THE STATE OF PAKISTAN'S ECONOMY

Second Quarterly Report
for the year 2019-2020 of the
Board of Directors of State Bank of Pakistan

State Bank of Pakistan

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LETTER OF TRANSMITTAL

April 13, 2020

Dear Mr. Chairman,

In terms of section 9A(2) of the State Bank of Pakistan Act, 1956, the Second Quarterly Report of the Board of Directors of the State Bank of Pakistan on the State of the Economy for the year 2019-20 is hereby enclosed for submission to the Majlis-e-Shoora (Parliament).

With warm regards,

Yours sincerely,

(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Muhammad Sadiq Sanjrani
Chairman
Senate
Islamabad

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(Dr. Reza Baqir)
Governor
Chairman Board of Directors

Asad Qaiser
Speaker
National Assembly
Islamabad

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1 Overview

1.1 Economic Review

Halfway through the current fiscal year, stabilization efforts have yielded notable improvements (**Table 1.1**). The current account deficit has shrunk significantly, foreign exchange reserves have risen markedly, the primary budget balance has moved into surplus, and core inflation has lately eased. Moreover, export-led manufacturing has gained further traction and signs of a pickup in construction activities have emerged recently, suggesting the economy is on the path of gradual recovery. Also, performance under the ongoing IMF program remains strong, and international rating agencies maintained a stable outlook for Pakistan.

Table 1.1: Economic Indicators

	FY19	H1-FY19	H1-FY20
	Growth rate (percent)		
LSM[a,1]	-3.3	-1.7	-2.8
CPI National (period average YoY)[a,2]	6.8	6.0	11.1
Private credit[b]	11.6	9.5	3.2
Money supply [b]	11.3	3.6	5.2
Exports[a]	-1.1	1.9	3.1
Imports[a]	-9.9	-2.6	-17.0
FBR tax revenue (billion Rs)[c]	3,828.5	1,794.8	2,094.1
Exchange rate (+app/-dep%)[b]	-24.1	-12.5	3.4
	million US dollars		
SBP's liquid reserves (end-period)[b]	7,280.4	7,203.7	11,336.1
Workers' remittances[b]	21,838.6	11,030.0	11,394.9
FDI in Pakistan[b]	1,668.0	796.8	1,341
Current account balance[b]	-13,830.0	-8,614.0	-2,099.0
Fiscal balance (% of GDP)[d]	-8.9	-2.7	-2.3

[2]YoY growth in the average of CPI index for half year. New base (2015-16)

Data sources: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

These gains primarily reflect the cumulative effect of stabilization and regulatory measures taken during the past one year. For instance, the reduction in the current account deficit to a six-year low level in H1-FY20 was facilitated by demand management measures, transition to a market-based exchange rate system, and regulatory efforts to curb non-essential imports and to increase the inflow of workers' remittances through formal channels. Similarly, the improvement in the fiscal position also reflects the impact of tax and non-tax measures to increase the revenue stream, and a significant restraint on expenditures by the government. In this stabilization process, domestic production and retail trade activities were adversely affected.

While the economic activity has started to show signs of a recovery, it is important to consolidate gains on stability front. More specifically, progress in some areas

remains vulnerable and more work is needed to put the economy on a firm path toward sustainable growth.

Developments in the balance of payments highlight this aspect. In particular, decline in the current account deficit has mostly stemmed from a reduction in the import bill; whereas, export receipts have yet to contribute significantly to this improvement. This is largely due to depressed international commodity prices, which partially offset the gains in terms of export volumes offered by a competitive exchange rate. Moreover, a narrow manufacturing base and limited market penetration of Pakistan's exports did not help either. Second, the outcome for foreign direct investment (FDI) inflow was also not encouraging as barring the telecommunication sector, inflows were about at the same level as last year. This dynamic needs to be addressed because FDI is intrinsically linked to the county's ability to expand its manufacturing and export base in the medium term. Therefore, to attract and sustain higher FDI inflows in the country, reform-related efforts need to be prioritized.

In the same vein, the primary budget surplus on the back of a substantial growth in revenues is encouraging. Domestic tax collection grew to its highest since H1-FY12, as the FBR reversed earlier concessions, resorted to new levies and also benefited from price increases especially in the energy sector. Nevertheless, the overall revenue targets were missed, primarily due to significant compression in the country's imports, which contributes heavily to revenue collection. These developments suggest scope for greater efforts to broaden the tax base and increase documentation in the economy. Moreover, the coordination between fiscal and tax authorities also needs to be enhanced to align expenditures' growth with expected revenue stream.

The real sector too has its long-standing challenges, especially in the agriculture sector. For instance, crop yields are low and water availability is constrained. With additional challenges such as climate change emerging, agriculture production appears less resilient to externalities. This year too, the cotton crop succumbed to unfavorable weather, low water availability, and pest attacks. The decline in cotton production is therefore set to undermine the agriculture performance in FY20, despite encouraging prospects for wheat crop and livestock.

On the inflation front, core inflation in both urban and rural areas has remained stable during H1-FY20, reflecting the impact of stabilization measures. However, easing of underlying inflationary pressures was not sufficient to arrest the climbing headline inflation, which was largely led by food inflation. Thus, headline inflation overshadowed the stability in core inflation, and consumer

confidence (which remained low in H1-FY20) further declined in the November-2019 wave of the IBA-SBP Consumer Confidence Survey. The policymakers, nonetheless, anticipated only a temporary impact of these food supply shocks on the future inflation path and kept the policy rate unchanged in both the September- and November-2019 decisions of the Monetary Policy Committee. However, it was also recognized that if these shocks result in sustained increases in inflation (such as on a month-on-month basis) they could entrench inflation expectations.

Thus, to make the stabilization successful on a sustainable basis, current efforts must be complemented with further structural reforms. In effect, greater policy vigilance and more vigor are required for the needed transition from stabilization to growth. In this regard, in addition to several other recommendations made in the past SBP reports, this report identifies the suboptimal state of competition in the domestic economy as an area needing immediate attention of the policymakers.

In this context, **Special Section** in this report, assesses the current state of competition in the country, and highlights the importance of competition for achieving economic growth and price stability in the economy. The latter is particularly important from the point of view of monetary policy, as central banks across the world prioritize targeting price stability as one of their major objectives. The section argues that the overall competitive environment in Pakistan has not been favorable for productivity enhancement and growth. In this context, a fundamental rethinking is needed with respect to the regulatory structure of the economy. The role of the public sector should generally be limited to addressing market failures through structural reforms, and only providing broad institutional support to businesses. Where targeted interventions are inevitable to initiate activity in the presence of market failures, it may be ensured that these are not entrenched.

1.2 Economic Outlook

Pakistan's economy had clearly moved out of the crisis-management mode before the Covid-19 infections started to be detected in the country. The current account numbers were getting better every month, and foreign exchange reserves were shoring up steadily. In addition, headline inflation was expected to revert to the medium-term target of 5–7 percent over the next 24 months. Nevertheless, achieving this year's real GDP growth target of 4.0 percent was unlikely, as the agriculture sector's performance was lower than expectations, whereas the export-driven growth in LSM was not sufficient to compensate for the subdued domestic market activity. Therefore, the SBP's projections for GDP growth were revised to 3.0 percent in FY20, down from 3.3 percent last year. These projections are now

likely to be revised downward further. But more broadly, with the twin deficits relatively under control, encouraging progress on FATF, a stable outlook from the credit rating agencies and confidence provided by the IMF program, Pakistan's economy had begun to improve. However, this optimism is now subject to risks arising from the global and domestic spread of Covid-19.

Covid-19 outbreak

Emerging from the city of Wuhan in China, the novel coronavirus has spread to 212 countries at the time of this writing, with around 1.4 million confirmed infections across the world. The World Health Organization has declared the virus a pandemic and urged countries to implement effective containment strategies. A large number of countries have completely suspended flight operations to contain the spread, and have implemented stringent measures to ensure social distancing. Nonetheless, the financial impacts of Covid-19 have already been sizable, and the economic effects are still unfolding.

At first, the Covid-19-related panic, along with the Saudi-Russia standoff over crude oil, jolted global capital and commodity markets. Global crude oil prices have fallen to 21-year low levels amid fears of a global recession and abundant supplies. From the demand standpoint, a significant impact on prices has also come from China, the original epicenter of Covid-19, which recorded a 13.5 percent contraction in industrial activity during the first two months of 2020 (though some recovery was recorded in March 2020).[1] In addition, sudden shutdowns faced by global aviation, automotive, tourism, and energy companies have significantly increased vulnerabilities in these sectors. In other sectors also, subdued retail buying, unsold inventories and disruptions in supply chains are triggering pressures – though improved liquidity buffers in the global banking industry (aided by recently announced monetary stimulus packages) have avoided financial distress so far.

As a result, the overall global economic outlook remains highly uncertain and clearly subdued compared to the pre-outbreak estimates, with layoffs expected to spike in response to lockdowns.[2] The OECD, ADB and IMF have all downgraded their growth outlooks for the global economy. Governments and central banks have responded with their traditional toolkits: many emerging market economies,

[1] Source: National Bureau of Statistics of China.

[2] According to the US Department of Labor, a record 6.6 million people filed for unemployment insurance in one week (ending March 28, 2020), which marks "the highest level of seasonally adjusted initial claims in the history of the seasonally adjusted series". This increase was on top of 3.3 million claims filed in the preceding week, which means that around 10 million people faced job losses in two-week time.

such as India, Indonesia, Malaysia, Philippines, South Africa, and Vietnam have lowered interest rates. The Fed has lowered interest rates to zero and also rolled out a quantitative easing program (initially worth US$ 700 billion). The ECB also put in place a similar program of US$ 820 billion to support EU economies. Later, both the Fed as well as the ECB removed the limits assigned to these bond purchase programs. Unemployment benefits are being scaled up in some countries, along with cash outlays, whereas selective tax breaks have also been offered.

Coming to Pakistan, the number of confirmed Covid-19 cases at the time of this writing has surpassed 4,400 – including both primary infections and secondary spreads. To minimize incremental infections, the government has suspended domestic and international flight operations and strictly tightened cross-border movement. Moreover, provincial governments have implemented lockdowns in various regions, allowing uninterrupted operations only in critical sectors, such as healthcare. Most avenues of social interactions, such as educational institutions, shopping centers, theaters and restaurants, have been closed down, whereas public transport, including ride-hailing services, have been suspended. Most employees of financial institutions, factories and businesses are working remotely, wherever possible, and only critical staff are being allowed at workplaces. All these measures will clearly weaken domestic economic activity and consumer demand.

Moreover, the spillover from the global economic slowdown may also be significant. On the positive side, as a net oil importer, Pakistan would benefit from the substantial decline in global oil prices. Apart from contributing to the SBP's disinflation efforts, this will further reduce the import bill and the current account deficit.

On the negative side, however, the outbreak of the virus in Europe and North America and the ensuing lockdowns may have an adverse impact on Pakistan's exports. Domestic exporters have already warned of cancellation of orders as retail sales in destination markets weaken and port and shipping activities are restricted. Under such circumstances, exporters may face a cash crunch for some time. Meanwhile, remittances from major destinations may decline temporarily in the coming months, with some transient downward impact on domestic consumption. Financial markets too have come under severe pressure. The equity market was the hardest hit, as domestic investors grew wary of the pandemic's trajectory. The corporate sector was already struggling with subdued demand and thin margins, which has now been compounded by the Covid-19 related uncertainty. The debt market too faced selling pressure, as foreign investors took

out over US$ 1.7 billion from T-bill investments in the month of March 2020, contributing to depreciation pressures in the foreign exchange market.
At this point, it is important to note that the situation with respect to Covid-19 is extremely fluid and uncertain. The government is responding fast to unfolding developments. Preventing the spread and ensuring robust healthcare facilities to test and treat patients, remains the top policy priority of the government. Ensuring food security is another important agenda on which the government is strategizing proactively and carefully. Moreover, social safety nets are also being beefed up to help minimize the impact of lockdowns on daily wage earners and laid-off workers. Certainly, all this requires a sizable amount of fiscal spending. More recently, the government has announced a Rs 1.2 trillion economic relief package which includes a steep cut in domestic petrol prices, stipend for daily wage earners and expansion in the scope for cash assistance under the Ehsas program, immediate release of export refunds by the FBR, deferment of utility bill payments, and additional allocation for the Utility Stores Corporation.

As for SBP, it has taken important measures to minimize the impact of Covid-19 on the economy. Within a span of 8 days (March 17 – 24, 2020), the Monetary Policy Committee (MPC) cut the policy rate by a cumulative 225 basis points. Furthermore, the SBP has announced multiple measures to facilitate the general public's access to financial services amid the Covid-19, simplified procedures for exporters and importers, and allowed banks leeway in booking losses pertaining to the outbreak on their financial statements (**Box 1.1**).

Box 1.1: Recent Measures Announced by the SBP to Mitigate the Impact of Covid-19

1. Refinance Facility for Combating Covid-19 (RFCC): To support hospitals, medical centers for the purchase of equipment to detect, contain and treat the Covid-19; total size of the scheme is Rs5 billion.

2. Advance payment limits withdrawn on coronavirus-related imports: SBP has allowed all federal and provincial government departments, public and private hospitals, charitable organizations, manufacturers and commercial importers to make Advance Payment Import and Import on Open Account, without any limit, for the import of medical equipment, medicines and other ancillary items for the treatment of Covid-19.

3. Facilitating credit flows to borrowers and easing loan repayment schedule:
SBP has reduced the Capital Conservation Buffer from its existing level of 2.5 percent to 1.5 percent; this effectively increases the loanable funds available with banks by around Rs 800 billion. Furthermore, the debt burden ratio requirement for consumer loans has been relaxed from 50 percent to 60 percent, which is expected to allow about 2.3 million individuals to borrow more from banks.

To ease borrowers' financing constraints, banks have been instructed to defer the payment of principal on loans and advances by one year, with no adverse consequences for the borrowers' credit history. For borrowers whose financial conditions require relief beyond extension of principal repayment for one year, SBP has relaxed the regulatory criteria for restructuring/rescheduling of

loans. The loans that are re-scheduled/restructured within 180 days from the due date of payment will not be treated as defaults, and banks would also not be required to suspend the unrealized mark-up against such loans. In addition, the timeline for classification of "trade bills" has been extended from 180 days to 365 days.

4. Extension in export performance periods for EFS & LTFF: Exporters availing the subsidized credit schemes are required to ship their goods within 6 months of availing credit under EFS. In case of failure, penalties are imposed. This period has been extended from six to twelve months.

Exporters were required to show performance under the EFS schemes by end-June 2020. This period has been extended by 6 months to end December 2020. Since the additional period will also be counted towards setting new limits, this will help the exporters in availing higher limits for FY21.

Exporters who want to avail credit under Long Term Financing Facility (LTFF) are required to have exports worth 50 percent, or US$ 5 million, of the total sales to become eligible. This limit has been reduced to 40 percent or US$ 4 million for all the borrowings under LTTF during the period January 01, 2020 to September 30, 2020. Moreover, the requirement of annual projected exports performance for four years to avail LTFF, has been extended by another year.

5. Extension in realization of export proceeds & arrival of goods under advance payment: SBP has allowed banks to enhance the time period for realization of exports proceeds from existing 180 days to 270 days on a case by case basis where the delay is related to Covid-19. To facilitate importers, SBP has extended the time period for import of goods into Pakistan against advance payment from existing requirement of 120 days to 210 days.

SBP has allowed exporters to directly dispatch the shipping documents of their exports' consignment to their foreign buyers without any limit, subject to some conditions. Earlier, exporters could dispatch the shipping documents directly to their foreign buyers for export consignments of up to USD 100,000, or equivalent in other currencies.

For importers, the SBP has enhanced the existing limit of US$ 10,000 per invoice for advance payment on behalf of manufacturing & industrial concerns and commercial importers for import of raw material, spare parts and machinery, to US$ 25,000.

6. Electronic submission of foreign exchange-related cases to SBP: The SBP has activated the Regulatory Approval System (RAS) for banks to electronically submit foreign exchange operations and policy-related cases to the Foreign Exchange Operations Department (FEOD) and the Exchange Policy Department (EPD).[3] The RAS would allow banks' customers to receive system-generated update status reports via email, from the time of case submission till completion.

7. Credit to SMEs: To incentivize banks to provide additional loans to retail SMEs, the existing regulatory retail limit of Rs 125 million per SME has been permanently enhanced to Rs 180 million.

8. Equity selloff and margin call requirements against bank financing: Keeping in view the steep decline in equities, margin call requirement of 30 percent vis-a-vis banks' financing against listed shares has been reduced to 10 percent. Banks have also been allowed to take exposure on borrowers against the shares of their group companies. Banks are also allowed to book impairment loss on their "available for sale" equity securities in a phased manner till December 2020.

[3] For cases pertaining to the EPD, banks are to submit the cases manually by surface mail as well, until further instructions are issued.

9. Disinfected cash notes: Detailed instructions have been provided by SBP to ensure to clean, disinfect, seal and quarantine all cash being collected from hospitals and clinics and to block circulation of such cash in the market. The banks shall report daily collection of cash from hospitals to SBP, which shall credit bank's accounts for the amounts so quarantined by them.

10. Stimulate investment in manufacturing via Temporary Economic Refinance Facility (TERF): SBP will refinance banks to provide financing at a maximum end-user rate of 7 percent for 10 years for setting up of new industrial units. The total size of the scheme is Rs 100 billion, with a maximum loan size per project of Rs 5 billion. It can be accessed by all manufacturing industries, with the exception of the power sector. It will require a letter of credit (LC) to be opened by end-March 2021.

11. No charges on IBFT/ATM withdrawals: SBP has instructed banks to waive all charges on fund transfers through online banking channels such as Inter Bank Fund Transfer (IBFT), SBP's Real Time Gross Settlement System, and ATMs

12. General customer facilitation measures
Banks have also been encouraged to adopt business processes that reduce customers' need to visit bank branches and minimize interaction time between customers and bank staff. These instructions cover processes where biometric verification of customers is required, such as account opening and branchless banking transactions. Banks have also been encouraged market their alternative delivery channels (online banking, ATMs etc), to reduce customer traffic at branches. SBP has also facilitated the cheque-clearing process, by allowing banks to provide Direct Cheque Deposit Facility under which a crossed cheque may be presented by the payee/beneficiary directly to the paying/drawee bank, instead of their bank branches (as per the prevalent practice). Banks have also been allowed to process scanned copies of cheques (for corporate and priority customers) after proper due diligence, and to facilitate customers by collecting cheques from customers' addresses.

1.3 Summary of the Report

Real sector

Overall, real economic activity was somewhat subdued during H1-FY20. The industrial sector in particular was affected by the impact of continuing macroeconomic stabilization measures. Nonetheless, a number of sectors managed to shrug off the economic slowdown and posted a solid performance, suggesting some bottoming-out of activity. The fertilizer sector was a case in point. Last year, small urea producing units had been inactive for three months during H1-FY19; however, this year, such small units remained active throughout the first half, leading to YoY growth in production. Furthermore, the current period saw an uptick in growth for the cement and textile industries, boosted by exports. The major drag on LSM came from the decline in production of the automobile sector; while the remainder was mostly attributed to petroleum and steel.

For agriculture, early estimates suggest that despite some improvement in area under wheat, the drag from decline in cotton production and negligible growth in sugarcane and rice output may limit the sector's growth during FY20. An increase

in the area sown under wheat was reported compared to last year, and the availability of inputs was also better in the *rabi* season. However, the area under wheat still remained below its FY20 target.

In the services sector, proxy indicators for *wholesale and retail trade*, like LSM, sectoral credit offtake, and growth in imports, suggested subdued activity. A similar picture emerged for the transport sub-sector, judging from a sharp dip in commercial vehicle sales in H1-FY20 and lower sector-wise POL sales. By contrast, the communication sub-segment appeared to fare better, with further gains in cellular teledensity and a 69.2 percent growth in mobile phone imports. Meanwhile, within *finance and insurance,* the after-tax profits of the banking sector grew by 21.0 percent during H1-FY20 compared to a year earlier.

Inflation & Monetary Policy

Inflationary pressures continued to build through the first half of FY20, as the headline inflation rose by 11.1 percent, compared to 6.0 percent in the same period last year, primarily because of a steep surge in food inflation. This trend was attributed to a number of factors such as temporary supply disruptions in perishables, higher transportation costs and sales tax rates on major kitchen items including edible oil and sugar. In contrast, non-food-non-energy (NFNE) inflation moderated on the back of demand compression; not only did it remain almost at the previous year's level, but it also declined in Q2-FY20, compared to the preceding quarter.

Therefore, despite a rise in inflation during the period under review, SBP's projections for average headline inflation for FY20 remained broadly unchanged at 11-12 percent. In addition, a notable improvement in the country's balance of payment situation (that also led to appreciation in Pak rupee) and an overall adherence of the government to fiscal consolidation efforts, also contributed to stability in the short-term inflation outlook. Therefore, the Monetary Policy Committee of SBP decided to keep the policy rate unchanged in its meeting held in November 2019; the prevailing rate seemed appropriate to the committee for bringing inflation down to the target range of 5-7 percent over the medium term.

As for the implementation of monetary policy, fewer interventions were required to keep interbank overnight rates close to the target rate. Furthermore, overnight interest rates exhibited less volatility during Q2-FY20, compared to the previous quarter. The ease in liquidity stemmed from net retirement by government to scheduled banks, as the government mobilized higher financing from external and non-bank sources during Q2-FY20, and also used its deposits (cash buffers) held with SBP.

In addition, credit demand from the private sector was also weak as industrial activities remained largely subdued. Some vibrancy was observed in export-oriented sectors, but their borrowing registered only a marginal increase compared to last year. These sectors enjoyed improved liquidity on account of higher exports earnings and smoother disbursement of tax refunds. Importantly, there was a compositional shift in favor of foreign currency loans, which entailed a similar interest rate gap as was available in case of SBP's concessional rupee financing scheme (EFS).

Fiscal Policy and Public Debt

A significant improvement was seen in the fiscal sector during H1-FY20. Both fiscal and revenue deficits were contained compared to the corresponding period last year. The fiscal deficit as a percent of GDP reduced from 2.7 percent in H1-FY19 to 2.3 percent in H1-FY20. The primary surplus surpassed the target and revenue growth was substantially higher, while expenditures on social sector and development picked up strongly. The rise in revenue collection was attributed to both tax and non-tax revenues. Policy measures such as increase in GST on petroleum products, enactment of taxes on telecom services, increased excise duty on cement and cigarettes, upward revision in salary slabs, adjustments in power tariffs, end of preferential treatment for certain sectors and zero-rating regime for five export-oriented sectors played an important role in higher tax collection. Non tax revenues, mainly coming from SBP profits and GSM renewal fees, also provided impetus to overall revenue collection. That said, import compression continued to adversely affect revenue mobilization.

On the expenditure side, both current and development expenditures grew sharply during H1-FY20. In particular, a sharp growth in expenditures was witnessed in the second quarter which more than offset the rise in revenues. Higher growth of current spending was led by interest payments and grants. In addition, development expenditures also grew both at federal and provincial levels with a higher pace during H1-FY20, mainly led by a rise in spending on infrastructure projects and social sectors.

Public debt accumulation was contained partly due to lower financing needs and partly due to an appreciation of PKR against the US dollar. Moreover, the government utilized its deposits with the banking system (especially in Q2) to meet its financing needs and also for retirement of existing debt stock. The government strictly adhered to its commitment of zero borrowing from the central bank and mobilized funds through commercial banks (mainly in Q1) and NSS. Meanwhile, external debt increased in dollar terms by US$ 3.7 billion during H1-

FY20 on account of fresh borrowing from multilateral and commercial sources, receipts of IMF tranches, and a rise in foreign investment in government securities. Debt servicing (both principal and interest payments) of public external debt increased to US$ 5.9 billion. Within principal payments, Sukuk (US$ 1.0 billion), bilateral and short-term credit repayments recorded a significant increase.

External Sector

Primarily led by a broad-based contraction in imports, the external account recorded a notable improvement, with the current account deficit (CAD) falling to a six-year low in H1-FY20. The reduction in imports resulted from ongoing macroeconomic stabilization measures, lower oil prices and power sector's shift away from furnace oil-based generation. In particular, import demand in the transport sector remained subdued, as automakers faced a sizable drop in car sales. This had a spillover effect on the steel sector, reducing its demand for imported steel scrap and finished products. Moreover, regulatory measures aimed at curbing non-essential imports and dumping by trading partners played a role in curtailing import payments.

Meanwhile, low global commodity prices continued to suppress export earnings of Pakistan's major export products, i.e. textiles and rice, offsetting decent rises in export volumes. Textile and rice exporters managed to increase their market shares in the EU, US, and Middle East. The currency adjustment in the recent past allowed exporters to remain competitive in the challenging global environment. At the same time, remittances continued to grow, on the back of higher inflows from the US, the UK and Saudi Arabia.

Introduction of a market-based exchange rate, and foreign investors' perception about its sustainability, helped the country to attract external financing during the period. The sizeable inflows from IFIs (including the IMF), commercial banks and portfolio investors allowed debt and deposit repayments during the period. These inflows allowed SBP to unwind its net short position in the forward market and re-build its reserves, which reached a twenty month high of [US$ 11.3 billion] by end-December 2019. As a result, the Pak Rupee appreciated 3.4 percent against the US Dollar during the period.

2 Real Sector

2.1 Overview

Real economic activity was somewhat subdued during H1-FY20. To an extent, this could be traced to the impact of continuing macroeconomic stabilization measures, which had a notable impact on the industrial sector. In addition, early estimates suggest that despite some improvement in area under cultivation of wheat, the drag from decline in cotton and sub-par performance of sugarcane and rice crops may limit growth of the agriculture sector in FY20. The services sector was also affected by the developments in the commodity-producing sector, as reflected in the moderation or decline in various indicators related to *wholesale and retail trade* and *transport, storage and communication*.

Specifically, the direction of growth in the agriculture sector in FY20 would depend on the output of wheat and livestock sector. While the indicators of the livestock sector are not yet available, increase in area under wheat over last year is a favorable development. That said, the wheat area is still below the target set by the government. Also, despite better input availability in the *Rabi* season, the expected increase in production may not be enough to compensate for the YoY decline in cotton.

The LSM sector started showing some positive signs during Q2-FY20. Compared to both Q2-FY19 and Q1-FY20, the growth outcome improved noticeably. Expansion was evident in the construction-allied industry that seemed to have benefited from an uptick in cement exports and an increase in government development expenditures. In addition, sugar production rose sharply owing to favorable weather conditions (which were conducive for extraction of high sucrose content from the raw material), as well as relatively timely start of the crushing season compared to last year. Textile sector's output also jumped on account of higher exports. On the negative side, performance of the automobile industry remained subdued while petroleum also played a part in dragging the growth of LSM down. Moreover, there was a slowdown in fertilizer sector due to gas supply bottlenecks. On the whole, lower domestic demand and heightened risks to global growth have increased the downside risks for the industrial sector.

The services sector's growth depends on the performance of the commodity-producing sector. Import compression and weak performance of the crop sector are likely to impede retail subsector growth, while the economic downturn will adversely affect activities in the transportation sector. This is further highlighted

by decrease in sale of POL products and commercial vehicles. The silver lining so far is bank profitability, which remained higher during H1-FY20 compared to a year earlier, attributed in part to the high interest rate scenario that prevailed at the time.

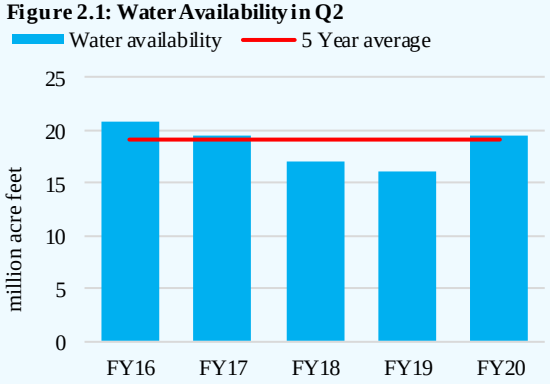
2.2 Agriculture

After a relatively subdued *Kharif* period, early indicators point to some improvement of agriculture sector during the *Rabi* season. For *Kharif*, cotton production is projected to decline by 4.2 percent over last year, hence missing the targets for FY20 by 25.7 percent. While still being below the target by about 1.5 percent, sugarcane production in FY20 is likely to be slightly higher than the last year. Similarly, FY20 turned out to be a marginal year for rice, as its overall production also missed the target by 3.0 percent and remained around the last year's level. Moving on to *Rabi* season, the input situation improved over last year. Specifically, water availability remained higher than the 5-year average, credit disbursements showed visible jump, and urea offtake rose compared to FY19. Better input situation compared to last year's *Rabi* season is likely to aid crop production, in particular the wheat crop.

Inputs

Canal water withdrawals increased during the first half of *Rabi* season compared to the 5-year average and also over same period last year (**Figure 2.1**). Major improvement was seen in Punjab and Sindh, which observed an increase in irrigation water supply during Oct-Dec 2019.[1] Moreover, increase in rainfall was recorded during the wheat sowing season over last year, especially in the provinces of Sindh and Punjab. Additionally, drop in temperatures during the germination and tillering stage of the wheat crop could prove crucial in enhancing the yields, come the harvest time.

Figure 2.1: Water Availability in Q2



Data source: Pakistan Space and Upper Atmosphere Research Commission (SUPARCO)

Agriculture credit also registered a significant increase of 16.5 percent during H1-

[1] Irrigation water supply rose by 24.5 percent in Punjab and 21.8 percent in Sindh, according to SUPARCO data.

FY20. Accounting for inflation rate of 11.1 percent during H1-FY20, real growth in credit clocked in at around 5.4 percent for the period. A notable increase in disbursements of fixed investment loans was among the highlights of agriculture credit during the period (**Box 2.1**).

Box 2.1: Highlights of Agriculture Credit during H1-FY20

Credit is a critical input for the agriculture sector, since monetary inflows and outflows depend on the crop production cycle. Given the scale of its importance in alleviation of temporary liquidity issues, the SBP encourages the formal lending institutions to provide credit to the rural sector. The primary tool at the SBP's disposal is the issuance of indicative targets. The central bank has also worked continuously on improving the regulatory oversight of lending institutions and easing the documentary bottlenecks for the borrowers. The success of these policies is evident from the fact that banks have been able to achieve their targets almost every year. From gross disbursements of Rs 260 billion in FY10, the central bank's target of Rs 1,350 billion in agriculture credit disbursement for FY20 is now within reach – a more than four-fold increase in the last decade.

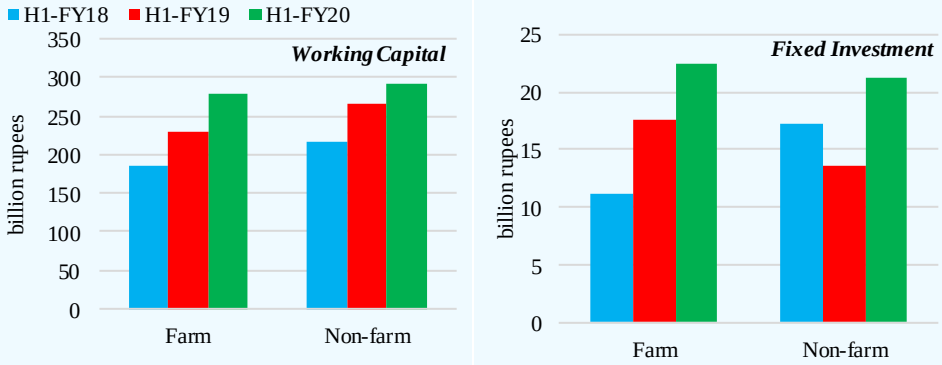
Table 2.1.1: Agriculture Credit Disbursements during H1

billion rupees, growth in percent

	FY19	FY20	Growth
Farm (I)	231	279.4	21.0
of which-Corporate farming	75.9	83.7	10.3
Non Farm (II)	265.2	291.3	9.8
of which-Poultry	61.5	120.4	95.8
of which-Livestock	132.6	148.8	12.2
Working capital (I+II=a)	496.2	570.7	15.0
Farm (III)	17.5	22.5	28.6
Non farm (IV)	13.6	21.2	55.9
of which-Poultry	1.2	6.8	466.7
Total production loans (III+IV=b)	31.1	43.7	40.5
Total credit (a+b)	**527.3**	**614.4**	**16.5**

Data source: State Bank of Pakistan

Figure 2.1.1: Gross Agriculture Loan Disbursements



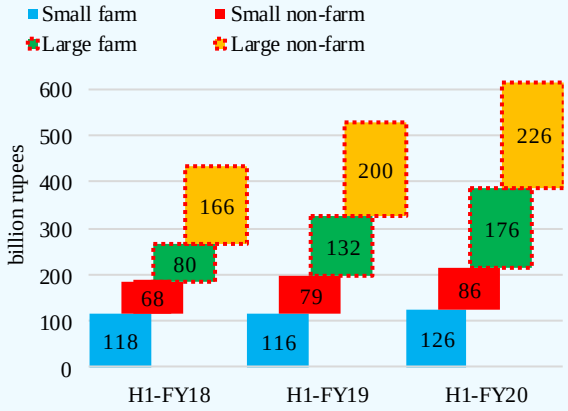
Data source: State Bank of Pakistan

In order to achieve its FY20 goals, SBP allowed Electronic Warehouse Receipt (E-WHR) financing and increased the maximum repayment tenure of development loans from 5 to 10 years in its Revised Prudential Regulations for Agriculture Financing. E-WHR would help in improving access

to credit for farmers, by allowing banks to accept E-WHRs as collateral for lending against storage of agriculture produce and commodities. In particular, it would benefit small farmers who usually find it difficult to access credit due to non-availability of agricultural land. It would also reduce post-harvest losses and increase farmer's profitability. In addition, SBP has increased indicative credit limits and updated eligible items for agriculture financing.

This approach proved to be successful, as evident from increase in development and working capital loans during H1-FY20 (**Figure 2.1.1**). On the fixed investment side, significant increase in credit uptake to poultry was observed; gross disbursements in the first half rose to Rs 6.8 billion during the review period from Rs 1.2 billion a year earlier (**Table 2.1.1**). Also, working capital loans to poultry sector almost doubled to Rs 120.4 billion in H1-FY20. The growth in loans to poultry sector both in development and working capital categories indicates the activity in this sector has increased. Meanwhile livestock/dairy and corporate farming also contributed to the increase in working capital loans.

Figure 2.1.2: Small vs Large Scale Agriculture Lending



Data source: State bank of Pakistan

Another dimension of agriculture loans during H1-FY20 was that growth was mostly concentrated in the large farm segment (**Figure 2.1.2**). The share of large farms jumped to 65.4 percent of the overall portfolio, from 56.9 percent two years ago. This switch underscores two important developments. First, banks are focusing on large-scale borrowers. Second, there is demand from large farms, especially from poultry and livestock subsectors.

From the perspective of institutional lending, the stimulus to agriculture credit growth came from conventional commercial banks, which contributed almost 90 percent to the increase in disbursements. Islamic banks contributed the rest. In contrast, the performance of the microfinance banks and institutions was subdued. It might be too early to make a definitive attribution, but recently issued guidelines designed to comply with AML/CFT regulations may have played a role in depressing the growth of Microfinance Banks and Institutions.

Fertilizer, another critical input, showed mixed trend during the ongoing *Rabi* season. Urea offtake increased by 10.3 percent, whereas DAP offtake continued to slide downwards and its offtake dipped by 11.0 percent during the period (**Figure 2.2**). The divergence in offtake reflects the farmers' preference for lower-priced urea compared to the costlier DAP. Urea remained cheaper by around 45.7 percent, despite a 15.2 percent increase in its price, compared to a 2.8 percent increase in DAP price during the period.

Figure 2.2(a): Urea Offtake and Price in Q2

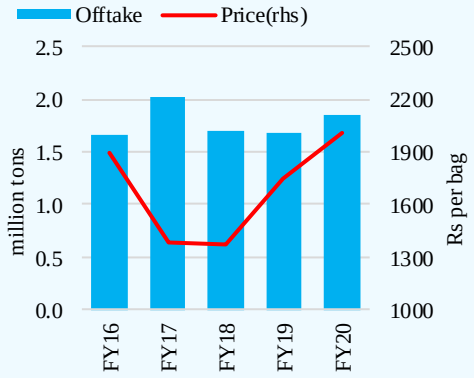
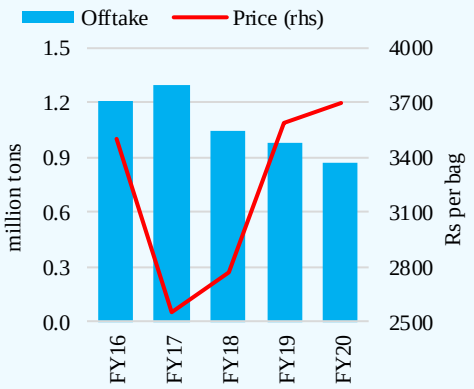


Figure 2.2(b): DAP Offtake and Price in Q2



Data source: National Fertilizer Development Center

Review of *Kharif* Crops[2]

It was another below-par year for the cotton crop, as production dipped below last year's level by 4.2 percent to around 9.5 million bales **(Table 2.1**). The target of 12.7 million bales was optimistic, given the performance of the last few years. Provisional estimates suggest that the target was missed by 25.7 percent. Unfavorable weather and low water availability during important stages of plant development played a critical role, along with pest attacks (pink bollworm and whitefly). Even though the overall area increased by 5.9 percent over last year, the overall performance remained below par due to lower yield, most noticeably in Sindh.

Table 2.1: Cotton Crop Estimates

					Growth in %	
	FY18	FY19	FY20^{T}	FY20^{P}	FY19	FY20
Area ('000 hectares)						
Punjab	2,053	1,888	2,145	1,860	-8.0	-1.5
Sindh	612	448	640	615	-26.8	37.3
Pakistan	2,700	2,373	2,895	2,513	-12.1	5.9
Production ('000 bales)						
Punjab	8,077	6,826	7,900	6,671	-15.5	-2.3
Sindh	3,776	2,938	4,600	2,680	-22.2	-8.8
Pakistan	11,946	9,861	12,720	9,451	-17.5	-4.2
Yield (Kg/hectares)						
Punjab	669	615	626	610	-8.1	-0.8
Sindh	1,049	1,115	1,223	741	6.3	-33.5
Pakistan	753	707		639	-6.1	-9.5

T=Target; P=Provisional
Data source: Cotton Crop Assessment Committee; Federal Committee on Agriculture; Pakistan Bureau of Statistics and SBP calculations

[2] Analysis in this section is based on minutes of FCA meeting, held on October 10, 2019. For cotton, assessment is on the basis of publications of the Cotton Crop Assessment Committee March 13, 2020.

In this backdrop, the country may need to import raw cotton, given that the domestic mill consumption tends to be well above 12 million bales per year on average. It implies imports of more than 2.5 million bales of cotton in FY20. During H1-FY20, imports have remained below last year's level, but this may change in the next half.

The revised production estimate of sugarcane crop suggests an increase of 0.7 percent over last year's output to 67.7 million tons. It was 1.5 percent lower than the target. Fall in area under sugarcane crop – particularly in Punjab – was the reason behind this performance, while increase in overall yield was recorded.

Rice production remained stagnant at 7.2 million tons in FY20 (**Table 2.2**). While there was an increase of 8.2 percent in area under the crop, driven in part by higher domestic prices and availability of inputs on subsidized rates, decrease in rice yield in Sindh dragged down the overall production.

Table 2.2: Rice Crop Performance

					Growth in %	
	FY18	**FY19**	**FY20^{T}**	**FY20^{P}**	**FY19**	**FY20**
Area ('000 hectares)						
Punjab	1,841	1,904	1,869	2,029	3.4	6.6
Sindh	828	690	770	776	-16.7	12.4
Pakistan	2,901	2,810	2,877	3,041	-3.1	8.2
Production ('000 tons)						
Punjab	3,898	3,979	4,000	4,144	2.1	4.1
Sindh	2,851	2,571	2,710	2,374	-9.8	-7.7
Pakistan	7,450	7,202	7,432	7,206	-3.3	0.1
Yield (kg/hectare)						
Punjab	2,117	2,090	2,140	2,042	-1.3	-2.3
Sindh	3,443	3,726	3,519	3,060	8.2	-17.9
Pakistan	2,568	2,563	2,583	2,370	-0.2	-7.5

T=Target; P = Provisional
Data source: Ministry of National Food Security and Research, and Federal Committee on Agriculture

***Rabi* season - Wheat**

Early estimates point to an increase in the area under wheat crop for the ongoing *Rabi* season. Overall, a 3.2 percent rise was witnessed, but it still fell short of the target set by the Federal Committee on Agriculture (FCA) by 2.4 percent (**Table 2.3**). Half of the increase in area under wheat can be traced to Punjab, where it exceeded last year's level as well as the target. Meanwhile, Sindh also witnessed a relatively sharper increase of 7.5 percent in area under wheat cultivation despite it being lower than the target by around 1.6 percent

Increase in wheat cultivation area in the two provinces (that produce almost 90 percent of the overall output), coupled with higher yields, is likely to reflect positively on production. Better input

Table 2.3: Area under Wheat Crop (Hectares)

	FY19	**FY20**	
	Actual	**Target**	**Estimate**
Punjab	6,495.9	6,560.0	6,636.7
Sindh	1,052.7	1,150.0	1,131.5
Khyber Pakhtunkhwa	724.1	900.0	747.2
Balochistan	389.6	550.0	427.2
Pakistan	8,662.3	9,160.0	8,942.6

Data source: Ministry of National Food Security and Research

situation compared to last year and lower temperatures during the early sowing season, also bode well for the prospects of the wheat crop in FY20. Specifically, increase in urea offtake and higher credit disbursements are expected to play a positive role. That said, the threat posed by locust attacks is a downside risk; by February 2020, a national emergency was declared over the locust swarms, and assistance was sought from the FAO and China to combat the locust threat, according to MNFSR press releases.

Regarding procurement, the government has raised wheat procurement price from Rs 1,300 in FY19 to Rs 1,365 in FY20. While this increase is not commensurate with the level of inflation, the revision in procurement price may affect wheat output. If the procurement agencies are able to procure the targeted 8.25 million tons of wheat, it will create additional public demand for the crop at harvest that was lacking last year.[3] However, the target seems optimistic, given that the government was able to procure around 6 million tons of wheat on average in the last 5 years. In the bigger picture, the fallout of the weak procurement drive by the provinces last year (when the country produced its lowest output since FY13) is being felt in FY20 in the shape of wheat and flour shortages. Sindh did not procure wheat last year, while Punjab also missed its procurement target. In this backdrop, it is imperative to redefine the optimal level of official wheat reserves at the national and sub-national levels.

Table 2.4: Minor Crops (*Rabi)*
Area in '000 Hectares; production in '000 MT; growth in percent

	FY19 Output		FY20 Target		Targeted growth (%)*	
	Area	**Production**	**Area**	**Production**	**Area**	**Production**
Potatoes	188	4,748	192	4,869	2	3
Onion	148	2,080	148	2,106	0	1
Gram	943	447	983	526	4	18
Tomatoes	38	414	54	601	39	45
Lentil	13	6	17	9	33	46

* FY20 target/FY19 output
Data source: Ministry of National Food Security and Research

Minor crops

While the first estimates of production of minor crops for the *Rabi* season were still forthcoming, the FY20 targets gave an initial sense of what to expect during H2-FY20 (**Table 2.4)**. The most notable increase, with respect to targeted area and production collectively, relates to the tomato crop. Keeping in mind the

[3] The wheat procurement target of 8.25 million tons was set by the Economic Coordination Committee in February, 2020. This represents one-third of the total wheat harvest based on last 5-year production.

developments during Q2-FY20, when tomato prices rose sharply, the envisioned increase in production would be a step in the right direction for self-sufficiency.

2.3 Large-Scale Manufacturing[4]

There are glimpses of some improvement in the output of the industrial sector during Q2-FY20 over the previous quarter. Specifically, LSM output's contraction decelerated sharply during Q2-FY20. It recorded a meager increase of 0.02 percent (YoY) as compared to the decline of 5.7 percent during Q1-FY20 **(Table 2.5)**. This outcome is heavily attributed to an increase in sugar production, excluding which LSM growth would have declined by 2.7 percent in Q2-FY20. This is an encouraging performance, but the seasonality factor linked with timely sugar production this year, as compared to the delayed start in FY19, means that it is hard to conclude if this trend can continue during Q3-FY20.

Table 2.5: LSM Growth (YoY)

percent

	wt.	H1		Q1		Q2	
		FY19	FY20	FY19	FY20	FY19	FY20
LSM	70.3	-1.7	-2.8	-0.5	-5.7	-2.9	0.0
Textile	20.9	-0.2	0.4	-0.2	0.2	-0.3	0.5
Cotton yarn	13	0.0	0.1	0.0	0.2	0.0	0.1
Cotton cloth	7.2	0.1	0.2	0.1	0.1	0.2	0.3
Jute goods	0.3	-8.0	-5.3	-8.1	-14.8	-8.0	3.5
Food	12.4	-3.3	3.9	1.9	-8.8	-7.6	15.4
Sugar	3.5	-37.2	97.1	-	-	-37.2	97.1
Cigarettes	2.1	6.8	-29.3	4.4	-34.5	9.1	-24.3
Vegetable ghee	1.1	1.7	5.1	4.1	2.0	-0.7	8.3
Cooking oil	2.2	1.3	7.0	6.9	0.2	-3.8	13.9
Soft drinks	0.9	-1.7	-12.0	-6.7	-13.5	8.1	-9.5
POL	5.5	-4.9	-10.3	-5.4	-14.5	-4.4	-5.9
Steel	5.4	-7.6	-12.3	-2.9	-17.0	-12.4	-6.8
Non-metallic minerals	5.4	-1.2	2.9	0.1	-0.9	-2.3	6.3
Cement	5.3	-1.6	2.7	0.1	-1.4	-3.0	6.3
Automobile	4.6	-3.8	-36.4	-1.2	-33.9	-6.4	-39.1
Jeeps and cars	2.8	2.3	-46.4	4.7	-38.6	-0.2	-54.6
Fertiliser	4.4	6.5	4.9	-4.8	15.9	19.2	-5.1
Pharmaceutical	3.6	-10.1	-6.2	-4.8	-11.9	-14.6	-0.7
Paper	2.3	-2.0	7.2	3.9	-1.3	-7.5	16.0
Electronics	2	20.1	1.9	16.9	11.0	23.1	-6.1
Chemicals	1.7	-3.3	-4.7	-6.7	-8.9	0.3	-0.4
Caustic soda	0.4	5.3	-14.7	17.2	-21.4	-5.3	-7.4
Leather products	0.9	-1.9	11.2	0.5	6.3	-4.1	16.0

Data source: Pakistan Bureau of Statistics

[4] The analysis in this section is based on Quantum Index for January 2020 of LSM industries.

Some other sub-sectors also performed better. The fertilizer sector's output expanded during HI-FY20; however, it lost some steam during Q2-FY20 as two smaller urea producing units ceased production in December 2019. The cement industry registered growth of 6.3 percent during Q2-FY20 in contrast to contraction in the previous quarter, owing to both higher exports as well as some revival in domestic demand. However, the steel sector, although having some complementarity with cement, was not able to post positive growth in Q2-FY20 despite improvement from Q1-FY20.

Meanwhile, other major industries continued to slide in line with the economic downturn. Automobile sector alone accounted for major portion of contraction in LSM during H1-FY20; however this performance did not include the production activity of the new entrants in the automobile industry. The petroleum industry, in addition to lack of demand, still continued to recover from the government's decision to phase out furnace oil based power plants. Growth in production of electric motors, that had driven the electronics industry's growth in the past few quarters, slowed down sharply as demand for the water extraction pumps subsided due to ample water availability in the *Rabi* season.

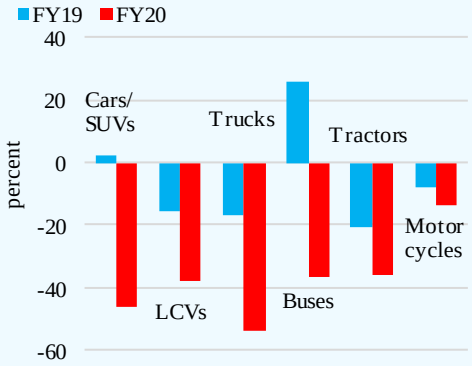
To sum up, LSM contracted by 2.8 percent during H1-FY20 on YoY basis, which is still more than the corresponding period in the last year. As the growth prospects look challenging, especially when production activity in sugar and fertilizer production is expected to decelerate in the coming months, the bottoming out phase of the industrial sector cannot be determined with any degree of certainty as yet.

Automobile

The automobile sector's output contracted 36.4 percent in H1-FY20. This is a record low growth since the rebasing of LSM in FY06. In addition, the sector decelerated further in Q2-FY20 compared to the preceding quarter. Major contributor to this performance – due to its weight in LSM Index – was the passenger car segment. That said, output of other subsectors also dipped sharply (**Figure 2.3**).

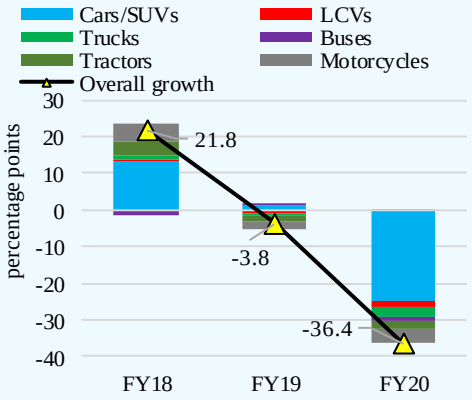
Focusing on LSM data for automobile sector, large increase in prices on account of exchange rate adjustment remained the major reason for decline in demand for automobiles. This was partially the result of low level of localization of auto parts. Moreover, the decline in output of the auto sector can also be traced to fiscal consolidation and tight monetary policy. In particular, the public sector's demand for vehicles waned as fiscal austerity measures took hold.

Figure 2.3a: Automobile Sector Growth in H1 (YoY)



Data source: Pakistan Automotive Manufacturers Association

Figure 2.3b: Auto Sector Growth & Contribution in Growth in H1

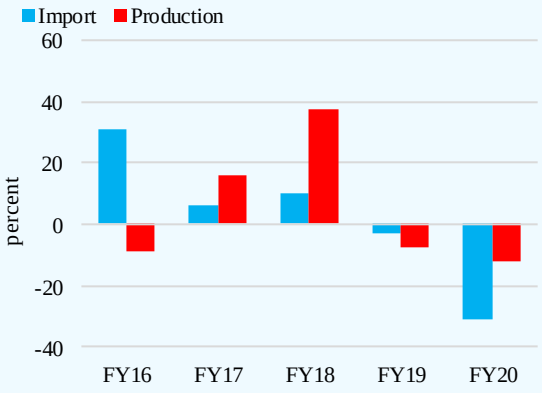


New entrants have somewhat altered the dynamics of the automobile industry. Since they are giving competition to existing players in multiple vehicle categories, this aspect is further accentuating the speed and extent of contraction in automobiles sector. At present, production data of these firms is not part of the LSM. If the output of these firms had been recorded in the LSM information set, the contraction may not have been so steep.

Construction-Allied Industries

The output of the steel industry declined by 12.3 percent during H1-FY20 (**Figure 2.4**); however, the pace of contraction slowed during Q2-FY20, compared to the previous quarter. On overall basis, the decline during H1-FY20 was more visible in billets, which is indicative of subdued construction activity in the economy. Scrap imports that are intermediate inputs for the steel industry, small-scale producers in particular, registered a 17.0 percent quantum drop as well. Finished steel products also saw significant fall in growth of 28.3 percent during the period. However, the demand for flat products (steel sheets) remained intact.

Figure 2.4: Steel Production and Import Growth in H1

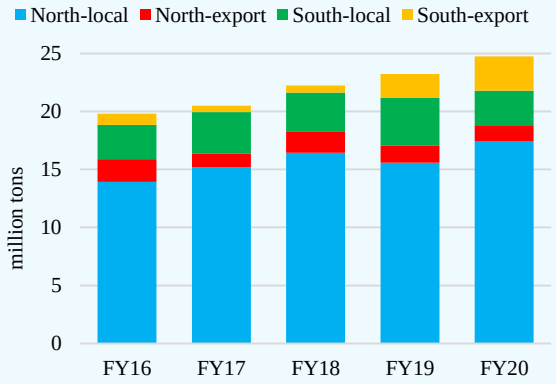


Data source: Pakistan Bureau of Statistics

Activity in the cement industry picked up pace in Q2-FY20. One of the main reasons for this uptick was the rise in clinker exports. Another factor was the relative improvement in domestic demand at the back of higher development expenditures and an increase in remittance inflows that may have contributed in expenditures on private construction.

All Pakistan Cement Manufacturers Association (APCMA) data on cement dispatches shows that growth reached 9.9 percent in Q2-FY20 from 2.6 percent in preceding quarter. The performance was driven in equal measure by local and export sales, as opposed to being predominantly export-driven previously. Furthermore, disaggregated data shows that the growth in local sales was driven entirely by the north region while the south contributed to export performance (**Figure 2.5**).

Figure 2.5: Cement Dispatches (H1)



Data source: All Pakistan Cement Manufacturers Association

Clinker exports were mainly to Bangladesh, whose previous supplier, Vietnam, diverted its supplies to Chinese market.[5] This benefited the domestic industry. The share of clinker in overall cement exports in quantum terms increased to 47.5 percent in H1-FY20 from 29.2 percent in H1-FY19. Meanwhile, Portland cement exports were recorded at almost the same level as last year, despite no exports to the Indian market that had consumed more than a quarter of our exports during FY17 and FY18 (**Chapter 5**).

As the decline in steel output is in contrast to cement industry's results given their complementarity in construction, healthy margins after depreciation of PKR and surplus capacity indicates that cement producers are well realigning their growth strategy towards exports. On the contrary, steel manufacturer's current output is still well below the domestic requirements, which is necessitating imports.

[5] In the process of fine-powdered Portland cement, clinker is produced, which reflects lumps or nodules. Clinker is grounded to produce Portland cement.

Another possible explanation of this mismatch could be the outdated LSM survey sample that does not reflect the present ground realities of the two industries. The LSM was last rebased in FY06 and since then, no major revisions have been made. This is notable, as apart from establishment of new firms, existing ones in both the sectors have also invested heavily in capacity expansion during this period.

Fertilizer

The fertilizer industry maintained its upward trajectory, growing by 4.9 percent during H1-FY20 compared to 6.5 percent growth in same period last year. Detailed data of the fertilizer industry highlights that growth was driven by the urea units, particularly the small scale units. However, the output of other fertilizers such as DAP, SSP, and NP declined further. Given the imbalance in fertilizer application in the country, this is not a good development as farmers would have to rely relatively more on imported fertilizer substitutes.[6]

Beginning with urea sector results, its growth was recorded at 7.8 percent in H1-FY20, slightly lower compared to 8.5 percent last year based on National Fertilizer Development Center (NFDC) data. Large urea units kept up growth momentum for the third year running, as their cumulative production grew by a further 2.3 percent during the period.

In addition, smaller units built on last year's performance and registered growth of 84.2 percent during H1-FY20. This production was the highest since FY11. As has been identified in the past reports, the performance hinges on the supply of gas to these units. During H1-FY19, these units received gas supplies predominantly during Q2 only. Small scale units were able to secure gas supplies for 5 out of 6 months during H1-FY20, and that helps to explain the jump in performance.

Urea production ceased during December 2019 due to disruption of gas supplies to small units. As there was ample availability of urea, it may not affect the domestic

Table 2.6: Fertilizer Balance in H1
million tons

	FY16	FY17	FY18	FY19	FY20
Opening inventory	0.2	1.7	1.1	0.1	0.2
Imported supplies	0.3	0.0	0.0	0.1	0.1
Domestic production	2.8	3.0	2.8	3.0	3.3
Total availability	3.3	4.7	3.9	3.2	3.6
Offtake	2.7	3.7	3.2	3.1	3.3
Export	0.0	0.0	0.4	0.0	0.0
Write off/on	0.0	0.0	0.1	0.0	0.0
Ending inventory	0.6	1.0	0.3	0.2	0.2

Data source: National Fertilizer Development Center

[6] According to FAO data, the fertilizer application is highly skewed in favor of Nitrogenous fertilizers in Pakistan due to its low cost and availability. As a result of imbalanced use, crop yields are low in Pakistan.

market for now (**Table 2.6**). Going forward, the government needs to devise a clear strategy for these units to keep them operational. The current policy of supplying subsidized gas when there is domestic shortfall for urea and withdrawing it when production exceeds a certain level is hurting the performance of these firms as well as the country's economic growth. This trend should also entail some uniformity in production level throughout the year.

The production of other fertilizer products recorded decline for the fourth year in a row. The output was the lowest since FY13. To increase agriculture productivity, the country needs balanced use of nutrients. The recommended usage of fertilizer is not being met and it is one of the reasons for slower growth in crop yields compared to other countries. In this backdrop, the decline in production of other fertilizer products means that the country has to import more quantities of these commodities.

Tobacco

Cigarette production fell by 29.3 percent in H1-FY20 compared to last year. The re-introduction of two-tier excise duty structure, uncertainty regarding the implementation and mechanism of track and trace system, and continued competition from counterfeits and smuggled alternatives hindered the industry's progress in H1-FY20.

The government reverted to two-tier duty structure for cigarettes to discourage tobacco usage and increase revenue collection. Notwithstanding the ensuing scale of decline in production, consumption may not have fallen by the same rate in such a short time, since cigarette use generally tends to be relatively inelastic in nature. It may have driven the consumers away from the formal market and towards the informal sector. In such scenario, the federal government may not be able to generate its targeted revenue.

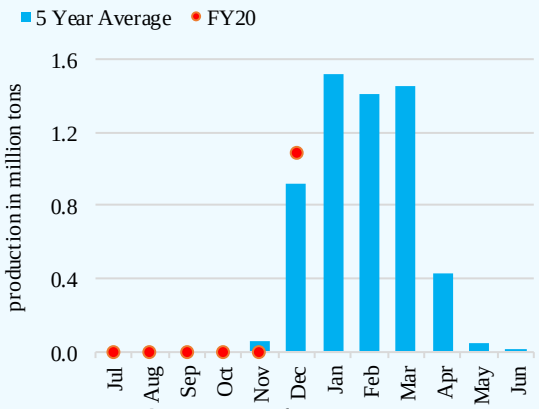
Sugar

The sugar industry's output surged by 97.1 percent during December 2019 against a contraction of 37.2 percent in the same month last year. A typical sugar production cycle in Pakistan is from November to April, with more than 90 percent of the activity concentrated in the 4 months of December to March. Favorable weather, depleting carryover stock of sugar from the last year, and competition among sugar mills, compelled firms to crush more sugarcane earlier this year (**Figure 2.6**).[7] Timely commencement of cane crushing, as compared to

[7] Cold weather is beneficial for sugar production as it increases sucrose content in the crop, which in turn increases sugar recovery yield.

the delay in FY19, led to an unusually high growth rate in sugar production due to the base effect. However, on an overall basis, processing is expected to remain around last year's level as estimates point to only a marginal increase in sugarcane production during FY20.

Figure 2.6: Sugar Production (Last 5 Years vs FY20)



Data source: Pakistan Bureau of Statistics

Over time, another aspect affecting the sugar industry is the lingering disagreements about sugarcane price-setting mechanism amongst growers, millers and the government.[8] Since sugarcane crop takes more than 12 months to mature, indicative pricing mechanism at the time of harvest does not favor the stakeholders. For instance, farmers who invest time and resources want returns commensurate with their investment. The cost of production varies and demand and supply situation tends to change over the cultivation period. As the situation changes, the indicative pricing at the start of the sugarcane crushing season affects the profitability of the crop for farmers. On the other hand, procuring sugarcane at indicative price announced by the government makes domestic sugar mills uncompetitive compared to international producers. The country has the potential to produce surplus quantity of sugar; however, persisting differences between stakeholders related to price-setting are creating volatility in sugarcane and sugar output.

Textile

The textile sector performance in H1-FY20 showed signs of recovery as it managed a growth of 0.4 percent in production compared to decline of 0.2 percent in H1-FY19. Impetus to growth came primarily from the yarn and cloth segments while woolen and jute goods registered substantial decline in production. On the export front, textile group grew 3.9 percent during H1-FY20 to US$ 6.9 billion, which was the highest level since H1-FY14.

The mismatch between the LSM and export data sets is widening as the textile industry continues to upgrade to products higher up in the value chain that are not

[8] This issue was earlier highlighted in the State Bank of Pakistan's State of Pakistan's Economy, First Quarterly Report for FY19.

covered in the industrial production data. Apparel exports grew sharply during the period while primary products were a drag on the export performance (see **Chapter 5**). A few producers have focused their attention on the export market while using in-house manufactured primary inputs (yarn, cloth, etc.), which were earlier contributing to LSM in the shape of final products.

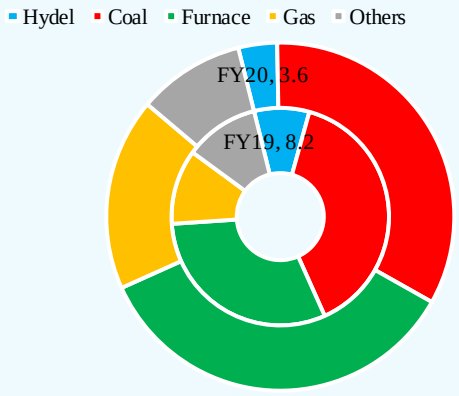
Electronics

The performance of electric motors was predominantly responsible for growth of electronics sector during the past few years. As the growth of electric motors started to slow down, it dragged the electronics industry's growth to only 1.9 percent in H1-FY20 compared to growth of 20.1 percent during same period last year. After growing by 10.9, 303.3 and 31.3 percent in H1 of past three years, production of motors recorded a meager growth of 4.1 percent during H1-FY20. The slowdown in electric motor segments can be attributed to contained demand from the rural sector for water extraction, concomitant to sufficient water availability in the country during the past few months.

Petroleum

The petroleum sector contracted by 10.3 percent during H1-FY20. However, comparing the performance of Q1 versus Q2 of FY20, the contraction was relatively well-contained during the latter. [9]

Figure 2.7: Electricity Generated from Furnace Oil



Data source: National Electric Power Regulatory Authority

With minor exceptions, there was a broad-based decrease in almost all the product categories. The phasing out of furnace oil and higher input prices hurt the supply side, while higher end-consumer prices and reduction in commercial activities curtailed the demand side, particularly for High-Speed Diesel. Production of furnace oil, petrol and diesel products contracted as a result. Improvement in electricity supplies from coal and hydel power stations also reduced the demand for furnace oil and diesel, which in turn adversely affected the industry's performance (**Figure 2.7**).

[9] Petroleum sector production declined 14.5 percent during Q1-FY20. The decline in Q2-FY20 was 5.9 percent.

2.4 Services

Wholesale and retail trade activity, which accounts for the bulk of services sector output, was subdued during H1-FY20. Proxy indicators like YoY growth in LSM and sectoral credit offtake declined during the first half (**Table 2.7**). By contrast, sectoral credit flows had been in the positive territory by the half-way point last year, and even so, the services sector had missed its FY19 full year target. Imports also dropped sharply, which could be attributed to the continuing macroeconomic stabilization measures.

Table 2.7: Selected Services Sector Indicators in H1

	FY19	FY20
Wholesale and Retail Trade (18.9%)		
Sectoral credit off take*- flow (billion Rs)	52.2	-38.8
Imports (billion US$)	28.0	23.2
LSM (YoY growth)	-1.8	-3.4
Agri credit (disbursements – Rs bln)	527.3	614.4
Transport, Storage and Communication (12.9%)		
POL sales to transport sector (million MT)	7.2	6.3
Commercial vehicle sales (units)	24,559	11,488
Cellular teledensity (%)	72.7	78.2
Broadband users (million)	50.5	78.0
Finance and Insurance (3.5%)		
Assets (billion Rs)*	19,682.1	21,991.3
Deposits (billion Rs)*	14,254.2	15,953.5
Profit after tax (billion Rs)	72,753	88,030
Infection ratio	8.0	8.6
General Government Services (8.4%)		
Expenses on general govt & defense*** (Rs billion)	1,796.7	2,450.3

Note: Values in brackets are sectoral shares in GDP, as of FY19.
* With adoption of ISIC-4 classification by SBP, the *wholesale and retail trade* and t*ransport, storage and communication* categories have been modified. Thus, one-to-one mapping of sectoral credit offtake numbers may not be possible in each case
** Stocks, as of end-December 2019
***Only Federal Government
Data source: SBP, PBS, OCAC, PAMA, PTA and MoF

Within the *transport, storage and communication* segment, there was a steep drop in commercial vehicle sales during H1-FY20 compared to last year, along with lower POL sales to the transport sector. In addition, the axle load issue (which appeared to be addressed by October 2019) resurfaced, prompting an eight-day strike by goods transporters in January 2020. In this backdrop, the downside risks emanating from the transport sub-segment may remain in play during the remainder of the year.

Meanwhile, in the communication sub-segment, cellular teledensity continued to rise and the number of broadband users grew appreciably. Imports of mobile phones also rose 69.2 percent during H1-FY20 compared to last year (in USD value terms).[10] Moreover, activities related to communication services may receive a further boost in the medium to long-term following the inauguration of the Digital Pakistan initiative in December 2019, which emphasizes access and

[10] Specifically, mobile phone imports rose from USD 364 million in H1-FY19 to USD 616.1 million in H1-FY20.

connectivity as key pillars.

Regarding *finance and insurance*, the after tax profits for the banking system as a whole rose by 21.0 percent during Jul-Dec 2018 compared to a year earlier. At the same time however, the infection ratio rose to 8.6 percent by December 2019, with outstanding (gross) NPLs amounting to Rs 761 billion. The total NPL amount includes the loans against sick industrial units. There is potential for such loans to be revived and rehabilitated after the establishment of the Pakistan Corporate Restructuring Company Limited (PCRCL) in January 2020.[11] Prompt restructuring and injection of fresh equity by the sponsors of sick units could help make this initiative a success.

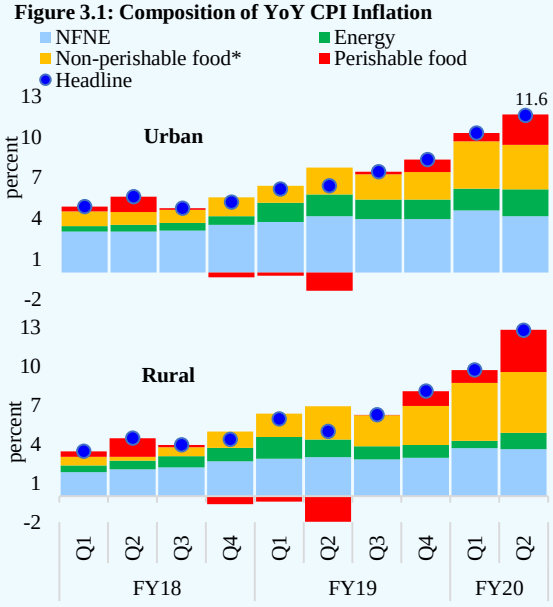
[11] PCRCL was established by ten commercial banks, namely Habib Bank, National Bank of Pakistan, United Bank, MCB, Allied Bank, Meezan Bank, Bank Alfalah, Bank Al-Habib, Habib Metropolitan Bank and Faysal Bank. For details, see SBP's press release titled 'Banking industry join hands to create Pakistan Corporate Restructuring Company Limited (PCRCL)', dated January 10, 2020.

3 Inflation and Monetary Policy

3.1 Overview

Inflationary pressures continued to build up throughout the first half of FY20. While the non-food-non-energy (NFNE) inflation exhibited stability on account of subdued demand conditions in the economy, food inflation surged steeply in both the quarters of FY20. Whereas pressures on food inflation in the first quarter stemmed mainly from non-perishable items, the increase in the second quarter was contributed largely by perishables (**Figure 3.1**).[1] Increase in administered prices of energy items also contributed to higher inflation. Other components of inflation remained almost unchanged during the second quarter, especially in urban areas. This trend suggests that the surging inflationary pressures during this period was an outcome of supply disruptions, which are typically seasonal and temporary.

Figure 3.1: Composition of YoY CPI Inflation



*Inclusive of alcohol beverages and readymade food
Data source: Pakistan Bureau of Statistics

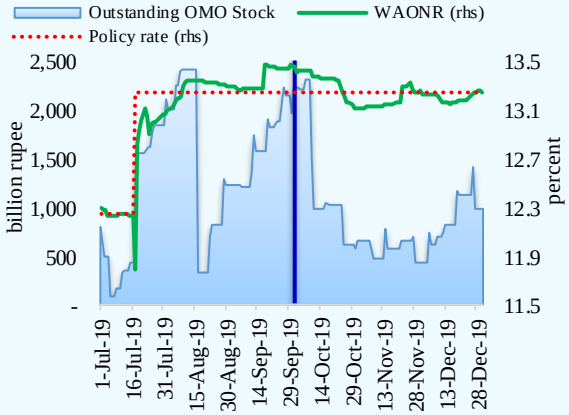
Therefore, the SBP's projections for the average headline inflation for FY20 remained broadly unchanged at 11-12 percent. This projection was premised on an ease in inflationary pressures during the second half of the year on the back of sluggishness in domestic demand, and temporary nature of perishables' shortages. In addition, the improvement in the balance of payments (that led to an

[1] Inflation in perishable food and non-perishable food items during Q2-FY20 clocked in at 60.1 percent and 11.2 percent respectively, compared to 16.6 percent and 11.2 percent in Q1-FY20. Importantly, the rise in perishable inflation was more pronounced in rural areas; since the country relied heavily on imports to plug the domestic demand-supply gap, this trend represented delays and costs involved in transporting these items from entry points (e.g., Torkham, Taftan and Karachi Port) to the rural areas.

appreciation in the Pak rupee) and the government's adherence to fiscal discipline, also continued to provide comfort to the short-term inflation outlook. Therefore, the SBP's Monetary Policy Committee (MPC) decided to keep the interest rates unchanged at 13.25 percent in its November 2019 meeting. The current level of interest rates also seemed appropriate to the MPC to bring the inflation down to the target range of 5-7 percent over the medium term.

Implementing the policy rate required fewer interbank market interventions in the second quarter, compared to the first. Both the outstanding OMO injections and volatility in the interbank overnight rates remained lower in Q2-FY20 compared to the preceding quarter, whereas limited activity was observed at the SBP's standing facility (**Figure 3.2**). This ease in the interbank liquidity stemmed primarily from net retirements by the government to scheduled banks and SBP's foreign exchange purchases. Although the overall fiscal deficit during the quarter remained higher than last year as well as the preceding quarter, the government had sufficient financing available from external and non-bank sources. Furthermore, the government also tapped on cash buffers it had placed with SBP during the previous two quarters.

Figure 3.2: Overnight Rates and OMOs



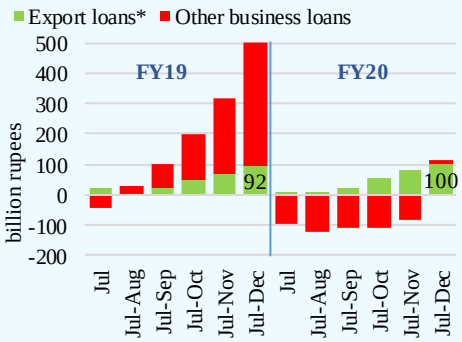
Data source: State Bank of Pakistan

In addition, credit demand from the private sector was also not forthcoming, as the industrial recovery on the whole remained elusive. Though the export-oriented sectors exhibited vibrancy during the quarter, their loan offtake from the banking system was only slightly higher than last year (**Figure 3.3a**). This probably represents firms' sound liquidity position on the back of significantly high export earnings in Rupee terms and relatively smoother tax refunds during the quarter.[2] However, an important development throughout the first half of FY20 was the switching between domestic and foreign currency loans. As shown in **Figure 3.3b,** firms heavily utilized Libor-based foreign currency (FE-25) loans, and relied

[2] In H1-FY20, the government's tax refunds grew by 37.0 percent to Rs 75.5 billion from Rs 55.1 billion in the same period last year.

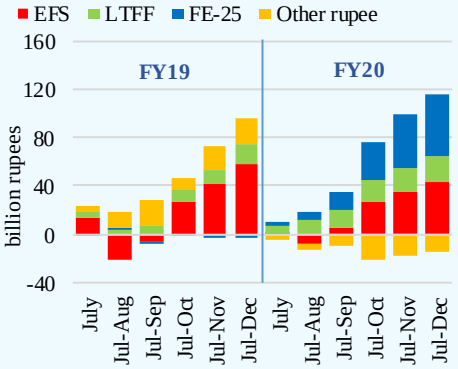
less on expensive rupee denominated loans as well concessional facility of SBP (EFS).

Figure 3.3a: Composition of Business Loans



*This includes all types of financing facilities to exporters i.e. EFS, LTFF, foreign currency loans and other rupee denominated loans
Data source: State Bank of Pakistan

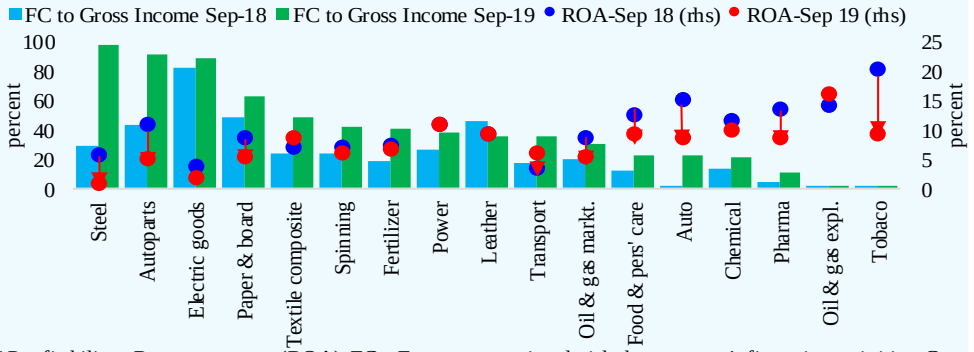
Figure 3.3b: Composition of Export Loans



Data source: State Bank of Pakistan

In contrast, the financial position of non-exporting sectors remained generally weak. In H1-FY19, the firms had leveraged excessively to address their cash flow constraints emanating from inventory build-ups and higher raw material and operational costs, which had inflated their financing expenses in subsequent months. In some industries such as steel, auto parts and electric goods, financing expenses had even touched 80 percent of firms' gross profit margins by end-September 2019 (**Figure 3.4**). As such, further leveraging did not seem to be a viable option for these firms, especially keeping in view the prevailing interest rate levels.

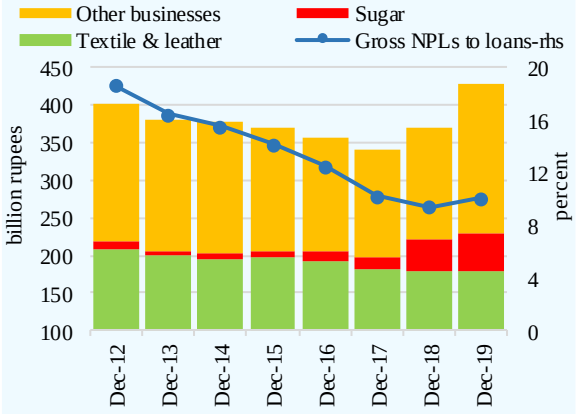
Figure 3.4: Financing Cost (FC) and Profitability of Non-Financial Firms



*Profitability= Return on assets (ROA), FC = Expense associated with the company's financing activities, Gross income/loss = Net sales + Other operating income - Cost of goods sold - Other operating expenses.
Data source: Bloomberg (financial data was available for 71 firms)

Therefore, a weakening in the repayment capacity of these firms in the first half of FY20, was not surprising. As shown in **Figure 3.5**, while the gross non-performing loans of major exporting sectors (textiles and leather) continued to decline, the NPLs in other sectors increased during this period. Importantly also, the overall NPLs as percent of total loans have also inched up slightly after declining steadily over the past 6 years.

Figure 3.5: Composition of Gross NPLs



Data source: State Bank of Pakistan

3.2 Monetary Aggregates

The broad money posted an expansion of Rs 812.1 billion during Q2-FY20, compared to Rs 554.8 billion in Q2-FY19 (**Table 3.1**). Bulk of this increase was due to a sharp expansion in the NFA of the banking system, specifically of the SBP. Meanwhile the expansion in NDA was quite modest, as credit demand from both the government and private sectors remained lower than last year.

Table 3.1: Monetary Aggregates in H1 [P]

billion Rupees

	FY19		FY20	
	Q1	Q2	Q1	Q2
M2 (A+B)	22.4	554.8	105.2	812.1
A. NFA	-148.5	-532.6	259.6	618.4
B. NDA	171.0	1,087.5	-154.4	193.7
Budgetary borrowing*	84.6	566.0	156.0	30.6
SBP	1518.3	-261.2	-1586.9	846.4
Scheduled banks	-1433.7	827.3	1742.9	-815.7
Commodity operations	-10.8	-74.6	-15.6	-12.9
Private sector	127.9	442.5	-16.9	232.5
PSEs	60.7	84.4	-2.0	-0.3
Other items net	-91.8	66.5	-275.2	-58.8
Reserve money	-31.0	198.5	-207.4	372.6

[P]: Provisional

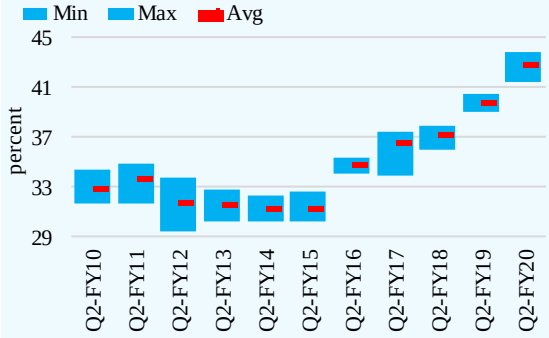
* These numbers are based on accrual basis. They do not tally with the amount of bank financing on cash-basis, as presented in Table 4.1.

Data source: State Bank of Pakistan

This expansion in the SBP's NFA reflects improvement in the current account deficit and growing confidence of IFIs and foreign investors. As a result, the SBP was able to rebuild its foreign exchange reserves through purchases from the interbank market, inflows from multilateral agencies, and the government's commercial borrowings (**Chapter 5**).

On the liability side, the growth of currency in circulation remained higher during the first half compared to last year. Meanwhile, deposits with the scheduled banks grew by Rs 587.4 billion during H1-FY20 compared to Rs 433.8 billion last year. Bulk of this increase was due to the growth in personal deposits. Encouragingly, the trend in personal deposits did not show a reversal after the month of December 2019, which is generally a period associated with a seasonal increase. This growth can potentially be attributed to attractive deposits rates, which was also reflected in the increase in the share of remunerative deposits from 59.3 percent at end-June 2019 to 61.3 percent at end-December 2019.[3]

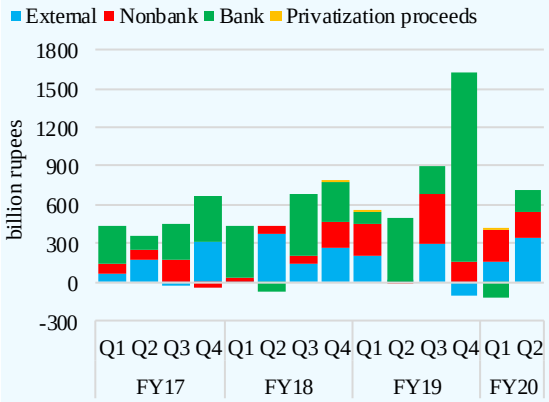
Figure 3.6: Currency to Deposit Ratio*



* The blue bars represent the min/max of currency to deposit ratio observed on a weekly basis during the quarter, whereas red lines indicate its quartelry averages.
Data source: State Bank of Pakistan

In contrast, almost the entire increase in the deposits of private businesses and NBFIs was only temporary in nature. Particularly, this trend highlights continued apprehensions of businesses over tightening of the noose around tax evasion, as well as financial scrutiny under AML/CFT regulations. In overall terms, the currency to deposit ratio continued to follow the upward trend that began in FY16 (**Figure 3.6**).

Figure 3.7: Sources of Fiscal Deficit Financing



Data source: State Bank of Pakistan

Government Borrowings

Government borrowings from the banking system (on cash basis) declined significantly during Q2-FY20 to Rs 164.7 billion, from Rs 485.1 billion last year. This was despite a marked increase in the

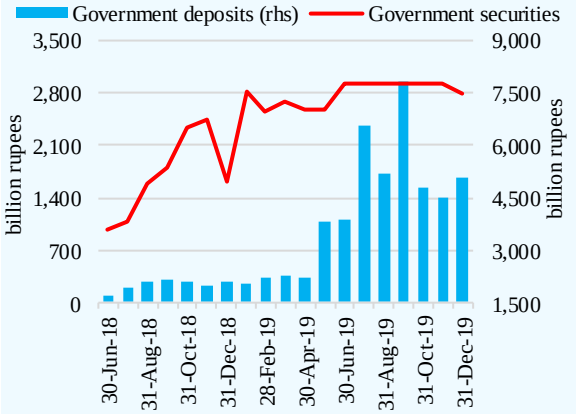
[3] The weighted average deposit rates (excluding zero-markup and interbank deposits) increased from 10.2 percent in June 2019 to 10.9 percent in December 2019.

financing gap, which widened to Rs 708.7 billion from Rs 488.2 billion last year. Bulk of the government's financing needs were met through external and domestic non-bank sources (**Figure 3.7**).

Within the banking system, the increase was reflected in borrowings from the SBP, as the government made retirements to scheduled banks. However, it is worth mentioning here that this *net increase* in SBP borrowings reflects the impact of the government drawing its deposits held with the SBP. In *gross terms*, the government retired Rs 285.0 billion worth of MRTBs to the central bank (**Figure 3.8**).

The pre-auction targets for market treasury T-bills were considerably low as compared to the maturities falling during the second quarter (**Table 3.2**). The government preferred adhering to the auction targets, as this provided an opportunity to reduce the borrowing cost at the shorter end of the yield curve. Specifically, in the first three auctions, the government slashed the cut-off rates by 44 bps, 55 bps and 106 bps for 3M, 6M and 12M T-bills, respectively. As a result, the net-of-maturity acceptances in the auctions remained negative.

Figure 3.8: Stock of Govt. Deposits and Securities Held by SBP



Data source: State Bank of Pakistan

Table 3.2: T-bill Auction Summary during Q2-FY20

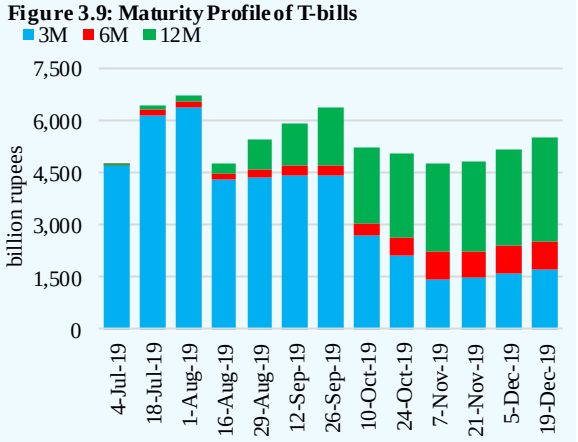
billion rupees

Auction Date	Target	Maturity	Offered*	Accepted
09-Oct-2019	1,000.0	2,064.5	2,563.3	883.5
23-Oct-2019	600.0	822.1	1,963.8	670.6
06-Nov-2019	600.0	1,174.4	1,513.0	887.8
20-Nov-2019	500.0	175.8	518.3	256.0
04-Dec-2019	300.0	74.9	1,147.8	398.4
18-Dec-2019	300.0	125.5	817.71	484.2
Q2-FY20	**3,300.0**	**4,437.2**	**8,523.7**	**3,580.7**

*competitive bids only

Data source: State Bank of Pakistan

Figure 3.9: Maturity Profile of T-bills



Data source: State Bank of Pakistan

With plunging rates, the participation of scheduled banks witnessed a slump in the fourth auction. This led the government to recalibrate the yields upwards for the 3M and 12M papers.

This not only revived market's interest in T-bills, but also helped the government borrow in excess of the maturities in the last three auctions of the quarter. Meanwhile, the government's maturity profile of short-term papers improved considerably during the quarter (**Figure 3.9**). At the close of Q1-FY20, around 70 percent of outstanding T-bills comprised of 3M papers. By end-December, this had reduced to only 31 percent, whereas the share of 12M papers rose to 55 percent. Going forward, less frequent maturities of T-bills would also help to restrict volatility in the interbank market.

Deeper rate cuts for longer duration bonds

In case of PIBs, the government had set a target of Rs 450.0 billion (fixed and floating rate combined) against maturities of Rs 255.4 billion during Q2-FY20 (**Table 3.3**). In case of fixed-coupon PIBs, though the market's response was not as pronounced in Q2-FY20 as it was in Q1-FY20, the offer-to-target ratio remained, on average, at 3.3 times – indicating the market's continued preference for long-term securities. However, just like T-bills, the acceptances remained on the lower side, which constrained the liquidity of the long-term bonds in the secondary market. With a relatively low supply and expectations of a rate-cut in the near term, the yields on long-term bonds declined sharply. This also helped the government reduce the cut-off

Table 3.3: PIB Auction Summary

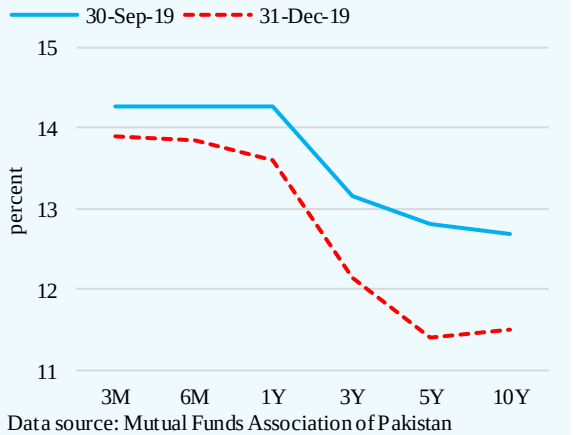
in billion rupees

	Target	Maturity	Offered*	Accepted
Fixed rate				
Q1-FY19	150.0	461.1	64.1	20.6
Q2-FY19	150.0	0.0	45.3	22.5
Q1-FY20	325.0	275.9	2,521.2	963.5
Q2-FY20	**300.0**	**255.4**	**1,003.5**	**411.4**
Floating rate				
Q1-FY19	150.0	-	151.5	108.3
Q2-FY19	150.0	-	93.4	-
Q1-FY20	400.0	-	334.2	219.4
Q2-FY20	**150.0**	**-**	**468.7**	**178.6**

*competitive bids only

Data source: State Bank of Pakistan

Figure 3.10: Yield Curve



Data source: Mutual Funds Association of Pakistan

rates by 117 bps, 123 bps and 120 bps for the 3Y, 5Y and 10Y PIBs, respectively, during the quarter, while comfortably meeting its pre-auction targets.

Consequently, the yield curve shifted downwards, with yields falling more steeply at the longer end **(Figure 3.10)**. This was due to two reasons: (i) on the demand side, market players continued to place bids at lower rates for longer duration bonds in anticipation of monetary policy easing; and (ii) on the supply side, the government proactively aligned the long-term rates to reduce its cost of borrowings.

3.3 Credit to Private Sector

Credit to the private sector continued its downward trajectory in H1-FY20, as businesses continued to scale down their activities and increasingly resorted to internal financing **(Table 3.4).** This trend was consistent with the subdued industrial production (mainly LSM) and a broad-based decline in imports during the quarter. Notably, the entire offtake was driven by working capital loans; in case of fixed investment loans, net retirements by non-manufacturing sectors such

Table 3.4: Loans to Private Sector Businesses H1*
flow in billion rupees

	Total Loans		Working Capital**		Fixed Investment	
	FY19	**FY20**	**FY19**	**FY20**	**FY19**	**FY20**
Private sector businesses	**506.7**	**111.9**	**469.7**	**112.8**	**37.0**	**-0.8**
Manufacturing	385.9	122.7	349.8	107.5	36.1	15.1
Textile	202.5	112.4	187.4	96.1	15.1	16.3
Motor vehicles	21.5	38.4	19.7	36.2	1.8	2.2
Rice processing	46.0	26.6	42.9	26.1	3.1	0.6
Cement, lime and plaster	27.2	10.2	7.5	12.8	19.7	-2.6
Basic iron and steel	6.3	10.4	6.8	3.0	-0.5	7.4
Fertilizers	17.0	-0.1	22.1	-0.7	-5.1	0.6
Paper & paper products	0.9	-6.5	2.3	-4.5	-1.4	-2.0
Vegetable and animal oils and fats	25.9	-10.3	29.5	-10.7	-3.6	0.4
Refined petroleum	33.0	-14.2	36.6	-14.3	-3.5	0.1
Sugar	-59.4	-45.6	-62.3	-41.5	2.9	-4.1
Telecommunications	-5.8	13.1	6.9	-2.9	-12.7	15.9
Mining and quarrying	5.8	1.2	2.5	-2.3	3.3	3.4
Real estate activities	6.5	5.2	2.0	5.1	4.5	0.0
Power generation, transmission and distribution	49.0	21.6	31.3	23.8	17.7	-2.2
Transportation and storage	10.5	17.2	11.2	21.9	-0.7	-4.7
Construction	-6.1	-26.1	6.6	-19.2	-12.7	-6.9
Wholesale and retail trade	52.2	-38.8	50.5	-28.1	1.7	-10.7

* The sector-wise data for FY19 and FY20 may not be fully comparable, as the flows for H1-FY19 are based on ISIC 3.1 whereas the flows for H1-FY20 are based on ISIC 4.0 classification.
**includes trade financing;
Data source: State Bank of Pakistan

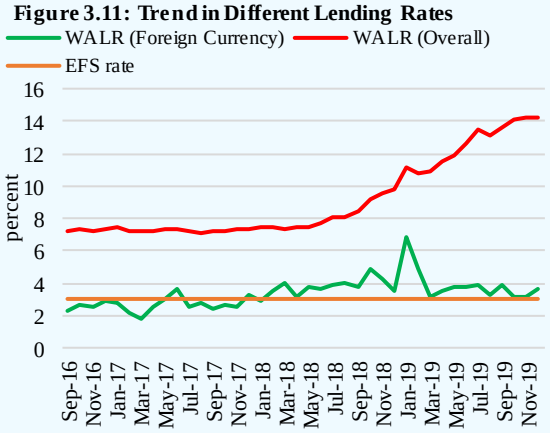
as construction, power and transport more than offset the increase in manufacturing sectors' loans (by sectors like textile).

Working capital loans

The increase in the stock of working capital loans in H1-FY20 was only a quarter of the increase observed in H1-FY19. This trend was explained both by lower offtake by textiles and rice processing sectors, as well as deleveraging by the sugar, petroleum refining and edible oil industries.

In case of export-oriented sectors, lower bank financing despite visibly buoyant sectoral activity mainly represents better liquidity conditions this year due to higher export values in Pak rupee terms, and a relatively smoother release of tax refunds by the FBR. Because of these factors, firms were not keen on borrowing against the SBP's concessional Export Finance Scheme (EFS), where the interest rate gap had widened to 10.81 percent, on average. Borrowing under EFS in fact fell to Rs 42.5 billion in H1-FY20 from Rs 58.0 billion in H1-FY19. Meanwhile, some exporters (likely those ineligible for EFS) opted for foreign currency financing (against FE-25 deposits) for trade purposes, given that rates on this type of financing were close to those on EFS (**Figure 3.11**). As it turned out, exporters were more drawn towards this financing; probably firms not eligible for EFS led this behavior.

Figure 3.11: Trend in Different Lending Rates



Data source: State Bank of Pakistan

As for the sectors that preferred to deleverage this year, the sugar sector figured prominently by making heavy seasonal retirements. In contrast, oil refineries opted to deleverage to shield their profit margins from getting further eroded by high financial charges in the current interest rate environment. As per the available balance sheet data, finance cost has even exceeded the operational income for most of the listed refineries during Q2-FY20. It may be recalled that the refining sector is already facing serious cash flow constraints stemming from regulatory changes and import-led compression in the commercial transport activity in the country. Facing restrictions with respect to the use of furnace oil in thermal power generation, refineries continue to struggle with inventory build-up

of furnace oil, which is constraining their operational activity (**Chapter 5**).
In case of fertilizer, the liquidity situation was relatively better this year, as the sector's sales revenue was Rs 2.1 billion higher in H1-FY20 as compared to the same period last year. In this regard, a strong urea offtake of 1.3 million metric tons in December 2019 played a crucial role in enhancing fertilizer sales. With this comfort, the sector marginally retired Rs 0.7 billion in H1-FY20, compared to borrowing Rs 22.1 billion last year.

In contrast, automobile assemblers increased their reliance on bank financing further. Struggling with unsold stocks that created cash flow constraints, auto assemblers borrowed heavily from banks to finance their operational activities. Before the current downtrend, this sector used to make little use of bank borrowing and mainly financed its working capital from customers' prepayments.

Among non-manufacturing businesses, short-term borrowing by the power sector was noteworthy. The increase could mainly be attributed to working capital requirement of a major IPP during Q2-FY20. Another notable increase was recorded in the transport sector, whose short-term borrowing rose by Rs 21.9 billion in H1-FY20 compared to Rs 11.2 billion last year. This mainly represents borrowing by a deep sea port operator that is modernizing its operations.

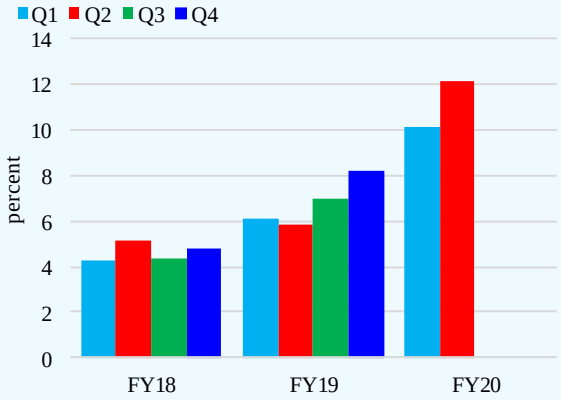
Fixed investment loans
Fixed investment loans marginally declined by Rs 0.8 billion in H1-FY20, compared to an increase of Rs 37.0 billion in the same period last year, as net retirements in construction and power sectors more than offset borrowings by manufacturing businesses, mainly textile and fertilizer.

Textile firms continued to position themselves to take advantage of pricing edge stemming from the exchange rate realignment and improved market opportunity in the key destinations (US and the EU) amid China's retreat from the apparel segment. Textile firms enjoyed lucrative rates of 5 percent under the SBP's Long Term Financing Facility (LTFF) for export-oriented projects. LTFF loans constituted around 95 percent of the textile sector's overall fixed investment borrowing during H1-FY20, compared to 77.5 percent last year.

3.4 Inflation

Following a steep rise in food prices, the overall inflationary pressures in the economy intensified for the fourth quarter in a row during Q2-FY20 (**Figure 3.12**). National CPI inflation clocked in at 12.1 percent during the quarter as food supplies were disrupted in both urban and rural areas. Moreover, while the landed cost of imported food items remained significantly higher than last year, a rise in transport costs and sales tax rates on major kitchen items (edible oil and sugar) put additional pressure on food inflation. Nonetheless, non-food-non-energy (NFNE) inflation observed stability; not only did it remain almost at last year's level in Q2, it also declined from the preceding quarter. This stability in NFNE signifies weak demand in the economy and well anchored-inflation expectations.

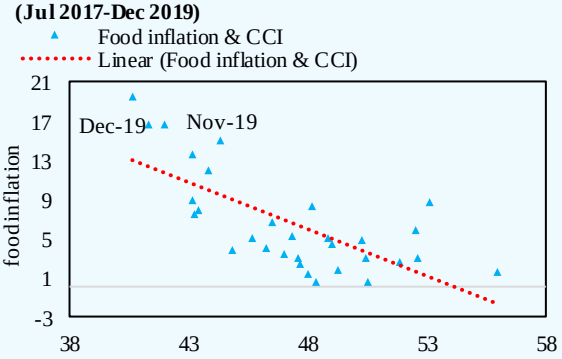
Figure 3.12: Quarterly Average of National CPI Inflation



Data source: Pakistan Bureau of Statistics

Nonetheless, with a combined 36.8 percent and 46.0 percent share in the consumption basket of urban and rural consumers respectively, rising food prices kept consumer confidence subdued (**Figure 3.13**). Struggling to preserve their purchasing power, households perceived current times to be challenging to purchase automobiles, durable household items and new houses, as noted in all the waves of the IBA-SBP surveys conducted in H1-FY20. Importantly, the overall consumer confidence showed a weaker reading in every successive wave.

Figure 3.13: Food Inflation and Consumer Confidence Index (Jul 2017-Dec 2019)

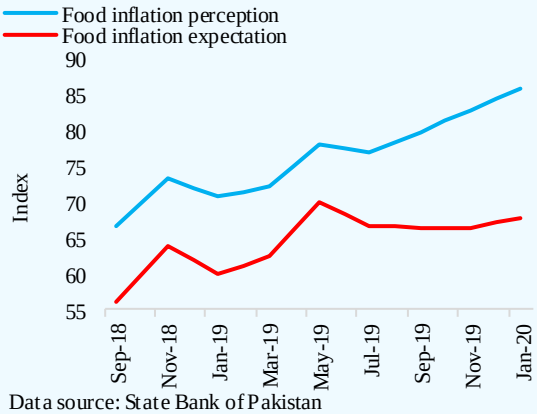


Consumer Confidence Indices (>50 represents more +ve views; <50 represents more -ve views

Data source: State Bank of Pakistan

However, households' expectations with respect to food and overall inflation presents a silver lining. Given the seasonal nature of food price increases, inflation expectations remained broadly anchored. Importantly, although households' *perception* of food prices (which represents how they view current food prices compared to past 6 months) has increased steadily since the July 2019 wave, their *expectations* of food prices for the next 6 months have remained mostly unchanged (**Figure 3.14**).

Figure 3.14: Comparison of Food Inflation Perception and Expectations



Data source: State Bank of Pakistan

Food inflation

Food inflation, which began to surge from the third quarter of FY19, increased to an 8-year high level in Q2-FY20. With a 36.8 percent weight in the urban CPI basket and 46.0 percent weight in the rural CPI basket, the food price increase during the quarter emerged as a major policy challenge (**Table 3.5**). From the monetary policy perspective, a persistent surge in these prices can potentially lead to faster wage growth in household services, triggering a wage-price spiral. From the fiscal policy perspective also, any subsidy-centric response to a persistent surge in food prices and the associated political challenges can dent the ongoing expenditure control efforts. For instance, to improve market sentiments, the ECC not only increased the support price for wheat for the next season (to encourage farmers to expand the cultivated area), but also allocated additional funding to save the upcoming wheat and minor crops from locust attack. Furthermore, the government also provided a food subsidy of Rs 15.0 billion to be spent through the utility stores network.

In this context, and before presenting a detailed analysis of developments in Q2, three aspects are important to note. First, the role of depreciation of the Pak rupee in FY19, continued increase in motor fuel prices, and the increase in sales tax rate on essential items (e.g., sugar and edible oil) appeared important in explaining the broad-based increase in food prices. Barring a further policy change down the road, the impact from these measures will dissipate on food inflation going forward.

Table 3.5: Average CPI Inflation and Contribution

Items	Urban						Rural					
	Wt.*	H1		Q2			Wt.*	H1		Q2		
		FY19	FY20	FY19	FY20	Cont.*		FY19	FY20	FY19	FY20	Cont.*
CPI	100.0	6.3	11.0	6.4	11.6	11.6	100.0	5.5	11.3	5.0	12.8	12.8
Food & non-alcoh. bev.	30.4	1.6	14.8	0.8	17.4	5.0	40.9	1.6	15.5	0.5	18.7	7.4
Wheat	0.6	3.8	12.5	3.9	15.3	0.1	3.5	3.5	13.3	3.4	17.2	0.5
Wheat flour	3.0	3.2	12.2	2.2	14.5	0.4	3.4	3.7	14.1	2.8	16.8	0.5
Potato	0.4	-22.4	39.8	-25.3	53.7	0.2	0.7	-27.3	37.4	-29.1	51.1	0.4
Onions	0.6	-42.7	109.6	-55.1	150.7	0.6	0.9	-45.8	112.7	-58.2	152.9	0.8
Tomatoes	0.3	-28.1	62.4	-51.4	187.1	0.6	0.5	-23.9	64.3	-48.0	179.2	0.8
Fresh vegetables	1.5	-5.0	28.2	-17.7	51.0	0.8	2.1	-5.3	30.1	-14.0	48.8	1.0
Sugar	1.1	-1.7	33.1	0.2	32.0	0.3	2.0	-0.8	34.2	0.8	32.7	0.5
Clothing and ft.wear	8.0	5.0	8.9	5.3	9.2	0.7	9.5	8.1	9.1	7.8	9.8	1.0
Cotton cloth	2.2	5.0	13.0	5.6	13.1	0.3	2.8	10.6	11.3	11.0	12.9	0.4
Housing, Elec., Gas	27.0	7.9	8.7	8.8	9.1	2.5	18.5	8.5	4.5	8.1	6.1	1.2
Electricity charges	4.6	9.8	6.0	9.1	15.4	0.7	3.4	9.8	6.0	9.1	15.4	0.5
Gas charges	1.1	19.3	79.9	38.6	54.8	0.7	n.a	n.a	n.a	n.a	n.a	n.a
Health	2.3	6.2	11.2	6.5	10.9	0.3	3.5	6.2	12.1	6.9	12.3	0.5
Transport	6.1	19.3	17.2	19.0	16.0	1.0	5.6	17.5	14.9	17.4	13.3	0.8
Motor fuel	2.9	27.8	19.8	25.8	18.3	0.6	2.5	27.6	19.7	25.1	18.5	0.5
Communication	2.4	2.1	5.4	2.3	5.2	0.1	2.0	2.2	1.9	2.3	1.8	0.0
Education	4.9	12.7	6.6	11.2	6.3	0.4	2.1	7.4	5.2	7.1	5.2	0.1
Restaurants and hotels	7.4	6.0	5.1	6.2	5.0	0.4	6.2	5.6	7.9	4.9	8.3	0.5

*wt. = weight and Cont.= Contribution for Q2
Data source: Pakistan Bureau of Statistics

Second, in the case of wheat and wheat flour, speculative activity seems to have engulfed the market during the period, as sufficient stocks were available in the country. Third, supply disruptions played an important role in case of perishables, which were seasonal and temporary in nature.

Here, it is important to note that for the government to control excessive variability in food prices, timely flow of information and an effective early warning system to predict imminent demand-supply gaps is extremely important. Unless information gaps are plugged, domestic food prices will remain vulnerable to weather-related agriculture outcomes (for details, see **SBP Staff Note 02/20, April 2020**[4]).

[4] Asma Khalid and Sabahat (April 2020), "Price Stabilization Mechanism in Pakistan's Food Market: Exploring Issues and Potential Challenges", SBP Staff Note 2/20. (http://www.sbp.org.pk/publications/staffNotes.htm)

Higher transport cost, revenue-led fiscal measures and PKR depreciation led to a broad-based increase in prices across the food basket

As highlighted in the heat map for both urban and rural areas (**Figure 3.15**), inflation pressures grew intense through most of the sub-indices by the end of Q2-

Figure 3.15 a: Heat Map- YoY Urban Food Inflation

	Wt.	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Food Index	36.8	0.6	2.6	5.9	8.8	8.3	9.0	7.5	7.9	11.9	15.0	13.7	16.6	16.7
Perishable food	4.5	-29.7	-15.3	6.8	27.6	25.4	29.7	14.3	5.4	13.3	27.2	35.9	66.0	76.4
Non-perishables	26.0	5.3	4.9	5.7	6.5	6.0	6.3	6.5	8.1	12.5	14.4	11.1	10.8	10.8
Dairy (Chicken, Eggs)	1.9	0.2	-13.6	-4.1	1.7	2.1	-7.1	-12.4	-6.6	50.0	52.0	-0.3	-13.0	-11.5
Pulses	0.7	2.6	4.2	4.1	7.7	8.8	12.2	15.1	16.9	18.6	18.7	19.0	22.8	21.7
Fresh fruits	1.4	0.7	-1.7	-1.1	0.0	11.0	24.5	0.6	9.7	8.2	6.7	5.4	7.9	9.1
Condiments & spices	1.3	14.0	16.3	17.7	17.3	18.7	19.8	20.3	18.9	21.9	20.5	18.1	19.2	17.6
Vegitables	2.9	-42.1	-23.3	10.8	47.2	34.8	32.4	23.3	2.1	13.3	34.5	47.5	92.5	118.3
Grains	4.9	2.7	2.4	2.2	2.5	2.4	5.1	6.0	7.7	7.9	9.8	9.2	12.9	13.9
Edible oil	2.2	6.8	8.1	8.6	8.8	12.3	12.1	12.4	13.9	18.4	19.3	18.0	16.0	16.5
Readymade Food	5.5	4.8	4.5	4.5	5.4	5.6	5.1	5.2	6.1	5.8	6.3	6.2	6.6	6.2
Meat (Meat, Fish)	2.4	8.2	8.7	8.6	8.9	8.1	10.5	11.1	11.8	12.2	12.6	13.5	13.2	13.5

<5 | 5 to 10 | 10 to 15 | 15-20 | >20

Figure 3.15 b: Heat Map- YoY Rural Food Inflation

	Wt.	Dec-18	Jan-19	Feb-19	Mar-19	Apr-19	May-19	Jun-19	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19
Food Index	45.9	0.5	1.8	5.2	9.3	9.3	9.7	9.1	9.3	12.6	15.0	14.6	19.3	19.7
Perishable food	5.8	-33.4	-21.5	-2.4	30.2	24.7	27.6	14.7	12.1	17.3	26.1	34.3	73.9	89.3
Non-perishables	35.1	5.6	4.3	5.2	6.4	7.1	7.3	8.0	8.2	11.4	12.3	10.6	12.0	12.0
Dairy (Chicken, Eggs)	2.0	7.6	-14.2	-5.9	1.6	4.0	-7.4	-6.4	-9.3	37.3	42.1	4.4	-10.4	-13.9
Pulses	1.1	2.6	2.6	5.3	6.1	11.4	13.9	16.3	17.8	19.9	18.1	19.5	23.9	23.7
Fresh fruits	1.5	-3.8	-2.3	-5.6	-0.4	13.9	17.6	3.6	15.9	14.7	10.7	6.7	13.2	21.5
Condiments & spices	1.5	15.5	16.1	14.9	17.2	15.9	15.4	15.2	11.5	13.4	13.7	11.1	14.7	22.1
Vegitables	2.1	-34.1	-19.1	-10.5	34.5	24.9	26.8	17.0	1.1	9.8	20.1	34.7	42.2	80.2
Grains	8.5	4.2	3.3	3.7	4.6	5.0	8.5	9.9	9.4	9.2	10.7	10.5	17.4	17.8
Edible oil	3.0	9.5	9.2	9.8	8.1	9.0	9.1	9.7	14.0	16.8	17.9	17.8	17.5	19.1
Readymade food	3.8	7.2	7.3	6.6	6.1	6.4	5.1	4.6	7.0	7.8	7.8	7.7	8.4	8.1
Meat (Meat, Fish)	2.0	9.5	10.3	12.6	12.0	14.0	12.0	13.0	12.5	11.3	12.1	12.7	12.0	12.2

<5 | 5 to 10 | 10 to 15 | 15-20 | >20

Data Source: Pakistan Bureau of Statistics

FY20. While prices of perishables observed the steepest rise compared to last year, some non-perishables, such as pulses, edible oil, condiments and grains, also felt heavier on consumers' pockets. A similar trend was observed in price trends in rural areas.

The broad-based nature of food inflation can be attributed to a number of policy measures taken over the past few months. First, prices of imported food items (such as pulses, edible oil and condiments) as well as imported farm inputs (mainly fertilizers) remained higher than last year due to a weaker Pak rupee. Second, revenue-enhancing measures, which involved raising the sales tax rate on sugar and edible oil and a significant revision in FED on cigarettes, put upward pressure on prices of these items. Third, higher diesel and petrol prices and the implementation of axle load management increased the transportation cost of food items to retail markets.

As shown in **Figure 3.16**, the dispersion in food prices has been quite large across various cities throughout the first half of FY20. This increase mainly reflects

localized supply shortages and the impact of transportation cost (both higher fuel prices and axle load) from farms/entry points to retail markets.

Figure 3.16a: Dispersion in Food Index Across Cities (Oldbase: 2007-08)

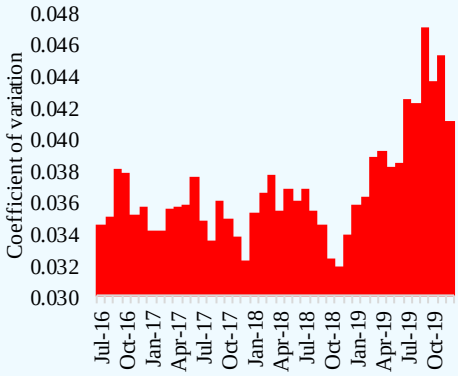
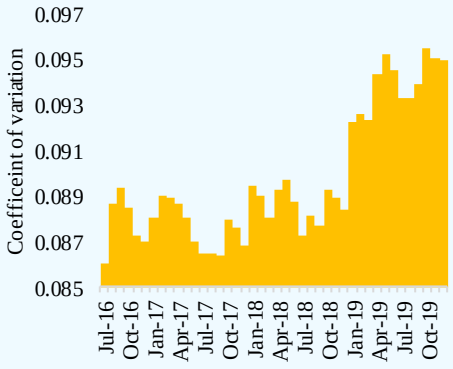


Figure 3.16b: Dispersion in Non-food Index Across Cities



Data source: Pakistan Bureau of Statistics

Specifically, most non-perishable food items land in the country via Karachi port (e.g., pulses, edible oil, powdered milk, etc.). If we plot the distance of each city from Karachi against the edible oil inflation it experienced during the quarter, we see a visible positive trend (**Figure 3.17a**). Such a trend was not observed last year (**Figure 3.17b**). Similarly, in case of perishables that Pakistan imported from Afghanistan to overcome the domestic shortfall (mainly tomatoes), a positive trend can be seen between the distance of each city from the Torkham border and the regional food inflation (**Figure 3.17e**). Finally, a similar positive trend is visible in case of wheat inflation when plotted against the distance from Punjab's wheat growing areas (**Figure 3.17c**).

ii. Trade barriers and speculative activity intensified the impact of temporary supply disruptions

It is important to mention here that the increase in vegetable prices was a regional concern in the second half of 2019, as weather-related shocks (high temperatures and untimely heavy rains) damaged harvests in India – the largest producer and exporter of onion, tomatoes and potatoes in the region. However, countries had been taking measures to control price hikes. For instance, India put an explicit ban on the export of onions and tomatoes in September 2019; it also made special arrangements to *import* onion from Egypt, Turkey, Afghanistan and Iran. Similarly, Bangladesh arranged onion airlifts from Myanmar, China, Turkey and Egypt to control their prices.

In case of Pakistan, however, production losses in food crops were relatively

Figure 3.17a: Inflation in Edible Oil and Distance across Cities from Karachi Port*

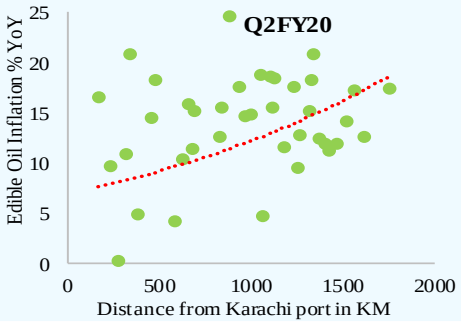


Figure 3.17b: Inflation in Edible Oil and Distance across Cities from Karachi Port

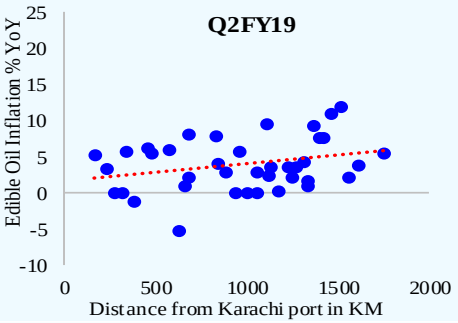


Figure 3.17c: Inflation in Wheat Flour and Distance across cities from Punjab's Key growing areas

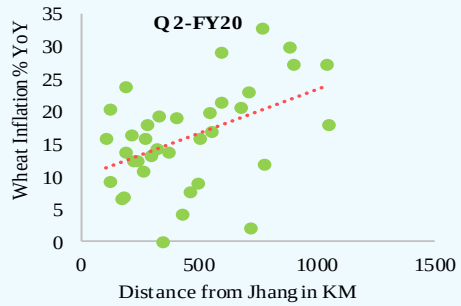


Figure 3.17d: Inflation in Wheat Flour and Distance across cities from Punjab's key Growing Areas

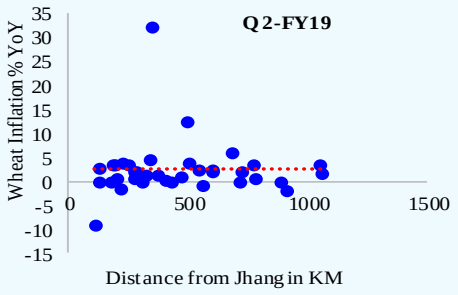


Figure 3.17e: Inflation in Tomatoes and Distance Across Cities from Torkham Border

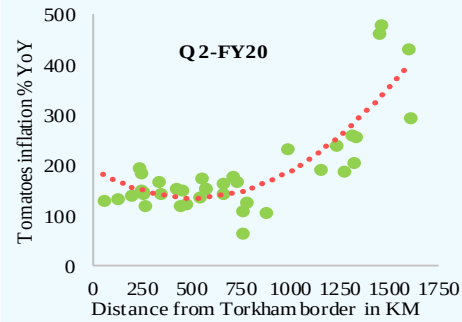
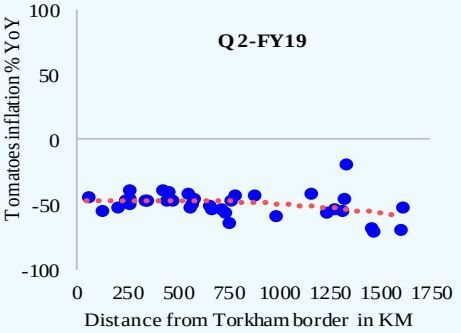


Figure 3.17f: Inflation in Tomatoes and Distance Across Cities from Torkham Border



* Powder milk and pulses (where imports constitute the bulk of the domestic supplies) depict similar relationship
Data source: Google Maps, Pakistan Bureau of Statistics (Old base: 2007-08)

contained.[5] Production of potatoes, onions and tomatoes were largely stable,[6] whereas the decline in wheat output in 2019 was limited to only 3.2 percent as

[5] Official data on minor crops production for FY20 was not available at the time of writing this report.

compared to the preceding season. However, speculative activity in the wheat market, lower procurements by government agencies and delays in the harvest of tomatoes and onions in Sindh, triggered price pressures in the domestic market. These pressures were intensified and prolonged by the import barriers and structural weaknesses in the overall price control mechanism for essential food items (for details, **SBP Staff Note 02/20, April 2020**). As a result, despite a reasonably good agriculture outcome, food inflation in Pakistan turned out to be the strongest among regional countries during the Jul-Dec 2019 period (**Figure 3.18**).

Figure 3.18a: Food Inflation Across South Asian Region

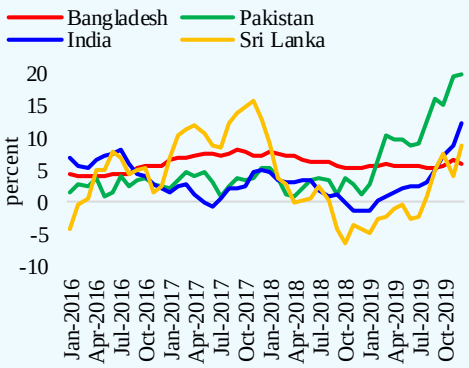
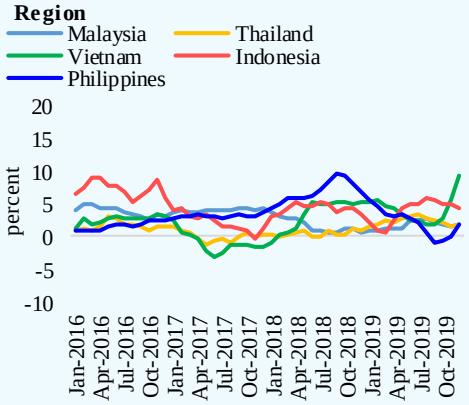


Figure 3.18b: Food Inflation Across East Asian Region



Data source: Haver Analytics

In case of tomatoes, untimely rains in the sowing season wiped out pre-winter plantations in Sindh and caused a delay in the harvest, which was expected to hit the market around October. Prices began to increase from mid-October as supplies became squeezed. In case of onions, the impact on domestic prices initially appeared to be linked with the regional phenomenon, but the crop estimates and trade data make it hard to comprehend market dynamics. First, India imposed a ban on exports in September 2019 following a large decline in onion production there. As a result, prices surged steeply in the South Asian region, and since these markets started eyeing Chinese varieties, prices of onion in China also increased.

It appears ambiguous as to how Pakistan was affected by these developments. As

[6] In FY19, the potato crop was estimated to have grown by 6.45 percent compared to last year, whereas production of tomatoes and onion remained more or less unchanged with growth of -1.9 and -0.2 percent respectively (Source: Federal Committee on Agriculture, Rabi Working Paper for 2019-20).

per estimates from provincial food authorities, Pakistan had a bumper onion crop this year. Still, prices rose over 150 percent YoY during Q2-FY20. A part of this increase can be explained by exports of nearly 72,000 MT during October and November 2019 – if we extrapolate this quantity to the full-year, it becomes equivalent to 20 percent of the country's annual onion production. However, it is equally important to note that the country also *imported* about half of this quantity (i.e., 36,000 MT) in the same months. Furthermore, a very strong correlation between onion inflation in India and Pakistan, despite the non-existent formal trade between the two countries, is also puzzling (for details, see **SBP Staff Note 02/20, April 2020**).

As far as wheat and wheat flour are concerned, their prices had been edging up since the beginning of the 2019 procurement season (i.e. mid-April). Crop shortfall, limited procurement by government agencies, falling operational reserves, continued exports and a ban on imports, all triggered speculative activity in the wheat market.[7] In September 2019, the government put an explicit ban on the commodity's exports to help alleviate pressure on domestic prices. Furthermore, the ECC repeatedly advised provincial procurement agencies to release their wheat stocks in the market to bridge the demand-supply gap. However, private traders maintained their positions; media reports with respect to restrictions on inter-provincial movement of wheat by the Punjab government further fueled speculative activity. As a result, retail wheat price touched Rs 426.3 per 10 kg by end December 2019, whereas retail flour price soared to Rs 463.9 per 10 kg.

Core inflation softened

The inflationary pressures in non-food-non-energy (NFNE) moderated during Q2-FY20 for urban areas, whereas rural inflation depicted a slightly increased trend. Almost half of the indices within NFNE registered lower inflation in Q2-FY20 as compared to the same period last year for urban areas (**Figure 3.19**). This signifies that the macroeconomic stabilization measures (including the increase in interest rates, fiscal consolidation and realignment of the exchange rate with fundamentals), have proved largely effective.

Component-wise analysis suggests that house rent and education played a significant role in driving down the overall NFNE inflation for urban areas. In education, the decline in inflation came from private school and coaching center

[7] Wheat production in 2019 was recorded at 24.3 million MT. Total availability of wheat was estimated at 28 million MT, including leftover stocks of 3.8 million MT. This compares with the national requirement of 26.9 million MT.

fees. This can be attributed to the Supreme Court's decision in September 2019 to restore school fees to the 2017 level, on which it fixed the maximum increase in fees at 5 percent a year.

Figure 3.19a: Frequency Distribution of NFNE Inflation in Q2 - Urban

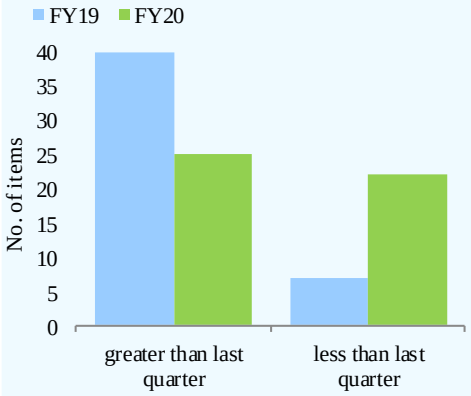
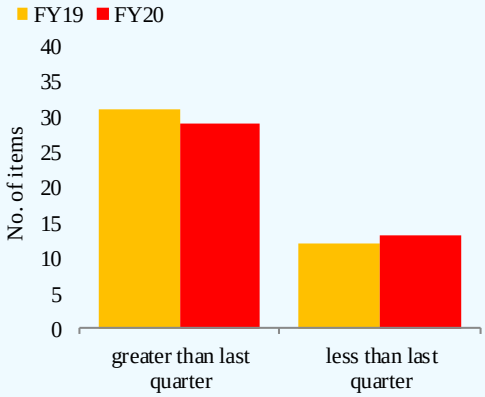


Figure 3.19b: Frequency Distribution of NFNE Inflation in Q2 - Rural



Data source: Pakistan Bureau of Statistics

Within NFNE, the goods' index posted a double-digit inflation during Q2-FY20. It appears that this increase partially represents the impact of the increase in motor fuel prices and the axle load management, which increased the overall transport cost in the country. Furthermore, revenue-enhancing measures taken in the budget 2019-20 have also affected goods' prices in the NFNE basket:

(i) Inflation in the clothing and footwear group rose in both urban and rural areas. Within this group, cotton cloth, and woolen and readymade garments posted significant price rises, as producers passed on the impact of ending of the zero-rating regime (effectively, an imposition of 17 percent GST) onto end-consumer prices;
(ii) The government imposed 17 percent federal excise duty (in sales tax mode) on various steel products, including billets, ingots, bars, etc. Previously, the steel sector was subject to fixed sales tax; and
(iii) The increase in cement prices reflects the impact of the increase in FED from Rs 1.5 per kg to Rs 2 per kg this year.

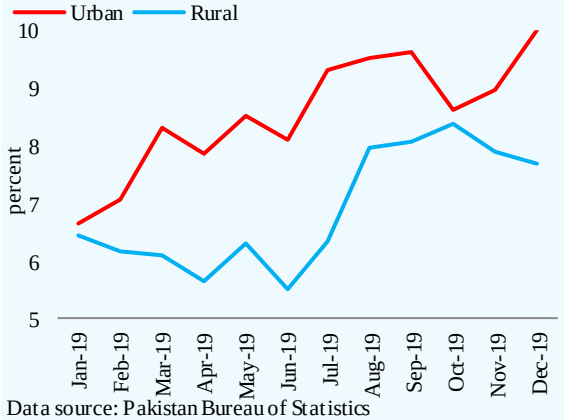
In contrast, inflation on services items remained on the lower side. However, within services, an upward pressure on low-end wages and service charges was visible, especially in urban areas (**Figure 3.20**). The index of low-end urban wages and service charges (with 3.4 percent weight in overall CPI), which represents services such as household servants, cleaning & laundering, tailoring, garbage collection, motor cycle tyre puncture, car service, carpenter, mason,

plumber and electrician, posted 9.2 percent inflation, on average, during Q2-FY20. This increase can possibly be viewed as the impact of overall inflationary pressures in the economy, which have affected real incomes of the low-income group the most.

Energy inflation continued to increase steadily

Despite a sizable drop in international oil prices, domestic energy prices continued to rise steadily. This trend represents the impact of previous policies that had led to generation of arrears in both the power and gas sectors, financial constraints for generation and distribution companies, and technical losses/theft. The unsustainable financial position of power and gas firms and its fiscal and quasi-fiscal impact, has made it inevitable for the government to carry out comprehensive reforms in these sectors; among others, this includes streamlining the tariff procedures and their timely notification.

Figure 3.20: Index of Low-end Wages and Service Charges - YoY Inflation



Data source: Pakistan Bureau of Statistics

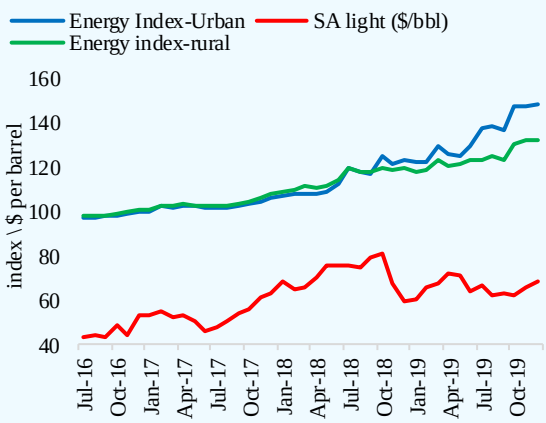
The urban energy index registered a 19.9 percent increase during Q2-FY20, whereas the rural index increased by 10.6 percent over the same period last year. Disaggregated analysis suggests that the largest impact on the urban energy index came from adjustments in gas tariffs in July 2019, which the Oil and Gas Regulatory Authority (OGRA) made to minimize the accumulation of arrears in the sector from delays in tariff notifications and technical losses. Another upward revision was expected in December 2019, in order to meet the additional revenue requirement of SSGC and SNGPL. However, this decision was deferred and gas tariffs were kept unchanged. Nonetheless, the impact of tariff revisions in October 2018 and July 2019 remained pronounced in Q2-FY20 inflation over a YoY basis. Since gas tariffs are not included in the CPI basket of rural areas, their energy index remained largely stable.

Similarly, electricity prices in both the urban and rural areas posted 15.4 percent rise during Q2-FY20. This rise represents the impact of quarterly tariff adjustment to cover the cost of rising capacity payments and the sector's losses, as well as fuel price adjustments. It is important to recall here that these quarterly

adjustments are part of the government's comprehensive plan to reduce the accumulation of power sector arrears.

In case of motor fuels, prices remained stable during Q2-FY20. However, the inflation remained pronounced on year on year basis, as the urban fuel index grew by 18.3 percent in Q2-FY20 compared to 25.8 percent rise in the same period last year, whereas rural prices grew by 18.5 percent in Q2-FY20 compared to 25.1 last year same period. Soft international oil prices over bleak global economic outlook and a stable domestic currency helped contain the inflationary impact in motor fuel segment (**Figure 3.21**).

Figure 3.21: Energy Index and International Oil Prices



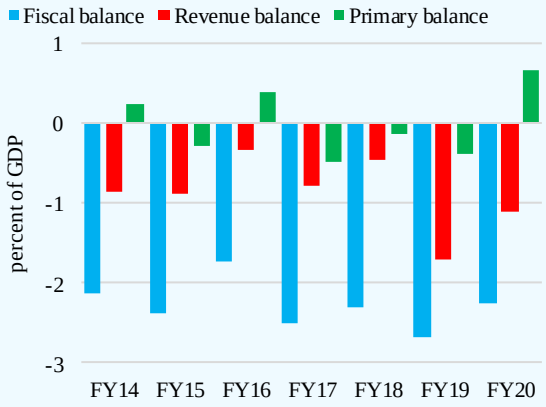
Data source: PBS and Bloomberg

4 Fiscal Policy and Public Debt

4.1 Overview

The fiscal position significantly improved during H1-FY20. Fiscal deficit was recorded at 2.3 percent of GDP, against 2.7 percent last year (**Figure 4.1**). In particular, the primary surplus was almost three times the revised target set by the IMF program. This improvement is primarily attributed to a large increase in revenue collection that outpaced the expenditure growth. While the increase in revenues emanated from both tax and non-tax segments, the overall expenditures rose on the back of higher interest payments, grants, and development expenditures.

Figure 4.1: Fiscal Indicators during H1



Data source: Ministry of Finance

The strict fiscal controls employed during Q1-FY20 provided greater fiscal space to increase expenditures in Q2. Importantly, there was an uptick in expenditures on social and development fronts. During Q2-FY20, the growth in expenditures, however, more than offset the rise in revenues. Resultantly, the fiscal deficit clocked at 1.6 percent of GDP in Q2, compared to 0.7 percent in Q1-FY20 and 1.3 percent in Q2-FY19.

Revenue collection increased sharply in contrast to a decline recorded during H1-FY19 despite an overall slowdown in economic activity and a marked contraction in imports (**Table 4.1**). Policy measures, such as an increase in GST on petroleum products, re-enactment of taxes on telecom services, increased excise duty on cement and cigarettes, upward adjustment in power tariffs, upward revision in tax rate on salary slabs, end of preferential treatment sectors and zero-rating regime for five export-oriented sectors, contributed to this higher growth in revenues. Higher inflation may have contributed in higher revenue mobilization as well. *One-off factors* such as the GSM renewal fee and higher SBP profits were the main sources of non-tax revenues. However, the tax revenue target agreed under

the IMF program could not be achieved during H1-FY20. Notably, the import compression measures adversely affected the revenue mobilization, since 40 percent of annual total tax collection is associated with imports.

Both current and development expenditures grew sharply during H1-FY20 as compared to last year **(Table 4.1)**. Higher growth of current spending was led by interest payments and grants, which were especially concentrated in Q2.[1] At the same time, the development expenditures also grew sharply at both the federal and provincial levels.

Table 4.1: Summary of Fiscal Operations in H1
billion rupees

	Actual			Growth		
	FY18	**FY19**	**FY20**	**FY18**	**FY19**	**FY20**
A. Total revenue	2,384.7	2,327.1	3,231.9	19.8	-2.4	38.9
Tax revenue	2,026.9	2,082.5	2,465.2	16.4	2.7	18.4
Non-tax revenue	357.8	244.6	766.7	43.4	-31.6	213.4
B. Total expenditure	3,181.0	3,357.0	4,226.6	14.0	5.5	25.9
Current	2,545.2	2,984.4	3,721.4	13.5	17.3	24.7
Interest payments	751.4	876.7	1,281.2	16.1	16.7	46.1
Development	574.8	361.1	464.9	15.6	-37.2	28.8
Net lending	2.0	8.3	8.3	-131.4	311.8	0.3
C. Statistical discrepancy	59.0	3.2	32.0			
Fiscal balance (A-B-C)	-796.3	-1,029.9	-994.7			
Revenue balance	-160.5	-657.3	-489.4			
Primary balance	-44.9	-153.2	286.5			
Financing	796.3	1,029.9	994.7			
External sources	384.1	218.0	513.6			
Domestic sources	412.2	811.9	481.1			
Banks	331.8	577.6	41.7			
Non-bank	80.4	234.4	439.4			
As percent of GDP						
Total Revenue	6.9	6.0	7.3			
Tax	5.9	5.4	5.6			
Non-tax	1.0	0.6	1.7			
Total expenditure	9.2	8.7	9.6			
Current	7.4	7.7	8.5			
Development	1.7	0.9	1.1			

Data source: Ministry of Finance

Lower financing needs, supported by an appreciation of PKR against the US dollar, contained the pace of public debt accumulation. The composition of

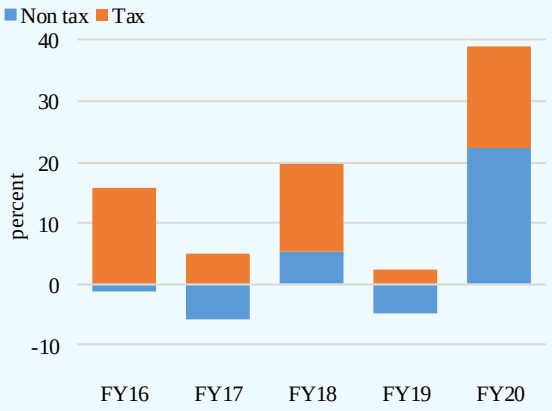
[1] The federal current spending was around 42.0 percent of the annual target during H1-FY20.

domestic debt also witnessed a transition, as the government strictly adhered to its commitment of zero borrowing from the central bank. Furthermore, as part of its debt management strategy, the government utilized its deposits (cash buffers) to meet its financing needs and retire existing debt stock. External debt increased in dollar terms on account of fresh borrowing from multilateral and commercial sources, receipt of IMF tranches, and a rise in foreign investment in government securities. These inflows more than offset the bulky repayments (including Sukuk of US$ 1.0 billion) during this period.

4.2 Revenues

Overall revenue collection increased during H1-FY20 compared to contraction observed during the same period last year **(Figure 4.2)**. The main increase came from a substantial rise in FBR taxes, supported by higher growth in non-tax revenues.

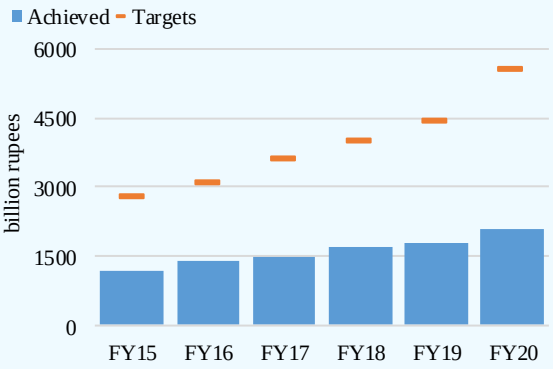
Figure 4.2: Contribution in Revenue Growth in H1



Data source: Federal Board of Revenue

Total revenue collection posted a growth of 38.9 percent during H1-FY20 against a decline of 2.4 percent in the corresponding period last year. Despite the economic slowdown and a significant contraction in imports, tax revenue recorded a growth of 18.4 percent compared to the average growth of 12.4 percent during H1 of the last five years. Notwithstanding a notable growth in FBR taxes and improved tax collection efforts, FBR taxes could only achieve 37.7 percent of the budgeted target for FY20 **(Figure 4.3)**.[2]

Figure 4.3: FBR Tax Revenue Collection during H1 in Comparison with Budgeted Target



Data source: Ministry of Finance

[2] On average, 42.0 percent of the budgeted annual target was achieved during first half of last 5 years.

FBR taxes

FBR tax collection grew by 16.7 percent during H1-FY20, compared with a meager growth of 4.3 percent in the corresponding period last year **(Table 4.2)**. The rise in FBR taxes was mainly supported by higher sales tax rates on various POL products, abolishment of zero-rating regime for export-oriented sectors, upward revision of tax rates on various salary slabs, re-enactment of WHT on telecom services, and higher FED rates. However, FBR would be required to put more collection efforts to further boost the revenues. In specific terms, FBR needs to collect Rs 3,143.9 billion in H2 to achieve the revised annual target of Rs 5,238.0 billion.

Table 4.2: FBR Tax Collection during H1

billion rupees; growth in percent

	Budget FY20*	Collection			Growth		
		FY18	FY19	FY20	FY18	FY19	FY20
Direct taxes	2,081.9	663.5	668.4	784.9	12.2	0.7	17.4
Indirect taxes	3,473.0	1,058.1	1,126.4	1,309.2	20.1	6.5	16.2
Customs duty	1,000.5	281.5	336.0	326.6	29.1	19.4	-2.8
Sales tax	2,107.7	686.5	688.0	857.5	18.9	0.2	24.6
FED	364.8	90.1	102.3	125.1	5.5	13.6	22.2
Total taxes	**5,555.0**	**1,721.6**	**1,794.8**	**2,094.1**	**16.9**	**4.3**	**16.7**

*Budget in Brief, Ministry of Finance

Data source: Federal Board of Revenue and Ministry of Finance

Importantly, the fiscal authorities have taken various steps during H1-FY20 to facilitate taxpayers in order to increase the tax base. These include: introduction of Fully Automated Sales Tax e-Refund system[3]; launch of FBR Tax Asaan mobile application; and a trade enablement program "Authorized Economic Operators" (AEO).[4] Moreover, FBR has introduced a Point of Sales (POS) system, which integrates the sales record with the FBR's centralized system of FBR.

Direct Taxes

Direct taxes, having a share of 37 percent in FBR taxes, recorded a growth of 17.4 percent in H1-FY20 against the growth of 0.7 percent in the same period last year.

[3] The refunds during H1-FY20 increased by 37.0 percent to Rs 75.5 billion against Rs 55.1 billion in H1-FY19.

[4] With AEO, the government will endorse the businesses with maximum compliance to the law, and shall be facilitated on priority basis.

This growth is explained by the upward revision in salary slabs, increase in tax rates on profit on debt, and the re-enactment of WHT on mobile phone top-ups.

The WHT contributed the most to direct taxes during H1-FY20 with salaries, bank interest and securities, and telephone together contributed 11.8 percentage points to the overall growth **(Table 4.3)**.[5] However, WHT from imports declined by 7.3 percent amid the declining trend in imports during H1-FY20.[6] Collection from contracts posted a growth of 5.9 percent in H1 FY20 compared to a 16.1 percent decline in the corresponding period last year. This rise was mainly because of an increase in PSDP releases.

Table 4.3: Major Revenue Spinners of Direct Taxes in H1
billion rupees; growth in percent

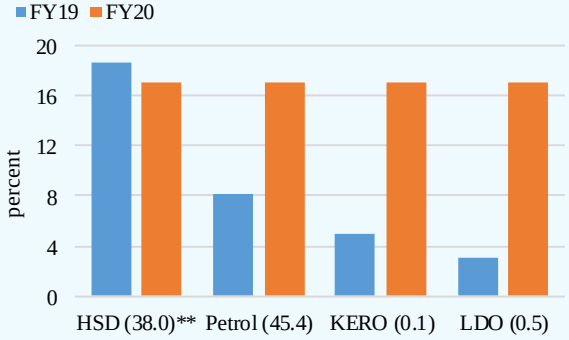
			Change	
	FY19	**FY20**	**FY19**	**FY20**
Withholding taxes	**449.4**	**544.5**	**-42.1**	**95.1**
growth	*-8.6*	*21.2*		
Imports	114.2	105.8	9.4	-8.4
Salaries	32.8	57.5	-25.0	24.7
Dividends	25.4	30.4	-5.4	5.0
Bank interest & securities	25.9	56.7	3.6	30.8
Contracts	106.5	112.8	-20.5	6.3
Exports	15.5	19.9	2.1	4.4
Cash withdrawal	17.8	8.6	1.7	-9.2
Electricity bills	19.2	24.9	2.6	5.7
Telephone	3.7	27.0	-21.4	23.3
Collection on demand	**32.7**	**19.7**	**-7.4**	**-13.0**
growth	*-18.5*	*-39.8*		
Voluntary payment	**227.1**	**248.2**	**52.9**	**21.1**
growth	*30.4*	*9.3*		
Miscellaneous	-15.0	8.6	-17.9	23.6
Net direct taxes	668.4	784.9	4.9	116.5

Data source: Federal Board of Revenue

Indirect tax

Indirect taxes posted a growth of 16.2 percent during H1-FY20 against the subdued growth of 6.5 percent in the corresponding period last year **(Table 4.4)**. The rise in indirect taxes mainly derived from the higher sales tax and FED rates. Sales tax (mainly on POL products) alone contributed around 15.1 percentage points to the 16.2 percent growth in indirect taxes. Meanwhile, the increase in sales tax rates on petroleum was the

Figure 4.4: Sales Tax Rates on POL Products in H1*



*Effective rates are calculated on basis of weighted averages for H1. **Shares in parentheses.
Data source: Federal Board of Revenue and SBP calculations

[5] Higher interest rates and increased tax rates on profit increased the collection from bank interest and securities by Rs 30.8 billion.
[6] The imports declined by 17.0 percent in H1-FY20.

major driving factor in the upsurge in the collection during H1-FY20 **(Figure 4.4).**

The collection from electrical energy was the second major contributor to the sales tax growth, which is explained by the upward price adjustments in tariffs and the abolishment of zero-rating regime for export-oriented sectors.[7] Moreover, the upward revision in sales tax rates on sugar also contributed in higher revenue collection. With increase in tax rates and higher import cost (in rupee terms), the collection from iron and steel also grew by 17.8 percent. At the same time, collection from textile related items also recorded an upsurge during H1-FY20 on the back of the abolishment of zero-rating regime.

Growth in FED almost doubled in H1-FY20 when compared to the 5 year average of the same period. This growth is attributed to the upward revision in FED rates.[8] Cement, cigarettes & tobacco, and beverages together contributed more than half to its growth during the review period.

Table 4.4: Major Revenue Spinners of Sales Tax in H1
billion rupees; growth in percent

	Actual		Growth	
	FY19	**FY20**	**FY19**	**FY20**
Sales Tax	**688.0**	**857.5**	**0.2**	**24.6**
Of which				
POL	222.4	264.2	-14.4	18.8
Electrical energy (DISCOS)	28.6	52.6	-8.6	83.9
Iron and steel	39.9	47.0	23.5	17.8
Nuclear reactor & boiler	34.5	31.8	16.3	-7.8
Plastics	24.3	27.7	907.3	14.2
Semiconductor	25.9	27.5	5.9	6.3
Vehicles	35.3	23.2	7.5	-34.3
Textile related items	1.6	25.0	-	-
Sugar	9.7	16.5	4.6	69.6
Others	278.5	344.4	0.8	23.7
Indirect taxes	**1,126.4**	**1,309.2**	**6.5**	**16.2**

Data source: Federal Board of Revenue

Table 4.5: Major Revenue Spinners of Excise and Custom Duty in H1
billion rupees; growth in percent

	Actual		Growth	
	FY19	**FY20**	**FY19**	**FY20**
FED				
Cement	27.8	35.5	17.8	27.6
Cigarettes & tobacco	32.2	35.4	31.4	9.9
Total services	19.6	20.0	-2.0	2.1
Beverages	10.3	14.3	6.2	39.2
Others	12.4	19.8	0.8	60.0
Total	**102.3**	**125.1**	**13.5**	**22.3**
Custom Duty				
Pol	41.5	45.4	37.0	9.4
Vehicles	48.4	30.6	-1.0	-36.8
Photosensitive semiconductor	19.0	29.8	30.9	56.8
Iron and steel	25.0	22.7	26.2	-9.1
Nuclear reactor & boiler	20.5	16.5	22.0	-19.7
Edible Oil	15.4	15.4	-	0.0
Other	166.5	166.3	10.1	-0.1
Total	**336.0**	**326.6**	**13.3**	**-2.8**
Indirect Taxes	**1,126.4**	**1,309.2**	**6.5**	**16.2**

Data source: Federal Board of Revenue

[7] These sectors are now liable to pay sales tax on electricity consumption.
[8] The revised rate for beverages was increased to 13.0 percent from 11.5 percent. While FED on cigarettes and cement was increased by Rs 700 per 1000 sticks and Rs 0.5 per kg respectively.

Major drag came from the collection from customs duty (25 percent of indirect taxes), which declined by 2.8 percent in H1-FY20. Within this category, the slowdown mainly stemmed from a decline in collection from imported vehicles; it is worth noting that the import of vehicles has been constrained by regulatory measures (**Chapter 5**) as well as an increase in their cost following the currency adjustment (**Table 4.5**). [9]

Non-tax revenues

The overall non-tax revenues grew significantly by Rs 522.1 billion in H1-FY20, compared to a decline of Rs113.2 billion during the same period last year **(Table 4.6)**. The major rise in non-tax revenue emanated from higher SBP profits and GSM license renewal fee. The higher SBP profit resulted on account of the government's high debt stock, higher interest rates, and revaluation gains on reserves and profits. Further impetus to the non-tax revenue came from the hydroelectric profits from provinces.

Table 4.6: Non-tax Revenues during H1 (Consolidated)

billion rupees

	Actual		Abs. change	
	FY19	**FY20**	**FY19**	**FY20**
Mark-up (PSEs & others)	5.8	27.4	-8.1	21.6
Dividends	30.2	26.2	11.0	-4.0
SBP profits	63.2	426.5	-62.0	363.3
Defense	6.3	6.5	0.2	0.2
Profits from post office/PTA	15.9	112.1	7.3	96.2
Royalties on gas & oil	41.9	43.8	15.3	2.0
Passport & other fees	9.3	11.4	1.8	2.1
Discount retained on crude oil	6.5	7.2	2.4	0.7
Windfall levy against crude oil	4.5	3.3	3.7	-1.2
Petroleum levy on LPG	1.8	1.7	1.5	-0.1
Other	59.3	100.6	-86.5	41.3
Total	**244.6**	**766.7**	**-113.2**	**522.1**

Data source: Ministry of Finance

4.3 Expenditures

The trend of expenditure containment in Q1-FY20 was reversed in Q2-FY20 with a broad-based growth in current and development spending. The increase in current spending was more pronounced in the second quarter and mainly came from higher interest payments and grants for social spending (*Ehsaas* program). In addition, the development spending also grew with a higher pace during H1-FY20 **(Table 4.7)**.

[9] Dutiable imports (in rupee terms) declined by 7.2 percent during H1-FY20, whereas duty-free imports recorded a growth of 18.2 percent in H1-FY20.

Table 4.7: Fiscal Spending
billion rupees, growth in percent

			Abs. change		Growth	
	FY19	**FY20**	**FY19**	**FY20**	**FY19**	**FY20**
Current expenditures	**2,984.4**	**3,721.4**	**439.1**	**737.0**	**17.3**	**24.7**
Federal	1,936.2	2,593.0	280.2	656.8	16.9	33.9
of which						
Interest payments	876.7	1,281.2	125.3	404.5	16.7	46.1
Domestic	752.1	1,120.7	74.1	368.6	10.9	49.0
Foreign	124.6	160.5	51.1	35.9	69.6	28.8
Grants	129.0	239.6	-1.0	110.6	-0.8	85.7
Defense	479.6	529.5	86.2	49.9	21.9	10.4
Public order and safety	68.8	72.1	9.3	3.3	15.6	4.8
Others	382.1	470.6	60.5	88.5	18.8	23.2
Provincial	1,048.2	1128.4	159.0	80.2	17.9	7.6
Development expenditures	**361.1**	**464.9**	-213.7	**103.9**	**-37.2**	28.8
PSDP	328.2	456.8	-191.6	128.6	-36.9	39.2
Federal	160.5	237.5	-42.5	77.0	-20.9	48.0
Provincial	167.7	219.4	-149.0	51.6	-47.1	30.8
Others	32.9	8.1	-22.2	-24.7	-40.3	-75.3
Net lending	**8.3**	**8.3**	**6.3**	**0.0**	**311.8**	**0.3**
Total Expenditure*	**3,353.8**	**4,194.6**	**231.7**	**840.9**	**7.4**	**25.1**

* Excluding statistical discrepancy
Data Source: Ministry of Finance

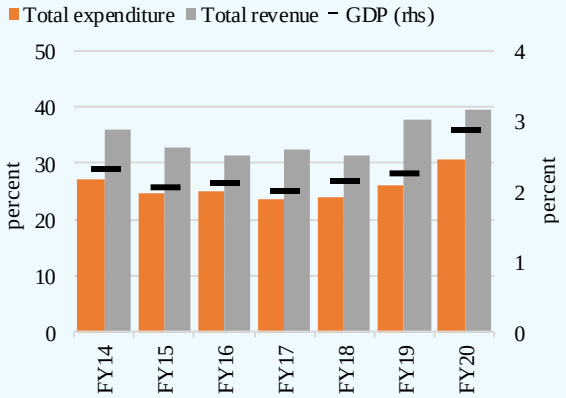
There was a notable increase in the grants during the period.[10] This shows the government's preference towards social spending, which is also evident from the launch of the *Ehsaas program* in March 2019. Interest payments also increased mainly on domestic debt during H1-FY20. The re-profiling of domestic debt besides higher interest rates largely contributed to higher interest payments.[11] As shown in **(Figure 4.5)**, interest payments relative to expenditures, size of the economy and revenues has grown substantially during the period under review. [12]

During H1-FY20, the development expenditures grew sharply across both federal and provincial levels **(Table 4.7)**. Specifically, PSDP releases recorded an

[10]Previously, the budget allocation of *development expenditure outside PSDP* was reported under the development spending. Now, under the revised public financial management, ***grants*** are reported under federal current spending. Also, the budgeted target for the grants was comparatively higher i.e. Rs 734.7 billion as compared to Rs 449.9 billion.
[11] In June 2019, the government converted the stock of short-term MRTBs held by the SBP into long-term PIBs of various maturities. Around 70 percent of the MRTBs were converted into 10-year PIBs with floating rates.
[12] Interest payments have an average share of about 43.5 percent in last 10 years in federal current spending during H1.

increase of 60.3 percent (39.4 percent of target) in contrast to a decline posted in the same period last year. However, they remained lower than the 50 percent expenditure envisaged in PFM procedures.[13] Further disaggregation of PSDP releases showed the same development preferences, such as the federal ministries, infrastructure (especially National Highway Authority), and some specialized development programs for special areas.

Figure 4.5: Interest Payments during H1 (as percent of)



Data source: Ministry of Finance

4.4 Provincial Fiscal Operations

Provinces adhered to the fiscal consolidation efforts by posting a surplus of Rs 348.4 billion during H1-FY20, which is around 82 percent of the full year budgeted target. Punjab and Balochistan contributed the most to this surplus **(Table 4.8)**.

Table 4.8: Provincial Fiscal Operations during H1

billion rupees and growth in percent

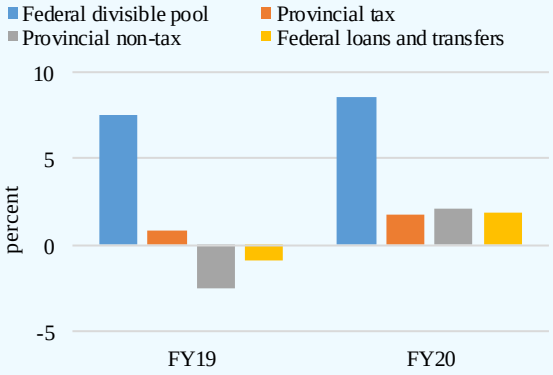
	Total		Growth	
	FY19	**FY20**	**FY19**	**FY20**
A. Total revenue (I+II+III)	1,471.8	1,683.4	4.9	14.4
I. Provincial share in federal revenue	1,199.3	1,325.8	9.6	10.5
II. Provincial Revenue	217.0	274.3	-9.9	26.4
Taxes	187.8	214.4	6.4	14.2
Non-tax revenue	29.3	59.9	-54.6	104.8
III. Fed loans and transfers	55.5	83.2	-18.6	50.0
B. Total expenditure (I+II)	1,224.3	1,359.7	0.9	11.1
I. Current**	1,056.6	1,140.4	17.9	7.9
II. Development	167.7	219.4	-47.1	30.8
Gap (A-B)	247.5	323.7	30.4	30.8
Financing* (overall balance)	**-273.2**	**-348.4**	**34.0**	**27.5**

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

[13] Revised Release Strategy for Funds Allocated for the Public Sector Development Programme (PSDP) 2019-20

Total provincial revenues grew by 14.4 percent during H1-FY20, as compared to 4.9 percent in last year. A big chunk of provincial revenue came from federal side in the form of provincial share (as per the NFC award) and federal loans and transfers. However, the provincial non-tax revenue rebounded from a decline and grew sharply during H1-FY20 **(Figure 4.6)**.

Figure 4.6 Composition of Provincial Revenue duirng H1 (Contribution in growth)



Data source: Ministry of Finance and SBP calculations

Encouragingly, provincial own revenue collection grew sharply by 26.4 percent during H1-FY20 as compared to a decline of 9.9 percent last year. The increase was broad-based as both the tax and non-tax sources contributed. General sales tax on services (GSTS) continued to be the major spinner of provincial tax collection;[14] all provinces recorded a significant increase, leading to a growth of 19.9 percent during H1-FY20 as compared to a decline of 1.8 percent recorded last year. However, a decline was observed in the collections of excise duty and motor vehicle taxes due to lower growth in the production of cars and motorcycles during the period under review.

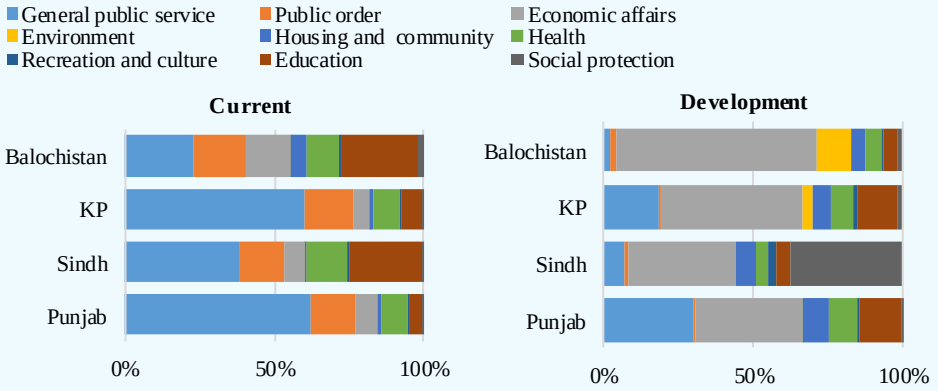
Non-tax revenue also surged mainly on the back of *profits from hydroelectricity*. KP (Rs. 13 billion) and Punjab (Rs. 6 billion) contributed the most in the collection under this head.

The total provincial expenditure rose by 11.1 percent during H1-FY20 as compared to 0.9 percent last year. This stemmed from a sharp growth in development spending; however, the current spending decelerated during H1-FY20.

[14] As per the *Human Rights Case No. 18877 of 2018*, there was a ban on collection of sales tax on mobile top-ups that was applicable to all the provinces. Since telecom services make as significant share of taxable services, the collection was lower in H1-FY19. However, the GSTS for provinces increased in H1-FY20 with the revoke of the ban.

The disaggregated analysis shows that the provincial current spending preferences continued to remain towards general public services followed by public order and health. [15] A major portion of development spending was allocated to economic affairs, primarily construction and transport, agriculture and food related spending. **Figure 4.7** summarizes the provincial priorities in the current and development expenditure during H1-FY20.

Figure 4.7: Composition of Provincial Expenditures during H1-FY20



Data source: Ministry of Finance

4.5 Public debt

The pace of public debt accumulation decelerated in H1-FY20 with an increase of Rs 1.0 trillion compared to a rise of Rs 2.5 trillion during the corresponding period last year (**Table 4.9**). This slowdown in growth of public debt was due to lower financing needs and appreciation of PKR against the US dollar. Bifurcation of public debt indicates that the Rupee value of external debt declined due to revaluation gains on the existing debt stock during H1-FY20. Although the domestic debt increased during the period under review, the rise was lower than the same period last year. Furthermore, the structure of domestic debt also changed in H1-FY20, as the government remained committed to zero fresh borrowing from the central bank and mainly relied on non-banks and commercial banks for fund mobilization.

Quarterly analysis reveals that the public debt decreased by Rs 0.5 trillion in Q2-FY20 compared to a rise of Rs 1.5 trillion in Q1-FY20. The government used its deposits with the banking system (cash buffers) to make net retirements of public

[15] General public services include executive, legislative, financial, and fiscal affairs, transfers to districts, administration of general services to public etc.

debt in Q2-FY20 (**Table 4.9)**. External debt, on the other hand, increased during the second quarter as foreign investment in government securities along with fresh borrowing from multilateral and commercial sources increased. These inflows led to smoother repayment of Sukuk and other bilateral and multilateral loans.

Table 4.9: Pakistan's Public Debt Profile
billion rupees

	End period stocks		Flows			
			FY20		H1	
	Jun-19	Dec-19	Q1	Q2	FY19	FY20
Gross public debt	32,707.9	33,711.6	1,532.8	-528.9	2,503.0	1,003.8
Government domestic debt	20,731.8	21,676.4	1,918.1	-973.5	1,119.5	944.6
Government external debt	11,055.1	10,993.0	-457.1	395.0	1,305.3	-62.1
Debt from the IMF	921.0	1,042.3	71.7	49.5	78.2	121.3
Total debt of the government*	29,520.7	29,969.3	-220.6	669.2	2,214.3	448.6
Govt. deposits with the banking system	3,187.2	3,742.4	1,753.4	-1,198.2	288.8	555.2

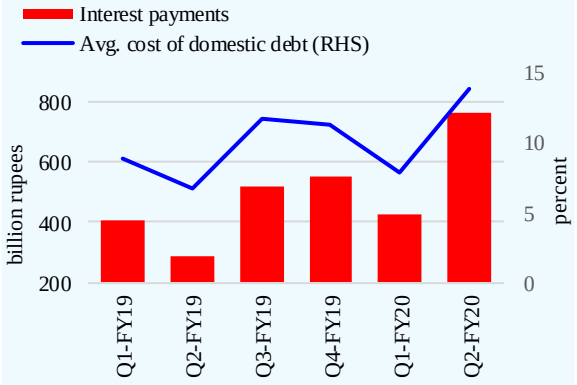
*Gross public debt minus government deposits with the banking system.
Data source: State Bank of Pakistan and Economic Affairs Division

In terms of the composition of public debt, the share of domestic and external debt has not changed much compared to end of FY19. However, tenor-wise analysis indicates that the share of long-term debt has increased. This bodes well from the debt management point of view, as the average term to maturity improved and roll-over risks associated with short-term debt decreased.

Domestic debt

Domestic debt increased by Rs 0.9 trillion in H1-FY20, lower than the accumulation of Rs 1.1 trillion witnessed in the same period last year. The government adhered to its commitment of zero borrowing from the central bank throughout H1-FY20. However, the average cost of domestic debt, measured by the actual interest paid as percent of average level of debt, also increased sharply in Q2-FY20 (**Figure 4.8**).

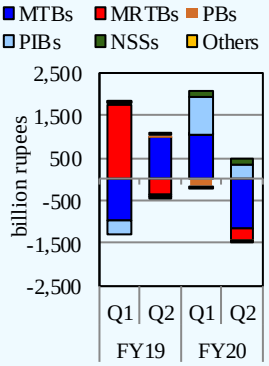
Figure 4.8: Annualized Average Cost of Domestic Debt*



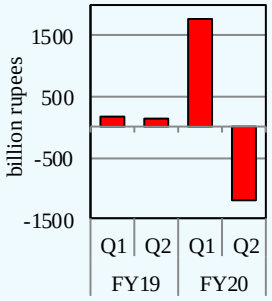
*actual interest paid, as percent of 2 year average level of debt
Data source: State Bank of Pakistan

Dynamics of domestic debt changed considerably in Q2-FY20. Unlike Q1-FY20, when the government mobilized substantial funding through T-bills and PIBs, Q2-FY20 witnessed a visible contraction in the stock of domestic debt. Main contribution to this contraction came from the net retirements of short-term loans (both to commercial banks and the central bank), while fund mobilization through PIBs also remained lower in Q2-FY20. It must be recalled that the government had created substantial cash buffers (accumulated deposits with the banking system) during the first quarter of FY20. However, in Q2-FY20, the government largely utilized its deposits with the banking system for repayments. As evident in **Figure 4.9**, the government's deposits declined significantly during Q2-FY20 by almost two-third of the deposits it accumulated in Q1-FY20.

Figure 4.9: Change in Domestic Debt



Change in the Government Deposits



Data sources: State Bank of Pakistan & Central Directorate of National Savings

Table 4.10: Net Receipts under NSS Instruments in H1
billion rupees

	Net Receipts		Avg. Profit Rates	
	FY19	**FY20**	**FY19**	**FY20**
DSCs	-1.0	89.6	9.1	11.8
SSCs	-1.8	-10.4	7.9	12.0
RICs	17.4	69.9	8.8	11.9
BSCs	42.1	63.7	11.0	13.6
SSAs	-79.3	32.3	7.9	12.0
PBAs	14.9	19.9	11.0	13.6
SFWAs	0.0	4.2	11.0	13.6
Prize bond	77.6	-157.8	NA	NA
Others	3.1	0.7	NA	NA
NSS	**73.0**	**112.1**	**NA**	**NA**

Data sources: Central Directorate of National Savings & State Bank of Pakistan

Fund mobilization through NSS accelerated

The government also accumulated debt through National Savings Schemes (NSS), as returns offered on most of the instruments remained relatively higher than the corresponding period of last year **(Table 4.10)**. In addition, there was also a possible switchover from the discontinued 40,000 denomination prize bonds towards other NSS instruments. An instrument-wise breakup shows that Regular Income Certificate (RIC) and Behbood Saving Certificate (BSC) were the major contributors.

Public external debt & liabilities

The pace of increase in public external debt & liabilities in US dollar terms accelerated in H1-FY20, an increase of US$ 3.7 billion compared to an increase of US$ 3.1 billion during the same period last year (**Table 4.11**). Although financing needs were lower in HI-FY20, the commencement of the IMF program and the improvement in credit outlook of the country helped mobilize funds through some multilateral and commercial loans. In addition, one third of the change in external debt was attributed to foreign investment in government securities. These inflows helped in smoothing the repayments of the maturing debt during this period.

Table 4.11: Public external debt & liabilities
billion US$

	Stock		Flow			
	Jun-19	**Dec-19**	**H1-FY19**	**H1-FY20**	**Q1-FY20**	**Q2-FY20**
A. Government debt	67.8	71.0	1.4	3.2	0.0	3.2
Of which						
Paris club	11.2	10.9	-0.3	-0.3	-0.2	-0.2
Multilateral	27.8	29.4	-0.4	1.6	0.3	1.3
Euro/Sukuk	6.3	5.3	0.0	-1.0	0.0	-1.0
Bilateral	12.7	13.2	2.7	0.5	0.1	0.4
Commercial loans (LT)	8.5	9.3	0.0	0.8	-0.5	1.3
Local currency securities (ST)	0.0	1.6	0.0	1.6	0.4	1.2
B. Debt from IMF	5.6	6.7	-0.2	1.1	0.7	0.4
C. Foreign exchange. liabilities	10.5	9.9	1.9	-0.6	-0.1	-0.4
Public external debt & liabilities (A+B+C)	83.9	87.7	3.1	3.7	0.6	3.1

Data source: State Bank of Pakistan and Economic Affairs Division

Revaluations gains helped in containing the pace of debt accumulation

The impact of fresh external borrowing was also partly offset by revaluation gains of approximately US$ 0.2 billion during H1-FY20. Out of this, the major contribution came from depreciation of the SDR, Japanese Yen, Euro and Chinese yuan against the US Dollar. It must be recalled that all of the revaluation gains (US$ 0.7 billion) arose during Q1-FY20. The US dollar depreciated significantly during Q2-FY20, leading to revaluation losses of US$ 0.5 billion.

Debt servicing remained high

Debt servicing of public external debt (both principal and interest payments) increased to US$ 5.9 billion in H1-FY20 as compared to US$ 3.8 billion in the same period last year. Within principal component, Sukuk (US$ 1.0 billion), bilateral and commercial loan repayments recorded a significant increase. Interest payments also recorded an increase of US$ 1.2 billion in H1-FY20, slightly higher

than US$ 1.0 billion in H1-FY19. This was mainly driven by higher payments on bilateral and commercial loans **(Table 4.12)**.

External debt sustainability indicators present a mixed picture

From sustainability perspective, relevant indicators (solvency and liquidity) present a mixed picture at the end of H1-FY20 (**Table 4.13**). Some of the solvency indicators such as the ratio of external debt and liabilities as percent of GDP have improved considerably compared to the end of FY19.

Table 4.12: Public External Debt Servicing in H1

million US$

	FY19	FY20	Change
Principal (P)			
Public debt(a+b)	2,676.8	4,656.5	1,979.7
a. Government debt	2,551.3	3,826.0	1,274.6
Paris club	315.6	340.3	24.8
Multilateral	663.5	726.7	63.2
Other bilateral	162.3	196.7	34.4
Commercial loans (LT)	200.0	1,130.0	930.0
Euro/Sukuk bonds	0.0	1000.0	1000.0
Short term	1,210.0	431.5	-778.4.
b. IMF	125.5	330.6	205.1
Interest (I)			
Public debt (a+b)	1,089.9	1,203.3	113.4
a. Government debt	946.2	999.8	53.6
Paris club	116.0	110.8	-5.2
Multilateral	217.2	229.6	12.4
Other bilateral	121.0	182.1	61.1
Euro/Sukuk bonds	251.8	215.1	-36.7
Commercial loans (LT)	198.1	235.1	37.0
Multilateral (ST)	31.0	16.8	-14.1
b. IMF	71.2	84.9	13.7
Total (P+I)	3,766.7	5859.8	2093.1

Data source: State Bank of Pakistan

Similarly, contained current account deficit and substantial inflows have improved the ratio of reserves to debt & liabilities. However, liquidity indicators deteriorated, as the share of short-term external debt ticked up during the period under review. Foreign investment worth US$ 1.6 billion in domestic government securities (mainly T-bills) during H1-FY20 increased the share of short-term external debt in total external debt from 1.5 to 3.2 percent.

Table 4.13: Indicators of External Debt Sustainability

Percent

	Jun-15	Jun-16	Jun-17	Jun-18	Jun-19	Dec-19
Solvency indicators						
Total external debt and liabilities/GDP	24.2	26.6	27.4	33.5	45	39.5
Public external debt/GDP	18.9	20.8	20.5	24.7	31.1	27.1
Total reserves/total external debt & liabilities	28.7	31.2	25.7	17.2	13.6	16.3
SBP reserves/total external debt & liabilities	20.8	24.5	19.3	10.3	6.8	10.3
External debt servicing/FX earnings	10.2	10.4	15.7	13.8	21	24.8
External debt servicing/export earnings	18	19.4	29.6	24.9	39.1	56.4
Liquidity indicators						
Short-term external public debt/PEDL	1.9	2.8	1.3	2.1	1.5	3.2
Short-term external public debt/total reserves	5.4	7.3	4.1	9.9	8.7	15.5
Short-term external public debt/SBP reserves	7.5	9.3	5.5	16.3	16.3	23.9

Data source: State Bank of Pakistan Calculation

5 External Sector

5.1 Overview

Pakistan's balance of payments position improved notably in the first half of FY20, with the current account deficit narrowing to a six-year low. This was largely due to a significant contraction in import payments, along with encouraging nascent rebounds in receipts from exports and remittances. The lower deficit was comfortably financed via the available financial flows, including two IMF tranches, a rebound in IFI funding, and sizable portfolio flows into local currency debt instruments.[1]

Table 5.1: Summary of Pakistan's External Sector

billion US$	Q2			H1		
	FY19	**FY20**	**Abs. Change**	**FY19**	**FY20**	**Abs. Change**
Current account balance*	-4.3	-0.6	3.7	-8.6	-2.1	6.5
Trade balance*	-7.8	-4.7	3.1	-16.2	-9.8	6.4
Exports	6.0	6.4	0.4	11.9	12.4	0.5
Imports	13.8	11.1	-2.7	28.1	22.2	-5.9
Energy	3.9	2.4	-1.5	8.1	5.3	-2.8
Non-energy	9.9	8.7	-1.2	20.0	16.8	-3.1
Services balance*	-1.1	-0.7	0.4	-2.2	-1.8	0.4
Workers' remittances	5.5	5.9	0.4	11.0	11.4	0.4
Financial account balance**	-3.3	-3.6	-0.3	-6.2	-5.6	0.6
FDI in Pakistan	0.2	0.8	0.6	0.8	1.3	0.5
FPI in Pakistan	-0.2	0.1	0.4	-0.4	0.5	0.9
o/w Eurobond/Sukuk	-	-1.0	-1.0	-	-1.0	-1.0
Local currency debt (net)	-	1.1	1.1	-	1.5	1.5
Inflow	-	2.0	2.0	-	2.6	2.6
Outflow	-	0.9	0.9	-	1.2	1.2
FX loans (net)	3.0	2.9	-0.1	5.3	3.9	-1.4
IMF (net of repayments)	-0.04	0.3	0.3	-0.1	1.1	1.2
SBP's liquid FX reserves (end-period)				7.3	11.3	4.2
PKR app(+)/dep(-) against US$ during period (%)	-10.6	1.0	-	-12.5	3.4	-

*+ve change shows improvement in balance **-ve value shows net FX inflow
Data source: State Bank of Pakistan

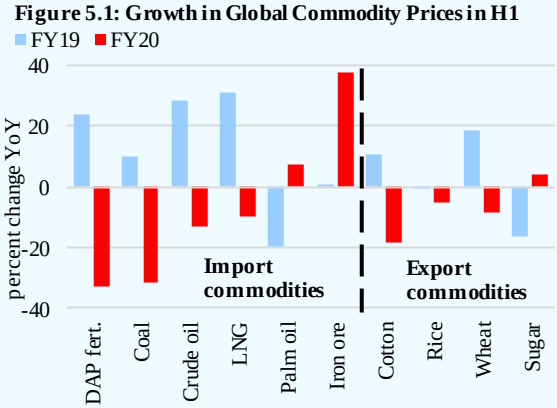
[1] In gross terms, the major sources of official inflows were the ADB (US$ 2.1 billion), commercial borrowings (US$ 1.8 billion), the IMF (US$ 1.5 billion), and portfolio investment in T-bills and PIBs (US$ 1.5 billion). The major repayments included a US$ 1.0 billion Sukuk, US$ 767 million commercial loan to a Chinese bank, and US$ 500 million of deposits placed by Qatar last year.

Besides plugging the current account gap, these inflows also allowed the country to make bulky retirements without putting pressure on the foreign exchange reserves. In fact, SBP's liquid reserves reached a 20-month high by end-December 2019, whereas the Pak Rupee appreciated by 3.4 percent against the US Dollar in the period (**Table 5.1**).

The significant reduction in the current account deficit mainly reflected the impact of macroeconomic stabilization measures undertaken over the past year, which have significantly curtailed the import demand of a wide range of non-energy and energy products. The ongoing slump in domestic auto sales figured prominently, as it not only hit automakers' demand for imported parts, but also contributed to a reduction in the steel industry's demand for imported raw materials and finished products. Regulatory measures – such as the imposition of anti-dumping duties on imports of finished steel products from Russia and Canada, and ongoing restrictions on used car imports – further curtailed transport and steel imports.

Meanwhile, low global commodity prices also played a major role in curbing import payments (**Figure 5.1**), particularly those of the energy group. A 15.3 percent reduction in average global oil prices on YoY basis was instrumental in lowering energy import payments to a three-year low, despite an increase in the quantum imports of fuels like LNG, coal and petrol. Policy-driven reorientation of the energy mix towards coal and LNG and away from furnace oil (FO) also had ramifications for energy imports, as the import profile shifted away from crude oil and POL products (**Section 5.5**).[2]

Figure 5.1: Growth in Global Commodity Prices in H1



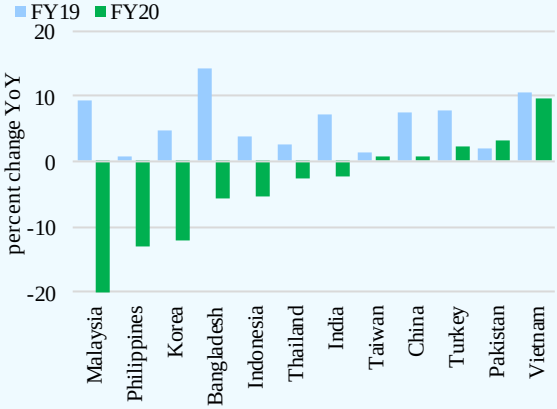
*Pakistan's non-basmati variety
Data sources: Haver Analytics & FAO

On the flip side, the lower international prices also suppressed export earnings of many emerging markets (**Figure 5.2**), including Pakistan's. Unit prices of

[2] With FO demand from the power sector dropping continuously, refineries are faced with a buildup in FO stocks. To avoid further adding to this glut, refineries have reduced their capacity utilization, which has lowered their demand for crude oil.

Pakistan's major export products – i.e. textiles and rice – continued to drop, suppressing export earnings. Furthermore, the slowdown in the global economy also affected export performances of emerging markets (EMs).[3] However, Pakistan was able to overcome these challenges, and in case of textiles and rice, the country's export volumes rose significantly, as exporters managed to increase their market shares in key destinations. In the case of textiles, Pakistani exporters benefitted from China's retreat from the US market amid the trade war (**Section 5.5**), and continued concessionary market access to the EU. In case of rice also, Pakistan's share in major African, Middle Eastern and European markets increased on the back of sizable increase in shipments.

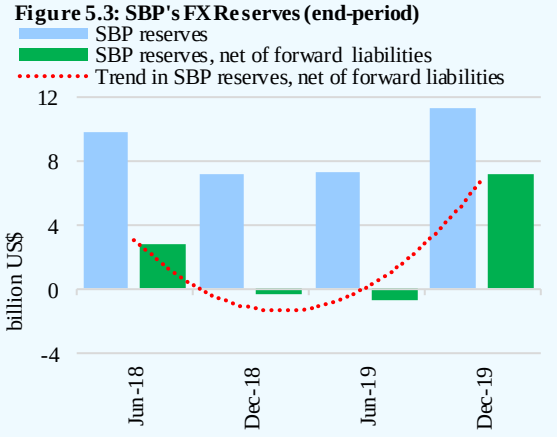
Figure 5.2: Export Growth in Major EMs during Jul-Dec



Data source: Haver Analytics

While the export environment continued to be challenging, the introduction of a market-based exchange rate system and foreign investors' positive sentiments about the sustainability of this system; successful completion of the first EFF review; and ongoing progress in reform-related efforts, played a large role in helping the country attract sizable external financing in the period. These cumulative inflows allowed the SBP to re-build its reserves and start unwinding its net short position in the forwards market

Figure 5.3: SBP's FX Reserves (end-period)



Data source: State Bank of Pakistan

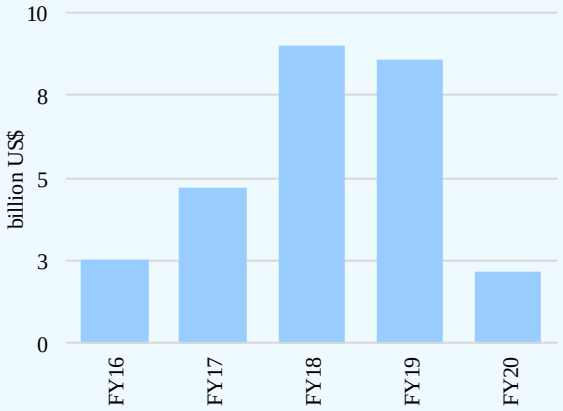
[3] Global economic growth slowed down to an estimated 2.9 percent in 2019, from 3.6 percent in 2018 (source: IMF World Economic Outlook, January 2020).

(**Figure 5.3**), which led to a US$ 3.8 billion reduction in net forward liabilities during the six-month period.

5.2 Current Account

A steep decline in import payments, along with encouraging growth in exports and remittances, limited the overall deficit in the current account during H1-FY20 to almost a quarter of the level seen in the same period last year (**Figure 5.4**). Receipts from both exports and remittances witnessed nearly 8 percent growth in second quarter and helped narrow the CAD in H1-FY20. The primary income, however, recorded a higher deficit, as both profit repatriation and interest payments increased in the period.

Figure 5.4: Current Account Deficit during Jul-Dec



Data source: State Bank of Pakistan

Workers' remittances

During CY 2019, the growth in the global remittance flows slowed substantially as compared to the previous year. A number of factors played a role, such as decelerating growth in advanced economies, lower oil prices and weakening of currencies of some of the source countries against the greenback, thereby lowering the US dollar value of remittance flows.[4]

Remittances inflows in Pakistan have decelerated to 5.3 percent in CY 2019, compared to 6.9 percent growth registered in CY2018. Despite the slowdown, growth in remittances appears reasonable when compared to other countries and regions (**Figure 5.5**).[5]

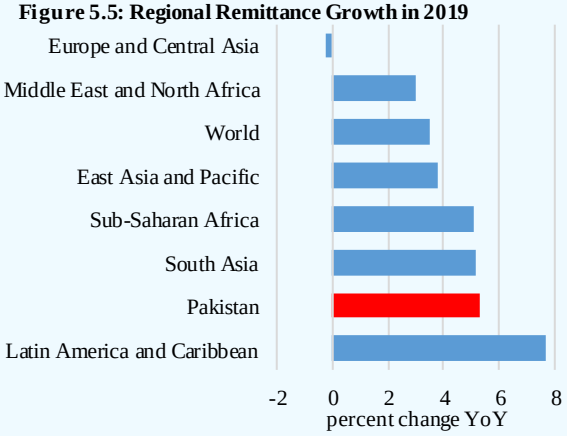
However, during H1-FY20, workers' remittances witnessed a growth of 3.3

[4] The World Bank estimates that around half of remittance flows to low and middle-income countries are in US dollars and a number of source country currencies depreciated against the US dollar during the year.

[5] In case of South Asian countries, Pakistan has contributed significantly to overall remittances growth. The remittances to India increased by 4.6 percent, while that of Sri Lanka went up by 2.9 percent. Flows to Bangladesh, however, grew by 12.7 percent in 2019 (source: World Bank).

percent. This can be traced to: (i) an increase in number of Pakistanis going abroad for work (**Table 5.2**); (ii) improved economic condition in GCC countries due to higher non-oil GDP growth;[6] (iii) a competitive exchange rate in interbank relative to open market, as the kerb premium remained negative during most of the first half; and (iv) an increase in the cost of living in Pakistan.

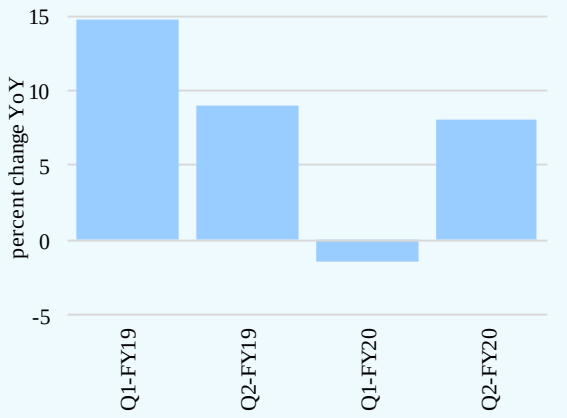
Figure 5.5: Regional Remittance Growth in 2019



Data source: World Bank

Quarterly break-up shows that after declining in Q1-FY20, the remittances rebounded in the second quarter (**Figure 5.6**). While the decline in Q1 could be largely traced to lower inflows from GCC countries (especially UAE), the recovery in Q2-FY20 was broad-based.

Figure 5.6: Growth in Remittance Flows to Pakistan



Data Source: State Bank of Pakistan

To support remittance inflows through formal channels, the government of Pakistan continued providing various incentives to customers, banks and exchange companies. These included relaunching of the reimbursement scheme, which had been introduced last year, for marketing charges to banks at the rate of Re 1 for each incremental US dollar for over 15 percent remittance growth.

Furthermore, the scope of scheme for reimbursement of telegraphic charges was enhanced by introducing one more tier. Now, the reimbursement of Saudi

[6] The GCC countries' non-oil GDP is estimated to grow by 2.4 percent in CY2019 from 1.9 percent in CY2018. However, the overall GDP growth remained suppressed at 0.7 percent, mainly due to decline in oil GDP by 1.4 percent (source: IMF).

Arabian riyal (SAR) 10 will also be made for home remittance transaction between US$ 100-200, in addition to re-imbursement of SAR 20 for transactions over US$ 200. The transaction limit for business to customer (B2C) and (C2B) has also been revised.[7]

Table 5.2: Number of Pakistani Registered for Overseas Employment

	2017	2018	2019	Change
Saudi Arabia	143,363	100,910	332,713	231,803
U.A.E.	275,436	208,635	211,216	2,581
Oman	42,362	27,202	28,391	1,189
Qatar	11,592	20,993	19,327	-1,666
UK	340	587	903	316
USA	229	339	505	166
Total	**496,286**	**382,439**	**625,203**	**242,764**

Data source: Bureau of Emigration & Overseas Employment

The country-wise remittance to Pakistan shows that flows from the GCC have slowed down from 2.5 percent in H1-FY19 to 1.4 percent in H1-FY20 (**Table 5.3**). Among the GCC countries, Saudi Arabia (KSA) and UAE were the major source countries contributing to the remittances growth. In case of KSA, the remittances recorded higher growth during H1-FY20, reflecting improved non-oil private sector activities on the back of rising government expenditures.[8]

Meanwhile, remittances from the US and the UK registered 9.1 and 6.4 percent growth in H1-FY20 respectively. In case of the US, labor market condition remained tight, as the unemployment rate hovered around 3.5 percent in July-December 2019 and led to higher wages, specifically in the 'blue collar' jobs. Though economic activity slowed in the UK in the wake of Brexit-related uncertainty, the situation benefited the labor market, with the unemployment rate dipping to 3.8 percent in fourth quarter of CY2019.[9]

Table 5.3: Country-wise Remittance Inflows (H1)
million US$; growth in percent

	FY19	FY20	Growth
GCC	5,972	6,057	1.4
Saudi Arabia	2,567	2,618	2.0
U.A.E.	2,348	2,349	0.0
Other GCC Countries	1,056	1,089	3.2
US	1,733	1,890	9.1
UK	1,647	1,753	6.4
EU	313	339	8.4
Others	1,204	1,394	15.8
Total	11,030	11,395	3.3

Data source: State Bank of Pakistan

5.3 Financial Account

The financial account in H1- FY20 saw a surge in the portfolio investment in local currency government securities, as foreign investors increased their focus on Pakistan due to reforms initiated in the exchange rate market and to encash the

[7] http://www.sbp.org.pk/epd/2019/FECL14.htm
[8] Source: World Bank's Economic Updates for Saudi Arabia and UAE (October 2019). https://www.worldbank.org/en/country/gcc/publication/saudi-arabia-economic-update-october-2019 https://www.worldbank.org/en/country/gcc/publication/uae-economic-update-october-2019)
[9] Office of National Statistics, UK.

available risk-adjusted returns in fixed income securities. Beside portfolio investment, some improvements were noticed in FDI inflows and long-term borrowing by the government from multilateral sources; while commercial borrowings also witnessed a sharp increase.

Foreign direct investment

In H1-FY20, net foreign direct investment in Pakistan grew sharply by 68.2 percent YoY to US$ 1.3 billion compared to 19.2 percent decline in the same period last year. This high growth was the result of lower outflows in H1-FY20, as the gross inflows of US$ 1.7 billion remained close to the US$1.9 billion received in same period of previous year (**Table 5.4**). In H1-FY19, both power and telecommunication sectors had witnessed substantial outflows, which led to a lower base effect for this year.[10]

Besides this base effect, a one-off inflow of US$ 478 million fetched by the three mobile phone operators for renewal of their operating licenses in Pakistan also helped the growth in net FDI in H1-FY20. As a result, telecommunication became the largest recipient in H1, with US$ 505 million inflows, ahead of the traditionally high FDI-attracting sectors, i.e. construction and power. Nonetheless, the power sector continued to attract significant inflows (US$ 359 million) due to ongoing work on CPEC-related projects. Within the power sector, Thar Coal Block-1 (power plant) and Suki Kinari hydropower station projects fetched US$ 152 million in Q2-FY20. Apart from power and telecommunication sectors, other major sectors witnessed lower inflows during H1-FY20 as compared to last year.

Table 5.4: Sector-wise Foreign Direct Investment
million US$

	H1-FY19			H1-FY20		
	Inflow	Outflow	Net	Inflows	Outflows	Net
Construction	296	8	288	16	6	9
Power	243	573	-330	359	69	290
Financial business	279	77	202	193	31	162
Exploration & prod.	159	1	157	115	2	113
Electrical machinery	125	0	125	118	0	118
Pharmaceuticals	46	1	45	27	2	25
Transport equipment	60	5	54	54	9	45
Telecommunications	72	209	-137	505	85	420
Others	569	177	392	346	187	159
Total	**1,848**	**1,051**	**797**	**1,732**	**391**	**1,341**

Data source: State Bank of Pakistan

[10] Last year, a Chinese power company had repaid an intercompany loan of US$ 530 million in October 2018 to its parent company, which not only increased the gross outflows but also depressed the net FDI in Pakistan during FY19.

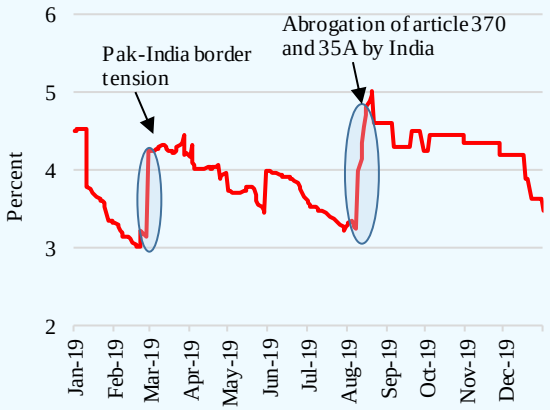
Foreign portfolio investment

Inflows into local currency government securities (T-bills and PIBs) dominated the overall portfolio investment, which rose to US$ 1.4 billion in H1-FY20. However, net inflows in portfolio investment account were relatively lower at US$ 471.0 million, due to retirement of a US$ 1.0 billion 5-yr Sukuk issued in November 2014.

Foreign fund managers invested into the T-bills and PIBs not only in chasing the risk-adjusted returns offered by Pakistan on the government securities, but also in response to the sharp improvement in the BoP, the reserves buffers (**Section 5.4**), and particularly reforms initiated in the exchange rate market. Previously, foreign portfolio investors were wary about the sustainability of the country's exchange rate system. However, investors' concerns have largely been addressed after the SBP adopted market-based exchange rate regime in May 2019.

Moreover, the country's creditworthiness has improved with the initiation of the EFF program and the successful conclusion of its first review in November 2019. In addition, in December 2019 Moody's upgraded Pakistan's outlook to stable from negative and affirmed the government's local and foreign currency long-term issues and unsecured debt rating at B3. These developments led Pakistan's credit default swap rate to decline significantly and reach 3.4 percent by end-December 2019, from a high of 5.0 percent in August 2019 (**Figure 5.7**).

Figure 5.7: Pakistan's Credit Default Swap Rate



Data source: Bloomberg

Besides inflows into debt securities, FPI into equities also witnessed a trend reversal, with a net inflow of US$ 19.0 million in H1-FY20 against an outflow of US$ 420 million last year. This further reflects foreign investors' increased confidence over Pakistan's economy.

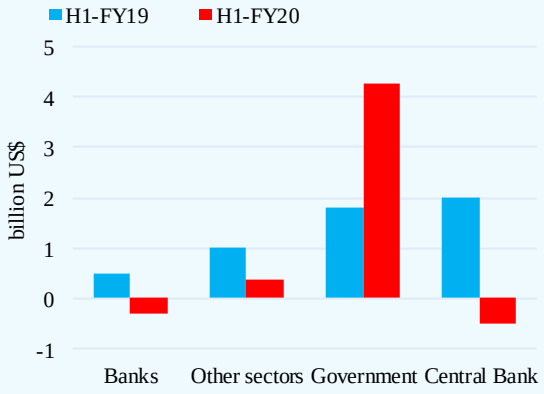
Net incurrence of liabilities

The net inflow of FX liabilities into the country amounted to US$ 3.9 billion in H1-FY20, down 27.3 percent from the same period last year. This decline was

recorded due to net retirement by central bank and private commercial banks. However, government loans more than doubled to US$ 4.3 billion as compared to US$ 1.8 billion realized last year (**Figure 5.8**).

The disbursement in H1-FY20 in the government account stood at US$ 7.0 billion. Sizable long-term inflows were received from the ADB, the IMF and commercial banks, which aided the government in lengthening maturity profile of the external debt. This has, to some extent, mitigated the rollover risk. On the other hand, H1-FY20 witnessed a retirement of US$ 2.8 billion.

Figure 5.8: Net Incurrence of FX Liabilities



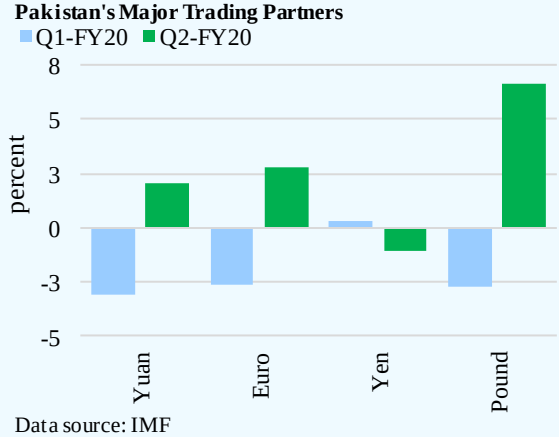
Data source: State Bank of Pakistan

Contrary to the government borrowings, the central bank repaid the US$ 500 million deposited by Qatar last year. Private commercial banks also retired their short-term obligations amounting to US$ 422 million. However, other private sectors loan witnessed a net inflow, albeit in lower quantum compared to last year.

5.4 Exchange Rate and Reserves

Pakistan's total liquid foreign exchange reserves increased to US$ 17.9 billion by end-December 2019, up by US$ 3.5 billion over end-June 2019. The breakup of reserves accumulation in this period shows that the SBP's reserves increased by US$ 4.1 billion, against US$ 603 million depletion in commercial bank's reserves.

Figure 5.9: Exchange Rate Dep(-)/ App(+) against US$ of Pakistan's Major Trading Partners



Data source: IMF

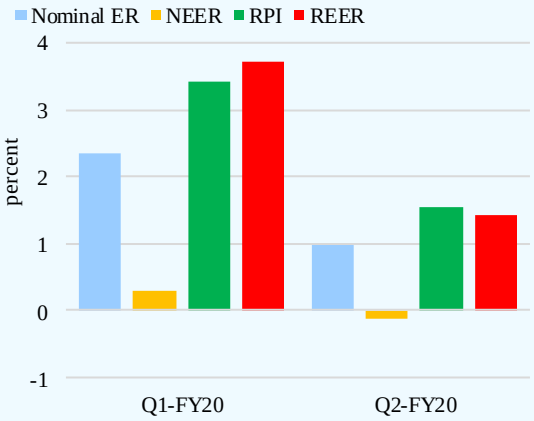
While the rise in SBP's liquid reserves seems substantial, an almost equivalent reduction in

net forward liabilities suggests that actual reserve accumulation by SBP over this period is much higher. Reserves, net of forward liabilities increased to US$ 6.0 billion by end-December 2019 compared to negative US$ 759.6 million at end-June. By end-June, the country's forward FX liabilities were more than the liquid FX reserves, which meant net liquid reserves were effectively in negative territory.

The reserve accumulation during H1-FY20 was a result of higher official disbursements and sufficient market purchases by the central bank. While IFI loans revived with the inception of IMF program, better market conditions allowed the SBP to make FX purchases.

The improvement in the country's FX reserves led to a 3.4 percent appreciation of Pak rupee against US dollar during H1-FY20. Though PKR appreciated in both quarters of FY20, the NEER depreciated in the second quarter (against appreciation in Q1), as the currencies of other major trading partners appreciated against the US dollar (**Figure 5.9**). However, the higher RPI, due to higher domestic inflation, resulted in REER appreciation in both quarters of FY20 (**Figure 5.10**).

Figure 5.10: Pakistan's Exchange Rate Dep(-)/ App(+)



Data source: State Bank of Pakistan

5.5 Trade Account[11]

The trade deficit contracted by 30.3 percent YoY to US$ 11.7 billion in H1-FY20; the drop was sharper than the decline of 5.3 percent recorded in the same period last year. This was mainly due to a sharp and broad-based drop in imports, which fell to a four-year low.

Lower import quantums of a wide range of energy and non-energy products played a dominant role in the import reduction, with declines in international

[11] This section is based on customs data reported by the PBS. The information in this section does not tally with the payments record data, which is reported in **Section 5.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

prices of key commodities, such as crude oil, LNG and coal, playing a supplementary role. Exports, meanwhile, recovered marginally, mainly due to quantum-led increases in rice, apparel and home textiles products.

Exports

Total exports rose 3.1 percent to US$ 11.5 billion in H1-FY20, the highest first half exports since H1-FY15; the growth was also higher than the 1.9 percent increase recorded in H1-FY19 (**Table 5.5**). Importantly, Pakistan was among the few countries within the competitor EM economies that witnessed a notable increase in its exports (as shown earlier in **Figure 5.2**). A sharp decline in REER since Q2-FY18 and the government's initiative to provide cheaper electricity to the textile sector have enhanced the competitiveness of the Pakistani products vis-à-vis its competitors in the global market. Moreover, FBR expedited refunds claims of major exporting sectors, which alleviated liquidity constraints of exporters thereby augmenting their capability to export more.[12].

Table 5.5: Pakistan's Major Exports during H1
million US$

	FY19	FY20	Abs. change	Quant. impact	Price impact
Food group	**1994.8**	**2199.7**	**204.9**	**-**	**-**
Rice	817.9	1033.0	215.1	232.3	-17.1
Wheat	97.2	11.4	-85.8	-87.1	1.3
Sugar	74.9	70.7	-4.2	-21.1	16.8
Fruits & veg.	312.1	345.2	33.1	-14.1	47.2
Meat & prep	102.6	155.8	53.2	48.7	4.5
Textile group	**6,644.3**	**6,905.1**	**260.8**	**-**	**-**
Raw cotton	14.1	15.3	1.3	4.5	-3.3
Cotton yarn	548.4	544.4	-4.3	38.5	-42.8
Cotton fabrics	1052.3	1013.1	-39.2	24.3	-63.3
Apparel	2735.3	2999.4	264.1	246.5	17.6
Bedwear	1161.2	1197.9	36.7	125.5	-88.9
Towels	378.0	379.5	1.5	27.7	-26.2
POL group	**269.5**	**168.0**	**-101.5**	**-61.1**	**-40.4**
Crude oil	145.9	110.3	-35.5	-19.1	-16.4
POL products	86.1	23.8	-62.3	-58.9	-3.4
Other manuf.	**1708.1**	1620.0	-88.1	-	-
Leather tanned	128.3	104.2	-24.0	-18.4	-5.7
Leather manufactures	247.4	274.7	27.4	17.3	9.9
Plastic	155.7	152.5	-3.3	31.4	-34.7
Chemicals	318.8	210.3	-108	-	-
Cement	157.0	145.3	-11.7	5.1	-16.8
Total Exports	11,181.2	11,524.3	343.1	820.8	-440.5

Data source: Pakistan Bureau of Statistics and SBP calculations

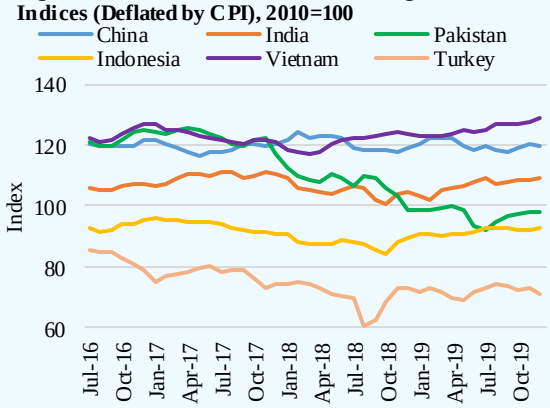
Rice, readymade garments (RMG) and hosiery (knitwear) were major contributors to this year's export growth, with higher quantum offsetting the lower price effects. On the other hand, exports of POL group, tanned leather, chemicals and cement were major drags on the overall growth.

[12] Through introduction of new electronic refund claims system (FASTER), FBR expedited the release of Rs 75.5 billion refunds in H1-FY20, Rs 20.4 billion more than the same period last year. Out of total refunds, sales tax refunds increased by 100 percent YoY to Rs 27 billion (source: FBR).

Textile exports

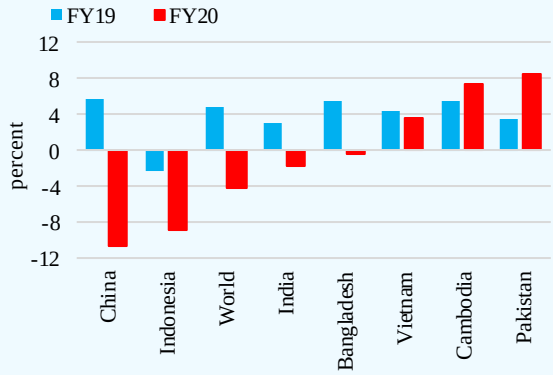
After staying flat last year, textile exports rose 3.9 percent to US$ 6.9 billion in H1-FY20; the highest level achieved since H1-FY14. Power subsidy provided to this sector in January 2019, when government had announced 7.5 cents/KWh flat power tariff, led to the increased value addition and improved export performance of this sector in H1-FY20.[13] Moreover, exchange rate adjustment of PKR against USD over the last two years brought REER down sharply, which kept unit prices of Pakistani textile exports in check and made Pakistani exports competitive (**Figure 5.11)**.

Figure 5.11: Broad Real Effective Exchange Rate Indices (Deflated by CPI), 2010=100



Data Source: JP Morgan

Figure 5.12: Quantum Growth in US' Apparel Imports from Major Countries during Jul-Dec



Source: Office of Textiles and Apparel (USA)

Higher textile exports came on the back of quantum growth in high value added products, particularly readymade garments. The improved performance of RMG was noteworthy, given negative growth in quantum apparel imports of the USA and the European Union in H1-FY20. Besides, home textiles (mainly bedwear and towels) saw their exports rise in the first half with higher shipments to the European Union.[14]

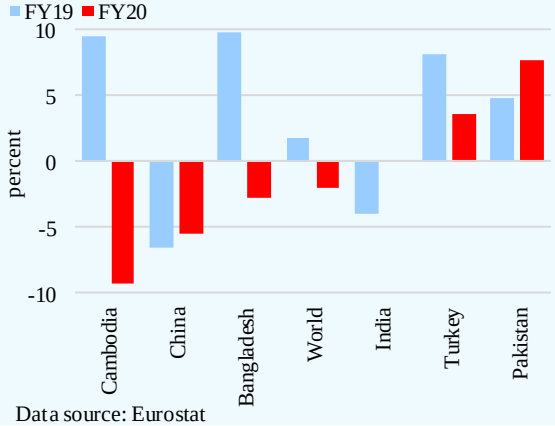
In case of the USA, its quantum apparel demand was 4.3 percent lower in H1-FY20 than the last year (**Figure 5.12**). It was mainly due to lower Chinese

[13] Power cost had been fixed at 7.5 cents/KWh vide S.R.O. 01(I)/2019 to S.R.O. 12(I)/2019, dated Jan 1, 2019 (source: Ministry of Energy).

[14] Substitution towards the higher value added product, in consequence, created drag in the low value added products exports, particularly cotton fabrics and yarn.

shipments as the US applied additional tariffs on Chinese apparel imports from September 2019. At the same time, the US buyers switched to low-cost suppliers that included Vietnam, India and Pakistan.[15] Pakistan was able to capture part of China's market, as it experienced higher growth than any of its competitors in H1-FY20 (**Figure 5.12**).

Figure 5.13: Growth in EU's Quantum Apparel Imports from Major Countries during Jul-Dec



Data source: Eurostat

The European Union's apparel imports from Pakistan accelerated from last year, both in value and volume terms, despite the decline in the bloc's overall apparel imports by 2.2 percent in Jul-Dec 2019 **(Figure 5.13)**. Weakening of Euro against US dollar and currencies of major apparel exporters except for the Pak Rupee led to the decline in the EU's apparel imports. The European buyers were attracted by continuously weakening PKR since Q4-FY18, as unit prices fell only for Pakistan in H1-FY20 vis-à-vis its competitors (**Table 5.6**). Price effect was further reinforced by duty-free/quota-free access under the GSP Plus agreement.

Table 5.6: Growth in Unit Values of EU's Apparel Imports from Major Countries, Jul-Dec

	Unit Values*		Currency**	
	FY19	FY20	FY19	FY20
Pakistan	-0.4	-0.7	-15.6	-13.9
India	1.5	1.8	-6.9	4.1
China	10.9	4.0	-1.1	1.8
Bangladesh	1.2	5.9	0.3	3.4
Cambodia	1.7	7.9	2.5	3.8
Turkey	-3.4	1.2	-32.4	1.4
World***	4.5	4.1	3.1	4.0

*In euros **YoY app(+)/dep(-) of respective currencies against Euro Jul-Dec ***USD against Euro

Data sources: Eurostat, Bloomberg and SBP calculations

Besides, similar to the US market, China's share in EU's apparel market has been receding in last two years, declining from 40.7 percent (in quantum terms) in H1-FY18 to 36.0 percent in H1-

Table 5.7: Shares in EU's Apparel Imports, Jul-Dec

	FY18	FY19	FY20
China	40.7	37.5	36.0
Bangladesh	22.0	23.8	23.6
Turkey	8.4	8.8	9.3
Pakistan	4.4	4.5	5.0
Cambodia	4.9	5.2	4.8
India	4.5	4.3	4.3

Data source: Eurostat

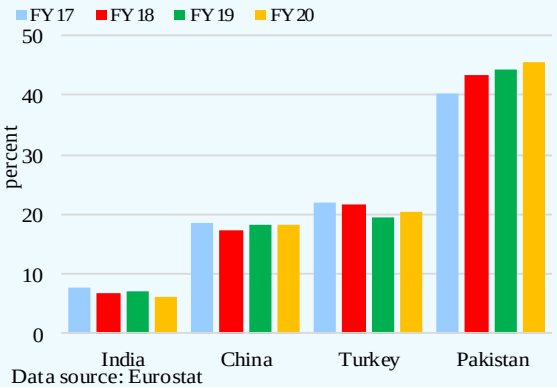
[15] A US Fashion Industry Association (USFIA) survey found earlier in 2019 that 83 percent respondents expected to decrease sourcing from China over the next two years.

FY20. At the same time, Bangladesh, Turkey and Pakistan have been able to increase their exports to the bloc (**Table 5.7**).[16]

In low value added textile products, cotton yarn shipments increased 7.0 percent YoY in H1-FY20. However, dollar receipts were pulled down by lower unit prices, which were in line with the declining prices in the international market.[17]

Despite decline in its overall apparel exports, China's demand for Pakistan's cotton yarn saw a decent uptick in H1-FY20, as it appeared to shift its yarn demand away from India and towards Pakistan.[18] This shift came as the two countries worked on reaching the second phase of Pak-China FTA. It is important to mention here that in cotton fabric imports of the European Union (in quantum terms), Pakistan has the highest share, which has also been rising over the last few years (**Figure 5.14).**[19] Home textiles (mainly bedwear and towels) also rose slightly to US$ 1.5 billion in H1-FY20, in response to higher demand in the EU, the largest export destination of Pakistan's home textiles.

Figure 5.14: Share in EU's Cotton Fabrics Imports from Non-EU Countries during Jul-Dec



Data source: Eurostat

Non-textile exports

Non-textile exports decelerated to 1.8 percent in the first half of FY20, down from 4.7 percent a year earlier. While petroleum group caused a drag, the growth in food group exports, specifically rice, provided the needed support to non-textile exports. Besides, low prices created drag on the cement exports, which decreased from last year.

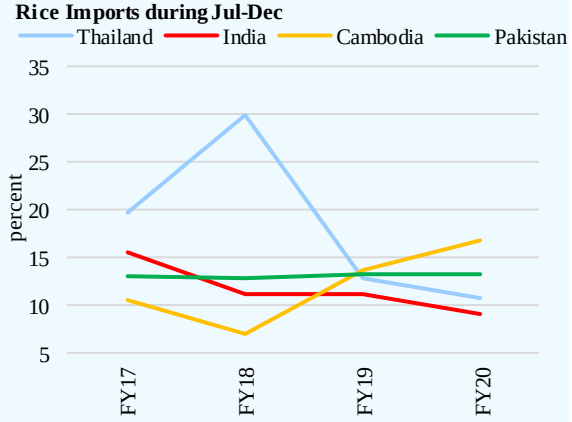
Rice exports grow stronger

Overall rice exports increased about one-fourth to US$ 1 billion for two main reasons. First, Pakistan's share in total rice imports of EU has been rising

[16] Bangladesh and Pakistan enjoy preferential trade treatment in trade with the EU.
[17] China, India and Pakistan witnessed 15.5 percent, 10.5 percent, and 10.4 percent decline in unit prices of yarn (in US$ per Kilo) respectively. (Source: Emerging Textiles)
[18] In H1-FY20, China imported 16.9 percent more yarn on YoY basis from Pakistan (source: PBS)
[19] They made up around 9 percent of Pakistan's total exports in the first half.

consistently ever since the bloc restricted Indian rice imports over excessive use of pesticides (**Figure 5.15**).[20] Second, currency movements of the competitor countries provided Pakistan an edge in its established African market.

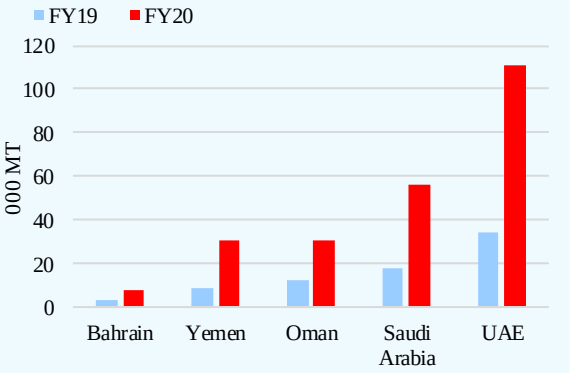
Figure 5.15: Share of non-EU Countries in EU's Quantum Rice Imports during Jul-Dec



Data source: Eurostat

In case of non-basmati, in H1-FY20, broken rice and other varieties saw an increased supply to Africa from US$ 184.0 million to US$ 332.0 million. Apart from Africa, some Asian markets, such as China, Indonesia, and Kazakhstan, also imported more non-basmati.

Figure 5.16: Milled Basmati Rice Exports to Middle East during H1



Data source: Pakistan Bureau of Statistics

Milled basmati rice performed particularly well as it fetched US$ 380 million in the first half of FY20, around fifty percent more than last year. In H1-FY20, quantum exports of milled rice increased substantially to the major markets in the Middle East, which were collectively responsible for about 59.5 percent of total exports in the period (**Figure 5.16**). Anecdotes suggest that some of these shipments, specifically to the UAE, are being transshipped to Iran, Oman, Yemen, Somalia and Iraq.[21]

Husked (brown) rice, which is mostly basmati variety, performed quite well in the European Union—mainly Belgium, Italy, the Netherlands and the UK—in H1-

[20] Maximum residue limit set for Tricyclazole use on basmati rice to be exported to EU after Dec 31, 2017 is 0.01 mg/kg.

[21] Since the UAE is a massive and dynamic market complemented by well-established seaport facilities, international traders there are well positioned to import rice from abroad, and export the same to regional markets.

FY20. This rice is further processed by mills to produce white rice that is commonly used in the European countries. White (milled) basmati attracts 175 Euro/1000 KG in tariff in European Union against zero percent tariff on brown basmati rice.[22] This also explains the decrease in share of milled basmati rice exports to the bloc, from 36.3 percent in H1-FY19 to 11.5 percent in H1-FY20.

Depressed performances of non-rice exports

The petroleum group fetched about US$ 101.5 million lesser receipts in first half of current fiscal year over last year, as import demand from Afghanistan witnessed a fall in response to declining engagement of foreign forces there.[23] Moreover, petroleum crude (condensates) exports declined 24 percent to US$ 110.3 million in the first half, as refineries are increasingly using condensate with low-gravity imported crude.

Meanwhile, cement and cement product exports decreased by 7.5 percent in H1-FY20 compared to 32 percent increase in the same period of FY19. However, Pakistani cement exports this year have become more diverse in terms of market access compared to last year, when India was the key importer of Pakistani Portland cement, importing one-fourth of Pakistan's quantum cement exports in H1-FY19. In H1-FY20, Pakistan exported 41.8 percent higher shipments to other destinations like Afghanistan, Madagascar and Sri Lanka.

Besides, Pakistan shipped significant quantum of clinker in the first half. The demand for the raw material was created in Bangladesh when Vietnam's exports to the country had started to recede as it redirected its supplies towards a much bigger market – China.[24] While overall clinker shipments of Pakistan rose 14.6 percent in H1-FY20, Bangladesh's share in Pakistan's clinker exports increased from 77 percent from a year before to 87 percent in the same period this fiscal year. Overall value of cement and clinker was pulled down by low unit prices.

Imports

The country's imports dropped 17.0 percent YoY to US$ 23.2 billion in H1-FY20 – the lowest level in four years. Import demand for a wide range of energy and non-energy products was suppressed, as industries and consumers adjusted to the second-round impact of the currency adjustment, tight monetary conditions, and some sector-specific policies (in case of oil refineries and steel). Lower import

[22] Source: Market Access Database, European Commission

[23] Quantum jet fuel exports decreased by 70 percent YoY in H1-FY20.

[24] The largest consumer of cement and clinker is substituting its cement production with clinker imports for environmental concerns. Vietnam is mainly supplying clinker to China.

quantums were complemented by lower international commodity prices (of crude oil, LNG, coal and metals) (**Table 5.8**).

The transport sector's import demand was especially hit, as auto assemblers, after significantly raising prices following the currency adjustment, are now faced with slumping domestic sales (**Figure 5.17**). The firms responded to the lower consumer demand by cutting back on production, which reduced their imports of CKD kits and other auto parts. Meanwhile, the regulatory restrictions on car imports under the gift and baggage schemes continued to dent CBU imports. As a result, overall transport imports fell to a 10-year low in H1-FY20.

The spillover of the downtrend in auto production was felt across the steel industry, whose demand for imported finished products

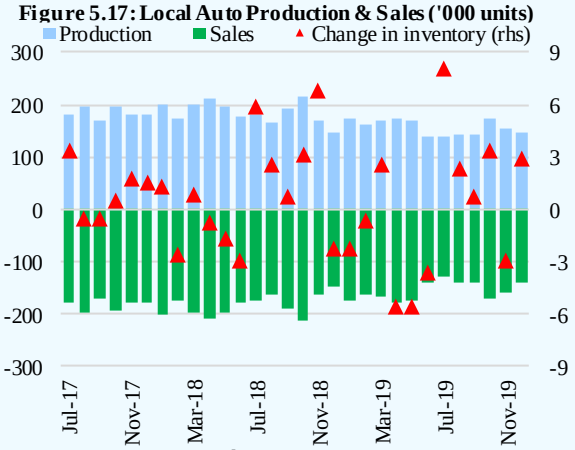
Table 5.8: Pakistan's Major Imports during H1
(million US$)

Items	FY19	FY20	Abs. change	Quantum impact	Price impact
Energy group	**7,665.0**	**6,142.2**	**-1,522.8**	-143.2	-1,379.5
POL prods.	3,415.1	2,591.1	-824.1	-324.3	-499.8
Crude oil	2,460.0	1,771.3	-654.8	-351.8	-303.0
LNG	1,709.3	1,626.8	-82.5	446.4	-528.9
Agri and chem	**4,584.1**	**3,821.7**	**-762.4**	-	-
Fertilizer	646.2	433.1	-213.1	-101.3	-111.8
Other chem.	2,194.0	1,848.4	-345.2	-	-
Transport group	**1,507.6**	**837.0**	**-670.6**	-	-
Cars	582.8	260.6	-322.2	-	-
CBUs	156.4	31.7	-124.8	-	-
CKDs	426.4	229.0	-197.4	-	-
Truck & buses	282.7	128.7	-153.9	-	-
Aircraft & ships	166.3	210.7	44.4	-	-
Metals group	**2,500.4**	**2,072.7**	**-427.7**	-	-
Steel scrap	765.5	806.3	40.7	-156.0	-196.8
Iron & steel	1,124.6	763.3	-361.1	-341.5	-19.7
Food group	**2,966.2**	**2,566.5**	**-399.7**	-	-
Tea	301.7	228.9	-72.8	-43.7	-29.1
Palm oil	931.7	842.4	-89.2	10.6	-99.9
Soybean oil	48.8	40.8	-7.9	-4.9	-3.1
Pulses	287.8	245.7	-42.1	-12.1	-30.0
Textile group	**1,344.5**	**979.6**	**-364.8**	-	-
Raw cotton	120.2	87.0	-33.2	-28.8	-4.4
Syn. yarn	302.2	272.8	-29.4	-16.2	-13.2
Machinery group	**4,479.3**	**4,433.1**	**-46.3**	-	-
Power gen	661.9	650.4	-11.5	-	-
Electrical	881.2	1,192.3	311.1	-	-
Construction	129.8	80.9	-49.0	-	-
Cell phones	364.0	616.1	252.1	-	-
Other machinery	1,606.6	1,184.8	-421.8	-	-
All other items	**2,359.2**	**1,920.8**	**-438.4**	-	-
o/w Coal	795.6	669.5	-120.0	35.5	-185.7
Total imports	**27,952.5**	**23,194.6**	**-4,757.8**	-	-

Data source: Pakistan Bureau of Statistics

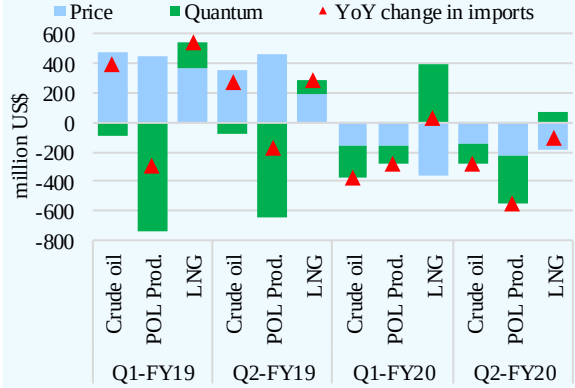
declined.[25] Finished steel imports were further suppressed after Pakistan imposed anti-dumping duties on some Russian and Canadian steel products into the country in September 2019.[26] Lastly, imports of items whose domestic production increased this year, such as DAP fertilizer, also declined.

Figure 5.17: Local Auto Production & Sales ('000 units)



Data source: Haver Analytics

Figure 5.18: Contribution of Unit Price & Quantum Effects to YoY Change in Energy Imports



Data source: Pakistan Bureau of Statistics

Energy imports

Pakistan's energy imports fell by a sizable 19.9 percent to US$ 6.1 billion in H1-FY20; the drop was steeper than the 14.8 percent reduction recorded in the same period last year. Import quantums and unit prices were both lower than last year (**Figure 5.18**). International oil prices were, on average, 15.3 percent lower in the period, and contributed sizably to curbing energy imports.

From the energy demand perspective, the lower import quantums mainly reflect changing power sector dynamics in H1-FY20. The first is that the *pace* of increase in power generation in the country witnessed over the past few years has now slowed, given that many

[25] For instance, Aisha Steel Mills mentioned in its Q1-FY20 report that the "local demand remained depressed throughout the period. The auto sector, in particular, was hit hard by the macro-economic adjustments, leading to slow offtake of CRC [cold rolled coil], the main raw material for the sector".
[26] The National Tariff Commission, on September 20, 2019, announced provisional anti-dumping duties of 13.94 percent ad valorem on "cold rolled coils/sheets/strips" imported from Canada and Russia. The duties would be in place for four months, and the NTC would make a final determination by end-March 2020 (source: National Tariff Commission).

of the large-scale power plants under CPEC are now operational.[27] As a result, the power sector's overall energy demand is now rising at a relatively lower rate than it was earlier on. Second, the *composition* of the energy mix is also changing, with reliance on FO declining significantly and greater emphasis placed on generation from coal (both imported and indigenous) and LNG. And third, the lower domestic demand for FO has created a glut-like situation and forced oil refineries to reduce their throughput, thereby reducing their demand for imported crude oil.

While some refineries are trying to diversify their output mix away from FO and towards other hydrocarbons, like bitumen and lubricants, the industry's operations are still constrained by sizable FO production. FO's share in overall domestic POL production has barely changed over the past four years, indicating the lack of needed investment by refineries to alter their output mix.[28]

Overall POL product imports fell by 24.1 percent to US$ 2.6 billion in H1-FY20, with lower quantums and unit prices almost equally responsible for the decline. Product-wise data shows that quantum imports of FO and HSD dropped quite sharply, to the extent that they offset a rise in petrol imports during H1-FY20. While the drop in FO imports was linked with lower demand from the power sector, HSD imports dropped in response to subdued demand from the heavy vehicle transport segment.[29] HSD sales declined 10.2 percent during H1-FY20. And even though the fuel's domestic production also dropped, the decline in demand was such that the gap did not have to be filled by additional imports. The heavy vehicular transport segment is passing through a soft patch owing to the slowdown in industrial activity and the heavy contraction in overall imports.

In contrast to HSD, domestic demand for petrol was relatively stronger and given the 8.7 percent fall in its local production, the country had to import higher quantities of the fuel. The higher domestic demand for petrol can be attributed to a few factors. First, OMC executives have indicated that due to the non-availability of CNG in Q2, many consumers had switched to petrol, pushing up

[27] During Jul-Dec FY20, overall power generation (excluding K-Electric) rose 2.0 percent YoY. This compares with the growth of 5.4 percent in the same period last year (source: NEPRA).
[28] FO had a share of 20.4 percent, on average, in domestic POL production during H1-FY20. This is marginally lower than the previous five-year average of 21.3 percent.
[29] However, there is also ample anecdotal evidence that a sizable part of local HSD demand is being met via gray channel imports from Iran.

the fuel's demand in the period (**Table 5.9**).[30] Second, the rapid growth of two van pool services in a couple of major cities has seen a heavy deployment of small vans and coasters on the streets; depending on their configuration, these vans mostly operate on petrol. With these companies constantly introducing new routes and increasing fleet sizes, some upward pressure on fuel demand from this segment is also likely.

Table 5.9: Growth in Quantum Sales, Production & Imports of POL Products during FY20
percent change YoY

	Q1			Q2			H1		
	Sales	**Prod.**	**Imports**	**Sales**	**Prod.**	**Imports**	**Sales**	**Prod.**	**Imports**
HSD	-15.6	-15.3	-6.3	-5.0	-4.6	-25.7	-10.2	-10.2	-17.9
Petrol	1.8	-15.3	10.3	7.3	-1.3	4.7	4.5	-8.7	7.4
FO	-21.4	-18.2	-84.3	-17.4	-9.3	-100.0	-19.8	-14.1	-90.7
Total products	-10.2	-14.5	-7.0	-2.5	-5.9	-11.7	-6.5	-10.3	-9.5

Data sources: OCAC & Pakistan Bureau Statistics

Meanwhile, crude oil was the single largest contributor to the import decline, with import values falling 27 percent. As mentioned earlier, refineries reduced their throughput to avoid adding to their FO stockpiles, which reduced their demand for crude oil. Also, some refineries have started utilizing locally extracted crude oil (in the form of condensate); this has also contributed to their lower demand for imported crude oil.

Among other energy items, LNG imports dropped 4.8 percent in H1-FY20 – the first decline in a six-month period since the country started importing LNG four years back. Disaggregated data show that the entire drop was recorded in the second quarter, and corresponded with a drop in LNG-based power generation during the period (**Table 5.10**). Two major LNG plants – Haveli Bahadur Shah and Balloki – were either undergoing scheduled maintenance or running at low capacities, lowering the country's import demand for LNG during the period.[31]

Lastly, coal imports declined by a sharp 15.8 percent to US$ 669.5 million during H1-FY20, with lower unit prices accounting for the entire drop in import values. Disaggregated data indicate that quantum coal imports had fallen during Jul-Oct, before surging by 65.8 percent in November 2019, pushing up quantum imports

[30] Domestic gas production declined by 9 percent YoY in Q2-FY20. Despite the decline, the government had increased the gas supply to the fertilized sector in Q2, while increasing the number of load shedding hours per week for the CNG sector (source: OGRA).
[31] Multiple power plants generally go on scheduled maintenance during the winter months, when power demand in the country goes down.

for the six-month period on YoY basis. [32]

Table 5.10: Fuel-wise Power Generation during FY20* (in GWh)

	Q1		Q2**		Jul-Dec**	
	Value	**Change YoY (abs)**	**Value**	**Change YoY (abs)**	**Value**	**Change YoY (abs)**
Furnace oil	2,106.2	-1,846.2	384.3	-1,306.6	2,490.5	-3,152.8
LNG**	9,601.2	196.2	4,426.0	-29.0	14,027.2	167.2
Hydro	15,349.8	2,700.4	7,062.1	773.7	22,411.9	3,474.1
Coal	6,145.3	1,915.6	6,558.2	2,835.6	12,703.5	4,751.2
Natural gas	4,964.1	-1,101.3	2,995.0	-2,109.3	7,959.2	-3,210.6
Nuclear	2,230.9	185.1	1,618.5	-986.8	3,849.4	-801.7
Others	1,506.6	-465.9	1,518.6	546.9	3,025.1	81.0
Total	**41,904.2**	**1,583.8**	**24,562.7**	**-275.5**	**66,466.9**	**1,308.4**

*Excluding K-Electric **provisional data for Nov & Dec 2020
Data source: NEPRA

A corresponding increase in coal-fired power generation was also noted in November, indicating that some of the drop in LNG generation was compensated for by generation from imported coal.[33] At the same time, some downward pressure on coal imports was exerted by the operationalization of a 660MW indigenous coal power plant, along with lower demand by the steel industry (for which coal is a major raw material).

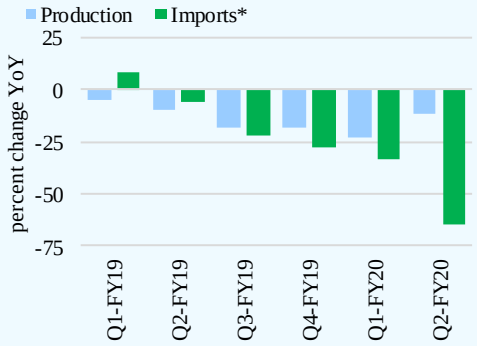
Non-energy imports

The country's non-energy imports fell 15.9 percent YoY to US$ 17.0 billion in H1-FY20; the drop was almost double the decline recorded in the same period last year. Imports of almost all product categories dropped, especially those of transport items, iron and steel, and fertilizer and other chemicals.

Transport group imports fell 44.5 percent during the period, with the drop concentrated in the automobile segment (comprising cars, motorcycles, buses and their associated parts). Also, the decline has deepened as the year progressed, with imports in Q2-FY20 falling to an 11-year low. The trend in auto imports has closely followed that of domestic auto production; as assemblers steadily lowered their production in response to lower consumer demand, their demand for imported parts shrank substantially (**Figure 5.19a**). Moreover, the tightening of regulations governing car imports under the gift and baggage schemes severely curtailed imports of finished automobiles (CBUs), as indicated in **Figure 5.19b**.

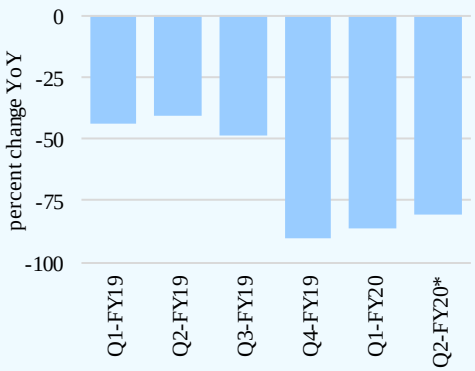
[32] Quantum coal imports rose by much lower 11.0 percent YoY during H1-FY20, after rising by 39.8 percent in the same period last year.
[33] Coal-based power generation had risen 94.5 percent YoY in November 2019 (source: NEPRA).

Figure 5.19a: Growth in Domestic Automobile Production & Auto Parts Imports



*comprising CKDs and parts, and excluding CBUs
Data source: PBS

Figure 5.19b: Growth in the Number of Cars (CBUs) Imported in Pakistan



The impact of lower automobile production and subdued construction activity was also felt on imports of steel items, which declined heavily in quantum terms (**Table 5.8**). Steel is a major raw material for the auto industry, which uses it to make car body frames, panels and other parts.[34] Cumulative iron and steel imports fell by 17.0 percent in H1-FY20, with the decline entirely coming from finished products. In addition to lower demand from the auto sector, finished product imports were also curtailed after Pakistan imposed temporary anti-dumping duties on Canadian and Russian steel products in end-September. Meanwhile, demand for raw material by local steel firms – in the form of scrap and old ships for shipbreaking – was also lower, as steelmakers adjusted their production in response to the slowdown in the auto sector.

In the machinery group, imports fell 1.0 percent to US$ 4.4 billion, after declining by 18.6 percent in H1-FY19. While imports across all sub-categories had dropped heavily last year, purchases of electrical machinery and cell phones recorded hefty increases this year.

In the case of cell phones, the 69.2 percent surge in imports was intriguing, as it appears at odds with the erosion in consumers' spending power in real terms. Two factors are likely at play. First, the Pakistan Telecommunication Authority's Device Identification Registration and Blocking System (DIRBS) went into effect

[34] Aisha Steel Mills Ltd., for instance, specifically cited the slump in the auto industry as a reason for its subdued sales performance. The company mentioned in its Q1-FY20 report that the "auto sector was hit hard in particular leading to slow off take of CRC, the main raw material for the sector. Both the leading players had to cut down production and adjust the prices downwards".

from December 2018, and effectively dented illicit cell phone imports by identifying and blocking non-registered cell phones that were using local SIM cards. As a result, a significant chunk of the cell phone trade occurring via grey channels has now shifted to the formal channel, leading to a surge in official import data. And second, the government had abolished a three percent value-added tax on commercial cell phone imports via the FY19 budget, which slightly reduced the cost of imports.

In the case of electrical machinery, detailed data indicate a rise in imports of heavy-duty electrical transformers (of greater than 10,000kVA capacity), and related equipment. The higher imports of these products is in line with ongoing work to expand the transmission network in the country, especially by K-Electric in Karachi. Also, as per the National Transmission and Despatch Company (NTDC), work is ongoing on 48 power transmission projects, with completion dates ranging from FY20 to FY22.[35]

Among other items, food imports dropped 13.5 percent during H1-FY20. Lower unit prices of palm oil was a major factor, as they pulled down import values by 9.6 percent and more than offset a marginal increase in quantum imports during the period. In contrast to palm oil, quantum imports and unit prices of other food items, such as tea and pulses, were both lower than last year. In particular, tea imports dropped 24.1 percent in the six-month period, with lower import quantums playing a more dominant role. Tea companies and retailers likely built up inventories last year when quantum imports had risen significantly, and are now utilizing these stocks instead of going for fresh imports.[36]

[35] Source: NTDC (https://www.ntdc.com.pk/casa), accessed on February 3, 2020.
[36] Quantum tea imports had risen 22.5 percent in full-year FY19, and then fell in both Q1 and Q2 of FY20 on YoY basis.

Special Section: The State of Competition in Pakistan[1]

S1.1 Introduction

Competition, defined as "the pressure exerted in the market by different players in search of market shares and profits",[2] is an important institutional pillar for developing a market economy characterized by efficiency, innovation and wider consumer choices. In such an economy, firms go all out to minimize costs, prioritize innovation and streamline production processes to make them leaner, responsive and profitable. Theoretical literature provides evidence that competition in product markets enhances firms' productivity, increases business opportunities, supports sustainable economic growth and international competitiveness, and benefits consumers through low and stable prices. The latter is particularly important from the point of view of monetary policy, as central banks across the world prioritize targeting price stability as one of their major objectives.

In the line of this argument, policymakers have come to widen the scope of the "enabling environment" objective of the state. Specifically, competition policy is now considered an essential element of this environment, alongside macroeconomic stability, investment in human capital development and a credible governance structure. Within this context, this section intends to: (i) highlight the significance of competition towards economic growth and development; (ii) describe the best practices with regards to competition polices in a cross-country context; (iii) elaborate upon the state of competition in Pakistan's economy; (iv) evaluate the institutional framework with regards to competition policy in the country; and (v) suggest a policy review that is needed to inculcate competitive practices in the economy.

S1.2 Competition, Competition Policy and Economic Development

Competition is crucial for economic development

Competition in the market pushes firms to minimize their costs, reduce redundant operational processes and keep innovating in order to maintain or increase their market share. Coupled with reduced barriers to trade and relatively open policies towards foreign investment, a competitive environment incentivizes businesses to improve their technological expertise and forge linkages with the global and regional value chains. Cumulatively, the progress in terms of productivity,

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[1] Authors are thankful to Waqas Ahmed (Lead Economist, SBP), Mazhar Khan (Senior Economist, SBP) and Muhammad Omer (Economist, SBP) for their valuable feedback.

[2] "The importance of Coherence between competition Policies and Government Policies", Note by the United Nations Conference on Trade and Development Secretariat, May 2011. TD/B/C.I/CLP/9

innovation, and smooth foreign exchange earnings results in a growth trajectory that is not only robust but also structurally balanced and sustainable.

As Table S1.1 shows, empirical evidence points towards the positive spillovers of competition in an economy. A high level of product market competition is found to lead to lower levels of inflation, an increase in the number of operating firms due to limited barriers to entry, higher labor productivity levels, and significant consumer savings. Encouragingly, the evidence of this is found across all sectors of the economy such as agriculture, industry, transport and retail. It is pertinent to state, however, that it is the enforcement of competition in the form of merger control, cartel identification and regulation, and government policy review exercises – and not just the existence of competition policies – that result in improved economic performance.

Table S1.1: Empirical Collection on Effect of Competition Policy Reforms [1]

Policy Area and Country	Study	Reform	Effect/Results
15 EU Countries*	Przybyla, Marcin; Roma, Moreno 2005		"Higher product market competition reduces average inflation rates for a prolonged period"
Canada**	Amirault, Kwan and Wilkinson, 2006		"Competition not only have a positive impact on price flexibility, it is more likely to place downward pressure on inflation."
Cross-country	Kee and Hoekman 2007	Introduction of competition law; elimination of restrictive government regulations	Increase in domestic firms of 7.2%
Panel	Buccirossi and others forthcoming	Increase in quality of institutional and enforcement policies as measured by a competition policy index	Total factor productivity growth of 1% resulting from 20% increase on index scale—roughly equivalent to moving from level of enforcement in the Czech Republic to that in the United Kingdom
United Kingdom	Symeonidis 2008	Introduction of cartel law (the Restrictive Trade Practices Act) in 1956	With intensification of price competition, closure of a 20–30 percentage point gap in labor productivity growth between cartelized and competitive industries
United States	Werden 2008	Cartel enforcement	Total consumer savings in 2000–07 estimated at about US$1.85 billion
Netherlands	Postema, Goppelsroeder, and Bergeijk 2006	Merger control	Net benefits to society estimated at about €100 million a year
Australia	Australian Productivity Commission 2005	Elimination of anticompetitive regional policies; introduction of competitive neutrality principles	Drop in average real electricity price of 19%, in rail freight rates of 8–42%, and in real port charges of up to 50%; increase in GDP of 2.5%

Vietnam	Kompas and others 2009	Land and market reforms moving from commune-based public ownership and output share contracts to private property and market-driven production and pricing	Large increase in total factor productivity in main rice-growing regions; national average annual increase in rice output of 3.5%
Kenya	Jayne and Argwings-Kodhek 1997	Opening of market and elimination of price controls for maize	Consumer savings of US$10.1 million a year (due to lower milling costs)
Lao PDR	Arnold 2005	Breaking up of Lao PDR trucking cartel and opening of transit to all Thai truckers	Reduction in logistics costs on Bangkok–Vientiane route of 30%
Mexico	Ros 2011	Opening of air transport and routes to low-cost entrants	Reduction in air fares of up to 37% (on routes served by low-cost carriers)
Cross-country panel	Micco and Serebrisky 2004	Improvement in the quality of air transport regulation and Introduction of "open skies" agreements to foster competition	Reduction in transport costs of 8-14%
Italy	Pellizari and Pica 2011	Removal of price floors and advertising ban in the legal profession	More productive lawyers more likely to stay in the profession
Australia	EC 2004	Elimination of the exclusive rights of lawyers	Potential drop in overall legal costs of 12%
Ukraine	Shepotylo and Vakhitov 2012	Liberalization of services	Increase in total factor productivity of 3.6%
United States	Goos 2005	Deregulation of shop opening hours	Increase in employment of 4.4–6.4% and in total revenue of 3.9–10.7% in deregulating industries
United Kingdom	Maher and Wise 2005	Liberalization and pro-competition regulations in gas, water, and electricity	Increase in productivity growth of more than 10%

Data source: * Przybyla, Marcin; Roma, Moreno (2005): Does product market competition reduce inflation? Evidence from EU countries and sectors, ECB Working Paper, No. 453, European Central Bank (ECB), Frankfurt, ** Amirault, D., Kwan, C. and Wilkinson, G. (2006), "Survey of Price-Setting Behavior of Canadian Companies," Working Papers 06-35, Bank of Canada.

[1] Kitzmuller, Markus; Martinez Licetti, Martha. 2012. Competition policy: encouraging thriving markets for development. Viewpoint; note no. 331. Washington, D.C.: World Bank Group.

Similarly, competition in markets help keep prices low and stable

The level of competition has also been found to be an important determinant of price stability in an economy. For example, Neiss (2001), in a cross-country analysis pertaining to 24 OECD economies, found that product markup rates and inflation were positively related.[3] A similar study by Cavelaars (2003) concluded that product markups helped explain 67 percent of the variation in inflation rates

[3] Neiss, K. S. (2001). The markup and inflation: evidence in OECD countries. Canadian Journal of Economics/Revue canadienne d'économique, 34(2), 570-587.

in the countries examined.[4] This was even after accounting for the commonly analyzed macroeconomic variables such as size of the country, stage of development, level of trade openness, autonomy of central banks, and effectiveness of relevant fiscal policy measures, etc. Importantly, Przybyla and Roma (2005) found that the relationship held across the different sectors of the economies, with higher product competition reducing inflationary pressures in the economy for a prolonged period (i.e. the negative relationship tended to persist beyond the temporary effects).[5]

Presence of an optimal competition policy is important

The existence of competition is not automatic and requires addressing of market distortions. This is where the need for effective competition policies that incentivize competition and credibly discourage market exploitation and monopolistic behavior arises. Historically, competition policies and regulations have been credited for the successful development phases in many advanced and emerging economies.

An optimal competition policy may thus be defined as "the set of policies and laws which ensure that competition in the marketplace is not restricted in such a way as to reduce economic welfare."[6] This brings us to explore the components of such a policy. The priority would be to enhance welfare in the society via promoting market integration, controlling excessive profit-making and ensuring fairness and equity in market dealings and structures, often all concurrently. Absence of such policies would gradually lead towards concentration of wealth and the emergence of cartels, which would distort the market and result in inflationary pressures, and general welfare loss in the society.[7]

Facilitative interventions by state institutions are important

The definition of competition mentioned above grants room for facilitative interventions in the market – the ones that improve the general welfare. Historical contexts are aplenty.[8] What is important to note is that competition policy will not

[4] Cavelaars, P. (2002). Does Competition Enhancement Have Permanent Ination Effects?. DNB staff Reports, (92).
[5] Przybyla, M; Roma, M (2005): Does product market competition reduce inflation? Evidence from EU countries and sectors, ECB Working Paper, No. 453, European Central Bank (ECB).
[6] Motta, M. (2004). *Competition Policy: Theory and Practice*. Cambridge University Press.
[7] The World Bank Markets and Competition Policy Assessment Tool of 2016 identifies common factors leading to cartelization as barriers to entry, high concentration and few firms, barriers to imports, product homogeneity, excess capacity, and lack of buyer power.
[8] It is often argued that the "miracle" growth of East Asian economies was achieved via consistent and well-directed state interventions. In addition to sound macroeconomic management and human capital development policies, this entailed prioritizing direct facilitation of certain industrial sectors

work in the absence of effective and strong public sector institutions. Here, the authorities must invest in costly and risky research and development; provide the physical, digital and collaborative infrastructure to the private sector; actively focus on human capital development and gender equality; improve access to effective and secure financial institutions; and open the economy to foreign competition and technology. This would lead to a market structure with competitive characteristics.

S1.3 Where does Pakistan stand in terms of competition and competitiveness?

Keeping in view the discussion above, it is first important to view the current structure of Pakistan's economy and the competition environment in light of the macroeconomic policies and public sector management. It can be stated that "high protection and import substitution" was laid at the very foundation of industrialization in the country in early 1960s.[9] This protective policy regime, comprising of high tariff and non-tariff barriers, generous fiscal incentives and provision of bank credit at concessional interest rates, is often blamed for inculcating rent-seeking tendencies in domestic businesses. While protection at the start enabled domestic producers and laborers to acquire the necessary skills and address cost disadvantages, by the end of 1960s such support was not needed to the prevalent extent anymore as firms had become able to compete successfully with imports (Kemal, 1979).[10] Furthermore, Soligo and Stern (1965) found that excessive protection provided to the businesses distorted the market, in that it led to too much investment in the consumer goods segment at the expense of gross capital formation activities in the investment goods and intermediate goods industries. In fact, the amount of protection provided to most consumer goods

under the "picking winners" policy. However, it is pertinent to highlight that picking winners did not mean that development of competitive markets was being overlooked, as might be incorrectly inferred in this case. On the contrary, the sectors were chosen based on their past performance and potential of innovation, and the objective of the interventions were confined to minimizing price distortions and encouraging export growth. For this, the government invested in public research on emerging technologies, setting sector-specific export targets, and enhancing collaboration between public and private sectors. Here, "contests" were also organized between firms with rewards in the form of export credit and foreign exchange. All this led the eight East Asian "miracle" economies (Japan, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia and Thailand) to become the fastest growing amongst all regions between 1965 and 1990. Source: Birdsall, N.; Campos, J.; Kim, C; Corden, W; MacDonald, L [ed] (1993). The East Asian Miracle: Economic Growth and Public Policy. A World Bank policy research report. Oxford University Press.

[9] Haque, Irfan-ul (2015) "Theory at Odds with Best Practice: The Travails of Industrial Policy". The Lahore Journal of Economics 20 : SE (September 2015): pp. 87–106

[10] Kemal, A. R. (1979) Infant Industry Argument, Protection and Manufacturing Industries of Pakistan. The Pakistan Development Review 1–19.

industries exceeded the contribution to value-added of those industries.[11] In aggregate terms, the average level of protection and subsidy to industries were found to be around two-fifths of value-added, and such trade-restrictive policies also resulted in domestic prices diverging widely from the prices that existed in the international markets (Lewis and Guisinger, 1968).[12]

Then during 1970s, the industrial sector's wholesale nationalization significantly increased government's footprint in nearly every sector of the economy. This further discouraged competition in the domestic market. Following the deregulation, privatization and trade policy reforms starting from late 1980s, the direct role of government reduced considerably, import barriers came down and investment policy was liberalized. However, it is important to highlight that even though the government significantly reduced its direct role in banking, telecommunications and manufacturing, its footprint on crucial sectors, such as transport (aviation, railways and road logistics) and energy (generation, transmission and distribution of natural gas and electric power) remained strong.

Furthermore, protectionist policies continued into the 1990s and 2000s, by which time industries were benefitting from subsidies worth 7 percent of GDP (Kemal 1999).[13] According to Khawaja and Mian (2004), during the period 1996 and 2002, political businesses (one defined so if its director participates in an election) borrowed 40 percent more than other firms, despite having 50 percent higher default rates. Moreover, they estimated that the economy-wide cost of rent-seeking in Pakistan stood between 0.3 percent and 1.9 percent of GDP per annum.[14] The result has been that the government policy with regards to industrial sector has not focused on product and market diversification, technological advancement and distribution of rents via incentives (Rasiah and Nazeer, 2016).[15] To summarize, Pakistan was "ultimately unable to attach performance conditions

[11] Soligo, R. and J. J. Stern (1965) Tariff Protection, Import Substitution and Investment Efficiency. The Pakistan Development Review 5:2, 249–270.
[12] Lewis Jr, S. R. and S. E. Guisinger (1968) Measuring Protection in a Developing Country: The Case of Pakistan. Journal of Political Economy 76:6, 1170–1198.
[13] Kemal, A. R. (1999) Patterns of Growth of Pakistan's Industrial Sector. Fifty Years of Pakistan's Economy. Karachi: Oxford University Press.
[14] Khawaja, A., & Mian, A. (2004). Corruption and Politicians: Rent-seeking in an Emerging Financial Market. Cambridge, United States: Harvard University, Kennedy School of Government. Mimeographed document..
[15] Rasiah, R. and N. Nazeer (2016) Comparing Industrialization in Pakistan and the East Asian Economies. The Lahore Journal of Economics 21:167.

to subsidies and large firms were able to form alliances with powerful political factions to prevent subsidies being reallocated once given."[16]

As things stand, other than transport and energy sectors where the direct *participation* of the government remains strong, manufacturing is another sector where the incidence of public institutions' involvement remained high.[17] For instance, the public sector authorities have retained the responsibility to set the gas allocation quota and feedstock prices for fertilizer units; set drugs prices in the pharmaceutical industry; determine margins for petroleum refineries and oil marketing companies; manage commodity procurement cost for sugar and wheat flour industries; and provide tariff protection to the automobile industry. Moreover, frequent recourse to revenue-centric tariff measures (including imposition of regulatory duties) also create distortions in import-dependent sectors such as steel and electronics. In contrast, the export-oriented sectors are also provided with subsidies in the form of tax refunds and duty drawbacks, and concessional financing. Finally, minimum support prices, fertilizer subsidies and minimal *abiana* charges do not incentivize efficient production practices in agriculture.

Under such an overarching regulatory structure, competitive markets in different sectors of the economy could not develop. Meanwhile, overall investment activity and entry of new players remained limited due to recurring macroeconomic imbalances, inadequate infrastructure, and low domestic savings.[18] Furthermore, it is equally important to acknowledge here that in sectors where businesses operate independently, firms face constraints of serious nature that impede their growth. An issue that merits a discussion in this regard is the limited access to finance for private sector in the country. According to the 2017 World Bank Global Findex database, the proportion of young (15-24 years of age) and older (25 years and above) adults in Pakistan having a bank account stood at only 15

[16] McCartney, M. (2014) The Political Economy of Industrial Policy: A Comparative Study of the Textiles Industry in Pakistan. The Lahore Journal of Economics 19:105.

[17] "Aside from tariffs, sectors are also protected using Statutory Regulatory Orders (SROs). SROs circumvent legislated commercial or trade policy, allowing the government or the commerce ministry to provide protection to sectors that can effectively lobby for it, bringing a high degree of uncertainty and arbitrariness to trade policy implementation. At the same time, export sectors in Pakistan, such as sports goods, garments, and surgical instruments, have always been proponents of enhanced trade and have suffered because of protectionist measures, as tariff escalation and more expensive imported inputs divert resources and investments toward the more inefficient rent-seeking sectors". Source: Deng, F; Illangovan, P; Blanco Armas, E. 2019. *Pakistan at 100: Regional Connectivity*. Washington, D.C.: World Bank Group.

[18] For details, see special chapter on "Factors Constraining Investments in Pakistan: Beyond Macroeconomics", SBP Annual Report for 2018-19 on the State of Pakistan's Economy.

percent and 25 percent, respectively. And the share of adults who accessed formal banking channels to borrow for business inception, conduct or expansion was zero percent for young adults and only 2 percent for older adults. The overall bank credit to GDP in Pakistan is one of the lowest among emerging market economies, with large corporates constituting the largest clientele of bank lending. Small and medium enterprises (SMEs) have a share of only 5.4 percent in banks' lending portfolio (at end December 2019).

Overdependence on own savings (retained earnings or owners' personal funds) and informal channels (which are both expensive and unreliable) makes it difficult for SMEs to expand their operations and compete effectively. Investment activities also stay subdued, as the meagre funds prove adequate enough to cover only the working capital requirements. Furthermore, with the focus predominantly on survival, objectives such as product diversification, innovation and productivity enhancement are not prioritized and firms get stuck with their existing mode of operations.

Potential and existing investors also complain about the legal and regulatory systems. For long, starting a business had entailed cumbersome documentation and approval procedures where multiplicity of steps at federal/provincial levels and a lack of coordination between various public authorities delayed business operations.[19] Furthermore, relatively standard court proceedings take considerable amount of time to conclude. For example, according to a 2017 OICCI survey, more than half of the investors interviewed stated that average dispute settlement period in the country exceeded 5 years. Issues such as these are not only time and cost sensitive, but they also result in anticompetitive practices of businesses potentially going unaddressed for a significant time.

Furthermore, laws and policies related to foreign direct investment are not clear regarding crucial elements, such as the permissible scope of investment activities, nature of sectors open for investment, and local content requirements, etc. This makes foreign investors wary of entering the domestic market and/or expanding their operations. Domestic firms also suffer, because joint ventures with large multinational players have been found to be a major contributor to improved R&D activities, robust product diversification, and productivity and competitiveness enhancement.

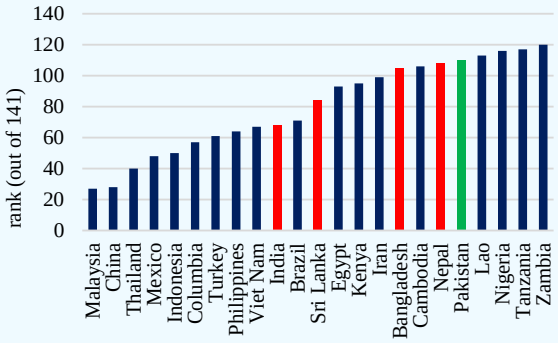
[19] Recently, the government has actively focused on simplifying business starting procedures amongst other measures targeting ease of doing business in the country. Resultantly, the country climbed up 28 places in the 2020 World Bank's Doing Business Rankings and featured as one of the ten best reformers.

In this context, it may be useful to examine the insights from the growth diagnostics presented by the Planning Commission. The commission identified two major constraints to economic growth: "(i) inadequate market development, characterized by a lack of competition, along with tax, tariff and policy distortions; entry barriers; government involvement; and poor regulation, etc.; and (ii) lack of efficient public sector management to facilitate markets and investment with informed policy and competent regulations, and promote deepening of physical, human and social infrastructure".[20]

This implies that over the years, state institutions have not been able to perform a facilitative role in the formation of a market economy. This can be envisaged from unfavorable outcomes in terms of institutional infrastructure, competition in non-tradable sectors/services, barriers to trade, and the ease and cost of doing business. Separately, this has undermined competitiveness of Pakistan economy on the whole.

Currently, Pakistan ranks 110th out of 141 economies in the World Economic Forum's Competitiveness Index 2019- the lowest amongst South Asian and most other developing economies (**Figure S1.1**). Disaggregated data shows that the country ranks below 100 (out of 141 countries) across all the indicators of enabling environment, markets, and human capital; the exceptions are market size (29th), business dynamism (52nd) and innovation capability (79th) (**Table S1.2**). This indicates that the private sector has the capacity to improve its operational practices. However, the shortcomings in the macroeconomic, regulatory and competition environment appears to be holding the country back from gaining a competitive edge over peer economies.

Figure S1.1: World Competitiveness Index Rankings 2019



Note: lower rank signifies higher competitiveness; red bars show other South Asian economies
Data source: World Economic Forum

[20] "Final Report: The Framework for Economic Growth" Planning Commission, Government of Pakistan, approved by the National Economic Council in its meeting held on 23rd May 2011.

Table S1.2: South Asian Countries in terms of Competitiveness - Score (and Rank)

	Pakistan	India	Sri Lanka	Bangladesh	Nepal
Overall	**51 (110)**	**61 (68)**	**57 (84)**	**52 (105)**	**52 (108)**
Enabling Environment					
Institutions	48 (107)	57 (59)	52 (79)	46 (109)	48 (103)
Infrastructure	56 (105)	68 (70)	69 (61)	51 (114)	52 (112)
ICT adoption	25 (131)	32 (120)	40 (107)	39 (108)	39 (109)
Macroeconomic stability	69 (116)	90 (43)	68 (118)	73 (95)	74 (90)
Human Capital					
Health	56 (115)	61 (110)	87 (43)	72 (93)	66 (100)
Skills	41 (125)	50 (107)	64 (66)	46 (117)	49 (109)
Markets					
Product Market	45 (126)	50 (101)	43 (131)	47 (119)	43 (132)
Labor Market	51 (120)	54 (103)	52 (118)	51 (121)	49 (128)
Financial System	55 (99)	69 (40)	57 (87)	52 (106)	66 (51)
Market Size	71 (29)	94 (3)	58 (58)	67 (36)	48 (85)
Innovation System					
Business Dynamism	63 (52)	60 (69)	60 (70)	50 (121)	56 (98)
Innovation Capability	36 (79)	51 (36)	35 (84)	31 (105)	29 (112)

Note: score out of 100; rank out of 141
Data source: Global Competitiveness Report 2019; World Economic Forum

The policy mix is also not optimal in terms of global market orientation. Particularly, Pakistan's *relative* position in factors like tariffs and non-tariff barriers, border clearance efficiency and competition in services, still remains challenging (**Table S1.3**). This suggests a low incidence of trade openness relative to other countries. The implications are manifold. According to a recent International Growth Centre (IGC) study,[21] most of Pakistan's non-tariff barriers, though lesser than some regional countries, are concentrated in agriculture, plant and food-related products. The study added that Pakistan's non-tariff measures (NTMs) lock competitors out of the market and are very general, whereas regional countries are effectively using NTMs to create competition in their local markets.

Table S1.3: Pakistan's Ranking in Product Market Indicators (126/141)

Indicator	Rank/141
Domestic competition	**88**
Distortive effect of taxes and subsidies on competition	65
Extent of market dominance	66
Competition in services	126
Trade openness	**138**
Prevalence of non-tariff barriers	115
Trade tariffs	139
Complexity of tariffs	49
Border clearance efficiency	128

Data source: Global Competitiveness Report 2019; World Economic Forum

[21] Shah, S. and Kayani, U. (2014), "Non-Tariff Barriers and Pakistan's Regional Trade", IGC.

A 2018 World Bank report on Pakistan also highlighted that the tariff structure was historically used to both protect certain industries and generate fiscal revenues.[22] Protected sectors thus lost the incentive to target other markets, while export-oriented sectors struggled to keep pace with their competitors due to costlier imported inputs. This protective environment shielded local firms from foreign competition (via imports), and also led to anti-export and anti-innovation biases. Resultantly, as Ali (2011) highlights, multiple industries developed oligopolistic characteristics, which over time led to increased market concentration and higher volatility in prices.[23]

A recent study conducted jointly by the OECD and World Bank on the economic harm caused by cartels in developing countries reveals that in Pakistan, the annual excess profits and the level of mispriced sales due to market power abuse by large firms for the years in which the existence of cartels was identified during 1995-2013, were among the highest in the sample of developing countries.[24] Between the period 2003-2011, sales worth around 1.1 percent of GDP were overcharged due to the presence of cartels, resulting in profits over and above the normal rates amounting to 0.2 percent of GDP (**Table S1.4**). While the profitability and sales estimates may not seem large, the existence of cartels was significant for two main reasons: (i) cartels were found to charge 20-25 percent higher prices relative to non-cartel players; and (ii) the presence of cartels was found to lower production levels by 15 percent. Furthermore, most of the cartels were producing

Table S1.4: Estimates of Economic Harm Caused by Cartelization - A Cross Country Comparison (1995-2013)

Country	Period Analyzed	Average excess profits (cumulative - percent of GDP)	Affected Sales (percent of GDP)
Brazil	1995-2005	0.21	0.89
Chile	2001-2009	0.06	0.92
Colombia	1997-2012	0.001	0.01
Indonesia	2000-2009	0.04	0.50
Korea	1998-2006	0.53	3.00
Mexico	2002-2011	0.01	0.05
Pakistan	**2003-2011**	**0.22**	**1.08**
Peru	1995-2009	0.002	0.01
Russia	2005-2013	0.05	0.24
South Africa	2000-2009	0.49	3.74

Data source: World Bank (2017)

[22] World Bank (2018), "Pakistan - Unlocking Private Sector Growth through Increased Trade and Investment Competitiveness", Washington, D.C.
[23] Ali, S. O. (2011). : Power, Profits and Inflation: A Study of Inflation and Influence in Pakistan. SBP Research Bulletin, 7, 11-41.
[24] Licetti, M., Pop, G., Nyman, S., & Begazo Gomez, T. P. (Eds.). (2017). *A Step Ahead: Competition Policy for Shared Prosperity and Inclusive Growth*. Washington, DC: World Bank.

intermediary products (such as cement and edible oil), which resulted in their inefficiencies spilling over into other sectors of the economy.[25]

S1.4 Competition Policy Environment Globally, and in Pakistan

In order to promote competition in their domestic industries, developing economies have followed liberal trade policies; streamlined procedures for starting a business in order to reduce barriers to entry; helped integrate their firms with global value chains; implemented business facilitation policies to attract both local and foreign investors; and focused heavily on exports.

Table S1.5: Comparison of Certain Functions Performed by Competition Agencies

Agency	Under a ministry	Organizational Structure	Public Policy Assessment	Market Studies	Market dominance rule	Compel firms to provide documents? Arrange Surprise Visits? If so, are warrants required?
Australian Competition and Consumer Commission	No	One Federal organization with nationwide offices	Yes	Yes	N/A	Yes/Yes/Yes
Anti-monopoly Commission China	Yes	Law is enforced via 3 different organizations	N/A	Yes	1 firm: 50%; 2 firms: 66%; 3 firms: 75%	Yes/Yes/No
Competition Commission of India	No	One Federal Organization	Yes	Yes	N/A	Yes/Yes/Yes
Japan Fair Trade Commission	No	Federal org. with a secretariat, 2 bureaus & multiple regional offices	Yes	Yes	>50%	Yes/Yes/Conditional
Malaysia Competition Commission	No	One Federal Organization	Yes	Yes	>60%	Yes/Yes/No
Competition Commission of Pakistan	No	One Federal Organization	N/A	Yes	40% unilateral merger	Yes/Yes/No
Consumer Affairs Authority of Sri Lanka	Yes	One Federal Organization	N/A	Yes	N/A	Yes/Yes/No
Vietnam Competition and Consumer Authority	Yes	One Federal Organization	Yes	Yes	1 firm: 30%; 2 firms: 50%; 3 firms: 65%; 4 firms: 75%	Yes/Yes/No

Data source: OECD (2018), Competition Law in Asia-Pacific: A Guide to Selected Jurisdictions

[25] In case of Pakistan, sectors where cartelization practices were discovered during the period 2003-2011 included banking, cement, jute, poultry, edible oil, and telecom.

When it comes specifically to putting in place a competition policy, a majority of countries has introduced antitrust/anti-monopoly acts and established competition authorities. As of February 2020, the number of countries and regions with competition authorities stands at 147.[26] Likewise, the regulatory scope of such agencies has widened over time. In addition to pursuing the objectives of price stability and collusion prevention, the authorities are also mandated to ensure consumer confidence through awareness and advocacy strategies; frictionless creation and dispersion of ideas (innovation) in the market; equal growth opportunity for all businesses; and equitable distribution of state aid and incentive schemes.

The competition authorities pursue these objectives by playing four major roles. First, they enforce antitrust policies in their jurisdictions. Second, they carry out investigative studies of various sectors of the economy to monitor and highlight practices hindering competition. Third, they serve as advocacy bodies and raise awareness about the benefits of competitive markets amongst key stakeholders. And fourth, they provide technical expertise to public sector authorities in the form of public policy assessments. A synopsis of the main functions performed by the competition agencies of Australia, China, India, Japan, Malaysia, Pakistan, Sri Lanka and Vietnam is presented in **Table S1.5**.

In Pakistan, the 'Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance' (MRTPO) was passed in 1970, under which the Monopoly Control Authority (MCA) was formed. The MRTPO was later replaced with the Competition Ordinance in 2007, under which the Competition Commission of Pakistan (CCP) was established. The CCP is mandated to undertake enforcement, advocacy, and research efforts to ensure free competition in all domains of commercial and economic activities, and its jurisdiction spans public as well as private entities (**Box S1.1**). In 2010, the Competition Ordinance 2007 became the Competition Act 2010.

Box S1.1: Mandate of the Competition Commission of Pakistan
The Competition Act 2010 mandates the Competition Commission of Pakistan (CCP) to carry out the following objectives:

Abuse of Dominant Position. The Act prohibits the abuse of a dominant position through any business practice. These include reducing production or sales, unreasonable price increases, price discrimination without objective justification, connections that make the sale of goods or services conditional on the purchase of other goods or services, predatory pricing, preventing new entry, refusing to deal, and boycotting or excluding any other undertaking from producing, distributing or selling goods, or providing any service.

[26] Source: United States Federal Trade Commission.

- **Prohibited Agreements.** The Act prohibits undertakings or associations from entering into any agreement or making any decision in respect of the production, supply, distribution, acquisition or control of goods or the provision of services, which have the object or effect of preventing, restricting, reducing, or distorting competition within the relevant market unless exempted under the law. Such agreements include market sharing and price fixing of any sort, fixing quantities for production, distribution or sale; limiting technical developments; as well as collusive tendering or bidding and the application of dissimilar conditions.
- **Deceptive Marketing.** The Act prohibits deceptive marketing practices. It includes distribution of false or misleading information that may harm the other business, any advertising or promotional material that misrepresents the nature, characteristics, qualities, or geographic origin of goods, services or commercial activities, misleading comparison of goods in the process of advertisement and fraudulent use of another's trademark, firm name, product labeling or packaging.
- **Approval of Mergers.** The law prohibits mergers that would substantially lessen competition by creating or strengthening a dominant position in the relevant market. The Act requires prior notice of proposed mergers or acquisitions that meet the notification thresholds specified in the law. If the CCP determines this to be the case, it can prevent mergers or acquisitions, set conditions or require divestitures.

Source: Competition Commission, Act 2010, Competition Commission of Pakistan

According to the Act, the CCP is empowered to: (i) initiate proceedings either over complaints filed by affected entities or on a suo motu basis; (ii) undertake sector specific research to evaluate existing market practices (either on its own or over complaints over anti-competitive practices); and (iii) review existing and new laws and policy frameworks and make suitable recommendations to make them pro-competition. In case of non-compliance, the commission is empowered to impose penalties of up to Rs 75 million or 10 percent of the annual turnover of entities involved (depending upon the findings); the financial penalty may be combined with imprisonment as well. Meanwhile, leniency provisions also exist in the Act that may relax the imposed penalties, subject to the businesses meeting the requisite conditions.

Table S1.6: No of Decisions and Policy Notes by CCP

	No. of Decisions	Approval of mergers	No. of Opinions/Policy Notes
2008	7	-	-
2009	15	-	6
2010	15	-	3
2011	13	3	1
2012	10	1	4
2013	5	-	2
2014	1	-	5
2015	13	24	4
2016	7	70	4
2017	12	62	-
2018	14	74	5
2019	15	54	6
2008-19	127	288	40

Data source: Competition Commission of Pakistan

Building upon the work of its predecessor (the MCA), the CCP has been proactive in identifying practices that prevent, restrict or distort competition. Since its inception in 2007, the CCP has taken about 127 decisions regarding firms' anti-

Table S1.7: Opinion/Policy Notes Prepared by the Competition Commission of Pakistan

Title	Opinion regarding competition
1. Competition Concerns in the **Automobile Sector** - 2019	"… the existing players have had ample time to recoup investments they have made in near monopoly conditions due to protections afforded to them. Pakistan automobile industry is essentially marred by a **lack of competition**."
2. Issues in the **Real Estate** Sector 2019	"The existing legal framework has failed to maintain a vigilant and a system of proper check and balance in this sector, which results in the general public as well as commercial investors losing their hard earned money… it is imperative that immediate attention is given to this sector by the government and necessary measures are undertaken to **organize, formalize and regularize** it."
3. Market and Regulatory Assessment of the **Air Transport** Sector -2019	"In its role of economic regulator, CAA is mandated with the oversight of monopolistic services pricing. CAA, as a 'dominant undertaking', is the provider of such services, setting charges to recover its costs. This **concentration of functions** leaves users of infrastructure services unprotected (airlines and passengers) in the presence of such conflict of interest, in terms of prices charged and quality rendered."
4. Market Assessment of **Mobile Telecommunications** - 2019	"In order to increase the value of the mobile network in Pakistan it is key to **enhance competition** (i.e., the level of firm rivalry) in the market and remove existing regulatory constraints."
5. Competition Assessment Study of **Wheat Flour Industry**- 2019	"**Monopolistic behavior** of Govt. functionaries (Sindh Agriculture Department, Punjab Agriculture Department, KPK Agriculture Department) hinders private sector participation"
6. Competition Concerns in the **Sugar Sector**-2018	"The sugar sector suffers from ***in*efficiencies** at all levels… The provincial governments should ideally not fix price floor of sugarcane and let the market determine price based on supply and demand. Price floors should only be imposed for limited periods in situations where food security is gravely threatened."
7. Exemptions to Certain Undertakings in the **Construction Sector**-2014	"Do the exemptions granted to FWO, NCL and NLC in the construction sector **distort market conditions and restrict competition**...The clients of various construction projects undertaken by the FWO, NCL and NLC have remained the federal and the provincial governments. Private sector contractors cannot compete for such projects due to these "exemptions". In the long-run, this affects their growth and international competitiveness."
8. Discriminatory Levy of GIDC on Selective **Fertilizer Plants**-2014	"Whether the selective levy of GIDC on pre-2001 fertilizer plants distorts market conditions and has **restricted competition** in the market of urea and thereby harmed consumers. …It is recommended that GIDC is charged equally to all fertilizer plants to create a level -playing field in the urea market. Therefore, it is proposed that the levy of GIDC on feed stock for pre-2001 fertilizer plants be withdrawn and that the Second Schedule of the GIDC Act may be amended to rationalize the GIDC on fuel gas used by fertilizer plants."
9. Discriminatory Application of **IFEM** (Opinion)-2014	"In the interest of eliminating discrimination among refineries and **creating a level playing field** in crude and refined oil markets, it is recommended that the Refinery be given the benefit of IFEM in terms of transportation cost of crude oil as allowed by ECC."
10. Exemption of RD on Import of Ware Potatoes by **IFFC**** (Opinion)-2009	"Withdrawal of 25% regulatory duty to International Fast Food Chains franchises operating in Pakistan on the import of ware potatoes, thereby discriminating local fast food chains and other local importers of ware potatoes, and placing them at a **competitive disadvantage**…In order to ensure free and healthy competition in the market and to create a level playing field for all the market players, it is essential that all undertakings are treated at par. Therefore, it is recommended that regulatory duty on ware potatoes should be imposed equally across the board…"

*Inland Freight Equalization Margin, **International Fast Food Chains Franchisees, Source: CCP Website

competitive behaviors (and imposed penalties totaling Rs 26.8 billion); approved around 288 mergers and acquisitions; and written 40 policy notes on various sectors of the economy (**Table S1.6**).

The policy notes and investigative reports published by the CCP, which include comprehensive sector-specific analysis and comparisons with similar international and national cases, have helped reveal that monopolistic practices exist in a number of sectors of Pakistan's economy. Such practices include, but are not limited to, assigning/fixing production quotas among members of industry associations; raising prices in a coordinated manner; reducing the bargaining power of purchasers in product or service provision agreements; and carrying out false/deceptive advertising activities, etc. (**Table S1.7**).

After identification, the CCP pursues cases against businesses suspected of being involved in anti-competitive practices. This usually begins with the agency sending show-cause notices to the firms or associations, and either warning them about punitive action if the practices are not corrected, or imposing fines and/or imprisonment according to the provisions under the Competition Act 2010 (**Table S1.8**).

However, it is important to note that CCP has been facing serious legal challenges in implementing its decisions. Companies under scrutiny often plead that the 18th amendment provides provinces the right of exclusion from federal laws.[27] As a result, any new action taken by the CCP is challenged, which inevitably results in the commission's inability to perform effectively. To-date, a total of 311 cases have been registered against the CCP's decisions, of which 127 pertain to the constitutionality of its laws. Consequently, recovery of imposed penalties becomes difficult, as the penalized parties obtain stay orders against the CCP's decisions. This can be envisaged form the fact that CCP has able to recover only Rs 33.3 million out of penalties worth Rs 27.0 billion since 2008.

S1.5 Policy Implications and the Way Forward

The discussion in preceding sections, based upon a careful examination of relevant literature, has revealed that the competition environment in Pakistan in general have not been favorable for productivity enhancement and growth. Public sector enterprises remain a major feature of the transport and energy sectors of the economy, while indirect interventions by government institutions in the

[27] The Competition Act 2010 states under section 12 (3) that the "Commission shall be administratively and functionally independent, and the Federal Government shall use its best efforts to promote, enhance and maintain the independence of the Commission".

Table S1.8: Show-cause Notices Issued by Competition Commission of Pakistan

Sector	Verdict/Comments	Fine/Action
1. Show cause notice issued to **Pharma Bureau** (2019)	"We reiterate here that the commission remain vigilant against all forms of collusion and cartelization that may take place in any market, including the pharmaceutical sector."	Warning Issued
2. Show cause notice issued to **Oil Companies Advisory Council** (OCAC)(2019)	"The entire process of procurement undertaken by OCAC for procurement of Fuel Marking Company is in violation of section 4 of the Act (Competition Act)."	In view of the compliance approach, no penalty imposed
3. Show cause notice to **Pakistan Fluor Mills Association (PFMA)** (2018)	"PFMA has been engaged in announcing and communicating, present and/or future retail and ex-mill flour prices through press releases to the public and local authorities and its members. This is in violation of the Section 4 of the Act."	Penalty of Rs 75 million
4. Show cause notice issued to **Utility Sores Corporation of Pakistan** (2017)	"The Commission directs the respondent to be mindful of the competition directions while drafting future tenders be it in the instant matter or otherwise, in order to provide a level playing field and not to hamper the competition in the relevant market."	In view of the compliance approach, no penalty imposed
5. Show cause notice issued to **Pakistan Poultry Association (PPA)**(2016)	"The main issue under consideration in this matter is whether PPA has taken anti-competitive decisions in terms of Section 4(1) of the Act by advertising the prices for broiler chicken and chicken eggs in newspapers."	Penalty of Rs 100 million
6. Show cause notice to **Pakistan Engineering Council**-PEC (2016)	"PEC has taken a decision in terms of Sec. 4(1) of the Act by setting a minimum requirement of 'AA' rating for insurance companies in prima facie violation of Sec. 4(1)"	Penalty of Rs 30 million
7. Show cause notice issued to **Dairy Companies** (2015)	"The main issue in this matter is whether the undertakings (Engro Food Limited, Noon Food Limited, Shakarganj Food Pakistan Limited) marketing campaigns relating to their dairy drinks, dairy liquids and/or tea whiteners constitute deceptive marketing practices in terms of Sec. 10 of the Act."	Penalty of .03% of last turn over for Engro Food Ltd., and Rs 2.5 million for others
8. Show cause notice issued to **Pakistan Automobiles Manufacturers Authorized Dealers Association** (2015)	"In view of the settled pattern of collusion demonstrated by PAMADA, as well as four instances of distinct violation in three relevant markets the commission hereby directs PAMADA to cease its collusive behavior."	Penalty of Rs 140 million
9. Show cause notice issued to **Indus Motor Company** (2013)	"PBO (Provisional Booking Order) gives Indus Motor the sole right to (i) change the price, (ii) design/specification, (iii) delivery schedule without any notice to the buyer. Such terms create a significant imbalance to the disadvantage of buyer's rights and obligations arising under the contract."	The PBO was amended
10. Show cause notice issued to **1-Link Guarantee Ltd. and Member Banks** (2011)	"It was observed that banks are charging uniform amount for ATM cash withdrawal transaction….In the absence of any direction from the SBP, uniform rates of ATM cash withdrawal services implemented by majority of banks raised a suspicion of collusion among banks"	Penalty of Rs 150 million to 1-Link, Rs 50 million to each founding members, Rs 10 million to each non-founding members

Data source: Competition Commission of Pakistan

manufacturing sector have also stayed persistently high. Both these developments have distorted the market structure of the economy and fueled anti-export and anti-innovation bias amongst the businesses. Furthermore, despite the existence of a proactive competition agency (CCP), the overall competition policy environment is constrained owing to challenges that are more legal in nature than operational. This has resulted in anti-competitive characteristics becoming more prevalent in the economy, a situation that is evident across most sectors as highlighted in the studies conducted by the CCP and the show-cause notices issued by the agency.

It is important to understand that governments in developing economies pursue multiple development goals, which may not always be compatible with each other. This represents a challenge for policymakers to balance their development strategies with preemptive and remedial measures against unwarranted spillover effects. The latter implies ensuring that the competition environment in domestic market is not compromised, at least in the long term. Thus, the element of coherence is crucial to the effectiveness of different policies in the areas of trade and investment.

In case of Pakistan also, market solution may not always admittedly be the best solution in achieving development goals the economy has set for itself. It may be argued that government interventions are needed in some of the sectors/industries where significant market failures are prevalent, including positive and negative externalities, public goods and information asymmetries, or redistributive policies that are pursued to achieve the broader development agenda. Such interventions, however, run the risk of going against the spirit of inculcating competition in the economy and generate a strong foothold of the government.

In this context, Pakistan's economy needs a fundamental rethinking with respect to its regulatory structure: while a deliberate push might be needed to encourage export orientation, investments, and ensuring food and energy security in the country, this may not necessarily require direct interventions and heavy regulation by the public sector institutions. Furthermore, even when government interventions are deemed necessary, such policy actions must not go beyond the initial objective of guiding business activities along a more sustainable and competitive growth direction. If prolonged, there is a danger that dependence on public sector involvement may become a permanent characteristic of that industry/structure. In the long run, the role of public sector should be confined to addressing market failures through structural reforms, and providing a broader institutional support to businesses.

In particular, the authorities should strive to streamline and rationalize the trade policy by committing to a minimal and uniform tariff structure in order to encourage competition and export-orientation. Higher tariff and non-tariff barriers have, over time, resulted in an industrial structure that promotes anti-export bias, ineffectiveness and rent-seeking behavior. Pakistan has to focus on developing a roadmap that is less intrusive and more facilitative for businesses.

In this regard, the approval of the country's first National Tariff Policy (NTP) is an encouraging development. With the NTP solely under the purview of the Ministry of Commerce, it has been made clear by the government that tariffs would not be used as revenue-generating measures, but would be leveraged to facilitate industrial development and support firms increase their presence in the international market.

The government should also promptly revisit the legal conditionalities to enhance the effectiveness of the CCP over all national and provincial competition matters. This is important because for a competition authority to be successful in its objective of ensuring price stability and avoiding the market distortion by dominant players, it also needs to be a credible *enforcer* of anti-monopoly policies. Competition authorities are deemed efficient and well-functioning if they satisfy the criteria of legality, independence, transparency, effectiveness and responsibility.[28]

Advocacy practices need to be strengthened by improving dissemination of information amongst stakeholders and providing them a platform for policy feedback. The latter is important for four reasons. First, greater awareness about the CCP's functions and the disadvantages of unchecked market practices would result in enhanced justification and credibility of the CCP as an institution. Second, policy advocacy channels would help firms and official authorities to amicably resolve potential disputes, rather than pursuing them through the legal channel. Third, it would improve enforcement by enabling the agency to monitor and review the practices of the firms after providing recommendations or reaching (leniency) agreements. Fourth, such results would then feed into the decision-making of the CCP, thereby improving the efficiency and effectiveness of its operational activities.

However, to achieve these objectives, the competition policy cannot work in isolation. Its objectives must align with the overall macroeconomic agenda followed by the government. One recommendation is to enable the CCP to

[28] Ottow, A. (2015). "Market And Competition Authorities: Good Agency Principles". OUP Oxford.

engage other institutions, such as the BOI and the FBR, to frame an overarching policy that incentivizes growth and innovation and punishes oligopolistic and market-distorting practices. Similarly, competition regulations can be coupled/supported with consumer protection laws to better safeguard consumers against exploitative practices and to ensure general price stability and quality control in the market.

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:

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

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

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

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

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

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

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

(a) Government borrowing for budgetary support:

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

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

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

(b) Commodity finance:

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

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

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

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

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

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

Acronyms

ADB	Asian Development Bank
AEO	Authorized Economic Operators
AML	Anti-Money Laundering
ATM	Automatic Teller Machine
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BOI	Board of Investment
BoP	Balance of Payments
bps	Basis points
BSC	Behbood Savings Certificate
CAA	Civil Aviation Authority
CAD	Current Account Deficit
CBU	Completely Built Up
CCI	Consumer Confidence Index
CCP	Competition Commission of Pakistan
CFT	Combating the Financing of Terrorism
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CNIC	Computerized National Identity Card
CPEC	China–Pakistan Economic Corridor
CPI	Consumer Price Index
CRC	Cold Rolled Coil
CY	Calendar Year
DAP	Diammonium Phosphate
DIRBS	Device Identification Registration and Blocking System
DNB	De Nederlandsche Bank (Central Bank of the Netherlands)
DSC	Defense Saving Certificate
ECB	European Central Bank
ECC	Economic Coordination Committee
EFF	Extended Fund Facility
EFS	Export Finance Scheme
EM	Emerging Market
EU	European Union

FAO	Food and Agriculture Organization
FASTER	Fully Automated Sales Tax e-Refund
FATF	Financial Action Task Force
FBR	Federal Board of Revenue
FC	Financial Cost
FCA	Federal Committee on Agriculture
FDI	Foreign Direct Investment
FE-25	Foreign Exchange-25
FED	Federal Excise Duty
FO	Furnace Oil
FPI	Foreign Portfolio Investment
FRDLA	Fiscal Responsibility and Debt Limitation Act
FTA	Free Trade Agreement
FWO	Frontier Works Organization
FX	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GSM	Global System for Mobile
GSP	Generalized System of Preferences
GST	General Sales Tax
GSTS	General Sales Tax on Services
H1	First Half
H2	Second Half
HSD	High Speed Diesel
IBA	Institute of Business Administration
ICT	Information and Communications Technology
IFEM	Inland Freight Equalization Margin
IFFCF	International Fast Food Chains Franchisees
IFI	International Financial Institution
IGC	International Growth Centre
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification

KERO	Kerosene Oil
KG	Kilogram
KHI	Karachi
KM	Kilo Meter
KP	Khyber Pakhtunkhwa
KSA	Kingdom of Saudi Arabia
LDO	Light Diesel Oil
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSM	Large scale manufacturing
LT	Long-term
LTFF	Long-term Financing Facility
MCA	Monopoly Control Authority
MNFSR	Ministry of National Food Security and Research
MoC	Ministry of Commerce
MoF	Ministry of Finance
MPD	Monetary Policy Department
MRTBs	Market related Treasury Bill
MRTPO	Monopolies and Restrictive Trade Practices (Control and Prevention) Ordinance
MT	Metric Ton
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Asset
NFC	National Finance Commission
NFNE	Non-food-non-energy
NHA	National Highway Authority
NITB	National Information Technology Board
NLC	National Logistics Cell
NSER	National Socio-Economic Registry
NSS	National Savings Scheme
NTC	National Tariff Commission
NTDC	National Transmission and Dispatch Company
NTP	National Tariff Policy

OCAC	Oil Companies Advisory Council
OECD	Organization for Economic Co-operation and Development
OGRA	Oil and Gas Regulatory Authority
OMO	Open Market Operation
OUP	Oxford University Press
PAMA	Pakistan Automotive Manufacturers Association
PB	Prize bond
PBA	Pensioners' Benefit Account
PBO	Provisional Booking Order
PBS	Pakistan Bureau of Statistics
PCRCL	Pakistan Corporate Restructuring Company Limited
PEDL	Public External Debt Liability
PFM	Public Finance Management
PFMA	Pakistan Flour Mills Association
PIB	Pakistan Investment Bond
PKR/Rs	Pakistan Rupee
POL	Petroleum, Oil and Lubricants
POS	Point of Sales
PPA	Pakistan Poultry Association
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PTA	Pakistan Telecommunication Authority
Q1	First Quarter
Q2	Second Quarter
Q3	Third Quarter
Q4	Fourth Quarter
REER	Real Effective Exchange Rate
RIC	Regular Income Certificate
RMG	Readymade Garment
ROA	Return on Assets
RPI	Relative Price Index
SAR	Saudi Arabian Riyal
SBP	State Bank of Pakistan
SDR	Special Drawing Rights

SFWA	Shuhadas Family Welfare Account
SIM	Subscriber Identity Module
SNGPL	Sui Northern Gas Pipeline Limited
SRO	Statutory Regulatory Order
SSA	Special Savings Account
SSC	Special Savings Certificate
SSGC	Sui Southern Gas Pipeline Limited
ST	Short-term
SUPARCO	Space and Upper Atmosphere Research Commission
SUV	Sports Utility Vehicle
T-bills	Treasury bills
UAE	United Arab Emirates
UK	United Kingdom
US$	US Dollar
USA/US	United States of America
USFIA	US Fashion Industry Association
WHT	Withholding tax
WTO	World Trade Organization
YoY	Year on Year