THE STATE OF PAKISTAN'S ECONOMY

First Quarterly Report
for the year 2018-2019 of the
Board of Directors of State Bank of Pakistan

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Box Items

Acronyms

AC&MFD	Agricultural Credit and Microfinance Department
ADC	Acquisition, development and construction
AML	Anti-Money Laundering
APTMA	All Pakistan Textile Mills Association
AQI	Air Quality Index
Avg.	Average
BISP	Benazir Income Support Program
BoP	Balance of Payments
BPM	Business Process Management
bps	Basis points
BPO	Business Process Outsourcing
BSC	Behbood Savings Certificate
CAD	Current Account Deficit
CAN	Calcium Ammonium Nitrate
CBU	Complete Built Unit
CFT	Combating the Financing of Terrorism
CGT	Capital Gains Tax
CVT	Capital Value Tax
CIA	Central Intelligence Agency
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CSF	Coalition Support Fund
DAP	Di Ammonium Phosphate
DC	District Collector
DHA	Defence Housing Authority
DSC	Defence Savings Certificate
DXY	Dollar Index
EBA	Everything but arms
EBOPS	Extended Balance of Payments Services

EMs	Emerging Markets
EPA	Environmental Protection Agency
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FIPI	Foreign Investors Portfolio Investment
FO	Furnace Oil
FX	Foreign Exchange
FY	Fiscal Year (July to June)
GCC	Gulf Cooperation Council
GBP	Great Britain Pound
GDP	Gross Domestic Product
GENCO	Generation Company
GSP	Generalized Scheme of Preferences
GST	Goods and Services Tax
GSTS	General Sales Tax on Services
HEIS	High Efficiency Irrigation Systems
HH	Household
HIES	Household Integrated Economic Survey
HS	Harmonized Systems
HSD	High Speed Diesel
HUBCO	Hub Power Company Limited
ICAC	International Cotton Advisory Committee
ICT	Information and Communications Technologies
IFI	International Financial Institutions
IH&SMEFD	Infrastructure & Small and Medium Enterprises Finance Department
IMF	International Monetary Fund
IT	Information Technology
ITES	IT-enabled services
KAPCO	Kot Addu Power Company Limited
KCR	Karachi Circular Railway
KIBOR	Karachi Interbank Offered Rate
km	Kilometer

KP	Khyber Pakhtunkhwa
KSA	Kingdom of Saudi Arabia
KSE	Karachi Stock Exchange
LIBOR	London Interbank Offer Rate
LNG	Liquefied Natural Gas
LSM	Large Scale Manufacturing
LT	Long Term
MAF	Million Acre-Feet
MoF	Ministry of Finance
MOITT	Ministry of Information Technology and Telecommunication
MPC	Monetary Policy Committee
MRTBs	Market Related Treasury Bills
MSITS	Manual on Statistics of International Trade in Services
MT	Metric Tonnes
MTB	Market Treasury Bill
MUFAP	Mutual Funds Association Of Pakistan
MW	Mega Watt
NCCPL	National Clearing Company of Pakistan Limited
NDA	Net Domestic Asset
NDFC	National Development Finance Corporation
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFDC	National Fertilizer Development Centre
NFNE	Non-Food Non-Energy
NGMS	Next Generation Mobile Services
NP	Nitro Phosphate
NPL	Non-Performing Loan
NSS	National Saving Scheme
OCAC	Oil Companies Advisory Committee
OECD	Organization for Economic Co-operation and Development
OGRA	Oil and Gas Regulatory Authority
OMO	Open Market Operation

O/N	Overnight
PAK	Pakistan
PAMA	Pakistan Automotive Manufacturers Association
PB	Prize Bond
PBS	Pakistan Bureau of Statistics
PHPL	Power Holding Private Limited
PIA	Pakistan International Airlines
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
POL	Petroleum, Oil and Lubricants
PROD	Production
PRI	Pakistan Remittance Initiative
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PSEB	Pakistan Software Export Board
PSF	Polyester staple fiber
PSO	Pakistan State Oil
PTA	Pakistan Telecommunication Authority
Q1	First Quarter (Jul-Sep)
Q2	Second Quarter (Oct-Dec)
Q3	Third Quarter (Jan-Mar)
Q4	Fourth quarter (Apr-Jun)
REER	Real Effective Exchange Rate
REIT	Real Estate Investment Fund
RLNG	Regasified Liquefied Natural Gas
RPI	Relative Price Index
Rs	Pakistan Rupees
SBP	State Bank of Pakistan
SDPI	Sustainable Development Policy Institute
SDR	Special Drawing Rights
SKD	Semi Knocked-Down
SME	Small and Medium Enterprises
SNGPL	Sui Northern Gas Pipelines Limited
SPDC	Social Policy and Development Centre
SSA	Special Saving Account

SSC	Special Saving Certificate
SSP	Single Superphosphate
ST	Short Term
T-Bill	Treasury Bill
TCL	Telephone Communication Limited
TPSP	third-party service provider
UAE	United Arab Emirates
UK	United Kingdom
US$	US Dollar
USA/US	United States of America
USDA	United States Department of Agriculture
VP	Voluntary Payments
WALR	Weighted Average Lending Rate
WHT	Withholding Tax
WPI	Wholesale Price Index
WTO	World Trade Organization
WWF	World Wildlife Fund
YoY	Year on Year

1 Overview

1.1 Economic Review

The overall macroeconomic environment remained challenging during the first quarter of FY19. The foremost concern was the steep rise in global crude prices, which not only reinforced the already strong underlying inflationary pressures in the economy, but also eclipsed emerging improvements in the external sector. Moreover, uncertainties lingered with regard to the needed balance of payments (BoP) support on account of a political transition underway. Fiscal pressures also remained intact as expenditure rigidities allowed only a limited room for the government to maneuver. Responding to these challenges, the new political regime immediately announced cuts in development spending, partially reversed tax relief measures, and also explored avenues to bridge the external financing gap. While the ongoing macroeconomic stabilization process would continue at least over the short term, it has now become important to urgently initiate and expedite the needed structural reforms in the economy.

Setting the direction and pace of the reforms is important not just to address the recurring macroeconomic imbalances, but also to push the economy's productivity frontier. In effect, this can help preserve growth, particularly at the juncture where the economy has begun to lose momentum (**Table 1.1**). In fact, large-scale manufacturing (LSM) contracted for the first time in over 7 years during Q1-FY19. The broad-based nature of this contraction suggested that the impact of exchange rate depreciation and stabilization measures (including a sharp cut in PSDP spending, increase in interest rates, and the imposition of regulatory duties) had begun to materialize. Furthermore, important budgetary measures such as the imposition of a ban on property and car purchases by non-filers restricted the activity in these sectors. The agriculture sector also under-performed, as lower-than-average

Table 1.1: Economic Indicators

	FY18	Q1-FY18	Q1-FY19
	Growth rate (percent)		
LSM[a]	5.4	9.9	-1.7
CPI (period average YoY)[a,1]	3.9	3.4	5.6
Private credit (flow)[b]	14.9	-0.7	2.1
Money supply (flow)[b]	9.7	-0.6	0.2
Exports[a]	13.7	10.5	4.2
Imports[a]	14.9	21.4	-0.04
FBR tax revenue (billion Rs)[c]	3,844.0	765.0	832.3
Exchange rate (+app/-dep%)[b]	-13.7	-0.5	-2.2
	million US dollars		
SBP's liquid reserves (end-period)[b]	9,789	13,857	8,409
Workers' remittances[b]	19,623	4,790	5,420
FDI in Pakistan[b]	3,092	765	439
Current account balance[b]	-18,989	-3,761	-3,622
Fiscal balance (% of GDP)[d]	-6.6	-1.2	-1.4

Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance
[1]YoY growth in the average of CPI index for the quarter.

rainfall in the country aggravated the prevailing water shortages. Resultantly, *kharif* crops were cultivated over a lesser area compared to last year, leading to a decline in crop harvests.

Notwithstanding the slowdown in economic activities, SBP shored up its stabilization efforts and tightened the monetary policy further during the quarter. In each of the two policy decisions that were held during the quarter, the Monetary Policy Committee increased the policy rate by 100 basis points. These decisions were guided primarily by the prevalence of high twin deficits as well as the increased likelihood of headline inflation surpassing the annual target of 6 percent. While demand pressures remained strong, core inflation continued to trend upwards also as the second-round impact of higher fuel prices and exchange rate depreciation began to seep into the broader economy.

The increased raw-material prices and capital outlay also meant that the credit appetite of the private sector was strong, despite a slowdown in the overall economic activity. The impact of input prices (especially cotton and crude oil) on the overall credit off-take can also be seen from the near doubling of average loan size in Q1-FY19 compared to the same period last year. This implies that a substantial part of the higher off-take during the quarter was price driven. From banks' perspective, the price effect was a favorable development, since it led them to temporarily readjust their asset portfolios away from government papers in anticipation of further interest rate hikes.

This development can be attributed to the government's consistent rejection of high-rate bids in primary auctions, contrary to market expectations of inflation trajectory and interest rates. The behavioral interplay between banks and the government continued to complicate debt and monetary management. From the debt management's perspective, the consistent shortening of the maturity profile raised refinancing and rollover risks for the government; and from the monetary management's perspective, the near-flattening of the yield curve and excessive government borrowings from SBP posed major challenges. The absence of long-term benchmark rates amid excess liquidity in the interbank market (due to heavy retirements by the government) did not allow a complete transmission of changes in the monetary policy to the retail lending rates.

From the government's standpoint, avoiding an increased mark-up was intended to contain the overall fiscal deficit, especially at a time when the stock of public debt had reached a record high. Importantly, interest payments (debt servicing) were already the single-largest expense incurred by the government in FY18, eating up 33.6 percent of the country's tax revenues. In Q1-FY19, these payments were 13.9 percent higher compared to the same period last year.

Although other expenditures remained subdued, especially PSDP that dropped by 45.5 percent over last year, the fiscal deficit stayed at a high level. This was mainly because revenue collection could not keep pace with growing current expenditures. Thus, the overall fiscal deficit reached Rs 541.7 billion in Q1-FY19 – almost Rs 100 billion higher than in Q1-FY18. Unlike the past few years, the bulk of the financing burden did not fall on the domestic banking system as domestic non-bank sources provided sufficient funding to the government. External funding was also available that made up for 38.9 percent of the total fiscal deficit.

Importantly, the latter also supported the country's external sector. The overall current account deficit declined slightly for the first time in over two years, but stayed at an elevated level in Q1-FY19. The persistence of a large deficit owed primarily to the worsening terms of trade: while export growth slowed down from 12.4 percent last year to only 3.8 percent in Q1-FY19, a sharp increase of 50.9 percent in global crude prices pushed up the import bill. In fact, the increase in oil payments was large enough to offset a combined gain from a decline in non-energy imports, exports growth, and a healthy increase in workers' remittances. With FDI falling 42.6 percent YoY, official borrowings played an important role in plugging the gap. Still, the reserves drawdown continued, and the level at end September 2018 was not sufficient to cover 2 months of the country's import bill.

In this context, although the economy is responding to stabilization measures taken over the past few months, the persistence of near-term challenges to the economy (low FX reserves and rising inflation) does not allow for any policy complacency to set in. Importantly, the domestic demand has witnessed moderation during Q1-FY19 relative to last year, but compared to recent averages, major indicators still reflect vibrancy. As mentioned earlier, the disaggregated analysis of core inflation also suggests contribution from both demand- and supply-side factors.

Therefore, it appears that the country would continue to move along the macroeconomic adjustment path for some time. However, in order to revert to a stable macroeconomic environment, it is equally important to address the policy uncertainties and spell out a clear path of economic reforms going forward. The most immediate requirement is to secure frontloaded BoP support that can lift some pressure from FX reserves as well as the Pak rupee. The confidence of consumers and businesses alike, which had improved sharply soon after the elections, seems to have tailed off in the most recent surveys on account of rising cost pressures and an uncertain outlook. Furthermore, since the new government has hinted at major revisions in investment and industrial policies, investors (especially foreign investors) seem reluctant to take long-term positions.

These developments run the risk of intensifying the impact of stabilization measures on broad economic activity. However, it is important to note that the government has initiated important reforms in the fiscal sector that can later be built upon to alleviate the structural deficit. For instance, policymaking power has been taken from the FBR, to be shifted to an independent authority. The FBR will be focusing solely on tax administration and collection. Furthermore, efforts are underway to ensure access to third-party data to have information on potential high net-worth individuals.

Moreover, taking an initial step towards reforming the real estate sector, the government has notified the establishment of the Directorate General of Immovable Properties, with the mandate ranging from conducting survey-based market valuations, to establishing linkages with provincial revenue & excise authorities. This is a major initiative, which along with the increased inter-provincial co-ordination, can potentially help reduce prevailing distortions in the economy's incentive structure and also improve revenue collection (**Special Section 1**). With regards to the energy sector, the government has approved an upward revision in gas prices in order to alleviate the financial burden of gas distribution firms.

In sum, while efforts are underway to regain macroeconomic stability, the concurrent progress towards reforms is welcome. It is now important to deepen and accelerate the pace of reforms within the fiscal and energy sectors, and also spread the process across other sectors of the economy. The objective should be to rationalize the economy's incentive structure; enhance ease of doing business via embracing technology and simplifying procedures; and improve public financial management and governance. Putting right policies in place is critical, even if it takes time, to get the economy out of the boom and bust cycle. This is important also to benefit on the productivity front, in order to push the growth momentum forward. At this point, when the country's growing labor force has to be productively engaged, the country cannot afford to get caught up again in a low growth-high inflation equilibrium.

1.2 Executive Summary

Real Sector

After achieving a 13-year high growth of 5.8 percent in FY18, Pakistan's economy is showing signs of moderation. Both the agriculture and industrial sectors have underperformed during Q1-FY19 relative to the same period last year. Within the agriculture sector, preliminary estimates indicate that the production of all major *kharif* crops remained lower compared to the last season. This decline can be attributed primarily to an alarming water availability situation, particularly in Sindh, which led to a 7.7 percent decline in the total area under production. Furthermore, crop yields also suffered due to subdued fertilizer offtake amidst rising prices of both urea and DAP.

The LSM sector, meanwhile, contracted by 1.7 percent during Q1-FY19, after experiencing healthy growth of 9.9 percent during Q1-FY18. Noticeably, the production of construction-allied and consumer durable segments, which were the major drivers of growth last year, decelerated on a YoY basis. In overall terms, the interplay of supply- and demand-side dynamics disrupted the growth momentum of the sector. While the supply-side was affected by rising energy and raw material prices, the slowdown in demand stemmed from a decline in PSDP spending and the imposition of a ban on non-filers from purchasing vehicles.

The underperformance of the commodity-producing sector, alongside a slowdown in import quantum, is expected to have a spillover impact on the services sector. In particular, the *wholesale and retail trade* segment may experience a slowdown on the back of lackluster industrial activity and weakening imports. Similarly, transport activities may also be relatively subdued, as indicated by the declining sale of commercial vehicles and POL sales.

Inflation and Monetary Policy

With underlying inflationary pressures remaining strong and the twin deficits staying at elevated levels, monetary policy continued to move along the adjustment path. During both the Monetary Policy Committee (MPC) meetings that were held during the quarter, the policy rate was raised by 100 basis points each.

Average inflation during Q1-FY19 increased to 5.6 percent – the highest quarterly growth since Q1-FY15. While underlying inflationary pressures remained strong, the second-round impact of higher fuel prices and exchange rate depreciation further shored up the NFNE component of CPI. Food inflation, though remaining somewhat stable during the quarter, also saw its contribution rise to the overall inflation, as the prices of major items such as wheat flour, tomato and fresh vegetables normalized after experiencing declines last year.

As for the private credit, strong expansion was observed during Q1-FY19 in contrast to the net retirements witnessed in the same quarter last year. This was primarily due to buoyant supply-side conditions in the interbank market. In particular, a sizable amount of banks' investments in government papers was maturing during the quarter, which the banks were not keen on rolling over in anticipation of a further increase in the interest rates. In overall terms, the government retired Rs 1.4 trillion to the commercial banks during Q1-FY19. Even after accounting for mop-ups in the open market operations, the net liquidity condition was such that the banks comfortably catered to credit demand from both public sector enterprises (PSEs) as well as the private sector without unwarranted pressures on the overnight rates. In fact, a negative deviation of 8 bps on average between the overnight rates and the policy rate persisted during the quarter.

In contrast, credit demand conditions were relatively downbeat during the quarter on account of increased borrowing costs as well as the overall slowdown in economic activity. This was evident from a sharp decline in the number of loan applications received by the banks during the quarter. Under such circumstances, the competition across banks for securing credible projects got intense, which restrained a strong pass-through of changes in the policy rate on retail lending rates; the latter increased by only 75 bps during the quarter.

As for the financing categories, the activity in working capital loans was more prominent since rising commodity prices and input costs increased the financing requirements of the corporate sector. The strongest impact was seen in the case of loans taken by petroleum refineries and thermal power producers. In contrast, a slower offtake was visible in the fixed investment category. Given the completion of several early harvest projects under the CPEC, some moderation was to be expected. However, anecdotal evidence also suggests that the corporate sector waited for an expected policy shift with respect to investment and trade, before it could realign its business strategy with the exchange rate movements, rising fuel costs and interest rate trajectory. Similarly, consumer financing also suffered a deceleration, as budgetary measures (such as the imposition of a ban on non-filers from purchasing new vehicles) and upward revisions in car prices following PKR depreciation reduced the demand for auto-financing.

In contrast to last year, both private and public sector borrowing contributed to an increase in the net domestic assets (NDA) of the banking system. However, the impact of rising NDA on broad money (which rose by Rs 26.6 billion during Q1-

FY19) remained subdued because of a net contraction in the net foreign assets (NFA) of the banking system as the country's overall external situation worsened.

Fiscal Deficit and Debt

The fiscal deficit widened to Rs 541.7 billion during Q1-FY19, compared to Rs 440.8 billion during the corresponding period last year. This increase came on the back of a steep rise in current spending (mainly debt servicing and defence), which more than offset marginal gains in the revenue collection.

The consolidated revenues grew by 7.5 percent during the quarter; however, this pace was lower than the 18.9 percent uptick witnessed during Q1-FY18. The slowdown in revenue growth was attributed to: (i) a sharp reduction in the GST rate on petroleum products in July 2018; (ii) the impact of income tax incentives announced by the outgoing government in the Budget 2018-19; (iii) lower collection of withholding tax against PSDP-related contracts; and (iv) an overall slowdown in the economy, especially in construction-allied sectors, which led to lower collections from cement and steel sales. The non-tax revenues, on the other hand, grew by a significant 11.6 percent.

On the expenditure front, a sharp decline in development expenditures led to overall growth slowing to 11.0 percent during Q1-FY19 from 13.5 percent during Q1-FY18. This improvement was offset by an 18.1 percent increase in current spending, on the back of higher interest payments and defense related spending. Provincial current expenditures also grew by 21.9 percent, as spending towards general public services, public order, and educational affairs increased.

The resultant higher fiscal deficit was financed through increased government borrowing from both domestic and external sources. In case of domestic sources, the government borrowed significantly from SBP to retire its bank debt; at the same time, reliance on non-bank sources (money market funds, pension funds, and corporates) also remained higher than last year. In case of public external debt, major contribution came from higher bilateral borrowings. In overall terms, Pakistan's gross public debt reached Rs 25.8 trillion by end-September 2018, compared to Rs 25.0 trillion by end-June 2018.

External Sector

Q1-FY19 was the eighth consecutive quarter in which the country's exports rose on a YoY basis. This development, coupled with a healthy uptick in workers' remittances, led to a slight narrowing of the current account deficit. However, the level of the deficit remained worrisome, as rising oil prices resulted in the quarterly import bill crossing US$ 4.0 billion mark for the first time since Q1-

FY15. With foreign investments declining on a YoY basis, and external borrowing by the private sector remaining subdued, the financial inflows proved insufficient. Resultantly, the pressure on the balance of payments continued to mount, with the country's FX reserves declining by US$ 1.4 billion and the PKR depreciating by 2.2 percent during the quarter.

As for exports, the growth rate dropped from double digits to 3.8 percent during Q1-FY19. This was primarily because of a sharp slowdown in textile exports, as plummeting unit prices for most products almost entirely offset the impact of higher quantum. However, there was the 29.2 percent rise in food exports, particularly of wheat and sugar.

On the other hand, the import bill growth stagnated during the quarter, as non-energy imports declined by a hefty 18.7 percent compared to Q1-FY18, the first such contraction in four quarters. This was principally because of a decline in machinery imports, as public sector development spending slowed and early-harvest CPEC projects neared completion. Energy imports, however, almost completely offset this decline, as a rise in international oil prices drove import payments upward by 20.9 percent. As a result, the trade deficit widened by 7.3 percent on a YoY basis; however, this expansion was much lower than the 38.6 percent YoY uptick noted in Q1-FY18.

Workers' remittances observed a healthy growth of 13.2 percent, as inflows from both GCC and non-GCC countries grew. The improving macroeconomic conditions in the UK and the US, besides the seasonal inflows, supported the remittances in Q1-FY19.

On the financing front, the major challenge in plugging the current account gap was the near-completion of several early harvest projects under CPEC, which led to a 42.6 percent YoY contraction in FDI and partially caused a drop in external borrowing by the private sector (mainly the power sector firms). Apart from CPEC-related inflows from China, no major activity was observed in FDI. As for portfolio investment, net *outflows* accelerated in Q1-FY19, as foreign selling from local bourses doubled compared to last year. This performance was very much in line with the trends in other emerging markets that are also facing selling pressures in the wake of monetary tightening by the US Fed and the resultant portfolio realignment by global fund managers. Under such circumstances, the burden of arranging BoP financing fell heavily on official sources. Here, too, projected inflows from IFIs could not materialize and Pakistan counted increasingly on government-to-government funding arrangements, in addition to drawing drown its FX reserves to plug the payments gap.

1.3 Economic Outlook

The policy environment through the rest of the year is likely to center around achieving macroeconomic stability. SBP has already increased the policy rate by another 150 bps in November 2018, in order to check inflationary pressures and rising inflationary expectations. SBP's inflation forecast for the full year stands at 6.5 to 7.5 percent (**Table 1.2**), which takes into account the impact of revisions in gas tariffs and the second-round impact of exchange rate depreciation. Similarly, fiscal policy has been recalibrated to work in tandem with the stabilization objective since the formation of the new government. In particular, it has cut budgeted development expenditures for FY19 and has partially reversed the tax relief measures that were announced earlier; as mentioned before, these measures had contributed to lower revenue mobilization during Q1-FY19.

Table 1.2: Key Macroeconomic Targets and Projections

	FY18	FY19	
		Target[1]	**SBP Projections**
		percent growth	
Real GDP	5.8	6.2	4.0 – 4.5
CPI (average)	3.9	6.0	6.5 – 7.5
		billion US dollars	
Remittances	19.6	21.2	20.5 – 21.5
Exports (fob)	24.8	27.9	27.0 – 28.0
Imports (fob)	55.8	58.5	56.0 – 57.0
		percent of GDP	
Fiscal deficit	6.6	4.9	5.5 – 6.5
Current a/c deficit	6.1	4.0	4.5 – 5.5

Data source: [1] Ministry of Finance and Planning Commission

Thus, with the policy focus now tilted predominantly towards macroeconomic stabilization, the 6.2 percent target for real GDP growth seems unachievable. *Kharif* crops have already underperformed, and given the persistent water shortages across the country, the overall crop sector is unlikely to rebound in the rest of the year. Therefore, the overall contribution of agriculture in GDP growth would largely depend upon the performance of the livestock sub-sector. Similarly, in case of LSM, the construction-allied industries will continue to give a subdued performance as the government is likely to contain its development spending. Consumer industries would also feel the brunt of reduced demand, as purchasing powers are hit by rising inflation, increasing interest rates and adverse currency movements.

As for the external sector, the most important development has been the bearish spell in the global crude market that began in early October and ran through the rest of Q2-FY19. Oil prices have fallen by a quarter during this period and reached a year-low level of US$ 54 per barrel. This will lift some pressure from Pakistan's oil import bill in at least the second quarter of the year.

In the case of non-energy imports, the current slowdown may continue going forward amidst weakening domestic economic activity, exchange rate depreciation and increase in import duties. At the same time, exports may gain from exchange rate depreciation and increase in consumer spending in the advanced economies, but their momentum could possibly be weakened by rising cost pressures. Still, the estimates for overall foreign exchange earnings are on the higher side, as workers' remittances are projected to sustain a high growth. Resultantly, the overall current account deficit is expected to narrow down to 4.5-5.5 percent of GDP, from 6.1 percent in FY18.

Financing of the current account might improve going forward as there is an expectation of receiving higher foreign exchange inflows from both private and official sources during the second half of FY19. In particular, recent bilateral arrangements, including the deferred oil payments facility, are likely to be available from January 2019 onwards. Not only would this bolster the country's foreign exchange reserves, but also ease pressures in the domestic foreign exchange market. Thus, continuing with a right mix of policies and sufficient BoP support, the country is expected to revert to a stable macroeconomic environment over the medium term.

2 Real Sector

2.1 Overview

The major indicators pertaining to Q1-FY19 suggest that the economic activity is losing momentum after observing a 13-year high in FY18. Rising macroeconomic imbalances in the fiscal and the external sectors have mainly arrested the forward motion in economic growth. The economy had begun to show signs of overheating, and policy actions in the form of regulatory measures, exchange rate depreciation and an increase in the policy rate were implemented to contain it. Consequently, some moderation was observed in domestic demand, which affected activities in the commodity-producing sector of the economy. This weak performance of the commodity-producing sector, coupled with a deceleration in import growth has constrained the performance of services sector as well.

Large scale manufacturing (LSM) witnessed a broad-based contraction of 1.7 percent during Q1-FY19, in stark contrast to the impressive growth of 9.9 percent observed during Q1-FY18. In particular, (i) regulatory measures such as the ban on purchase of new vehicles for non-filers; (ii) changes in the sales tax structure on cigarettes; (iii) the increasing share of imported RLNG and coal in the electricity generation mix in place of locally processed furnace oil; and (iv) PKR depreciation, all had a negative impact on domestic demand. On the external front, rising international commodity prices served as an adverse shock for the economy (**Box 2.1)**.

In the agriculture sector, a reduction in the area under cultivation, lower water availability, and a drop in fertilizer offtake led to an overall under-performance of the *kharif* crop sector in FY19. Though all the major *kharif* crops (except cotton) achieved their targets, their output remained considerably lower than last year's record harvests.[1]

Box 2.1: LSM and International Commodity Prices

The increase in international commodity prices is one of the factors that led to a contraction in the LSM growth in Q1-FY19. In the last few years, LSM had been on an upward path as international prices had remained calm. That, coupled with stable exchange rate spurred private sector investment, leading to an expansionary phase in many of the sectors. Recent bout of exchange rate depreciations and increase in international commodity prices has changed the earlier situation. The

[1] According to the Ministry of National Food Security and Research (MNFSR), targets of each crop are decided and allocated to the provincial governments after taking into consideration the input situation (water, fertilizer, seeds and pesticides availability) and weather forecast. The targets set for all *kharif* crops in FY19 are marginally different from those set for FY18.

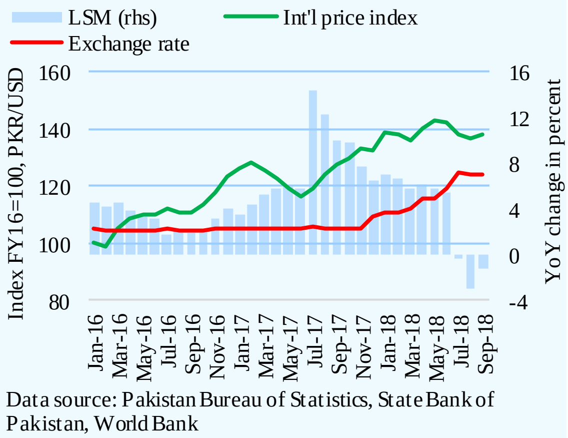
cumulative effect of price movements may continue to leave its footprint on LSM over the forthcoming quarters as well. Latest Consumer and Business Confidence Surveys conducted by SBP somewhat mimic these sentiments about the future state of the economic activity in general.

Prices of raw materials in the international market had been increasing since January 2016.[2] The domestic economy was able to absorb some of the earlier effect, as stable exchange rate insulated the LSM sector from price volatility. No significant change in administered prices of the imported energy products also shielded the domestic producers to some extent.

However, as the twin deficits swelled, the exchange rate started to depreciate and protection afforded to the industry from external commodity shock started to erode. The transmission of the exchange rate to domestic prices became more apparent in Q1-FY19. WPI rose in double digits in three out of last four months. It was the highest quarterly growth in five and a half years and the resultant price shock hampered manufacturers' production activities **(Figure 2.1.1** and **2.1.2)**.

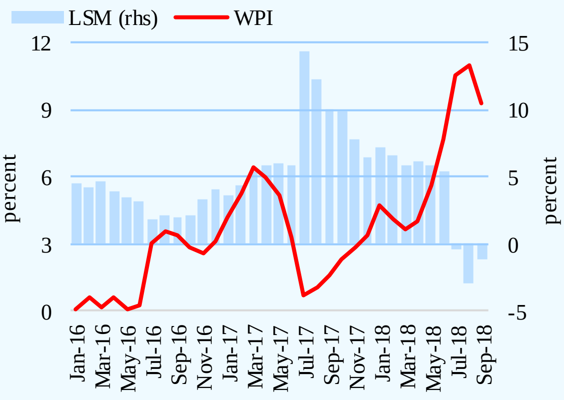
Going forward, it would not be easy for the producers to pass on all the increase in cost of production to the consumers easily,[3] amid slowdown in aggregate demand. It is therefore likely that the performance of the LSM sector would face headwinds in the forthcoming quarters.

Figure 2.1.1: Exogenous Commodity Price Shock and LSM



Data source: Pakistan Bureau of Statistics, State Bank of Pakistan, World Bank

Figure 2.1.2: WPI and LSM (YoY change)



Data source: Pakistan Bureau of Statistics

2.2 Agriculture

Preliminary estimates for the major *kharif* crops, namely cotton, rice, sugarcane and maize, reveal a subdued performance of the sector. This is largely explained by a considerable decline in the area under cultivation, especially in Sindh where

[2] International commodity price index is calculated using the World Bank commodity price indices weighted by their respective share in imports for Pakistan. The weights used for the purpose of calculating the index are; machinery 38 percent, energy 26 percent, agriculture inputs 16 percent, food 11 percent and textile 9 percent.
[3] This is evident from falling margins as reported in quarterly reports of the corporate sector.

water shortages resulted in a drought-like situation. The total area sown under *kharif* crops for FY19 stood at 7.54 million hectares, a decline of 7.7 percent over FY18. Moreover, water shortages and lower fertilizer application might also have an adverse impact on crop yields. Thus, in overall terms, the contribution of *kharif* crops in the gross value addition (GVA) of the agriculture sector might fall significantly below the FY18 level.

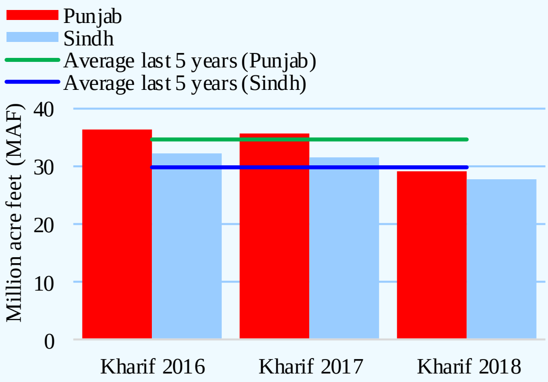
Input situation:

On the input front, the situation was not encouraging either. The total water availability for the *kharif* crops (Apr-Sep 2018) remained considerably lower than last year, as canal water (a major water source for irrigation) availability remained lower compared to last year by 17.8 percent and 11.6 percent for Punjab and Sindh, respectively. The water shortfall in Punjab was covered to some extent by groundwater withdrawals. However, owing to constraints such as brackish and saline groundwater, Sindh suffered a reduction in the area under cultivation (**Box 2.2**).

Box 2.2: Water Situation: Need for Managing Erratic Supplies

The *kharif* 2018 season has witnessed alarming shortages of canal water alongside changing patterns of rainfall in the country. When compared to the average of the last five years (Apr-Sep), the irrigation water withdrawal remained 15.9 and 6.6 percent lower for Punjab and Sindh, respectively. Furthermore, replenishment in groundwater was lower on accounts of below-normal monsoon rainfalls. This reduced water availability was the main cause of reduction in area under cultivation of cotton, sugarcane and rice crops, especially in Sindh. The situation is expected to get more volatile in near future especially under climate change, which is why there is an urgent need to manage water flows during and between the seasons.

Figure 2.2.1: Canal Water Withdrawals for Kharif (Apr-Sep 2018)

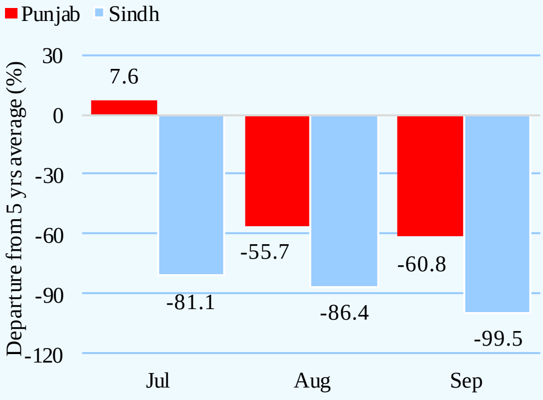


Data source: Indus River System Authority

The low rainfall in Sindh, 89 percent below the 5-year average, in the monsoon season is further aggravating the situation. Recorded rainfall in Punjab for three months of Jul-Sep FY18 was also lower by 33 percent compared to the last five years' average (Apr-Sep 2013-2017) **(Figure 2.2.1** and

2.2.2). The changes in rainfall and irrigation flows is the result of climate changes as weather patterns are changing.[4] It is also important to note that certain crops will be affected more than the others due to this phenomenon.[5] Going forward, *Rabi* season is expected to receive 35-40 percent lower canal water flows compared to the actual allotment of 37.0 MAF. The erratic nature of river inflows and monsoon rainfall requires proper management at the provincial level for meeting the crop water requirement. The following measures at the provincial level are urgently required:

Figure 2.2.2: Monsoon Rainfall Q1 FY19



Data source: Pakistan Meteorological Department

- ***Developing small storages at water-course/canal level:*** Storages at the watercourse and canal level are crucial for managing the timings issue between demand and supply within a cropping cycle. Storages are also needed to store the rainwater.
- ***High Efficiency Irrigation Systems (HEIS):*** Encouraging HEIS by subsidizing drip/ sprinkler irrigation and laser land leveling is also needed. These technological measures will help farmers conserve water, increase per hectare yields, and save costs of electricity/ fuel on water pumping. There is a need for further expansion of the systems, as they help save 50-60 percent of water and 40-50 percent savings on fertilizer.[6]
- ***Farmer participation*** in managing the canal infrastructure would increase the accountability of the system and hence improve the system maintenance. Farmers' organizations and area water boards have been the successful models as farmers take ownership of the system, resulting in reduced wastages. This will also ensure an adequate allocation of water for each season.
- ***Water pricing:*** Increasing water tariffs at par with the value of water would affect farmers' behavior. Additionally, aligning water rates with supply is also required, such as sugarcane may be charged higher per hectare for using more water. A tier system based on the placement/location at the water-course levels would also yield efficient results.

Lower availability of water, coupled with a decline in the area under cultivation and increased urea and DAP prices,[7] resulted in a lower fertilizer offtake during

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[4] The start of the rainy season has been delayed by up to 30 days per decade in the past 20 years. This delays the sowing of many crops. Source: Climate Risks and Food Security Analysis: A Special Report for Pakistan. World Food Programme and SDPI. http://vam.wfp.org.pk/publications.aspx

[5] Increase in precipitation for instance does not harm rice crop but is harmful for the cotton crop. Source: Siddiqui, R., Samad, G., Nasir, M., and Jalil., H., (2012) The Impact of Climate Change on Major Agricultural Crops: Evidence from Punjab, Pakistan. *The Pakistan Development Review* 51:4, 261 276.

[6] Source: Agriculture Department, Government of Punjab

[7] Average prices of urea increased by 23.8 percent in Q1-FY19. On average in July and August prices of urea rose by 24 percent whereas DAP prices rose by 28 percent.

the *kharif* season. Specifically, urea offtake contracted by 10.7 percent and Diammonium Phosphate-(DAP) by 9.3 percent compared to growth of 19.6 percent and 43.1 percent, respectively, for the *kharif* season last year.[8] One possible reason could be stockpiling of fertilizers by the agents who expected the prices to increase in the likely event of the withdrawal of subsidies amidst rising international prices.[9] Anecdotal evidence also indicates that the retailers/agents may have built up the reserves before the start of the season to reap benefits of an expected price hike later.

Table 2.1 Agriculture Credit Disbursements in Q1

	billion Rupees			Growth in %	
	FY17	**FY18**	**FY19**	**FY18**	**FY19**
Farm sector					
A. Production	41.5	57.5	82.4	38.8	43.3
All crops	31.0	38.5	40.1	24.3	4.2
B. Development	3.2	3.3	6.0	2.8	81.5
Tractor	0.7	1.1	1.0	52.7	-8.0
C. Total farm sector (A+B)	44.7	60.8	88.4	36.2	45.3
Non-farm sector					
Livestock/dairy	29.0	41.2	61.5	42.1	49.2
Poultry	15.8	24.7	26.6	56.1	7.5
Other	14.3	29.1	35.7	102.9	22.5
D. Total non-farm sector	59.2	95.0	123.7	60.6	30.2
Total agriculture (C+D)	103.9	155.9	212.1	50.1	36.1

Data source: AC&MFD, State Bank of Pakistan

Table 2.2: Cotton Crop Performance

			FY19		Growth in %	
	FY17	**FY18**	**Target**	**Provisional**	**FY18**	**FY19**
Area ('000 hectares)						
Punjab	1,815	2,053	2,300	1,947	13.1	-5.2
Sindh	637	612	620	422	-4.0	-31.0
Pakistan	2,489	2,700	2,955	2,406	8.5	-10.9
Production ('000 bales)						
Punjab	6,980	8,077	10,000	8,077	15.7	0.0
Sindh	3,600	3,776	4,200	2,600	4.9	-31.1
Pakistan	10,676	11,945	14,370	10,847	11.9	-9.2
Yields (Kg/hectares)						
Punjab	654	669	739	705	2.3	5.4
Sindh	961	1,049	1,152	1,047	9.2	-0.2
Pakistan	729	752		766	3.1	1.9

Data source: Central Cotton Crop Assessment Committee and Federal Committee on Agriculture.

On an encouraging note, credit disbursements to the agriculture sector grew by 33.9 percent during the *kharif* season (Apr-Sep 2018) over the same period last year. Amid the discouraging major *kharif* crop situation, higher borrowings by the agriculture sector indicate that the requirements for other purposes, especially non-farm requirements for livestock/dairy and poultry farming, are on the rise. This is a continuation of the trend observed in FY18,

[8] Source: Fertilizer Review, Mid October 2018, National Fertilizer Development Corporation (NFDC)

[9] Offtake in Jan-Mar, 2018 preceding the *kharif* season increased by 43.7 percent on YoY basis.

during which the non-farm segment had a significantly higher share in the total disbursements than the farm segment (**Table 2.1**).

Cotton:

The latest estimates for cotton crop reveal a worrying picture, as the total production in FY19 is estimated at 10.8 million bales,[10] a decrease of 9.2 percent over the last year's production level, and trailing 24.3 percent behind the targeted level of 14.4 million bales for the year (**Table 2.2**). This below-expectation performance of the cotton crop was largely due to a contraction in the cultivated area. It is pertinent to highlight here that the cotton cultivated area was the lowest in the last seven years;[11] this was mainly due to a lower than average availability of canal water and poor quality of the groundwater.

Estimates of lower production in the country and rising international cotton prices have put upward pressure on prices of seed cotton in the domestic market.[12] Given the stability in the cotton prices, farmers are expected to improve their agronomic practices (pesticides application and soil management) which might enhance cotton production and yield in the coming seasons.

Given the average mills' annual consumption of around 14 million bales in the country,[13] the production is expected to remain short by around 23 percent for the ginners as per their installed capacity for value addition. It is important to note here that raw cotton imports for the Q1-FY19 already stand at 218 thousand bales compared to imports of 113 thousand bales in Q1-FY18, and it is likely that this trend would continue going forward.[14]

Sugarcane:

Estimates place sugarcane production at 68.3 million tons, matching the set target of 68.2 million tons for the year, but falling 16.9 percent short of the production level achieved in the last year (**Table 2.3**). The decline in sugarcane production was expected due to several factors: i) irrigation water shortages, ii) lower area

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[10] The production estimates are provided by the first assessment of the Cotton Crop Assessment Committee (CCAC) held on 12th September 2018.

[11] The decline was most prominent in Sindh, which observed a 31.3 percent decline in area under cultivation on a YoY basis. Cotton cultivation in Punjab also reduced by 5.2 percent because of 32 percent lower canal water availability in sowing season of April- June 2018.

[12] Monthly prices of Cotlook 'A' index rose to US$ 1,995.2 per ton in Sep 2018 from US$ 1,782.1 per ton in Sep 2017, mainly on expectations of lower global cotton output. Cotton Outlook: ICAC Washington DC. Meanwhile, the prices of 40 kg of seed cotton in July 2018 was Rs. 4,232 compared to Rs. 3,286 per 40 kg in July 2017. Monthly Review of Cotton Prices for October 2018

[13] Source: All Pakistan Textile Mills Association (APTMA)

[14] Source: Daily Cotton Market Report, 29-10-2018, Pakistan Central Cotton Committee

under crop production after the crushing season delays and price disputes experienced by the farmers last year; and iii) profitability concerns amidst pending payments to the farmers by the sugar mills for last season's crop FY18

In Punjab specifically, the major sugarcane producing districts such as Rahimyar khan, Faislabad, Jhang, and Chiniot, all witnessed a decline in the area under cultivation. This occurred simultaneously with an increase in the area under rice cultivation, as farmers shifted to the latter to avoid the chance of facing the above-mentioned challenges associated with the sugarcane crop for the second year in a row. Contraction in yields, with the poor quality of seeds and irregular application of fertilizer and pesticides also playing a role in suppressing the production.

Meanwhile, in Sindh, water availability issues translated not only into a decline of 22.7 percent in the area under cultivation but also into a sizable contraction in yields.[15] Moreover, poor quality of seeds and irregular application of fertilizer and pesticides also played a role in suppressing the production. As mentioned in earlier reports, the policy of indicative pricing has caused distortions in the overall agriculture commodity market in recent years. In particular, sugarcane production has been consistently exceeding the domestic demand at the cost of a decline in production of cotton and other crops, such as oil seeds (**Box 2.3)**.

Table 2.3: Sugarcane Crop Performance

			FY19		Growth in %	
	FY17	**FY18**	**Target**	**Provisional**	**FY18**	**FY19**
Area ('000 hectares)						
Punjab	778	859	728	733	10.5	-14.7
Sindh	321	333	322	270	4.0	-19.0
Pakistan	1,218	1,342	1,161	1,115	10.2	-16.9
Production ('000 tons)						
Punjab	49,613	55,068	44,000	47,186	11.0	-14.3
Sindh	18,160	20,612	18,752	15,730	13.5	-23.7
Pakistan	73,433	82,128	68,157	68,252	11.8	-16.9
Yields (Kg/hectares)						
Punjab	63,786	64,099	60,406	64,385	0.5	0.4
Sindh	56,660	61,842	58,236	58,236	9.1	-5.8
Pakistan	60,309	61,207		61,198	1.5	0.0

Data source: Ministry of National Food Security & Research and Federal Committee on Agriculture

Box 2.3: Sugarcane - the Cost of Indicative Pricing

The policy of indicative pricing for sugarcane is aimed at protecting the sugarcane farmers and to meet the domestic demand of sugar. The policy has culminated in increase in the number of sugar mills in Punjab and Sindh. Consequentially in FY18, the production of cane reached a record of 82.1 million tons - an increase of 31 percent above the output of 62.8 million tons in FY15. The expansion is largely based on an area increase of 18 percent, with the yield growth contributing around 11 percent only.

[15] Sugarcane consumes 0.05 million cubic meters to hectares compared to 0.02 for cotton and 0.03 for rice crop. Source: Development of Integrated River Basin Management for Indus Basin: Challenges and Opportunities. Simi Kamal, Dr. Pervaiz Amir, Khalid Mohtadullah. WWF- Pakistan 2012

Resultantly, sugar production has exceeded demand levels, as the pace of growth in sugar production remained significantly higher than consumption; during FY18, sugar production amounted to 7.5 million tons with domestic consumption standing at 5.5 million tons. To ensure that the price of sugar remains in sync with the indicative prices, the domestic market is shielded by a 40 percent tariff on imports. However, this indicative pricing practice has led to several issues:

- **Even farmers could not benefit:** Farmers have been suffering as excess sugar stocks with mills means depressed prices for sugarcane that are lower than the provincially announced per 40 kg rates. In FY18, payment to farmers was as low as Rs 120-140 per 40 kg compared to the notified prices of Rs 180 per 40 kg in Punjab and Rs 182 in Sindh. Inability to dispose off cane at even lower rates became problematic, as the market was glutted with excess supply.
- **Huge subsidy cost:** To offload excess stocks, export subsidies at federal level are announced before the start of the crushing season. The average monthly price of domestic sugar was US$ 448.3 per ton compared to the global price of US$ 329.7 during FY18. Technically, the exports are costing more to the government than its benefits as a significant expenditure is incurred. In FY18, exports subsidy announced by the federal government at Rs 10.7 per kilogram resulted into a total expenditure of Rs 14 billion that is still due. Given the precarious fiscal situation, this expenditure is unnecessary.
- **Distorted signals for competing crops:** The mushroom growth of sugar mills in the main cotton-growing regions of Southern Punjab and Sindh has placed the cotton crop in direct competition with sugarcane for area and resources. According to calculations, the share in area in dominant cotton districts of Punjab was 11.1 percent in FY14, which rose to 14 percent in FY18. Hence, the crop heavily affects cotton production resulting into higher imports for cotton and a burden on the foreign exchange reserves.
- **Excessive use of water in the crop:** Given the lower water availability situation in the country, rationalization of water according to food security and value addition is required. Sugarcane crop consumes relatively large quantities of water, while the production exceeds local consumption and fails to generate export earnings under the current pricing mechanism.

In a nutshell, indicative pricing has distorted the agriculture commodity market in the country. The resultant inefficiencies call for the need to liberalize the market and align domestic pricing with the global prices.

Rice:

Initial estimates indicate that rice production stood at 7.1 million tons during the FY19 *kharif* season, higher than the target of 6.9 million tons but 4.4 percent lower than the record crop witnessed during FY18. While the basmati performance in Punjab is laudable as the estimated crop exceeded the 4 million tons mark, the production in Sindh suffered a contraction of 15.2 percent on a YoY basis, largely due to a contraction in the area under cultivation.

Variety-wise breakdown suggests that the production of basmati has increased in Punjab on the back of an expansion in the area sown due to several factors: i) improved relative profitability for the rice variety compared to sugarcane and cotton in the previous period;[16] ii) the increasing demand of the commodity in international markets, and iii) a general stability in domestic basmati prices.

Table 2.4: Rice Crop Cultivated Area for Punjab and Sindh

	FY17	FY18	FY19		Growth in %	
			Target	1st Estimates	FY18	FY19
Area cultivated in Punjab ('000 hectares)						
Basmati	1,352.8	1,416.4	-	1,494.1	4.7	5.5
Irri	145.3	134.8	-	133.5	-7.2	-0.9
Others	238.4	289.8	-	296.2	21.6	2.2
Total	1,736.5	1,840.9	1,800.0	1,923.9	6.0	4.5
Area cultivated in Sindh ('000 hectares)						
Basmati	51.0	55.2	-	56.1	8.2	1.6
Irri	333.4	351.6	-	258.3	5.5	-26.5
Hybrid	343.7	393.9	-	352.6	14.6	-10.5
Others	22.4	27.2	-	19.5	21.4	-28.1
Total	750.5	827.9	770.0	686.5	10.3	-17.1

Data source: Ministry of National Food Security & Research and Federal Committee on Agriculture

However, irri and hybrid varieties in Sindh suffered due to exceptional water shortages (a decline of 43 percent during the period under review) and the poor quality of groundwater,[17] resulting in a total area contraction of 17.1 percent compared to FY18. **(Table 2.4).**

As domestic rice production exceeds the annual requirement of 3 million tons,[18] major production is left for exports dominated by the non-basmati variety. Hence, global prices play a dominant role in determining the rice production and domestic prices.

It is worth mentioning here that the overall value-addition of the crop segment in GDP would largely depend on the production of wheat, the largest crop of the year. Looming challenges such as increased fertilizer prices, higher cost of borrowing, and, above all, a 35-40 percent decline in water availability in the *rabi* 2018-19 season hold the potential to adversely affect prospects in this regard.[19] Moreover, delay in harvesting of sugarcane crop in certain areas will have a significant bearing on the performance of the upcoming wheat crop as the area may not be vacated in time.

2.3 Large Scale Manufacturing (LSM)

LSM contracted by 1.7 percent during Q1-FY19 compared to a remarkable growth of 9.9 percent during the same period last year **(Table 2.5)**. This subdued performance can largely be attributed to a deceleration in the construction-allied industries and consumer durables. It may be noted that these two sectors had mainly driven the growth in LSM during the last few years. Factors such as: (i) a

[16] Source: Punjab Crop Reporting Centre
[17] Source: Sindh Crop Reporting Centre
[18] Food Security Commissioner: Ministry of National Food Security and Research
[19] Source: Indus River System Authority.

decline in public sector development spending; (ii) exchange rate depreciation; (iii) increasing costs of raw material; (iv) rising inflation; (v) policy measures like barring/ restricting non-filers from purchase of certain assets; and (vi) regulatory bottlenecks that resulted in the buildup of circular debt, all restricted the growth in the specific industries.

Table 2.5 : YoY Growth in LSM (Q1)

growth in percent, contribution in percentage points

		YoY Growth		Contribution in Growth	
	wt.	FY18	FY19	FY18	FY19
LSM	70.3	9.9	-1.7		
Textile	20.9	0.8	-0.2	0.2	0.0
Cotton yarn	13.0	0.1	0.0	0.0	0.0
Cotton cloth	7.2	0.0	0.1	0.0	0.0
Jute goods	0.3	98.1	-8.1	0.1	0.0
Food	12.4	12.3	-4.2	1.8	-0.6
Sugar	3.5	0.0	0.0	0.0	0.0
Cigarettes	2.1	92.0	4.4	1.1	0.1
Vegetable ghee	1.1	11.1	2.4	0.2	0.0
Cooking oil	2.2	9.1	-9.4	0.3	-0.3
Soft drinks	0.9	2.6	-8.3	0.1	-0.3
POL	5.5	13.6	-5.4	0.9	-0.4
Steel	5.4	47.0	-2.9	1.8	-0.2
Non-metallic minerals	5.4	12.3	-1.5	1.4	-0.2
Cement	5.3	12.4	-1.4	1.4	-0.2
Automobile	4.6	29.1	-1.5	2.0	-0.1
Jeeps and cars	2.8	31.4	4.7	1.1	0.2
Fertilizer	4.4	-5.8	-4.8	-0.4	-0.3
Pharmaceutical	3.6	1.9	-3.7	0.2	-0.3
Paper	2.3	9.6	4.2	0.4	0.2
Electronics	2.0	76.9	7.8	1.4	0.2
Chemicals	1.7	5.6	-1.8	0.1	0.0
Caustic soda	0.4	18.1	17.2	0.1	0.1
Leather products	0.9	-0.3	1.5	0.0	0.0

Data source: Pakistan Bureau of Statistics

Construction allied activities

A multitude of factors constrained the pace of the construction activities in Q1-FY19. A fall in development spending during the interim government, which was in office for almost the first half of Q1-FY19, lowered the demand on the public sector front, while the imposition of ban on transfer and purchase of properties in excess of Rs 5.0 million dented the demand of the private sector.

Fiscal consolidation measures also resulted in a reduction in development spending in the revised budget for FY19. Consequently, during Q1-FY19, PSDP dipped to Rs 106.6 billion from Rs 165.0 billion during the same period last year.[20] Private sector spending on housing projects also slowed down with the resurgence of inflationary pressures and certain regulatory measures. CPI data indicates that prices in the construction sector rose sharply from 4.1 percent in Q1 FY18 to 9.6 percent in Q1-FY19. Construction items that have a heavy import footprint such as paints, ceramics, sanitary and steel surged in tandem with an increase in the international prices and depreciation of the domestic currency.

[20] Data source: Ministry of Finance

Cement

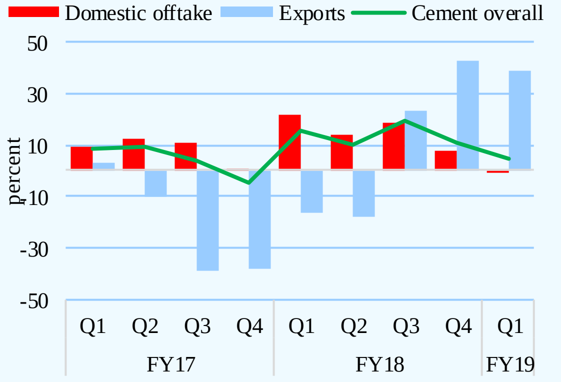
The cement sector's output contracted by 1.4 percent in Q1-FY19 against a sizeable growth of 12.4 percent during the same period last year. The decline came despite the fact that the sector's capacity grew from 49.4 million tons to 54.2 million tons during the review period. A slowdown in cement dispatches in the midst of capacity enhancements resulted in a fall in the utilizations levels by 4 percent in Q1-FY19 to 80 percent.

For the last few years, robust domestic demand had helped cement manufacturers increase their capacity utilization significantly, thereby ensuring healthy margins for the cement industry. However, in Q1-FY19, the domestic sales witnessed a decline of 0.4 percent on a YoY basis, putting considerable pressure on the utilization levels. Encouragingly, however, exports grew remarkably, as they did during the previous expansionary phases as well **(Figure 2.1)**. In quantum terms, the manufacturers exported 39.1 percent more cement during Q1-FY19, which was in stark contrast to the last year's decline of 16.7 percent (**Chapter 5**).

Steel

Steel output shrank by 2.9 percent in Q1-FY19 compared to a significant growth of 47.0 percent during same period last year. Given the dependence of the steel industry solely on domestic market, this deceleration is in tandem with the overall slowdown in construction activities in the country. Furthermore, the demand for steel from the automobile sector slowed down, as the sector experienced a notable moderation during the period under review. The increase in raw material prices in the aftermath of exchange rate adjustments also played a pivotal role in undermining the sector's performance.[21] Imported scrap and raw iron products, the major raw materials of the steel industry in the country, became expensive,

Figure 2.1: Cement Growth



Data source: All Pakistan Cement Manufacturers' Association (APCMA)

[21] The steel manufacturers of Pakistan are dependent on imported raw materials for their products; hence, the industry is prone to developments in global commodity prices as well.

with a rise in the energy costs further escalating the cost of production. With the price differential between locally produced and imported finished products (especially from China) widening, a sizeable share of domestic demand continued to be met by the imports.

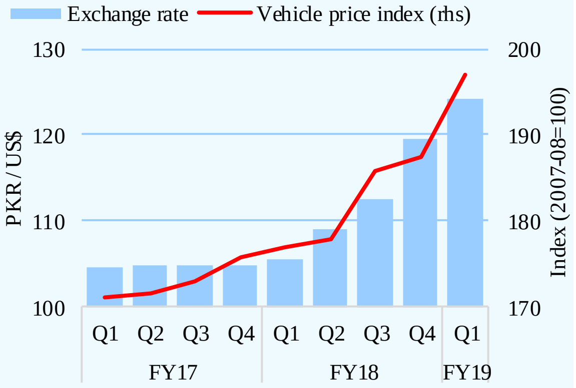
Automobile

Production in the automobile sector contracted by 1.5 percent in Q1-FY19 compared to a significant growth of 29.1 percent that was observed during the same period last year. The primary factors that contributed to this decline are: (i) a ban on non-tax filers on registration of vehicles; (b) an increase in interest rates by 275 basis points since January 2018 that pushed up the borrowing costs; and (c) PKR depreciation which led to a considerable increase in vehicle and fuel prices. This culminated in the lowest quarterly growth in auto sales in the last five years.

The enforcement of a regulatory measure that requires buyers to be active tax filers had a negative impact on the auto demand. While there is still some growth in the cars segment, the shortening of car delivery times from the date of booking is reflective of the impact this regulation has had on the industry. Earlier, the delivery times were 6-9 months for certain popular variants; the lag has now gone down to 2-4 months recently. Importantly, the measure has had a major bearing on the prospective buyers from the rural economy, which is largely informal. According to industry sources, car assemblers have stopped booking of cars to non-filers since the amendment in income tax ordinance 2001 in June 2018.

Furthermore, the increase in car prices, along with higher financing costs, might also have contained the demand for automobiles during Q1-FY19. As shown in **Figure 2.2**, the vehicle prices have responded quite strongly to the movement in the exchange rate, as all the major assemblers passed on the impact of rising input costs to the customers. Meanwhile, the off-take of car loans from commercial banks also posted a sharp decline during Q1-FY19.[22]

Figure 2.2: Exchange Rate and Automobile Prices



Data source: Pakistan Bureau of Statistics and State Bank of Pakistan

[22] Please refer to section on credit to private sector in **Chapter 3** for more details

The demand for two and three wheelers dampened by 3.0 percent in Q1 FY19. It was the first quarterly drop since Q4-FY15 (**Table 2.6**). Anecdotal evidence points to a strong relationship between the performance of the agriculture sector and the demand for motorcycles. As the agriculture segment underperformed during the *kharif* season relative to the same period last year, it negatively affected the sales of bikes and three-wheelers.

Table 2.6: Automobile Sector Production during Q1

	Units in numbers			Growth (percent)	
	FY17	**FY18**	**FY19**	**FY18**	**FY19**
All cars	38,601	49,298	53,258	27.7	8.0
Cars <800 cc	9,083	11,851	12,854	30.5	8.5
Cars between 800-1000 cc	7,957	13,007	13,515	63.5	3.9
Cars >1000cc	21,561	24,440	26,889	13.4	10.0
Sports utility vehicles	219	2,769	2,147	1,164.4	-22.5
Light commercial vehicles	12,076	12,753	11,803	5.6	-7.4
Trucks	1,798	2,452	2,049	36.4	-16.4
Buses	372	294	281	-21.0	-4.4
Tractors	7,237	15,618	13,939	115.8	-10.8
Motorbikes	364,536	468,681	454,502	28.6	-3.0

Data source: Pakistan Automotive Manufacturers' Association (PAMA)

Fertilizer

The fertilizer industry continued on its downward trajectory, contracting by 4.8 percent in Q1-FY19 on top of the 5.8 percent decline witnessed in Q1-FY18. The contraction came on the back of the lowest production levels since FY06 of the smaller urea plants during the quarter. Significant decline in other fertilizers such as CAN, NP, SSP and DAP also restricted growth.[23] One of the main reasons behind the overall decrease in production was the complete closure of processing activities at Pak Arab fertilizer plant which, in addition to urea, produces sizeable quantities of CAN and NP products.

The smaller urea units had ceased production due to the non-availability of domestic natural gas at affordable rates. Feedstock gas at Rs 123 per mmbtu for larger units was not provided to the smaller units.[24] Moreover, operating these units on imported RLNG in an increased prices scenario remained financially infeasible. Natural gas, which is a primary input for domestic urea plants, constitutes more than 60 percent of the total cost of the production. During Q1-

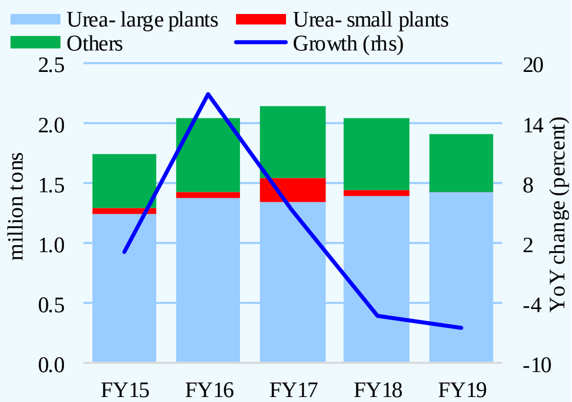
[23] CAN, NP, SSP and DAP are calcium ammonium nitrate, nitrogen-phosphorous, single superphosphate and di-ammonium phosphate respectively.
[24] Data source: OGRA, https://www.ogra.org.pk/consumer-gas-prices

FY19, the difference between feedstock gas from domestic sources and imported RLNG amounted to around Rs 1440 per MMBTU.

On the other hand, large urea producers remained largely unaffected, registering a growth of 2.3 percent during Q1-FY19 compared to 3.1 percent last year on the back of smooth and affordable domestic gas supplies **(Figure 2.3)**. Despite larger units operating at almost full capacity, the performance of these companies was not enough to compensate for the losses from the smaller production units.

Going forward, the announced increase in the gas prices for the fertilizer plants will have a considerable effect on the production levels, as natural gas is one of the critical inputs in fertilizer production especially in case of urea. The resultant price pressure on the fertilizer products, coupled with an uninspiring performance by the crop sector, would weaken their demand. Increasing international fertilizer prices and declining rupee would further exacerbate the situation for the manufacturers. Recognizing these concerns, the government has proposed a solution to the smaller urea plants in the form of the provision of some blend of imported RLNG and domestic gas with revised prices to keep their operations afloat.

Figure 2.3: Fertilizer Production and Growth during Q1



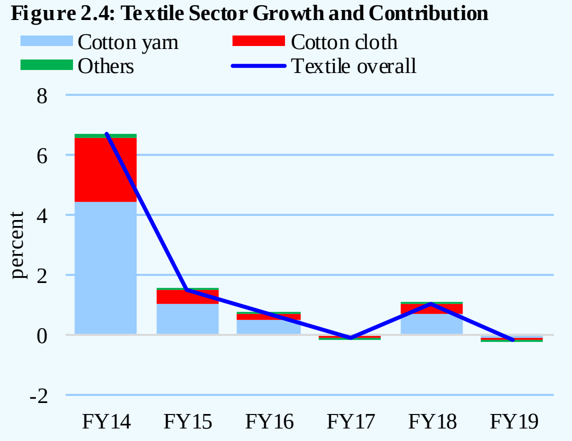
Data source: National Fertilizer Development Corporation (NFDC)

Electronics

Continuing on its strong growth trajectory, the electronics industry posted a growth of 7.8 percent during Q1-FY19, on top of the 76.9 growth observed during the same period last year. The uptick was driven primarily by an increase in the production of electric motors and various cooling equipment. Improvement in electricity supplies alongside an extended summer season, drove the demand for the electronic goods. The consistent growth of the segment has attracted the attention of the foreign investors as well. For instance, TCL, the third largest television set producer in the world, has announced plans to expand its footprint in the Pakistani electronic market.

Textile
The performance of the textile sector remained subdued during the period under review, as a contraction of 0.2 percent was observed against a meagre 0.8 percent growth during Q1-FY18 **(Figure 2.4)**.

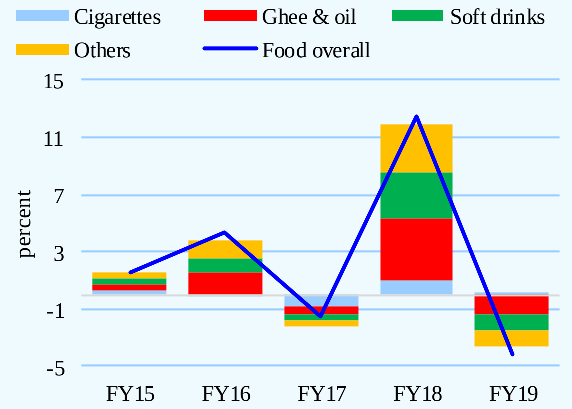
Figure 2.4: Textile Sector Growth and Contribution



Data source: Pakistan Bureau of Statistics

Contrary to the LSM data that points to a rather stagnant textile sector, the exports data reveals encouraging growth (especially in quantum) during Q1-FY19. This discrepancy is primarily explained by a difference in the coverage of the two data sets: the exports data is more extensive than the LSM data, as in addition to cotton yarn and fabrics, it also includes the higher value-added items like hosiery, knitwear, towels, and readymade garments. Furthermore, this data is reflective of the exporting activities of both the LSM and the SME segments.

Figure 2.5: Food Sector Contribution in Growth (Q1)



Data source: Pakistan Bureau of Statistics

Food
The food sector also recorded a contraction of 4.2 percent in Q1-FY19 compared to a growth of 12.3 percent in the corresponding period last year **(Figure 2.5)**. Mainly, a decline in the production of the cooking oil and soft drinks categories overshadowed the growth in the cigarettes production.

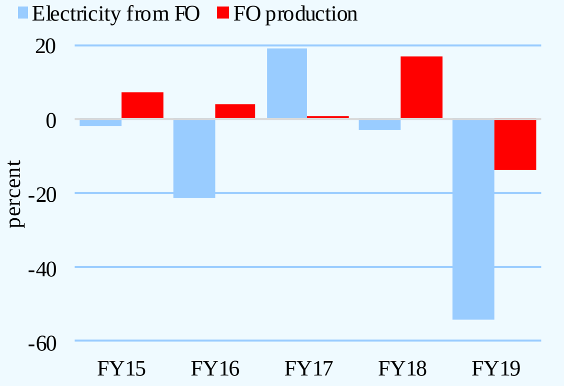
The production of cigarettes expanded by 4.4 percent during Q1-FY19 against an exceptional growth of 98.1 percent during same period last year. It is pertinent to highlight here that during FY18, factors such as the introduction of a three-tier tax structure, a crackdown on the illicit production facilities, and curbs on illegal imported products provided a strong stimulus to the domestic industry. The prominent impact of the latter is evident from the fact the industry managed to record growth despite an increase in the federal excise duties during Q1-FY19.

POL

The POL sector is undergoing a significant shift in the country owing to the government's policy of reducing the reliance on electricity generated from furnace oil based power plants **(Figure 2.6)**. The resultant fall in demand for furnace oil has escalated the cost of production, as the product is one of the major outputs of the crude oil cracking process. Consequently, this has contributed to a buildup of furnace oil stocks and has exacerbated the storage situation. The refineries, therefore, had to lower their production levels, which resulted in a contraction of 5.4 percent in the sector's output in Q1-FY19, in stark contrast to an impressive growth of 13.6 percent that was observed during the same period last year.

Furnace oil production that had recorded growth of 16.7 percent in Q1-FY18 contracted sharply by 13.9 percent in the current year. This can be explained with reduction in electricity generated from furnace oil based power plants, which fell by 54.3 percent in Q1-FY19 compared to output of 8,650 Gwh last year. Industry leaders remain apprehensive about investing in processing units for cracking furnace oil into other petroleum products due to ad-hoc policy changes regarding the product. Meanwhile, foreign investors are taking keen interest in setting up new mega refineries in the country.

Figure 2.6: Growth in Furnace Oil (FO) Production and Electricity Generation from FO (Q1)



Data source: NEPRA and Pakistan Bureau of Statistics

It may also be noted that, in the changing scenario, where RLNG and coal are emerging as major fuel for electricity generation and industrial usage purposes, the indicator of POL sales would not be able to gauge the economic activity in the country. An energy index based on the relative weights of all the components may prove to be a better indicator.

2.4 Services

The services sector holds the dominant share (i.e. 60 percent) of Pakistan's real GDP. As such, its performance has an important bearing on the state of the economy. However, while the services sector either achieved or surpassed its annual target in the last three years, early indications suggest that achieving the FY19 target of 6.5 percent growth may prove to be challenging (**Table 2.7)**.

Table 2.7: Services Sector Indicators (Q1)

	FY18	FY19
Wholesale and Retail Trade (34.4%)		
Credit off take- flow (billion Rs)	6.2	-4.9
Imports (billion US$)	14.2	14.2
LSM (Jul-Sep; YoY growth)	9.9	-1.7
Agriculture credit (disbursements - billion Rs)	155.9	212.1
Transport, Storage and Communication (20.0%)		
Credit off take - flow (billion Rupees)	3.9	7.7
POL sales to transport sector (million MT)	4.1	3.6
Commercial vehicle sales (units)	14,223.0	11,014.0
Cellular tele density (percent)	71.8	73.2
Broadband users (million)	48.1	61.6
Finance and Insurance (3.6%)		
Assets (billion Rs)*	17,560.0	18,118.0
Deposits (billion Rs)*	12,609.0	13,603.3
Profit after tax (billion Rs)	21.9	34.8
General Government Services (14.2%)		
Expenses on general government & defense**	783.7	932.8

Note: Values in brackets indicate sectoral shares within the services sector, as of FY18. The remainder consists of housing services (10.0 percent) and other private services (17.8 percent).
* Stocks, as of end-September 2018
**Only Federal Government
Data source: SBP, PBS, OCAC, PAMA, PTA and MoF

Specifically, the prospects for *wholesale and retail trade* may be dampened to some extent by lackluster industrial activity. For instance, subsectors like cement, steel and automobiles registered notable declines during Q1-FY19, compared to a sizable growth during the same period last year. Secondly, imports in general experienced a marked slowdown (0.42 percent) during the quarter, compared to growth of 21.4 percent seen in Q1-FY18.

Thirdly, there were net retirements of credit amounting to Rs 4.9 billion for *wholesale and retail trade* during Q1-FY19, compared to borrowings of Rs 6.2 billion during the same period last year. Moreover, though agriculture credit disbursements during the review period were higher compared to last year, the preliminary assessment of crops (discussed earlier) suggests that other factors may ultimately hold back the crop production and related trading activities.

With regards to *finance and insurance*, the commercial banks remained active in lending to the private sector during Q1-FY19, a departure from the seasonal retirements witnessed in the comparable period last year. In part, this was because the banks' expectations of further interest rate hikes did not materialize in terms of rollover of longer tenor PIBs. As for the demand side, the borrowing by private sector businesses was substantial compared to net retirements observed in the comparable period last year, owing to a combination of factors like (1) expedited work on projects already in the pipeline, (2) price pressures, emanating from both PKR depreciation and global commodity price increase, and (3) higher activity, as reflected in exports of certain sectors (for details, see **Chapter 3**). Overall, the profit after tax reported for Q1-FY19 was higher compared to the same period last year.

As for *transport, storage and communication*, its leading indicators present a mixed picture. On the one hand, credit off-take to the segment doubled compared to its level in Q1-FY18. On the other hand, commercial vehicle sales and POL sales to the transport sector declined by 22.6 percent and 12.2 percent, respectively. As for the telecom sector, the marked increase in broadband users and continuing gains in cellular tele-density are encouraging. That said, it is unlikely that the gains in the communication sub-segment would boost the overall performance of *transport, storage and communication*, since it is the transport component that tends to account for the dominant share in the gross value addition within the segment.[25]

In the bigger picture, marked deficiencies in urban public transport appear to have fueled the demand for private motor vehicles in the past few years in a manner that may not be sustainable (**Box 2.4**). This pattern of shifting preferences on a large scale – away from efficient public transport to less efficient private means of commuting – tends to be associated with negative externalities, and requires that the root cause, i.e. the gaps in public transport, is urgently addressed.

Box 2.4: The Deficiencies in Urban Public Transport

Urbanization is on the rise in Pakistan. While the degree of urbanization varies across different parts of the country, each province has witnessed a rising share in its urban population over time. These trends have put a significant amount of burden on the government to design and implement comprehensive urban planning programs in order to ensure social welfare.

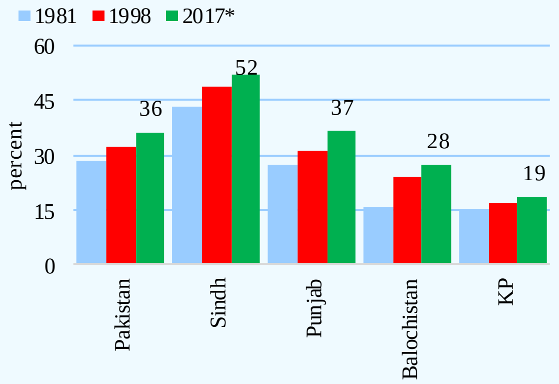
Transport infrastructure is one such area where governments invest heavily to facilitate the general public. This is because despite the positive externalities (associated with environmental concerns), public transport may be under-supplied if left purely to market forces. Thus, government intervention is often required, either in the direct provision of public transport, or indirectly in the sense that the government may regulate and even subsidize private sector operators. Also, since public transport typically benefits the lower-income strata of the society more, its provision at

[25] The individual contributions within the *transport, storage and communication* segment during FY18 (in terms of gross value addition, based on provisional figures released by PBS) were: transport (81.0 percent); communication (16.4 percent); and storage (2.6 percent).

subsidized fares is a transfer payment that redistributes income from the privileged tax-payers to the lower-income segment of the population.

In case of Pakistan also, growing urbanization makes a strong case for a sound public transport infrastructure across major cities (**Figure 2.4.1**). However, a very low road density compared to other Asian countries reinforces its significance (**Table 2.4.1**).

Figure 2.4.1: Share of Urban Population



* Provisional results from sixth Population and Housing Census
Data source: Pakistan Bureau of Statistics

Despite this, there are notable deficiencies in the existing public transport system in the country's urban areas. Neither the quantity nor the quality of public transport provision across the country is particularly encouraging. In terms of quantity, the lack of investment in public transport is reflected in limited fleet additions in the past several years (**Figure 2.4.2**).

Moreover, the quality of public transport, as viewed by commuters, also raises grave concerns. In a survey conducted by the Social Policy and Development Centre (SPDC), a non-profit think tank based in Karachi, a significant share of respondents deplored the state of public transport services in cities (**Table 2.4.2**), on aspects ranging from the condition of vehicles, to reliability, uncertainty, fares, and even the behavior of bus operators.

Table 2.4.1: Estimated Road Density

	Year	Total roadways (km)	Land area (sq. km)	Road density (km/100 sq. km)
Japan	2015	1,218,772	364,485	334.4
India	2015	4,699,024	2,973,193	158.0
Philippines	2014	216,387	298,170	72.6
China	2015	4,577,300	9,326,410	49.1
Pakistan	2014	263,942	770,875	34.2

Data source: SBP' computations using The World Factbook (CIA) data

Karachi's Public Transport System Epitomizes the Deficiencies

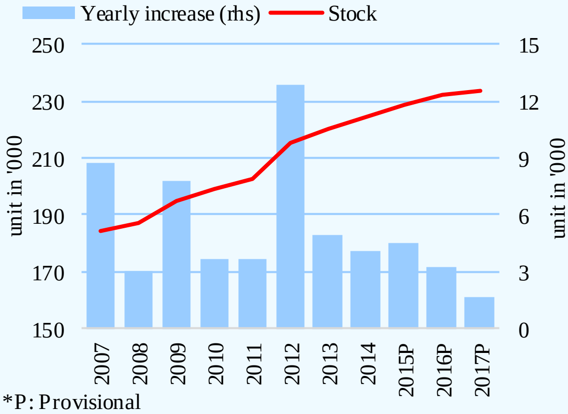
While dissatisfaction with public transport services is widespread, the perceptions relating to Karachi present a particularly grim picture. A recent World Bank (2018) report sheds light on the myriad shortcomings, including the following observations:[26]

[26] World Bank. 2018. *Transforming Karachi into a Livable and Competitive Megacity: A City Diagnostic and Transformation Strategy.* Directions in Development. Washington, DC: World Bank. doi:10.1596/978-1-4648-1211-8. License: Creative Commons Attribution CC BY 3.0 IGO

- The size of the bus fleet in Karachi has been declining; an estimated 8,000 more buses are required to meet the immediate demand alone. Furthermore, the number of minibuses in the city has also fallen from 22,000 in 2010-11 to around 9,500 at present.

- In terms of the number of vehicles on the roads, public transport has a share of 5 percent, while cars and motorcycles have a share of 84 percent. Yet, it is public transport that shoulders the burden of 42 percent of travelers, while cars and motorcycles only account for 40 percent of the commuters.

Figure 2.4.2: Number of Bus Registrations



*P: Provisional
Data source: Pakistan Bureau of Statistics

- Existing buses are overcrowded. Around 45 passengers compete for a single bus seat in Karachi, compared to just 8 passengers in Hong Kong, China, and 12 passengers in Mumbai.

- The roads are also overcrowded. To be specific, 110 percent of the total capacity of roads is utilized, as implied by average volume-to-capacity road traffic ratio of 1.1.

Table 2.4.2: Quality of Public Transport (2015)
percent of households which described the quality of public transport as 'bad' or 'very bad'

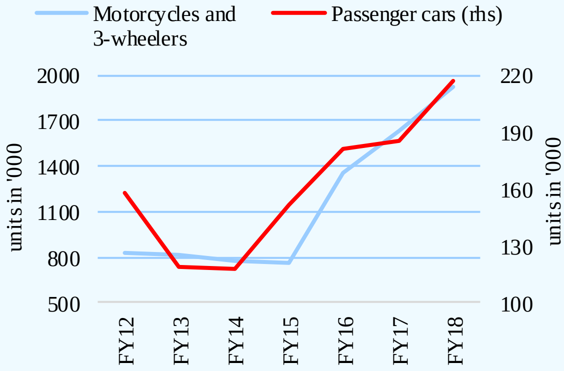
	Operator's behavior	Fare	Uncertainty*	Reliability**	Vehicle condition	Road conditions
Provinces						
Punjab	38	39	38	38	30	28
KP	51	34	43	61	49	33
Balochistan	54	77	25	75	64	70
Sindh	65	68	65	63	57	70
Metropolitan/Municipal Corporation						
Multan	26	39	34	25	15	11
Lahore	33	29	33	35	22	25
Sialkot	36	43	35	40	37	26
Faisalabad	37	40	47	45	36	22
Peshawar	48	30	44	59	46	32
Rawalpindi	55	38	56	43	41	43
Quetta	62	71	28	74	67	77
Sukkur	64	74	71	72	66	88
Karachi	76	65	61	61	53	51

* Arriving time ; ** Time to destination
Data source: SPDC Citizens' Perceptions of Urban Public Services, Research Report No. 97, May 2016

Private vehicles filling the gap across the country

When public transport fails to meet the expectations, citizens by and large tend to prefer owning and commuting via private motor vehicles instead. This idea receives support from the data, with sales of passenger cars, motorcycles and three-wheelers all on an upward trajectory during the past few years (**Figure 2.4.3**).

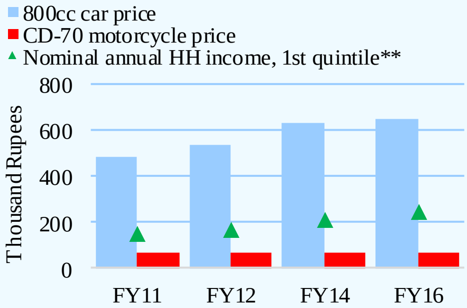
Figure 2.4.3: Motor Vehicle Sales



Data source: Pakistan Automotive Manufacturers Association (PAMA)

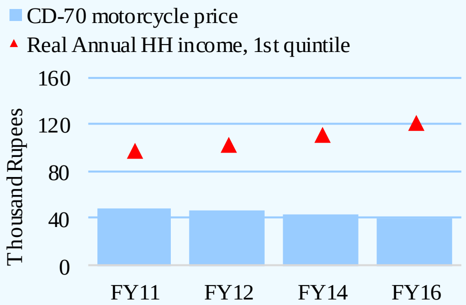
To some extent, this development has been supported by rising real incomes on the one hand, and relative affordability of motor vehicles on the other. Specifically, even urban households belonging to the lowest income bracket (or first quintile), who are prime candidates for public transport, have seen their incomes rise over the past few years (**Figure 2.4.4a and Figure 2.4.4b**). Purchasing an 800cc car still remains a stretch for such households; however, the decline in motorcycle prices (in real terms), coupled with enhanced income, appears to have made two-wheelers an affordable and attractive alternative to public transport, even for the low income segment.

Figure 2.4.4a: Nominal Urban Household (HH) Income, 1st Quintile vs Motor vehicle Prices*



*Prices for Suzuki 800cc car and Honda CD-70 motorcycle, as measured by CPI
** Annualized from average monthly HH income
Data source: HIES, PBS, and SBP's calculations

Figure 2.4.4b: Real Urban HH Income vs Motorcycle Prices*

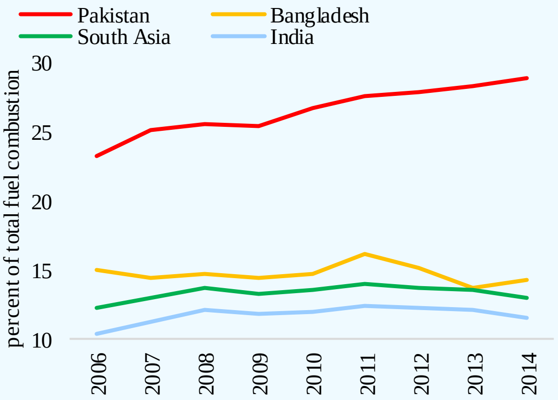


*HH income deflated by CPI index; vehicle prices deflated by motor vehicle index
Data source: HIES, PBS, and SBP's calculations

But this entails negative externalities

In the big picture, increasing car and motorcycle ownership (boosted in part by gaps in the public transport) tends to exacerbate environmental concerns. In this regard, carbon dioxide emissions associated with transport, which were already higher for Pakistan as compared to regional peers, have worsened since 2009 (**Figure 2.4.5**). More broadly, air quality in megacities like Lahore and Karachi has been ranked among the worst in the world of late. This underscores that, while vehicular emissions are only a part of the broader air quality problem, such cities cannot afford further deterioration in air quality. In particular, Lahore's Air Quality Index (AQI) values repeatedly breached the 300 mark during October 2018.[27]

Figure 2.4.5: CO2 Emissions from Transport



Data source: World Development Indicators

And a burden on balance of payments

Equally important are the import pressures that accompany the rising motor vehicle demand. Pakistan is no stranger to such pressures. In particular, the country spent US$ 1.2 billion on average on the import of passenger cars and motorcycles during the last 3 years. The spillover effect is also strong, as the increased use of passenger vehicles has led to a higher consumption of transport fuels. It is important to note that 59.3 percent of the total petroleum sales in the country in FY18 was consumed by road transport alone.[28] In dollar terms, the country had imported US$ 11.7 billion worth of crude and petroleum products during the year, which takes the contribution of road transport roughly to US$ 7 billion. Not only does this reflect a significant drain on the country's FX reserves, it also represents the economy's overall vulnerability to global oil price fluctuations.

Policy Implications

In future, the broad two-pronged strategy to address the deficiencies in public transport may involve: (i) developing efficient public transport systems across the country as a viable alternative to private modes; (ii) incentivizing the use of public transport (via targeted subsidies), or gradually taxing the use of private modes, in order to encourage more individuals to shift to public transport. There is a need to develop a homegrown approach to overhaul the public transport system, both in terms of quantity and quality. Karachi's experience with respect to the KCR in particular, and an under-supplied and overburdened bus fleet in general, illustrates what happens when investment in public transport fails to keep pace with the growing mobility needs of the citizens. In the absence of corrective interventions, the general public may have no option but to devise their own solutions to mobility issues. These individual choices, like the growing preference for private motor vehicle ownership and use, may be sub-optimal from the perspective of the economy as a whole.

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[27] Source: AirVisual. For reference, AQI values in the 201 to 300 range are deemed to be very unhealthy, while values in the 301 to 500 range are classified as hazardous (source for classifications: United States Environmental Protection Agency report, 'Air Quality Index: A Guide to Air Quality and Your Health', February 2014).

[28] Source: Oil Companies Advisory Council

3 Inflation and Monetary Policy

3.1 Overview

Following a cumulative increase of 75 bps in the policy rate in H2-FY18, monetary policy continued to move along the adjustment path. In each of the two policy reviews during Q1-FY19, the monetary policy committee (MPC) raised the policy rate by 100 bps as external vulnerabilities, rising inflationary pressures and overall macroeconomic stress, all necessitated shoring up of the stabilization efforts (**Table 3.1**).

Table 3.1: Macroeconomic Indicators

		FY18				FY19
	Unit	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**
CPI inflation*	percent	3.4	4.1	3.8	4.4	5.6
Core inflation-NFNE*	percent	5.5	5.4	5.4	7.0	7.7
Exchange rate (M2M) *	Rs/US$	105.4	106.5	111.2	116.8	124.4
Current account deficit	billion US$	3.7	4.6	4.3	6.3	3.6
Oil prices (Saudi Light)*	US$/barrel	50.4	59.8	65.7	73.2	75.9
Import cover (SBP) (end period)	months	3.3	3.2	2.6	2.1	1.8
Fiscal deficit	% of GDP	1.2	1.0	2.0	2.3	1.4

* Quarterly average
Data sources: State Bank of Pakistan, Pakistan Bureau of Statistics and Bloomberg

In its July meeting, the MPC particularly took stock of fiscal slippages in the second half of FY18, as these could potentially undermine SBP's efforts to contain demand pressures. By the time MPC met for the first time in July 2018, these pressures had already triggered a sense of policy urgency, as the current account deficit had reached an unsustainable level with no foreseeable respite in reserves drawdown. Moreover, a steady increase in core inflation since March 2018, growing cost push pressures stemming from PKR depreciation and global crude prices, and high inflation expectations increased the likelihood of headline inflation for FY19 surpassing the annual target of 6 percent. In fact, SBP's model-based range for average CPI inflation had increased to 6.0-7.0 percent for FY19 – a 50 bps increase from the earlier forecast. Thus, with the balance of risk shifting increasingly in favor of further tightening, the MPC raised the policy rate with a consensus vote count.

The considerations guiding the MPC's decision in September policy review were not different from the earlier ones. However, new challenges also emerged that required further consolidation of earlier policy decisions. For instance, estimates of output gap had increased further with inflationary pressures evident in both the food and non-food items. More importantly, SBP's inflation projections for FY19 increased further in the range of 6.5-7.5 percent. The following factors played a key role in this regard: (i) a higher than anticipated rise in international oil prices and its pass-through to domestic fuel prices; (ii) an upward revision in domestic gas prices; (iii) further increase in regulatory duties on imports in early September 2018; and (iv) a continued second-round impact of previous PKR depreciations.

Furthermore, although the non-energy imports posted a decline as early harvest projects under CPEC matured and edible oil prices softened, the payment pressure remained strong due to higher crude oil prices. The increase in import bill more than offset the improvement observed in workers' remittances and exports during the first two months of FY19; resultantly, pressure on the current account persisted. In addition to domestic developments, the MPC also took stock of global developments, especially the protectionist policies adopted by some of the advanced economies and the diversion of capital flows away from the emerging market economies. In view of all these developments, the MPC decided to raise the policy rate further by 100 bps.

It is pertinent to highlight here that SBP's stabilization efforts are getting increasing support from the fiscal policy, as evident from the cuts in development spending in Budget 2018-19, and a partial reversal of earlier tax relief measures.[1] Budgetary borrowings from the banking system remained subdued during Q1-FY19, as the fiscal deficit was funded predominantly by domestic non-bank sources as well as external borrowings. Within the banking system, the government borrowed extensively from SBP, primarily to repay a large volume of its maturing debt held by the commercial banks.

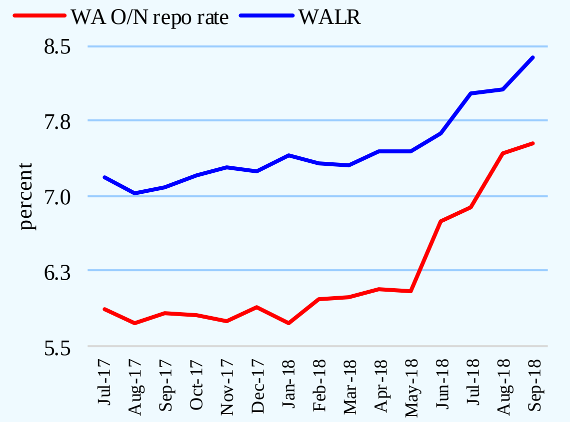
In overall terms, the government retired Rs 1.4 trillion held by commercial banks during Q1-FY19. Since this significant amount ran the risk of disrupting the interbank liquidity management and the levels of overnight rates, SBP had to unwind its earlier OMO injections substantially (to the tune of Rs 1.5 trillion). The net liquidity condition enabled the banks to cater to increased credit demand from both the private sector as well as PSEs during the quarter, without any unwarranted pressure on the overnight rates. A negative deviation of 8 bps on average between the overnight rates and the policy rate persisted nonetheless.

Easy liquidity conditions and a passive impact of the policy hike on the WALR (which increased by only 75 bps during the quarter) helped the private sector maintain its borrowing momentum in Q1-FY19 (**Figure 3.1**).

[1] PSDP spending declined from Rs 165.0 billion in Q1-FY18 to Rs 106.6 billion in Q1-FY19.

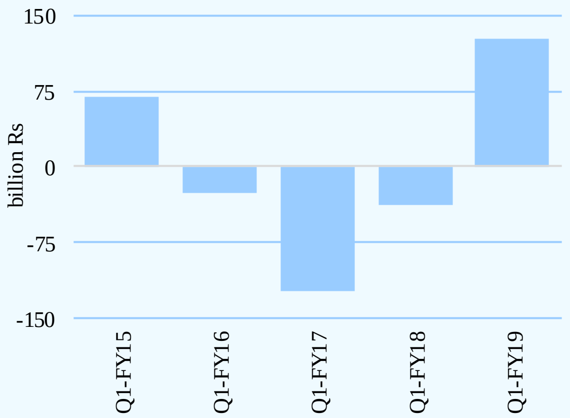
Against a seasonal decline witnessed in Q1-FY18, the overall offtake of private credit increased by Rs 127.9 billion in Q1-FY19 (**Figure 3.2**). The increase was evident primarily in working capital loans, as growth in fixed investment loans tapered during the quarter with maturing early harvest projects under the CPEC.

Figure 3.1: Trend in Key Interest Rates



Data source: State Bank of Pakistan

Figure 3.2: Credit to Private Sector- Flows



Data source: State Bank of Pakistan

Within working capital loans, borrowings by textiles and energy sector more than offset heavy retirements by sugar and rice processing firms. While the textile sector borrowings can be attributed to the higher export-driven activity as well as a sharp rise in cotton prices, the offtake by the energy sector mainly represented the price impact. In particular, rising crude prices increased the financing requirements of the petroleum refineries, while the higher furnace oil prices escalated the cost of thermal power generation; the overall activity in these two sectors remained weaker than last year. The impact of crude prices was also visible in the loans taken by the public sector enterprises (PSEs). Specifically, the increase in fuel cost further intensified the cash-flow related challenges (stemming from circular debt) in the energy sector value-chain.

Therefore, contrary to the developments in Q1-FY18, during which the entire growth in the net domestic assets (NDA) of the banking system had come from heavy public sector borrowings, the growth in Q1-FY19 has come from both the public sector and the private sector borrowings. However, the impact of NDA growth in overall money supply (M2) was partially offset by a net contraction in the net foreign assets (NFA) of the banking system, leading the M2 to post a net expansion of Rs 26.6 billion during Q1-FY19. This was unlike last year, when the impact of NDA growth on overall money supply was completely offset by a sharp contraction in NFA.

3.2 Monetary Aggregates

Broad money (M2) expanded by Rs 22.4 billion during Q1-FY19, as compared to a contraction of Rs 88.4 billion the same period last year. The entire increase stemmed from NDA of the banking system, as NFA continued to post net contractions during the period under review. In flow terms, SBP NFA recorded a smaller contraction compared to last year, which can be traced to the availability of external funding to the government during the quarter. Nevertheless, the outstanding stock of SBP NFA turned negative by the end of Q1-FY19 for the first time after February 2014, reflecting overall weaknesses in the country's external sector (**Table 3.2**).

Table 3.2: Monetary Aggregates
billion Rupees

	Flows		Stocks
	Q1-FY18	Q1-FY19	end Sep18
Government borrowing	333.1	73.5	10,273.2
Budgetary borrowings	369.9	84.9	9,477.6
From SBP	201.2	1,518.3	5,131.7
From scheduled banks	168.7	-1,433.7	4,345.8
For commodity operations	-36.3	-10.8	808.9
Credit to non-government	-32.2	189.2	7,222.8
Private sector	-37.4	127.9	6,100.8
PSEs	5.1	60.7	1,104.7
Other items (net)	-130.6	-91.8	-1,119.5
NDA	170.2	171.0	16,376.5
NFA	-258.6	-148.5	-357.0
SBP	-237.1	-92.2	-79.7
Scheduled banks	-21.5	-56.4	-277.2
Monetary assets (M2)	-88.4	22.4	16,019.6
Reserve money	-134.7	-31.0	5,453.7

Data source: State Bank of Pakistan

Credit to Public Sector Enterprises (PSEs)

Credit to the PSEs registered an increase of Rs 60.7 billion during Q1-FY19 compared to Rs 5.1 billion during the corresponding period last year. Importantly, a major share of PSE borrowings was attributed towards addressing liquidity constraints in the energy sector rather than investing in development projects to stimulate the real activity.

For instance, the bulk of the PSE credit was taken by Pakistan State Oil (PSO). The entity utilized these borrowings for payment settlements with its domestic and international debtors, which were pending for some time due to stuck-up receivables from different energy related enterprises, such as Gencos (mainly HUBCO and KAPCO), PIA and SNGPL. Similarly, additional borrowings by Power Holding Private Limited (PHPL) also contributed to this increase.

Commodity financing

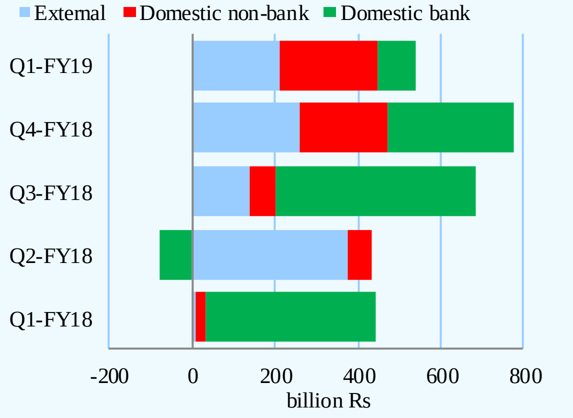
Procurement agencies, especially those involved in wheat related operations, had scaled up their bank borrowings to a 5-year high level during the fourth quarter of FY18. This represented not only strong commodity purchases but also cash flow problems faced by procurement agencies that emanated from their failure to offload a sizable portion of their stocks. However in Q1-FY19, these agencies were able to offload a significantly large amount of hypothecated stock compared to Q1-FY18,[2] primarily as export prospects became healthier on the back of recovery in global prices along with availability of heavy government subsidies.[3] However, as it turned out, there have been fewer seasonal retirements under commodity finance during Q1-FY19 compared to the same period last year.

This anomaly can be explained by the delayed interest payments by the procurement agencies on outstanding principals. In particular, responding to the policy rate hike, commercial banks had increased the mark-up amount due on the outstanding commodity loans, which impaired the repayment capacity of the procurement agencies. Resultantly, the agencies held up their scheduled repayments for some time and negotiated with banks for a better pricing. Furthermore, the expected improvement in the cash flow of agencies also did not materialize due to delays in subsidy payments by the government.

Budgetary borrowings

The overall budgetary borrowings from the banking system fell to a multi-year low during the first quarter of FY19. Although the overall fiscal deficit was higher in Q1-FY19 compared to the same quarter last year, its funding was skewed heavily towards non-bank domestic resources as well as external funding. In fact, banking system had financed 92.6 percent of fiscal deficit in Q1-FY18, but in Q1-FY19, its

Figure 3.3: Composition of Budgetary Finance



Data source: State Bank of Pakistan

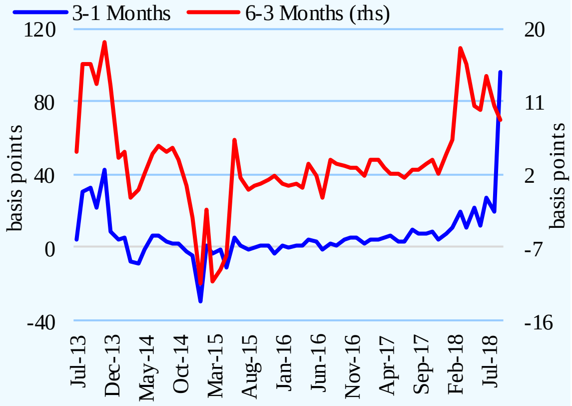
[2] During Q1-FY19, procurement agencies were able to offload 518.9 thousand MT of wheat. Last year, they could offload only 121.4 thousand MT.

[3] Global wheat prices were 12.7 percent higher on average during Jul-Sep 2018 compared to Jul-Sep 2017.

contribution in the same was only 17.1 percent (**Figure 3.3**).

Within the banking system, the reliance of the government on SBP financing increased considerably during the quarter, since scheduled banks' appetite for government securities remained muted because of expectations of a further increase in interest rates. These expectations are also reflected in the widening yield spreads in the secondary market between the 3-months and 1-month, as well as the yield spread between the 3-months and 6-months (**Figure 3.4**).

Figure 3.4: Yield Spreads in the Secondary Market



Data source: MUFAP

Therefore, the participation of the banks remained muted in most T-bill auctions (5 out of 7) during the quarter. The only two auctions where an active participation of banks could be seen were those held right after the July rate hike. In these two auctions, banks placed cumulative offers of Rs 4.4 trillion – all in 3m paper – against the maturities of Rs 2.0 trillion. As a result, the government was able to meet its pre-auction targets. However, in all other auctions, the government not only missed its pre-auction targets, but the net-of-maturity acceptances also remained negative. Importantly, 6m and 12m T-bills cumulatively failed to attract even one percent of the offers and acceptances in any auction held during the quarter.

Table 3.3: Auction Profile of Government Securities (face value)

billion Rupees

	T-Bills			**PIBs -fixed rate**			**PIBs -floating rate**		
	Target	Offered*	Accepted	Target	Offered	Accepted	Target	Offered	Accepted
In gross terms									
Q1-FY18	3,900.0	4,511.2	4,406.3	300.0	107.3	55.6	-	-	-
Q1-FY19	5,450.0	5,119.0	4,687.0	150.0	65.2	20.6	150.0	151.5	101.5
Net of maturity									
Q1-FY18	218.5	829.7	724.8	-296.6	-489.6	-541.0	-	-	-
Q1-FY19	-210.6	-541.6	-973.6	-311.1	-395.9	-440.6	150.0	151.5	101.5

*only MTB offered amount, excludes non-competitive bids

Data source: State Bank of Pakistan

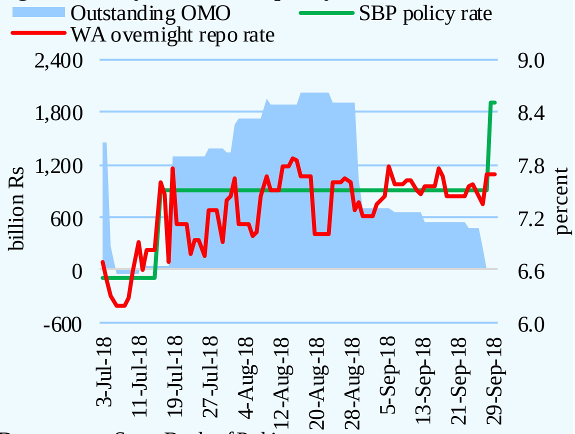
Likewise, fixed coupon PIBs demonstrated a similar trend where one out of three auctions was scrapped during the period under review. Moreover, the gross acceptances amounted to Rs 19.4 billion compared to maturities of Rs 461.1 billion. In contrast, floating rate PIBs remained the most favored instrument in the longer tenor bonds as the offered amount marginally exceeded the target compared to fixed rates where banks offered less than half of the target amount during Q1-FY19 (**Table 3.3**).

To sum up, the entire burden of sizable maturities of government papers as well as the additional government borrowing requirements was borne by the SBP. Resultantly, during Q1-FY19, government borrowings from the central bank soared to Rs 1.5 trillion.

3.3 Liquidity Conditions in the Interbank

The size of maturing government papers was sufficient for allowing banks to comfortably meet the liquidity demand emanating from: (i) higher credit off-take by private sector as well as PSEs; (ii) lower retirements by the government procurement agencies; (iii) uptick in FX injections; and (iv) a slowdown in the deposit growth.[4]

Figure 3.5: Key Interbank Liquidity Indicators

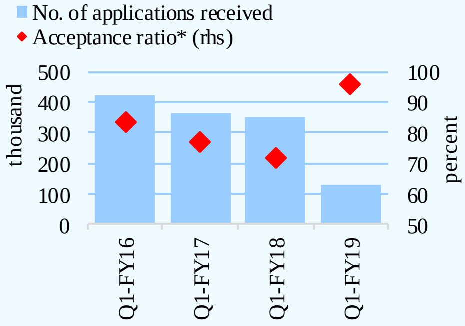


Data source: State Bank of Pakistan

Consequently, SBP rolled back the outstanding OMO injections to remove surplus liquidity from the market. The average outstanding OMO injections stepped down to Rs 1.0 trillion during Q1-FY19 compared to Rs 1.4 trillion last year (**Figure 3.5**). Despite the efforts, however, excess liquidity persisted in the interbank market, as evident from a negative 8 basis points deviation of overnight rates from the policy rate during Q1-FY19, compared to a 5 basis points positive deviation in Q1-FY18.

[4] Total deposits with commercial banks grew by 0.01 percent during Q1-FY19 compared to 0.37 percent last year.

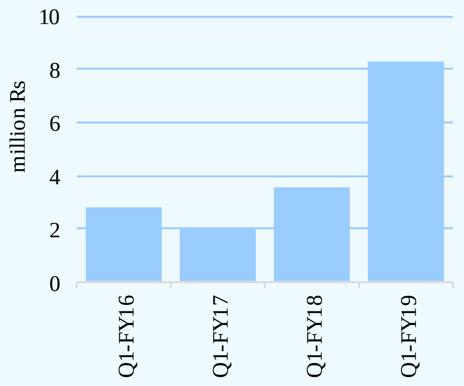
Figure 3.6a: Number of Loans Applications and Banks' Acceptances



* No. of loan applications accepted by banks divided by no. of loan applications received

Data source: State Bank of Pakistan

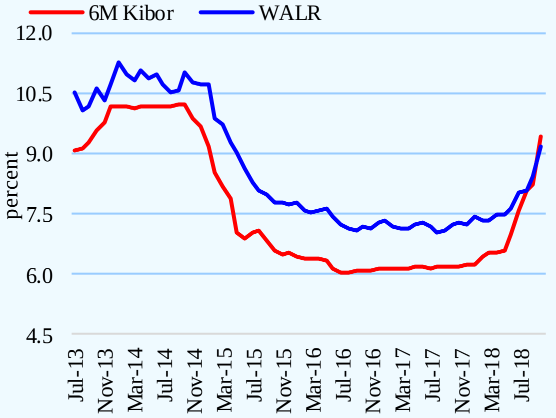
Figure 3.6b: Average Loan Size for Accepted Applications



Data source: State Bank of Pakistan

Thus as banks were not keen on investing in government papers, they focused solely on expanding private loan portfolios to park available liquidity. Although the credit demand conditions were not as upbeat as in the previous few quarters, partly due to higher interest rates and macroeconomic uncertainty, a strong competition persisted among banks for securing credible and financially viable projects. In fact, the number of loan applications that the banks received during the quarter posted a sharp decline during the quarter (**Figure 3.6a**). However, banks accepted most of these applications; the average loan size against accepted applications was also quite large (due to higher input prices) compared to the same quarter of preceding three years (**Figure 3.6b**). Their eagerness to expand loan portfolio is also reflected from the fact that the banks even lent at kibor to some of their prime customers, which almost wiped out the premium between 6-month kibor and the overall weighted average lending rates (**Figure 3.7**).

Figure 3.7: Trend in Lending Rates



Data source: State Bank of Pakistan

3.4 Credit to Private Sector
Credit to the private sector rose by Rs 127.9 billion in Q1-FY19, compared to a net retirement of Rs 37.4 billion in the same period last year. This healthy credit offtake indicates an encouraging start of FY19, as first quarter of fiscal year usually exhibits seasonal retirement of private credit. The credit developments during Q1-FY19 can be explained by (i) rising input costs (especially cotton and petroleum) which increased the demand for working capital loans; (ii) a sharp depreciation of PKR, which increased the rupee cost of imported inputs and machinery/equipment; and (iii) expedited work on planned investments in cement industry, which boosted its demand for long-term loans. Meanwhile, the pace of consumer financing slowed due to policy measures such as ban on non-filers from transactions in auto and house purchases/registration during Q1-FY19.

The growth in fixed investment loans tapered
The growth momentum in fixed investment loans weakened during Q1-FY19 (**Table 3.4**). The offtake by manufacturing sector was particularly subdued as the loan offtake more than halved compared to Q1-FY18. Within manufacturing, cement and sugar were the only two sectors where any noticeable activity was observed.

Long term borrowing in cement can be traced to expedited work on already planned investment of some projects. These projects had faced temporary slowdown last year due to regulatory constraints, however, work on these projects have now been resumed.[5]

As for the sugar sector, a higher credit offtake during Q1-FY19 represents liquidity constraints. Although firms were able to export a sizable quantity of sugar during the period, their cash flows did not improve considerably as the government did not make full payment of the export subsidy amount. Sugar manufacturers also blame the prevailing depressed prices in the domestic market for their liquidity problems. A number of firms have defaulted on their scheduled payments to the banks as the sector's outstanding non-performing loans (NPLs)

[5] For instance, Maple Leaf Cement temporarily held back work on its 7,300 tons per day project in Q2-FY18 due to an order issued by Punjab Environmental Protection Agency (EPA) in December 2017. Later in January 2018, the Lahore High Court put aside the EPA order in favor of the firm. Since then the firm resumed its expansion plan, which also progressed in Q1-FY19. Other firms borrowed to keep progress towards commencing operations of new plants according to their scheduled timelines. For instance, Cherat Cement borrowed for installation of Waste Heat Recovery for Line III, Kohat Cement for grey cement line of 7,800 tons per day capacity expansion, Pioneer Cement for 24 MW power plant, and Flying Cement for Waster Heat Recovery unit.

Table 3.4: Loans to Private Sector Businesses (Flows)

	Total Loans		Working Capital*		Fixed Investment	
billion Rupees	**FY18**	**FY19**	**FY18**	**FY19**	**FY18**	**FY19**
Private sector businesses	**-31.8**	**99.0**	**-85.9**	**64.1**	**54.0**	**34.9**
Manufacturing	-42.6	50.5	-87.3	30.2	44.7	20.3
Cement	0.5	17.4	-2.6	6.6	3.1	10.8
Textiles	-3.6	29.6	-18.0	29.4	14.5	0.2
Refined petroleum	-2.8	20.1	-1.9	22.0	-1.0	-1.9
Iron & steel	6.4	15.3	6.1	12.9	0.3	2.4
Edible oil and ghee	17.6	12.1	14.2	11.8	3.4	0.2
Motor vehicles	1.3	9.9	1.1	8.7	0.2	1.3
Fabricated metal products	1.1	5.1	0.0	4.3	1.1	0.8
Paper	-2.9	4.1	-4.4	5.1	1.5	-1.0
Fertilizer	-11.5	-7.4	-11.1	-2.9	-0.4	-4.5
Sugar	-31.5	-21.9	-39.9	-32.3	8.4	10.4
Rice processing	-12.7	-23.4	-13.0	-23.7	0.3	0.3
Electricity, gas and water supply	-4.5	35.2	-0.3	35.0	-4.1	0.2
Prod, trans and distribution of electricity	-4.2	36.1	0.6	35.7	-4.8	0.5
Prod, trans and distribution of gas	-0.3	-0.9	-1.0	-0.7	0.7	-0.2
Real estate & related	7.3	8.4	3.4	5.3	3.9	3.1
Transport, storage and communications	3.9	7.7	1.9	4.8	2.0	2.9
Construction	-1.1	5.7	-4.4	3.6	3.3	2.1
Mining and quarrying	2.6	2.0	-0.6	-2.4	3.2	4.3
Agriculture	9.3	-2.2	5.4	0.5	3.9	-2.8
Commerce and trade	5.3	-4.6	4.0	-5.5	1.3	0.9
Ship breaking	1.0	-10.4	1.0	-10.2	0.1	-0.2

*includes trade financing
Data source: State Bank of Pakistan

have grown by 41.6 percent during Q1-FY19.[6] So apparently, the sector's reliance on bank funding has increased to partially settle its dues with the banks; while some firms defaulted, others actually retired their short-term loans (working capital) by taking long-term loans (fixed investment). Given an uncertain liquidity position ahead, and the looming crushing season, these firms might also be finding it appropriate to lengthen their debt maturity profile.

Increased input costs raised the demand for working capital loans

Working capital rose by Rs 64.1 billion in Q1-FY19, compared to net retirements of Rs 85.9 billion in the same period last year. While the first

[6] The overall infection ratio of the sector has also increased from 5.2 percent at end June 2018 to 8.3 percent in September 2018.

quarter typically represents seasonal retirements in the working capital loans, the offtake remained higher this year due to a sharp rise in input/commodity prices. For example, the impact of higher prices of key inputs (stemming from both the global price increase as well as PKR depreciation) seems quite dominant in the increased borrowings by petroleum refineries and power generation units. These two sectors cumulatively borrowed Rs 57.7 billion in Q1-FY19 compared to only Rs 1.3 billion last year. However, if we adjust their borrowings with price trends in crude oil and thermal fuels (furnace oil, high speed diesel and coal), the increase in working capital loans during Q1-FY19 becomes quite marginal (**Table 3.5**).[7] This impact is also visible in relatively weak activity in these sectors: while the pace of thermal power generation slowed down in Q1-FY19, refining activities actually posted a contraction of 5.4 percent compared to the same period last year. Here it is also important to mention that the energy sector's reliance on the banking system on the whole is at elevated level due to the circular debt problem. This is especially true for petroleum refineries, as these firms typically generate sufficient amount of liquidity on their own when smoothly receive payments for the fuels sold.

As for the textiles, while the impact of 36.6 percent YoY increase in domestic cotton prices appears quite prominent in Q1-FY19, the activity in this sector (as reflected in higher export quantum) also explains a sharp increase in working capital loans. The overall working capital borrowing of textile firms increased by Rs 29.4 billion during Q1-FY19, in contrast to the net retirements of 18.0 billion that were observed during Q1-FY18. Since most of the activity in the sector was export-centric, around 39 percent of the borrowing was met from SBP's export refinance schemes, which were offered at a subsidized rate of 3.0 percent during Q1-FY19.

Table 3.5: Working Capital Borrowings by POL and Power sectors in Q1 (Flows)
billion Rupees

	POL		Power	
	Nominal	**Real***	**Nominal**	**Real****
FY18	-1.9	-0.2	0.6	0.0
FY19	22.0	0.2	35.7	0.2

*Deflated using Saudi Arabian Light,
**Deflated using WPI index of furnace oil, coal and HSD
Data source: State Bank of Pakistan

The fertilizer sector, on the other hand, retired its working capital loans in Q1-FY19. This was consistent with the decline in both the fertilizer offtake and production during the review period. Fertilizer off-take fell by 6.1 percent in Q1-FY19, compared to a rise of 1.2 percent in Q1-FY18 on a YoY basis, as a fall in area under cultivation of different Kharif crops was reported. Furthermore, two

[7] Arab light prices were 50.5 percent higher on average between Jul-Sep 2018 compared to Jul-Sep 2017.

out of three small units could not resume production due to non-availability of cheaper feedstock. This situation contributed to fertilizer sector's production falling by 4.8 percent during Q1-FY19, compared to a fall of 5.8 percent during the same period last year. [8]

Underserved segments such as SMEs need immediate attention of banks

Segment-wise analysis reveals that the corporate borrowers remained the major beneficiaries during Q1-FY19, while the share of SME advances continued to fall. The number of SME borrowers also declined in Q1-FY19 compared to the same period last year (**Table 3.6**). Most of this decline was evident in the big 5 banks, as the other banks increased their SME exposure by establishing hub branches in SME concentrated locations. However, their clientele growth too failed to pick up. This suggests that the focus of the banking industry is misplaced; instead of extending small loans to a large number of borrowers, they are focusing on expanding their aggregate loan portfolio.

Table 3.6: Major Indicators of SME Financing in Q1

flow in billion Rupees

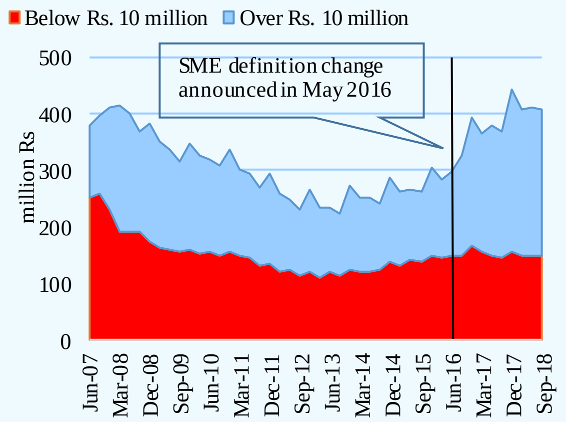
	FY17	FY18	FY19
SME finance	27.4	-10.8	-4.8
Big 5 banks	-3.9	-1.0	-6.8
*Other commercial banks**	31.1	-9.6	2.0
Share in advances (%)	6.3	6.0	5.4
Big 5 banks	4.5	4.9	4.3
*Other commercial banks**	7.9	6.9	6.3
No. of borrowers	164,585	173,785	172,899
Big 5 banks	31,425	43,848	46,494
*Other commercial banks**	95,140	91,986	88,561
NPLs ratio (%)	25.9	21.1	18.5

*excluding specialized

Data source: State Bank of Pakistan

Specifically, the existing SME portfolio is skewed towards big-ticket loans, as the share of loans over Rs 10 million has increased to 76.7 percent in the total SME advances at end-September, 2018, from 74.1 percent at end-September, 2017. Moreover, since March 2016, the overall rise in the SME loans is stemming from big-ticket loans only (**Figure 3.8**). It is important to note that this shift appeared after the

Figure 3.8: Composition of SME Loans by Size



Data source: State Bank of Pakistan

[8] Data source: National Fertilizer Development Centre (NFDC) and Pakistan Bureau of Statistics.

relaxation of SME definition in SBP's prudential regulations.[9] SBP has already undertaken various measures to improve credit availability across various sectors. In this regard, banks need to take advantage of the recent SME policy announced in FY18 to revive credit to this under-served sector on a priority basis.

Budgetary measures decelerated the pace of major consumer segment

After rising consistently for the last four quarters, the flow of consumer financing decelerated to Rs 15.3 billion in Q1-FY19 (**Table 3.7**). In particular, the offtake of car loans in Q1-FY19 more than halved compared to the same quarter last year, with banks also receiving much fewer applications for car loans in Q1-FY19 compared to the same quarter last year (**Figure 3.9**).[10] The government's decision of barring non-filers from purchasing/ registering vehicles mainly contributed to this slowdown, as complying with government directives, two of the three largest auto assemblers had suspended advanced car bookings for non-filers back in May 2018.

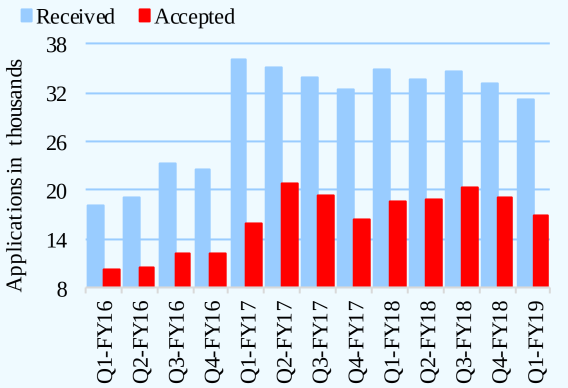
Table 3.7: Consumer Financing Q1 (flows)
billion Rupees

	FY18	FY19
Total	18.4	15.3
1) For house building	6.3	5.4
2) For transport i.e. purchase of car	11.2	5.0
3) Personal loans	0.8	3.5
4) Credit cards	1.6	1.1
5) Consumer durables	-1.5	0.3

Data source: State Bank of Pakistan

The decelerating impact of auto-finance on overall consumer financing was offset to a large extent by the Rs 3.5 billion rise in personal loans during Q1-FY19. Data suggests that some banks having high branch penetration and a large customer base of salaried class were able to push further in this segment during the quarter under review.

Figure 3.9: Trend in Applications Received and Accepted for Auto Loans



Data source: State Bank of Pakistan

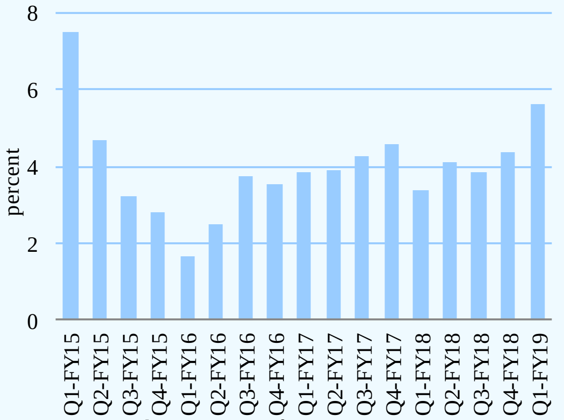
[9] IH&SMEFD Circular No. 02 of 2016, dated May 06, 2016 available at http://www.sbp.org.pk/smefd/circulars/2016/C2.htm

[10] PKR depreciated by 2.2 percent during Q1-FY19, compared to only 0.5 percent depreciation in the same period last year.

3.5 Inflation

Average headline CPI inflation increased to 5.6 percent during Q1-FY19 compared to 3.4 percent in Q1-FY18. This is the highest level of quarterly inflation observed since Q1-FY15 – the period from where global oil prices had begun to soften (**Figure 3.10**).

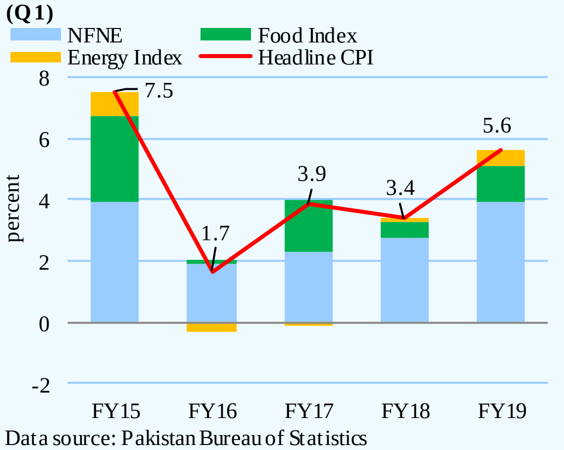
Figure 3.10: Average Headline CPI Inflation



Data source: Pakistan Bureau of Statistics

On the face of it, the most dominating push to headline CPI inflation during the quarter came from non-food-non-energy (NFNE) component, which typically represents the underlying demand pressures in the economy (**Figure 3.11**). However, it is important to highlight here that the increase in NFNE during Q1-FY19 also contained cost-push pressures, particularly the second round effects of higher oil prices as well as PKR depreciation.

Figure 3.11: Composition of Average Headline CPI Inflation (Q1)



Data source: Pakistan Bureau of Statistics

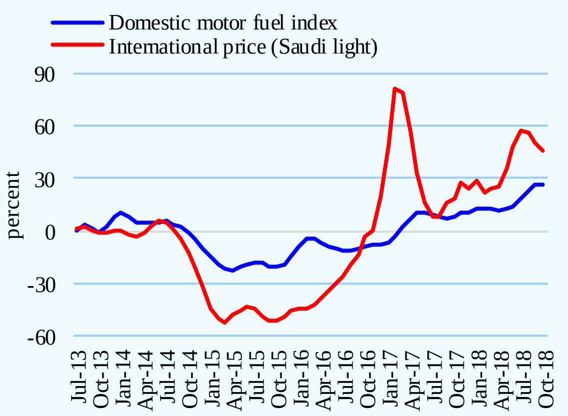
One such item within NFNE is transport services. Here, the entire impact can be attributed to the pass-through of increase in fuel prices (petrol, diesel and CNG). Similarly, motor vehicle prices have also increased by 10.7 percent during Q1-FY19, which the domestic auto assemblers have justified with PKR depreciation and the resultant increase in cost of imported CKDs/SKDs and other auto parts. Other items such as footwear and household equipment, where market supplies primarily contain imported items, also reflect some impact of PKR depreciation in addition to strong demand.

The direct impact of fuel prices on headline CPI inflation was also strong. These contributed nearly 18 percent to the *increase* in headline inflation in Q1-FY19 over the same period last year. Furthermore, food inflation also remained stronger than last year, as prices of major items such as wheat and sugar recovered from their depressed levels that had persisted throughout FY18. This recovery has come at a fiscal cost, since subsidy-led exports played an important role in offloading surpluses. Furthermore, the impact of fuel prices was also felt on most food items, as retailers passed on the impact of higher transportation costs to the consumers. This impact was more pronounced in the case of milk and meat.

Rising global and domestic oil prices

International oil prices continued on their upward trajectory during Q1-FY19. After increasing by 64.5 percent in FY18, price of Saudi Light increased by another 4.6 percent during Q1-FY19. Responding to this, the government has increased the petrol prices by only 1.5 percent (Rs 1.4 per liter) during Q1-FY19. This increase is quite subdued when we consider the following: (i) the government had only partially passed on the impact of increase in global crude prices that were observed in FY18, which suggests that a lagged pass-through of the earlier price increases was due; and (ii) Pak rupee posted a depreciation of 13.7 percent and 2.2 percent against the US dollar during FY18 and Q1-FY19 respectively; its impact on domestic petrol prices was also expected.

Figure 3.12: Changes in Global and Domestic Fuel Prices

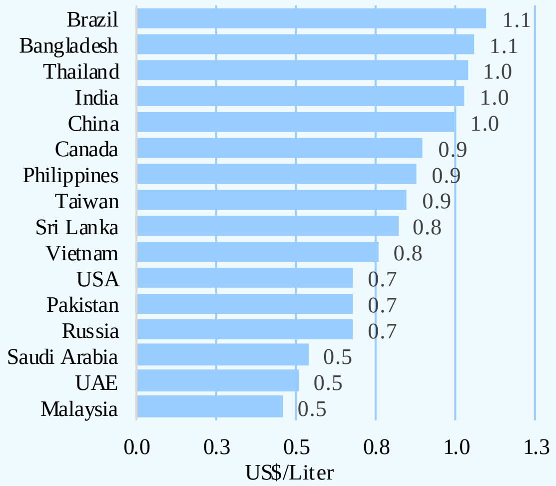


Data sources: PBS and Bloomberg

As shown in **Figure 3.12**, a one-to-one relationship between global and local fuel prices does not exist, especially as governments try to manage the volatility in the domestic fuel markets. That said, a contained increase in petrol prices recently may have also had some political considerations. Since 2018 was an election year, the outgoing government as well as the newly incumbent government, both were reluctant to raise the prices significantly to avoid public criticism. The outcome is that the current level of petrol prices in Pakistan continues to stay closer to the level that is observed across oil exporting countries (**Figure 3.13**). Not only does this entail fiscal burden but it also maintains the domestic petrol demand at an elevated level.

Nevertheless, the prices of transportation services were adjusted upward by 14.4 percent – a double-digit growth after an interval of 6 years. Items that contributed the most to transport inflation were train fares for short distances (less than 100 km), as well as fares of buses and air travel. Together, fuel and transport services contributed about 20 percent of the increase in non-food inflation during Q1-FY19, compared to their combined contribution of 3.4 percent during Q1-FY18.

Figure 3.13: Retail Petrol Prices (as of 14th Jan 2019)



Data source: www.globalpetrolprices.com

Table 3.8: Average CPI Inflation and Contribution from Different Items during Q1
growth in percent, contribution in percentage point

		Growth		Contribution	
	Weight	**FY18**	**FY19**	**FY18**	**FY19**
Overall CPI	**100.0**	**3.4**	**5.6**	**3.4**	**5.6**
Food *of which*	**37.5**	**1.2**	**2.7**	**0.5**	**1.1**
Cigarette	1.4	-16.4	0.6	-0.4	0.0
Wheat flour	4.2	-2.3	3.9	-0.1	0.2
Fresh vegetable	1.7	-5.7	4.0	-0.1	0.1
Tomatoes	0.4	-12.9	22.9	-0.1	0.1
Sugar	1.0	-17.5	-3.3	-0.2	0.0
Pulses	1.1	-17.5	-11.3	-0.3	-0.1
Meat	2.4	7.0	10.8	0.2	0.3
Milk	6.7	3.7	3.9	0.3	0.3
Non Food *of which*	**62.5**	**5.0**	**7.6**	**2.9**	**4.5**
Fuel	3.0	7.2	25.8	0.1	0.5
Transport services	2.7	0.1	14.4	0.0	0.3
Clothing & footwear	7.6	3.9	6.5	0.3	0.5
Education	3.9	10.1	13.7	0.4	0.6
Household equip	4.2	2.8	6.1	0.1	0.3
House rent	21.8	7.2	7.6	1.3	1.5
Recreation	2.0	0.3	6.7	0.0	0.1
Construction index	0.9	4.1	9.4	0.0	0.1
Motor vehicle	0.7	4.1	10.7	0.0	0.1
NFNE	**53.5**	**5.5**	**7.7**	**2.8**	**4.0**

Data source: Pakistan Bureau of Statistics

Food prices normalized during the quarter

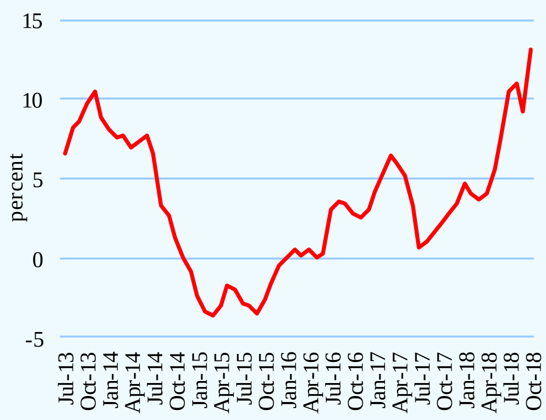
A slightly higher growth in food index was primarily due to the impact of cigarette prices. It may be recalled that the prices of cigarette uncharacteristically tumbled by 16.4 percent during Q1-FY18 due to a change in the duty structure by the government (**Table 3.8**).[11] This year, the prices remained more or less stable. Similarly, the prices of wheat flour, tomato and fresh vegetables also normalized in Q1-FY19 after witnessing a decline last year.

In addition, the prices of sugar and pulses continued to post negative growth during the period under review, although the downward drag was much contained compared to during Q1-FY18. In case of the former, a record sugarcane production and an excess availability had depressed its price last year; this year, increased sugar exports helped stabilize the price in the domestic market.

Cost-push pressures are increasing

With the surge in global commodity prices along with a sharp depreciation of Pak Rupee against the US Dollar, domestic prices of key raw-materials and capital goods have increased in recent months. These items are included in the wholesale price index (WPI), which has recorded a double-digit growth during Q1-FY19 – the first time in the last 7 years (**Figure 3.14**).

Figure 3.14: YoY Growth in WPI Index



Data source: Pakistan Bureau of Statistics

It is important to note that although the inflation in petroleum products was the strongest (especially in the case of kerosene and furnace oil), non-oil products have also experienced a higher inflation compared to the same period last year. These mainly included (i) construction related items, such as cement, steel, pipe fittings etc.; (ii) agriculture inputs, such as tractors, fertilizers and pesticides; and (iii) other industrial inputs like metal and plastic products (**Figure 3.15**).

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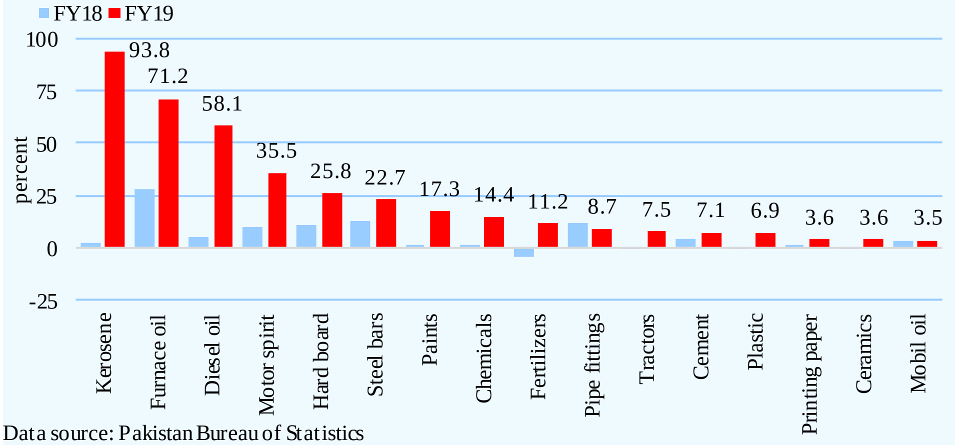
[11] For details, see SBP's First Quarterly Report of 2017-18 on The State of Pakistan's Economy,

Figure 3.15: Increasing Cost Push Pressures (Inflation in Key WPI Items during Q1)



Data source: Pakistan Bureau of Statistics

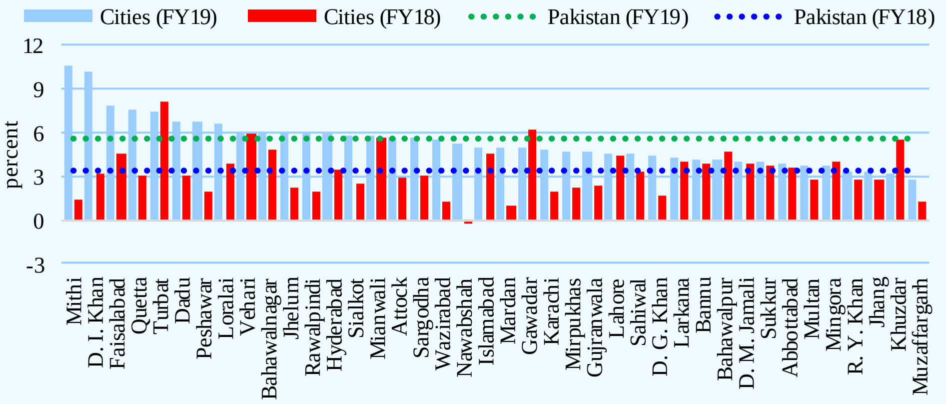
Education

As highlighted in previous quarterly and annual reports of SBP, the education index of CPI has increased by an average of more than 10 percent during the past few years, even when the overall inflation remained quite subdued. In Q1-FY19 also, education witnessed 13.7 percent inflation, whereas the index grew by 10.1 percent during Q1-FY18. Typically, the uptrend in education inflation was led by the private institutions, especially schools. However, in Q1-FY19, fee increase in public institutions was also a major contributing factor.

Skewed inflation rate across cities

Average headline CPI inflation during Q1-FY19 has varied across the 40 cities for which the data is compiled. While the average inflation during the quarter was 5.6

Figure 3.16: City-wise Inflation (Q1)



Data source: Pakistan Bureau of Statistics percent, the range of inflation amongst cities is 7.8 percentage point, with a maximum of 10.6 percent inflation in Mithi to a minimum of 2.8 percent in Muzzafargarh. The range is not different than last year; however, both the minimum and maximum of Q1-FY19 are higher than the same period of FY18.

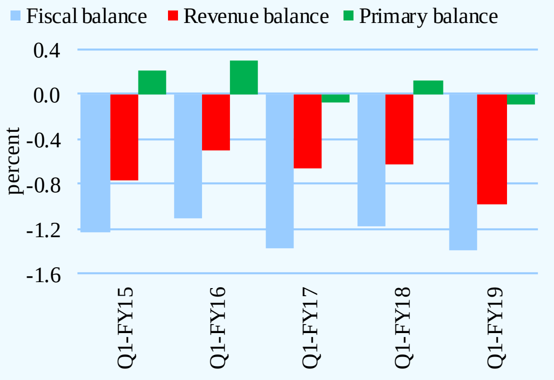
Mithi and Dera Ismail Khan are the cities that stand out for Q1-FY19 in two ways. First, they have the highest inflation amongst the 40 cities within the CPI index during Q1-FY19 (**Figure 3.16**). Second, they are the top 2 cities that showed the highest *increase* in inflation during Q1-FY19 compared to Q1-FY18. At a disaggregated level, nearly all the sub-indices of these cities recorded higher inflation. It is necessary to highlight here that the CPI has equal weights for all the 40 cities. Therefore, inflation in small cities like Mithi and Dera Ismail Khan affects the overall inflation as much as a populous city like Karachi or Lahore. It has been the case that the inflation has been quite volatile (and sometimes higher) in smaller cities (probably due to supply related issues), which eventually translates into a generally high and volatile country-wide inflation as well.

4 Fiscal Policy and Public Debt

4.1 Overview

The fiscal deficit increased to 1.4 percent of GDP in Q1-FY19 as compared to 1.2 percent recorded in the corresponding period of FY18 (**Figure 4.1**). While the overall expenditure growth remained unchanged despite a sizeable cut in development spending, it was the marked slowdown in revenue growth that increased the fiscal gap. In fact, the revenue growth fell short of the rise in current spending as well as non-interest expenditures. This weakened the government's capacity to finance its operational expenses (leading to a higher revenue deficit), and also made it challenging to manage its debt (primary deficit).

Figure 4.1: Fiscal Indicators (percent of GDP)



Data source: Ministry of Finance and SBP calculations

The slowdown in tax revenues can be traced to a number of factors: (i) a sharp reduction in the rate of sales tax applied on major petroleum products in July 2018; (ii) a reduction in corporate and personal income tax rates announced by the government in Q4-FY18; (iii) a sharp fall in PSDP spending, which lowered the withholding tax collection from contracts; and (iv) an overall slowdown in the economy, particularly in the construction-allied industries, which led to lower collections from cement and steel sectors.

On the expenditure front, the major challenge was the steep rise in debt servicing payments, which grew by 13.9 percent during Q1-FY19 compared to 7.5 percent last year. The higher growth can be explained by rising interest rates amid a large (and increasing) volume of public debt, and also by the PKR depreciation, which increased the rupee value of mark-up payments on external debt. Other current expenditures of both the federal (especially defence-related) and the provincial governments also grew sharply.

Thus, facing expenditure rigidities and a slowdown in revenue collection, the government had to cut *discretionary* development expenditures in order to keep the fiscal deficit under check. Still, the overall fiscal deficit increased by Rs 100 billion, or 0.2 percent of GDP, on a YoY basis.

Table 4.1: Summary of Fiscal Operations

billion Rupees

	Actual		Growth (%)	
	Q1-FY18	**Q1-FY19**	**Q1-FY18**	**Q1-FY19**
A. Total revenue	**1,025.1**	**1,102.1**	**18.9**	**7.5**
Tax revenue	911.4	975.2	21.4	7.0
Non-tax revenue	113.7	126.9	1.9	11.6
B. Total expenditure	**1,465.9**	**1,643.8**	**12.8**	**12.1**
Current	1,240.5	1,479.9	15.9	19.3
Interest payments	*445.4*	*507.1*	7.5	13.9
Development	189.9	109.2	-0.6	-42.5
Net lending	0.9	-0.3	-454.4	-127.3
C. Statistical discrepancy	34.6	54.9	-10.3	58.6
Fiscal balance (A-B-C)	**-440.8**	**-541.7**		
Revenue balance*	-215.4	-377.8		
Primary balance**	4.5	-34.6		
Financing	440.9	541.7		
External sources	7.9	210.8		
Domestic sources	432.9	330.9		
Banks	408.0	92.5		
Non-bank	24.5	238.4		
As percent of GDP				
Total revenue	3.0	2.9		
Tax revenue	2.6	2.5		
Non-tax revenue	0.3	0.3		
Total expenditure	4.2	4.3		
Current	3.6	3.9		
Development	0.6	0.3		

*The revenue balance is total revenue less current expenditures. **The primary balance is the fiscal balance excluding interest payments.

Note: The fiscal indicators are based on nominal GDP, calculated using the government's targeted level of GDP growth and inflation for FY19

Data source: Ministry of Finance

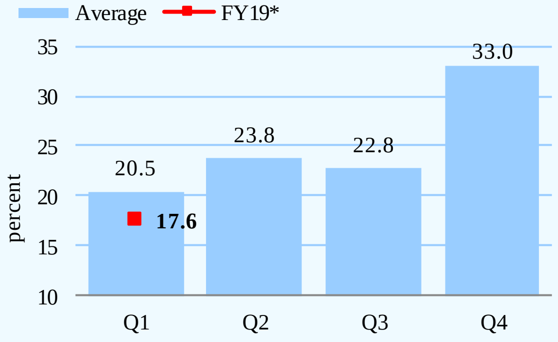
This deficit was financed through increased borrowing from both external and domestic sources (**Table 4.1**). For domestic financing, the government relied primarily on non-bank sources and the SBP, and partially retired its debt to commercial banks. External financing was arranged through bilateral loans, primarily to support the country's balance of payments. Here, it is important to mention that the external debt accumulation in US dollar terms was higher during Q1-FY19 compared to the same period last year, despite revaluation gains of US$ 436 million. These gains represented the impact of the US dollar's appreciation against the Japanese Yen and SDRs.

The overall public debt management remained challenging for the government. First, as the primary balance remained in deficit, the government had to borrow to meet all of its debt obligations. Second, the maturity profile of government domestic debt tilted further towards shorter tenors, as banks were not keen on investing in longer tenor debt instruments in anticipation of an increase in interest rates (**Chapter 3**). This shift in the maturity profile increased the government's exposure to repricing risk.

4.2 Revenue

The pace of revenue collection slowed to 7.5 percent during Q1-FY19 compared to a substantial growth of 18.9 percent observed during Q1-FY18. The slowdown was evident in both federal as well as provincial tax receipts. However, the non-tax revenues increased at a greater pace than last year's, despite a contraction on the provincial front. Importantly, revenue collection growth vis-à-vis the target lagged behind at 17.6 percent during Q1-FY19, compared to the average first quarter performance during the last five years of 20.5 percent (**Figure 4.2**).

Figure 4.2: 5-years Average Share in Revenue Collection



* This represents share in revenue target set in the budget presented in April 2018.
Data source: Ministry of Finance

<u>FBR taxes</u>

The FBR taxes, which contribute around 84.0 percent to the total tax collection, grew by 8.8 percent during Q1-FY19, compared to a 22.0 percent increase witnessed during the same period last year (**Table 4.2**). Both direct and indirect tax collection contributed to this deceleration.

Direct tax collection grew by 5.5 percent during Q1-FY19, compared to the 21.0 percent growth observed during Q1-FY18. The major contributor to this slowdown was the 4.6 percent contraction in withholding tax (WHT) receipts (which have a 72.0 percent share in direct taxes) as opposed to an expansion of 18.0 percent last year.

Table 4.2: FBR Tax Collection in Q1
billion Rupees and percent growth

	Actual		Growth	
	FY18	**FY19**	**FY18**	**FY19**
Direct taxes	282.9	298.5	21.0	5.5
Indirect taxes	482.1	533.8	22.5	10.7
Customs duty	128.9	156.5	27.8	21.5
Sales tax	314.4	335.1	20.2	6.6
Federal excise duty	38.8	42.1	25.0	8.5
Total taxes	765.0	832.3	22.0	8.8
Percent of GDP	2.22	2.16		

Note: The fiscal indicators are based on nominal GDP calculated using government's targeted level of GDP growth and inflation for FY19.
Data source: Federal Board of Revenue

Voluntary payments (VP) also grew by 9.0 percent, but this rate was roughly half of what was observed in the previous year (**Table 4.3**). The Collection on Demand (CoD), a major source of additional resource mobilization, contracted by 0.8 percent compared to an increase of 39.4 percent recorded during Q1-FY18.

The drag in the withholding tax collection largely stemmed from the categories pertaining to contracts, salary income, and dividend income and telephone bills. The scaling down of PSDP had a major impact on receipts from contracts, whereas the suspension of tax on mobile phone top-up led to lower collection

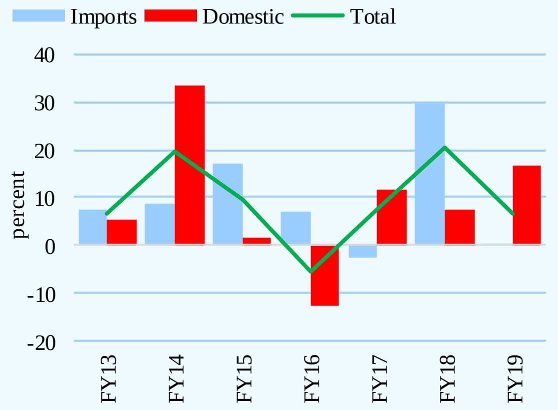
Table 4.3: Break-up of Direct Taxes during Q1

	billion Rupees		Growth (%)	
	FY18	**FY19**	**FY18**	**FY19**
Collection on demand	11.4	11.3	39.4	-0.8
Voluntary payments	66.3	72.3	16.9	9.0
Withholding taxes	224.6	214.2	18.0	-4.6
of which				
Trade	57.3	64.7	14.8	12.9
Contracts	57.0	49.2	25.7	-13.7
Salary	26.7	15.4	28.5	-42.3
Interest & securities	12.1	14.0	12.1	16.0
Cash withdrawal	7.1	8.9	5.6	24.8
Dividends	9.8	8.6	53.9	-12.2
Electric bills	5.9	9.3	9.4	57.1
Telephone	12.1	1.9	-1.0	-84.1
Others	36.5	42.1	11.8	15.2
Gross Income Tax	302.8	324.0	19.8	7.0
Net direct taxes	282.9	298.5	21.0	5.5

Data source: Federal Board of Revenue

from telephone bills. The decline in dividend income was partly due to a reduction in the tax rate on dividends issued to unit holders of REITs.[1]

Figure 4.3: Trend in Sales Tax Collection during Q1



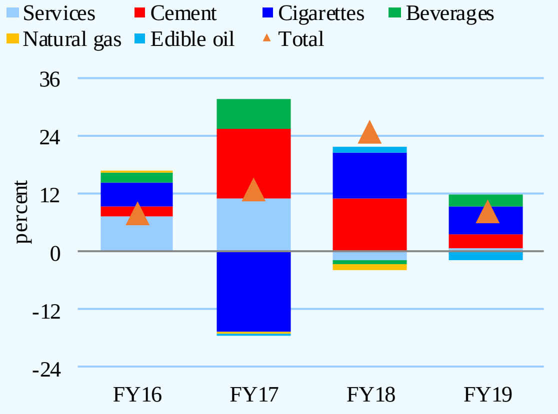
Data source: Federal Board of Revenue

Meanwhile, the growth in indirect taxes decelerated to 10.7 percent during Q1-FY19, almost half of the level achieved during the corresponding period of last year. All the components of indirect taxes (i.e., sales tax, federal excise duty and customs duty) contributed to the deceleration.

Specifically, the growth in sales tax collection, the largest contributor to tax collection, slowed to 6.6 percent in Q1-FY19 from 20.2 percent witnessed during the same period last year (**Figure 4.3**). The drag mainly resulted from a reduction in the sales tax rate on petroleum products by the government.

The sales tax collection at the domestic stage grew by 16.5 percent during Q1-FY19, led by an uptick in taxes from electric energy and food products (particularly cigarettes). However, some of this increase was offset by a decline in sales tax collection from petroleum products. While an upward revision in the rates led to an 8.5 percent growth (mainly from the cigarette and cement segments) in FED collection (**Figure 4.4**), the customs duty collection also grew by 21.5 percent during Q1-FY19 on the back of an increase

Figure 4.4: Contribution to the Growth of FED during Q1

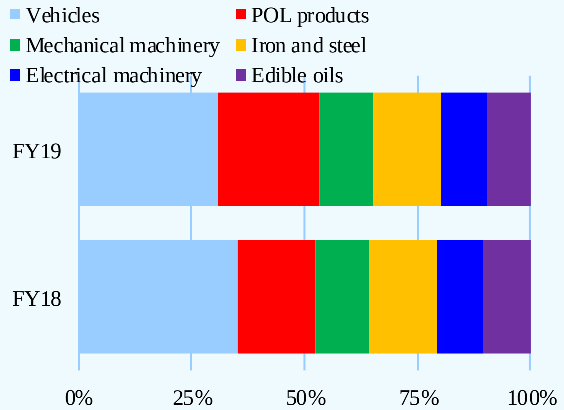


Data source: Federal Board of Revenue

[1] The WHT rate on dividends issued to unit holders of REITs was reduced to 7.5 percent from 12.5 percent in the Finance Act 2018.

in customs/regulatory duty rates on a number of items (**Figure 4.5**).

Figure 4.5: Composition of Custom Duty Collection during Q1



Data source: Federal Board of Revenue

Non-tax revenues

Non-tax revenues grew by 11.6 percent during Q1-FY19 compared to a marginal increase of 1.9 percent recorded in the corresponding period last year. The growth remained broad-based, with positive contributions coming from almost all the major components; though categories benefitting from higher interest rates and commodity prices figured more prominently (**Table 4.4**).

Table 4.4: Non-tax Revenues in Q1

billion Rupees

	Actual	
	FY18	**FY19**
Mark-up (PSEs and others)	0.6	1.2
Dividends	0.4	4.5
SBP profits	45.0	50.7
Defence (including CSF)	2.7	2.4
Profits PTA/post office	5.4	6.1
Royalties on gas and oil	13.0	23.6
Discount retained on crude oil	2.1	3.1
Windfall levy against crude oil	0.4	2.1
Others	40.0	29.9
Total non-tax revenue	113.7	126.9

Data source: Ministry of Finance

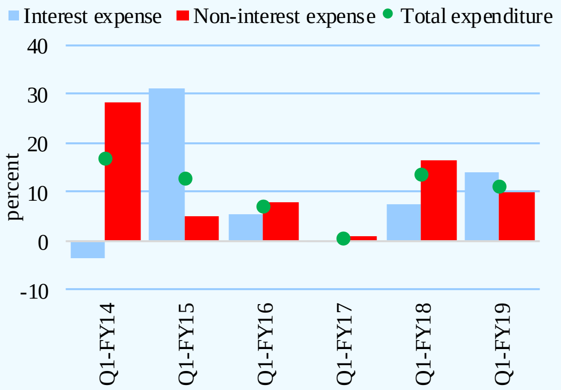
4.3 Expenditure

Consolidated fiscal expenditures rose by 11.0 percent during Q1-FY19, against the 13.5 percent growth recorded during the same period last year. Despite a sharp growth in current spending, a significant cut in development expenditures led to the overall deceleration (**Figure 4.6** and **Table 4.5**).

Federal current spending grew by 18.1 percent during Q1-FY19, compared to the 11.7 percent increase witnessed during Q1-FY18. This was mainly led by growing non-discretionary interest payments. The higher growth in interest payments was due to: (i) an increase in the volume of public debt; (ii) higher markup rates (both in the domestic market and in LIBOR terms); and (iii) an increase in interest payments of external debt in rupee terms due to the PKR depreciation. Provincial current spending, on the other hand, grew by 22.0 percent as compared to the 25.9 percent in the same period last year.

By contrast, the development expenditures declined sharply by 42.5 percent during the quarter compared to a decline of 0.6 percent witnessed in the last corresponding period. The contraction was broad-based, as PSDP spending at both the federal and the provincial fronts declined (**Figure 4.7** and **Figure 4.8**).

Figure 4.6: The Trends in Expenditure Growth



Data source: Ministry of Finance

Table 4.5: Fiscal Spending
billion Rupees

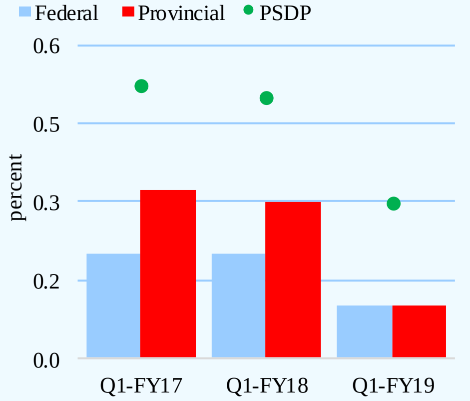
	Q1			Growth (%)	
	FY18	FY19	Abs. change	FY18	FY19
Current expenditures	**1,240.5**	**1,479.9**	**239.4**	**15.9**	**19.3**
Federal	846.4	999.3	152.8	11.7	18.1
of which					
Interest payment	445.4	507.1	61.7	7.5	13.9
Defense	181.9	219.4	37.5	20.1	20.6
Public order and safety	27.9	32.7	4.8	16.2	17.1
Others	191.2	240.1	48.9	13.8	25.5
Provincial	394.1	480.7	86.6	25.9	22.0
Development expenditures	**189.9**	**109.2**	**-80.7**	**-0.6**	**-42.5**
PSDP	165.0	106.6	-58.4	-1.3	-35.4
Federal	69.5	50.9	-18.6	8.4	-26.8
Provincial	95.4	55.7	-39.7	-7.4	-41.6
Others (including BISP)	24.9	2.6	-22.3	3.9	-89.5
Net lending	0.9	-0.3	-1.2	-454.4	-127.3
Total Expenditure*	**1,431.3**	**1,588.9**	**157.6**	**13.5**	**11.0**

* Excluding statistical discrepancy
Data source: Ministry of Finance

4.4 Provincial Fiscal Operations

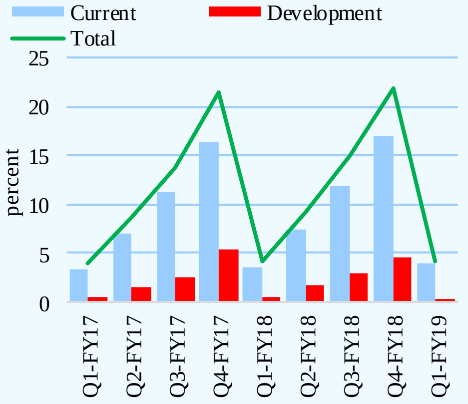
The consolidated provincial surplus reached Rs 196.7 billion during Q1- FY19, about 68 percent of the target; Punjab and Sindh were the biggest contributors (**Figure 4.9**). The higher surplus was on the back of a surge in revenue collection (largely stemming from the constitutional share of provinces) and a deceleration in expenditure growth (**Table 4.6**).

Figure 4.7: PSDP Trends during Q1 (% of GDP)



Data source: Ministry of Finance and SBP calculation

Figure 4.8: Trends in Spending (% of GDP)

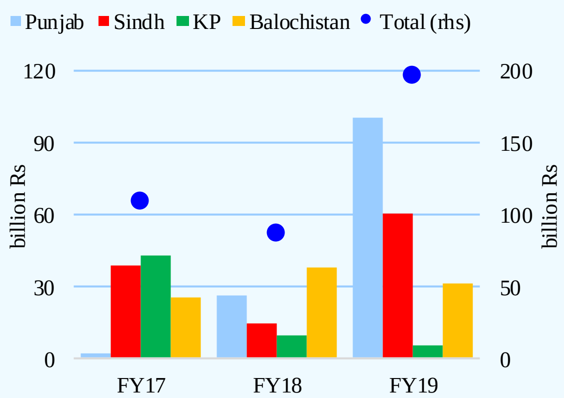


Data source: Ministry of Finance and SBP calculation

Provincial revenue

The consolidated provincial revenues grew sharply by 36.9 percent during Q1-FY19 against the 15.1 percent increase recorded during the same period last year. The relatively higher growth this year was mainly supported by a rise under the provinces' share in federal transfers; the provinces' own revenue collection, on the other hand, declined by 9.6 percent on YoY basis.[2]

Figure 4.9: Provincial Surplus during Q1



Data source: Ministry of Finance

The decline in the provinces' own revenue is attributed to a stagnation in the General Sales Tax on Services (GSTS), a decline in property taxes, and a deceleration in almost all the main tax revenue spinners **(Figure 4.10)**. Already having a negligible share in the total provincial revenue collection, the slower growth in almost all the revenue spinners necessitates the provincial performance in revenue mobilization.

[2] The federal transfers may vary across quarters with no discernable pattern. The increase recorded in Q1-FY19 might be for supporting the ongoing projects in the provinces.

Table 4.6: Provincial Fiscal Operations during Q1
billion Rupees and percent growth

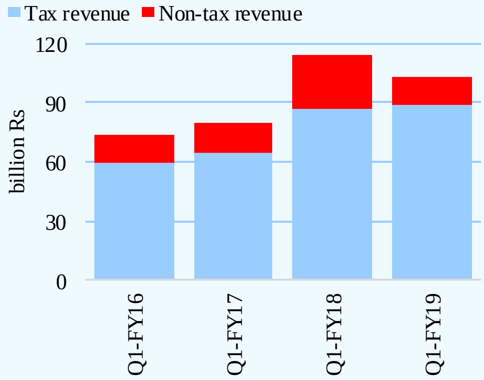
	Punjab	Sindh	KP	Balochistan	Total	Growth
FY19						
A. Total revenue	390.6	209.4	116.0	71.2	787.2	36.9
Provincial share in federal revenue	325.8	163.4	107.7	65.9	662.9	54.6
Provincial own revenue (I+II)	51.0	43.0	5.9	3.2	103.2	-9.6
I. Taxes	42.6	39.9	4.1	2.0	88.6	2.0
II. Non-tax revenue	8.5	3.1	1.8	1.3	14.6	-46.6
Fed loans and transfers	13.7	3.0	2.3	2.1	21.1	-34.6
B. Total expenditure	264.1	145.3	86.6	44.6	540.6	9.6
Current**	233.8	132.2	75.8	43.1	484.9	21.9
Development	30.3	13.1	10.8	1.5	55.7	-41.6
Gap (A-B)	126.5	64.1	29.4	26.7	246.6	200.5
Financing* (overall balance)	-100.0	-60.5	-4.9	-31.4	-196.7	128.3
FY18						
A. Total revenue	280.1	153.7	76.2	65.2	575.2	15.1
Provincial share in federal revenue	200.7	106.2	66.3	55.5	428.7	2.9
Provincial own revenue (I+II)	58.0	41.8	6.5	7.9	114.2	43.6
I. Taxes	45.0	36.0	4.0	1.8	86.9	34.7
II. Non-tax revenue	13.0	5.8	2.5	6.1	27.4	81.8
Fed loans and transfers	21.4	5.6	3.4	1.8	32.3	783.0
B. Total expenditure	248.6	139.2	66.6	38.7	493.0	17.6
Current**	182.9	119.9	56.8	38.0	397.6	25.8
Development	65.7	19.3	9.8	0.7	95.4	-7.4
Gap (A-B)	31.5	14.5	9.6	26.5	82.1	2.0
Financing* (overall balance)	-25.7	-14.1	-9.1	-37.4	-86.2	-20.6

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

The provincial non-tax revenue declined to Rs 14.6 billion during Q1-FY19, about half the amount recorded in the last corresponding period. The contribution from major revenue sources, such as profits from hydroelectricity and irrigation, remained negligible.

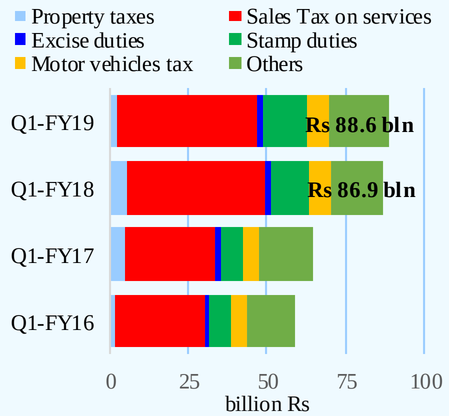
The growth in provincial spending slowed down to 9.6 percent as compared to a 17.6 percent growth recorded in the corresponding period of last year. This is mainly attributed to a sharp decline in development spending, along with a slight deceleration in current expenditures. The current provincial spending grew by 21.9 percent, after rising 25.7 percent in the same period last year. However, the provincial development spending declined by 41.6 percent during Q1-FY19, steeper than the 7.4 percent decline recorded last year (**Figure 4.11**).

Figure 4.10a: State of Provincial Own Revenue during Q1



Data source: Ministry of Finance

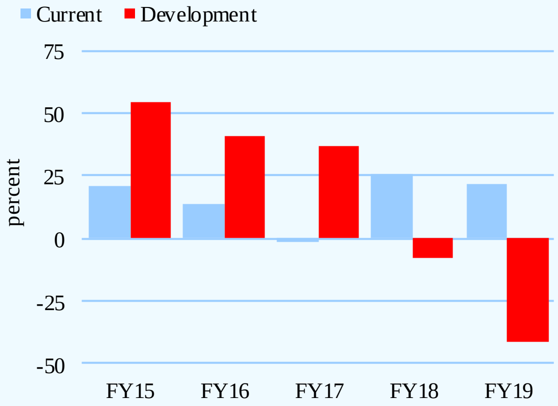
Figure 4.10b: State of Provincial Tax Revenue during Q1



Provincial spending

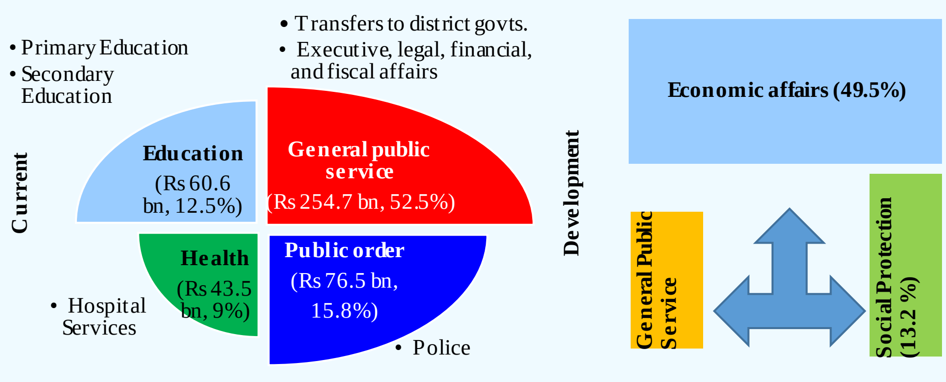
The disaggregated data shows that the provincial current expenditures were mainly directed towards general public services, followed by public order, safety and educational affairs. Along with the usual allocations to general services (including transfers, financial, legal, and fiscal affairs), about 78 percent of the expenditures were assigned to *public order*, with the Police department receiving the major share. Meanwhile, the expenditures incurred on economic affairs were mainly focused on agriculture, construction and transport segments **(Figure 4.12)**.

Figure 4.11: Growth in Provincial Expenditure during Q1



Data source: Ministry of Finance

Figure 4.12: Provincial Spending Preferences during Q1-FY19 (billion rupees and percent shares)



Data source: Ministry of Finance

4.5 Public debt

The country's public debt grew by 3.3 percent during Q1-FY19, slightly higher than the 3.0 percent growth observed during the same period last year. In absolute terms, the public debt stock reached Rs 25.8 trillion by end-September 2018, from Rs 25.0 trillion at end-June 2018 (**Table 4.7**). Unlike last year, when around 80.0 percent of the increase came from domestic sources, only 60.6 percent of the YoY uptick in public debt was contributed by domestic debt in Q1-FY19. The contribution of external debt increased primarily as the exchange rate depreciation increased its rupee value.

Table 4.7: Pakistan's Public Debt Profile

billion Rupees

	Stock				Flow (Q1)	
	Jun-17	**Sep-17**	**Jun-18**	**Sep-18**	**FY18**	**FY19**
Public debt	21,408.7	22,056.0	24,952.9	25,783.4	647.4	830.6
Domestic debt	14,849.2	15,371.7	16,416.3	16,919.8	522.5	503.6
Government external debt	5,918.7	6,029.8	7,795.8	8122.9	111.1	327.1
Debt from the IMF	640.8	654.5	740.8	740.7	13.8	-0.1

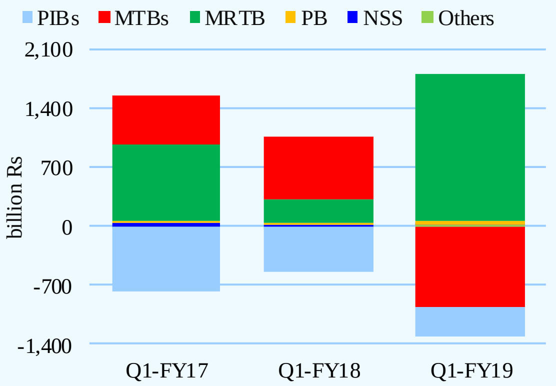
Data source: State Bank of Pakistan and Economic Affairs Division

Domestic debt

The government's domestic debt grew by 3.1 percent in Q1-FY19 as compared to a rise of 3.5 percent recorded during Q1-FY18. Even though the growth was lower this year, the composition of the domestic debt shifted towards non-bank sources and borrowings from the central bank (**Figure 4.13**).

The government's reliance on non-bank sources remained higher than last year (**Table 4.8**). In case of tradable securities, the holding of T-bills by corporates recorded a significant increase during the period. From NSS, the government was able to raise only Rs 10.5 billion during Q1-FY19, while inflows from prize bonds increased significantly to Rs 42.1 billion, from Rs 26.6 billion in Q1-FY18.

Figure 4.13: Composition of Domestic Debt during Q1 (flows)



Data source: State Bank of Pakistan

The government mainly borrowed from the SBP to retire its debt held by the commercial banks. During Q1-FY19, the government borrowed Rs1,749.5 billion from the SBP and retired Rs 1,488.0 billion to the commercial banks.

Despite higher returns on government securities in Q1-FY19, the bidding pattern of commercial banks was largely driven by the tightening of the monetary policy stance. During Q1-FY19, the commercial banks remained mainly interested in the 3-month T-bills, as the 12-month T-bills failed to attract even a single bid (**Table 4.9**).

Table 4.8: Change in Non-bank Holding of Domestic Debt

billion Rupees

	FY18	Q1-FY18	Q1-FY19
T-bills	175.6	111.1	146.3
Other securities	-73.3	-143.0	38.7
NSS (including prize bonds)	206.7	45.7	57.0
of which			
DSC	10.7	0.9	-0.1
SSC	-51.2	-11.7	3.5
BSC	45.4	12.8	20.6
SSA	59.9	18.5	-34.9
Prize bond	103.9	26.6	42.1
Total	309.0	13.7	242.0

Data source: State Bank of Pakistan

In case of fixed rate PIBs, the overall bids remained miniscule relative to T-bills, and the offered amount was only 14.1 percent of the maturities during the quarter. In contrast, banks' participation in the auctions of 10-year floating rate PIBs (launched by the government in May 2018) was relatively better. Against the target of Rs 150.0 billion in Q1-FY19, banks offered Rs 151.5 billion; this was more than five times the maturity of 10-year fixed rate PIBs.

Table 4.9: Auction Profile of Government Securities (Face Value)
billion Rupees

	Q1-FY18				Q1-FY19			
	Offer (competitive)	Maturity	Accepted	Accepted net of maturity	Offer (competitive)	Maturity	Accepted	Accepted net of maturity
MTBs								
3-M	3,501.6	1,800.4	3,463.1	1,662.7	5,093.0	5,612.9	4,685.9	(927.0)
6-M	942.8	1,391.0	895.5	(495.5)	26.0	0.0	1.1	1.1
12-M	66.8	490.1	47.7	(442.4)	0.0	47.7	0.0	(47.7)
Total	4,511.2	3,681.5	4,406.3	724.8	5,119.0	5,660.6	4,687.0	(973.6)
PIBs								
3-Y	60.4	376.3	23.4	(353.0)	22.9		0.0	
5-Y	18.4	196.4	10.2	(186.2)	23.7	426.1	20.6	(405.5)
10-Y (fixed)	28.5	23.9	22.1	(1.8)	18.7	35.0	0	-35.0
10-Y (floating)					151.5	0	101.5	101.5
Total	107.3	596.6	55.7	(540.9)	216.7	461.1	122.1	(339.0)

Data source: State Bank of Pakistan

Public external debt

The stock of public external debt rose by US$ 1.1 billion during Q1-FY19 and reached US$ 71.3 billion by end-September 2018 (**Table 4.10**). Despite higher debt servicing, the increase in public external debt was higher during Q1-FY19 as compared to Q1-FY18. This increase largely stemmed from the government's borrowing from bilateral sources.

Table 4.10: Public External Debt
billion US dollars

	Stock				Flow	
	Jun-17	**Sep-17**	**Jun-18**	**Sep-18**	**Q1-FY8**	**Q1-FY19**
A. Government debt	56.4	57.2	64.1	65.4	0.8	1.2
Of which						
Paris club	12.0	12.1	11.6	11.5	0.1	-0.1
Multilateral	27.6	27.9	28.1	27.6	0.3	-0.5
Other bilateral	6.3	6.8	8.7	10.8	0.4	2.2
Bonds	4.8	4.9	7.3	7.3	0.0	0.0
Commercial loans	4.8	4.9	7.5	7.2	0.1	-0.2
Multilateral (ST)	0.8	0.7	1.0	0.9	-0.1	-0.1
B. Debt from IMF	6.1	6.2	6.1	6.0	0.1	-0.1
Total (A+B)	62.5	63.4	70.2	71.3	0.9	1.1

Data source: State Bank of Pakistan and Economic Affairs Division

Moreover, revaluation gains due to the depreciation of major currencies against the US dollar reduced the dollar value of country's external debt by US$ 436.7 million during Q1-FY19. Nearly 77 percent of these gains were due to the US dollar's appreciation against the Japanese Yen and the Special Drawing Rights (SDR) during the period.[3]

External debt servicing increased

Pakistan's external debt servicing went up by US$ 214.1 million during Q1-FY19 over Q1-FY18. In fact, principal and interest payments observed almost a similar increase during the quarter (**Table 4.11**). The increase in principal payments was due to higher amortization of multilateral, bilateral and short-term debt. The higher interest expense, on the other hand, was mainly driven by a rise in the benchmark rate (i.e. LIBOR).

Table 4.11: Public External Debt Servicing during Q1
million US dollars

	FY18	FY19	Change
Principal			
I. Public debt (a+b)	1,349.1	1,458.4	109.3
a. Government debt	1,349.2	1,374.5	25.4
Paris club	25.2	25.1	-0.1
Multilateral	392.8	412.2	19.4
Other bilateral	78.1	139.8	61.8
Commercial loans/credits (LT)	408.0	200.0	-208.0
Short term	445.1	597.5	152.4
b. IMF	0.0	83.9	83.9
Interest			0.0
II. Public debt (a+b)	291.1	395.9	104.8
a. Government debt	260.2	360.2	100.0
Paris club	8.0	6.3	-1.6
Multilateral	89.7	113.9	24.1
Other bilateral	79.4	98.9	19.5
Euro/Sukuk bonds	0.1	32.7	32.6
Commercial loans /credits(LT)	55.7	90.2	34.5
Multilateral (ST)	27.3	13.6	-13.8
b. IMF	30.9	35.7	4.8
Total (I+II)	1,640.2	1,854.3	214.1

Data source: State Bank of Pakistan

[3] External debt denominated in Japanese Yen and SDR constituted around 38 percent of external debt stock and these currencies depreciated by 2.8 and 0.8 percent against US$ respectively, resulting decline in the dollar value of external debt as on end September 2018.

5 External Sector

5.1 Overview

Pakistan's balance of payments continued to present a challenging picture in Q1-FY19, as a significant uptick in global oil prices pushed the country's energy import payments past the US$ 4.0 billion-mark for the first time since Q1-FY15. This offset much of the gains from a decline in non-energy imports, continued growth in exports, and a healthy uptick in workers' remittances. As a result, even though the current account deficit (CAD) declined slightly for the first time in over two years, it stayed at an elevated level of US$ 3.6 billion in Q1-FY19 (**Table 5.1**).

This deficit could only partially be financed by available financial inflows, as foreign investments could not keep up last year's momentum. Even in terms of liabilities, only the official borrowings provided some support, as external borrowings by banks and the non-financial private sector dried up. Thus, with financial inflows falling short, the remaining deficit had to be financed from SBP's FX reserves, which declined US$ 1.4 billion during the quarter. The exchange rate also remained under pressure and depreciated by 2.2 percent during Q1-FY19.

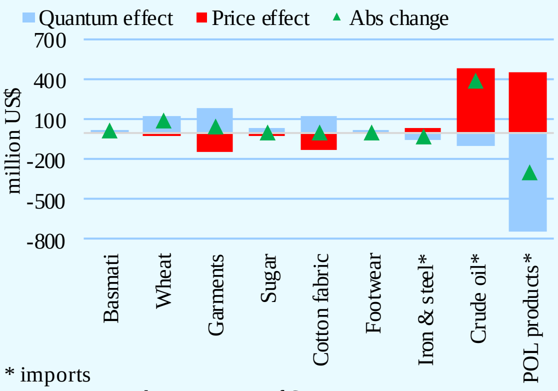
Table 5.1: Pakistan's Balance of Payments
million US dollars

	Q1-FY18	Q1-FY19	Absolute change
Current account balance	-3,761	-3,622	139
Trade balance	-7,314	-7,848	-534
Exports	5,679	5,897	218
Imports	12,993	13,745	752
Oil	2,945	4,130	1,185
Non-oil	10,048	9,615	-433
Services balance	-1,276	-904	372
Primary income balance	-1,057	-1,098	-41
Secondary income balance	5,886	6,228	342
Workers' remittances	4,790	5,420	630
Capital account balance	107	103	-4
Financial account balance	-1,870	-2,391	-521
Direct investment inflow	765	439	-326
Portfolio investment inflow	-126	-185	-59
Other investment	-1,205	-2,086	-881
Net incurrence of liabilities.	817	1,700	883
Gen. government	126	1,561	1,435
Banks	333	73	-260
Private (excluding banks)	358	65	-293
SBP's reserves (end-period)	13,857	8,409	-5,449
Total reserves (end-period)	19,775	14,921	-4,854
PKR app(+)/dep(-) in percent	-0.53	-2.21	-

Data source: State Bank of Pakistan

Notwithstanding the continued BoP stress during the quarter, it is important to note a few emerging trends as the economy now enters a stabilization phase. First, as the government has cut down its development spending and as early-harvest CPEC projects approach completion, the import of power generation and electrical machinery has remained subdued. In fact, a sharp fall in machinery-related payments contributed the most to the declining non-oil import bill in Q1-FY19. Similarly, the imposition of a ban on non-filers from purchasing cars suppressed the domestic car sales and CBU imports alike; the growth in CKD imports was also lower as compared to last year. Furthermore, a broad-based decline in quantum imports suggests that the overall shift in the policy mix towards stabilization and demand-compression appears to be yielding the desired results. The policy shift is reflected by the exchange rate adjustments, 200 bps policy rate hike, pass-through of the increase in the oil prices to domestic prices, cuts in development expenditure, and the raising of customs duty and imposition of cash margins on a wide range of consumer imports.

Figure 5.1: Breakdown of Change in Pakistan's Major Export & Import Items



* imports
Data source: Pakistan Bureau of Statistics

Second, the country's external account has taken a setback from worsening terms of trade. Specifically, the unit prices of Pakistan's principal imports, petroleum and its products, have risen quite significantly this year, whereas those of its major exports, particularly garments, wheat, basmati rice and sugar, have dropped (**Figure 5.1**). In the case of exports, the growth in FX receipts slowed down to just 3.8 percent in Q1-FY19 from 12.4 percent last year, as lower unit prices partially offset the growth in quantum exports of a number of items. On the other hand, energy import payments reached their highest level in four years, at US$ 4.1 billion. With international oil prices on average 50.9 percent higher in Q1-FY19 as compared to Q1-FY18, the savings from lower quantum energy purchases (excluding LNG), as well as a decline in non-energy imports, were completely offset.

Third, attracting private financial inflows has become challenging for the country, as the completion of early harvest CPEC projects has led to a 42.6 percent contraction in net FDI (mostly from China), as well as a drop in external borrowing by mainly private power sector firms.[1] Furthermore, outflows from portfolio investment also accelerated this year. Under such circumstances, the burden of arranging BoP financing is falling disproportionately on official sources. Here, too, IFI funding is not forthcoming and therefore, Pakistan is counting increasingly on government-to-government funding arrangements.

So, in sum, the depleting FX reserves and the country's access to limited external financing during Q1-FY19 have led to increased external vulnerability. SBP's FX reserves had reached US$ 8.4 billion by the end of September, with the import coverage falling below the 2-month mark. This has come at a time when geopolitics and trade-related tensions between the US and China are impacting key commodity prices and creating uncertainty about the demand dynamics in some of the major export destinations for Pakistan (as discussed in **Box 5.1**). Building FX buffers has therefore become important. On a positive note, the government has recently managed to sign trade and investment agreements with Saudi Arabia, China, UAE and Malaysia, and short-term BoP support has already materialized from some of these countries. That said, for attaining medium to long-term external sector sustainability, instituting reforms that stimulate efficiency and competitiveness, and discourage rent-seeking in the economy, are needed.

Box 5.1: Opportunities and Challenges for Pakistan Amid US-China Trade Tensions

The ongoing tensions between the US and China has contributed to big swings in key commodity prices and has added uncertainty to the global trade dynamics.[2] Together, the US and China accounted for 21.8 percent of global exports and 23.5 percent of worldwide imports in 2017.[3] Bilateral trade between these two amounted to US$ 584.8 billion in 2017, accounting for 3.3 percent of global trade in the year.

Since July 2018, additional tariffs have been imposed on US$ 360.0 billion of goods traded between the US and China, which account for 61.6 percent of the bilateral trade between the two countries last year. China has been hit harder as US$ 260.0 billion of its exports are now attracting higher tariffs in the US; against this, US$ 100.0 billion of American exports to China are affected by the retaliatory tariffs. These tariffs are in addition to across-the-board tariffs on iron and steel products that the US had put in place in May 2018.

For Pakistan, the imposition of these cross-tariffs offers some interesting opportunities as well as challenges. On a positive note, key food items, such as rice, seafood and soybean (both seeds and oil), have come in the crosshairs, which offer an opportunity for Pakistan to reduce its trade deficit.

[1] A large chunk of this YoY decline in FDI (51.3 percent) came from China. This was in line with the progress on early harvest CPEC-related power projects, most of which have either been concluded or are nearing completion.
[2] So far in FY19, the IMF, World Bank and WTO have all lowered their projections of global economic growth and trade volumes.
[3] Source: International Trade Center.

On the other hand, the volatility in iron and steel prices in recent months after the imposition of tariffs by the US presents a challenge from Pakistan's perspective.

Impact on Pakistan's exports

Among the thousands of items on which additional tariffs have been imposed by the two countries, three product categories stand out from Pakistan's exports standpoint: seafood, rice and cotton (raw cotton, fabric and yarn). Specifically, American seafood exports to China are now much costlier as a result of the tariffs, as are Chinese exports of rice and cotton items to the US.

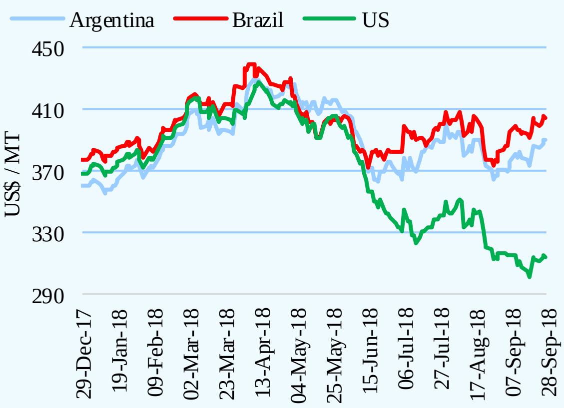
Seafood: China is a major global importer of seafood items, and imported 16.3 percent of its overall seafood imports from the US in 2017 (worth US$ 1.3 billion). It mainly imports lobsters, oysters, flatfish and sardines, all of which are now attracting additional tariffs, and all of which are also exported by Pakistan. Pakistan's global exports of these specific products amounted to US$ 338.9 million in FY18 and constituted 75.1 percent of the country's overall seafood exports in FY18. As the US' seafood exports to China have now become much costlier, Pakistani exporters might increase their presence in the Chinese market.

Impact on Pakistan's Imports

Though Pakistan can benefit from the diverging trend in soybean prices, its iron and steel imports may come under strain from the trade tensions.

Soybean: China is the world's largest importer of soybean, and the US is the second-largest producer and exporter of the commodity, after Brazil. Importantly, soybean is the US' single largest export item to China, and the country accounted for 56.9 percent of the US' soybean exports in 2017 and 9.4 percent of the US' total exports to China.

Figure 5.1.1: Divergence in Soybean Export Prices



Data source: USDA

Given these dynamics, soybean was among the first items targeted by China when the first round of retaliatory tariffs went into effect in July 2018. China then shifted its demand for soybeans to Brazil and Argentina. As a result, soybean export prices of Brazil and Argentina have spiked, whereas those of the US have plunged since the tariffs went into effect (**Figure 5.1.1**). This presents an opportunity for edible oil mills in Pakistan to reduce their imports of soybean oil and seed in value terms by diverting their purchases to the US, where the prices are falling.

Encouragingly, there are indications that this switch is already taking place. Brazil's share in Pakistan's overall soybean imports (both seeds and oil) fell to 49.5 percent in FY18 from 58.4 percent in FY17, whereas the US' share rose to 45.4 percent from 32.1 percent. Further enhancing soybean imports from the US will yield more FX savings for Pakistan, assuming that the US prices stay depressed in the wake of a record-high projected inventory level for 2018-19.[4] This dynamic also helped Pakistan's soybean oil imports in Q1-FY19, when the unit value imports were 20.3 percent lower as compared to Q1-FY18.

Table 5.1.1: US's Imports of Iron & Steel Products Attracting Across-the-Board Tariffs

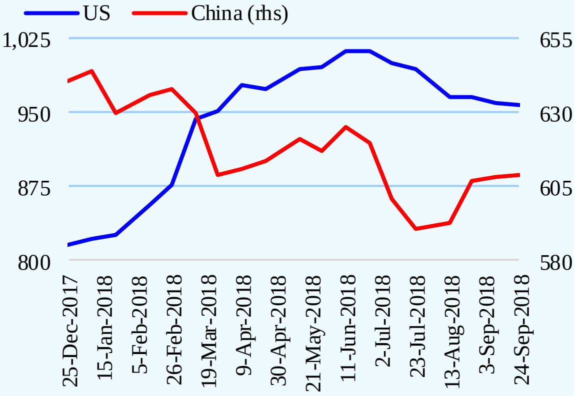
	Values (million US dollars)		**Growth (% change, YoY)**		**Shares (%)**	
	2017	**Jun-Sep 2018**	**2017**	**Jun-Sep 2018**	**2017**	**Jun-Sep 2018**
Canada	5,152.2	1,654.7	27.6	-3.4	18.2	18.1
South Korea	2,790.9	692.1	18.9	-36.6	9.9	7.6
Mexico	2,411.5	861.3	26.9	-0.7	8.5	9.4
Brazil	1,869.2	934.3	55.6	40.8	6.6	10.2
Japan	1,653.4	522.6	0.9	-12.8	5.9	5.7
Germany	1,506.8	500.4	17.5	-8.2	5.3	5.5
Russia	1,387.4	398.6	107.2	-30.5	4.9	4.4
China	1,001.7	254.4	8.4	-30.8	3.5	2.8
Others	10,466.4	3,331.1	39.9	-15.0	37.1	36.4
Total	**28,239.4**	**9,149.5**	**31.4**	**-11.5**	-	-

Data source: US Census Bureau

Iron and steel: Iron and steel prices have been volatile ever since they came under the crosshairs of US tariffs. These tariffs were applied in two phases. In the first phase in May 2018, the US imposed additional tariffs *across the board* on roughly 44.0 percent of the iron and steel products that it imported. These tariffs particularly affected the US' neighbors and allies (specifically Canada, Mexico, South Korea and Japan), instead of China. However, some of these countries were later exempted from the tariffs after they agreed to export quotas. While China is the largest exporter of overall iron and steel products to the US, its share in the *specific* products attracting the additional tariffs was minimal (**Table 5.1.1**).

In September 2018, with anti-trade measures in full swing, the US targeted the bulk (49.1 percent) of the iron and steel products that it imported from China (and which were not part of the earlier across the board tariffs), and imposed additional tariffs on them. For these specific products, China was the single largest exporter to the US, with a market share of 27.0 percent in Jan-Sep 2018.

Figure 5.1.2: Trends in Cold Rolled Coil (CRC) Prices in US & China (US$/MT)



Data source: Steel Benchmarker

[4] According to the US Department of Agriculture, soybean inventory in the US is projected to more than double to 885.0 million bushels by end-Sep 2019, from 438.0 million bushels by end-Sep 2018. A significant increase in the crop's yield, coupled with tepid ex-China global demand, is credited with the projected stock build-up.

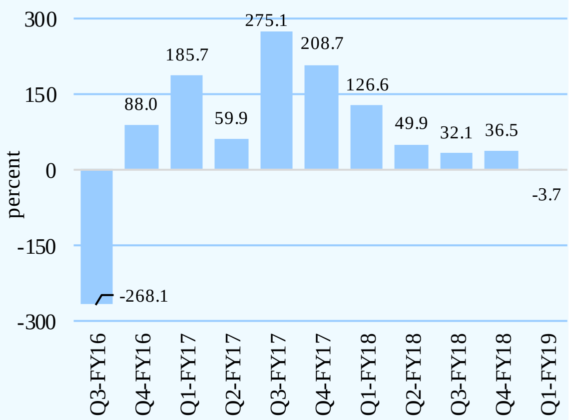
Steel prices in China also present a complicated picture. Prices were falling during the first half of 2018, as uncertainty loomed about the extent of the protectionist measures that would be adopted by the US. Further downward pressure came from a cooling off in China's economy this year, which has impacted its demand for steel. However, Chinese steel prices have been rising since August 2018 (**Figure 5.1.2**), partly as a result of an expected drop in steel production in the winter months as the country tries to limit the harmful emissions and control smog.

All of this uncertainty has created challenges for Pakistan, as the unit value of the country's iron and steel imports (both scrap and finished products) has been rising, though with significant fluctuations. Even though Pakistan imports most of its steel from China, the unit value of its steel imports have not dipped. Nonetheless, a slowdown in broader economic activity as the country tries to stabilize its economy, has already stalled the demand for imported iron and steel products. In Q1-FY19, quantum imports of these items have already dropped 10.1 percent on YoY basis.

5.2 Current Account

Tapering demand for machinery, along with the demand compression measures taken by the government in the recent past, arrested the growth in import payments in Q1-FY19. This, coupled with a sharp rise in workers' remittances and a steady increase in exports, led the current account deficit to decline by a marginal 3.7 percent YoY; this was the first drop in 10 quarters (**Figure 5.2**).

Figure 5.2: Growth in Current Account Deficit (YoY)



Data source: State Bank of Pakistan

This moderation was observed in the months of August and September; in July 2018, the current account deficit had hit US$ 2.1 billion, as the country cleared the payment backlog for earlier oil purchases. Oil payments had risen by 69.6 percent YoY during the month to US$ 1.8 billion, which was the highest monthly level ever.

Table 5.2 Pakistan's Trade in Services
million US dollars

	Value in Q1			Growth (%)	
	FY17	FY18	FY19	FY18	FY19
Exports	1,204	1,312	1,290	9.0	-1.7
Imports	2,366	2,588	2,194	9.4	-15.2
Trade Balance	-1,162	-1,276	-904	9.8	-29.2

Data source: State Bank of Pakistan

Services Account[5]

The services trade deficit narrowed by 29.2 percent and reached US$ 0.9

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

billion in Q1-FY19. Despite a marginal decline of 1.7 percent in the services exports, the fall of 15.2 percent in the services import payments kept the services deficit relatively contained **(Table 5.2)**.

Importantly, the decline in the services imports was broad-based, as transport, travel, and government services imports all witnessed significant declines (**Table 5.3**). Within transport, the import of freight services declined by 20.0 percent in Q1-FY19 due to a lower quantum of merchandise imports. This is in contrast to Q1-FY18, when freight imports had risen by 26.9 percent.

Table 5.3: Key Services Imports in Q1
million US dollars

	FY17	FY18	FY19
Transport	907	946	864
Travel	590	611	418
Telecom, Comp, &Info	111	119	112
Other Business	430	536	527
Government	119	158	119
Others	209	218	154
Total	**2,366**	**2,588**	**2,194**

Data source: State Bank of Pakistan

At the same time, the import of foreign travel services, particularly FX purchases by residents going abroad for tourism, and for covering educational expenses, decreased by 31.6 percent in Q1-FY19, after rising 3.5 percent in the same period last year. The first quarter of FY19 also included the *hajj* period, when travel for *umrah* and other religious activities typically declines. Moreover, higher travelling costs following the PKR's depreciation may have also tapered the demand for these services.

Table 5.4: Corridor-wise Workers' Remittances in Q1
million US dollars

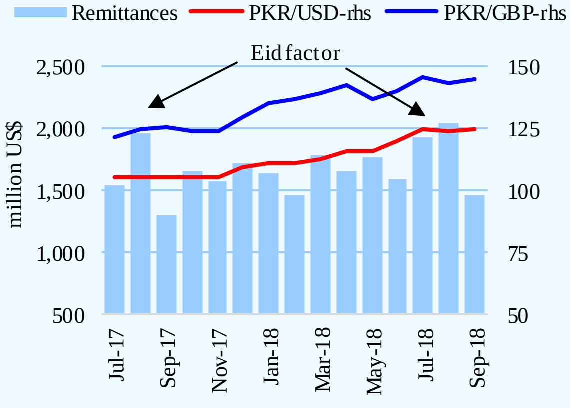
	FY17	FY18	FY19
Total	4,740	4,790	5,420
GCC	2,975	2,869	2,985
Saudi Arabia	1,324	1,228	1,263
UAE	1,076	1,078	1,196
Other GCC	576	563	526
Non-GCC	1,766	1,921	2,434
UK	550	643	759
USA	613	626	828
EU	123	160	166
Others	480	492	681

Data source: State Bank of Pakistan

<u>Workers' remittances</u>
Workers' remittances witnessed a robust growth of 13.2 percent YoY in Q1-FY19, with inflows crossing the US$ 5.0 billion mark in a quarter for the first time.

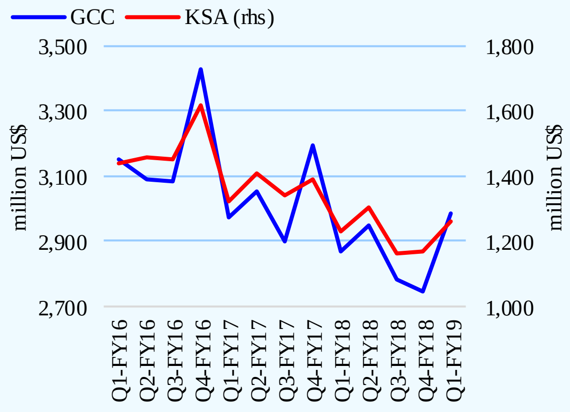
The increase in remittances was more pronounced from the non-GCC corridors, especially the US and the UK (**Table 5.4**). This can be attributed to multiple factors. First, increased economic activity in the developed economies may have incentivized the Pakistani diaspora in these countries to remit more to their families. Besides, the months falling before *Eid-ul-Azha* usually witness an uptick in inflows, as expatriates remit funds back home for buying sacrificial animals (**Figure 5.3)**. Importantly, remittances from the GCC in general, and Saudi Arabia (KSA) in particular, witnessed marginal growth in this quarter, which might be due to a seasonal phenomenon. Since Q1-FY17, remittances from these corridors have been largely following a declining trajectory, barring small seasonal spikes (**Figure 5.4**). In Q1-FY19, inflows from the GCC and the KSA grew by 4.0 percent and 2.8 percent, respectively. It is possible that the pace of layoffs of Pakistani workers in the region has fallen in recent months, which might have led to a bottoming out of the decline in remittances from the GCC. That said, it remains to be seen if this trend reversal would continue going forward.

Figure 5.3: Remittances & Exchange Rate Movements



Data source: State Bank of Pakistan

Figure 5.4: Workers' Remittances from GCC & KSA



Data source: State Bank of Pakistan

Workers' remittances remain a key source of financing of Pakistan's persistent trade deficit. More importantly, it does not create a repayment or repatriation obligation. Generally, these obligations keep the current account balance under pressure, especially when the trade deficit widens. It is not surprising that the government remains committed to supporting the flow of remittances into the country. **Box 5.2** details the various measures taken by the government and SBP to support the inflow of remittances into Pakistan.

Box 5.2: Government Support for Enhancing Workers' Remittance Inflows
The remittance inflows have been under stress for the past couple of years due to low oil prices and the Gulf economies' adoption of nationalization policies and fiscal consolidation measures.

As workers' remittances remain a key source of balance of payments support for Pakistan, the government has intensified its efforts for increasing these inflows into the country. In this regard, Pakistan expects early implementation of Qatar's decision to allow 100,000 workers from Pakistan to come and work in the country.[6] Moreover, following the government's suggestion, Saudi Arabia has agreed to reduce the visa fee for Pakistani workers. This step will help enhance Pakistan's workforce in the kingdom. Furthermore, the government is initiating a survey of overseas Pakistani workers, specifically those in the Middle East, to get their feedback on further facilitating and incentivizing the home remittance process.

Besides the government, the SBP has also taken a number of measures to incentivize overseas Pakistanis to send remittances through legal channels.

- SBP has allowed authorized dealers (banks) to implement Business to Customer (B2C) and Customer to Business (C2B) transactions through foreign correspondent entities under either existing or new home remittance agency arrangements.

- An individual, in B2C transactions, is allowed to receive up to US$ 1,500 per month for providing freelance and information systems services. Service providers other than of computer and information services are also allowed to receive up to US$ 1,500 per individual per month. Individual pensioners can now also receive up to Rs 250,000 per month in remittances.

- Meanwhile, in C2B transactions, overseas Pakistanis can directly pay utility bills, fees of Higher Education Commission-accredited institutions, insurance premiums, and charges incurred at superstores and on credit cards. Overseas Pakistanis are also allowed to remit funds to purchase residential and commercial houses, plots, flats and buildings from reputed real estate builders/developers and housing societies. However, remittances cannot be sent for equity participation in an enterprise.

- Moreover, the government has increased the incentive for mobile wallet users who receive remittances; now, users will receive up to Rs 2.0 as airtime for every US$ 1.0 of remittance transaction, up from Rs 1.0 previously. Similarly, exchange companies and banks that bring in 15.0 percent more remittances than they did in the previous financial year will also get Rs 1.0 for each US$ 1.0 incremental remittance that they brought.

Primary income

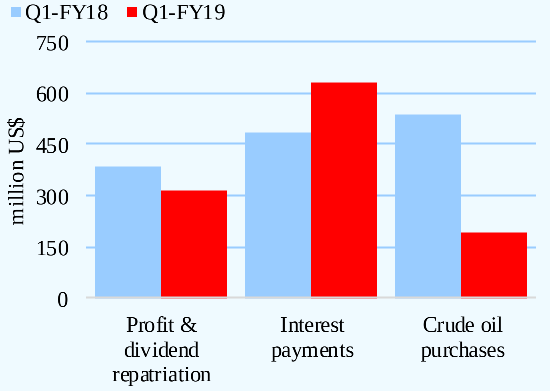
5.1 The primary income deficit increased by a marginal 3.9 percent in Q1-FY19 to US$ 1.1 billion. This was despite a significant 30.0 percent rise in interest payments and a 17.5 percent growth in the repatriation of profits and dividends by foreign firms operating in the country (**Figure 5.5**). The substantial increase in the

[6] Press release issued by the Prime Minister's Office dated October 19, 2018 (http://www.pmo.gov.pk/news_details.php?news_id=897). Already during Q1-FY19, an 80.6 percent YoY increase was noted in the number of Pakistanis who went to Qatar for work (source: Bureau of Emigration and Overseas Employment).

interest payments and profit repatriation, however, was offset by a 64.6 percent decline in the repatriation of profit under the purchase of crude oil.

In Q1-FY19, foreign companies repatriated US$ 190.0 million on account of profit on the purchase of crude oil; this was much lower than last year's comparable amount of US$ 537.0 million. The decline in the quantum of POL product sales in the quarter may have resulted in lower profit being repatriated under this head.

Figure 5.5: Outflows from Primary Income Account



Data source: State Bank of Pakistan

5.3 Financial Account

Inflows in the financial account increased by 27.9 percent to US$ 2.4 billion in Q1-FY19, from US$ 1.9 billion received in the same period last year. The entire increase came from external loans/liabilities, as not only did the foreign direct investment decline significantly, but outflows from the portfolio investment also remained higher as compared to Q1-FY18.

<u>Foreign direct investment</u>

The net FDI inflows into Pakistan posted a broad-based decline of 42.6 percent in Q1-FY19. As many of the early-harvest energy projects under CPEC are nearing completion, FDI inflows from China into the power sector have been slowing down. However, Chinese investment in the construction sector improved in Q1-FY19, and as a result, China continued to remain the top investor in Pakistan, with a 64.0 percent share in net FDI in the quarter **(Table 5.5)**.

Table 5.5: Net FDI in Pakistan (sector wise)

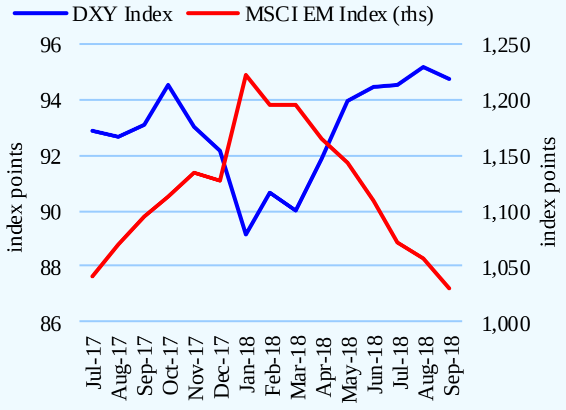
million US dollars

	FY18				FY19
	Q1	**Q2**	**Q3**	**Q4**	**Q1**
Construction	124.8	226.1	176.0	181.6	180.2
Power	205.3	406.6	111.3	273.9	74.7
Financial business	190.1	86.0	85.0	39.1	50.1
Exploration & prod.	52.8	53.9	46.2	39.6	35.4
Pharmaceuticals	0.8	1.2	12.1	1.1	26.4
Textiles	10.8	15.0	10.8	13.1	4.7
Telecommunications	62.8	-78.0	3.2	112.1	-48.6
Others	118.0	156.1	191.5	163.3	116.6
Total	**765.2**	**867.0**	**636.0**	**823.8**	**439.5**

Data source: State Bank of Pakistan

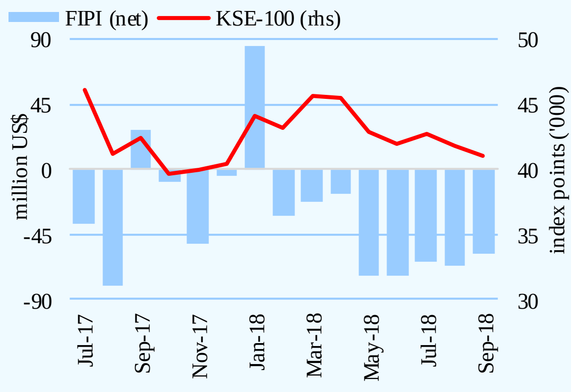
Apart from CPEC-related inflows from China, no major activity was observed in FDI. The non-CPEC related FDI that Pakistan has received over the past couple of years has remained mostly concentrated in a few non-export oriented manufacturing sectors, such as power, construction, financial business, oil & gas explorations, telecommunications and food. In fact, over the last five years, 80.6 percent of the average annual FDI received by Pakistan went into these six sectors. On the contrary, the key exporting sectors, such as textiles and leather products, attracted only 1.3 percent of the net FDI, on average, in the same period. Therefore, there is a need to promote foreign investment in the export-oriented manufacturing sectors, such as textiles and leather products. This may help boost the country's exports.[7]

Figure 5.6: Trend in Dollar Index and MSCI EM Index



Data source: Bloomberg

Figure 5.7: Foreign Investment in Pakistani Equities & PSX's Performance



Data source: NCCPL & Pakistan Stock Exchange

<u>Foreign portfolio investment</u>

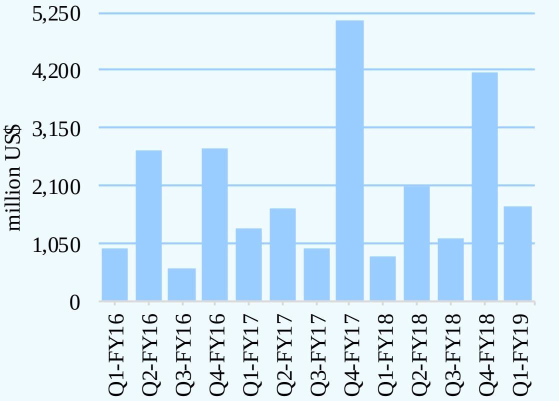
Portfolio investment witnessed a higher net outflow of US$ 185.0 million in Q1-FY19, compared to an outflow of US$ 126.0 million recorded in the same period last year. Private investment entirely led this outflow.

The recent strengthening of the US dollar against major currencies in the wake of monetary tightening by the US Fed has prompted global fund managers to realign their portfolio positions. This has led to outflows in portfolio investment from the

[7]According to the Ministry of Commerce's draft 'Trade Related Investment Policy Framework 2015-23', the FDI in Pakistan's manufacturing sector remains market-seeking rather than efficiency-seeking; the latter could have helped make the export-oriented sectors more competitive.

emerging equity markets across the globe (**Figure 5.6**). Pakistan's equity market, similarly, remained under pressure in Q1-FY19 and witnessed a net foreign selling of US$ 189.0 million, compared to a net selling of US$ 90.6 million during the same period last year (**Figure 5.7**). Besides global factors that triggered the private equity outflow, domestic factors such as the uncertainty over weakening macroeconomic indicators (specifically the external account position) did not allow any recovery in investors' confidence. Going forward, official inflows may continue to dominate the overall foreign portfolio inflows, as the government is planning to raise US$ 3.0 billion by issuing bonds in the international capital market during FY19.[8]

Figure 5.8: Net External Loan Inflows



Data source: State Bank of Pakistan

Net incurrence of liabilities

The net inflow of FX liabilities more than doubled in Q1-FY19 to US$ 1.7 billion, from US$ 0.8 billion recorded in the same quarter last year (**Figure 5.8**).

The short-term debt repayments of the government exceeded short-term loan disbursements in Q1-FY19. However, the government secured US$ 2.0 billion in long-term loans, which lent major support in partially closing the current account gap.

5.4 Exchange Rate and Reserves

SBP's foreign exchange reserves depleted by US$ 1.4 billion during Q1-FY19. This drawdown was relatively contained compared to the same period last year, when 50.0 percent of the CAD was financed by reserves.

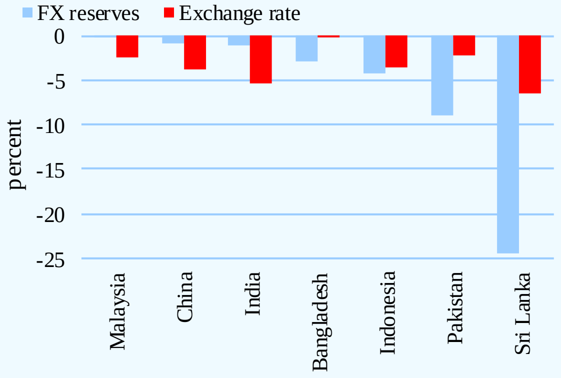
With the pressure on FX reserves, the Pak rupee continued to depreciate against the US dollar, sliding by 2.2 percent in Q1-FY19. However, the magnitude of the depreciation was lower than the preceding quarter (Q4-FY18) when the Pak rupee had weakened by 4.9 percent. Importantly, not just the PKR, but the currencies (and FX reserves) of a number of EMs also dropped significantly against the US

[8] Source: Economic Affairs Division.

dollar during the period under review (**Figure 5.9**).

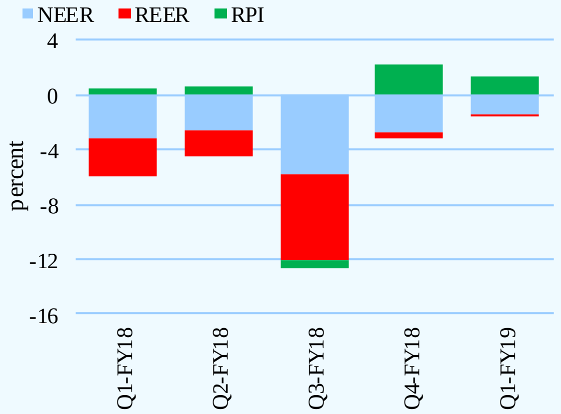
Furthermore, the increase in domestic inflation has also eroded most of the potential competitive gains that Pakistan could achieve from the currency depreciation. This is evident from a marginal depreciation of 0.04 percent in the country's real effective exchange rate (REER) in Q1-FY19. By contrast, other EMs witnessed sizable deterioration in their REERs **(Figure 5.10)**. It is important to recall here that Pakistan's REER had experienced a hefty depreciation of 11.0 percent in FY18, whereas the REERs of the other EMs had declined only marginally.

Figure 5.9: Change in FX Reserves and Exchange Rates against US dollar for Selected Asian Economies (Jul-Sep 2018)



Data source: Haver Analytics, State Bank of Pakistan

Figure 5.10: Change in PKR's REER and its Components



Data source: State Bank of Pakistan

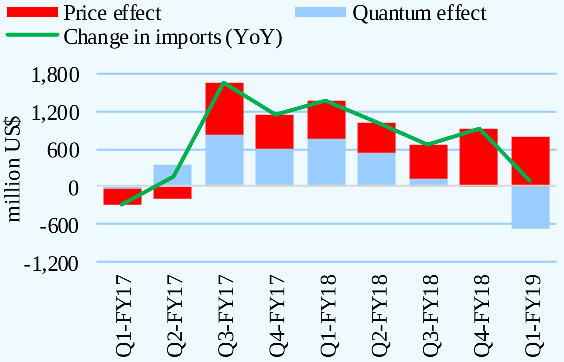
5.5 Trade Account[9]

After growing consistently for the past 11 consecutive quarters, Pakistan's trade deficit declined 2.5 percent YoY to US$ 8.8 billion in Q1-FY19. The drop originated from a slowdown in import growth (wherein a contraction in machinery imports partially offset the price-led uptick in energy imports), as well as a continued growth in exports. While the decline in PSDP spending and completion of early harvest CPEC power projects have lowered the imports of power generation and electrical machinery, a slowdown in broader economic activity amid exchange rate adjustments and other demand compression measures has led to a slackening in the demand for both

[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.

energy and non-energy imports as well (**Figure 5.11**).[10] This led to a drop in quantum purchases of both. However, the potential FX savings from lower import quantums were entirely offset by the higher international oil prices, which remained, on average, 50.9 percent higher in Q1-FY19 as they were in the same quarter last year.

Figure 5.11: Contribution of Quantum & Price Effects to Change in Import Values

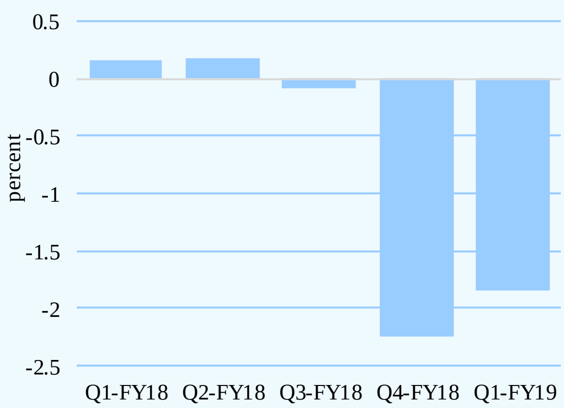


*excluding LNG
Data source: Pakistan Bureau of Statistics

In the case of exports, unit prices moved in unfavorable direction as well. While the export quantum was higher for a wide range of products as compared to last year, lower unit prices subdued the export revenue growth.[11]

Thus, the worsening trend in Pakistan's terms of trade that began in Q4-FY18, continued to keep the trade deficit at a high level in Q1-FY19 as well (**Figure 5.12**). Going forward, if this trend continues, then maintaining the current growth momentum of overall exports may become challenging. Similarly, the continuation of subsidies on agricultural exports will also determine the country's export performance down the road.

Figure 5.12: YoY Change in Pakistan's Terms of Trade



Data source: Pakistan Bureau of Statistics

This is because in Q1-FY19, the export growth was largely driven by the food group, particularly wheat and sugar (**Figure 5.13**), and subsidies were in play for

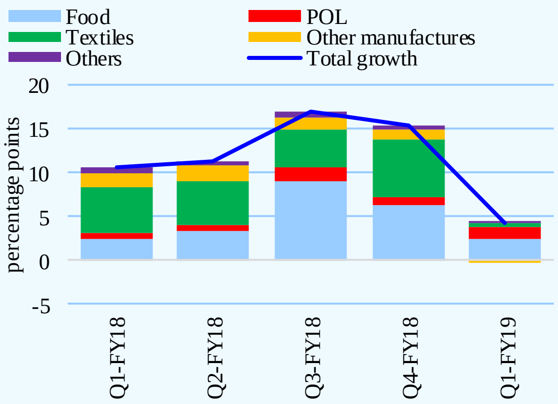
[10] A drop in large-scale manufacturing, and sales of automobiles and transport fuel in Q1-FY19 all point to a slowdown in general economic activity in the country.
[11] It is possible that some exporters, particularly those of apparel, are taking hits on their profit margins while trying to retain their shares in competitive markets, such as the US. This would have resulted in a drop in the unit values of their exports.

both these items. Already, the subsidy on sugar exports have been rolled back, and it is uncertain if Pakistani sugar exporters can compete on their own in the international market.

Exports

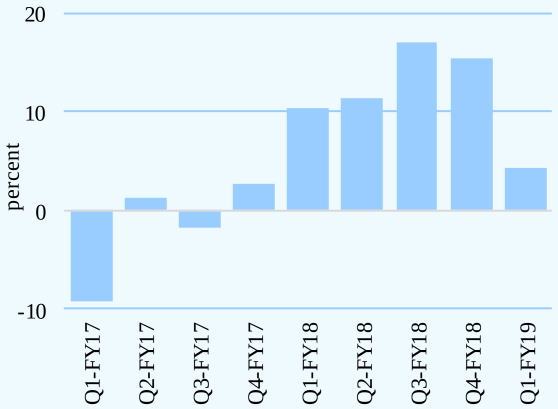
Pakistan's export growth momentum entered its sixth straight quarter in Q1-FY19, with values rising 4.2 percent to US$ 5.4 billion. However, the growth rate has dropped significantly from the previous few quarters (**Figure 5.14**). The major reason was a hefty drop in textile exports, which were pulled down by lower unit prices. Nonetheless, Pakistan is not unique in this respect, as the export growth of many EMs has also fallen this quarter as compared to the same period last year (**Figure 5.15**). What differentiates Pakistan from the rest, though, is that its export growth moderated in Q1-FY19 while its currency remained stable in real terms. On the contrary, other EMs saw their export growth subside despite witnessing a significant depreciation in their REERs (**Section 5.5**).

Figure 5.13: Sector-wise Contribution to Export Growth



Data source: Pakistan Bureau of Statistics

Figure 5.14: Annual Growth in Pakistan's Export Values



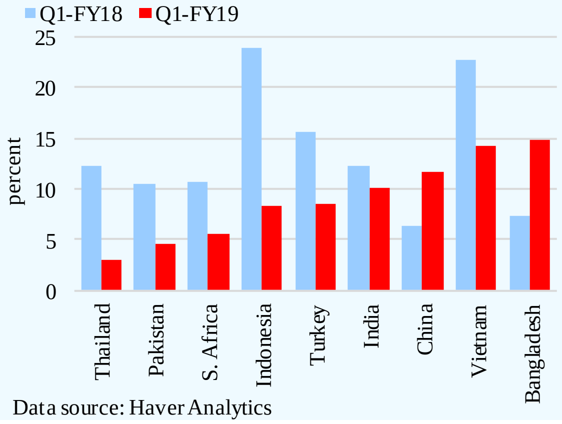
Data source: Pakistan Bureau of Statistics

Textile exports stagnate amid falling unit values

Overall textile exports grew by 0.6 percent YoY and reached US$ 3.3 billion in Q1-FY19, after rising by 7.9 percent in Q1-FY18. The exports of readymade garments and raw cotton, which had propelled last year's performance, both declined this year, pulling down the growth in the overall textile exports to their lowest in almost two years. That said, in the case of readymade garments, the decline was entirely due to lower unit prices, which completely offset a healthy growth in their quantum exports. The US, as opposed to the EU, emerged as the main drag on the garment exports.

In the US market, Pakistani exporters failed to increase their share. The US' total textile and apparel imports grew at a higher rate in Q1-FY19 than they had last year (**Table 5.6**), as robust economic growth and low unemployment encouraged consumers to spend more.[12] While the demand for synthetic garment imports maintained their growth momentum from last year, the demand for cotton apparel witnessed a trend reversal (**Table 5.7**). This was in response to the rising prices of synthetic garments, which, in turn, reflected an uptick in the prices of polyester and other man-made fibers.

Figure 5.15: Export Performances of Major EMs (YoY Growth)



Data source: Haver Analytics

Table 5.6: US' Total Quantum Textile & Apparel Imports from Major Countries in Q1
percent

	Growth		Share	
	FY18	**FY19**	**FY18**	**FY19**
Bangladesh	1.4	3.7	3.1	3.0
Cambodia	4.3	8.6	1.7	1.7
China	5.4	4.9	52.7	52.4
Germany	-16.5	26.9	0.7	0.8
India	5.8	10.9	7.2	7.6
Indonesia	-9.3	-3.9	2.2	2.0
Italy	-7.5	22.1	0.4	0.5
Pakistan	8.3	-0.9	3.6	3.3
Turkey	2.7	7.5	1.1	1.2
Vietnam	7.8	5.6	7.1	7.1
US' overall imports	3.2	5.6	-	-

Data source: Office of Textiles and Apparel

Despite higher imports by the US, Pakistan's overall textile and apparel exports to the country could not benefit and instead declined by 0.9 percent YoY in quantum terms. Even within the cotton apparel segment, the growth in Pakistan's quantum exports in Q1-FY19 was lower than last year, despite a rebound in the US' cotton apparel imports in the quarter under review.[13]

On the other hand, Pakistan's non-cotton apparel exports to the US dropped by a

[12] Retail sales of clothing and accessories in the US rose 5.4 percent YoY in Q1-FY19, as opposed to rising by 1.1 percent in Q1-FY18 (source: US Census Bureau).
[13] Perhaps, Pakistani exporters are more focused on the duty-free access of the EU market.

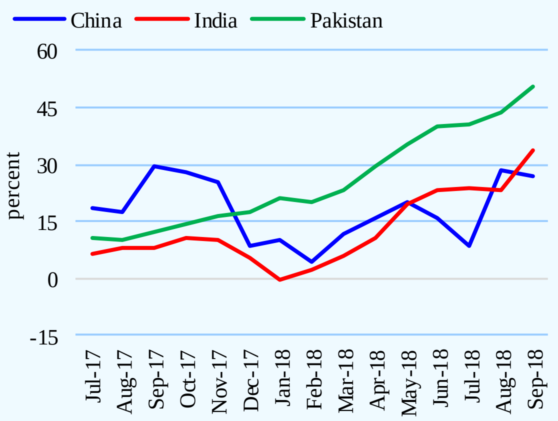
sharp 14.6 percent in quantum terms, as the exporters found it hard to control costs in the wake of spiking polyester staple fiber (PSF) prices in local currency terms. PSF prices have risen more rapidly in Pakistan than they have in China and India, which made it harder for Pakistani exporters to compete against their peers (**Figure 5.16**).

Table 5.7: US' Quantum Cotton Apparel Imports from Major Countries in Q1
percent

	Growth		Share	
	FY18	**FY19**	**FY18**	**FY19**
Bangladesh	-3.2	5.8	11.3	11.8
Cambodia	8.3	21.2	3.6	4.3
China	-3.0	-1.5	32.5	31.6
India	3.0	4.9	5.7	5.9
Indonesia	-4.3	0.3	4.3	4.3
Pakistan	5.2	2.0	4.0	4.0
Turkey	11.3	-1.8	0.3	0.3
Vietnam	5.0	0.2	12.6	12.5
US' imports	-2.8	1.1	-	-

Data source: Office of Textile and Apparel

Figure 5.16: Growth in PSF Prices in Local Currency Terms



Dara source: Emerging Textiles & SBP calculations

At the same time, to Pakistan's detriment, a gradual shift in the US' sourcing of textile and apparel products also seems to be underway, both in response to the trade tensions with China and evolving consumer preferences. First, the ongoing trade tensions with China have induced US retailers to look for other low-cost producers. This increasingly means countries that enjoy concessional or duty-free market access to the US, such as Cambodia. Usual suppliers like India and Vietnam have also benefitted. Pakistan is at a disadvantage on both counts, as its costs tend to skew upwards and it also does not enjoy duty-free access to the US. Even though Pakistan is a beneficiary under the US' GSP scheme, its textile and apparel products do not fall under the duty-free regime.

In contrast to the US, Pakistani exporters did quite well in the EU, where they managed to increase their market share (**Table 5.8**). While the growth in the EU's overall textile and apparel imports actually declined in Q1-FY19 in volume terms, in line with a moderation in the bloc's GDP growth, not all apparel suppliers were affected equally.[14] In fact, countries enjoying duty-free access to the EU, namely Bangladesh, Pakistan and Cambodia, experienced sizable export growth, at the expense of China and India. Moreover, Vietnam's exports to the EU also maintained their momentum, as the two parties edged closer to ratifying the free trade agreement.[15]

Meanwhile, the 74.0 percent decline in Pakistan's quantum raw cotton exports in Q1-FY19 can be traced to lower expected local production of the crop in the 2018-19 season, which led the spinning industry to accumulate stocks for domestic use instead of export.[16] In fact, the entire decline in cotton's export values was due to lower quantums, as unit prices were just marginally higher than last year.

Going forward, Pakistan's textile exporters are likely to face a tough time, given the shifting dynamics in the US, and Vietnam's expected surge in the EU market. That said, there are a few upshots in the offing. First, in September, Bangladesh announced a 51.0 percent increase in the minimum wage for its garment workers, which will go into effect in January 2019. The wages were last increased in 2013. Any net increase in production costs in the country could allow Pakistani exporters to compete more effectively in the EU and possibly increase their market share at Bangladesh's expense. Second, the EU launched a six-month review process in October 2018 to determine the continuity of Cambodia's duty-free access to the bloc under the Everything-But-Arms (EBA) scheme, following controversial elections in the country in July. While the eventual outcome of this review is uncertain, Pakistani exporters would stand to gain if Cambodia's garment exports to the EU, which are rising quite rapidly (**Table 5.8**), come

Table 5.8: EU's Quantum Apparel Imports from Major Countries in Q1
percent

	Growth		Share	
	FY18	**FY19**	**FY18**	**FY19**
Bangladesh	6.5	8.2	21.6	23.6
Cambodia	14.3	12.0	4.7	5.3
China	0.2	-11.3	43.4	38.8
India	0.1	-5.9	4.6	4.4
Indonesia	-2.0	-5.8	1.1	1.0
Pakistan	13.4	4.7	4.1	4.4
Turkey	2.4	8.2	7.5	8.2
Vietnam	5.5	2.3	2.9	2.9
EU's total imports	3.9	-0.8	-	-

Data source: Eurostat

[14] Real GDP growth in the EU-28 slid to 1.9 percent YoY in Q1-FY19, from the average growth of 2.3 percent in the previous three quarters (source: Eurostat).
[15] As per the draft of the agreement made public in September 2018, the EU has proposed either immediate or phase-wise elimination of tariffs on clothing and apparel products from Vietnam (under HS Codes 61 and 62). Currently, some of these products attract tariff as high as 12.0 percent.
[16] Local cotton sowing had missed its target by 8.0 percent, and the production target was revised down by 25.0 percent to 10.8 million bales, according to the Cotton Crop Assessment Committee.

under the normal duty regime.

Food group leads the way in non-textile exports
Overall food exports rose 16.7 percent to US$ 866.3 million in Q1-FY19, with wheat and sugar cumulatively responsible for 84.5 percent of this increase. For both of these commodities, a hefty uptick in quantum exports offset lower unit prices, as exporters continued to utilize the subsidies that were in place during the period.[17] Meanwhile, rice exports declined by a marginal 2.6 percent to US$ 312.1 million in the quarter. In the case of basmati rice, quantum exports rose sufficiently enough to offset a drop in unit prices. Like last year, shipments to European countries, such as Belgium, Italy, Netherlands and the UK, were up significantly.

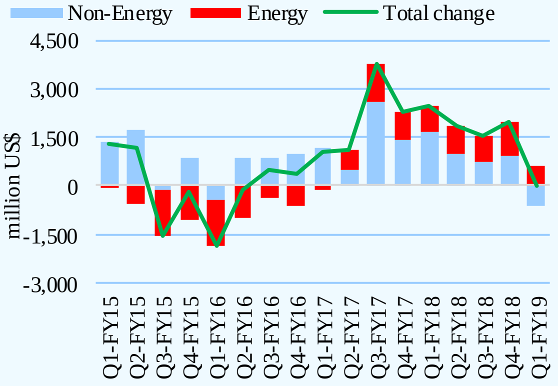
Among other products, cement exports surged 58.6 percent YoY to US$ 77.6 million. With additional capacity coming online in the south in H2-FY18, firms in the region have been aggressively marketing to foreign buyers. That said, initial customs data as well as market intelligence suggests that clinkers, instead of finished (Portland) cement, drove the increase in quantum exports in Q1-FY19.[18] Clinker is a relatively lower value product that is further processed to make cement. Pakistani firms are said to be more price-competitive in this segment instead of cement, and are exporting clinkers to countries like Bangladesh and Kenya, where local companies process them to make Portland cement.

Imports

Pakistan's import growth declined marginally (by 0.04 percent) in Q1-FY19, against the 21.4 percent increase recorded last year, with import values reaching US$ 14.2 billion. The slowdown originated entirely from the 5.3 percent YoY decline in non-energy imports, which was the first such drop in three years (**Figure 5.17**). Imports of almost all major non-energy categories, led by machinery, declined during the quarter. Energy imports, on the other hand, rose significantly, mainly due to the higher international oil prices.

[17] Intriguingly, despite international wheat prices being 20.8 percent higher, on average, during Q1-FY19 over last year, unit prices of Pakistan's wheat exports were down 23.3 percent on YoY basis. One reason could be that exporters were willing to offload their surplus stocks at lower prices, and then claim the difference from subsidies already in place. However, in case of sugar, average international prices were 21.2 percent lower in Q1-FY19, indicating that subsidies played a prominent role in boosting its quantum exports.
[18] In both SBP and PBS' trade data, "cement" comprises both Portland cement and clinkers. As per PBS, quantum clinker exports in Q1-FY19 amounted to 631,673 MT, significantly higher than the 2,747 MT exported in the same period last year.

Figure 5.17: Breakdown of Absolute Change in Import Values



Data source: Pakistan Bureau of Statistics

Energy imports

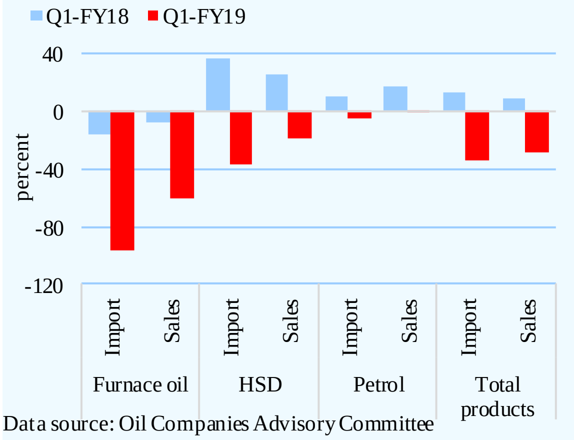
Pakistan's energy imports rose 8.6 percent to US$ 3.4 billion in Q1-FY19, with LNG contributing the most to this increase. Unlike other POL products, LNG imports are being driven by both higher prices and quantum purchases. With LNG replacing natural gas and furnace oil in the power, fertilizer, transport (CNG) and other industrial sectors, its quantum imports have been rising consistently ever since its introduction in the domestic fuel mix in Q1-FY16. The power sector has a dominant share in LNG consumption, followed by general industry, fertilizer and transport. Moreover, its imports are likely to stay elevated going forward, given the government's announcement that industries will be supplied LNG during the winter months, as cheaper and locally produced natural gas is diverted to domestic consumers.[19]

With regards to price, Pakistan mainly imports LNG from Qatar under a state contract, with the import prices linked with those of crude oil. During Q1-FY19, Arab Light crude prices averaged US$ 75.9 per barrel, against last year's average price of US$ 50.3.[20] Inevitably, LNG imports more than doubled in value terms and reached US$ 939.2 million in the quarter.

On the other hand, quantum imports of POL products declined 37.0 percent during the quarter.[21] Unlike previous quarters, furnace oil (FO) was not the sole drag on quantum product imports, as foreign purchases of transportation fuels, such as high speed diesel (HSD), petrol and jet fuel, were all lower as compared to last year (**Figure 5.18**). The lower imports corresponded with a drop in the sales of these fuels. While the decline in FO imports is understandable given its reduced usage in power generation, the drop in sales and imports of transport fuels is intriguing. Nonetheless, some factors explain this development.

[19] Source: Press Information Department press release dated October 16, 2018.
[20] Benchmark spot LNG prices in Japan were also 23.5 percent higher, on average, in Q1-FY19 as compared to Q1-FY18 (source: Haver Analytics).
[21] Source: Oil Companies Advisory Committee (OCAC).

Figure 5.18: Growth in Import and Sales of POL Products



Data source: Oil Companies Advisory Committee

First, the overall POL sales during Q1 were pulled down due to an exceptionally low consumption in August. Extended Eid holidays during the month led to a heavy contraction in the sales of HSD, and a relatively minor drop in those of petrol.[22] Data for September indicates that all fuel sales had returned to normalized levels. Second, domestic production of petrol had risen by a solid 17.6 percent during Q1-FY19, which lowered the demand for its imports. Third, the pass-through of the hefty rise in international oil prices to domestic petrol and HSD prices also played a role in curbing the demand for these fuels. Some substitution between petrol and CNG is also possible, as prices of the former had risen far more than those of the latter.[23]

Meanwhile, subdued demand for FO and transportation fuels led refineries to lower their purchases of crude oil, which recued the demand for imports of the commodity. Yet, the sizable increase in its international prices completely offset the impact of lower quantums, and contributed entirely to the 48.2 percent rise in import values during the period.

Non-energy imports

Pakistan's non-energy imports amounted to US$ 10.4 billion in Q1-FY19, down 5.3 percent from Q1-FY18. The broad-based decline was led by lower purchases of machinery during the period (**Figure 5.19)**. With the completion of many early-harvest CPEC projects, purchases of foreign power generation and electrical machinery have declined (along with FDI inflows in this sector from China).[24] At the same time, transport imports dropped 17.4 percent to US$ 790.9 million in

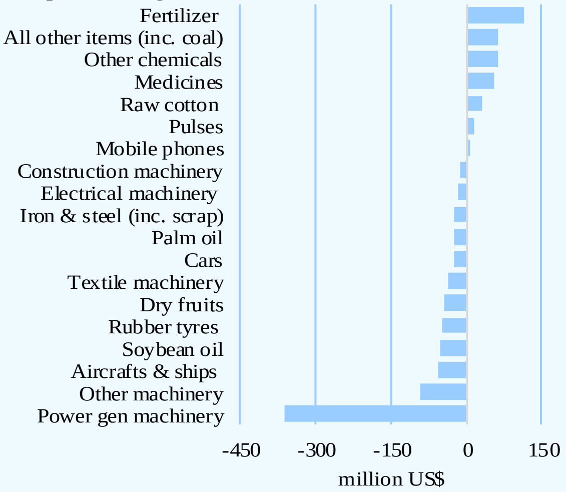
[22] HSD sales in August 2018, at 493,941 MT, had dropped to their lowest monthly level since March 2014. That said, sales then picked up to 736,807 MT in September 2018 (source: Oil Companies Advisory Committee).

[23] Petrol and HSD prices were, on average, 33.7 percent and 41.9 percent higher in Q1-FY19 as compared to Q1-FY18. By contrast, average CNG prices were 13.1 percent higher this year as compared to last year. Average CNG prices, in absolute terms, were also much lower (at Rs 81.9) than those of petrol and HSD (Rs 94.6 and Rs 111.0 per liter).

[24] For details, see **Section 5.4**.

the quarter. A sizable 35.9 percent decline was noted in car CBU imports, as additional customs duty was imposed on vehicle imports in the budget 2018-19, and the government decided to ban non-filers from purchasing cars. Meanwhile, imports under the ships and aircraft category were also lower than last year, mainly due to a low-base effect.[25]

Figure 5.19: Absolute YoY Change in Non-Energy Imports during Q1-FY19



Data source: Pakistan Bureau of Statistics

Further relief came from the low international prices of palm and soybean oil, which reduced the import values of these two commodities during Q1-FY19. In the case of palm oil, a build-up of inventories in the second-largest producer Malaysia, coupled with the ongoing slump in the Malaysian Ringgit against the US dollar, led to a drop in its international prices.[26] This encouraged edible oil mills in Pakistan to purchase higher quantities while the prices were low. As a result, even though quantum palm oil purchases went up 12.8 percent, its import values declined 4.8 percent to US$ 485.7 million in Q1-FY19. Similarly, lower international prices of soybean oil kept its import values in check, though quantum imports of the commodity were also lower as compared to the same period last year.

Meanwhile, the cumulative quantum imports of iron and steel (both scrap and finished products) dropped 5.9 percent YoY in the quarter due to a general slowdown in construction activities in the period. This was also reflected by lower domestic cement dispatches and steel production during the period.[27] Due

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[25] Import of airplanes and parts (propellers, etc.) had amounted to US$ 74.5 million in Q1-FY18, which had inflated that quarter's transport imports. During Q1-FY19, aircraft imports had fallen to US$ 22.4 million, according to customs' data.

[26] Between Jun-Sep 2018, palm oil prices fell 18.8 percent (source: Bloomberg). Malaysian palm oil stocks had reached an eight-month high by Sep 2018, as a seasonal uptick in production and a simultaneous slowdown in exports led to this build-up (source: USDA Oil Crops Outlook, Oct-2018).

[27] Domestic cement dispatches declined by 0.4 percent YoY in Q1-FY19, after rising by a strong 21.9 percent in Q1-FY18 (source: All Pakistan Cement Manufacturers Association). Meanwhile,

to lower quantum, the import values of these items dipped 2.3 percent from last year.

On the other hand, upward pressure in the non-energy imports came particularly from coal, which is classified under “all other items” under both SBP’s and PBS’ trade data (**Figure 5.19**). Coal imports stayed elevated as the international prices reached their highest levels since April 2012; average coal prices were 23.7 percent higher on YoY basis in Q1-FY19. Besides, the demand for coal from the power and cement sectors remained strong, putting further upward pressure on its imports. As a result, coal import payments surged 120.1 percent YoY and reached US$ 464.3 million in the quarter.[28]

Meanwhile, fertilizer imports grew 49.6 percent and reached US$ 344.2 million, as domestic production declined by 5.1 percent during Q1-FY19. Local production was down as three fertilizer plants shut their operations amid gas supply issues. Going forward, fertilizer imports will stay elevated, as the government has allowed the import of 100,000 MT of urea to offset domestic supply shortages in the current cropping season.[29]

Besides these items, import demand for raw materials of the textile industry also stayed strong, as the industry tried to maintain its export growth momentum. Raw cotton imports surged 86.4 percent to US$ 65.2 million as the industry procured the material from abroad in the wake of lower expected cotton production. Imports of high staple cotton, used primarily to make export-quality garments, also continued. At the same time, import values of synthetic fibre and of chemicals used to make man-made fibres also went up, following the rising trend in their international prices as well as the local textile industry’s efforts to catch up with the changing global clothing trends.[30]

domestic steel production declined by 3.3 percent YoY in Q1- FY19, after growing by a phenomenal 48.4 percent in Q1-FY18.

[28] Power generation from coal was over two hundred percent higher in Q1-FY19 as compared to the same period last year.

[29] The necessity of these imports has risen at an inopportune time, as international fertilizer prices are floating near three-year highs. Average foreign prices of urea and DAP were 31.6 percent and 28.2 percent higher in Q1-FY19 as compared to last year (source: Haver Analytics).

[30] For details about how Pakistan has continued to produce cotton-based clothing while the foreign demand has shifted towards synthetic textiles, see the Special Section titled “Synthetic Textiles is Key to Sustaining Export Growth Momentum” in SBP’s *State of the Economy Report* for Q3-FY18.

Annexure: Data Explanatory Notes

1) **GDP:** SBP uses the GDP target for the ongoing year, as given in the Annual Plan by the Planning Commission, for calculating the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

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

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

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

Where I_t is consumer price index in t^{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.*

Special Section 1: Real Estate – Implementing the Announced Reforms

The Finance Act 2018 introduced important measures to counter the under-documentation in the real estate sector and to minimize instances of using the property market for avoiding tax obligations. These included (i) imposition of ban on non-filers on purchasing property above Rs 5 million; (ii) legal proceedings against any property transactions and exchanges that are deemed to be understated for the purpose of either concealment of the source of income and/or tax avoidance; and (iii) vesting power with the government to purchase the property in question in case the understatement is proven.

There is an immense potential in these measures for improving revenue mobilization, all the while adjusting the incentive structure to provide a level playing field for other investment avenues. This section explains the dynamics of under-documentation of the real estate sector, and highlights the crucial need of timely implementation of the recently announced reforms.

1. Real estate development is crucial for Pakistan

The real estate sector – constituting housing, construction, retailing, hoteling, and renting of spaces for official or trading purposes[1] – has gradually evolved into an important source of economic growth in Pakistan. The combined direct contribution of construction and housing sectors (the latter of which is a part of the services sector in the national accounts) to the country's GDP has been consistently higher than 9 percent over the past decade; whereas, a steady expansion in wholesale & retail trade activities in the country has kept the buoyancy in commercial real estate intact. Spillover effects are also strong as evidenced by the sustained increase in activities of a large number of vertically integrated sectors (such as cement, steel, wood, cables, ceramics, etc.) with flourishing real estate sector.

While evaluating the macroeconomic relevance of the real estate development, the social dimension of the sector cannot be ignored. Pakistan's housing deficit is estimated to be around 9 million units;[2] this means that more than a third of the 32 million households in Pakistan are not provided with adequate housing. Market frictions such as non-availability of a common record of land and entitlement, and stringent regulations for site development, are responsible for the limited progress.

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[1] This definition is based on the categorization of loans to income-producing real estate under the BASEL-III framework. The three categories encompassing the activities of the sector are: (i) residential real estate; (ii) commercial real estate; and (iii) land acquisition, development and construction (ADC) exposures.

[2] Source: 11th Five Years Plan (2013-18), Ministry of Planning and Commission, Pakistan.

The demand side has not been helpful either as financing limitations have priced out lower-to-middle-income segments. On the one hand, banks remained reluctant to expand their mortgage portfolio due to weak contract enforcement, uncertainty of title deeds and their general inclination toward risk-free financing; and on the other hand, available mortgages have remained unaffordable for the majority of population due to low-income levels and savings capacity. Thus, while the structural demand for housing and potential supplies remained large, the real estate market has been operating at a low equilibrium.

2. However, the sector became a haven for tax avoidance and wealth concealment

Most recent empirical estimates put the size of informal economy of Pakistan between 70-91 percent of the GDP.[3] In addition, a strong contribution of informal sector (over 70 percent) in providing jobs, a high cash to GDP ratio, and tax gap of around 10 percent of GDP[4], all signify presence of a large informal economy. A significant share of the unreported gains finds its way to the country's property market, which is characterized by low regulatory oversight and absence of concrete know-your-customer requirements. This, coupled with very low official property valuations, provides individuals a 'legal' way of under-documenting the transactions; those are benefited particularly who aim to minimize their tax liabilities and/or conceal their wealth as well as the sources of income.

Table S1.1: Comparison of DC, FBR and Market Rates in Lahore, Karachi and Islamabad as of September 2018

Average Valuation of 1 kanal Residential Property/House (thousand Rupees)

	Lahore			Karachi			Islamabad		
	DHA Phase V	**Cantt Area**	**WAPDA Town**	**DHA Phase VI**	**North Karachi**	**Gulshan-e- Iqbal**	**D-12**	**E-11**	**G-11**
DC rate	14,000	14,000	8,800	6,987	1,197	6,987	N/A	N/A	N/A
FBR rate	8,400	11,700	8,400	15,124	3,024	15,124	19,541	15,730	23,050
Market rate	60,254	55,876	41,975	102,180	62,111	59,437	50,437	75,936	78,495

Data source: FBR, Punjab IT Board, Zameen.com, SindhZameen.gos.pk (Sindh Government)

Specifically, District Collector's (DC) rates are used in Pakistan for the calculation of provincial tax liabilities such as capital value tax, property tax and stamp duties. These rates are significantly lower than the actual property valuation with gap estimated between 2 to 5 times depending upon the city. In 2016, FBR introduced valuation tables for the collection of capital gain tax and withholding tax; these valuations were higher than the DC rates, but far below the actual valuations. In 2018, Punjab government made upward revisions in the DC rates for most areas

[3] Khan and Khalil (2017) and Kemal (2013).

[4] World Bank estimates potential tax capacity of Pakistan at 23 percent of GDP, against the actual of 13 percent.

and brought these closer to the FBR valuations in order to enhance revenue mobilization; however the rates in the rest of the provinces remained unchanged at a level much lower than the FBR valuations. **Table S1.1** provides few examples from the country's major urban centers.

Thus, while the activity in property market remained upbeat, both the Federal and provincial governments have not been able to mobilize revenues from this source. Compared with other emerging market economies, where the contribution of property tax in overall revenue mobilization is generally lower compared to advanced economies, Pakistan's performance remains weak (**Table S1.2**).

Table S1.2: Property Taxes - A comparison

Advanced Economies	As percent of Revenue	As percent of GDP
Australia	4.7	1.6
France	8.9	4.3
Singapore	5.4	1.1
Switzerland	5.4	1.8
United Kingdom	8.6	3.3
United States	9.3	2.9
Emerging and Developing Economies		
Bangladesh (FY15)*	2.1	0.2
Brazil	3.5	1.5
China	0.9	0.3
India (2014)**	4.8	0.8
Indonesia	2.7	0.4
South Africa	3.7	1.4
Pakistan (FY17)* **	**0.4**	**0.0**

Data source: IMF GFS; *Bangladesh's Ministry of Finance; **OECD;[5] ***Provincial budget statements/PBS
Ratios for 2016, unless stated otherwise.

3. Property prices were bound to boom

The property market in major urban centers of the country has been under pressure due to genuine demand emanating from a heavy influx of population from rural areas, and consistently rising remittance inflows over the past decade. This demand was further fueled by property purchases with an objective of wealth concealment and tax avoidance. Moreover, attracted by the potential of earning significant capital gains, a sizable amount of speculative and short-term investments also found its way into the sector. Resultantly, price pressures in the property market have persisted.

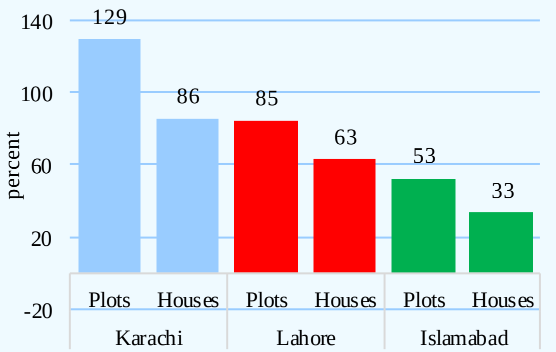
Since June 2011, from where any estimates of property prices are available, prices of plots in Pakistan have nearly tripled, whereas house prices have grown by 139 percent.[6] The relatively higher price surge for plots with respect to that of

[5] Joumard, I., A. Thomas and H. Morgavi (2017), "Making income and property taxes more growth-friendly and redistributive in India", OECD Economics Department Working Papers, No. 1389, OECD Publishing, Paris, https://doi.org/10.1787/5e542f11-en.

[6] The information on property prices throughout this document has been taken from Zameen.com, which is a customer-to-customer online marketplace for buying, selling, and renting residential property in the major cities of Pakistan. Launched in 2006, the platform expanded its operations gradually and in 2016, also started working as an online information intermediary by compiling

residential units indicates the consistently strong speculative interest in the real estate market of major urban centers (**Figure S1.1**).[7] Buoyancy was particularly noticeable during the past 5 years, when a noticeable improvement in the law and order situation of the country (following the decisive military operations) had played a key role in improving the overall business confidence.

Figure S1.1: Percentage Increase in Property Prices Between Jun 2013 and Jun 2018 in Major Cities of Pakistan



Data source: Zameen.com

4. Booming property prices had significant economic and social fallouts

Such huge capital gains, along with a steady increase in rentals and a subdued tax liability, made the real estate sector the most sought-after avenue for high net-worth individuals/firms. This was despite the investment appetite in other productive sectors remaining strong as the economy struggled within the low-growth-high-inflation equilibrium. More importantly, while the development in this sector is much welcome, anecdotal evidence suggest that a sizable amount of activity took place in sale and purchase of plots without a corresponding activity in the real estate development.

<u>Diversion of resources away from productive investments</u>

While the overall investment rate in major sectors of the economy remained weak over the past decade, the investment activity in housing services stood strong (**Figure S1.2a**). In fact, the overall gross fixed capital formation in housing services has even surpassed the same in the manufacturing sector, which has historically played a key role in several successful experiences with economic development across the world.

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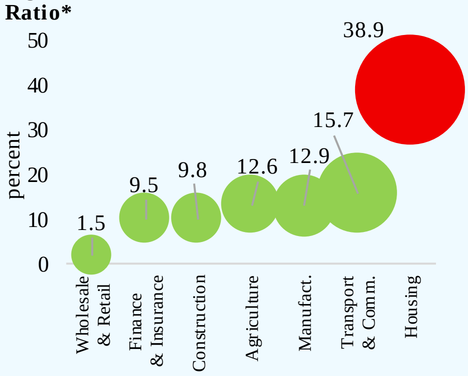
housing and plot price indices for various localities across Tier-1 and Tier-2 cities of the country. The tool was developed in collaboration with the Lahore University of Management Sciences (LUMS).

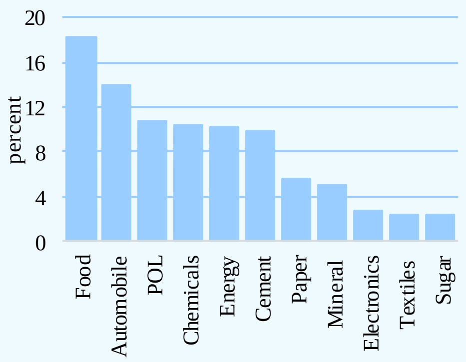
[7] Within these cities, investment activity in housing schemes that offered superior amenities (for instance, DHA and Bahria Town) were more upbeat, as plot prices in those areas nearly quadrupled during the last 5 years.

Figure S1.2a: Sector wise Investment to GDP Ratio*



*Calculated as sectoral gross fixed capital formation divided by sectoral GDP (both at current prices)
Data source: Pakistan Bureau of Statistics

Figure S1.2b: Average Return on Assets Earned by Listed Firms in Various Sectors (2011-16)



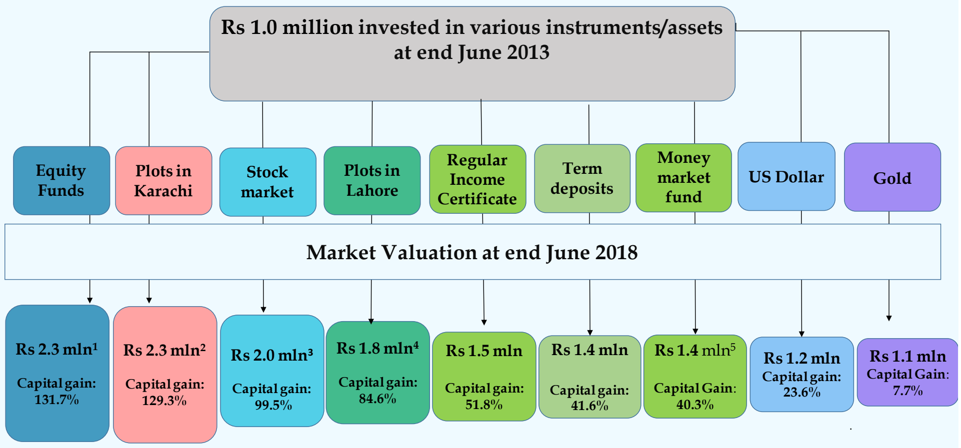
Data source: SBP's Financial Statement Analysis of Non-Financial Companies listed on PSX (2013-17)

Anecdotal evidence suggests that some of the large industrial groups have preferred to invest their retained earnings in the real estate – both residential as well commercial (shopping malls and restaurants), instead of expanding their industrial base. This trend made sense also because of a steady rise in production costs (especially utilities) and overall weaknesses in the ease of doing business in the country during these years. Other than consumer industries, such as food (FMCGs) and automobiles, profitability in most industrial sector remained subdued compared to returns in property market (**Figure S1.2b**). Earnings of the export sector (mainly textiles) were particularly suppressed, as here the margins were constrained due to stiff competition with other countries; this is probably one of the reasons why big export houses have been diversifying in other inward-looking businesses.

<u>Unwarranted competition with the formal savings channels</u>
Formal modes of savings such as bank deposits and financial instruments cannot offer even a close competition as not only their returns/capital gains are much contained, but all the earnings are also taxable on fair value. Consider the following as an example: if someone had invested Rs 1 million in a plot in Karachi at end-2013, it would have attained a market valuation of around Rs 2.3 million in 2018 – a considerable capital gain of 129 percent in just 5 years (**Figure S1.3**). Savers enjoyed comparable returns only in equity funds; however, this avenue has not been much successful in attracting capital inflows due to the risk-averse behavior among savers and a general lack of awareness about the platform. In addition, capital gains under equity funds are subject to a 15 percent *unevadable* tax.

Earnings from other alternate avenues have remained quite subdued, such as 51.8 percent in case of regular income certificate; 41.6 percent in case of term deposits; and 7.7 percent in case of gold. Certainly, returns may vary depending upon the global and domestic economic environment, but the fact remains that a strong incentive structure has persisted in the country that favored property investments over others. The outcome of such gains was natural; the demand for formal savings instruments remained low, which effectively hindered the overall growth of financial institutions and availability of loanable funds for private businesses.

Figure S1.3: Comparative Performance of Various Assets Available for Investment Over the Last 5 Years



1 and 5: Based on Open-End Fund returns provided by the Mutual Funds' Association of Pakistan.This includes capital gains, interest payments and dividend payouts
2 and 4: Based on plot price index available at Zameen.com; does not include rental values and gains from short-term sale/purchase
3: Based on KSE-100 index value; does not include gains from short-term trading

Pricing out of Genuine Buyers

Another fall out of growing housing demand and booming prices was a gradual decline in the purchasing power of the genuine buyers. Making things worse, financing limitations and high cost of borrowing could not empower the lower-to-middle income segments of the society to afford housing. Nearly all of the urban housing shortage lies in the low-income segment of society. This situation basically represents failure of the formal financial sector in Pakistan in providing adequate and affordable housing finance products to a large segment of the population that could help catering their housing needs.

5. A number of reform measures have been introduced in recent years

Most of the earlier reform measures announced by the government were focused on increasing transparency and realize tax collection potential in the real estate sector (**Table S1.3**). In 2009 for instance, filing of tax returns was made compulsory for individuals owning a land area greater than 500 yards. Further, in 2012, a capital gains tax was introduced which was applicable on the sale of immovable property having a holding period of less than two years.

Table S1.3: Timeline of Major Government Reform Measures to Regulate the Real estate Sector

S. No	Year	Measure
1	2009	Mandatory filing of returns by persons owning immovable property with land area ≥ 500 square yards and/or having flat with covered area of 2000 square feet or more located in a rating area [Finance Act 2009 page 7]
2	2010	Through 18th amendment, provinces were empowered to collect Capital Value Tax (CVT) on immovable property (located in province). [FBR circular No C.No.ITP/B-2010-11/EC-e-Dox # 105236-R dated July 16, 2010]
3	2012	Introduction of a Capital Gain Tax (CGT) on sale of immovable properties, holding period of which is less than 2 years. [Finance Act 2012 page 437, Division VIII of the amended Income Tax Ordinance 2001]
4	2014	CGT charged at 10 percent for properties where the holding period was up to 1 year, and 5 percent where holding period is greater than or equal to 2 years. For holding period greater than 2 years, no CGT would be charged. [Finance Act 2014, page 135, Income Tax Ordinance 2001 amended up to June 2014, pp 328-329]
6	2014	Adjustable advance tax on sale of immovable properties at 0.5 percent for filers and 1 percent for non-filers of the gross amount of the consideration received. In case of purchase, the rate of tax was 1 percent for filers and 2 percent for non-filers. Properties with values below Rs 3 million exempted from the advance tax. [Finance Act 2014, pp 146 and Income Tax Ordinance 2001 amended up to June 2014, pp 346 and page 349]
7	2016	CGT on disposal of immovable property acquired on or after July 1, 2016 was kept at 10 percent (holding period up to 1 year); but this was raised to 7.5 percent (in case, 1 year > holding period < 2 year), and 5 percent (in case, 2 year > holding period < 3 year). For immovable property acquired before July 1, 2016, where holding period is ≤ 3 year, rate of CGT was 5 percent and if holding period > 3 years, rate of CGT was zero. [Income Tax Ordinance 2001 amended up to 31-8-2016, pp 364-365]
8	2016	Advance tax on purchase of immovable property (value > Rs 4 million) was increased to 2 and 4 percent for filer and non-filer, respectively. The rate of tax in case of sale was 1 percent of the gross amount of the consideration received for filers and 2 percent for non-filers. [Finance Act 2016 and Income Tax Ordinance 2001 updated up to 31-8-2016, pp 388 and 390-391]
9	2016	FBR valuation rates for 20 major cities were introduced effective July 31, 2016, for the purpose of calculation of federal taxes such as CGT and advance tax on sale and purchase of immovable property. [https://www.fbr.gov.pk/Contents/Valuation-of-Immovable-Properties/11042]
10	2018	An amnesty scheme for declaration of undeclared assets through Foreign Assets (Declaration and Repatriation) Act 2018 and Voluntary Declaration of Domestic Assets Act 2018 was introduced till June 2018.
11	2018	Non-filers were barred from purchasing property above Rs 5 million [Finance Act 2018, section 227C pp 82 and Income Tax ordinance 2001 amended up to 30 October 2018, pp 342]

Data source: Federal Board of Revenue

However, in 2016, a major move was taken when the FBR valuation rates were introduced for the first time for the collection of advance tax and capital gain tax. As mentioned before, these valuations in most cases were significantly lower than the actual prices. Provincial tax collection, nonetheless, remained subdued due to the prevalence of very low DC rates. In fact, the introduction of FBR rates created significant amount of ambiguity in the market, as buyers and sellers now had to take into account both the federal and the provincial rates.

In April 2018, the government announced (as part of budgetary measures for FY19) the imposition of ban on property purchases (above 5 million) by the non-filers. Furthermore, it was also suggested to abolish the FBR rates, whereas an advice was made to provincial governments to abolish the DC rates. In their place, the Budget introduced only a declared property value for the purpose of tax collection; however, to ensure that the value declared by buyers and sellers is the fair market value, the Finance Bill 2018-19 empowered the government with the first right to purchase.

Specifically, the government can purchase land and property at 100 percent above the declared value, in case the under-declaration is proven. The process involves the instatement of Directorate General of Immovable Property, who will be granted the authority to send a property for an evaluation in case it has reason to believe that the declared value is below the fair market value.[8] Moreover, instead of paying multiple taxes to different authorities, buyers and sellers of the property will face reduced tax incidence on property registrations. The simplification of tax collection by introducing a one-stage charge is of particular importance, as it holds the potential to increase government revenues by reducing the cost and time of paying taxes for the general public and nudging them towards filing returns.

6 An early implementation of the announced reforms is crucial

The dual objective of transparency and revenue collection necessitates the implementation of targeted and timely measures in the real estate sector. It is encouraging to note that the government has established the Directorate General Immovable Properties, which will act as FBR's specialized agency on all matters relating to the real estate. These include: geo mapping of immovable properties; survey and market analysis of real estate market segments; tracking online marketing of immovable properties; tracking operations of foreign real estate concerns; liaison with provincial Excise & Taxation and Land Revenue authorities for coordinated operations; identification of high end properties on sale and rent; Discreet Video Surveys of new & upcoming real estate projects

[8] According to FBR's notification F.No.1(01)/18-DG(BTB)/2018-19 dated 29th November, 2018, the formal filed structure of Directorate General IMP-IR has been initiated. Currently, DG BTB and Commissioners BTB Islamabad, Lahore and Karachi shall be assigned the additional charges of these newly established offices.

However, to make the property valuation process more transparent and effective, it is important for the provincial governments to abolish DC rates and discontinue the collection of stamp duties and other provincial levies. So far, none of the province has abolished DC rates. Since revenue mobilization from immovable property is a provincial subject post 18th amendment, there is little that the federal government alone can do to address the prevailing distortions. It is important to take all the provinces on board before reforms can be implemented.

Meanwhile, uncertainty prevails amongst stakeholders in the property market regarding valuations, tax incidence as well as the future course of property prices. Anecdotal evidence suggests a subdued activity recently as transactions have reportedly been put on hold – especially until the interested individuals do not register as filers. Similarly, some prospective sellers might just be extending the property holding period to reduce the burden of capital gain tax. Since credible data on transaction volumes is not available, a sense of market activity can only be taken from information available on prices; and this suggest subdued activity. Between April and September 2018, plot prices in Karachi have dropped by around 15 percent, whereas the same in Lahore have nearly stagnated. In the near term, therefore, tax collection might remain subdued due to a lower transaction volume, but in the medium to long term, these reforms would improve both the revenue collection as well as the overall incentive structure.

On the social front, addressing the housing supply situation is of paramount importance. In this regard, the government announced a new "Naya Pakistan Housing Program" on October 10, 2018, aiming to establish 5 million dwelling units across the country to cater to the needs of the lower-income class. State Bank of Pakistan has also increased its policy focus on the provision of low-cost housing finance in the country. In this context, it is important to put in place a non-judicial foreclosure framework in the country, in order to make it convenient for banks to exercise their right to collateral. However, the urgency to address property market issues needs to be felt across the entire chain of stakeholders in the property market, including federal and provincial governments, real estate developers, builders, banking industry, and suppliers of construction materials, if the industry's dynamics are to be improved.

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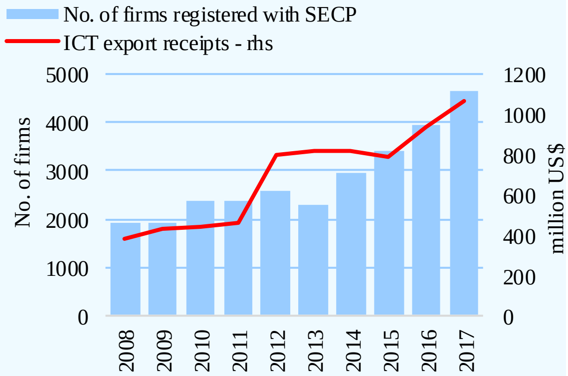
Special Section 2: Performance of ICT Exports of Pakistan

Official ICT exports of Pakistan touched US$ 1 billion for the first time ever in FY18 (**Figure S2.1**). While Pakistanis have begun to figure prominently in electronic freelancing lately, it was the sharp increase in consultancy services provided by the country's ICT firms that has dominated the export trend over the last couple of years. This section analyzes in detail the dynamics of ICT exports, and highlights the challenges faced by the firms and individuals in increasing their share in the growing business process management (BPM) and micro-works global market.

Figure S2.1: The Growth in ICT Sector in Pakistan



Data source: Securities and Exchange Commission of Pakistan and SBP

Table S2.1: Pakistan's Exports of Telecommunication, Computer & Services*

million US dollars

	FY13	FY14	FY15	FY16	FY17	FY18	Q1-FY18	Q1-FY19
Total (1 + 2 + 3)	**802.9**	**816.6**	**821.2**	**788.6**	**939.5**	**1,065.0**	**254.0**	**250.6**
of which								
1. Computer services	293.0	330.0	458.6	492.8	572.2	726.0	163.5	180.8
Computer software	212.8	225.1	322.7	286.6	264.4	320.2	62.8	69.7
Software consultancy	42.0	63.8	81.5	139.2	227.3	287.7	74.7	80.2
Other computer	33.5	39.3	52.6	64.2	76.4	118.2	26.0	30.9
2. Telecom services	508.6	485.7	361.3	294.3	365.8	3354	90.0	69.4
Telecom	471.1	445.6	300.7	221.4	282.9	231.4	67.8	46.0
Call centers	37.5	40.1	60.6	72.8	82.9	104.0	22.2	23.5
3. Information services	1.3	0.9	1.3	1.5	1.6	3.5	0.5	0.3

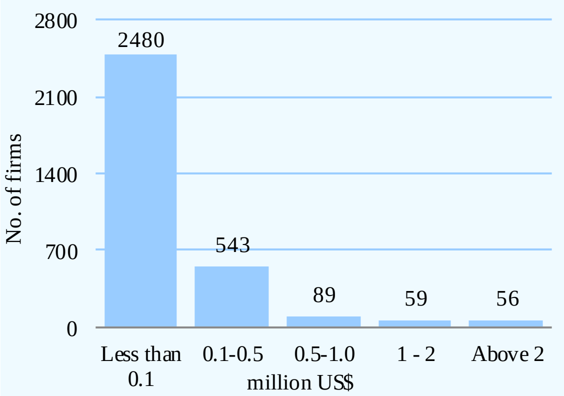
* as per BPM6-Extended Balance of Payments Services Classification (EBOPS 2010)

Data source: State Bank of Pakistan

Low value-added segment dominates

As per the official statistics, computer services have generated most of the export momentum in recent years (**Table S2.1**). However, while software exports have displayed a more-or-less stagnant export performance over the previous 5 years, a steady growth has been observed in the export of consultancy services. As for the sector's composition, export revenues of only 30 percent of the total 3,228 ICT exporting entities came from computer software during FY18; the rest had either limited or no product orientation, as they generated revenues only from low value-added services (e.g. call centers). From FX generation perspective, this dominance of low value-added services is not favorable. The breakdown of FY18 data suggests that the average receipts from software exports (across firms) were more than double the average receipts from other ICT exports. Therefore, it is not surprising to see that only 56 firms had exports of US$ 2 million and above, as an overwhelming majority of firms could not even fetch US$ 0.1 million receipts during the year (**Figure S2.2**).

Figure S2.2: Distribution of Firms by Size of Export Receipts



Data source: State Bank of Pakistan

Informal exports are probably higher than formal exports

Estimates by industry experts place the total size of Pakistan's ICT exports at around US$ 2.5 billion. Of these exports, registered firms using formal banking channels to collect export receipts account for around US$ 1 billion (as captured in **Table S2.1**). However, roughly US$ 1 billion is attributed to SME exports in the grey market, and the remaining US$ 0.5 billion is accounted for by freelancers in the IT and IT-enabled services (ITES) space that serve international clients.

While the major stakeholders – including Pakistan Software Export Board (PSEB), associations, and industry analysts – provide different estimated figures pertaining to the undocumented exports, a common narrative prevails when it comes to reasons behind the under-representation of receipts in the official statistics. First, the absence of PayPal – the most widely used payment method across the globe, and which both employers and freelancers consider relatively more convenient, cheap and safe – is a major concern.[1] Therefore, a number of ICT and business process outsourcing (BPO) firms prefer to receive their revenues using money transfer organizations like Western Union, with some even

[1] This is important because: (i) foreign employers generally make their transactions through PayPal, rendering it undesirable for them to concurrently use the alternative platforms; (ii) PayPal gives an additional payment reversal/dispute resolution facility to the employers, which helps in increasing the level of trust between the transacting parties; and (iii) domestic freelancers or the exporters of digital content have to pay extra to settle their transactions via alternative channels (e.g. Payoneer and Skrill).

preferring to have their revenues deposited in banks outside Pakistan to avoid the associated transfer costs. In the case of former, the export receipts reflect as workers' remittances, whereas in case of latter, these earnings remain unrecorded altogether.

Second, anecdotal evidence also suggests that some firms and individuals themselves bypass proper documentation in order to either stay under the radar of tax authorities, or avoid the hassle of filling out SBP's Form 'R' (considered both cumbersome and redundant). Furthermore, most firms simply opt out of negligence and lack of awareness about the proper export procedures.

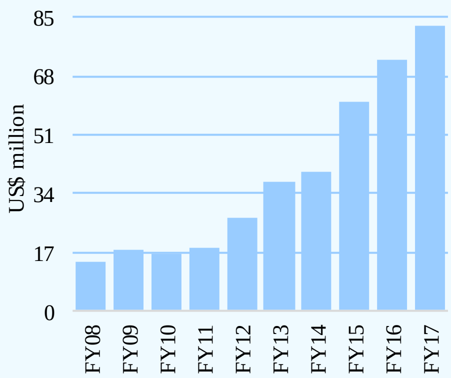
Call centers are expanding

Within the ICT sector, call centers are considered low-end services as these jobs pay on average around half of what may be earned under the software development segment. Irrespective of this, these services hold significance for developing economies because these can generate employment at a very large scale. Pakistan had made a very late entry in this outsourcing industry, as an inadequate telecom infrastructure and slow pace of skill-building of the human resource did not allow it to capitalize on significant expansions in the global BPO industry that started a couple of decades ago.

The sector took a promising start, but it faced a setback in its early years when the country's only internet landing point (SMW3) went through a major breakdown in 2005. Since no backups were available at that point, Pakistan remained disconnected from the web for almost two weeks. As a result, the export-oriented IT and IT enabled service industry had to face significant financial losses, as well as reputational issues in the global market. Resultantly, call centers in the country began shutting down as the international clientele switched to alternate destinations such as India and Philippines.

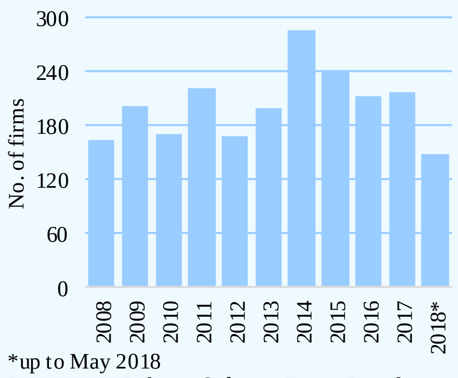
Encouragingly, however, Pakistan's service-oriented ICT industry has reemerged in recent years owing primarily to a significant improvement in the telecommunication infrastructure, a growing focus of young population in technology sector, and a gradual improvement in the country's perception as a BPO destination. In particular, Pakistan has significantly developed its backup internet support by installing six internet gateways, all the while widening the accessibility with the rollout of the NGMS (3G/4G/LTE) services. Not only has this helped improve the reliability of the communication system, but it has also aided in enhancing the speed and ability of the system to ensure faster connectivity. Realizing this opportunity, an average of 200 call centers got registered with the Pakistan Software Export Board (PSEB) on an annual basis over the past decade, with their export earnings, albeit still at a low level in terms of value, consistently growing at a rapid pace (**Figure S2.3a** and **S2.3b**).

Figure S2.3a: Call Center Exports



Data source: State Bank of Pakistan

Figure S2.3b: Total Number of Call Centers Registered



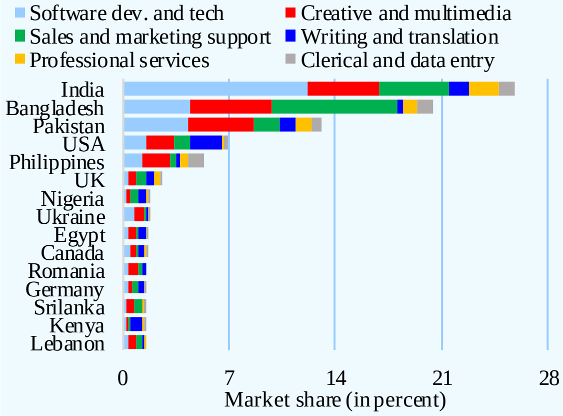
*up to May 2018

Data source: Pakistan Software Export Board

Pakistan is figuring prominently in other BPO segments as well

BPO is a cost-saving measure to outsource processes that are not the core business of an entity but are nonetheless essential for a company to operate. Fundamentally, this involves delegating specific business tasks such as customer relationship management, data entry, bookkeeping, human resource management, payroll processing, and marketing, etc. to a third-party service provider (TPSP), usually situated outside the firm's country of operation.

Figure S2.4: Online Labour Index: Top 20 Worker Home Countries



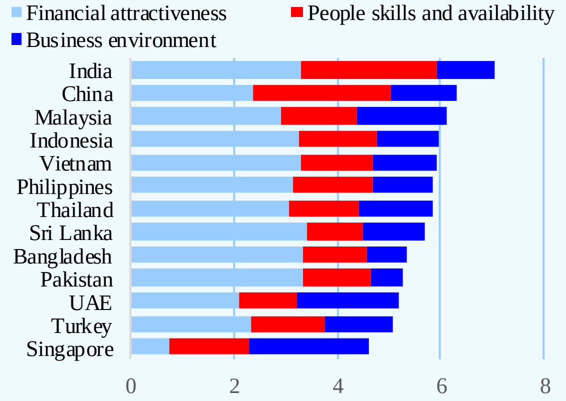
Data source: Oxford Internet Institute; Index retreived at end September 2018

Globally, the BPO industry has witnessed a period of robust growth post 2002 and, according to industry experts, has expanded into a US$ 180 billion industry. It is expected that this market will grow further to US$ 250 billion by 2020, as remote work gets increasingly popular around the world, especially via freelancing websites (such as Upwork and Fiverr). Pakistan was home to the third largest population of professionals related to global online gig industry after India and Bangladesh, as per the ranking available at end September 2018 (**Figure S2.4**).[2] Improved internet access to more than 2,000 cities across Pakistan; a large number of graduates entering the workforce; and government efforts to promote freelancing are the key factors behind this growth.

However, significant improvement is needed before Pakistan can attract more business

According to the A.T. Kearney Global Services location index of 2017, Pakistan is the 10th most attractive destination among Asian countries, and 30th in the world, for offshore services (**Figure S2.5**). Pakistan's score was most encouraging in financial attractiveness: 3rd largest among Asians after Sri Lanka and Egypt amongst the 55-country index. This is representative of the relatively favorable wage rates in Pakistan compared those in more established destinations such as India and China. However, when it comes to cross-country comparison of other off-shoring fundamentals (quality of human resource and overall business environment), Pakistan lags behind its regional competitors. Indeed, despite the fact that the country was able to increase its ICT revenues, it has fallen two points in the rankings compared to last year.

Figure S2.5: A.T. Kearney Global Services Location Index 2017



Data source: A.T Kearney Global Service Location Index

In particular, the low ranking in the 'people skills and availability' category is a big concern. It is pertinent to note that Pakistan has an abundant supply of young and English-speaking population who can potentially assume the nature of the jobs that BPO has to offer. However, since the industry is relatively new to the country, it is still not being pursued as a long-term career; the more qualified employees tend to upgrade their careers and move into software development,

[2] Otto Kässi, Vili Lehdonvirta, Online labour index: Measuring the online gig economy for policy and research, Technological Forecasting and Social Change, Volume 137, 2018. The regularly updated open dataset of Online Labour Index tracks all the projects or tasks posted on five major English-language online freelancing platforms (i.e. upwork.com, Peopleperhour.com, Freelancer.com, Guru.com and Mturk.com).

quitting the BPO industry after a very short span of time. As for the new entrants, the lack of technical and professional capacities works as a major growth barrier, making it hard for the BPO industry to compete in the international market.

Going forward, focusing on skill building and improvement of payments infrastructure would be the key

The government is taking administrative measures through PSEB to promote the sector's smooth progress. For instance, the recently announced Digital Pakistan Policy provides multiple tax incentives to the industry and envisions a strong interplay between IT firms, cellular operators, and government institutions. SBP is also guiding banks on proper documentation of the proceeds of BPO outlets and working with the industry to sort out associated payment-related issues. It is vital that the government continues to work in this trajectory and embrace the idea of technology-centric Special Economic Zones (SEZs), where companies can take advantage of IT-ready plug and play clusters and operate under a one-window structure with the government.

As for the human resource, some important initiatives have been taken by Ministry of Information Technology and Telecommunication (MOITT) and associated private enterprises, including the launch of National Incubation Centers and the Digital Skills Training Program. Furthermore, Pakistani freelancers often find Massive Open Online Course providers like Coursera, edX, Alison, etc. useful in improving and learning new skills. Last year, Coursera collaborated with Pakistan (among six other countries) to provide training to 3,000 young professionals. Local universities that specialize in IT also need to focus more on the education quality, especially with respect to developing programming/coding skills in demand in the global market.

As far as cross border payment solutions are concerned, although exchange services of intermediaries such as Payoneer and Skrill are available for individuals and startups associated with the freelancing and BPO industry, little progress has been made in introducing the most widely used digital payment service of PayPal. As things stand, data privacy is one of the major hurdles in the way of PayPal to enter Pakistan.[3] Furthermore, as PayPal's funds transfer mechanisms work in a bidirectional fashion, there are concerns for countries with weak external buffers to risk excessive outward remittances of foreign exchange.

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[3] In past, PayPal had to cease or narrow down its operations in multiple countries by failing to satisfy the local regulatory authorities on the issue of data security. The platform stores information on data-handling from all the countries on a universal cloud platform. This practice is often inconsistent with the banking regulations of the countries, as sensitive information of the citizenry is held offshore.

Nonetheless, to facilitate freelancers and the BPO industry, SBP has recently allowed commercial payments - both B2C and C2B - through the bulk payment-processing channel under the Pakistan Remittance Initiative (PRI),[4] which may not perfectly substitute PayPal but can potentially provide some relief in the form of lower financial charges relative to other channels. Cumulatively, such efforts would help improve industry's fundamentals going forward.

[4] Exchange Policy Department, SBP circular No 11 of 2018, dated October 22, 2018 available at http://www.sbp.org.pk/epd/2018/FEC11.htm

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Analysts:

Chapters:

1. Overview	Asma Khalid
2. Real Sector	Dr. Waqas Ahmad; Javed Iqbal; Khurram Ashfaq Baluch; Saher Masood; Talha Nadeem
3. Inflation and Monetary Policy	Asma Khalid; Fatima Khaliq; Umer Khan Baloch; Amjad Ali; Umar Mashhood
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Special Sections	
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Publication Manager:	Asma Khalid
Director:	Dr. Omar Farooq Saqib
Publication Review Committees:	
PRC of the Management	Dr. Saeed Ahmed (Chairman); Dr. Inayat Hussain; Syed Irfan Ali; Muhammad Ali Malik; Syed Samar Husnain; M. Ali Choudhary; Muhammad Javaid Ismail; Dr. M. Farooq Arby; and Dr. Omar Farooq Saqib
PRC of the Board	Ardeshir Khursheed Marker (Chairman); and Zubyr Soomro

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For feedback and queries: quarterly.report@sbp.org.pk