.4	28.4	39.8

Data source: Ministry of Finance

Meanwhile, growth in current expenditures, the major contributor in absolute terms, also increased sharply. Again, the major push came from higher provincial spending. The increase in federal current expenditures largely reflects higher

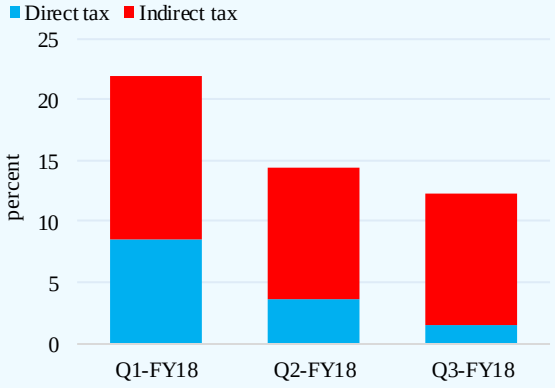
spending related to debt servicing, defense, general public services[1], economic affairs[2], and public order and safety.

The pace of revenue collection, still quite high compared to last year, slowed down considerably in Q3-FY18 compared to the first two quarters. The major setback came from a slower growth in direct tax collection, owing to lower corporate profitabilty, especially banks's profitability. The indirect tax collection, on the other hand, has continued to remain buoyant on the back of robust growth in economic activity, strong domestic demand, and pass-through of rise in international commodity prices to domestic prices.

Growth in non-tax revenue also rebounded with a significant increase in provincial non-tax revenue on account of transfer of hydel profits. Higher mark-up income, dividend income and PTA/postal service profit also contributed to higher non-tax revenue during Jul-Mar FY18.

Yet, the the growth in overall revenue collection edged lower compared to that of expenditures during Jul-Mar FY18. The resultant higher financing requirement was mostly met through external sources and increased recourse to SBP borrowings. In case of external finance, government heavily relied on commercial loans and bonds. In addition, revaluation losses due to appreciation of major currencies against US$, along with depreciation of rupee, also added to external debt. This has led to a considerable increase in debt during Jul-Mar FY18, with record accumulation in Q3-FY18 since FY14.

Figure 4.3 : Contribution to Growth in FBR Taxes



Data source: Federal Board of Revenue, SBP calculations

4.2 Revenue

The total revenue collection increased by 16.0 percent during Jul-Mar FY18 compared to 6.2 percent

[1] The general public services refer to the administrative activities of the provincial government such as handling executive and legislative organs, financial and fiscal affairs and transfers etc.
[2] This includes general economic affairs, commercial and labor affairs, agriculture, food, irrigation, etc.

growth realized in the same period of last year. The revenue growth was also broad-based, contributed by both tax (FBR and provincial) and non-tax revenues. While growth in revenue collection still remained impressive compared to last year, the pace slowed down considerably in Q3-FY18. This was primarily due to slower pace of FBR tax collection as growth in non-tax and provincial own tax collection remained strong.

FBR taxes

FBR tax collection grew by 15.8 percent during Jul-Mar FY18 compared to 8.6 percent growth last year. Though the growth was significantly higher compared to last year, its pace has consistently tapered off during 2nd and 3rd quarters of FY18. The major drag came from a slower growth in direct tax collection, while growth in indirect tax collection also weakened somewhat (**Figure 4.3**). The latter also reflects higher payment of tax refunds, especially to export-oriented industries, that increased by 34.4 percent (Rs 100.7 billion) during Jul-Mar FY18 (**Table 4.2**).

Table 4.2: FBR Tax Collection (Jul-Mar)
billion rupees

	Budget FY18	Collections		% Growth	
		FY17	FY18	FY17	FY18
Direct Taxes	1594.9	900.5	1001.4	11.2	11.2
Indirect Taxes	2418.1	1,368.2	1,626.4	7.0	18.9
Customs Duty	581.4	343.4	428.4	24.4	24.8
Sales Tax	1605.2	897.7	1,053.7	1.3	17.4
FED	231.5	127.2	144.3	8.6	13.5
Total Taxes	**4013.0**	**2,268.7**	**2,627.8**	**8.6**	**15.8**

Data source: Federal Board of Revenue and SBP's calculations

Direct taxes

The growth in direct tax collection decelerated to 9.3 percent in Q3-FY18 from 21.0 percent in first quarter. The cumulative growth however, remained at 11.2 during Jul-Mar FY18, same as witnessed during the corresponding period of last year. The voluntary payments (VP), having a share of 22.6 percent in total direct taxes, decreased by 3.1 percent during Jul-Mar FY18 compared to 7.7 percent increase in the corresponding period of last year.[3] The decline in FY18 can be attributed to reduction in corporate tax rate and lower bank profitability.[4] The

[3] The decline in VP was mainly concentrated in Q2 and Q3 FY18.
[4] Banking sector profit fell by 20 percent to Rs180.9 billion during Jul-Mar FY18 compared to Rs 226.9 billion in the corresponding period of last year.

impact of decline in VP on overall pace of direct tax collection during Jul-Mar FY18 was partially offset by higher withholding taxes and Collection on Demand (COD). Acceleration in growth of withholding taxes in particular reflects higher collection from rising trade volumes, contracts, salaries and dividend income (**Table 4.3**). The withholding taxes, also greatly benefited from the government's policy of differential taxation, especially in case of dividend income, registration of motor vehicles and sale and purchase of immoveable property etc.[5]

Table 4.3: Break-up of Direct Taxes Jul-Mar FY18

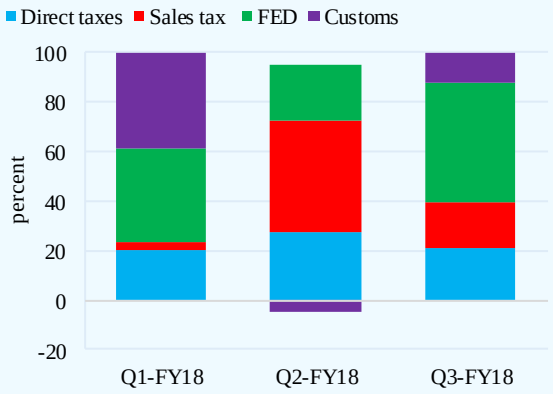
billion rupees

	Actual		Growth	
	FY17	FY18	FY17	FY18
I. Collection on demand	**51.9**	**68.4**	**9.9**	**32.0**
II. Voluntary payments	**247.7**	**240.0**	**7.7**	**-3.1**
III. Withholding taxes	**645.7**	**749.7**	**12.3**	**16.1**
Imports and exports	159.0	180.0	7.4	13.2
Contracts	165.2	194.6	14.7	17.8
Salary	75.2	95.2	19.3	26.6
Interest & securities	31.0	32.3	-15.8	6.7
Cash withdrawal	21.8	25.1	4.1	15.4
Dividends	31.0	39.3	24.4	27.0
Electric bills	17.9	24.0	-3.2	33.9
Telephone	36.8	38.0	8.9	3.3
Others	106.6	119.0	26.8	11.6

Data source: Federal Board of Revenue

Differential taxation was aimed at increasing cost for non-filers besides encouraging them to file tax returns and become part of the formal system. This intervention, to some extent, helped increase number of tax filers. In addition, FBR drive for broadening of tax base has helped in bringing filers into the tax net.[6] Despite these efforts, however, the number of tax filers continue to remain small compared to size of the

Figure 4.4: Contribution to Growth in FBR Taxes



Data source: Federal Board of Revenue, SBP calculations

[5] However, it continues to have negative implications for financial intermediation as reflected in the increase in the currency-to-deposit ratio since its scope was extended to include financial transactions in 2015.

[6] According to FBR, the number of tax filers have crossed 1.3 million. Specifically, the campaign to broaden tax base has added 0.2 million new tax filers during FY14 to FY17 in response to 0.5 million notices served to potential tax payers.

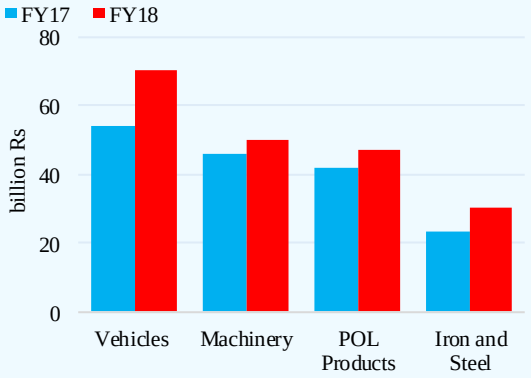
population.

Indirect taxes

The indirect tax collection grew by 18.9 percent during Jul-Mar FY18, compared to a subdued growth of 7.0 percent in last year. This sharp growth was supported by all segments – sales tax, customs, and FED – in line with strong domestic demand and increased sale volumes, surge in imports, and better manufacturing activity. The major contribution, nevertheless, came from a rebound in sales tax collection (**Figure 4.4)**.

Sales tax collection recovered strongly, growing by 17.4 percent during Jul-Mar FY18 against a marginal increase of 1.3 percent in the corresponding period of last year. It generally reflects increase in domestic demand supported by sustained expansion in real economic activity, which has resulted in substantial rise in domestic sales as well as imports. It can also be attributed to higher domestic prices of petroleum products as government promptly passed on the increase in international oil prices to domestic consumers. Moreover, rationalization of sales tax rates on petroleum products at the time of rising sales also contributed to higher collection, especially in Q3-FY18.[7]

Figure 4.5: Revenue Spinners of Custom Duty during Jul-Mar



Data source: Federal Board of Revenue

Substantial rise in imports and increase in regulatory duty helped to keep the growth momentum of custom duty collection, that grew by 24.8 percent in Jul-Mar FY18, on top of 24.4 percent in the same period last year. Depreciation of rupee also contributed to higher custom duty collection by increasing the landed price of imports. Largely, higher import of vehicles, POL products and iron and steel contributed to increase in custom duty collection during Jul-Mar FY18 (**Figure 4.5**). It is also worth mentioning that the prime objective of

[7] FBR vide SROs 1331(I)/2017 dated 31st December 2017;SRO 98(I)/2018 dated 31st January 2018; and SRO 265(I) 2018 dated 28th February 2018; raised sales tax rate on Kerosene and Light Diesel Oil up to 17 percent from previously applicable zero percent.

increase in regulatory duty was to address pressures on balance of payments and revenue collection was only a by-product.

Likewise, collection from federal excise duty grew by 13.5 percent during Jul-Mar FY18 compared to 8.6 percent growth observed in the corresponding period of last year. This acceleration can be attributed to increase in production of cement and cigarettes. Higher collection from cement reflects both increase in demand for cement and an upward revision in duty structure. Similarly in case of cigarettes, introduction of three-tier duty structure has helped partially recover FED collection.

Non-tax revenue

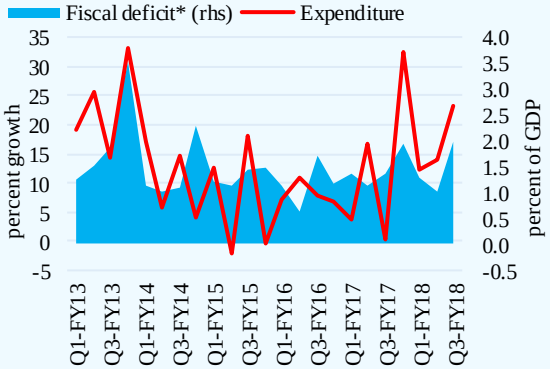
The non-tax revenue grew by 27.2 percent during Jul-Mar FY18 compared to a decline of 6.2 percent in the same period of last year. The growth looks impressive in the absence of CSF and given the SBP profit was almost same as in last year. In fact, the growth in non-tax revenue largely owes to one-off increase in provincial non-tax revenue – transfer of hydel profits to provinces (mainly Punjab and KP). Moreover, receipts from mark-up, dividend income, and profits of PTA/post office were also higher during Jul-Mar FY18 (**Table 4.4**).

Table 4.4: Non-tax Revenues (Jul-Mar)
billion rupees

		Actual	
	Budget FY18	**FY17**	**FY18**
Mark-up (PSEs & others)	96.0	12.1	21.7
Dividends	93.3	22.1	33.6
SBP profits	260.0	144.8	143.2
Defense (incl. CSF)	141.8	64.4	9.3
Profits from post office/PTA (3G)	11.3	0.7	8.8
Royalties on gas & oil	58.5	40.3	42.4
Passport & other fees	28.0	13.6	11.9
Discount retained	10.0	5.9	6.5
Windfall levy	8.0	1.0	2.3
Other*	547.8	146.3	294.1
Total non-tax revenue	**1,254.7**	**451.2**	**573.8**

* Includes provincial non-tax revenue
Data source: Ministry of Finance

Figure 4.6: The trends in Expenditure and Fiscal Deficit



* The negative value means surplus
Data source: Ministry of Finance, SBP calculations

4.3 Expenditures

The overall fiscal spending grew sharply by 17.2 percent, almost three times the growth observed during the corresponding period of last year. This was broad-based as both current and development expenditures were significantly higher across federal and the provincial governments **(Table 4.5)**.

Quarter-wise data reveals that the acceleration in expenditure growth mainly came from a jump in spending by 23.4 percent in Q3-FY18 **(Figure 4.6)**.

Table 4.5: Analysis of Fiscal Spending
billion rupees

	Jul-Mar		Abs. change	Growth	
	FY17	**FY18**		**FY17**	**FY18**
Current expenditures	**3,605.1**	**4,075.4**	**470.3**	**5.8**	**13.0**
Federal	2,439.3	2,653.3	214.0	**3.0**	**8.8**
of which					
Interest payments	1,094.5	1,172.8	78.4	1.4	7.2
(i) Domestic Debt Servicing	1,009.9	1,071.4	61.5	0.7	6.1
(ii) Foreign Debt Servicing	84.6	101.4	16.8	10.5	19.9
Defense	535.7	623.8	88.2	10.9	16.5
Public order and safety	81.9	94.0	12.1	8.6	14.8
Others	727.3	762.7	35.4	-0.5	4.9
Provincial	1,165.8	1,422.1	256.3	12.3	22.0
Development expenditures	**803.9**	**1,042.5**	**238.6**	**14.9**	**29.7**
PSDP	764.6	980.5	215.9	22.7	28.2
Federal	324.0	402.8	78.8	28.9	24.3
Provincial	422.7	577.8	155.1	13.6	36.7
Others (including BISP)	57.2	61.9	4.7	-24.7	8.3
Net lending	**-34.2**	**9.2**	43.4	-417.0	126.8
Total Expenditure*	**4374.7**	**5127.1**	**752.4**	**6.3**	**17.2**

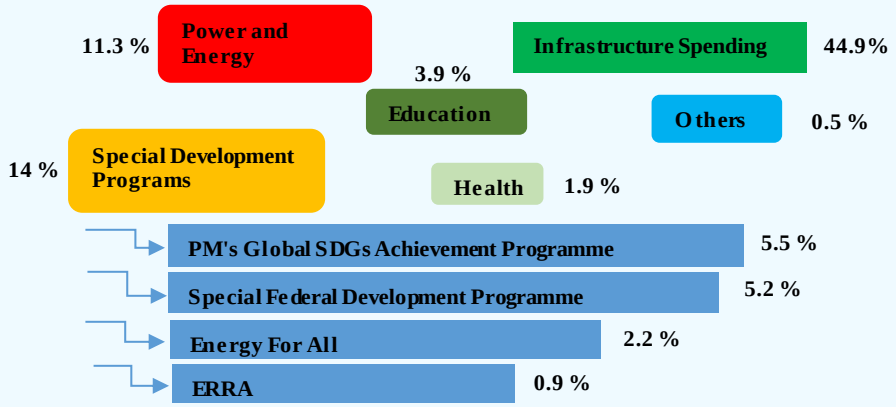
* Excluding statistical discrepancy
Data source: Ministry of Finance

The disaggregated data further shows that provinces contributed the most to improvement in growth of current expenditures. The overall current expenditures grew by 13.0 percent as compared to 5.8 percent recorded last year. The federal current expenditures, being larger in absolute terms, increased by 8.8 percent mainly due to higher interest payments and security-related spending. Going forward, higher interest payments could narrow space for development spending for sustaining higher growth in medium term.

Similar to current expenditures, acceleration in growth of development expenditures was also spearheaded by higher spending from provinces, though growth in federal spending also remained high above 24 percent. Higher development spending mainly reflects government's efforts to complete ongoing development projects before the term of current assemblies comes to an end. The breakup of PSDP releases shows that the major chunk of PSDP was allocated for

infrastructure development followed by *Special Development Programs'*, and *Power and Energy* **(Figure 4.7)**.

Figure 4.7 : The Development Spending during Jul-Mar FY18 (as percent of total PSDP spending)



Data source: PSDP Releases as on 30-03-2018

Moreover, growth in other development expenditures, especially aimed at poverty reduction, also rebounded with 8.3 percent increase against a decline of 24.7 percent recorded last year.[8]

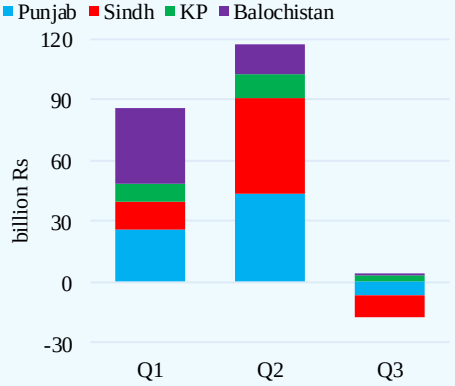
4.4 Provincial Fiscal Operations

The provinces posted a combined surplus of Rs 191.1 billion during Jul-Mar FY18, down from Rs 227.6 billion in the corresponding period of last year. All the provinces, except for Balochistan, recorded decline in surplus (**Table 4.6**). Quarter-wise data shows that the drag came in Q3-FY18, when provincial expenditures grew sharply (38.3 percent) against a relatively slower revenue growth in the quarter **(Figure 4.8** and **4.9).**

As discussed in **Section 4.3**, a sharp increase in both current and development expenditure led to a 25.8 percent increase in provincial expenditure during Jul-Mar FY18 compared to 12.6 percent increase in last year (**Table 4.5 and 4.6**).

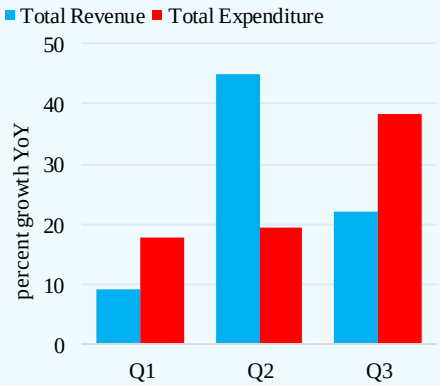
[8] This was due to higher allocation under Poverty Reduction Strategy Paper (PRSP) for both federal and provincial levels during Jul-Dec FY18 that are more concentrated on education and infrastructure projects.

Figure 4.8: Province-wise Surplus* During FY18



* Negative financing numbers represents surplus
Data source: Ministry of Finance

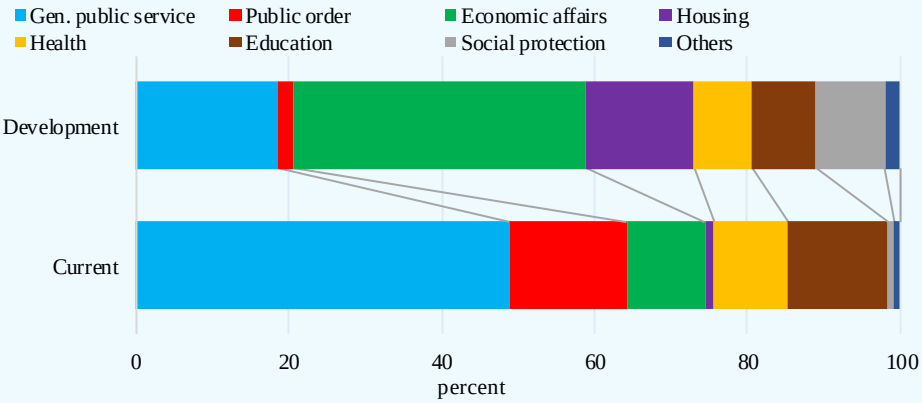
Figure 4.9: Provincial Fiscal Position During FY18



Data source: Ministry of Finance, SBP calculations

The composition of provincial expenditures elucidates that most of the current and development expenditures were allocated towards general public service and economic affairs followed by public order, housing, education, and social protection (**Figure 4.10**).

Figure 4.10: Provincial Expenditures During Jul-Mar FY18



Data source: Ministry of Finance

On the other hand, lower provincial revenue in Q3-FY18 was mainly because of a negligible growth in federal transfers; these were significantly higher in Q2-FY18, bolstered by higher federal revenue receipts. In contrast, provincial own revenue maintained the growth momentum, rising to Rs 233.3 billion in Q3-FY18. Yet, on a cumulative basis during Jul-Mar FY18, revenue collection increased by 25.8

percent compared to 13.7 percent reported in last year. The higher growth during Jul-Mar FY18 was mainly supported by provincial own revenue collection and federal loans and transfers **(Table 4.6)**.

Though growth in provincial revenue collection remained strong during Jul-Mar FY18, it was mainly supported by higher growth in non-tax revenue (**Table 4.6**). Slight deceleration in growth of tax revenue was mainly due to a slower growth in GSTS, motor vehicle tax, and other miscellaneous taxes. However, collection from stamp duties recorded a sharp increase of Rs 44.9 billion while excise duties rebounded during the period under review that followed trends in domestic production.

Table 4.6: Provincial Fiscal Operations during Jul-Mar
billion rupees

	Punjab	Sindh	KP	Balochistan	Total	Growth
FY18						
A. Total Revenue	1036.0	603.1	361.4	184.1	2184.6	25.8
Provincial share in federal revenue	801.7	418.1	269.3	159.9	1648.9	16.0
Provincial Revenue (I+II)	221.2	156.2	81.2	15.6	474.2	63.6
I. Taxes	141.2	119.3	13.0	6.5	280.0	21.4
II. Non-tax revenue	80.0	36.9	68.2	9.1	194.2	227.5
Fed loans and transfers	13.1	28.9	10.9	8.6	61.5	154.1
B. Total expenditure	1018.8	529.1	321.4	141.2	2010.4	25.8
Current**	659.5	413.9	237.7	121.6	1432.7	21.8
Development	359.3	115.2	83.7	19.6	577.8	36.7
Gap (A-B)	17.3	74.1	40.0	42.9	174.2	26.6
Financing* (overall balance)	**-62.8**	**-50.0**	**-24.5**	**-53.8**	**-191.1**	**-16.1**
FY17						
A. Total Revenue	808.4	500.3	263.1	164.3	1736.1	13.7
Provincial share in federal revenue	665.6	382.2	224.3	150.0	1422.1	13.5
Provincial Revenue (I+II)	132.8	107.4	41.3	8.3	289.8	25.2
I. Taxes	112.3	101.7	12.1	4.5	230.5	23.5
II. Non-tax revenue	20.6	5.7	29.2	3.9	59.3	32.6
Fed loans and transfers	10.0	10.7	-2.4	5.9	24.2	-42.4
B. Total expenditure	723.0	455.5	290.2	129.8	1598.5	12.6
Current**	484.0	363.4	216.4	112.1	1175.9	12.3
Development	239.1	92.1	73.8	17.7	422.7	13.6
Gap (A-B)	85.4	44.8	-27.1	34.5	137.6	28.2
Financing* (overall balance)	**-82.7**	**-41.9**	**-67.0**	**-36.0**	**-227.6**	**2.9**

*Negative sign in financing means surplus. ** Current expenditure data may not match with those given in Table 4.5 as numbers reported here includes the markup payments to federal government.
Data source: Ministry of Finance and SBP calculations

Provincial non-tax revenue jumped by Rs 134.9 billion on account of transfer of profits from hydroelectricity (mainly to Punjab and KP) and PSDP grants. A

strong showing by non-tax revenue contributed significantly to 63.6 percent growth in provincial revenue during Jul-Mar FY18 **(Table 4.6)**.

4.5 Public debt

Both a large fiscal deficit and widening of current account deficit led to a considerable accumulation in public debt during Jul-Mar FY18, which was more than double the increase recorded in the corresponding period of last year. Most of the addition in debt was concentrated in third quarter of FY18, Rs 1.3 trillion, the highest increase seen in a quarter since FY14.[9] Moreover, external debt contributed the most to overall rise in debt during Jul-Mar FY18. This is in contrast to last year when 90 percent of the increase was due to domestic debt in the same period (**Table 4.7**).

Table 4.7: Pakistan's Public Debt Profile

billion rupees

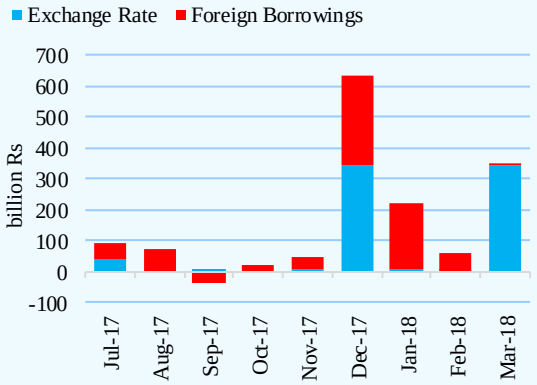
	Stock		Flow				
			Jul-Mar		FY18		
	Jun-17	Mar-18	FY17	FY18	Q1	Q2	Q3
Gross Public Debt	**21,408.7**	**24,076.3**	**1,197.2**	**2,667.6**	**651.2**	**761.0**	**1,255.5**
Domestic debt	14,849.2	16,074.1	1,120.1	1,224.8	526.3	61.9	636.7
External debt	5,918.7	7,269.6	83.8	1,350.9	111.1	662.8	577.0
Debt from the IMF	640.8	732.6	-6.7	91.9	13.8	36.3	41.8
External liabilities	373.8	432.0	-9.0	58.1	6.3	23.1	28.7
Total Debt of the Government*	19,635.4	22,059.7	1,070.8	2,424.3	558.8	685.1	1,180.4

*Gross public debt minus government deposits with the banking system.

Data source: State Bank of Pakistan

Besides higher external financing needs, revaluation losses due to appreciation of major international currencies against US$ also added to the external debt in dollar terms. At the same time, depreciation of Pak rupee further increased external debt in rupee terms (**Figure 4.11**). The combined impact of currency changes (both PKR and other currencies

Figure 4.11: PKR Depreciation and External Debt



Data source: State Bank of Pakistan & Economic Affairs Division

[9] Previously, the highest increase in gross public debt was recorded in Q1-FY14, when debt increased by a little less than Rs 1 trillion.

against US$) added around 2.1 percent in overall debt/GDP ratio.

With these developments, gross public debt rose by Rs 2.7 trillion during Jul-Mar FY18 to reach Rs 24.1 trillion as of end-March 2018. Within gross public debt, the government debt increased by Rs 2.4 trillion to reach Rs 22.0 trillion as of end-March 2018.

Domestic debt

With an addition of Rs 1.2 trillion, domestic debt reached 16.1 trillion as of end-March 2018. The entire increase in domestic debt during the period came from short-term debt, mostly in 3-month T-bills, as the government retired maturing longer-term debt (**Table 4.8**).

Table 4.8:Absolute Change in Government Domestic Debt
billion rupees

	FY17	FY18	FY18		
	Jul-March		Q1	Q2	Q3
Government domestic debt	**1,120.10**	**1,224.8**	**526.3**	**61.9**	**636.7**
Permanent debt	-561.8	-999.3	-510.5	15.2	-503.9
of which					
PIBs	-644.9	-1,067.7	-541.0	0.0	-526.8
Prize bond	83.1	68.5	30.4	15.2	22.9
Floating debt	1599.9	2,174.7	1,017.8	20.4	1,136.5
of which					
MTBs	1077.9	-57.0	745.9	1.8	-804.7
MRTBs	734.6	2,231.7	271.9	-188.7	2,148.5
Unfunded debt	82	49.0	19.0	26.1	3.8
Foreign currency loans	0	0.4	0.0	0.2	0.2

Data source: State Bank of Pakistan

Continuing the trends observed in Q2-FY18, banks remained reluctant to invest in long-term government securities in anticipation of increase in interest rates. This was particularly reflected in PIB auctions where the offered amount was about a quarter of the target and only a fraction of maturities in Q3-FY18 (**Table 4.9**). Against this, the government rejected all the bids as banks demanded higher rates. As shown in **Figure 4.12**, there was a clear upward shift in yield curve since December 2017; the situation did not change much after 25 bps increase in the policy rate in January 2018.

Table 4.9: Auction of Government Securities*
ratios

	Offer/ maturity	Target/ maturity	Accepted/ maturity
T-bills			
Q1-FY18	1.2	1.1	1.2
Q2-FY18	1.3	1.0	1.0
Q3-FY18	1.1	1.1	0.8
PIBs			
Q1-FY18	0.2	0.5	0.1
Q2-FY18			
Q3-FY18	0.1	0.4	0.0

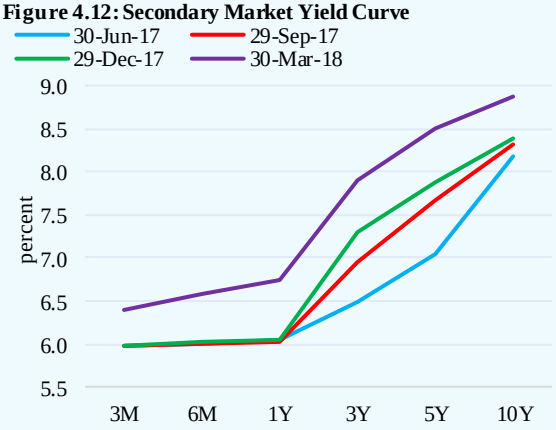
* Face value in case of offer and accepted amounts. Moreover, accepted amount is only from competitive bids.

Data source: State Bank of Pakistan

In case of T-bills too, the offers from commercial banks were heavily tilted towards 3-month tenor, and also at relatively higher rates. These factors made it

hard for the government to raise the targeted amount, which also included incremental amounts, over and above maturities during the quarter. Similar to commercial banks, the non-bank entities also shifted their investment towards short-term bills.

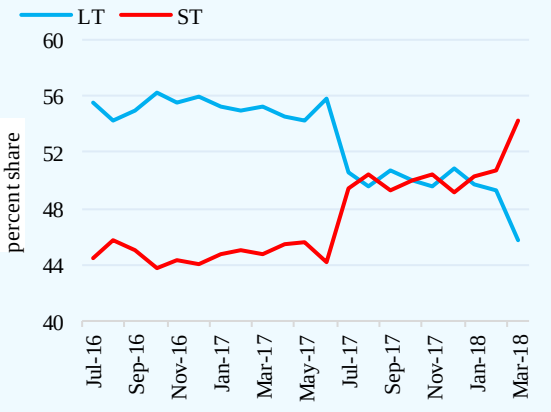
Figure 4.12: Secondary Market Yield Curve



Data source: MUFAP

In this backdrop, for retirement of maturing long-term government securities and to meet its additional financing requirement, government heavily relied on SBP borrowings. This led to the highest ever creation of MRTBs, Rs 2.1 trillion, in a single quarter since FY14, pushing the outstanding stock of MRTBs to a record Rs 4.7 trillion. As a result, the share of MRTBs in domestic debt rose to 29.2 percent in March 2018 from 16.5 in December 2017.

Figure 4.13: Composition of Domestic Debt



Data source: State Bank of Pakistan

The resulting surge in stock of 3-month T-bills and MRTBs led to a significant increase in the share of short-term debt in overall domestic debt (**Figure 4.13**). Though these developments bode well in terms of debt servicing cost, the rollover risk has increased.[10]

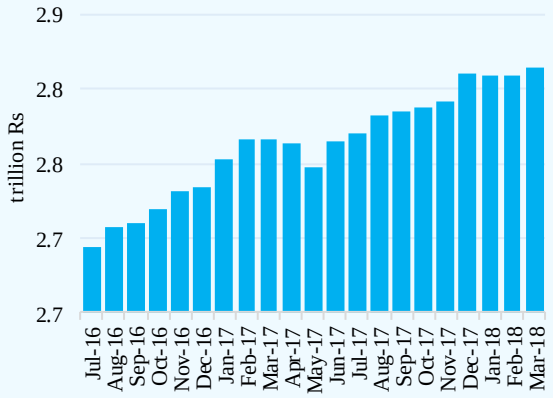
Unfunded debt:

The stock of unfunded debt increased only moderately during third quarter of FY18 (**Figure 4.14**). The increase was primarily driven by inflow under Behbood saving certificates and pensioner's benefit account, while other major schemes

[10] To revive commercial bank's interest in PIBs, the government has recently decided to issue PIBs on floating rates (Source: State Bank of Pakistan, DMMD Circular No. 09 of 2018)

recorded net retirement during the period. This is despite several efforts by CDNS to attract savers, and largely reflects lower rates of return. As SBP has increased the policy rate cumulatively by 75 bps since January 2018, a concurrent increase in NSS rates may revive savers' interest going forward.

Figure 4.14: Stock of Unfunded Debt



Data source: CDNS

External Public Debt

External debt rose by US$ 6.7 billion during Jul-Mar FY18, to reach US$ 69.3 billion as of end March 2018 (**Table 4.10**). Along with higher external borrowings, revaluation losses due to appreciation of major borrowing currencies against US dollar also added to external debt in US$. During Jul-Mar FY18, these losses added US$ 1.7 billion to country's external debt. Out of this, around US$ 1.0 billion was realized in Q3-FY18 alone, when Japanese Yen and SDR – having a combined share of around 40 percent in external debt – appreciated by 5.6 and 2.0 percent respectively.

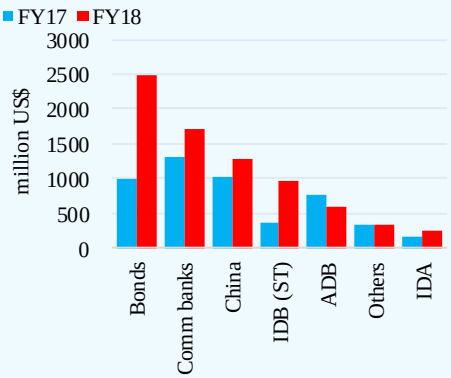
Table 4.10: Public External Debt & Liabilities

billion US dollars

	Stock		Flows				
	End-period		Jul-Mar		FY18		
	Jun-17	Mar-18	FY17	FY18	Q1	Q2	Q3
External public debt & liabilities (i+ii+iii)	66.1	73.0	0.6	6.9	0.9	3.5	2.5
External Public debt (i+ii)	62.5	69.3	0.7	6.7	0.9	3.5	2.4
i. Government debt	56.4	62.9	0.8	6.5	0.8	3.4	2.3
Of which;							
Paris club	12.0	12.3	-0.8	0.4	0.1	-0.2	0.4
Multilateral	27.6	28.4	-0.4	0.8	0.3	0.0	0.5
Other bilateral	5.8	7.2	0.8	1.4	0.4	0.2	0.7
Euro/Sukuk bonds	4.8	7.3	1.0	2.5	0.0	2.5	0.0
Commercial loans	4.8	5.7	1.3	0.9	-0.1	0.5	0.5
Short term	0.9	1.5	-0.5	0.6	0.0	0.4	0.2
ii. IMF	6.1	6.3	-0.1	0.2	0.1	0.0	0.1
iii. Foreign exchange liabilities	3.6	3.7	-0.1	0.2	0.0	0.0	0.1

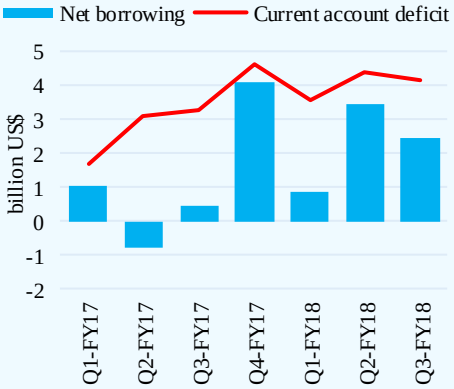
Data source: State Bank of Pakistan and Economic Affairs Division

Figure 4.15: Entity-wise External Borrowing (Gross) During Jul-Mar



Data source: State Bank of Pakistan

Figure 4.16: Net Borrowing viz-a-viz Financing Needs



Data source: State Bank of Pakistan

The gross external disbursement recorded US$ 2.6 billion YoY increase to reach US$ 7.6 billion during Jul-Mar FY18. More than half of the inflows were in the form of commercial borrowings by the government (US$ 1.7 billion from banks and US$ 2.5 billion from Sukuk and Eurobonds). Moreover, CPEC related inflows from China recorded moderate increase, while loans from multilateral donors remained almost at last year's level. (**Figure 4.15**). Overall, most of increase in debt during Jul-Mar FY18 was in the form of non-project loans, with its share rising to 70 percent in Jul-Mar FY18 from 50 percent in the same period last year. Such large borrowing primarily reflects requirements arising from financing of widened current account deficit **(Figure 4.16)**.

External debt servicing was up by US$ 221.2 million only, reaching US$ 3.2 billion

Table 4.11: Servicing of Public External Debt during Jul-Mar
million US dollars

	FY17	FY18	Change
Principal (Long-term)			
i. Government debt	2,045.5	2,045.3	-0.2
of which			
Paris club	153.8	321.8	168.0
Multilateral	999.6	1,069.6	70.0
Other bilateral	233.4	190.1	-43.3
Euro/Sukuk bonds	0.0	0.0	0.0
SAFE China deposits	500.0	0.0	-500.0
Commercial loans	138.8	463.9	325.1
ii IMF	0.0	43.6	43.6
iii. External liabilities	0.0	0.0	0.0
I. Total (i+ii+iii)	2,045.5	2,088.9	43.3
Interest			
i. Government debt	814.1	997.6	183.5
of which			
Paris club	129.6	128.2	-1.4
Multilateral	233.3	273.0	39.7
Other bilateral	166.8	190.6	23.9
Euro/Sukuk bonds	201.9	171.9	-29.9
SAFE China deposits	10.3	0.0	-10.3
Commercial loans	43.1	177.9	134.8
ii. IMF	60.9	94.6	33.7
iii External liabilities	55.7	16.3	-39.4
II. Total (i+ii+iii)	930.7	1,108.5	177.8
Grand Total (I+II)	**2,976.2**	**3,197.4**	**221.2**

Data source: State Bank of Pakistan

during Jul-Mar FY18 (**Table 4.11**). This was mainly due to higher interest payments, as the principal repayment recorded only a marginal increase. Repayment to both multilateral donors and the commercial lenders increased significantly during the period.

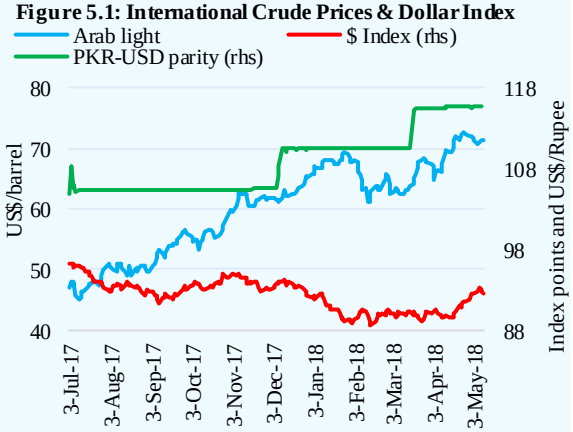
The interest payments grew quite significantly, particularly to commercial banks and multilateral/bilateral donors, in line with recent borrowing trends. Along with the higher borrowing amount, increase in the benchmark rate i.e. LIBOR, at which most debt is contracted, also contributed to higher interest payments this year.

5 External Sector

5.1 Overview

Changes in global currency and commodity dynamics besides the recovery in the advanced economies, and persistence in domestic aggregate demand mostly drove Pakistan's external balance during Jul-Mar FY18 (**Figure 5.1**). While a weakening Pak rupee against major currencies and the rebound in the advanced economies have strengthened Pakistan's FX receipts from exports and workers' remittances, the increase in oil prices and higher import payments for machinery, transport and metals continued to keep the country's current account under pressure (**Table 5.1**). Consequently, the country has witnessed the highest current account deficit during Jul-Mar of a fiscal year.

Figure 5.1: International Crude Prices & Dollar Index



Data source: Bloomberg

A significant increase in portfolio inflows and a marginal growth in net FDI – amid lower net loan disbursements – were insufficient to fill the widening gap in the current account. As some of the import payments were made from interbank market, this drained FX liquidity from the interbank market. At the same time, with the expectation of PKR depreciation consolidating throughout the year, FE-25 deposits with banks continued to rise. Resultantly, the kerb rate increased swiftly from October 2017 onwards, ahead of the PKR depreciation in December 2017 and March 2018 (**Figure 5.2**).[1]

Managing FX liquidity in such circumstances proved to be quite challenging for the central bank. SBP's market-stabilization efforts during the period were constrained by the continuously declining stock of official liquid reserves, barring an uptick in December 2017 owing to official portfolio inflows. By end-March, official reserves had declined by US$ 4.5 billion and reached US$ 11.6 billion;

[1] There is sufficient anecdotal evidence to show that retail investors and the general public, in anticipation of a PKR depreciation, started purchasing dollars from exchange companies (i.e. kerb market) and depositing them in their FCY accounts.

these were sufficient to cover over two months of the merchandize import bill.

While the reserves balance is indeed a concern, there has been some improvement in the trade account as the year progressed. Pakistan's exports, after a lackluster FY17, witnessed a broad-based recovery in Jul-Mar FY18, with strong performances from textiles and rice, and welcome contributions by sugar, wheat, POL products and fertilizer.

Table 5.1: Pakistan's Balance of Payments[P] (billion US$)

	Jul-Mar			Q3		
	FY17	**FY18[P]**	**Abs change**	**FY17**	**FY18[P]**	**Abs change**
Current account balance	-8.0	-12.1	-4.1	-3.3	-4.2	-0.9
Trade balance	-18.5	-22.3	-3.8	-7.1	-7.7	-0.6
Exports	16.3	18.3	2.0	5.7	6.5	0.8
Imports	34.8	40.6	5.8	12.8	14.2	1.4
Energy	7.8	9.8	2.0	2.8	3.5	0.7
Non-Energy	27.0	30.8	3.8	10.0	10.7	0.7
Services balance	-2.9	-3.9	-1.0	-0.6	-1.2	-0.6
CSF	0.6	0.0	-0.6	0.6	0.0	-0.6
Primary income balance	-3.4	-3.6	-0.2	-1.0	-1.0	0.0
Interest payments	1.4	1.8	0.4	0.5	0.6	0.1
Secondary income balance	16.8	17.7	0.9	5.5	5.8	0.3
Workers' remittances	14.1	14.6	0.5	4.6	4.9	0.3
Capital account balance	0.3	0.3	0.0	0.2	0.1	-0.1
Financial account balance	-6.3	-7.7	-1.4	-1.6	-1.3	0.3
Direct investment in Pakistan	2.0	2.1	0.1	0.6	0.6	0.0
Portfolio investment in Pakistan	0.6	2.4	1.8	-0.1	0.0	0.1
Eurobond / Sukuk	1.0	2.5	1.5	0.0	0.0	0.0
Other investment	0.6	2.4	1.8	-1.2	-0.7	0.5
Net incurrence of liabilities	-3.7	-3.3	-0.4	1.0	0.6	-0.4
General government	1.2	2.3	1.1	-0.3	0.7	1.0
Private sector (excl. banks)	1.8	0.6	-1.2	0.9	0.0	-0.9
Banks	0.9	0.2	-0.7	0.4	0.0	-0.4
SBP's liquid reserves (end-period)*	16.5	11.6	-4.5	16.5	11.6	-2.5
Total liquid reserves (end-period)*	21.6	17.8	-3.6	21.6	17.8	-2.4
PKR app(+) / dep(-) against US$ (in %)	0.0	-9.2	-	-0.2	-4.4	-

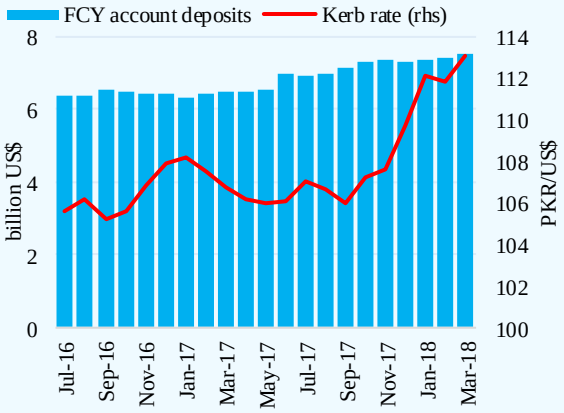
[P] Provisional Data source: State Bank of Pakistan * change during Jul-Mar FY18 and Q3-FY18

On the contrary, in case of imports, three categories – energy, machinery and metals – were responsible for 72.0 percent of the YoY increase in import payments during Jul-Mar FY18. SBP data suggests that payments for machinery items imported earlier for CPEC projects are now being made from the interbank market. However, customs data depicts a YoY decline in machinery imports in the same period (**Section 5.5**), which indicates that payment pressure from these

imports will subside soon.[2]

Nonetheless, as of now, the absolute magnitude of machinery import payments is still quite high, averaging US$ 720.2 million per month in FY18. The timing of these higher payments is not ideal as they have coincided with increasing global crude prices.[3] Not only have higher prices significantly inflated the country's crude imports, but it also offset the positive impact of a slowdown in quantum POL product imports in the year.

Figure 5.2. Growth in FCY Deposits & Kerb Rate



Data source: State Bank of Pakistan

To sum up, there are two main concerns at this point: the country's vulnerability to external shocks, and its ability to keep financing the BoP deficit given the gradual erosion in the FX reserves position. The country's growth prospects are encouraging, with benign inflation and favorable outlooks for exports and remittances, and some relief expected from reduced non-energy import payments down the road. However, until there is a significant improvement in the current account balance, the payment pressure will continue to fall on the country's reserves. This, in turn, creates the constant need to arrange external financing so that the FX reserves position offers some level of comfort.[4]

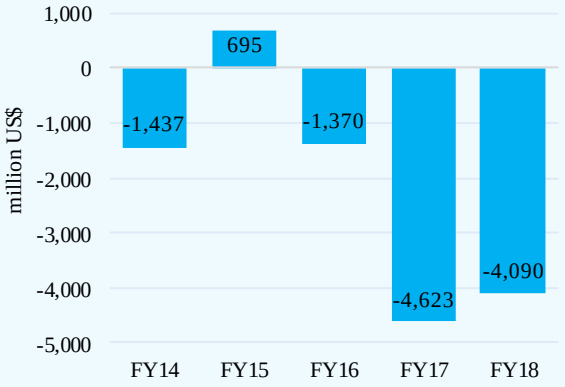
5.2 Current account

The current account deficit increased to US$ 12.1 billion in Jul-Mar FY18, the highest the country has seen during Jul-Mar of a fiscal year. In the same period of last year, the CAD was US$ 8.0 billion only. However, the pace of its increase slowed down for the first time in the last two years (**Figure 5.3**). This slowdown resulted from a deceleration in the import pressure spurred up in the last two years with the initiation of power and infrastructure-related projects under

[2] As the year progressed, the YoY growth of machinery import payments has also slowed down from 46.3 percent in Q1 to 23.3 percent in Q2 and further to 3.0 percent in Q3-FY18.
[3] Saudi Light oil prices were, on average, 22.0 percent higher in Jul-Mar FY18 as compared to Jul-Mar FY17 (source: Bloomberg).
[4] Already in April, with official liquid reserves dipping to US$ 10.9 billion, the government borrowed US$ 1.0 billion from a Chinese commercial bank.

CPEC. Moreover, the adjustment in the exchange rate also helped tame the expansion in the current account deficit by contributing to the export growth and encouraging remittance inflows from the UK and the US.

Figure 5.3: YoY Change in CAD in Jul-Mar



Data source: State Bank of Pakistan

5.2.1 Trade in services[5]

Following the widening trend of the merchandize trade deficit, the services deficit increased by more than a third on YoY basis during Jul-Mar FY18 to US$ 3.8 billion. While services exports declined 10.4 percent to US$3.9 billion, services imports rose by 7.3 percent YoY to US$ 7.7 billion (**Table 5.2**).

Table 5.2 Pakistan's Trade in Services (Jul-Mar)

	Value (US$ billion)			Growth (%)		
	FY16	FY17	FY18	FY16	FY17	FY18
Exports	4.1	4.3	3.9	-14.1	5.6	-10.5
Imports	6.4	7.2	7.7	-2.5	13.3	7.3
Trade Balance	-2.3	-2.9	-3.9	28.7	27	33.8

Data source: State Bank of Pakistan

Export of government goods and services, which constitute a major part of services exports, declined by 38.0 percent to US$ 957.0 million. Inflows under this category comprise amounts received on account of diplomatic and defense provisions, which also include Coalition Support Fund (CSF) receipts. In the absence of CSF inflows in FY18, under which Pakistan received US$ 550.0 million in FY17, the decline in government services exports was expected. Meanwhile, Telecommunications, computer and information services exports grew by 13.4 percent during Jul-Mar FY18 to US$ 787.0 million.

Among major categories, imports of transport services during Jul-Mar FY18 stood at US$ 3.0 billion, up from US$ 2.8 billion last year. Freight import – which is the largest sub-component of the services account– rose by 15.2 percent to US$ 1.9 billion during the period. Further impetus to higher freight charges came from the rise in international oil prices.

[5] The analysis in this section is based on the data compiled by State Bank of Pakistan. The data is compiled as per BPM6 (EBOS-2010) classification and is aligned with MSITS-2010.

Meanwhile, almost 23.5 percent of the services import bill consists of 'Other Business Services', which include professional, technical and management consulting services. China and the US remained key service providers in this category, with their exports to Pakistan valued at US$ 542.1 million and US$ 397.2 million, respectively.[6]

5.2.2 Workers' remittances

Remittances sent by overseas Pakistani workers rose by 3.6 percent YoY to US$ 14.6 billion during Jul-Mar FY18 (**Table 5.3**). Apart from the UAE, inflows from other GCC countries, specially Saudi Arabia, continued their declining trend. Fiscal consolidation and job nationalization policies undertaken by the Saudi government restricted foreign labour demand in the kingdom, which also led to repatriation of a number of foreign workers to their home countries.

Table 5.3: Workers' Remittances to Pakistan
(million US$)

	Q3		Jul-Mar		
	FY17	**FY18**	**FY17**	**FY18**	**Change**
Total	**4,600**	**4,861**	**14,105**	**14,606**	**501**
GCC	2,902	2,783	8,929	8,603	-326
S. Arabia	1,343	1,160	4,078	3,691	-387
UAE	1,007	1,104	3,143	3,265	122
Dubai	662	811	1985	2426	441
Abu Dhabi	333	281	1120	796	-324
Other GCC	552	520	1,707	1,648	-59
Non-GCC	1699	2077	5176	6003	827
USA	567	667	1,739	1,948	209
UK	561	680	1,658	2,031	373
EU	102	164	333	479	146
Others	469	566	1,446	1,545	99

Data source: State Bank of Pakistan

Contrary to the trend witnessed from the rest of the GCC, remittances from the UAE increased by US$122.0 million in Jul-Mar FY18, primarily due to US$ 441.0 million uptick from Dubai. Remittances from Dubai increased sharply after October 2014, and remained strong since then even when inflows from the next important state, Abu Dhabi has been declining. The dynamic of remittance inflows from the UAE is less straightforward as compared to other GCC countries. **Box 5.1** further analyzes the trend in workers' remittances from the UAE to Pakistan in the recent past.

Fortunately, remittances from non-GCC countries compensated the decline in inflows from the Gulf region. The low unemployment rate in both USA and UK amid rising economic activity in these economies and appreciation of their currencies against the Pak rupee led to higher remittances from these corridors.

[6] Business services imports from mainland China stood at US$ 415.3 million and those from Hong Kong at US$ 126.8 million.

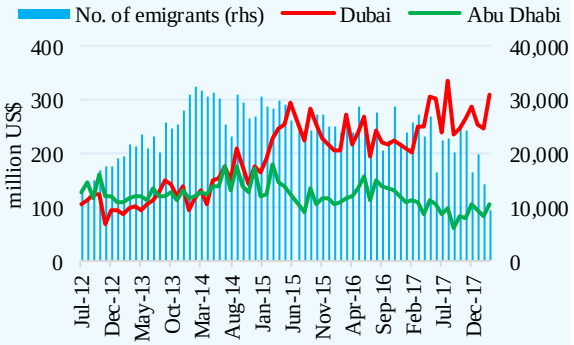
Going forward, the recent tax reform is expected to further stimulate the US economy, as investment is picking up in the country. Higher employment in US is likely to augment remittances inflow in Pakistan. In addition, Saudi Arabia plans to build a mega city, 'Neom,' on the Red Sea coast that will stretch into Egypt and Jordan. As labour demand may resurge in the KSA, the declining trend of remittances from the kingdom may reverse in the near future.

Box 5.1: Dynamics of Remittances Inflows from Dubai and Rest of United Arab Emirates

The United Arab Emirates (UAE), on the back of inflows from Dubai, is the second-largest source of remittances for Pakistan. Dubai, a commercial hub of the Middle East, is one of the seven states of the UAE, and is least dependent on oil revenue. In the passing decade, the state of Dubai has invested heavily in infrastructure projects, which led to a sharp increase in labour demand from Pakistan, specifically since 2012 (**Figure 5.1.1**).

However, inflow of workers' remittances from Dubai remained almost similar to those from Abu Dhabi until October 2014, when federal law on combating money laundering crimes came into force in the UAE. The new anti money laundering (AML) law passed by the UAE Federal National Council prohibits funding of unlawful organisations, directs regulatory authorities and courts to freeze accounts, and seize funds related to money laundering or terrorism-financing offences, and clarified that money laundering is an offence in its own right.

Figure 5.1.1: Remittances and Work-related Emigration to UAE



Data source: State Bank of Pakistan, Bureau of Emigration and Overseas Employment

Remittance inflows from Dubai have witnessed a sharp jump since then, and continued to rise even when falling oil prices created a recession-like situation in the GCC countries, forcing many of them to adopt retrenchment measures.

With some caveats, there could be a few economic explanations.[7] For example, as Dubai's economy is least dependent on oil, the downsizing, as witnessed in the broader GCC region in response to the oil price decline, was less severe in Dubai. Workers mostly stayed there and continued to send their savings back home. Second, foreign exchange inflows from Dubai may be attracting intense scrutiny of AML monitoring institutions, as the state has graduated to a major international financial

[7] There are caveats that need to be considered in disentangling the remittance inflow trend from Dubai and other UAE states with precision. First, states in the UAE are in vicinity of each other, and spillover between the sending sources is not beyond possibility. Second, the head offices of most of the remitting entities are located in Dubai, which blurs the remittance inflows by source states. And third, disaggregated monthly data on workers emigrating from Pakistan to the UAE for work is not available, which could have helped pin down the source of remittances precisely.

hub in recent years. This could have discouraged the hundi/hawala activity between Dubai and Pakistan.

Third, the Pakistani government started disbursing the rebate on remittance transactions more regularly, which may have incentivized the remittance transmitting entities in the UAE to opt for the legal channel.

More recently, in December 2017, the Government of Pakistan conducted the 'First Pakistan Remittance Summit 2017' in Dubai, in cooperation with the Pakistan Remittance Initiative. The aim of the summit was to engage overseas Pakistanis and the remitting agencies to send money through legal channels. This initiative, among others, may have led to a US$ 149.0 million increase in remittances from Dubai in Q3-FY18 (**Table 5.3**).

These kinds of initiatives, if undertaken in the other Gulf countries as well, may help reverse the declining trend of workers' remittances from the rest of the GCC corridor.

5.3 Financial account

Although higher than last year, financial inflows in Jul-Mar FY18, at US$ 7.7 billion, could only partially cover the current account deficit in the period. Besides a marginal growth in FDI, the government's recourse to foreign financing led to reasonably high portfolio investment inflows and an uptick in official loans. At the same time, external borrowing by commercial banks and non-bank private firms was much lower than last year.

Foreign direct investment

Although net FDI in Pakistan rose by 4.4 percent YoY in Jul-Mar FY18; excluding one-time acquisition inflows received last year in the food and electronics sectors, the YoY growth in FDI this year jumps to 47.7 percent. FDI in Jul-Mar FY18 remained concentrated in power, construction and financial business sectors (**Table 5.4**). China was the major source of FDI inflows in the power and construction sectors, as its investments remained focused on CPEC projects (**Figure 5.4**).

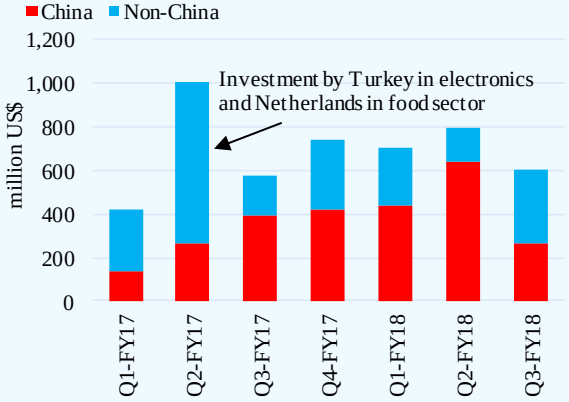
Table 5.4: FDI inflows to Pakistan (Jul-Mar)
million US dollars

	FY17	FY18	Change
Total FDI (net)	**2,005**	**2,094**	**89**
Construction	263	525	263
Power	468	712	244
Telecommunications	-108	-33	75
Financial business	230	256	26
Food	509	93	-417
Electronics	151	42	-110
Others	492	499	7

Data source: State Bank of Pakistan

On the contrary, the telecom sector continued to witness FDI outflows, albeit in reduced volume as compared to last year. An inflow of US$ 110.0 million from Malaysia was more than offset by a relatively higher outflow from a Norwegian telecom company. The Malaysian firm had acquired the operation of telecom towers from one of the leading cellular service providers in Pakistan. Meanwhile, the outflow in this sector represents the repayment of intercompany loans to the parent company by its subsidiary operating in Pakistan.

Figure 5.4: Source of Net FDI Flows to Pakistan

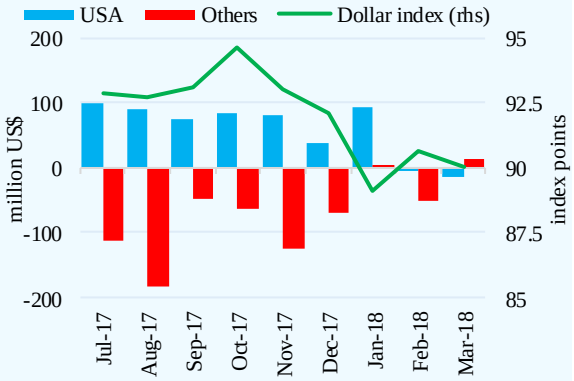


Data source: State Bank of Pakistan

Foreign portfolio investment

Foreign portfolio investment increased to US$ 2.4 billion in Jul-Mar FY18 from US$ 0.6 billion in the same period of FY17. The FPI was dominated by the public sector, as the government raised US$ 2.5 billion in Eurobond and *Sukuk* in December 2017. On the contrary, private equity investment witnessed a net outflow of US$ 93.3 million in Jul-Mar FY18. An inflow of US$ 539.8 million from the US was offset by the outflow of US$ 694.2 million to other countries.

Figure 5.5: Private FPI to Pakistan by Source and Trend in the Dollar Index



Data source: State Bank of Pakistan, Bloomberg

The weakening of the US dollar against a basket of major international currencies, as suggested by the Dollar Index, explains this divergence in the private equity flow trend to and from Pakistan. The portfolio realignment by foreign investors in the wake of weakening US dollar increased volatility in the global capital flows, as well as in Pakistan, specifically in Jul-Jan FY18 (**Figure 5.5**).

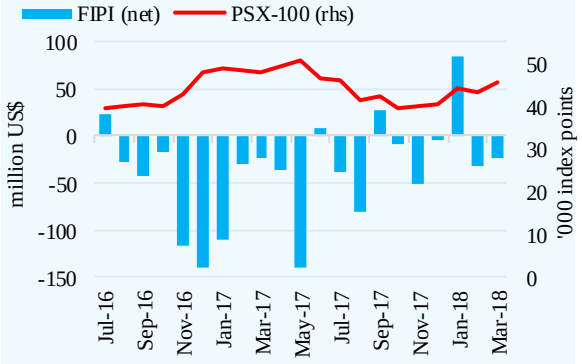
The growing concern on the US inflation outlook in recent months and the expected increase in the Fed policy rate instigated further uncertainty in the global portfolio investment flows. Not surprisingly, Q3-FY18 witnessed sell-offs in equity markets across the globe, triggered by concerns over higher interest rates and their impact on corporate profitability in the US.

Therefore, foreign investors repatriated funds by liquidating emerging market assets, including in Pakistan. Excluding US$ 92.4 million inflow from the US in January 2018, net FPI saw an outflow in Q3-FY18. On the back of the nonresident portfolio flow, the PSX remained roughly unchanged in Q3-FY18.

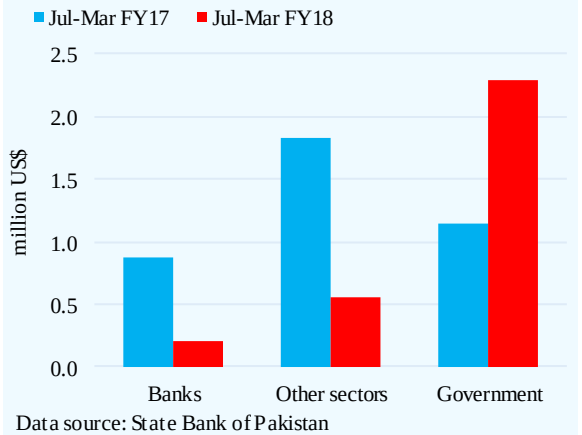
On a cumulative basis, the PSX witnessed net foreign selling of US$ 124.0 million during Jul-Mar FY18, compared to net selling of US$ 483.0 million in the corresponding period of last year (**Figure 5.6**).

Apart from the global currency movements that instigated private equity outflow, investors' confidence was further dented by the recent downgrade in Pakistan's credit outlook by Fitch, which raised yields of Pakistani Eurobond in secondary markets in February. Moreover, the political uncertainty arising due to upcoming general election may have dampened the prospect of further inflows in the portfolio investment, as investors may hold their fund till new government unfolds its future policy direction.

Figure 5.6: PSX performance and Foreign Investors' Net Buying(+) / Selling(-)



Data source: National Clearing Company of Pakistan Ltd., Pakistan Stock Exchange



Data source: State Bank of Pakistan

Other investment

Within external borrowings, net government loans more than doubled in Jul-Mar-FY18 over the same period last year (**Figure 5.7**). This increase is mainly due to relatively higher gross borrowings and lower payments during the period.

Table 5.5: Sources of Official Borrowings
(gross disbursements in million US dollars)

	Jul-Mar FY17	Jul-Mar FY18	Change
Total external loans	**4,955**	**7,529**	**2,574**
Eurobond/Sukuk	1,000	2,500	1,500
Comm. banks	1,315	1,722	407
China	1,033	1,215	182
IDB (ST)	351	950	599
ADB	757	586	-171
IDA	158	240	83
IBRD	178	130	-48
Others	164	187	23

Source: Economic Affairs Division

The government continued to borrow from commercial banks and from China – for BoP support as well as for infrastructure projects. Moreover, to finance the oil import bill, the government borrowed from the Islamic Development Bank on short-term basis (**Table 5.5**).

5.4 Exchange rate

The Pak rupee vis-à-vis US dollar depreciated by 9.2 percent during Jul-Mar FY18 in two episodes: 4.4 percent in December 2017 and 4.3 percent in March 2018. In contrast, most of the major currencies, like euro, British pound and Japanese yen, gained against the US dollar, leading to a sharp decline in the Pak rupee during Jul-Mar FY18 against these currencies (**Table 5.6**).[8]

Table 5.6: Appreciation(+) / Depreciation(-) of Selected Currencies against US Dollar

	Q3		Jul-Mar	
	FY17	FY18	FY17	FY18
PKR	-0.24	-4.81	-0.01	-9.61
INR	4.72	-2.33	4.09	-0.7
JPY	4.31	5.73	-8.23	5.34
CNY	0.75	3.38	-3.61	7.9
Euro	1	2.34	-4.15	8.08
GBP	1.22	3.72	-7.77	8.24
THB	4.12	4.07	2.23	8.94
MYR	1.37	4.04	-8.99	11.09

Data source: State Bank of Pakistan

As a result, the PKR's Nominal Effective Exchange Rate (NEER) depreciated by 11.1 percent in this period. While inflation in Pakistan remained benign, the depreciation in NEER almost similarly translated into the Real Effective Exchange Rate (REER), which depreciated by 10.6 percent.

The depreciation of REER indicates that Pakistan's export competiveness in real terms has increased in the global market over this period (**Figure 5.8**). As

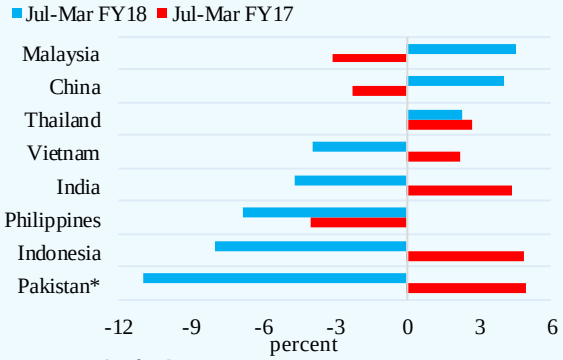
[8] During Jul-Mar FY18, the PKR depreciated against the euro (16.0 percent), Japanese yen (13.9 percent) and the British pound (16.1 percent).

inflationary expectations are gaining strength in the western economies, the PKR's REER may remain low in the next couple of months if inflationary pressures in Pakistan remain subdued.

5.5 Trade account[9]

Despite strengthening export growth and decelerating import growth, Pakistan's trade deficit reached a historic high of US$ 9.5 billion in the third quarter of FY18.[10] A broad-based increase in export quantums was overshadowed by an upsurge in import quantums, with higher commodity prices further aggravating the situation. Cumulatively, during Jul-Mar FY18, the trade deficit reached US$ 27.4 billion, up 17.6 percent from the same period last year.

Figure 5.8: REER Appreciation(+)/ Depreciation(-) of Major Asian Currencies



*State Bank of Pakistan
Data source: Haver Analytics

Exports

Exports grew by 13.1 percent YoY in Jul-Mar FY18 and reached US$ 17.1 billion. Exports in Q3-FY18 alone recorded a growth of 17.1 percent YoY, the highest growth in Q3 in more than six years, with FX earnings rising to US$ 6.1 billion. The impetus came from higher shipments of traditional items (e.g., textiles and rice), as well as non-traditional products, like sugar, seafood, fruits and POL products (**Table 5.7**).

Three major factors explain the growth in multiple exporting sectors. First, higher domestic production of cotton, rice and sugar, and surplus wheat stock, ensured that the country had exportable surplus available this year.[11]

[9] This section is based on customs data reported by the PBS. The information in this section may not tally with the SBP data reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.
[10] The Jul-Mar FY18 trade deficit was also the highest on record. Meanwhile, according to SBP data, Q3-FY18 marked the second-highest trade deficit in the country's history; the highest gap (US$ 8.2 billion) was recorded in Q4-FY17.
[11] Domestic rice production reached a record-high of 7.4 million tons this year, whereas cotton production also grew 11.9 percent to 11.9 million bales.

Second, favorable movements in Pak rupee against the US dollar and the euro, especially from December 2017 onwards, played a role in pushing up exports of textiles and rice in both quantum and value terms in the third quarter. In case of textiles, Pakistani exporters to the EU were able to make most out of the dual advantage of the PKR depreciation against the euro and the zero-duty access under GSP Plus.[12]

Table 5.7: Pakistan's major exports during Jul-Mar
million US dollars

Items	FY17	FY18	Abs. change	Quantum impact	Price impact
Food group	2,679.1	3,403.3	751.2	-	-.
Basmati rice	290.9	368.2	77.3	46.2	31.0
Non-basmati	879.8	1,126.5	246.7	147.5	99.3
Seafood	275.8	315.6	39.8	75.2	-35.4
Textile group	9,270.8	9,983.3	712.5	-	-
Raw cotton	41.1	55.8	14.7	17.0	-2.3
Cotton yarn	941.4	987.6	46.2	111.3	-65.1
Cotton fabrics	1,614.3	1,630.6	16.3	61.4	-45.1
Knitwear	1,734.4	1,971.8	237.4	29.0	208.5
Bedwear	1,594.0	1,674.0	80.0	70.3	9.7
Towels	591.3	598.8	7.6	54.7	-47.1
Readymade garments	1,704.6	1,918.9	214.3	215.9	-1.6
POL group	138.4	297.7	159.3	-	-
POL products	56.3	142.5	86.2	61.6	24.6
Crude oil	49.6	115.9	66.2	46.2	20.0
Other manufactures	2,283.8	2,527.7	243.9	-	-
Leather	252.4	196.8	-55.7	65.0	-120.7
Leather manufactures	375.2	354.6	-20.6	-	-
Plastic	164.7	162.4	-2.3	25.2	-27.5
Pharma	158.2	153.8	-4.5	3.6	-8.1
Cement	191.5	107.9	-83.6	-16.2	-67.4
Total exports	**15,096.5**	**17,069.0**	**1,972.5**	1,822.0*	27.0*

Data source: Pakistan Bureau of Statistics
*: for 27 items whose price and quantum data is available

Third, a strengthening consumer demand in the US, as reflected by growing share of consumption in real GDP growth and rising retail sales of clothing and accessories (**Figure 5.9**) has boosted the demand for clothing imports in that country.[13] Pakistan, along with other EMs, catered to this higher demand;

[12] The PKR was on average 17.3 percent lower against the euro and 5.2 percent against the dollar in Dec-Mar FY18 over Dec-Mar FY17. Meanwhile, the EU's GSP Plus status for Pakistan was renewed for two more years in February 2018.
[13] For instance, in the US, QoQ growth in personal consumption expenditures has exceeded overall real GDP growth in five of the last seven quarters (source: Haver Analytics).

however, Pakistani exporters benefited less compared to the other countries (**Table 5.8**).

Textile

Pakistan's textile exports grew by 7.7 percent YoY to US$ 10.0 billion in Jul-Mar FY18. Encouragingly, quantums played a dominant role in boosting export earnings. In some cases, like readymade garments, higher quantums even compensated for lower unit values during the period (**Figure 5.10**).

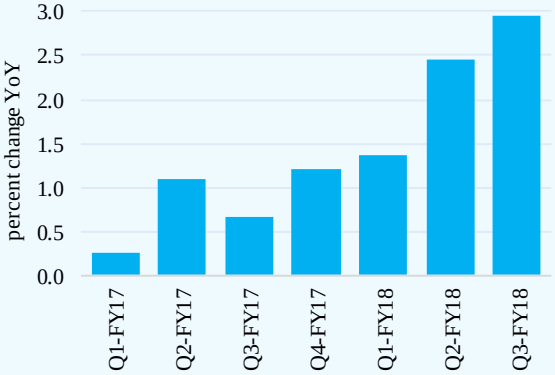
In terms of market, exports to the EU where Pakistani textiles enjoy zero-rated status under the GSP Plus scheme, continued on their rising trajectory. Similarly, textile exports to the US also rebounded, though they were pulled down by lower unit values during the period.

Non-textile

Pakistan's food exports rose by a solid 28.0 percent to US$ 3.4 billion in Jul-Mar FY18, amid healthy contributions from rice, sugar and wheat.

Pakistan's rice exports rebounded strongly in Jul-Mar FY18, rising by 27.7 percent to US$ 1.5 billion in the period. Both basmati and non-basmati sales grew by double digits, as exporters capitalized on: (i)

Figure 5.9: Growth in Retail Clothing Sales in the US*



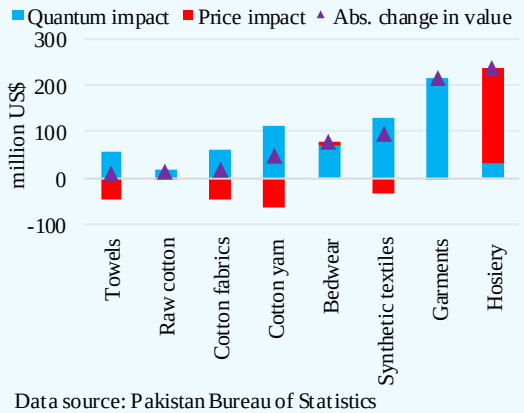
*Seasonally adjusted by source
Data source: US Census Bureau

Table 5.8: Textile and Apparel Imports by the US (Jul-Mar)

	Growth (%)		Share (%)	
	FY17	FY18	FY17	FY18
Bangladesh	-1.9	0.9	3.4	3.3
Cambodia	-10.0	11.3	1.6	1.7
China	0.0	7.4	48.6	49.8
India	8.4	5.6	7.8	7.8
Indonesia	-2.0	-8.0	2.7	2.4
Vietnam	4.7	5.6	7.3	7.3
Pakistan	-5.2	3.3	3.9	3.8
US' textile and apparel imports	0.0	4.8	-	-

Data source: OTEXA

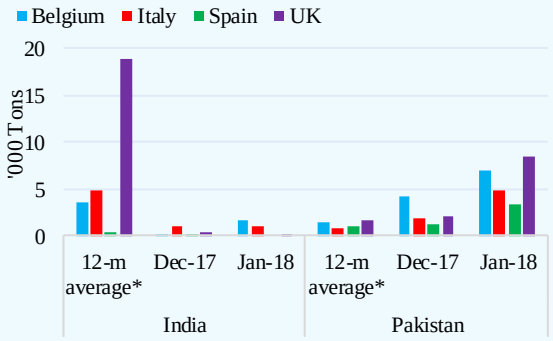
Figure 5.10: Price & Quantum Impact of Change in Textile Exports During Jul-Mar FY18



Data source: Pakistan Bureau of Statistics

emerging demand in African countries; and (ii) one-off weather shocks in Bangladesh and Madagascar, which damaged their paddy crops and necessitated hefty imports. Availability of an exportable surplus as well as the PKR depreciation in December also contributed to the uptick in exports.[14]

Figure 5.11: Trend in India and Pakistan's Basmati Exports to Key EU Countries



*average exports in previous 12 months
Data source: APEDA, Pakistan Bureau of Statistics

In terms of markets, Pakistan's basmati rice exporters partially captured India's share in the lucrative EU market, particularly in the UK and Belgium (**Figure 5.11**). This occurred as the bloc's ban on use of a pesticide on crops came into effect from January 2018 and severely dented India's basmati exports to the region. Fortunately for Pakistan, higher shipments to the EU completely offset the decline in quantum exports to the traditional Middle Eastern markets (UAE, Qatar and Yemen).

Meanwhile, a strong pick-up in shipments of non-basmati rice to African countries, particularly Madagascar and Senegal, helped completely offset the impact of lower quantum exports to Asian countries, like Afghanistan, China and Indonesia.[15]

Going forward, this year's one-off positive demand shock from Bangladesh and Madagascar will no longer be in play, and exports to these countries will likely normalize.[16]

Meanwhile, export subsidy announced by the government led to significant export

[14] The YoY growth in both quantum and value rice exports was the strongest in the third quarter of FY18. Quantum rice exports grew 31.1 percent YoY in Q3, after rising by 22.0 percent and 1.9 percent in Q1 and Q2 respectively. Similarly, in value terms, rice exports went up 40.9 percent in Q3, against 32.0 percent and 12.6 percent in Q1 and Q2.
[15] This is based on latest available Jul-Feb FY18 detailed data released by the PBS.
[16] Bangladesh's rice import is projected to decline by 25.0 percent in the 2018 season, on the back of a rebound in domestic production. Same is the case with Madagascar, which is likely to recover from a 13-year low rice production in 2017 due to a weather shock (source: Rice Market Monitor April 2018, FAO). Importantly, Madagascar accounted for over 69.9 percent of the YoY increase in Pakistan's quantum non-basmati exports during Jul-Feb FY18.

of both sugar and wheat. Specifically, sugar exports gained momentum from November 2017 onwards, as the government allowed exports of 500,000 MT, at a subsidy of up to Rs 10,700 per MT.[17] Though the export quota was enhanced later to 2.0 million MT, yet exporters could sell only half the allowed quota (i.e. 1.0 million MT) abroad by end-March 2018. Afghanistan and India emerged as the largest purchasers of Pakistani sugar this year.

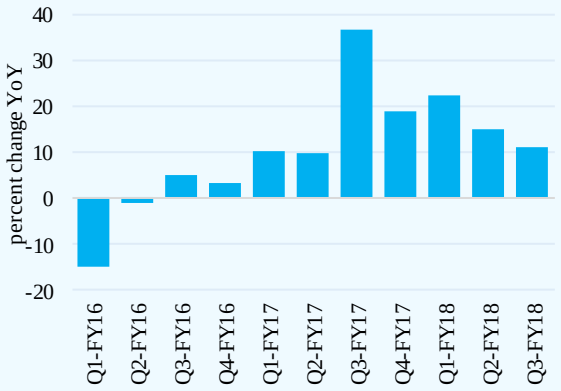
Similarly, wheat exports gained momentum from February 2018 onwards. In fact, quantum wheat exports are on-track to be the second-highest ever, with over 0.3 million MT already shipped abroad in Jul-Mar FY18. Consecutive bumper crop production over the past two years have led to a sizable build-up of stocks with procurement agencies (**Chapter 2**).[18] This led the government to allow exports, despite having to subsidize them.

Moreover, Pakistan's seafood exports rose 14.4 percent to US$ 315.6 million in Jul-Mar FY18. China, Japan and Indonesia were the top buyers of Pakistan's seafood items. Major export products under this category included shrimp, crabs and lobsters.

<u>Imports</u>

Pakistan's merchandise imports amounted to US$ 44.4 billion in Jul-Mar FY18, up 15.8 percent from the same period last year. While the growth in imports has slowed down from last year (**Figure 5.12**), it was still enough to completely offset the healthy growth in exports. The favorable impact of lower machinery imports and subdued food imports were more than offset by a mainly price-led surge in energy and metal purchases, and swelling transport imports (**Table 5.9**).

Figure 5.12: Growth in Pakistan's Imports



Data source: Pakistan Bureau of Statistics

[17] The fiscal cost of Pakistan's 1.0 million MT of sugar exports during Jul-Mar FY18 amounts to Rs 10.8 billion (or US$ 97.0 million, at the average kerb rate of Rs110.84 for a US Dollar for the period Nov-Mar FY18). However, it is not certain if the government has released the entire amount accrued in sugar export subsidy, yet.

[18] In January 2018, the government allowed 2.0 million MT of wheat to be exported, at a subsidy of up to US$ 159 per MT. The subsidy will stay in place till end-June 2018.

Table 5.9: Pakistan's Major Imports during Jul-Mar
million US dollars

Items	FY17	FY18	Abs. change
Energy group	**7,756.2**	**10,224.3**	**2,468.2**
POL products	4,848.0	5,459.9	611.9
Crude	1,840.7	2,933.5	1,092.8
LNG	887.2	1,610.6	723.4
Machinery group	**8,824.1**	**8,470.7**	**-353.5**
Power gen	2,370.3	1,922.8	-447.5
Electrical	1,661.6	1,591.2	-70.5
Construction	373.2	268.1	-105.1
Textile	401.1	424.2	23.1
Other machinery	2,531.1	2,678.1	147.0
Transport group	**2,287.4**	**3,248.0**	**960.6**
Cars	770.5	952.5	182.0
Trucks & buses	420.5	468.2	47.6
Aircraft & ships	329.6	762.1	432.5
Food group	**4,526.7**	**4,728.3**	**201.6**
Tea	411.2	451.3	40.1
Palm Oil	1,384.1	1,543.9	159.8
Pulses	722.7	408.0	-314.6
Textile group	**2,377.1**	**2,534.9**	**157.8**
Raw cotton	487.3	573.5	86.2
Synthetic yarn	486.4	487.5	1.1
Agri and chemicals	**5,546.7**	**6,481.7**	**935.0**
Fertilizer	478.5	615.3	136.7
Metals group	**3,148.0**	**3,992.3**	**844.3**
Iron & steel scrap	767.5	1,164.8	397.3
Iron & steel	1,530.6	1,842.8	312.2
Total imports	**38,369.2**	**44,438.6**	**6,069.4**

Data source: Pakistan Bureau of Statistics

Energy imports

Pakistan's energy imports – mainly comprising POL products, crude oil and LNG – shot up 31.8 percent to US$ 10.2 billion in Jul-Mar FY18. Importantly, the price effect was more dominant, accounting for 85.6 percent of the YoY increase in imports of crude and POL products. This tallies with the rising trend in global oil prices during the period, which were, on average, 22.0 percent higher in Jul-Mar FY18 than in the same period last year. Similarly, average benchmark global LNG prices were 17.6 percent higher this year as compared to Jul-Mar FY17.[19]

[19] This refers to LNG import price (cif) for Japan (source: Haver Analytics).

With regards to POL products, their quantum imports dropped 9.8 percent YoY during Jul-Mar FY18; however, this was more than offset by an increase in their unit prices. As a result, import values rose 12.6 percent to US$ 5.5 billion.

Meanwhile, this quantum decline was almost entirely due to lesser purchases of furnace oil (FO) in all three quarters of the year (**Table 5.10**). A shift in power generation away from FO towards coal and LNG, and an increase in domestic production of the fuel, have lowered the import demand for the fuel this year.[20] Furnace oil sales to the power sector also dropped 26.5 percent this year.[21]

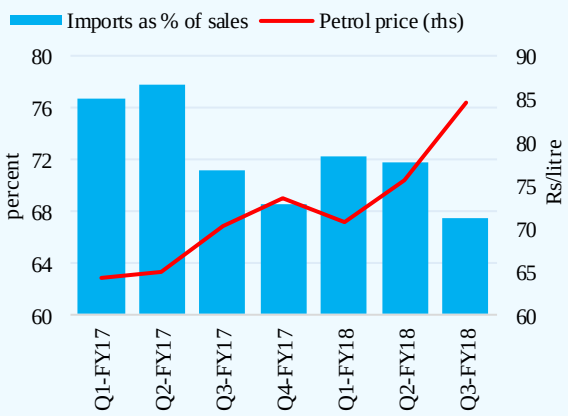
Table 5.10: Pakistan's Quantum Energy Imports (million MT)

	Jul-Mar			Q3		
	FY17	**FY18**	**Growth (%)**	**FY17**	**FY18**	**Growth (%)**
HSD	2.7	3.0	8.8	0.9	0.9	-2.8
Furnace oil	5.0	3.2	-36.0	1.3	0.2	-82.5
Crude oil	6.3	7.8	24.1	2.0	2.6	31.7
Petrol	3.7	3.9	4.2	1.1	1.2	2.3
Other	0.1	0.2	110.7	0.0	0.1	142.2
Total	**17.8**	**18.0**	**1.2**	**5.4**	**5.0**	**-7.9**
LNG*	2.1	3.6	71.4	-	-	-

Data source: Oil Companies Advisory Council *PBS, Data for Jul-Feb

Among other products, quantum imports of petrol and high speed diesel (HSD) continued to rise, reflecting strong demand from the transport sector. That said, a gradual slowdown has been noted in case of petrol imports. Rise in domestic production as well as the pass-through of higher international oil prices to domestic ones, have likely suppressed demand for petrol imports (**Figure 5.13**).[22]

Figure 5.13: Trend in Petrol Prices and Imports



Data source: Oil Companies Advisory Council

Meanwhile, imports of LNG and coal surged, both in quantum and value terms, in

[20] In fact, FO's share in total power generation during Jul-Mar FY18 slipped to 20.7 percent, from 30.4 percent last year (source: National Electric Power Regulatory Authority).
[21] Source: Oil Companies Advisory Council.
[22] During Jul-Mar FY18, the government raised petrol prices by a cumulative Rs 15.27 per litre (21.0 percent). In the same period, domestic petrol production had risen 18.6 percent on YoY basis.

line with mainly higher demand from the power sector (**Table 5.11**).[23] LNG imports have risen by 81.5 percent and reached US$ 1.6 billion by end-Mar FY18. In tandem, quantum of LNG imports had risen by a sizable 65.9 percent by end-February 2018.

Table 5.11: Power Generation by Source (in GWh)

	Jul-Mar FY17	Jul-Mar FY18	Abs change
Hydro	22,944	20,904	-2,039
Gas	22,087	28,804	6,717
Furnace oil	23,011	17,720	-5,292
Coal	58.64	7,393	7,335
Nuclear	4,284	6,572	2,287
Others	3,349	4,158	810
Total	**75,734**	**85,552**	**9,818**

Data source: National Electric Power Regulatory Authority

With regards to coal, its quantum imports more than doubled during Jul-Jan FY18, mainly reflecting demand from two major power projects that came online this year, as well as from cement manufacturing firms that use it as a raw material.[24] At the same time, a 13.3 percent increase in average international coal prices during this period further pushed up the value of coal imports.[25]

Non-energy imports

Machinery imports

Machinery imports, the largest group of non-energy imports, declined 4.0 percent to US$ 8.5 billion during Jul-Mar FY18. This is in sharp contrast to last year, when these purchases had surged 42.0 percent and played a major role in inflating the country's overall imports.

Further analysis of sub-categories shows that the imports required for CPEC projects – i.e. power generation, electrical, and construction machinery – have all declined this year, as most of the early harvest CPEC power projects are nearing completion.

On the other hand, mobile phone imports rose 15.1 percent to US$ 603.4 million in the nine-month period, which pushed up overall telecom sector imports to US$ 1.1 billion. Interestingly, while the overall number of mobile phones imported has gone down, their import values have risen – indicating the changing public's

[23] According to the Economic Survey of Pakistan 2017-18, 63 percent of the LNG imported during Jul-Feb FY18 was utilized by the power sector.

[24] The two projects are Sahiwal and Port Qasim, which were inaugurated in July and November 2017 respectively. Meanwhile, domestic cement production rose 12.1 percent in the comparable period (i.e. Jul-Jan FY18), leading to higher demand for coal.

[25] During Jul-Feb FY18, the country imported 7.7 million MT of coal, at a cost of US$ 772.5 million.

preference towards the expensive, high feature phones.[26]

Transport

The country's transport imports surged 42.2 percent and reached US$ 3.3 billion in Jul-Mar FY18. Aircraft parts and engines imports contributed the most, in nominal terms, to the YoY increase in transport imports during the period. Besides, car imports (both CBU and CKD) continued on their upward trajectory, growing 23.6 percent and almost touching US$ 1.0 billion mark (**Table 5.12**). In terms of contribution to growth, CKD imports dominated, as domestic assemblers continued to operate at elevated capacity levels (**Chapter 2**).[27]

Table 5.12: Breakdown of Transport Imports

million US dollars	FY17	FY18	Abs. change
Cars	**770.5**	**952.5**	**182.0**
CBU	*294.9*	*360.5*	*65.6*
CKD	*475.6*	*592.0*	*116.4*
Buses & trucks	**420.5**	**468.2**	**47.7**
CBU	236.7	186.1	*-50.6*
CKD	*183.8*	*282.1*	*98.3*
Motorcycles	*68.3*	*83.3*	15.0
Parts	351.0	436.8	85.8
Others	201.2	212.6	11.4
Aircrafts, ships and boats	329.6	762.2	432.5
Other transport equipment	146.3	332.6	186.3
Transport group	**2,287.5**	**3,248.0**	**960.6**

Data source: Pakistan Bureau of Statistics

Meanwhile, the breakdown of CBU car imports showed that the highest number of cars imported belonged to the 1,000-1,500 cc category, whereas in terms of YoY increase, 800-1,000cc category cars were the most prominent. Due to their reportedly better mileage and navigation features, these vehicles are being increasingly used not only by car hailing service providers, but also by middle and high-income groups.

Food

Overall food group imports rose 4.5 percent to US$ 4.7 billion in Jul-Mar FY18. The increase would have been much higher had pulses' imports maintained their last year's growth momentum. As it turned out, these imports dropped 43.5 percent, almost entirely due to lower quantums. While domestic pulses production in FY18 was about the same as last year, ample stocks available due to

[26] During Jul-Feb FY18, the number of cell phones imported in the country stood at 6.9 million, down 29.4 percent from the same period last year. Yet, the import values amounted to around US$ 527.1 million this year, up 14.7 percent from Jul-Feb FY17 (source: Pakistan Bureau of Statistics).
[27] Domestic car production was 15.9 percent higher in Jul-Mar FY18 as compared to the same period last year. This corresponded with a 15.6 percent rise in car sales during the period (source: Pakistan Automobile Manufacturers Association).

hefty imports in FY17, led to reduced demand for its imports.[28]

On the other hand, FX savings from lower pulses imports were partially offset by higher edible oil imports. Within this category, palm oil imports rose 11.5 percent to US$ 1.5 billion, while those of soybean oil rose 52.6 percent to US$ 110.6 million. While soybean oil still has a minor share in the country's edible oil imports, interestingly, its quantum imports have more than doubled this year. That said, a drop in both quantum and value terms was noted for both palm and soybean oil in the third quarter.

Iron and steel

Pakistan's iron and steel imports surged by 30.9 percent to US$ 3.0 billion in Jul-Mar FY18, reflecting continued momentum in domestic construction activities. Within this category, while finished products were dominant in terms of value (US$ 1.8 billion), it was scrap imports that posted the higher growth (up 51.8 percent to US$ 1.2 billion) in the period. The higher scrap imports, in turn, led to a healthy growth in local production: billets and sheets production rose 31.7 percent and 23.4 percent YoY respectively in Jul-Mar FY18.[29] The quantum imports of both scrap and finished products was dominant during the period, as the price impact was slightly affected by lower international prices in the second and third quarters.[30]

[28] Cumulative domestic pulses production (of Gram, Mung, Mash and Masoor) was 473,000 tons in FY18, as compared to 474,000 tons last year (source: Economic Survey of Pakistan 2017-18). In fact, average domestic pulses prices were down 17.9 percent in Jul-Mar FY18 over Jul-Mar FY17.
[29] The presence of a favorable regulatory environment for the domestic industry (with heavy duties imposed on imported finished steel products), also contributed to the sector's better performance this year. For details on the regulatory duties in place on steel imports, please see Section 5.5 in SBP's First Quarterly Report on the State of Pakistan's Economy for FY18.
[30] Average international iron ore prices were 10.9 percent lower in Oct-Mar FY18 as compared to the same period last year (source: Bloomberg).

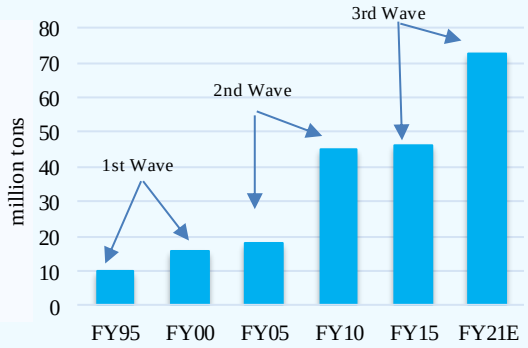
Special Section 1: Cement Industry-Current Dynamics and Future Prospects

Sustained expansion in economic activity and investment in various infrastructure projects under PSDP and CPEC, coupled with increased demand from private housing schemes have bolstered construction sector during last few years. This has had a spillover impact on the allied segments of cement and steel as well. Rising demand and healthy margins has also induced cement manufacturers to expand their production capacities aggressively, from 49.4 million tons to 72.8 million tons in the next few years. This capacity may further expand if other small firms also joined the campaign of maintaining market share. In this backdrop, the section analyzes the overall potential of the industry to sustain its growing momentum in the medium to long run.

Overview of the cement industry

The cement industry is important for the economy. Besides making a direct contribution of 7.5 percent to large-scale manufacturing, the industry influences growth in the allied segments (e.g., steel; chemicals, wood etc). At present, there are 24 manufacturing units operating in the country with a total installed annual capacity of 49.4 million tons.[1] The industry operates in two separate zones - North and South - with Northern Zone representing around 80 percent of the total production capacity and sales.[2] The manufacturers in the South Zone have more room for revenue diversification as they can tap a number of export markets (via sea).[3] The export potential for manufacturers in the Northern Zone, however, is limited to Afghanistan and India only.[4]

Figure S1.1: Production Capacity



E: Expected
Data Source: APCMA and Companies Financials

Large capacity expansion is underway

The cement industry is

[1] Source: All Pakistan Cement manufacturers Association (APCMA).
[2] Punjab, KPK, AJK, GB are part of North Zone (with 19 players) while South Zone (with 5 players) includes Sindh and Balochistan.
[3] However, the key export markets for South Zone players (Nigeria, Tanzania, Mozambique, Iraq, Ethiopia and DR Congo) are undergoing local capacity expansion, their reliance on imports may reduce thereby affecting dispatches, going forward.
[4] Even exports to Afghanistan are under pressure due to worsening relations with the country, and slowdown in construction activities along with influx of cheaper Iranian cement.

currently undergoing a major transformation, as a number of players are planning capacity expansions (**Figure S1.1** & **Table 1**). Specifically, almost half of the players in the industry have so far announced capacity expansion (more than 3.0 million tons capacity has already been added during FY18). In cumulative terms, this would add 23.4 million tons towards the production facility – a staggering increase of about 50 percent in next few years – to reach around 72.8 million tons. The expected expansion may be even higher if other firms (with 8.1 million tons in pipeline) also join this campaign.

Table S1:Expansionary plans

Company	Expansion mln tons	US$ mln	Completion
Lucky Cement Ltd	2.3	200	FY18-FY21
Attock Cement Pakistan Ltd	1.1	120	FY18-FY19
Cherat Cement Company Ltd	4.6	315	FY17-FY19
D G Khan Cement Company Ltd	2.6	200	FY18-FY21
Fecto Cement Ltd	1.0	100	FY18-FY20
Gharibwal Cement Ltd	2.4	200	FY18-FY21
Bestway Cement Pakistan	1.7	190	FY19-FY20
Pioneer Cement Ltd	2.3	225	FY19
Power Cement Ltd	2.1	235	FY18-FY19
Maple Leaf Cement Ltd	2.3	225	FY19
Kohat Cement Company Ltd	1.0	110	FY19-FY21
Total	**23.4**	**2120**	

Data source: Companies' Financials/PSX notices

The factors behind this extraordinary expansionary drive in cement industry mainly include:

a) ***Continued activity under CPEC related projects:*** The prospect of growing cement demand are stemming from CPEC related project which include construction of an integrated road infrastructure; modernization of railways; and development of Gwadar city, seaport and airport. Moreover, the development of special economic zones across the country may also sustain demand for cement going forward.

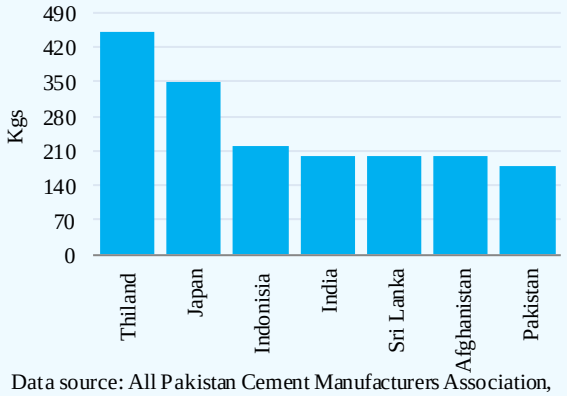
b) ***Increased focus on development spending by the government:*** The demand for cement is also likely to remain high as government has a planned numerous mega projects. In this regard, the worth noting mega water and power sector projects include: Dasu, Diamer Bhasha[5] and Bunji multipurpose projects; and major rehabilitation and expansion of Mangla, Tarbela and Warsak power stations. In addition, large highway and motorway projects

[5] The construction of a project of the size of Diamer Bhasha is estimated to create an additional cement demand of about 10 million tons. Likewise, ten nuclear power projects are planned for construction in the country by 2030, while work on two of these projects in Karachi is in progress.

(which are outside the ambit of CPEC) have been initiated by the government;[6]

c) ***Huge construction activities due to housing deficit:*** [7,8] The demand pressures may continue going forward due to persistent housing shortages (bridging this gap would require huge quantity of cement and related construction materials). The room for growth is evident from the fact that per capita cement consumption in Pakistan is the lowest amongst regional economies (**Figure S1.2**).[9]

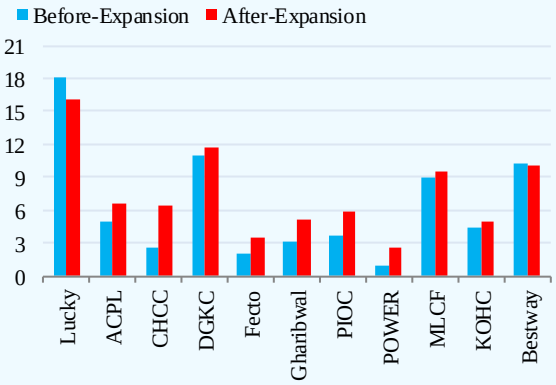
Figure S1.2: Cement Per Capita Consumption (2017)



Data source: All Pakistan Cement Manufacturers Association, Global Cement Magazine

Major players' drive to maintain market share intact: Manufacturers also strive to maintain their market share, which drives up their production capacity. A historical review of the industry suggests that the firms strategize their capacity expansions to uphold position in the market. In some cases, established and strong manufactures even acquire

Figure S1.3: Market share to remain unchanged



Data source: Companies Financials

[6] The government has allocated Rs 2113 billion for development expenditure in FY18, which is more than 26 percent higher than last year. This includes Rs 320 billion for NHA.

[7] The rural-urban mix for the country has shifted from 65:35 in 2005 to 60:40 in 2016 (Economic Survey 2015-16).

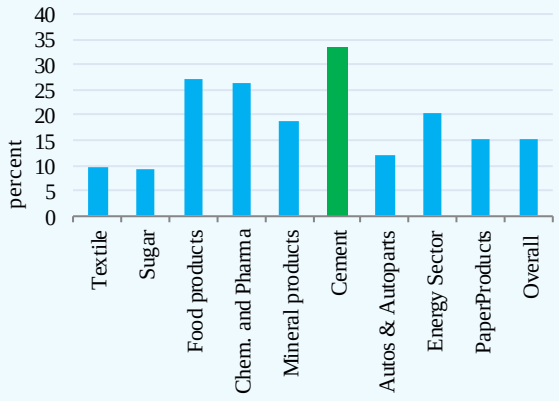
[8] For example, the development work on Bahria Town, DHA City, Fazaia, and ASF Housing Schemes and other private housing projects across the country has been in progress.

[9] According to estimates, the housing shortage in the country stood at 10 million units in 2017 (source: The World Bank - Pakistan Housing Finance Project- Report No: 114473, March 2017). Bridging this gap would require huge quantity of cement and related construction materials.

smaller firms.[10] As a result, the overall market share of large firms undergoes only a minor change following an expansionary phase (**Figure S1.3**).

***Industry's high profit margin*:** Healthy profit margin is another important factor that helps the industry to undergo capacity expansion (**Figure S1.4**). Specifically, the gross profit to sales ratio has averaged around 33 percent for the last five years – more than double the manufacturing sector's overall average.[11] The industry benefited from a slump in global market for raw material (e.g., POL and coal) and historic low domestic interest rates. The margins for the industry strengthened when, instead of passing on the benefit to consumers, firms increased the local retail prices.

Figure S1.4: Gross profit to sales ratio (last 5 year average)



Data source: FSA 2010-2015, SBP and Companies financials

Industry's diversification plans: Further gains to industry were achieved due to the economies of scale, improvement in cost efficiency (**Box S1.1**), and a decline in the debt-to-equity ratio.[12] This has led to a number of firms diversifying their operations towards other sectors of the economy as well.

Box S1.1 Cost efficiency in Cement Industry with Alternative Energy

Several factors are contributing to lower overall cost efficiencies in the industry. Size of plant and technology are of great significance, which determine economies of scale, energy efficiency[13] and simple operation and maintenance, thus keeping the overall cost structure competitive. The sector has proactively pursued captive power generation to meet their energy needs.

[10] It is expected that large manufacturers that have not yet announced their capacity expansion plans would acquire small firms (Thatta Cement, Dandot Cement, Dewan cement etc). In fact, Dewan Cement is already up for sale with three local firms (Lucky cement, Kohat cement, and Bestway cement) and one Chinese player competing to acquire the plant.

[11] The interest shown by one of the foreign firms in local manufacturing indicates that the prevailing margins in the industry are quite attractive.

[12] The debt-to-equity ratio fell from 143 percent in 2010 to less than 60 percent in 2017.

[13] Investment in Refuse Derived Fuel (RDF) provides the solution for affordable and efficient fuel alternatives, which is modern technology using the municipal waste to produce energy. Fauji Cement has successfully adopted this technology, blending RDF with coal, and others are currently implementing similar projects, providing economical fuel besides other advantages.

Particularly, they have installed waste heat recovery (WHR) units that utilize existing plants heat to generate power. While coal prices in the global market have been falling in tandem with oil prices since December 2014, these together have brought down energy costs.

On the efficiency and cost fronts, since most firms have installed Waste Heat Recovery units that help them reducing dependence on fuels, major changes in energy costs and a recovery in oil and coal prices will not affect them hard. Therefore, the margins of industry are expected to persevere at the current level **(Table S1.1**).

Table S1.1:Cement industry energy projects

Company	WHR	Coal Power Plant
Fauji	12-MW	-
Lucky	10-MW	660-MW
ACPL	6-MW	40-MW
CHCC	6-MW	-
DGKC	12-MW	30-MW
PIOC	12-MW	-
MLCF	6-MW	40-MW
Dewan	6-MW	-
Bestway	27-MW	-
KOHC	15-MW	-

Data source: Companies Financials/ PSX notices

Financing requirements

Industry needs FX to finance machinery imports: According to information collected from firms and PSX notices, the additional capacity would result in the imports of machinery of around US$ 1.5 billion (near Rs 178 billion) over next few years. In the cement industry, cost of machinery imports comes around 70 percent of total cost of the unit/project. This means, the overall estimated cost of expansion would be around Rs 254 billion (**Table 2**).

Table S2: Investment and Financing

Total estimated projects cost (billion USD)[1]	**2.2**
in billion Rs (@ Rs115.6 per US$)	254
Machinery and equipment (billion USD)[2]	1.5
in billion Rs (@ Rs115.6 per US$)	178
Financing Requirements (billion Rs)	
Equity component	
@30 percent equity	76
@40 percent equity	102
@50 percent equity	127
@60 percent equity	153
Borrowing	
@70 percent bank finance	178
@60 percent bank finance	153
@50 percent bank finance	127
@40 percent bank finance	102

[1] Expansion plans announced so far

[2] Assuming machinery is 70 percent of the project cost

Data source: Companies Financials/ PSX notices

Despite healthy cash position, industry's borrowing needs will increase: Given the healthy cash position of the leading players who have undertaken capacity expansions, the equity component has dominated the financing requirements[14]. However, if smaller players also join the campaign aggressively, in such case the financing pattern would change in favor of bank financing.[15] While the prevailing

[14] Cement Sector has availed Rs 34 billion for fixed investment purposes during July 2016 till March 2018.

[15] Even if 30 percent is assumed as equity component, this leaves significant financing burden on banking sources

low interest rates would encourage firms to borrow more from the banking system, the commercial banks would also be willing to take exposure on the industry due to a decline in infected loan ratio, and healthy balance sheets of cement manufacturing firms.[16]

Table S3 : Demand Needed to Absorb Production Capacity
million tons

	Total sales	Exports	Domestic sales	Growth in Domestic Sales (percent)
		Actual		
FY13	33.4	8.4	25.1	
FY14	34.2	8.1	26.1	4.2
FY15	35.4	7.2	28.2	8.0
FY16	38.9	5.9	33.0	17.0
FY17	40.3	4.6	35.7	8.2
FY18[E]	46.5	4.4	42.1	18.0
@11.1 percent growth in total sales (last five year average growth)				
FY19	51.2	4.4	46.8	11.1
FY20	56.4	4.4	52.0	11.1
FY21	62.2	4.4	57.8	11.1

Assumptions

1. The absorption of this production would require continuity of last five year growth rate (11.1 percent) in domestic sales; it will help the industry to operate at 86 percent capacity utilization;
2. Despite the decline trending, we assumed stagnant exports for our analysis;
3. The burden for absorbing higher cement production would therefore fall on domestic sales.

Data source: APCMA

Future prospects

Current expansion phase is skewed towards domestic market: In the current scenario, the absorption of announced capacities would require the industry to maintain its last five years' CAGR in cement sales over the next 3-4 years (**Table 3**). Moreover, domestic sales of cement indeed recorded a strong average growth of 12.6 percent during FY16-FY17. This trend also continued in FY18, where Jul-Apr growth stands at 17.5 percent on the back of strong domestic demand.

High PSDP and CPEC related spending still remain crucial to keep cement demand high: Even normalized local dispatches growth of 7-9 percent in next 3-4 years would be sufficient to keep industry's capacity utilization above 70 percent post expansions. Factors like; (i) growing income levels; (ii) real estate boom and housing backlog of 10 million units;[17] (iii) demand emanating from CPEC projects; (iv) higher PSDP spending; and (v) increased focus of banking sector towards housing finance would be vital in keeping domestic demand at this level.

Capacity expansion is also beneficial for economies of scale and export of cement: On the export front, with influx of cheap Iranian cement in Afghanistan and imposition of anti-dumping duties on Pakistani cements in South Africa (the two main export destinations), exports may remain a challenge. For a sound market share in export market, the cement manufacturers will have to compete

[16] The infected loan ratio fell from 18.5 percent in December 2010 to 5.9 percent in December 2017.
[17] Apart from the needs, people in Pakistan rank real estate (plots, houses and buildings) investment amongst the safest avenues, resulting in improved demand (source: The World Bank - Pakistan Housing Finance Project- Report No: 114473, March 2017).

with Iranian and Chinese cement manufacturers through improvement in cost efficiencies. With current expansion plans, the industry might be able to exploit economies of scale and gain competitive advantage. While there is a need to explore new markets to utilize their excess capacities post expansion, efforts in this regard could also increase export earnings in coming years.

Special Section 2: Synthetic Textiles is Key to Sustaining Export Growth Momentum

Pakistan's textiles exports have grown by 10.8 percent in the first 9 months of the ongoing fiscal year. Keeping in view a consistently weak performance by the sector over the past 3 years and its repercussions on the country's overall balance of payments, the revival in exports is indeed comforting. However, this momentum needs to be sustained. In this context, while the extension in GSP plus status is encouraging, the textiles sector must undergo a paradigm shift and diversify the range of products it offer over the medium to long term. Most importantly, Pakistani manufacturers should penetrate aggressively in the global synthetics products market which has long surpassed the cotton market. Though starting late, Pakistan's exporters can still sail through if allowed to access essential raw materials at competitive prices. This section explains in detail the dynamics of global synthetic textiles market and why local manufacturers have had been laggard so far.

Background

The share of cotton in global fiber consumption has fallen from nearly 70 percent back in 1960, to only 27 percent by end 2016.[1] Its place has now been captured by synthetic or man-made fibers (MMF) – especially polyester. Synthetic polymers are popular with respect to travel and sportswear, mostly due to their superior resistance to wrinkling and moisture compared to conventional cotton counterparts. Despite its growing appeal, however, Pakistan's textile industry is advancing into synthetics at a snail's pace, at best: the fiber mix still stands at 80:20 in our garment exports with only 25 percent of Pakistan's spinning machines currently using MMF to produce blended yarn.[2] Moreover, the country's share in MMF apparel market is almost negligible (only 0.4 percent in the US market).

More than 80 percent of the world's production of polyester staple fiber (PSF) takes place in China, India and Southeast Asian countries. Therefore, it is not surprising that these countries are also the dominant exporters of synthetic textiles.[3] The production

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[1] Source: International Cotton Advisory Committee

[2] Kamal and Islam (2010) note "The bulk of Pakistan's garment industry remains cotton based, with roughly 72% of the total textile related investments and 82% of the textile industrial units based in cotton spinning, weaving and processing". Complete source: Munir, Kamal A., Dr., and Faheem Ul Islam, Dr. *Accelerating Economic Transformation Program: Profile of Textile & Clothing Industry of Pakistan*. Rep. no. TA-7137(PAK). N.p.: Asian Development Bank, 2010. Print.

[3] For instance, they have a combined share of 68.2 percent in 2016 in the US' import of man-made textile items.

of synthetic polymers (such as polyethylene terephthalate, or PET) is a capital and technology intensive task, and one that requires availability of a fully integrated chemical industry.[4] However, this does not suggest that only countries with a complete indigenous value-chain can export synthetic textiles; Vietnam, Bangladesh, and Cambodia import man-made fibers, yarns and fabric from other countries to produce and export synthetic garments. In fact, Vietnam is the second biggest exporter of synthetic textile to the US (with China being the biggest), followed by Bangladesh and Cambodia at 7th and 11th positions, respectively.

This implies that with adequate availability of raw materials in the country, Pakistan too could have excelled in global synthetic textiles market.[5] As described below however, domestic policies and market conditions have hindered the country's foray into this emerging market.

Anti-export bias

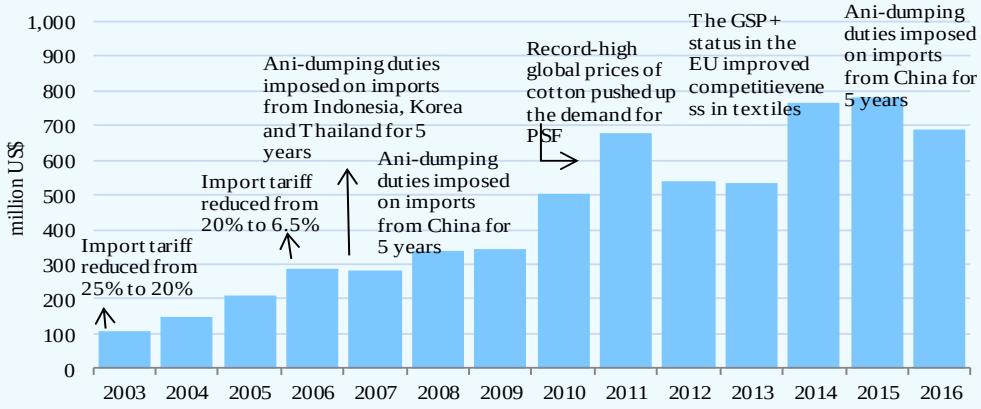
Local manufacturers in chemical industry have historically enjoyed high protection rates – especially with respect to products such as purified terephthalic acid (PTA) and PSF. In this regard, the imposition of import tariff of 25 percent back in 1998-99 was the most prominent; this was the year when the share of man-made fibers in domestic fiber consumption peaked in the country (at 22 percent).[6] More importantly, this was also the year around which the MMF-based textiles began to dominate the global textile industry. Nonetheless, the high tariff rate remained in place for the next 5 years, during which the use of synthetic fiber consumption in Pakistan stagnated. In 2003 however, tariffs were reduced to 20 percent to encourage the use of synthetic fibers and spur competition in the industry. With the implementation of 2005-06 budget, the tariffs were eventually reduced to only 6.5 percent (**Figure S2.1**).

[4] In particular, hydrocarbons (like naphtha and ethylene) obtained from petroleum refining process are broken down to collect valuable compounds (olefins) which are eventually processed to form various polymers. Although Pakistan has developed a petroleum refining industry in the country, it does not have facilities to break down these hydrocarbons.

[5] As there are only 3 producers of polyester fiber and filaments in the Pakistan, the country heavily depends upon imported materials to meet its demand.

[6] Cotton-Textile-Apparel Sectors of Pakistan: Situations and Challenges Faced: By Caesar B. Cororaton, Abdul Salam, Zafar Altaf, David Orden and Reno Dewina, Nicholas Minot, Hina Nazli.

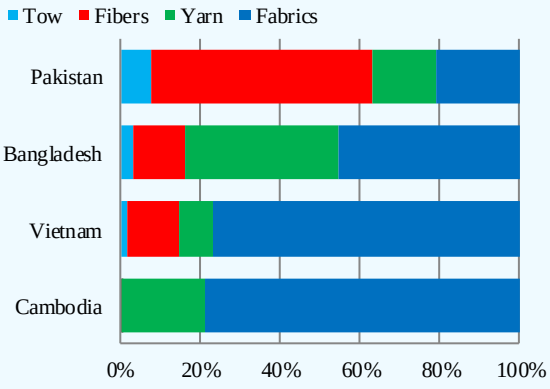
Figure S2.1: Explaining the Trends in Import of Man-made Staple Fiber in Pakistan (Code 55)



Data source: Pakistan Bureau of Statistics; National Tariff Commission; and Ministry of Commerce

However, the tariff liberalization was implemented in a non-uniform manner. This is evident from the higher level of protection enjoyed by finished products compared to raw materials such as tow and fibers. This escalating tariff structure benefits domestic producers, but at the expense of weakened backward linkages and stymied competition and diversification in the domestic market. Although Pakistan gives some tariff concessions to SAFTA countries, these are not very effective: India is the only country within SAFTA that produces man-made fibers, and trade with India is quite restricted.[7] Similarly, concessional tariffs under Pakistan-China Free Trade Agreement are also not applicable on most synthetic products (these items are included in the 'no concession' list for the agreement). This has skewed Pakistan's imports

Figure S2.2: Import of Man-made Fiber Value-Chain Across Countries (2016)



Data source: International Trade Center

[7] In fact, polyester fibers and yarns are among 1,209 items included in the negative list for trade with the eastern neighbor.

predominantly towards fibers, whereas regional economies such as Vietnam and Cambodia import the entire value chain of synthetic textiles (**Figure S2.2**). In addition to customs tariffs, the import of synthetic textiles inputs is also disrupted by the imposition of anti-dumping duties on major suppliers.

Just a rough comparison of tariff structure on synthetic raw-material with other countries indicates that while major players in value-added exports are encouraging cheap influx of the raw material, Pakistan is still protecting its domestic value chain (**Table S2.1**). Pakistan is only importing fibers and that too at a very high tariff rates compared to other countries. As noted by Hamid and Nabi (2017), "Global trends demand that Pakistani firms move to a 50:50 mix to stay competitive. High duties on the import of yarn or fabric made from artificial fibers also prevent firms from diversifying their product range or reaching out to new high-end clients".

Table S2.1: Tariff Structure of Various Products of Man-made Fibers Across Countries

	Pakistan	*Preferential treatment*	Bangladesh	*Preferential treatment*	Vietnam	*Preferential treatment*	Cambodia	*Preferential treatment*
Synthetic filament yarn (other than sewing thread), not put up for retail sale, including synthetic monofilament of less than 67 decitex : Textured yarn : Of nylon or other polyamides, measuring per single yarn more than 50 tex (540232)	11%	0% for Malaysia and Sri Lanka; 5% for China and SAFTA	10%	3% for SAFTA	0%	None	0%	None
Synthetic filament yarn (other than sewing thread), not put up for retail sale, including synthetic monofilament of less than 67 decitex : Textured yarn : Of polyesters (540233)	11%	5% for SAFTA	25%	None	3% MFN; 4.5 % non-MFN	0% for Korea, AANZFTA, ASEAN, China, Eurasian Economic Union; and 1% for Japan	0%	None
Synthetic staple fibers, not carded, combed or otherwise processed for spinning : Of polyesters : Of polyesters not (550320)	7%	5% SAFTA	5%	0% SAFTA	2% MFN; 3% non-MFN	0% for ASEAN, China, AANZFTA, Korea, Eurasian Economic Union; and 1% for Japan	0%	None
Synthetic staple fibers, not carded, combed or otherwise processed for spinning : Acrylic or modacrylic (550330)	0%	5% SAFTA	5%	0% SAFTA	0%	None	0%	None
Artificial staple fibers, not carded, combed or otherwise processed for spinning : Of viscose rayon (550410)	0%	None	5%	0% SAFTA	0%	None	0%	None

Artificial staple fibers, not carded, combed or otherwise processed for spinning : Other (550490)	0%	0% Sri Lanka	5%	0% SAFTA	0%	None	0%	None
Yarn (other than sewing thread) of synthetic staple fibers, not put up for retail sale : Containing 85 % or more by weight (550921)	11%	5% SAFTA	10%	None	5% MFN; 7.5% non-MFN	0% for ASEAN, China, AANZFTA, Korea, Eurasian Economic Union; 2% for India; and 1% for Japan	0%	None
Woven fabrics of artificial staple fibers : Containing 85 % or more by weight of artificial staple fibers : Dyed (551612)	16%	5% SAFTA; 0% Sri Lanka	25%	None	12% MFN; 18% non-MFN	0% for ASEAN, China, Korea, Eurasian Economic Union; 8% for India and Chile; and 5% for AANZFTA	7%	0% for ASEAN and China; 5% for India and Korea

Source: International Trade Centre

Despite all the protection available to the domestic polyester industry, it becomes pertinent to ask why the domestic industry is not flourishing enough. The escalating tariff structure (and resulting high costs of production) is leading to a rise in informal trade of value-added polyester products from other countries. Major industrial players specifically highlight the role of Afghan Transit Trade route in facilitating cheaper influx of synthetic products in the country.

Recent measures and policy recommendations

In January 2017, the government (upon recommendation from the Ministry of Textiles) exempted customs duty on the import of a number of synthetic fibers (acrylic, viscose and nylon), which are not produced locally. As shown in **Table S2.2**, the import of these items posted a sharp increase during Jul-Mar FY18.

Table S2.2: Import of Synthetic Fibers in Jul-Jan Exempted from Customs Duty via SRO/39(1)/2017

(000 US$)

		FY17	FY18	% change
55031100	Of aramids	3,153	8,485	169.1
55031900	Other	646	940	45.5
55033000	Acrylic or modacrylic	6,760	15,368	127.4
55039000	Synthetic staple not carded	713	762	6.9
55041000	Of viscose rayon	129,698	160,030	23.4
55049000	Other fiber not carded	27,402	39,955	45.8
55063000	Acrylic fiber carded	835	3,214	284.8

Data source: Pakistan Bureau of Statistics

However, for other (and probably more commonly used) fibers like polyester, the government has kept the customs duty at 7 percent as part of protectionist policy in favor of local manufacturers. To give some relief to garment exporters, the

government allowed duty drawback on the use of imported as well as domestically produced synthetic fiber on deemed import basis. This mechanism has now been fully implemented.

Although this measure will be helpful in increasing the use of these fibers in garment manufacturing, the drawback settlement mechanism needs to be streamlined in order to smoothen firms' cash flows. Importantly, it is not just man-made fibers, but for all other inputs also (where exporters are eligible for refunds), the cost and delays are significant irritants. According to one estimate, these constitute minimum 10 percent of the value of the refund claim.[8]

Therefore, while the duty exemptions granted on the import of various fibers are yielding positive results, there is a room to broaden their scope. The government can reconsider protectionist policies for polyester fiber and filaments, if a meaningful change in the fiber mix is to be achieved in the country.[9] Finally, local industry would benefit and tariff-based policy measures to enhance the use of man-made fibers in domestic textile industry will become effective, only if the influx of smuggled goods is contained.

[8] "Implementing Policies for Competitive Garments Manufacturing" Final Report, International Growth Centre, January 2017, F-37211-PAK-1.
[9] Presently, exporters are paying 11 percent customs duty, as well as 5 percent regulatory duty, on the import of filament yarn.

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

3-M	Three month
3-Y	Three year
AANZFTA	ASEAN-Australia-New Zealand Free Trade Area
Acc.	Accepted
ACPL	Attock Cement Pakistan Ltd
ADB	Asian Development Bank
AML	Anti-Money laundering
APCMA	All Pakistan Cement Manufacturers Association
ASEAN	Association of Southeast Asian Nations
BDRC	Business Development Research Consultants
BISP	Benazir Income Support Programme
BoP	Balance of Payments
CAGR	compound annual growth rate
CBU	Completely Built Up
cc.	Cubic centimeters
CDNS	Central Directorate of National Savings
CHCC	Cherat Cement Company Ltd
CKD	Completely Knocked Down
CNY	Chinese Yuan
COD	Collection on Demand
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
CSF	Coalition Support Fund
DAP	Diammonium phosphate
DGKC	D G Khan Cement Company Ltd
EIU	Economist Intelligence Unit
EM	Emerging Markets
EU	European Union
ERRA	Earthquake Reconstruction and Rehabilitation Authority
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FE	Foreign Exchange

Fed	Federal Reserve
FED	Federal Excise Duty
FO	Furnace oil
FPI	Foreign Portfolio Investment
FX	Foreign Exchange
FY	Fiscal Year
GAIN	Global Alliance for Improved Nutrition
GBP	Great British Pound
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
GSTS	General Sales Tax on Services
GVA	Gross Value Addition
H1	First Half
HCV	Heavy Commercial Vehicle
HSD	High Speed Diesel
IBRD	International Bank for Reconstruction and Development
IDB	Islamic Development Bank
IMF	International Monetary Fund
INR	Indian Rupee
IPP	Independent Power Producer
IR	Infection Ratio
JPY	Japanese Yen
KOHC	Kohat Cement Company Ltd
KP/KPK	Khyber PakhtunKhwa
LCV	Light Commercial Vehicle
LIBOR	London Interbank Offer Rate
LNG	Liquefied Natural Gas
LSM	Large Scale Manufacturing
M2	Broad Money
Mat.	Maturity
MFN	Most Favored Nation
MLCF	Maple Leaf Cement Ltd
MMF	Man Made Fiber

MoF	Ministry of Finance
MPC	Monetary Policy Committee
MRTBs	Market Related Treasury Bills
MUFAP	Mutual Funds Association of Pakistan
MYR	Malaysia Ringgit
NDA	Net Domestic Assets
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Assets
NFIS	National Financial Inclusion Strategy
NFNE	Non-Food-Non-Energy
NSS	National Savings Certificate
Off.	Offered
OMOs	Open Market Operations
PAMA	Pakistan Automotive Manufacturers Association
PARC	Pakistan Agricultural Research Council
PBS	Pakistan Bureau of Statistics
PET	Polyethylene Terephthalate
PHPL	Power Holding Private Limited
PIB	Pakistan Investment Bond
PIOC	Pioneer Cement Ltd
PKR	Pakistani Rupee
POL	Petroleum, Oil, and Lubricants
PPA	Pakistan Poultry Association
PSDP	Public Sector Development Programme
PSEs	Public Sector Enterprises
PSF	Polyester Staple Fiber
PSO	Pakistan State Oil
PSX	Pakistan Stock Exchange
PTA	Pakistan Telecommunication Authority
PTA	Purified Terephthalic Acid
PTCL	Pakistan Telecommunication Company Limited
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter

Q4	Fourth Quarter
QoQ	Quarter-on-quarter
Repo	Repurchase Agreement
Rhs	Right Hand Side
SAFE	State Administration of Foreign Exchange
SAFTA	South Asian Free Trade Area
SBP	State Bank of Pakistan
SDR	Statutory Drawing Right
SECP	Securities and Exchange Commission of Pakistan
SME	Small and Medium Enterprises
SMEDA	Small and Medium Enterprise Development Authority
SPI	Sensitive Price Index
SRO	Statutory Regulatory Order
SDG	Sustainable Development Goals
T-Bills	Treasury Bills
TCP	Trading Corporation of Pakistan Private Limited
THB	Thai Baht
UAE	United Arab Emirates
UK	United Kingdom
US	United States
US$	United States Dollar
USA	United States of America
USD	United States Dollar
VP	Voluntary Payments
WALR	Weighted Average Lending Rates
WAPDA	Water and Power Development Authority
WHR	Waste Heat Recovery
WPI	Wholesale Price Index
WTI	West Texas Intermediate
YoY	Year-on-Year