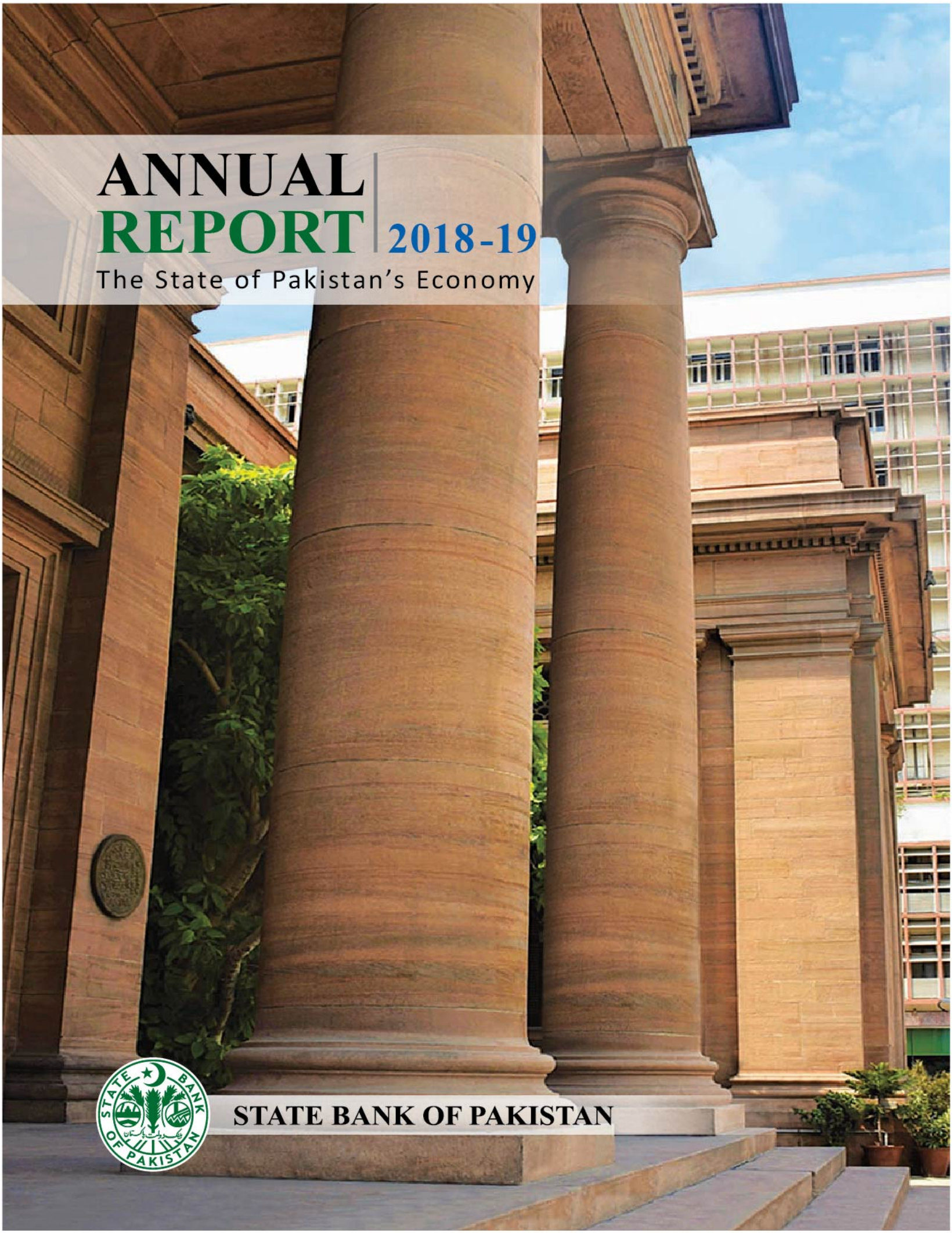

ANNUAL REPORT 2018-19

The State of Pakistan's Economy

STATE BANK OF PAKISTAN

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1 Economic Review

1.1 Overview

The economy experienced marked adjustments during FY19. The exchange rate was realigned with the market fundamentals; interest rates were sharply increased; public sector development expenditure was significantly curtailed; and energy prices were raised. These measures were taken to manage the twin deficit crisis, caused by the consumption-led growth of the past few years. The policy actions helped contain demand pressures and contributed to import compression, which led to a significant reduction in the current account deficit. However, in the process large-scale manufacturing contracted and inflation rose above its target after four years. Meanwhile, high input costs combined with water shortages undermined agriculture sector's output and the drag in the commodity-producing segments spilled over to the services sector as well. These developments impacted real rural incomes and urban wages, thus constricting the household budgets and ultimately savings and consumption. Resultantly, the real GDP growth fell to its lowest in the past nine years (**Table 1.1**).

Table 1.1: Selected Macroeconomic Indicators

	FY16	FY17	FY18[R]	FY19	
				Target	Actual[P]
percent growth					
Real GDP[1]	4.6	5.2	5.5	6.2	3.3
Agriculture	0.2	2.2	3.9	3.8	0.8
Industry	5.7	4.6	4.9	7.6	1.4
Services	5.7	6.5	6.2	6.5	4.7
Private sector credit[2]	11.2	16.8	14.9	-	11.6
CPI inflation[1]	2.9	4.2	3.9	6.0	7.3
percent of GDP					
Current a/c balance[2]	-1.7	-4.1	-6.3	-4.0	-4.8
Fiscal balance[3]	-4.6	-5.8	-6.6	-4.9	-8.9
Gross public debt[3]	67.7	67.0	72.1	68.0	84.8

P: Provisional; R: Revised

Data sources: [1] Pakistan Bureau of Statistics; [2] SBP; [3] Ministry of Finance

To put the developments of FY19 into perspective, early warning signs of an impending correction had begun with large twin deficits by the close of FY18. As a result, SBP had begun proactively tightening of monetary policy as early as January 2018. However, the central bank's efforts were diluted to some extent, since a corresponding fiscal consolidation did not materialize.

At the start of FY19, addressing the twin deficits and the precarious level of foreign exchange reserves was among the top priorities of the government. However, it initially opted for a homegrown stabilization program, rather than an IMF sponsored arrangement. On top of raising interest rates, this involved letting the value of Pak rupee to be aligned with macroeconomic fundamentals and undertaking several regulatory measures to contain imports. The strategy delivered positive results with a prominent decline in imports. This, along with a healthy growth in workers' remittances, led to a significant improvement in the current account deficit in FY19.

Despite this improvement, the overall reserve position remained challenging as plugging the current account deficit and financing external obligations became increasingly difficult. As the year progressed, it became obvious that such bilateral inflows could only serve as a complement – not a substitute – for an IMF program. Beyond direct BoP support, being under the umbrella of an IMF program gives comfort to other IFIs and helps the government in its efforts to attract foreign investors and raise funds from the international capital markets. Ultimately, the government reached an agreement with the IMF in May 2019.

In terms of fiscal imbalances, the new government announced partial reversal of tax reliefs and implemented PSDP cuts. By the end of the year, however, these measures proved insufficient as the tax revenue collection for the year fell well short of the target. Tax collection effort was also underscored by the fact that revenues could not even keep pace with nominal GDP growth during the

year. Moreover, weak collection from sectors which typically contribute the bulk of revenue mobilization and over-reliance on non-tax revenues exposed high degree of dependency on just a handful of revenue spinners. Meanwhile, in order to close the revenue-expenditure gap throughout the year, the government continued to borrow heavily from SBP, which in turn somewhat diluted the impact of contractionary monetary policy.

The expenditure side proved to be equally frail. Despite a sharp decline in development spending, growth in overall expenditure remained higher than last year. Not only interest payments increased substantially, the control on non-interest current spending also remained weak. The result was that the primary deficit deteriorated while the overall fiscal deficit reached a historic high. This also led to a much faster accumulation of public debt while deviating further from the limit under FRDLA. These dynamics remained one of the major challenges facing the government at the onset of FY20.

Besides the tangible factors behind the economic moderation, a sense of unease remained a persistent theme for most of the year, stirred up by a number of underlying factors. These included: speculations on the signing of the IMF program; anxiety over possible implications of FATF reviews; uncertainty regarding currency depreciation; and cross-border tensions with India. These developments deflated the confidence of businesses and consumers, unsettled the currency and equity markets, and in some cases inadvertently caused a flight towards greater informality.

Meanwhile, steady increase in headline inflation remained a constant source of concern throughout FY19. The inflationary impact of underlying demand pressures from FY18 were further compounded by the government's decision to increase the administered energy prices to contain the fiscal deficit. This further stoked the inflationary pressures through the energy and transport components of CPI; prices of non-food items also rose as the second round impact came into play. Moreover, pass through of Pak rupee depreciation, which mainly affected imported goods as well as goods with a heavy imported content, and a sharp increase in food prices during Q4-FY19 added to the buildup of inflationary momentum. While six successive increases in the policy rate during the fiscal year helped subdue the demand-pull pressure on prices towards the end of FY19, inflation continued to be high. In particular, slippage in food inflation remained quite prominent since it also exposed the lax administrative measures and lack of contingency plans in case of unanticipated shocks, such as damage to the domestic minor crops.

In addition, macroeconomic challenges raised some concerns with respect to banks' non-performing loans (NPLs), which increased sharply during FY19. On a yearly basis, gross NPLs posted a growth of 23.2 percent during the year, which is the highest growth observed since FY11. This occurred along with a 3.3 percentage point decline in the growth of private sector credit, as the fixed investment component more than halved, in response to moderation in the economy and due to several stabilization measures. Nonetheless, owing to high input prices, working capital requirements expanded more than the previous year.

In the big picture, though real GDP growth picked up during FY17 and FY18, the sharp downturn in FY19 highlighted the fact that the economic expansion in these years had not been based on a sustainable strategy and was susceptible to various stabilization measures, such as the cut in development expenditure. This has exposed the structural deficiencies faced by the economy yet again, requiring immediate policy attention. For example, a steadily rising tax to GDP ratio is imperative for fiscal sector sustainability. However, the ratio, after expanding for two consecutive years, considerably shrank to single digit in FY19. Even more alarming is the high level of fiscal deficit in spite of a substantial decline in the development expenditures during the year. All this, in effect highlights the fundamental structural deficiencies in Pakistan's taxation system, which can be traced to weaknesses stemming from a low tax base and ad hoc approaches to tax policies. Indeed,

more concerted efforts are needed to improve the tax system; beyond the federal level, provinces should also aim at enhancing their own revenue base.

Another concern is that, although exports posted a substantial growth in terms of volume during FY19, the overall export receipts declined in terms of value. This decline is explained by a reduction in the unit values of the major exporting products, such as apparel, cotton fabric, basmati rice, and leather garments, which otherwise experienced growth in volume terms. It is worth mentioning that regional competitors were also affected by the fall in unit values of such exporting commodities. Meanwhile, the drop in exports of wheat and sugar was attributed to the muted export subsidies on these commodities from Q2 onwards.

Moreover, certain structural imbalances and gaps have been building up over time. Paramount among these is the increasing share of services in the GDP break-up, which are mostly non-tradable, and therefore do not add to the exports base. Meanwhile, the contribution of commodity-producing sectors is weakening. Thus, there is a need for more profound structural reforms aimed at: (a) reversing the decline in commodity-producing sectors by further increasing competitiveness of Pakistani goods in both domestic and international markets through gains at production level; (b) adapting to international trends through good degree of product and market diversification; and (c) facilitating a gradual shift towards exportable services. This will only be possible if there is a meaningful improvement in human capital and productivity. Specifically, the provision of quality education, health, and vocational training needs to receive top priority. Since these are the pivotal factors that would determine the sustainability of growth, efforts are required from both the public and the private sector.

This also involves improving the share of investments in GDP, which has historically remained low in Pakistan especially when compared with other high performing Asian economies. In this regard, a considerable amount of literature singles out the importance of macroeconomic stability and factors such as savings for increasing the share of investments in Pakistan. However, as seen even in times of stability, in not too distant past, Pakistan's share of investments in GDP has stagnated. Therefore, digging beyond the conventional line of thinking of low savings, shallow financial markets, high dependency ratio, or large informal sector, the Chapter 7 of this report identifies the legal and institutional weaknesses which could be held responsible for a low level of investments in Pakistan. These include *de jure* and *de facto* differences in investment policies; stagnancy in SME sector owing, for example, to poor management practices; poor state of the human capital development; dysfunctional institutional and operational infrastructure; and dearth of access to equity and debt financing.

1.2 Review of Developments during FY19

Real Sector

Growth in real GDP decelerated to 3.3 percent in FY19, compared to 5.5 percent last year. While all the sectors of the economy contributed towards this lackluster performance, the major drag came from the commodity-producing sector. The slowdown was broadly attributed to contractionary economic policies and inflationary pressures in the aftermath of exchange rate depreciation. The services sector also grew at a relatively lower pace compared to the last few years.

In agriculture, slower growth could primarily be traced to below par performance of major crops. With the exception of maize, important crops posted lower output compared to last year. Lower water availability, especially in Sindh, constrained the area under cultivation, while low fertilizer uptake (mainly on account of higher prices) was behind less than impressive yields. The rest of the cropping sector was able to post marginal growth owing to some recovery witnessed in oilseed cultivation. Particularly noteworthy was the shortfall in cotton production relative to its annual target for the

seventh consecutive year, attributed to reduced area under cultivation and depressed yields. Taking a leaf from the experiences of peer countries, **Box 2.1** sheds light on policy measures that may be adapted to the local context in order to boost production of cotton, which remains a cash crop and textile industry input of vital importance. Meanwhile, the livestock sector was able to sustain its growth momentum during FY19, driven mainly by value addition in dairy products.

The industrial sector faced a significant fallout of lower fiscal outlay and monetary tightening during FY19. The slowdown was more evident in construction-related industries due to lower investments made by both the public and private sectors. Furthermore, the automobile industry, with its low level of localization, was hit hard by exchange rate depreciation, with assemblers passing on the impact to consumers in the shape of higher retail prices. Meanwhile, the government's continued push towards cheaper sources of fuel for electricity generation undermined the prospects of the petroleum industry. In addition, the performance of the textile and food industries also remained subdued. Within the latter, sugar industry output was hindered mainly by surplus carryover stocks and lower availability of raw material. On the positive side, healthy growth in electricity generation and electricity and gas distribution moderated some of the impact of an otherwise broad-based decline in the industrial sector.

The impact of slowdown in the commodity-producing sector spilled over to the services sector as well. The *wholesale and retail trade* was especially affected from developments elsewhere in the real economy. Similarly, lower deposit mobilization and subdued bank lending to the private sector set the tone for the moderation in *finance and insurance activities*. By contrast, road transport services expanded appreciably, with growth almost doubling compared to a year earlier. Meanwhile, growth in *general government services* remained fairly robust, which may be due to the associated remuneration of the government employees.

Monetary Policy and Inflation

Keeping in view the rising headline inflation, low level of foreign exchange reserves and large twin deficits, SBP's monetary policy committee (MPC) continued with its monetary tightening stance throughout FY19. The committee noted as well the surge in core inflation. The central bank increased the policy rate in all six decisions during the year, by a cumulative 575 basis points.

The inflation was fueled by a number of factors, including underlying demand pressures, increase in administered prices, and pass-through of Pak-rupee depreciation. During the initial months of the fiscal year, core inflation predominantly explained the continuously rising trend in inflation. In the subsequent months, however, a sharp increase in food and energy inflation aggravated inflationary pressures further. Thus, headline CPI inflation in Pakistan clocked in at 7.3 percent during FY19, compared to 3.9 percent last year.

Meanwhile, growth of private sector credit moderated in FY19 as a result of monetary tightening. Importantly, the private credit offtake remained upbeat throughout the first half of the fiscal year, mainly due to heavy working capital financing availed by the export-oriented industries. Subsequently in H2-FY19, the credit growth decelerated as the economic slowdown deepened.

By contrast, government budgetary borrowings increased substantially in FY19 compared to last year. This was because of a significant increase in current expenditures coupled with a slowdown in the revenue collection, which overshadowed the impact of PSDP cut. Further, PSE debt jumped from 4.0 percent of GDP a year earlier to 5.3 percent in FY19. Thus, the growth of money supply remained skewed towards the public sector. This signifies that fiscal discipline needs to be maintained in order to enhance the effectiveness of monetary policy.

Fiscal Policy

Major fiscal indicators deteriorated further in FY19. The overall budget deficit during the year stood at historic high of 8.9 percent of GDP, which was well in excess of the 6.0 percent target set in the Budget 2018-19. This deterioration was due to a sharp decline in revenue collection and a steep rise in current expenditures. It is worth noting that factors beyond the control of fiscal authorities also contributed in the deterioration; these included, among others, a steep rise in interest rates (which escalated the debt servicing burden); legal constraints on the revenue side; and an overall slowdown in the economy.

Total revenues declined by 6.3 percent during FY19, largely stemming from a sharp reduction in non-tax revenues. Tax revenues also stagnated as FBR's collection fell significantly short of the annual target. Provincial collection improved but its level still remained too low to make an impact. A sharp decline in development spending was not enough to control the pace of total spending. The latter grew by 11.3 percent during FY19 as current expenditures recorded a sharp acceleration, mainly due to higher interest payments.

Domestic and External Debt

Debt dynamics deteriorated further in FY19. In absolute terms, Pakistan's total debt and liabilities reached Rs 40.2 trillion by end FY19 – an increase of Rs 10.3 trillion during the year. One third of this increase in TDL was due to financing needs. The rest of the change emerged from revaluation of the external debt stock due to depreciation of PKR, BoP support from friendly countries and lastly a sharp increase in the government borrowing that it has deposited in the banking system.

From debt management perspective, government undertook a major re-profiling of its domestic debt in FY19. The composition of long-term debt in total domestic debt rose from 45.8 percent a year earlier to 73.4 percent in FY19. While this structural shift mitigates the rollover risks, debt servicing may become costlier as a result. Within external debt, the share of commercial loans increased further in FY19. Foreign debt servicing is likely to become more challenging in the future as most of the loans had been secured at floating interest rates. Uptick in international benchmark interest rates or changes in credit rating by the rating agencies may pose serious questions particularly when external debt sustainability indicators have shown deterioration.

External Sector

With the macro adjustment policies in place, the external imbalances that had built up over the past two years started to show improvement in FY19. Specifically, the current account gap narrowed substantially, after reaching a historic high in FY18.

The improvement mainly came from a contraction in both merchandize and services import payments, and a healthy growth in worker remittances. The completion of early harvest CPEC projects and lower PSDP spending led to a sizable reduction in power and electrical machinery imports, whereas the normalization of aircraft import payments also helped. With the policy-induced slowdown impacting construction activity, demand for imported raw materials, such as iron and steel, and of transport fuel for heavy vehicular transport (i.e. HSD) shrank sharply, and contributed to the decline in import payments. Critical support also came from a softening in global oil prices during H2-FY19, which complemented the quantum decline in imports of crude oil and POL products, and led energy import payments to drop in both Q3 and Q4. As a result, the overall import payments declined substantially in the last two quarters, and offset the increase recorded during H1-FY19.

At the same time, worker remittances reached a record high in FY19. Most of the YoY increase came from the US, UK and Malaysia corridors. Encouragingly, inflows from the largest source – Saudi Arabia – also rebounded in the year, after declining over the last two years. The uptick can be traced

to a number of incentives announced for both overseas Pakistanis and commercial banks, to increase the inflow of remittances via formal channels.

Despite the lower current account gap, the country had to arrange significant external financing to meet the upcoming loan and Eurobond repayments during the year. Financial inflows in the form of FDI, private FX inflows into the local equity market, and IFI financing were insufficient to bridge the CAD gap. As a result, the country had to rely on bilateral partners – namely China (both the Chinese government and commercial banks), Saudi Arabia, UAE and Qatar – to meet its external financing needs. Inflows from these sources proved to be critical, and helped cushion the fall in the country's FX reserves.

1.3 Factors Constraining Investments in Pakistan: Beyond the Macroeconomics

Investment is considered an integral part of the economic development process. However, Pakistan's investment to GDP ratio has not only been consistently falling since the 1980s, it also lags considerably behind the rates observed in other regional and peer economies. The macroeconomic determinants such as the overall stability, regulatory uncertainty, low savings rate, shallow financial markets, and a large informal economy are generally referred to in order to explain this worrying trend. However, as **Chapter 7** highlights, the macroeconomic factors alone do not present a complete picture, and investment dynamics in the country are more nuanced.

Over the years, issues such as the discrepancies between investment policies, laws and bilateral treaties, coupled with noticeable differences in the *de jure* and *de facto* operational environment for the enterprises, have also made domestic as well as foreign investors wary of expanding their capital formation activities in the country. Similarly, the complex nature of tax system; perception and incidence of corruption; and cumbersome documentation processes have resulted in a number of firms avoiding documentation of their operations and becoming a part of the tax net. With regard to the private sector, the inadequate management practices of small and medium enterprises have resulted in minimal focus on product innovation, machinery upgradation, operational advancement and growth. Likewise, the low level of human capital development and a poor standing in competitiveness rankings also explains why the country has fallen behind other economies in terms of investment attractiveness, facilitation and growth potential. What becomes evident is that the factors that constrain productive capital formation in Pakistan have been common across both domestic and foreign investors. However, due to limited information available with respect to the perception of domestic investors, the Chapter draws heavily from surveys that capture the opinion/ apprehensions of foreign investors, e.g., OICCI Perception and Investment Survey.

Encouragingly, the government has started focusing on streamlining the tax system and ramping up the policy advocacy and investment retention initiatives led by the country's investment promotion agency (BOI). However, a lot still remains to be done. First, provincial and federal policies on investment and human capital development must be aligned. Second, the investment laws and policy documents need to be modernized in light of the global best practices. Third, while SME segment incentivization is important, it should be carefully crafted to reward all firms with potential and ambition. Fourth, though the recent documentation and tax automation drive initiated by the government would bear positive results in the near future, such policy changes need to be clearly communicated to the private sector to assuage their concerns and ensure proper compliance. Lastly, the state must take a leading role to invest in important segments of the economy in order to provide the private sector with a dependable and conducive ecosystem in which to carry out R&D and capital formation activities.

1.4 Economic Outlook

Macroeconomic stabilization will continue to be the cornerstone of economic policies during FY20. Real GDP growth is likely to remain subdued, though the early signs of recovery are already visible. Development spending may play a pivotal role, since there has been an observed tendency that Pakistan's GDP growth and PSDP spending move in the same direction, and similar has been the case in FY19. On this note, it is worth highlighting that the government has budgeted a greater outlay for PSDP during the year compared to the actual spending in FY19. Other triggers may include an improvement in market sentiments vis-à-vis the IMF program. A better showing by the agriculture sector compared to last year, and further improvement in the current account balance, may also improve the final outcome.

Inflation, meanwhile, is expected to exceed its annual projection by the Planning Commission of Pakistan for FY20 (**Table 1.2**). While demand pressures have generally subsided, cost-related impact may be more pronounced in the first half of the fiscal year, taking the cue from one-off adjustment in prices of utilities and other FY20 budget-related measures. By the second half, further supported by the end of deficit monetization by the government, price pressures may begin to recede, setting the tone for considerably lower inflation in FY21. However, cross-border tensions (which have flared up intermittently since Q3-FY19 and worsened during Q1-FY20) represent an upside risk to this outlook, given their tendency to drive up food inflation. At the same time, the global slowdown may pose a downside risk to the outlook, especially if international oil prices fall more sharply than anticipated.

Table 1.2: Key Macroeconomic Targets and Projections

	FY19	FY20	
		Target[1]	SBP Projections[2]
		percent growth	
Real GDP	3.3	4.0	3.0 - 4.0
CPI (average)	7.3	8.5*	11.0 - 12.0
		billion US$	
Remittances	21.8	24.0	22.5 - 23.5
Exports (fob)	24.2	26.2	25.4 – 25.9
Imports (fob)	52.4	53.7	49.8 – 50.3
		percent of GDP	
Fiscal deficit	8.9	7.1	6.5 - 7.5
Current a/c deficit	4.8	3.0	2.5 - 3.5

Data sources: [1] Ministry of Finance and Planning Commission; [2] SBP
*Projection for CPI inflation, Annual Plan 2019-20, Planning Commission

The external sector's outlook is positive on the whole, albeit being subject to both upside and downside risks. The current account deficit, after shrinking on YoY basis during FY19, is anticipated to subside further in FY20. Exports are projected to pick up during the year, conditional on demand conditions among the country's major trading partners and buoyancy in commodity markets. In particular, onset of fiscal stimulus and successful resolution of trade negotiations involving major economies would be instrumental in supporting global consumer demand, which would in turn bode well for exporting partners, including Pakistan, along with improved prospects of foreign investments. The FTA-II with China and preferential trade agreement with Indonesia may also give a boost to exports. Decline in imports would be instrumental in improving the current account as the policy-induced import compression would continue on top of subdued prices, barring any adverse shock from international oil prices. Moreover, workers' remittances are expected to remain robust in FY20 on the back of measures taken and incentives given to overseas Pakistanis remitting under the Pakistan Remittance Initiative (PRI).

The outlook for the fiscal sector, by contrast, is not straightforward. The FY20 budget looks to fix the deficiencies of the tax system and represents an earnest effort to increase documentation. It envisages a sizeable reduction in the deficit, by enhancing revenues and squeezing expenditures. However, achieving the ambitious tax collection target in the middle of a broader economic slowdown may present a challenge. Moreover, even if things pan out more or less according to plan, the fiscal deficit may be in the neighborhood of 7 percent nevertheless, implying that there would still be some way to

go before fiscal consolidation is achieved. That said, the government is expected to make a concerted effort to meet the IMF's quarterly targets, implying a measure of fiscal discipline.

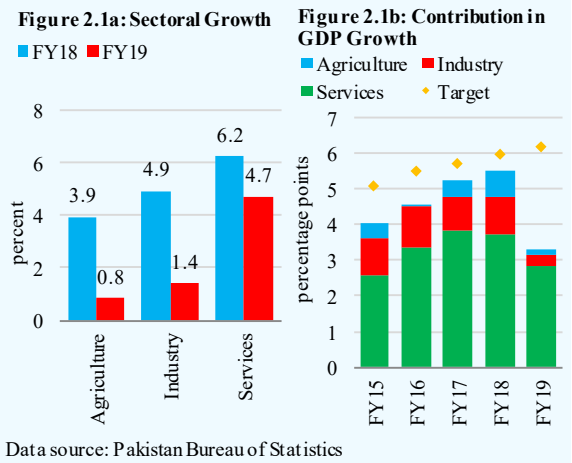
On an optimistic note, the private sector would be mindful that even as the economy rebalances and there is reduced demand in some sectors, new opportunities are simultaneously opening up in other areas. For example, imports of many consumer items and finished goods are shrinking due to a combination of regulatory duties and exchange rate depreciation. This generates an opportunity for domestic companies to step in and fill in this demand in the short to medium term. Moreover, alignment of the exchange rate represents improved prospects for export-oriented enterprises. The government's stated commitment to foster the ease of doing business and pursue investor-friendly policies is also welcome.

Meanwhile, domestic investors should also be looking to tap underserved markets and segments. Beyond provision of traditional goods and services, innovation must be the new watchword. It is especially encouraging to see that proactive, technology-driven domestic startups have already ushered in a positive disruption in industries ranging from banking (fintechs) to transportation (ride-hailing apps) and consumer goods and food (delivery apps), to name just a few. Such examples may inspire those investors who have been sitting on the fence for some time now to abandon the wait-and-see mode, and take positions sooner rather than later. In the grand scheme of things, a collective shift in sentiment and more optimism could prove to be a much needed catalyst for the revival of economic activities.

2 Economic Growth

2.1 Overview

Policy measures taken to subdue the twin deficits had a profound impact on economic activity during the year. Real GDP growth slowed to 3.3 percent in FY19 from 5.5 percent a year earlier, marking the downturn of the growth cycle. The fallout for the industrial sector (especially manufacturing activities) was quite severe, as reflected in the sector's squeezed contribution to GDP growth (**Figure 2.1**). Similarly, the agriculture sector fared poorly on the whole, as water shortages and costlier inputs dented the production of important crops. Growth in the services sector also decelerated visibly compared to last year, owing to its interlinkages with the commodity-producing sectors.



Data source: Pakistan Bureau of Statistics

The agriculture sector registered a marginal growth of 0.8 percent during FY19, in sharp contrast to 3.9 percent growth a year earlier. This was primarily due to a contraction in the production of the crop sector. A sharp decline in output of important crops offset the positive growth in minor crops. Production of major *kharif* crops (except maize) declined, while the main *rabi* crop, wheat, also showed contraction. The *kharif* months were characterized by a reduction in the area under cultivation, largely due to water shortages and low market prices for sugarcane, rice, and cotton in the preceding period. Regarding cotton production, **Box 2.1** touches upon some important aspects and policy lessons from peer countries that can be helpful in boosting output in future.

Furthermore, a hike in input prices during FY19 led to lower fertilizer offtake (particularly DAP) and inadequate application of pesticides, further affecting the yields. The situation noticeably improved in the *rabi* season as healthy rains reduced stress on water availability; however, other constraints persisted along with the lower fertilizer offtake. All these factors led to a decline in wheat yield for the second successive year, although the contraction was of a lower magnitude compared to FY18. Overall, the crop sector's contribution remained negative, and it was the livestock sector's sustained contribution which kept agriculture sector growth in the positive territory. This growth in livestock sector was attributable to contributions by milk and poultry production.

Meanwhile, industrial sector growth fell from 4.9 percent in FY18 to 1.4 percent in FY19, the lowest level in six years.[1] This can mainly be traced to a decline in large-scale manufacturing (LSM) and construction. Construction-allied industries felt the impact of lower public development expenditure and subdued private sector construction activities. In addition, the sugar industry's performance was adversely affected by surplus stocks during the earlier part of the crushing season[2]. In the second part of the season, lower availability of the raw material, sugarcane, hampered crushing activities. The automobile industry contracted due to various issues, such as a ban on purchase of cars by non-tax-filers, increase in vehicle prices prompted by exchange rate depreciation, and higher financing costs.

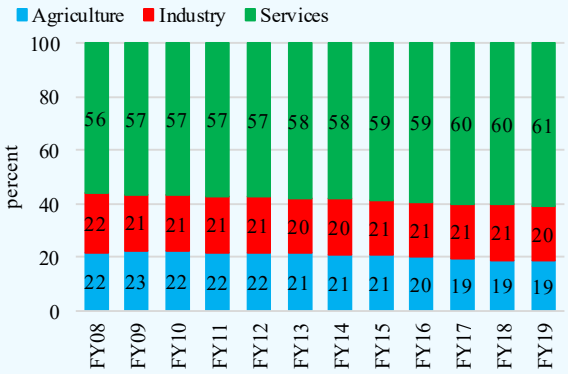
[1] The previous low for the industrial sector's growth (0.75 percent) dates back to FY13.
[2] Sugar mills start their operation in October-November and the season ends in March-April the following year.

Besides the underwhelming results of LSM and construction sectors, mining and quarrying also posted a decline on the back of lower output of coal and natural gas extraction. That said, a silver lining worth mentioning is that significant growth in *electricity generation and electricity and gas distribution* kept overall industrial growth in the positive.

In line with the subdued performance of the commodity-producing sectors, growth in the services sector slackened to 4.7 percent during FY19, compared to 6.2 percent a year earlier. *Wholesale and retail trade*, which accounts for a significant share of the country's GDP, saw its growth nearly halve compared to FY18. Nonetheless, anecdotal evidence regarding the growing popularity of e-commerce activity and mega shopping malls suggests that a certain component of domestic sale of goods and services performed well; this impression is further supported by a 7.2 percent increase in sales tax collection excluding POL products during FY19, compared to 4.8 percent growth in the preceding year (for details, see **Chapter 4**). *Finance and insurance activities* also faced moderation, as deposit generation and lending to the private sector by scheduled banks was relatively lackluster for the greater part of the year. Also, while *general government services* experienced a slowdown compared to FY18, the segment's growth remained relatively robust on account of the real increase in remunerations and pensions of serving and retired government employees respectively. Among the positive developments, growth in road transport services nearly doubled compared to last year.

As it stands, the rising share of the services sector, at the expense of industry and agriculture, needs to be addressed (**Figure 2.2**). The country largely produces non-tradable services that are consumed domestically. At the same time, industrial output, exports and FDI have faltered. This pattern needs to be corrected in order to make the trade deficit sustainable in the years to come. Putting in place a coherent industrial policy should be among the immediate priorities, while a gradual shift away from non-tradable services in favor of exportable services should also be pursued in the medium term.

Figure 2.2: Sectoral Share in GDP*



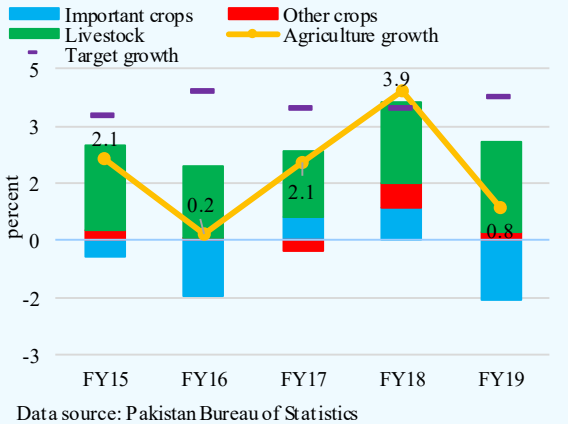
* Rounded off to nearest whole number; shares may not sum to100

Data source: Pakistan Bureau of Statistics

2.2 Agriculture

The agriculture sector's performance remained below target as the sector registered a marginal growth of 0.8 percent in FY19 compared to a notable growth of 3.9 percent last year (**Figure 2.3**). After two consecutive years of commendable performance in FY17 and FY18, the sector's growth contracted due to subdued crops sector output. This was largely on account of considerable decline in production of important crops, with the exception of maize. The *kharif* season months were characterized by reduction in area under cultivation largely due to water shortages and low preceding period market prices for sugarcane, cotton and rice. Furthermore, decline in yields was also noticeable, resulting from the hike in input prices that led to lower

Figure 2.3: Contribution to Agriculture Sector Growth



Data source: Pakistan Bureau of Statistics

fertilizer offtake and inadequate application of pesticides. While the *rabi* season improved as healthy rains reduced the stress on water availability, lower fertilizer offtake led to minimal yield growth for wheat as other factors persisted. The important crops sector contracted by 6.6 percent in FY19, compared to a growth of 3.6 percent in FY18.

While minor crops' growth of 2.0 percent was weaker than an impressive growth of 6.2 percent in FY18, improvements were seen in the production of oilseeds (growth of 22.4 percent) and pulses (growth of 23.5 percent) as compared to last year. Eventually, it was the livestock sector's sustained growth of 4.0 percent, which pushed the agriculture sector growth to the positive territory.

Inputs

On the input front, water availability remained under stress as irrigation water availability in the cropping period (April 2018- March 2019) was 10.4 percent lower compared to FY18. Shortages in FY19 were felt more heavily during the *kharif* season, as total availability was14.8 percent lower than last year. The situation in Sindh, where the groundwater is largely saline, was acute. In Punjab, however, farmers resorted towards tubewells. The prolonged dry spell ended when healthy rainfalls in Q2-FY19 provided relief to farmers in the *rabi* season.

With the lower water availability and the hike in prices, fertilizer offtake contracted by a considerable 6.8 percent in FY19 as compared to a growth of 8.6 percent in FY18. Offtake of urea and DAP dropped by 4.2 percent and 13.9 percent respectively in the FY19 cropping season. This is owed to the strong rise in prices as compared to the last two years. Urea offtake improved slightly in the *rabi* season; however, DAP offtake further receded, leading to a double-digit fall in the total cropping season offtake (**Table 2.1**). The price of DAP rose due to increase in international price and pass through of the PKR depreciation, while urea prices rose due to an increase in the gas tariffs and withdrawal of subsidy.[3]

Table 2.1: Fertilizer Off-take and Prices

offtake in thousand tons; prices Rs per 50 kg bag; growth in percent

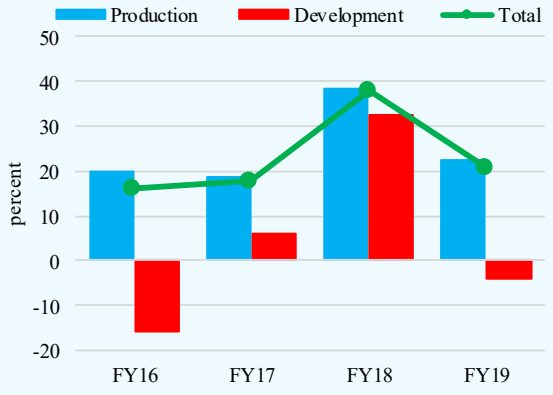
		Offtake			Prices		
		Kharif	Rabi	Total	Kharif	Rabi	Average
Urea	2017	2,704	2,892	5,596	1,648	1,369	1,508
	2018	3,234	2,944	6,178	1,336	1,404	1,370
	2019	2,887	3,033	5,920	1,549	1,783	1,666
	Growth	*-10.7*	*3.0*	*-4.2*	-	-	
DAP	2017	696	1,607	2,303	2,849	2,544	2,696
	2018	994	1,403	2,397	2,597	2,860	2,729
	2019	901	1,164	2,065	3,251	3,576	3,414
	Growth	*-9.4*	*-17.0*	*-13.9*	-	-	-

Kharif is Apr-Sep and Rabi is Oct-Mar

Data source: National Fertilizer Development Center

Given the performance of the crop sector, agriculture credit grew at a lower rate of 20.7 percent in FY19 against 38.1 percent in FY18, with total disbursements reaching Rs 1,174 billion. The growth in disbursements was due to a notable growth in production loans, which are mainly driven by expansion in loans to corporate farming. In contrast, development loans, after notable growth in FY17 and FY18, contracted by 4.1 percent due to lower purchase of tractors and other machinery (**Figure 2.4**). Disbursements to non-farm sector also showed healthy growth, amid rising demand for meat and livestock products.

Figure 2.4: Growth in Agriculture Disbursements



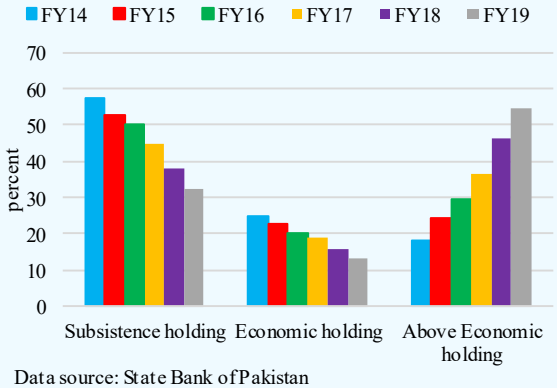
Data source: State Bank of Pakistan

[3] Cash subsidy on urea, at Rs 156 per bag in FY17 and Rs 100 in FY18, was completely eliminated in FY19.

Output

In FY19, the crop sector contracted on account of decline in production of all major *kharif* and *rabi* crops, with the exception of maize (**Table 2.2**). Growth in minor crops, though positive, was noticeably lower compared to FY18; however, oilseed crops' production improved. The contraction in *kharif* crops was largely due to lower area under cultivation as total area under sugarcane, rice and cotton declined by 9.5 percent on YoY and was the lowest in the last 9 years. Furthermore, improvements in yields were insufficient to cover the area losses. At the provincial level, area under major crops in Sindh declined for all crops by a significant 16.3 percent.

Figure 2.5: Holding-wise Disbursements as a Percentage of Total Farm Sector Disbursements



Data source: State Bank of Pakistan

Table 2.2: Performance of Important Crops

growth in percent

				Growth	
	FY17	FY18	FY19	FY18	FY19
Area (in thousand hectares)					
Cotton	2,489	2,700	2,373	8.5	-12.1
Rice	2,724	2,901	2,810	6.5	-3.1
Sugarcane	1,218	1,343	1,102	10.3	-17.9
Wheat	8,972	8,797	8,771	-2.0	-0.3
Maize	1,348	1,251	1,318	-7.2	5.4
Production (in thousand tons; for cotton, thousand bales)					
Cotton	10,671	11,946	9,861	11.9	-17.5
Rice	6,849	7,450	7,202	8.8	-3.3
Sugarcane	75,482	83,333	67,174	10.4	-19.4
Wheat	26,674	25,076	24,279	-6.0	-3.2
Maize	6,134	5,902	6,309	-3.8	6.9
Yield (in kilograms per hectare)					
Cotton	729	752	706	3.3	-6.1
Rice	2,514	2,568	2,562	2.1	-0.2
Sugarcane	61,972	62,050	60,956	0.1	-1.8
Wheat	2,973	2,851	2,768	-4.1	-2.9
Maize	4,550	4,718	4,787	3.7	1.5

Data source: Pakistan Bureau of Statistics

Kharif Crops

Cotton

The year-end production numbers for cotton crop showed a significant dip to 9.9 million bales after two consecutive seasons of gradual recovery in FY17 and FY18. Registering the second-lowest production in the last 10 years, this was a result of a double-digit decline in cultivated area. The contraction in area was 12.1 percent, of which the major share was in Sindh. Contraction in area was mainly due to two main reasons: i) water shortages experienced specifically in Sindh; and ii) lower prices leading to lower returns in the preceding season. Seed cotton prices averaged at Rs. 2,928 per 40 kg for Sept-Mar 2018, compared to Rs. 3,401 for Sept-Mar 2017, a decline of 16.2 percent.

In addition to fall in area under cultivation, yield also declined by 6.1 percent. This is reflected by lower per hectare production in Punjab (**Table 2.3**), despite an improvement in Sindh. The decline in yields was largely due to: i) attack of pests in the harvest season; and ii) adoption of poor agronomic practices.[4] While production growth is mainly driven by enhancement on the area front, improvement in yields through better quality seeds is required. The policy makers are in a process of designing a policy for cotton improvement; however, a major focus area for now is the introduction of a cotton indicative pricing. Indicative pricing is aimed at improving area under the crop, yet there are other aspects and policies that need to be considered. (**Box 2.1**).

[4] Source: Weekly update on Cotton Crop, various issues during FY19

Box 2.1 Cotton Policy: Indicative Pricing & Other Important Aspects to Focus On

The output of cotton crop, which is one of the major cash crops and is crucial for the textile industry, has been significantly lower than the demand in the last several years. Despite being one of the top producers of cotton in the world, Pakistan imports better grade cotton for blending and production of export quality textile products. The average annual local mills' consumption of cotton stands at 13-14 million bales.[5] However, cotton production, which averaged 12.9 million bales per year between FY10-FY15, has dropped to 10.6 million bales on average since FY16, significantly below the government's annual targets. Hence, the shortage in last several years has been an average of 3-4 million bales. The production shortfalls have been the result of reduced area under crop and lower yields (**Figure 2.1.1**). To increase production, one solution is to introduce an indicative pricing mechanism. While the government is still contemplating on it and any details are yet to come out, it is to be noted that the policy of indicative pricing requires significant effort on the part of the government to stimulate private sector procurement at indicative prices. This will have to discard the international pricing benchmark that governs the domestic price of cotton at present. This box highlights the existing policies for cotton in Pakistan and identifies production issues. Furthermore, besides pricing, other important aspects for high and sustainable level of cotton production are discussed with lessons drawn from peer countries.

Existing policies for cotton:

Historically, intervention in the cotton market had been relatively limited as compared to other major crops. Production of the crop is dominated by private farmers, benefiting from the policy of subsidies on inputs such as water and fertilizer, similar to all other crops. Furthermore, the provincial governments have implemented policies for disbursement of seeds at subsidized rates to farmers. At the marketing stage, ginners and spinners purchase cotton at market rates where prices are based on market dynamics and international pricing trends; hence, intervention by the government on this front is absent. On the trade front, Pakistan generally observes minimal tariff restriction on imports; however, to limit inflows and encourage local crop

Figure 2.1.1a: Cotton Area and Yield Trend

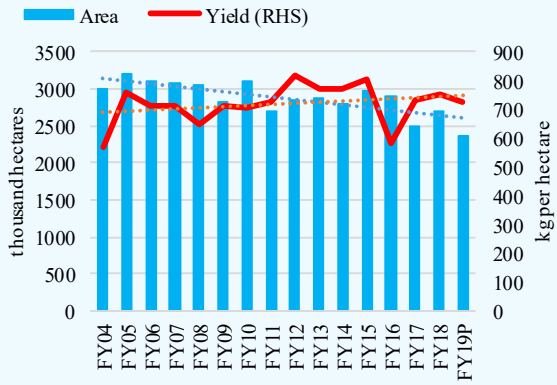
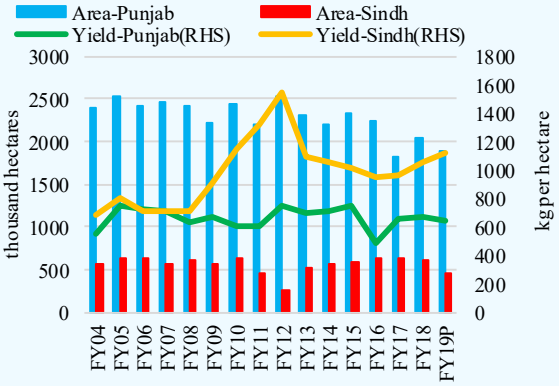


Figure 2.1.1b: Province wise Area and Yield



Data source: MNFSR

consumption, the government imposes tariffs during the harvest season (Jul-Dec). The tariffs are eliminated from January onwards, depending on the size of domestic supply. In Jul-Dec 2018, a 4 percent tariff and a 5 percent sales tax was imposed on imported cotton, whereas domestic cotton was exempted from sales tax. However, due to lower domestic production and absence of high quality varieties, cotton imports have remained significant.

Issues in production:

- The growth rate in production is highly correlated with area under the crop. The area under cultivation has recently been dwindling mainly because of lower profitability of the crop, as it is in direct competition with rice – the exportable crop – and sugarcane, which requires lower usage of fertilizer and is less susceptible to disease. (**Figure 2.1.1a**). Comparison of the cost of production of cotton and other crops shows that return to overall investment is higher for sugarcane and rice.[6]

[5] Source: Pakistan Central Cotton Committee

[6] According to the calculation on the 2015-16 crops, returns to overall investment in Punjab for sugarcane were Rs 237 per day of crop duration and Rs 225 per day for rice. Compared to this, cotton earned farmers Rs 209 per day. In Sindh, sugarcane farmers received Rs 232 per day of crop duration and compared to this cotton farmer received Rs 205 per day. Furthermore, sugarcane earned farmers comparatively higher return of Rs 3.86 per rupee of purchased inputs cost, while cotton earned Rs 2.64 per rupee of input cost in Punjab. Source: Cotton Policy Analysis for 2016-17. Agriculture Policy Institute. MNFSR

- On the yield front, significant gains were achieved 15 years ago when BT cotton entered the market. The average yield between FY00-FY04 was 607 kg per hectare; it jumped to 709 kg per hectare between FY05-09 and 758 kg per hectare between FY10-FY14. Currently, 95 percent of the area is covered in the old generation of BT cotton, a type that presents challenges to farmers due to its increasing ineffectiveness against bollworms. Due to slow process of patenting, Pakistan has been behind its neighbors in enhancing yields and production through the introduction of the latest seeds in the BT line-up.

Policy considerations and lessons from other countries:

In such a situation, policymakers are aiming to implement indicative pricing as part of the cotton policy to encourage area under the crop. However, as highlighted above, the indicative pricing might not be enough and complimentary policies focusing on yields, improved inputs and financing are required. Following are the key policy suggestions and lessons from other countries:

- **Improving agronomic practices**: The issue of production also stems from poor agronomic practices in terms of application of pesticides, picking practices and irrigation application. The pricing policy itself provides limited incentive for farmers to increase yields through adoption of better quality seeds and agronomic practices. As has been observed for both wheat and sugarcane, the gains in yield have been minimal, since most growth in production is achieved through area enhancement. Improving extension services and involving ginners and millers in the farming might improve this process.
- **Seed quality improvement through system of intellectual rights and agreements:** Even though BT cotton was introduced 15 years ago by some progressive farmers, yet it was officially recognized only in 2009, and first grown in 2010. To overcome the delays in official introduction of proper seed technology, improvement in policies such as patenting and licensing of seeds is crucial. The enforcement of the amended Seed Act 2015 and the Plant Breeder's Act of 2018 is key for further improvements in the sector, with provision of necessary intellectual property rights. The Plant Breeders Act will further enhance the development of new variety of seeds. Also, agreements with reputed international biotechnology firms would facilitate the adoption of new generation pest resistant seed varieties. As compared to Pakistan, India in 2002 legally introduced the BT cotton technology through agreement with Monsanto. There the improved systems of intellectual property rights and availability of legal seeds largely prevented the penetration of low quality fake seeds.
- **Financing for high quality seeds**: Access to credit is crucial for the purchase of high-yielding seeds and adoption of improved technology. One example is China, which has been providing subsidized credit to cotton farmers to obtain better quality seeds. Attractive financing options mean that farmers will focus on buying good quality seeds and resultantly the final product will improve.
- **Crop insurance for changing weather patterns**: The cotton crop is more prone to weather changes, as rainfall at harvest times and high levels of humidity result in the emergence of various pests. Going forward, climate change is expected to further increase weather unpredictability, leading to further losses. Despite indicative pricing, production might suffer unless the agronomic practices are improved, while also taking account of weather conditions. Given the erratic weather nature and climate change, insuring cotton farmers under a comprehensive insurance policy is needed to mitigate risks and increase investment. Several Asian countries, such as India, Thailand, and Vietnam, have developed government subsidized insurance systems that protect small farmers and mitigate the risk of crop damages. In FY19, Punjab implemented an insurance program for cotton farmers under the World Bank SMART program, compensating a small number of participating farmers for yield shortfalls. However, such a program needs to be implemented across the country to increase investment in high quality inputs and introduce better crop management practices.
- **Targeted subsidy:** A targeted subsidy might be better, as observed in the case of China. In 2017, China started a target price-based subsidy policy for Xinjiang, one of its major provinces where yields were relatively higher. Since then, Xinjiang has received higher subsidies compared to other provinces, motivating farmers in other, lower yield cotton producing regions to switch to other important crops. Furthermore, instead of announcing the price every year, the Chinese government announces it every three years, to curb fluctuations in annual output. In similar vein, policies at the district level in Pakistan may be implemented to encourage production in districts with higher yields to achieve maximum production rather than an overall indicative pricing.

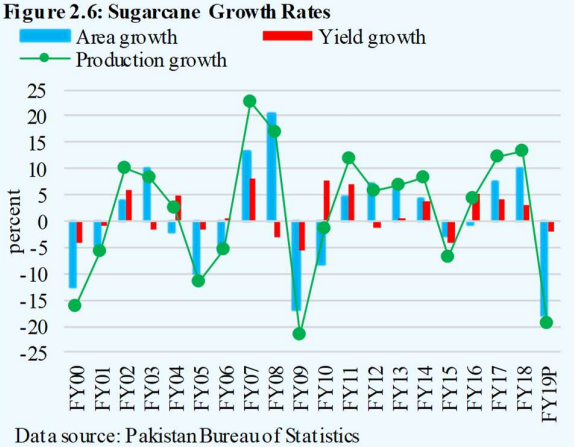
Given the highlighted issues in area and production, in addition to an introduction of indicative pricing, a multi-pronged approach needs to be adopted to ensure higher quality and sustained production levels.

Sugarcane

Sugarcane production declined to 67.2 million tons, compared to a record output of 83.3 million tons last year. The double digit drop resulted from a sizeable reduction of 17.9 percent in area under cultivation in all provinces due to delay in payments to growers in the preceding season, coupled with water shortages. Area shrunk by double digits in Punjab and Sindh, while cultivated area in the latter was the lowest in the last 6 years. Moreover, decline in yields compounded the impact of reduced area. Decline in yields was a result of lack of high yielding varieties and inadequate fertilizer and pesticide usage.

In order to incentivize the farmers to grow enough sugarcane that can fulfill domestic demand for sugar, the government continued its policy of indicative pricing in FY19. However, the price was kept unchanged between Rs 180-182 per 40 kg – its FY18 level – despite the inching up of the cost of production.[7] This, along with the backlog of payments to the sugarcane farmers amid unsold surplus sugar stock, played the major role in holding back sugarcane production. Since similar issues have been recurring for the past few years, there are hardly any incentives to enhance yields, let alone to bring more area under cultivation (**Figure 2.6**). In the FY20 budget, the government, in its agriculture sector plan, has targeted an improvement in yields, which is a step in the right direction.[8]

Figure 2.6: Sugarcane Growth Rates



Data source: Pakistan Bureau of Statistics

Rice

Despite a 3.3 percent drop, rice production surpassed its target and reached a decent 7.2 million tons in FY19. The YoY decline was largely the result of a double digit decline in area under cultivation in Sindh, which led to a 9.8 percent contraction in the province's production. Plantation in Sindh was the lowest in the last 5 years, and even though yield per hectare rose by 8.2 percent, it was still insufficient to cover the fall in area.

Detailed data at the variety level shows that even though production of basmati variety delivered gains, the expansion was unable to offset the decline in irri and hybrid varieties (**Table 2.4**). In Sindh, the major producer of non-basmati varieties, severe early sowing period water shortages resulted in lower area under cultivation, while marginal improvement was observed in basmati cultivation. Going forward, if water shortages persist, it would hamper cultivation of non-basmati varieties.

Table 2.4: Rice Crop Variety-wise Area and Production

growth in percent

	Punjab			Sindh		
	FY18	FY19	Growth	FY18	FY19	Growth
Area (in thousand hectares)						
Basmati	1416.4	1473.0	4.0	55.2	57.4	4.0
Irri	134.8	133.5	-0.9	351.6	262.0	-25.5
Hybrid	-	-	-	393.9	351.3	-10.8
Total	1840.9	1903.9	3.4	828.4	690.3	-16.7
Production (in thousand tons)						
Basmati	2816.6	2949.2	4.7	76.5	79.0	3.3
Irri	362.5	351.1	-3.2	878.3	761.4	-13.3
Hybrid	-	-	-	1863.1	1706.0	-8.4
Total	3898.0	3979.1	2.1	2850.4	2571.1	-9.8
Yield (in kg per hectare)						
Basmati	1988.6	2002.2	0.7	38.6	37.6	-2.5
Irri	2690.1	2630.0	-2.2	149.8	190.6	27.2
Hybrid	-	-	-	373.0	385.9	3.5
Total	2117.5	2089.9	-1.3	244.1	272.5	11.6

Data source: Pakistan Bureau of Statistics

Rabi Crops

Wheat

Wheat production was recorded at 24.3 million tons, which according to the latest estimates stands 4.9 percent short of the target of 25.5 million tons.[9] This shortfall in production was the result of untimely rainfall and unforeseen hailstorms in the harvest period. The contribution of cultivated area to production was satisfactory, as area under cultivation marginally declined to 8.7 million hectares compared to 8.8 million hectares in FY18. However, untimely rains in Q3-FY19

[7] The cost per 40 kg at mill gate in FY19 was calculated at Rs 179.0 for Punjab and Rs 178.1 for Sindh (source: MNFSR).
[8] Source: PM's Agriculture Emergency Program- Pakistan Economic Survey 2018-19- Ministry of Finance.
[9] This production level for wheat is different from the one in the Economic Survey of Pakistan 2018-19, as it incorporates losses due to rainfall. Data source: Brief on Wheat 16.09.2019 by Ministry of National Food Security & Research.

caused noticeable damage to the standing crop, resulting in production falling below the 25 million-ton mark for the first time in six years.

This second consecutive yearly decline in wheat production was primarily due to four developments: (1) delayed cane crushing led to decline in area under cultivation; (2) inadequate nutrient offtake, particularly potash (-13.0%) and phosphorous (-13.8%) during Oct-Feb due to higher prices, which resulted in lower yield; (3) heavy rains in the harvest period, particularly in mid-April that resulted in crop losses, especially in southern Punjab; and (4) higher prevalence of rust disease due to untimely rains.

Another important reason for decline in area under cultivation and lower yields in the last 2-3 years could be the unchanged support price amidst increasing input prices, which reduced the crop's profitability. The support price offered to farmers has been Rs 1,300 per 40 kg, which was last changed in FY14 from Rs 1,200. The positive impact of the support price on production seems to be over as farmers' returns have substantially been squeezed due to hike in prices of major inputs, such as fertilizer, seeds and labour. The analysis of *rabi* period data for fertilizer shows that urea and DAP prices increased by 30.2 percent and 40.1 percent respectively since FY17.

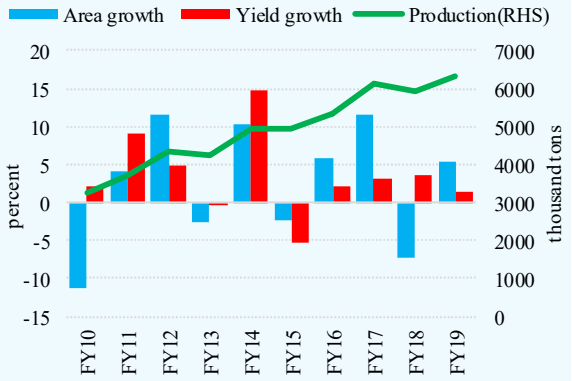
The stocks of wheat at the start of May 2019 were 3.8 million tons compared to 7.3 million tons in May 2018. However, despite this, the total procurement was 4.0 million tons, significantly lower than the revised target of 5.2 million tons and last year's procurement of 5.9 million tons.[10] The decrease in production and lower stocks compared to last year led to farmers receiving better prices, particularly in Punjab. Prices rose on account of lower supply and higher demand. Raw wheat market prices at the national level rose on average by 6.9 percent during Apr-Jun FY19 compared to the same period last year.

Maize

In sharp contrast to other important crops, maize crop performed much better, with production rising 6.9 percent YoY to a record high of 6.3 million tons. The notable performance was primarily the result of a recovery in area under cultivation of 5.4 percent, after a reduction of 7.2 percent in FY18 (**Figure 2.7**). The expansion in cultivated area was mainly in Punjab, with a growth of 9.5 percent. In case of Khyber Pakhtunkhwa (KP), with contribution to total land of 35 percent, improved production was achieved on the back of yield enhancements.

The crop has rapidly expanded its share within the important crops, increasing from 8.8 percent in FY15 to 11.8 percent in FY19. The growth is primarily attributable to the use of hybrid seeds and the complete package of extension services and technology transfer provided by private seed companies. Government intervention in the corn crop is limited to 30 percent duty on imports to protect producers. The trade is limited to the private sector, with the poultry sector being the major consumer of the crop. Hence, the manufacturers have heavily invested in the research of seed and provide advisory services and technology transfer. The country's third

Figure 2.7: Maize Production, Area and Yield

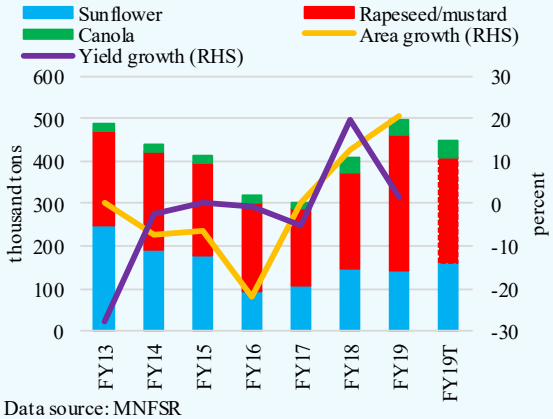


Data source: Pakistan Bureau of Statistics

[10] Data source: SUPARCO Monthly Bulletin Vol 9 Issue 6, June 2019

largest grain crop previously showed impressive yield improvements in FY14, but the yield gains have gradually slowed down, with improvement of only 1.5 percent coming in FY19 (**Figure 2.7**). Further research and improved agronomic practices are needed to boost the yields further.

Figure 2.8: Oilseeds Production, Area and Yield Trends



Data source: MNFSR

Other Crops

The growth in minor crops, despite being positive, remained lower than FY18's growth rate. A breakup of the data shows that oilseeds performed noticeably better, continuing on a path of production recovery since FY17, with production growth of 22.4 percent YoY. The total oilseeds output achieved the target largely due to improvement in rapeseed & mustard production. Canola and rapeseed/mustard showed commendable growth of 10.5 and 41.3 percent respectively.

The encouraging performance was primarily driven by improved area under the crop which grew by 20.4 percent, while yield growth was a minimal 1.7 percent (**Figure 2.8**). Province-wise breakdown reveals that sunflower sowing in Sindh and canola and rapeseed/mustard sowing in Punjab were the main drivers of the noticeable area growth. Lack of timely availability of seeds led to lower than target area under crop for sunflower in Punjab with farmers shifting to canola and rapeseed/mustard. Whereas in Sindh, availability of good quality seeds led to higher production of the sunflower crop. Going forward, the Punjab government's efforts to provide certified seeds at subsidy is expected to enhance sunflower and sesame seed output.

Livestock

The livestock sector grew at a higher rate of 4.0 percent in FY19 against 3.7 percent last year, offsetting the impact of negative growth in crop production. The sector's performance was mainly driven by value additions in milk and related products, which has the highest share in gross output (**Table 2.5**).

Table 2.5: Value Added in Livestock

billion Rupees; growth in percent

	FY18	FY19	Growth	
			FY18	FY19
A. Gross output	1,666	1,724	3.4	3.5
Animal sold for slaughtering	381	392	2.9	2.9
Natural growth/regeneration	231	238	3.0	3.0
Livestock products	872	898	3.0	3.0
Milk	747	771	3.2	3.2
Others	125	127	1.5	1.6
Poultry products	175	189	7.8	7.9
B. Intermediate consumption	291	294	2.9	1.0
C. Gross value added (A-B)	1,375	1,431	3.6	4.0
D. Other GVA*	9	9	19.4	4.9
E. Total GVA	**1,384**	**1,440**	**3.7**	**4.0**

R: Revised, P: Provisional, * hunting & animal husbandry

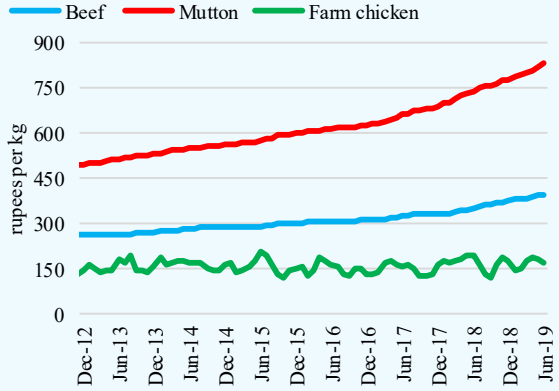
Data source: Pakistan Bureau of Statistics

The federal level data shows continued growth of the livestock sub-sector, averaging at 3.5 percent during FY13-FY19, in contrast to other major sub-sectors within the agriculture sector. Derived mainly from increase in animal production and its impact on the livestock products, this growth, on aggregate level, is in contrast to several developments: (i) fodder crop, one of the main livestock inputs, declined by 1.4 percent this year, while the production of most cereal crops contracted as well; and (ii) the Livestock Census conducted by Punjab in 2018 reveals that the milk production was around 18 billion liters in 2018,

which is not much different from the average production during 2006 and 2015.[11] This was largely due to the fact that in Punjab the cattle and buffalo herd population, according to the Livestock Census 2006, Agriculture Census 2010 and the latest Punjab Livestock Census 2018, stagnated at around 29 million.

Another important trend observed over the years is the growth in prices of beef, mutton and milk. On the other hand, market prices of poultry have stabilized between Rs 100 to Rs 200 per kg of live broiler, which is in line with the higher investment in the poultry sector and the rapid emergence of poultry farms. However, the upward trend in mutton and beef production shows less consummate growth, recorded at 4.7 percent for FY19, to meet the rising external and domestic demand (**Figure 2.9**).

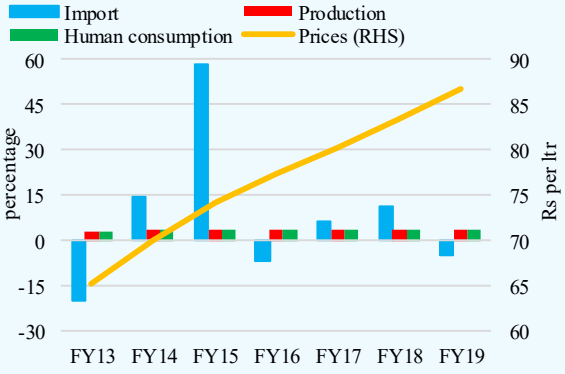
Figure 2.9: Livestock Products Prices



Data source: Pakistan Bureau of Statistics

Furthermore, in the milk market, the data published by PBS and generated by the MNFSR shows that consumption and production on average grow at the same rate. However, the yearly growth in milk imports shows fluctuations that are not in line with production and consumption growth rates. This makes it hard to understand if domestic milk production was in line with domestic milk demand or if there was any mismatch. The impact of exchange rate depreciation could be a reason for decline in milk imports during FY19 (**Figure 2.10**), but to substantiate the exact input and output situation in the sector there is a need to conduct the long due National Livestock Census. This will facilitate in establishing the true population of animals and quantity of milk and meat produced every year.

Figure 2.10: Growth in Milk, Production Consumption and Imports



Data source: Pakistan Bureau of Statistics

2.3 Industry

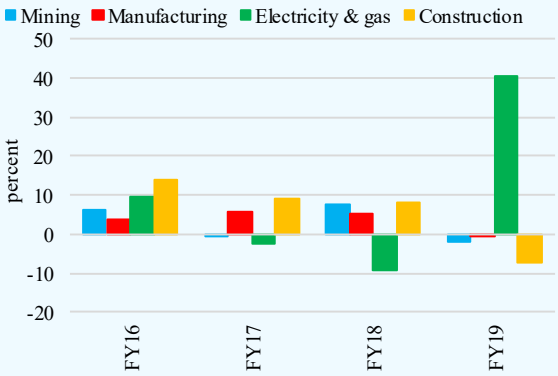
Growth in the industrial sector slowed down from 4.9 percent in FY18 to 1.4 percent in FY19. The major drag came from the manufacturing subsector, which carries the highest weight in the industrial sector. Within manufacturing, small-scale processing and slaughtering segments were able to maintain a similar level of growth as last year. However, the LSM sector was not able to withstand constraining economic environment triggered by exchange rate depreciation and contractionary monetary and fiscal policies. LSM performance turned negative for the first time in the last 10 years, as it fell by 3.6 percent in FY19 against positive growth of 6.4 percent in FY18.

Meanwhile, mining & quarrying and construction segments also witnessed notable declines during the year after posting healthy growth last year. Mining registered negative growth that can be traced back

[11] Source: Livestock Census Punjab 2018. Available online at http://www.livestockpunjab.gov.pk/LiveStockAdmin/uploads/editor_files/livestock_census_punjab_2018_sven4.pdf

to a decline in natural gas and coal extraction. Construction activities in the country dipped sharply on account of lower PSDP expenditure as well as a slowdown in the rest of the economy.

Figure 2.11: Industrial Subsectors Growth



Data source: Pakistan Bureau of Statistics

On an encouraging note, the growth of electricity generation and electricity and gas distribution subsectors turned positive. From the contraction of 9.1 percent in FY18, it increased by 40.5 percent in FY19, phenomenally exceeding the target of 7.5 percent (**Figure 2.11**). The growth in this sector can largely be attributed to increase in expenditure on gross fixed capital formation for capacity additions in the past few years, adjustment in energy prices, and higher consumption of electricity. That said, investment has now shifted from production towards development of transmission network, particularly in Karachi. This is evident from significant pick-up in fixed investment loans by the power sector.

Large-Scale Manufacturing

LSM witnessed contraction of 3.6 percent in FY19 against healthy growth of 6.4 percent in FY18. (**Table 2.6**). Barring electronics and fertilizer industries that posted noteworthy increases, a broad-based decline was recorded in FY19 in the rest of the sector. Construction-allied, automobile and POL industries, which had driven LSM growth in the past four years, experienced downturns as contractionary economic policies took hold. Moreover, two large industries, textile and food, with a combined share of 47.3 percent, also registered declines.

Table 2.6: Growth in LSM
percent

	Weight	Growth			Contribution in growth		
		FY17	FY18	FY19	FY17	FY18	FY19
LSM	70.3	5.8	6.4	-3.6	5.8	6.4	-3.6
Textile	20.9	0.8	0.5	-0.2	0.2	0.1	0.0
Cotton Yarn	13	0.7	0.1	0.0	0.1	0.0	0.0
Cotton Cloth	7.2	0.4	0.0	0.2	0.0	0.0	0.0
Jute Goods	0.3	8.1	23.9	-9.5	0.0	0.0	0.0
Food	12.4	11.7	3.0	-7.2	2.4	0.6	-1.5
Sugar	3.5	37.8	-6.8	-19.9	2.5	-0.6	-1.5
Cigarettes	2.1	-35.8	72.0	2.8	-0.7	0.8	0.1
Vegetable Ghee	1.1	3.1	10.7	-2.8	0.0	0.1	0.0
Cooking Oil	2.2	2.7	0.7	2.1	0.1	0.0	0.1
Soft Drinks	0.9	13.7	0.3	-6.3	0.4	0.0	-0.2
POL	5.5	2.8	13.2	-8.4	0.2	0.8	-0.5
Steel	5.4	20.5	21.8	-11.2	0.7	0.8	-0.5
Non-Metallic Minerals	5.4	4.4	11.0	-2.4	0.5	1.2	-0.3
Cement	5.3	4.5	11.1	-3.0	0.5	1.2	-0.3
Automobile	4.6	11.2	17.8	-11.8	0.7	1.2	-0.9
Jeeps and Cars	2.8	5.4	21.4	-6.2	0.2	0.7	-0.2
Fertilizer	4.4	1.7	-9.9	7.7	0.1	-0.6	0.4
Pharmaceutical	3.6	9.1	1.3	-7.7	0.8	0.1	-0.6
Paper	2.3	9.6	9.4	-2.5	0.3	0.3	-0.1
Electronics	2	21.6	97.1	12.5	0.4	1.8	0.4
Chemicals	1.7	-2.3	-0.3	-3.6	-0.1	0.0	-0.1
Caustic Soda	0.4	-0.6	20.7	-8.7	0.0	0.1	0.0
Leather Products	0.9	-16.5	-10.6	2.3	-0.3	-0.2	0.0

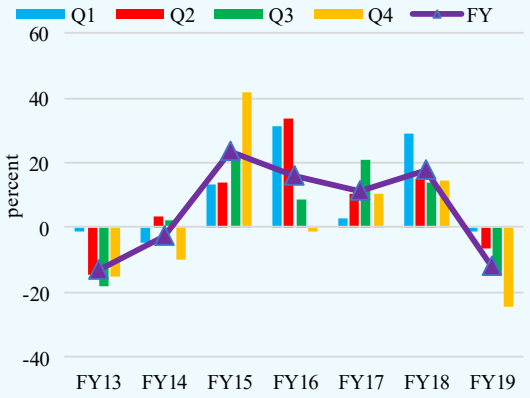
Data source: Pakistan Bureau of Statistics

Automobile sector

After witnessing growth of 17.8 percent during FY18, the automobile industry contracted by 11.8 percent in FY19 (**Figure 2.12**). A combination of macroeconomic and industry-specific factors was responsible for this dip in performance. The exchange rate depreciation led to assemblers passing on the impact of increase in cost to their customers. In addition, higher interest rates lowered demand from the private sector. On the regulatory side, restrictions on purchase of vehicles for non-filers and imposition of regulatory duties on high-end cars further restrained demand.

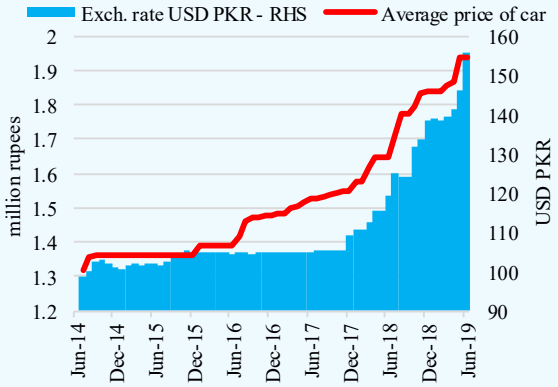
The price of vehicles rose sharply as the exchange rate continued to depreciate throughout the year. The close linkage between car prices and exchange rate depreciation is illustrated in **Figure 2.13**. This is due to low localization levels of the domestic industry.[12] The figure shows the prices increased in tandem with the PKR losing its value against the US dollar. Furthermore, the exchange rate depreciation resulted in an increase in domestic fuel prices. While the price of oil remained relatively stable in international markets, the domestic price of fuel – diesel and petrol – rose by 24.1 percent in FY19, increasing the operating costs of vehicles amid declining real incomes.

Figure 2.12: Automobile Sector Growth



Data source: Pakistan Bureau of Statistics

Figure 2.13: Impact of ER depreciation on Car Prices



Data source: Pakistan Bureau of Statistics, SBP

In addition to the impact of the exchange rate depreciation, higher interest rates also changed the market environment for the automobile industry, as it escalated the financial costs for consumers. This is evident from banking data, which shows that consumer car financing declined to Rs 22.2 billion in FY19, compared to record lending of Rs 43.3 billion just a year earlier.

Regulatory measures taken by the government also influenced the sector's performance. In continuation of the policy to document the economy, the government placed restrictions on purchase of vehicles for non-tax-filers at the start of the year. This effectively barred the large informal segment from purchasing cars. As growth of the sector turned negative, the government in Q3-FY19 allowed non-filers to purchase vehicles below 1,300cc in order to improve demand for vehicles.

Another regulatory measure during Q3-FY19 was the introduction of 10 percent federal excise duty on cars with engine displacement greater than 1,700cc. It increased the price of luxury variants by the same percentage, as assemblers passed on the tax to the consumers. As a result, the demand for these vehicles dipped and affected segment's growth.

[12] The localization level is around 45-60 percent, according to market sources.

At the same time, to alleviate the pressure on BoP, the government started to implement the gift and baggage schemes of vehicle import policy in its true spirit. Further, the government amended the policy, which now required duties and taxes to be remitted in foreign exchange by the person importing the vehicles. This had a positive impact on the domestic automobile sector, as it helped divert the customers from imported vehicles toward locally produced variants. Consequently, by the close of the year, the import bill of cars had decreased from US$ 455.2 million in FY18 to US$ 222.0 million in FY19.

The significant decline in production of 800cc cars can be explained by discontinuation of a popular variant by a manufacturer in Q3-FY19 (**Table 2.7**). Meanwhile, the SUV segment posted a decline due to substantial price increase. Commercial vehicles also witnessed contraction of 3.1 percent in FY19, primarily due to a sharp increase in prices and uncertain economic outlook.[13] The slowdown in construction and trade activities also hampered the growth in production of trucks in FY19.

Table 2.7: Automobile Sector Production

					Growth	
	FY16	FY17	FY18	FY19	FY18	FY19
All Cars	149,856	167,405	195,895	191,526	17.0%	-2.2%
Cars <800 cc	36,869	38,311	47,199	32,121	23.2%	-31.9%
Cars between 800-1000 cc	26,276	35,313	49,848	56,760	41.2%	13.9%
Cars >1000cc	86,711	93,781	98,848	102,645	5.4%	3.8%
Sports Utility Vehicles	773	3,530	13,364	7,525	278.6%	-43.7%
Light Commercial Vehicles	65,924	43,796	50,934	42,182	16.3%	-17.2%
Trucks	5,666	7,712	9,187	6,035	19.1%	-34.3%
Buses	1,070	1,118	784	913	-29.9%	16.5%
Tractors	34,914	53,975	71,894	49,902	33.2%	-30.6%
Motorbikes	1,362,096	1,632,965	1,928,757	1,766,423	18.1%	-8.4%

Data source: PAMA

The lower production of major crops in FY19 hurt tractor and motorcycle demand in the country. These segments rely on the performance of the agriculture sector; as incomes in rural areas remained stagnant, the sector was not able to provide the necessary impetus for the automobile sector in general and tractors and motorcycles in particular.

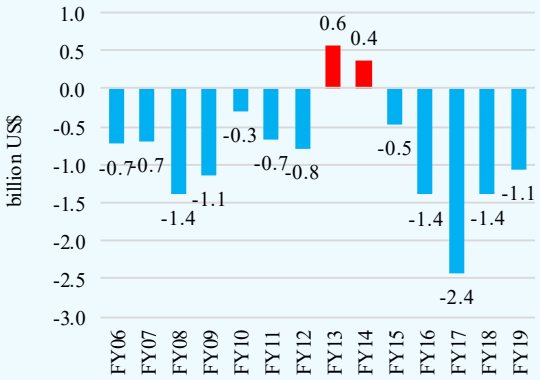
At present, when new assemblers are starting their production activities, especially in the car segment, some aspects need attention. Past experience of car manufacturers that had entered and later exited the market reveals that in addition to setting up assembling units, the entrants have to develop a dealership and service network throughout the country and ensure availability of parts in order to gain foothold in the domestic market. In addition, a critical factor that could facilitate the newcomers would be an enhanced scope and effectiveness of the auto finance market; estimates indicate that only one in ten cars is purchased through financing at present, whereas the ratio is close to eight-in-ten in many countries.

[13] Also, a few manufacturers in this segment have not been accounted for, neither in the LSM nor PAMA data, and that may have also altered the results of the sector.

Food

Growth of the food industry turned negative in FY19, with production contracting by 7.2 percent. The subdued performance does not bode well for an agricultural country like Pakistan. From the standpoint of international trade, Pakistan remains a net importer of food products (**Figure 2.14**). Net imports had averaged US$ 1.6 billion in the last four years. Major imports include palm oil, pulses, milk products and tea, accounted for 55.6 percent of the US$ 5.7 billion bill.

Figure 2.14: Net Food Imports



Data source: Pakistan Bureau of Statistics

Whereas there was improvement in net exports in FY19, it had more to do with depressed international prices of palm oil and pulses rather than quantities imported. Output of the local food industry declined in FY19. Furthermore, only a marginal increase in fixed investment in the sector was recorded. Taken together, it does not paint a bright outlook for the industry. Except for rice, the industry has predominantly catered to local needs only. This inward-looking approach is one explanation for low growth of this sector.

FY19 proved to be another year of below par results for the food processing sector. As was the case last year, the major drag came from sugar industry due to its weight in the food group. Other industries within the food group could not compensate for the substantial decline in sugar output. As a result, overall output of the food industry declined in FY19.

Given that agriculture is still the mainstay of the economy, the country needs to substitute imports of several commodities with localized production. This would significantly ease the pressure on BoP originating from the import of food items. For instance, palm oil imports, which constitute one-third of the food import bill, can be reduced by focusing on developing a domestic oil seed industry.

Sugar

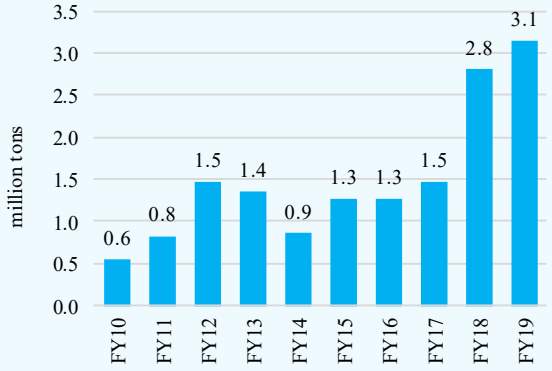
Several factors hurt the sugar sub-component in FY19. First, there was lower availability of sugarcane in FY19, after a record crop in FY18. Last year saw growers selling their product at almost 50 percent discount to indicative prices. In response the growers curtailed the area under sugarcane in FY19 by 17.9 percent.

Second, the liquidity situation of the sugar mills (and, by extension, the growers) got worse in the presence of record stockpile of sugar at the start of the crushing season. The country had accumulated stocks of 3.1 million tons, the highest ever, at the start of FY19 (**Figure 2.15**). It culminated in delayed payments to the growers as stocks went unsold. Meanwhile, the high interest rate environment further constrained the mills' operations.

Third, on the export front, the country exported 0.7 million ton of sugar in FY19 against the allowed quota of 1.1 million. While all exports of 1.5 million tons were made possible through subsidy scheme last year, the country managed to offload some of the stocks without subsidy at the start of the crushing season in FY19. However, the exports gained momentum once the Punjab government announced an export subsidy of Rs 5,350 per ton in Q3-FY19

Another favorable development for the sugar industry towards the end of the year was that the depreciation of the local currency made exports viable without support of subsidies. **Table 2.8** illustrates this point. The sugar industry's crushing capacity is dependent on the availability of sugarcane, and given the country's surplus production, it can earn significant foreign exchange by exporting the commodity. Going forward, this may have a knock-on effect on the industry. As the liquidity position of the sugar mills improves, the financial situation of the growers may also get better.

Figure 2.15: Sugar Carryover Stocks at Start of Period



Data source: USDA

Another source of concern has been the indicative pricing mechanism for sugarcane. Provincial governments, which announce the price of sugarcane at the start of each crushing season, have not changed them in the last 5 years. Setting a high price for sugarcane has resulted in surplus production of both the crop and sugar. The same pricing issue hampered growth in FY19 as well. Respective governments again fixed the indicative price at the same level. Production remained above the consumption level in FY19, albeit by a smaller margin compared to the last few years. Meanwhile, on the trade front, the price differential between the domestic and international markets meant that exports were not possible without subsidy for majority of the year.

Table 2.8: Average Sugar Prices

US$ per ton

	Pakistan	International	Differential
FY15	491	398	-93
FY16	475	412	-63
FY17	469	517	48
FY18	448	365	-83
FY19	366	337	-29
June FY19	**313**	**337**	**25**

Data source: USDA, Ministry of Finance

Given the surplus sugar production in the past few years, one avenue for the industry can be the development of an ethanol market for domestic consumption. Ethanol blended with fossil oil fuels enhances their octane rating. This can be done in coordination with oil marketing firms and refineries. In addition, developing an ethanol fuel industry would create employment, decrease emissions and reduce dependence on imported fuels. Such a transition would also provide an opportunity for the industry to shift from sugar to ethanol production whenever oil prices rise relative to sugar prices.

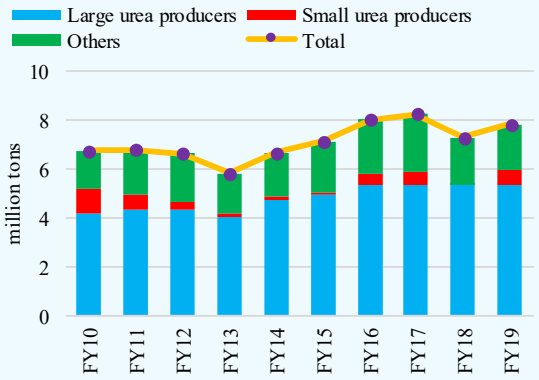
The government had earlier attempted to introduce ethanol blended fuels, but it was not able to gain traction in the market. While a lot of countries around the globe use such fuels, a lack of awareness and negative bias towards such fuels in the local economy meant that their acceptance remained poor. This happened despite the fact that fuel ethanol has a higher RON (Research Octane Number) rating than regular gasoline. Moreover, limited availability of ethanol after the sugar crushing season, also undermined its uptake in the country.

Fertilizer

The domestic fertilizer production can be broadly classified into three categories: (1) urea produced by large, efficient firms that have guaranteed and subsidized domestic gas supplies and tend to post little variation in output; (2) small urea manufacturing firms, whose operations predominantly depend

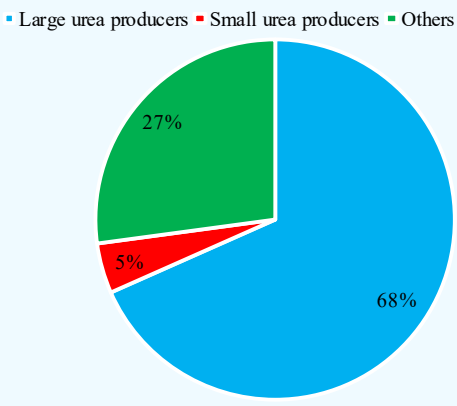
on the government's decision for allocation and price of natural gas; and (3) other fertilizer producers (**Figure 2.16**).

Figure 2.16a : Fertilizer Production



Data source: NFDC

Figure 2.16b: Average Share in Production Shares FY15-19



Pakistan is self-sufficient in urea production, as the industry at full capacity can meet domestic requirements. When smaller units halt production due to diversion of gas to other industries, the government allows import of the commodity. Although addition of RLNG in the energy mix has increased the total availability of gas, it is considerably more expensive than local gas. Given that natural gas accounts for around 70 percent of the cost of urea, small firms are priced out of the market.

To resolve the gas supply issue faced by smaller firms, the government decided to share half of the cost of RLNG in FY19, which helped to revive activities at small urea producing units. At the same time, the output from large urea and other fertilizer manufacturers was recorded at the same level as last year. Thus, small urea firms proved to be the main driver of growth in FY19. Overall output of the industry expanded by the same magnitude as the increase in production of small units, registering growth of 7.7 percent during the year.

Construction Allied Industries

As the economy went into a downtrend, construction allied industries (steel and cement) could not maintain their growth trajectory and contracted significantly in FY19. Aided by public spending, CPEC and private sector investment, the sector had grown impressively on the back of capacity expansions in recent years.

PSDP spending went down from Rs 1,456 billion in FY18 to Rs 1,008.2 billion in FY19. With a major component of this expenditure typically going into construction activities, the considerable slowdown in spending hurt cement and steel industries. Meanwhile, the sector's growth was also weighed down by completion of early harvest CPEC projects.

Developments related to the private sector also played a part. Uncertainty in the real estate market regarding restrictions on non-filers had a negative impact on the industry.[14] In addition, sharp increase in prices of building materials, especially imported goods following the PKR depreciation, also contributed to the slowdown. In the midst of rising costs and uncertain economic outlook, buyers

[14] The government imposed a ban on non-filers from transferring and purchasing properties in excess of Rs 5.0 million.

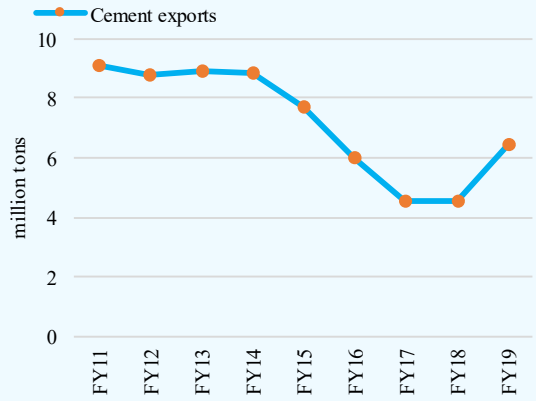
and investors remained cautious, resulting in much lower turnover of real estate transactions during FY19.

Cement

Cement production declined by 3.0 percent in FY19 compared to a double digit growth of 11.1 percent in FY18. The dip in performance can mainly be attributed to the factors outlined above. Prior to FY19, the sector had grown by 7.4 percent per annum during the past 12 years on the back of healthy economic growth.[15]

The tone for FY19 was set early on, as the fiscal year got underway with low PSDP spending under the interim government and a ban on purchase of properties of more than Rs 5 million for the non-tax-filers. The low demand from the both the private and public sectors throughout the rest of the year remained an issue for the sector. However, some of the losses in the domestic market were offset by an increase in exports.

Figure 2.17: Quantum of Cement Exports



Data source: Pakistan Bureau of Statistics

After years of decline, the quantum of cement exports witnessed growth of 40.5 percent in FY19 (**Figure 2.17**). This was largely driven by clinker, which explains the low unit value of the products; in US$ terms, exports saw a jump of 21.9 percent. The diversification of exports market was also a favorable development. The traditional markets of neighboring countries experienced a continuing slowdown; however, domestic firms were able to capture market shares in South Africa, Madagascar, Mozambique and Sri Lanka.

In the middle of this slowdown, the installed capacity of the sector registered an increase of 15.5 percent from last year's level. Major players such as Bestway Cement, Lucky Cement and D.G. Khan Cement added 7.7 million tons to the domestic capacity in FY19. While this is encouraging, utilization levels, which had remained in excess of 90 percent in FY18 fell well below 80 percent in FY19. In order to boost sales in the current situation, the industry needs to focus more on the export market, as domestic demand faces a downward shift. Furthermore, recent depreciation of PKR and alignment of exchange rate with market fundamentals provides the industry a competitive edge to gain more share in the global cement market.

Steel

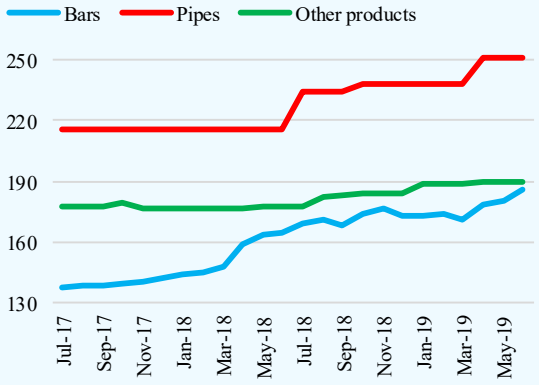
The steel industry's performance was hampered by low domestic demand, resulting in negative growth of 11.2 percent in FY19. Decline in demand from sectors like housing, automobiles, and transportation explains this outcome.

In addition to low demand, the exchange rate depreciation played a significant role in the sector's outcome. Imported raw materials, such as scrap and coal, became expensive. Moreover, increase in electricity prices further escalated the cost for steel producers. In this backdrop, increase in prices was recorded (**Figure 2.18**). On the trade front, a sizable share of demand was met via imports,

[15] The average includes the slowdown in FY11, when the industry had contracted by 8.2 percent.

despite falling by 8.3 percent in FY19. The domestic industry could not meet the country's overall requirements despite lower demand.

Figure 2.18: Price Indices of Steel Products



Data source: Pakistan Bureau of Statistics

Pharmaceutical

The pharmaceutical sector registered a decline of 7.7 percent in FY19. It was only the second time the industry had contracted since the LSM index was rebased in FY06. This downslide has implications for the state of health conditions and the trend is contrary to the rising population; the country is adding more than 5 million people every year at the reported annual growth rate of 2.4 percent.

The broad-based deterioration in the performance of the pharmaceutical industry can be attributed to several factors. First is the sub-optimal drug pricing policy. The regulatory delay in adjustment of prices, with persistent discord between pharmaceutical firms and DRAP over the price-setting mechanism, has hampered the industry's growth prospects for quite a while (as already highlighted in an earlier SBP report).[16]

The industry has also been impeded by low levels of investment, especially with respect to generic drug development. The country is still reliant on imports of raw material from neighboring countries. These imports cost more than US$ 1 billion annually, the majority of which is for generic drugs. Another development that could help explain the performance is linked to the reporting firms in the LSM survey for the pharmaceutical industry. Some firms that are not reporting have shifted their production activities from the south of the country to the north due more conducive business setting opportunities and better regulatory environment.

Electronics

Growth in the electronics sector was driven by the production of electric motors in FY19, a continuing pattern from last year. Production of motors grew by 23.3 percent this year, on top of the hefty 354.0 percent growth recorded in FY18. Since motors are widely used in a range of industrial applications and finished goods, such as washing machines, refrigerators, deep freezers and air conditioners, this propelled the growth of this sub-sector. Improvement in electricity supplies also contributed to the healthy performance.

Meanwhile, since the domestic consumption was on the downward trend, the increase in demand for electric motors from the makers of large appliances cannot completely explain the substantial increase in growth. An increase in the number of reporting LSM firms, which rose from the earlier 17 units to 28 units, may account for this significant growth.

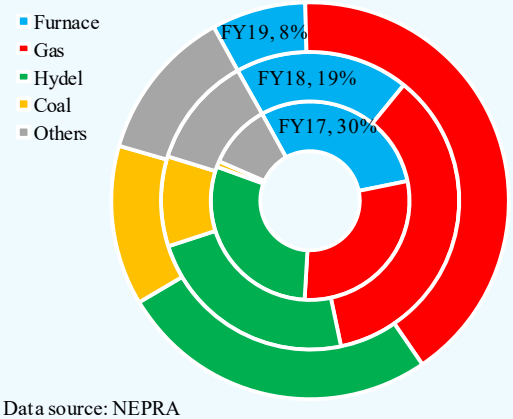
POL

The POL production suffered a decline of 8.4 percent in FY19, in contrast to double digit growth previously. Sales of petrol, diesel and furnace oil, which had been driving growth in recent years, either slowed down or contracted in FY19.

[16] See SBP's The State of Pakistan's Economy Report for Q2-FY19.

While petrol production still managed to post positive growth, it decelerated sharply. This is explained by the strong demand from the private sector for non-commercial purposes, mainly driven by an increase in the numbers of private vehicles on roads. However, the deceleration can be explained by increase in prices of fuel products and lack of commercial activities. Meanwhile, in the diesel market, slow uptake from the industrial and transport segments hurt production activities. A shift in the government's policy on furnace oil in FY18 led to reduced production in this segment in FY19. The preference for RLNG in the place of furnace oil for electricity production became evident over the year (**Figure 2.19**).

Figure 2.19: Electricity Generated from Different Sources



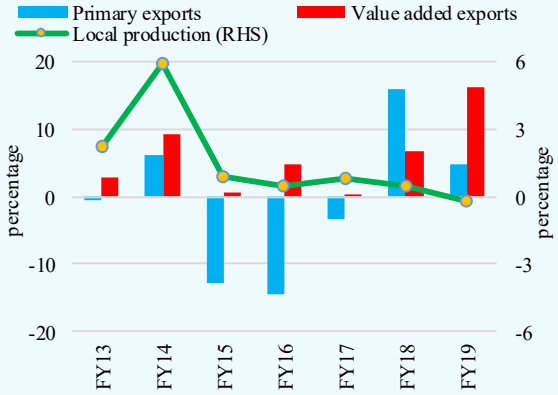
Data source: NEPRA

The refineries are adjusting to the policy measure by investing in hydrocracking units. PRL has planned to invest US$ 1 billion in a Diesel Hydrodesulphurisation Unit to produce Euro-II specification fuel. Further, a proposed deep conversion refinery in Gwadar with technical and financial aid from Saudi Arabia would increase the production capacity of cleaner fuels in the country. Although these projects would take time, the long term growth prospects of the industry look bright.

Textile

The textile sector had a challenging year; the industry contracted by 0.2 percent, compared to marginal growth of 0.5 percent in FY18. The stagnancy of the sector continued, with average growth of less than 0.5 percent for the past 5 years. This corresponds with lower growth in exports of primary textile products such as cotton yarn. On the other hand, LSM data does not completely capture the performance of companies producing high value added products, whose exports have risen in FY19. **Figure 2.20** illustrates the point; growth in quantum of primary textile export was relatively subdued compared to high value added items in FY19.

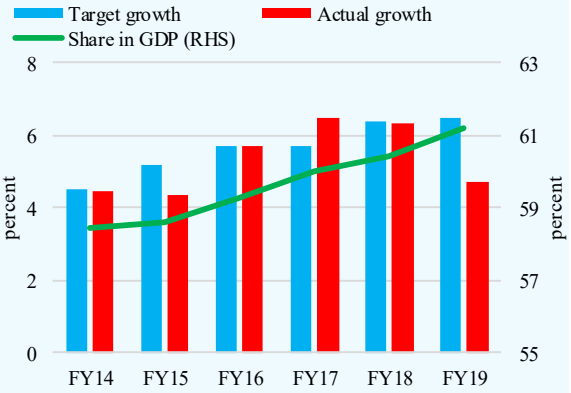
Figure 2.20: Textile Sector Growth



Data source: Pakistan Bureau of Statistics

Further analysis of the sector reveals that jute and woolen products are in a state of constant decline. The production of these commodities had fallen over the years, and this has also contributed to the overall performance of the textile sector. That said, the share of both these products is less than 4 percent in the textile group compared to the lion's share (96.3 percent) of the cotton-based industry.

Figure 2.21: Services Sector Performance



Data source: Pakistan Bureau of Statistics

2.4 Services

The services sector grew by 4.7 percent during FY19, missing the annual target by 1.8 percentage points. This was the most noticeable deviation between the actual and targeted growth rate of services in the past few years (**Figure 2.21**).

Table 2.9: Segment-wise Performance of the Services Sector*

percent

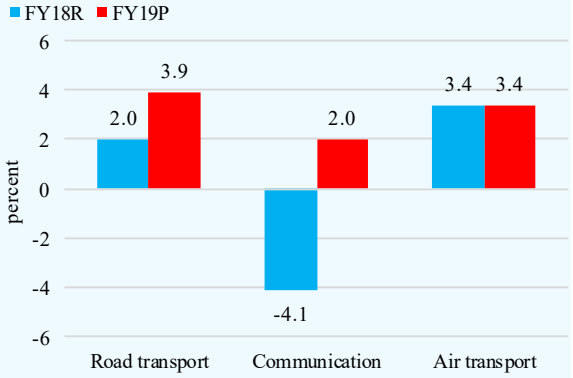
	Share in GDP - FY19	Growth		Contribution to services	
		FY18	FY19	FY18	FY19
Wholesale and retail trade	18.9	6.6	3.1	2.0	1.0
Transport, storage and comm.	12.9	2.1	3.3	0.5	0.7
Other private services	11.0	8.1	7.1	1.4	1.2
General government services	8.4	11.8	8.0	1.5	1.1
Housing services	6.6	4.0	4.0	0.4	0.4
Finance and insurance	3.5	7.0	5.1	0.4	0.3
Services	**61.2**	**6.3**	**4.7**	**6.3**	**4.7**

* Provisional numbers for FY19; revised numbers for FY18

Data source: Pakistan Bureau of Statistics

Growth in the *wholesale and retail trade* segment more than halved compared to last year, attributed in part to the lackluster performance of the commodity-producing sectors (**Table 2.9)**. However, despite a net contraction in LSM and crops, there was still an overall increase in *wholesale and retail trade*. A certain component of domestic sales and services did well, with anecdotal evidence indicating a growing popularity of e-commerce activity and mega shopping malls. This impression was further supported by an increase in sales tax collection excluding POL products during FY19. Furthermore, this trend was also partly explained by the higher than inflation price impact of imports amid PKR depreciation.

Figure 2.22: Transport, Storage and Communication - Growth in GVA of Top-3 Heavyweight Segments



Data source: Pakistan Bureau of Statistics

The *transport, storage and communication* segment grew by 3.3 percent during FY19, an improvement over last year's performance. Three subsectors, namely road transport, communication, and air transport, continued to account for nearly 93 percent of the gross value addition in *transport, storage and communication*.[17] Among these, growth in road transport services nearly doubled compared to last year (**Figure 2.22**). The NHA's activities, boosted by CPEC, contributed to an extension of the road network. This included 17 different short-term projects for the completion of 3,005 km length of roads on the eastern alignment and 6 different short- to medium- term projects for the construction of 1,799 km of roads on the western alignment.[18] The NHA also continued to expand the motorway network, with work on a number of segments completed during FY19 and some activities spilling over to the next year (**Table 2.10**).

Growth in the communication subsector also recovered to some extent during the year, compared to the decline witnessed in FY18. Within telecom, cellular teledensity and broadband penetration rose to 76.8 percent and 33.8 percent, respectively, as of end-June 2019, compared to 72.8 and 28.3 percent

[17] Road transport, communication, and air transport had 71.3 percent, 15.4 percent, and 6.3 percent shares in the GVA of the *transport, storage and communication* segment during FY19. The remainder consisted of water transport (3.7 percent), storage (2.6 percent), railways (0.6 percent), and pipeline transport (0.1 percent).

[18] Data source: Pakistan Economic Survey 2018-19.

last year.[19] Meanwhile, the growth in gross value addition (GVA) by air transport services remained at a similar level as compared to last year.

Apart from the three dominant subsectors in *transport, storage and communication,* the gross value addition by railways services grew by 38.9 percent during FY19. Various performance indicators of Pakistan Railways underscored its growth potential (**Table 2.11**). Growth in the passenger segment stood out in particular, as a number of new trains were launched during the year.

Finance and insurance services faced a slowdown during the year compared to FY18, mirroring the GVA pattern of scheduled banks, which have the largest share in this segment (**Table 2.12**). Deposit generation remained subdued for the greater part of FY19 compared to last year, barring a spurt in the last week of the fiscal year.[20] Growth in bank credit to the private sector was also lower than last year (for details, see **Chapter 3**).[21] The performance of mutual funds was also muted on the whole; the portfolio of such entities typically consists of investments in the equity market, which performed poorly during FY19.[22] By comparison, insurance, reinsurance and pension funds performed much better, given that their growth during FY19 was built on a high base from last year. Regarding the central bank, its gross value addition declined during the year in the backdrop of exchange rate depreciation.

Table 2.10: Motorway Network

Motorway	Length (Km)	Status
Islamabad - Lahore, M-2	357	Completed
Lahore - Abdul Hakeem, M-3	230	Completed*
Peshawar- Islamabad, M-1	156	Completed
Shorkot - Khanewal, M-4	64	Completed
Gojra- Shorkot, M-4	62	Completed
Faislabad - Gojra, M-4	58	Completed
Pindi Bhattian - Faisalabad, M-4	57	Completed
Khanewal - Multan, M-4	56	Completed
Karachi-Hyderabad (M-9)	136	Completion: June 2019
Sukkur - Multan (M-5)	392	Completion: Sep, 2019
Sialkot - Lahore	91	Completion: Dec, 2019
Hakla-D.I Khan	285	Completion: Jun, 2020
Havelian - Mansehra	39	Under construction
Hazara Motorway (E-35)	59	Under construction
Hyderabad - Sukkur, (M-6)	296	Procurement in process

* Status updated from newspaper report
Data source: Pakistan Economic Survey, 2018-19

Table 2.11: Performance of Pakistan Railways

	Jul-Feb FY18	Jul-Feb FY19	Growth
Number of passengers carried (millions)	35.9	39.9	11.1
Passenger traffic (kms)	16,753.2	18,745.8	11.9
Freight carried (million tons)	5.2	5.3	1.9
Freight carried (kms)	4,887.4	5,269.6	7.8
Gross earnings (million Rs)	30,891.2	34,066.1	10.3

Data source: Pakistan Economic Survey, 2018-19

General government services continued to be the fastest-growing segment within the services sector, despite the government's shift in favor of austerity. While it experienced a slowdown compared to FY18, the segment's growth remained relatively robust that can be traced to the real increase in remunerations and pensions of serving and retired government employees respectively.

There are certain downside risks to the outlook of the services sector in FY20. A case in point is the smooth implementation of the Axle Load Control regime on motorways and national highways, an issue which came to the fore towards the close of FY19. The regime shift's basic premise was to curb overloading of vehicles, in order to protect the road infrastructure and also prevent accidents caused

[19] Data source: PTA. Broadband penetration is the ratio between the number of subscribers and total population, multiplied by 100 to represent broadband penetration per 100 inhabitants. Similarly, cellular teledensity represents the number of cellular connections per 100 inhabitants.
[20] Deposit generation grew 4.7 percent between 1-Jul-2018 to 21-Jun-2019, compared to 5.1 percent during 1-Jul-2017 to 22-Jun-2018. By end-Jun 2019 though, it had risen to 10.6 percent for FY19, compared to 8.8 percent for FY18. These developments occurred in the backdrop of a 30-June-2019 deadline for the Assets Declaration Scheme and other documentation measures.
[21] Bank credit to the private sector grew by 11.6 percent during FY19, compared to 14.9 percent a year earlier.
[22] The GVA by mutual funds is captured in the 'Activities auxiliary to financial services' subcategory.

by overloading. However, the move was met with stiff resistance from certain quarters of the business community and transporters, who argued that it would hamper the timely transportation of goods and unnecessarily increase the cost of doing business, among other things. The decision was initially deferred in June 2019, but then put into motion the next month. Its impact remains to be seen, particularly for *transport, storage and communication* and *wholesale and retail trade*, the two segments which typically drive activity in the services sector. There can be ramifications for inflation as well.

Table 2.12: Finance and Insurance
percent

	Share in FY19	Growth	
		FY18	FY19
Other monetary intermediation	87.0	8.8	6.2
Scheduled banks	82.1	7.5	5.3
Non-scheduled banks	4.9	46.1	24.6
Activities auxiliary to financial services	5.2	-21.7	-7.3
Insurance, reinsurance & pension funds	5.0	26.3	12.8
Central banking	1.7	15.7	-12.5
Other financial services	1.1	-3.7	-8.2
Finance and insurance	**100.0**	**7.0**	**5.1**

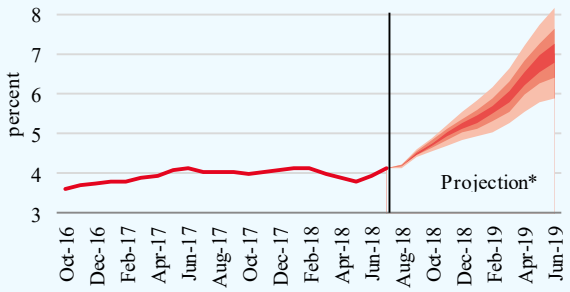
Data source: Pakistan Bureau of Statistics

3 Monetary Policy and Inflation

3.1 Overview

The monetary policy environment remained challenging throughout FY19, as macroeconomic stress – manifested in rising core and headline inflation, low level of foreign exchange reserves and large twin deficits – continued to persist despite policy measures taken last year. While the economy was already bracing for a policy-led slowdown along with a more flexible exchange rate regime, it also had to put up with speculations with respect to the decision on the IMF program. Moreover, to comply with international regulatory standards and also to broaden the tax base, the government scaled up its documentation efforts and tightened financial scrutiny. All of this weakened the confidence of businesses and consumers, which sparked volatility in currency and equity markets, increased cash penetration in the economy, and slowed down deposit mobilization in the banking system.[1] While the ongoing structural measures will take some time to settle down before financial markets and businesses could stabilize and firmly reposition, the SBP continued to maintain tight monetary conditions to manage demand and anchor inflation expectations. The SBP's monetary policy committee (MPC) increased the policy rate in all six decisions during the year, by a cumulative 575 bps.

Figure 3.1: CPI Inflation Projections at the Start of FY19
(12 Months Moving Average Inflation)



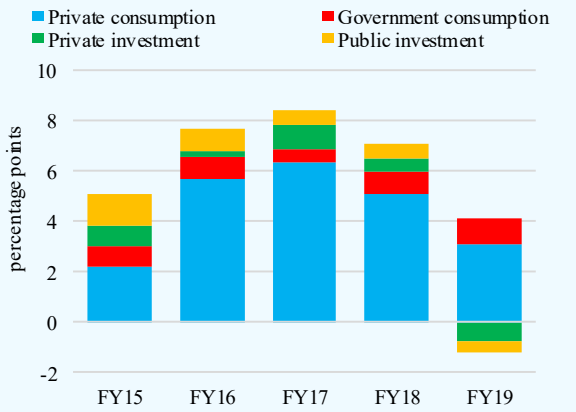
*Probability distribution of risks around the average point forecast of 6.8 pecent. Shades indicate various levels of confidence interval.
Data source: SBP projections (July 2018)

The foremost concern was the steady increase in headline inflation. Here, the impact of demand overhang was exacerbated by rising cost pressures in the economy, as the government pushed up administered energy prices in an attempt to limit its current expenses amid growing fiscal constraints. Not only did this escalate inflation in the energy and transport components of the CPI basket, but it also had a spillover impact on other food and non-food items. A similar pressure came from the pass-through of the ongoing, as well as the earlier, depreciation of Pak rupee on prices of imported goods, and goods with heavy imported content. Making things worse, food inflation rose steeply during the 4th quarter, which reflected weaknesses in the intervention mechanism and monitoring system in wheat and sugar markets, and the absence of an immediate contingency plan to cope with crop damages and disruptions in the distribution chains. As a result, the inflation outlook, which already projected a higher-than-target outcome at the start of the year (**Figure 3.1**), became more challenging through the course of it. The persistence of large twin deficits did not help either; in fact, this triggered significant upside risks to the near-to-medium term inflation outlook.

[1] The overall deposit growth had weakened to 3.9 percent in the first 11 months of FY19, compared to 4.8 percent in the same period last year. However, in the month of June 2019, a steep rise in deposits was observed, when the government announced the withdrawal of Rs 40,000 bearer prize bond (latest by March 31, 2020). These bonds can be converted into Premium Prize bonds, replaced with Special Saving Certificates (SSC)/Defence Savings Certificates (DSC), or encashed at face value through bank accounts. Under this scheme, Rs 64.8 billion worth of Rs 40,000 bonds were encashed in June 2019, with some of the corresponding Rupee value placed with banks as deposits. Excluding the impact of June 2019, the average currency-to-deposit ratio remained at an elevated level of 39.4 percent, compared to 36.8 percent in FY18.

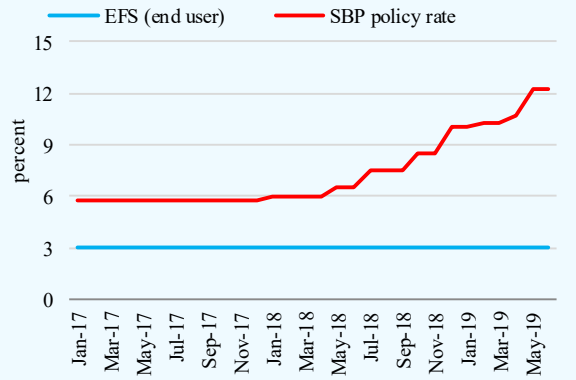
Specifically, although import compression measures helped bring down FX payment pressure in the economy, the official foreign exchange reserves remained below the standard adequacy level (3-month import cover). This led the Pak rupee to depreciate at frequent intervals. On the fiscal front, a sharp rise in current spending and a slowdown in revenue collection more than offset the impact of the cut in PSDP. The resultant higher deficit ran the risk of diluting the impact of consolidation efforts, especially when its financing was increasingly made by borrowings from the SBP. Nonetheless, the combined impact of a decline in PSDP spending, the depreciation of Pak rupee, and other regulatory and administrative measures was significantly noted on private consumption and investment (**Figure 3.2**). The efforts specifically dented activities in the industrial sector, which typically generates nearly 61 percent of businesses' credit demand.

Figure 3.2: Composition of Growth in Domestic Demand



Data source: Pakistan Bureau of Statistics

Figure 3.3: Trend in SBP Policy Rate and End-user Rate of Export Finance Scheme (EFS)



Data source: State Bank of Pakistan

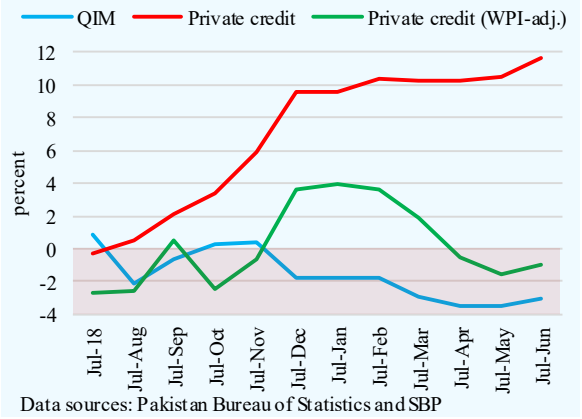
Surprisingly though, the offtake of private credit was quite upbeat in the first half of the year, despite the fact that the LSM activity had begun to fall since the beginning of FY19. This trend can be explained by heavy borrowings by export-oriented industries for working capital during the period, as interest rates under the SBP's subsidized loan schemes (already at historic low levels) have been kept unchanged (**Figure 3.3**). Around 25 percent of manufacturing loans were taken under these schemes during the year. However, it is important to note that while export quantums of these industries posted improvement over the last year (especially value-added textiles, basmati rice and leather footwear), a sharp increase in raw material prices also had a major role in escalating their borrowing requirements. For instance, rice and cotton were available in the domestic wholesale market at prices 11.2 percent and 25.2 percent higher than last year. Similarly, the depreciation of the Pak rupee had also increased the cost of imported inputs, such as dyes and chemicals. Non-exporting industries, too, faced the brunt of the rising cost of both energy and non-energy components (such as iron and steel bars).

Another important aspect of private credit was the slowdown in fixed investment loans. Three factors contributed to this trend: (i) as PSDP spending fell and early-harvest projects under the CPEC approached completion, the investment activity in the energy and transport sectors weakened; (ii) this impact was reinforced by the expected end to the recent capex cycle in the manufacturing sector, and the scheduled repayments associated with earlier capex in energy, manufacturing and construction sectors; and (iii) a general wait-and-see approach observed across the business community in response to steep movements in exchange rate and interest rates; moreover, there have been general apprehensions about growing emphasis on documentation and tax efforts. Nonetheless, as was the case in working capital loans, the depreciation of the Pak rupee also escalated the cost of imported

machinery, which was reflected in higher offtake of fixed investment loans by textiles, sugar and power generation and distribution sectors.

Although cost pressures persisted in the later months of the year, the overall credit momentum weakened significantly as the economic slowdown deepened and steadily spread across a number of sectors. For the full year, the private credit offtake posted a growth of 11.6 percent in FY19 compared to 14.9 percent last year. However, after adjusting with movements in the WPI index, the offtake in overall private credit this year was much subdued (**Figure 3.4**).

Figure 3.4: Cumulative Trend in Manufacturing Index and WPI-adjusted Private Credit



Data sources: Pakistan Bureau of Statistics and SBP

With the cost-driven momentum in private credit and heavy fiscal borrowings, the overall growth in money supply in FY19 was higher than last year. Furthermore, the composition of M2 growth remained heavily skewed towards public sector borrowings, which implies that fiscal discipline needs to be maintained to enhance effectiveness of monetary policy tightening. This is going to be a complex task going forward, given the fact that the outsized stock of government's domestic debt has already been repriced following the steep rise in the policy rate: in FY20, the government has estimated its mark-up expense to increase by 45.5 percent compared to FY19, eating up more than half of the FBR's estimated tax revenues. Under these circumstances, effective implementation of monetary policy will hinge upon management of the primary balance, and commercial banks' portfolio choice. As for the government, it has set a much lower target for the primary deficit next year under the IMF program; committed not to take additional budgetary financing from SBP; and devised a plan to gradually reduce the existing outstanding stock of debt held by the central bank.[2] Furthermore, to address unwarranted liquidity requirements, the government has recently approved the Cash Management and Single Treasury Account Policy 2019-2029.[3] These measures are expected to contribute positively towards monetary policy transmission going forward.

While these improvements are welcome, fresh challenges have emerged with respect to the formulation and effectiveness of monetary policy, and the overall stability of the financial sector. First, the administrative measures to control the level and volatility in food prices have had been sub-optimal during the year, to say the least. In case of important commodities such as wheat and sugar, the surge in prices during Q4-FY19 seems to be an outcome of the absence of an effective mechanism of measuring available stocks in the country, delayed decisions with respect to managing demand conditions, and also weak administrative control over collusive behavior and hoarding practices across the distribution chain. Furthermore, to ensure smooth availability of minor crops (fruits and vegetables), the country seems to be lacking a contingency plan in case damages are done to domestic crops and/or geopolitical factors constrain timely import from immediate neighbors. The increase in food inflation, if it persists, can prove counterproductive to disinflationary measures taken by the SBP.

The second challenge pertains to the growing cash penetration in the economy. The currency-to-deposit ratio, which has been on an increasing trend ever since the government imposed withholding

[2] To this end, the stock of mostly short-term government debt held by the SBP has already been re-profiled into PIBs of various maturities by end-June 2019.
[3] This policy is aimed at ensuring an efficient and integrated cash management system to restrain deficit monetization.

tax on non-cash based transactions, increased further in FY19 to 39.4 percent against last year's average ratio of 36.8 percent. Importantly, the regulatory environment is getting even more challenging for deposit growth in the country, especially in the light of apprehensions regarding sharing of depositors' data with tax authorities; tightening of the noose around tax evasion and short-filing; stiff competition from alternative savings instruments; and intense monitoring with respect to money laundering and terror financing. As mentioned before, these concerns would linger for some time before banks and the general public would get attuned to increased financial scrutiny and implementation of international regulatory standards. In the meantime, it is important to ward off any unwarranted pressure on bank deposits; one recommendation is to remove the withholding tax on non-cash transactions for all customers. Moreover, banks also need to effectively engage with their customers to address their due concerns, and step up efforts to provide convenient and lucrative solutions for their savings needs.

Finally, the macroeconomic challenges have raised some concerns with respect to banks' asset quality. Specifically, the banks' non-performing loans (NPLs), which began to creep up since Q2-FY19, continued to increase through the rest of the year. On a yearly basis, gross NPLs posted a growth of 23.2 percent, which is the highest growth observed since FY11. Importantly, the impairment in asset quality was observed in both gross and net terms, even though banks have provided for most of the delinquencies.[4]

3.2 Monetary Aggregates

The broad money grew by Rs 1.8 trillion in FY19 compared to Rs 1.4 trillion last year. Though the contraction in the NFA was significantly higher compared to last year, the overall increase in the NDA – due to sizable budgetary borrowings – more than offset the decline in NFA.

Within NFA of the banking system, the SBP's NFA shrunk by Rs 1.1 trillion, whereas that of scheduled banks' recorded a net contraction of Rs 159 billion. In case of the central bank, this fall was mainly on the back of borrowings from other countries and international organizations in order to provide a support to FX reserves amidst challenges on the external front. As for the NDA, the higher growth in FY19 represented a steep rise in budgetary borrowings and credit to public sector enterprises, which more than offset the lower offtake in credit to the private sector as compared to last year (**Table 3.1**).

Table 3.1: Monetary Aggregates [P]

billion rupees

	Abs. change in stocks		Growth rate in percent	
	FY18	**FY19**	**FY18**	**FY19**
M2 (A+B)	1,416.3	1,801.3	9.7	11.3
A. NFA	-810.5	-1,298.7	-134.6	-623.1*
B. NDA	2,226.8	3,100.0	15.9	19.1
Government borrowing	1,244.1	2,137.9	13.9	21.0
Budgetary borrowing	1,110.9	2,204.4	13.4	23.5
SBP	1,263.3	3,079.3	53.8	85.2
Scheduled banks	-152.4	-875.0	-2.6	-15.1
Commodity operations	133.2	-63.3	19.4	-7.7
Non-government borrowing	1,022.3	1,021.7	17.0	14.5
Private sector	775.5	693.5	14.9	11.6
PSEs	245.4	326.0	30.7	31.2
Reserve money	616.7	1,088.8	12.7	19.9

[P]: Provisional

* Outstanding stock at end June 2018 was Rs -208.4 billion and at end June 2019 was Rs -1,507.1 billion.

Data source: State Bank of Pakistan

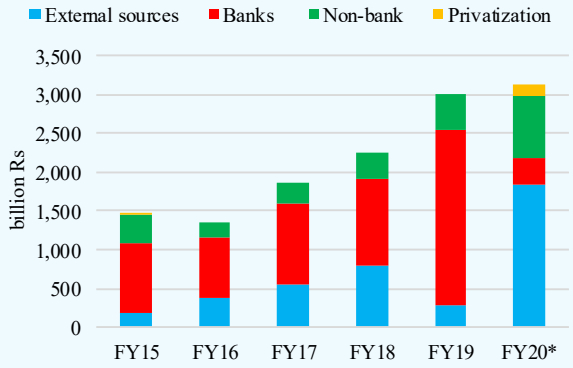
Government budgetary borrowings

The government's budgetary borrowings from the banking system doubled during FY19 compared to last year. This increase represented: (i) a large fiscal deficit, an outcome of a shortfall in revenue collection and higher than budgeted interest payments and defense expenditures; and (ii) a sharp decline in the availability of external financing during the year, which largely offset the impact of higher debt mobilized via NSS instruments and money market funds (**Figure 3.5**).

[4] While gross NPLs as percent of total loans have increased from 7.9 percent at end-June 2018 to 8.8 percent by end-June 2019, net NPLs to loan ratio has increased from 1.1 percent to 2.1 percent during the same period.

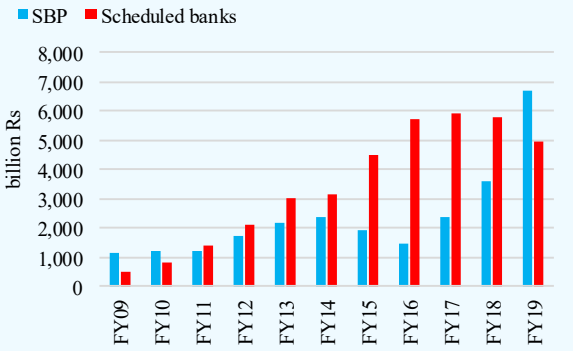
Within the banking system, the government borrowing remained heavily skewed towards the central bank. Borrowing an all-time-high of Rs 3.1 trillion from the SBP to bridge fiscal imbalances, the government retired Rs 875.0 billion debt held by commercial banks. It appears that in the wake of growing fiscal constraints, the government gave more weight to cost-effective mobilization while managing public debt. Consequently, the outstanding budgetary support from the central bank surpassed the outstanding level of government borrowings from scheduled banks for the first time since FY11 (**Figure 3.6**). While these borrowings were in clear violation of the SBP Act, which stipulates zero quarterly borrowing from the central bank, it also fueled growth in reserve money, risking additional inflation in the economy.

Figure 3.5: Financing of Fiscal Deficit



* budgeted
Data source: State Bank of Pakistan

Figure 3.6: Outstanding Stock of Budgetary Borrowings from the Banking System



Data source: State Bank of Pakistan

T-bill auctions

In gross terms, banks offered Rs 23.3 trillion in T-bill auctions against the cumulative target of 19.5 trillion. These large volumes mainly represented repeated rollovers of 3-m papers during the 26 auctions held during the year. If maturities are netted out, the banks' total offers fall to Rs 4.1 trillion, of which the government's acceptances stood at a *negative* Rs 307.3 billion.

Scheduled banks had been expecting an upward interest rate trajectory almost throughout the year, keeping in view the trend in inflation and the growing BoP stress (**Table 3.2**). Since the monetary policy committee was meeting every two months, and banks were expecting a rate increase in nearly all the decisions, their perceived duration risk for all the tenors was quite sizable (certainly, it was less in case of 3-m paper).[5] Importantly, this risk was embedded in their bids in T-bill auctions, which were held every fortnight. Therefore, the banks preferred to bid only in 3-m paper: their combined offered volume in 6-m and 12-m papers was not even 1.0 percent of the total offers. And even in case of 3-m paper, it was observed that the deviation of the maximum bid from the cut-off was fairly large, especially in auctions that were held during the first half of the year.

In contrast, the government was already struggling with a large carryover stock of public debt and mark-up payments and was, therefore, defying market expectations of rate hikes. Thus, while the banks priced in their expectations of future interest rate increases in their bids, the government was only passing on previous policy rate increases to the auction cut-off rates. As a result, in nearly half of the T-bill auctions held during the year, the net-of-maturity acceptances by the government remained negative. By the end of October 2018, almost the entire stock of 6-month and 12-month paper was matured and banks were left with only 3-month paper in their fixed-income portfolio. This

[5] Duration is the sensitivity of the price of a bond to changes in interest rates.

trend had negative implications for the government in terms of the heightened roll-over risk amid frequent voluminous maturities.

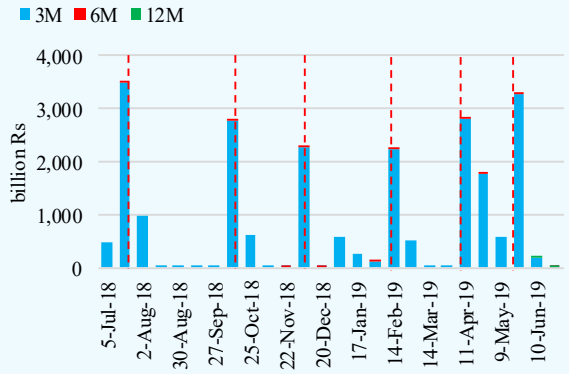
Table 3.2: Monetary Policy - Market Expectations

Month	Expectations of Policy Direction (Majority)	Details of Voting (SBP MPC Market Pulse)	Bloomberg Survey
Jul-18	Increase	61 percent ⇨ 50 bps hike 22 percent ⇨ 100 bps hike 17 percent ⇨ 25 bps hike	48 percent ⇨ 50 bps hike 43 percent ⇨ 100 bps hike 10 percent ⇨ 150 bps hike
Sep-18	Increase	50 percent ⇨ 50 bps hike 32 percent ⇨ 100 bps hike 18 percent ⇨ no change	56 percent ⇨ 50 bps hike 30 percent ⇨ 100 bps hike 7 percent ⇨ no change 7 percent ⇨ 75 bps hike
Nov-18	Increase	78 percent ⇨ 100 bps hike 11 percent ⇨ 150 bps hike 11 percent ⇨ no change	74 percent ⇨ 100 bps hike 19 percent ⇨ 50 bps hike 3 percent ⇨ 75 bps hike 3 percent ⇨ 200 bps hike
Jan-19	No Change	71 percent ⇨ no change 29 percent ⇨ 50 bps hike	83 percent ⇨ no change 13 percent ⇨ 50 bps hike 3 percent ⇨ 100 bps hike
Mar-19	Increase	47 percent ⇨ 50 bps hike 26 percent ⇨ 25 bps hike 16 percent ⇨ 100 bps hike 11 percent ⇨ no change	42 percent ⇨ 50 bps hike 42 percent ⇨ 25 bps hike 10 percent ⇨ 75 bps hike 3 percent ⇨ no change 3 percent ⇨ 100 bps hike
May-19	Increase	47 percent ⇨ 50 bps hike 47 percent ⇨ 100 bps hike 6 percent ⇨ 75 bps hike	52 percent ⇨ 100 bps hike 17 percent ⇨ 125 bps hike 14 percent ⇨ 150 bps hike 10 percent ⇨ 50 bps hike 7 percent ⇨ 75 bps hike

Data source: State Bank of Pakistan and Bloomberg

A common trend witnessed across all T-bill auctions was that the banks' participation remained upbeat in the auctions (for 3-month paper only) held right after the announcement of monetary policy; in subsequent auctions, their participation lessened (**Figure 3.7**). In its place, banks increasingly used OMOs as an alternative avenue to temporarily park their funds until the announcement of the next monetary policy. This strategy was convenient from the banks' perspective, since the SBP had been regularly conducting these OMOs to keep the overnight rates close to the target rates.

Figure 3.7: Auction-wise Offers of T-bills



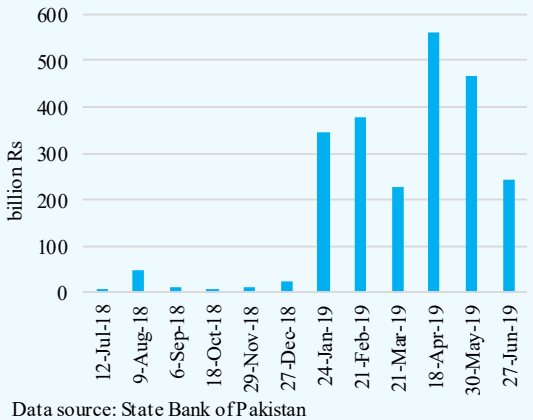
* red dotted lines represent MPC meeting dates
Data source: State Bank of Pakistan

PIB Auctions

In case of PIBs, while the duration risk perception of commercial banks was the same as for T-bills, the government followed a different strategy. After observing the banks' lackluster participation in PIB auctions during the first 5 months of FY19, the government gave a steep rise in the cutoff yield in the auction held in December 2018. Although the banks did not participate actively in this auction as well, the signal they got for subsequent auctions was important. From January 2019 onwards, the

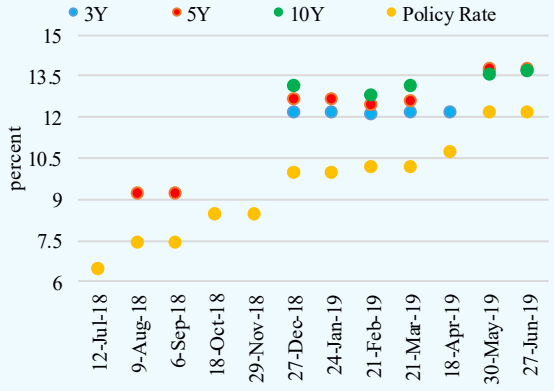
participation in PIB auctions gained momentum, as the market found the prevailing cutoff yield lucrative enough to lock funds for the long term (**Figure 3.8a** and **b**). Furthermore, based on a visible moderation in domestic demand, flattening core inflation and improvement in the current account balance, interest rates were perceived to have neared plateau. Importantly, in the last two auctions of fixed rate PIBs of FY19, the highest amount of offers were placed in the 10-year paper: around 44.1 percent (May 2019) and 52.8 percent (June 2019) of the total bids were received for the 10-year paper.

Figure 3.8a: Auction-wise offers for Fixed Rate PIBs



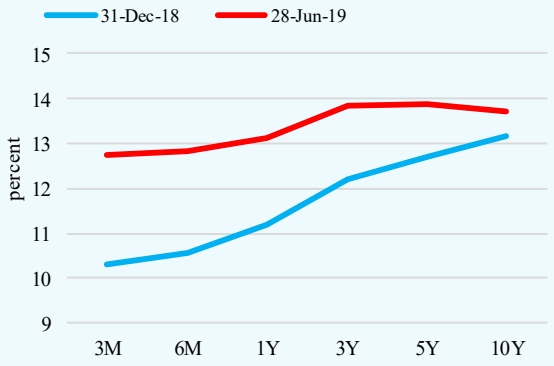
Data source: State Bank of Pakistan

Figure 3.8b: Narrowing of Spread between Policy rate and PIB cut-off rates



The yield curve also validates these expectations, as after showing a steep upward trend at the beginning (and by the middle) of this year, it flattened by the end of FY19. Importantly, the spread between 10-year and 3-year paper also turned negative in June 2019, thereby leading to a slight inversion at the longer end of the yield curve (**Figure 3.9**). Going forward, such developments will help the government increase the average maturity of its outstanding debt.

Figure 3.9: Yield Curve



Data source: MUFAP

On the other hand, the market for floating rate PIBs is developing gradually. Against the target of Rs 850 billion, offers amounting Rs 706.3 billion were received (**Table 3.3**). However, a majority of these offers were made at a higher margin relative to the prevailing rate. Eventually, on the very last auction of the fiscal year, the government opted to increase the margin of floating rate PIBs by 5 bps since none of the bids were received at the previous cut-off margin. It is important to recall here that this was the second instance when the margin of this security was increased since its first issuance in May 2018. Last time, it was increased by 20 bps in August 2018 to 70 bps.

The margin serves as the compensation for the term and liquidity premium for this bond. Since this is a relatively new instrument in the market, the associated liquidity risk is a bit on the higher side,

which is primarily the reason the market is demanding a higher cut-off. Nonetheless, such frequent changes in the margin are not desirable for the development of the secondary market for this particular bond. An important development that came towards the close of the fiscal year was the amendment in the determination of coupon. Previously, it was linked only to the weighted average yield of the latest successful 6-month T-bill auction; but as per the new instructions, in case the latest 6M T-bill auction was either scrapped or there was no participation from the market, the PKRV rates would be used as an alternative benchmark.[6] The new method will help mitigate the risks associated with excessive reliance on the primary auction rates.

Table 3.3: PIB Auction Summary

billion Rupees

	Target	Maturity	Offers	Accepted
Fixed Coupon				
FY17	800.0	1,427.3	1,757.9	894.0
FY18	900.0	1,123.4	347.5	101.7
FY19	800.0	843.6	2,350.9	873.5
Floating –Rate				
FY18	100.0	-	296.1	43.1
FY19	850.0	-	706.3	311.7

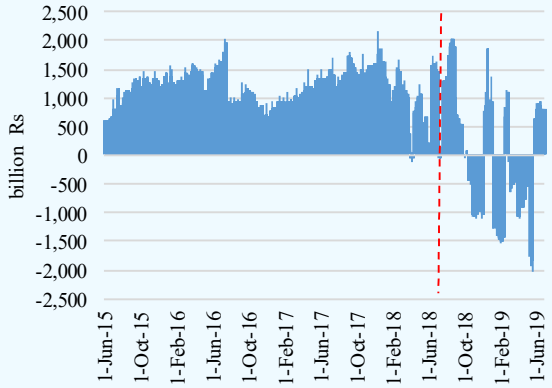
Data source: State Bank of Pakistan

Liquidity Management

In terms of the frequency and volume of central bank interventions, FY19 emerged as a unique year. The interbank money market witnessed several episodes of outsized liquidity swings that required massive interventions in both directions (**Figure 3.10**). The year also witnessed the highest level of net absorption (Rs 2.0 trillion) at one point, ever since the corridor facility was put in place.

The entrenched liquidity problems in the interbank market were associated primarily with developments in the primary government bond market (as detailed in section 3.2). Moreover, a strong momentum in private credit

Figure 3.10: Outstanding OMOs



Data source: State Bank of Pakistan

Table 3.4: Snapshot of Open Market Operations

		FY16	FY17	FY18	FY19
Interventions	No. of Mop-up	10	6	13	91
	No. of Injections	92	78	77	39
	Vol of OMO Mop-up (billion Rs)	546.4	415.4	1,397.4	40,108.3
	Vol of OMO Injections (billion Rs)	67,599.7	58,420.6	66,534.8	27,307.9
Discount Window	No. of visits on Discount Window	73	58	47	88
	No. of visits Ceiling	52	35	37	54
	No. of visits Floor	21	23	10	34
	Vol of Discount Window Operations	3,285.1	1,301.0	1,018.4	3,325.0
	Vol Ceiling (billion Rs)	2,754.8	935.7	838.9	2,491.9
	Vol Floor (billion Rs)	530.4	365.4	179.5	833.2
	No. of Banks on Ceiling	167	70	79	124
	No. of Banks on Floor	69	40	18	67
Overall	No. of Days when outstanding OMO was -ve	0	0	12	189
	No. of Days when outstanding OMO was +ve	366	365	353	167

Data source: State Bank of Pakistan

[6] DMMD Circular No. 16 of 2019 dated June 25, 2019

during H1-FY19 and its abrupt weakening in the second half, also undermined liquidity management and forecasting for bank treasuries. Therefore, the SBP had to scale up the frequency and volume of its open market operations in order to stabilize the money market rates close to the policy rate (**Table 3.4**). However, despite this elevated level of interventions, the commercial banks' resort to the discount window facility was quite frequent. In particular, the banks' recourse to the discount window coincided with open market operations on 41 instances; of these, on nearly half the days, the direction of intervention and discount window operation was identical. This highlights the prevailing inefficiencies in the money market, which makes it challenging for the banks to: a) accurately forecast their overnight cash flow needs; and b) place their surplus funds or meet their borrowing needs without relying on the SBP.

Commodity Operations

Commodity operations recorded a net retirement of Rs 63.3 billion during FY19 compared to an increase of Rs 133.2 billion last year (**Table 3.5**). These retirements mainly reflected the ease in cash flow of wheat procuring agencies, which were able to pay back Rs 73.1 billion to the banking system during FY19.

Table 3.5: Commodity Financing

Flow in billion Rupees

	FY18	FY19
Wheat	135.1	-73.1
Cotton	0.0	0.0
Rice	0.2	-0.4
Sugar	-1.0	4.5
Fertilizer	-1.1	5.7
Total	**133.2**	**-63.3**

Data source: State Bank of Pakistan

It is important to note that during the previous 7 consecutive years, wheat procurement agencies were accumulating debt, as back-to-back bumper crops and depressed prices in the international market made it hard for them to offload a sizable amount of their procured stocks. Markup payments too added to their cost of operations. Last year also, procurement agencies were unable to pay off bank liabilities despite a sharp increase in subsidy-led exports, and their debt accumulation reached a 5-year high. In FY19, however, the procurement agencies were able to sizably cut their hypothecated stocks.[7] Crop damages and price management efforts mainly explained this trend.

Specifically, wheat prices in the wholesale market, after declining consistently in the last four years, began to surge from the start of the year. This movement represented the demand-supply mismatch in the market stemming from weak issuances from the government godowns amid heavy export of the commodity (both formal and informal). However, market conditions aggravated in Q4-FY19, when heavy rains and hailstorm in the peak harvest season sparked fears of commodity shortage in the domestic market. The WPI wheat prices rose steeply by 9.8 percent and 11.3 percent YoY in May and June 2019. Thus, to bring stability in the market and keep prices under control, the government scaled up its issuances.

Another factor that improved the cash flow situation for procurement agencies and helped retire wheat-related loans, was the payment of Rs 21.0 billion subsidy to Passco by the federal government during FY19. This subsidy was due from the government under the procurement agencies' contribution towards strategic reserves and the World Food Program.

Credit to PSEs

The overall PSE debt, which had already touched 4 percent of GDP by end-June 2018, increased further in FY19, as the power generation and distribution sector continued to rely heavily on the domestic banking system for smooth functioning. This year, banks lent another Rs 326.0 billion to PSEs, the bulk of which ended up with the energy sector. These primarily comprised banks' investments in Sukuk issued by the Power Holding Private Limited – the entity in which over Rs 700

[7] There was a 3.1 million MT reduction in hypothecated stock during FY19, compared to an increase of 0.1 million MT last year.

billion of the circular debt of energy sector is parked.[8] It is important to note that though such efforts can help reduce the immediate liquidity crunch in the energy-related firms, structural problems have persisted in the country's energy supply chain that do not allow the sector to run on a sustainable basis. The issues of energy mispricing, low recoveries, large transmission and distribution losses, managerial and technical inefficiencies at Discos' level, have all remained unaddressed for long, and the stopgap measures taken in the past could fix institutional liquidity problems only temporarily.[9]

In the recently approved Extended Fund Facility program, the IMF has assigned structural benchmark on the elimination of circular debt. The fund requires an effective tariff structure that reflects true costs. This will help contain the buildup of circular debt as new capacity comes online. Following the required prior actions, the government has already raised power and gas tariffs in July 2019 and another adjustment is expected in the coming months. Besides, amendments are planned in the Nepra Act to fully adopt a mechanism of automatic adjustment on tariffs on a quarterly basis. Furthermore, the government is required to prepare a detailed plan to reduce the circular debt through improving collection, efficiency gains and good governance.

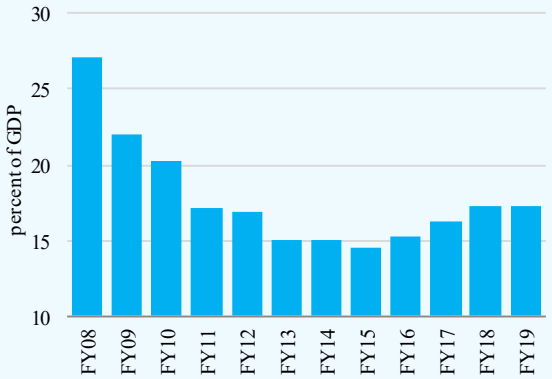
Importantly, similar reforms have been entrusted in the gas sector, where besides the tariff rationalization, the government has to prepare a comprehensive plan to reduce losses, increase private sector participation in gas sector through two distribution companies, and amend OGRA Act to notify end-consumer tariffs in a regular and timely manner. To minimize the impact of annual increase in power tariff, consumers with 300 units/month are exempted; for this purpose, the government has to allocate a new subsidy equal to 0.1 to 0.2 percent of GDP.

3.3 Credit to Private Sector

With the moderation in the economy and a decline in the industrial activity, the momentum in private credit weakened: private sector credit expanded by Rs 693.5 billion during FY19, compared to Rs 775.5 billion last year. Resultantly, the credit to GDP ratio remained stagnant at 17.3 percent in FY19 (**Figure 3.11**).

The development that differed markedly during FY19 from last year was the dominant role of higher input prices arising from the stabilization measures (e.g. regulatory duties, exchange rate depreciation) and increase in administered energy prices, which intensified the financing needs of the businesses (**Figure 3.12**). In real terms (deflated by non-food WPI), credit to private sector declined by 4.9 percent in FY19, compared to a growth of 9.7 percent last year. Moreover, the expansion in loans for fixed investment more than halved compared to FY18, as businesses' sentiments faltered in response to a slowdown in the overall economic activity; completion of the early-harvest CPEC projects; significant reduction in PSDP expenditures; and continuation of import compression measures that contributed to lower imports of capital goods.

Figure 3.11: Private Sector Credit



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

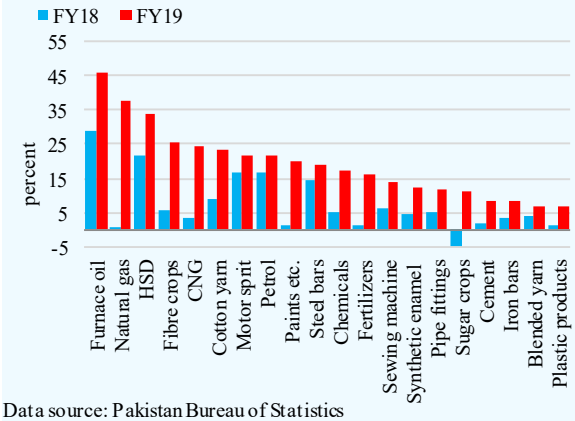
[8] The government mobilized Rs 200 billion via the Pakistan Energy Sukuk-I in March 2019 and made payments to IPPs and a few OMCs that eased liquidity constraints in the energy supply chain.

[9] Earlier in November 2011, the government swapped Rs 313.0 billion of sovereign securities for PHPL's liabilities. Similarly, the government once again settled Rs 322.0 billion of circular debt by issuing PIBs in June 2013. However, in FY19, the credit to PSEs, especially PHPL, surged again due to settlement of IPPs' dues. By end-June 2019, PSEs' debt had reached 5.3 percent of GDP, from 4.0 percent in June 2018.

Fixed investment loans lost traction

Fixed investment loans had recorded a consistent increase since FY14 in response to higher PSDP expenditures and progress on CPEC-related infrastructure projects. A number of industries, including cement, iron & steel and power generation spent on capex and BMR activity, and resorted to bank financing for the import of machinery and equipment. In FY19, however, long-term loans grew only Rs 82.9 billion – less than half of the Rs 203.9 billion increase recorded in FY18.

Figure 3.12: Inflation in Key Inputs



Data source: Pakistan Bureau of Statistics

Importantly, by end-FY19, it was expected that the capex cycle in construction-allied industries would begin to stall due to: (i) a number of early-harvest CPEC projects nearing completion, and lack of clarity through most of the year with respect to the expected initiation of new projects under the phase II; (ii) new political regime taking over that took some time to settle in before initiating spending on public works and announcing new mega projects; and (iii) stringent regulations on private real estate market and an expected slowdown in the housing sector. Moreover, export prospects for these industries were also not upbeat enough to encourage manufacturers to pursue additional capacity expansions.

This phenomenon was most prominent in the case of cement. It may be recalled that the sector was increasingly borrowing in long-term to finance its expansion cycle from FY14 onwards. Now that many projects have already achieved their commissioning stage and some are in trial running stage, several firms started retiring their loans from Q3-FY19 onwards. Resultantly, the sector's fixed investments increased by Rs 17.5 billion in FY19, lower than Rs 36.9 billion rise noted last year.

In case of other manufacturers, only textile and sugar increased their long-term borrowings in FY19, albeit at a slower pace than last year (**Table 3.6**). In the case of textiles, though the import of machinery declined in dollar terms, the depreciation of local currency raised the financing requirements of the firms. Textile businesses continued to position themselves to take advantage of the GSP Plus and to capitalize on opportunities arising from the trade war between the US and China. While the market interest rates were on an increasing trend during FY19, the subsidized end-user rate of 5 percent to textile businesses provided them a cushion to continue long-term borrowing – LTFF loans constituted more than 100 percent to the overall expansion in fixed investment loans in FY19, which suggested that except for the export-oriented industries, businesses deleveraged during FY19.

As far as the sugar sector was concerned, the liquidity situation appeared to be difficult during FY19. Mills blamed the recent prolonged episode of low domestic as well as international prices and a double-digit increase in sugarcane's wholesale prices during FY19 for their cash flow constraints. Since the sector relies heavily on bank financing, some mills may have considered it prudent to lengthen the maturity profile of their loans by borrowing long-term and retiring short-term loans in FY19.

Apart from the manufacturing sector, the power sector's borrowing momentum was the most prominent in FY19, as the increase was highest since FY14 when the overall fixed investment started rising. A deeper look into the data reveals that major variation was due to the KE and few CPEC-

Table 3.6: Loans to Private Sector Businesses
billion rupees

	Total Loans		Working Capital*		Fixed Investment	
	FY18	FY19	FY18	FY19	FY18	FY19
Private Sector Businesses	**657.9**	**574.6**	**454.0**	**491.6**	**203.9**	**82.9**
Manufacturing	419.7	411.6	295.7	362.1	124.0	49.5
Textiles	117.8	132.0	87.5	105.9	30.4	26.1
Refined petroleum	9.9	36.9	10.2	42.3	-0.3	-5.4
Cement	54.7	33.1	17.7	15.5	36.9	17.5
Edible oil and ghee	27.4	30.4	21.0	34.6	6.4	-4.2
Rice processing	13.4	26.5	12.7	26.0	0.7	0.5
Fertilizer	-43.5	23.7	-33.1	32.3	-10.4	-8.5
Iron & steel	30.1	22.5	29.8	20.4	0.3	2.1
Motor vehicles	2.5	20.5	1.9	14.5	0.5	6.0
Sugar	35.7	-19.6	20.8	-31.0	14.9	11.4
Production, transmission & distribution of electricity	46.1	95.6	45.8	47.0	0.2	48.6
Commerce and trade	69.0	65.6	52.1	42.8	17.0	22.8
Mining and quarrying	2.5	22.2	-0.5	14.7	2.9	7.5
Real estate & related	36.1	20.3	20.6	10.3	15.4	10.0
Agriculture	8.0	-5.6	-0.3	5.8	8.3	-11.4
Transport, storage and communication	23.4	-2.1	7.4	21.8	16.0	-23.9
Construction	27.6	-12.8	11.2	6.6	16.4	-19.4
Ship breaking etc.	24.3	-32.7	24.9	-34.3	-0.7	1.6

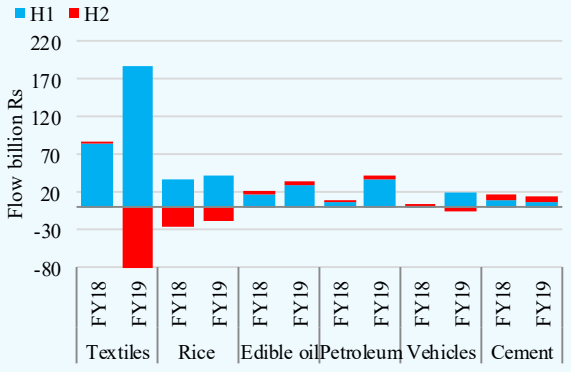
*includes trade financing
Data source: State Bank of Pakistan

related projects. KE took investment loans primarily to improve its transmission network. As per industry sources, such investments in the past have brought significant improvement in the company's transmission network and helped reduce its T&D losses. Traditionally, the distribution and transmission sector has suffered due to lack of investment; the issue has been highlighted several times in various SBP reports on the State of the Economy. Besides KE, a Karachi-based IPP leveraged in FY19 to finance an increase in its stake in various projects. Similarly, another coal-based IPP also borrowed from commercial banks to complete its project during FY19; the project started commercial operations in July 2019.

Exports and cost-driven demand pushed up working capital loans

Private businesses took Rs 491.6 billion in working capital loans during FY19, compared to Rs 454.0 billion last year. Within manufacturing, the sectors that drove the credit expansion included textiles, rice processing, petroleum refining, edible oil & ghee and motor vehicles (**Figure 3.13**). Although the flow for FY19 was higher than last year, the demand for working capital did not appear vibrant as banks actually received around 14 percent fewer applications for working capital loans as compared to last year. Several sector-specific factors influenced the demand for working capital loans during FY19.

Figure 3.13: Working Capital Loans in Selected Manufacturing Sectors



Data source: State Bank of Pakistan

Export-oriented activity and subsidized loan products drove up working capital loans in textiles and rice

Financing requirements of the textile sector remained high in FY19 due to an increase in export-led activity. The sector borrowed Rs 105.9 billion from banks during FY19, which was a 13-year high. Most of the borrowing activity was concentrated in H1, as the sector retired some of its loans in the second half of the year. It is important to highlight that despite a considerable increase in the SBP's policy rate, the end-user rate on EFS scheme was kept unchanged at 3.0 percent, which made it very lucrative for export-oriented businesses to borrow under such schemes. Of the total working capital borrowing by the textile sector, which is traditionally a major beneficiary of subsidized loans, around 44 percent was taken under the EFS scheme. In addition to export activity, higher cotton prices (25.2 percent up YoY) in the domestic market further raised the financing requirements of textile businesses.

Rice was another beneficiary of EFS loans, as around 30 percent of working capital taken by rice processors was under this scheme. Similar to textiles, higher financing requirement of rice processors was due to a better performance of exports during FY19, especially basmati varieties that recorded a double-digit increase. Importantly, Pakistani basmati has been able to penetrate in European markets in recent years as the Indian basmati was banned in these markets due to excessive use of certain pesticides. To capitalize on these opportunities, rice processors borrowed Rs 26.0 billion in FY19, compared to Rs 12.7 billion last year.

PKR depreciation raised financing requirement in import-dependent sectors

With regards to import-dependent industries such as edible oil & ghee manufacturers and refined petroleum, the depreciation in the Pak rupee jacked up firms' short-term financing requirements. In case of edible oil & ghee, the impact of depreciation was strong enough to offset the benefit from a double-digit decline in global prices of palm oil (**Table 3.6**). In the petroleum refining industry, the cost-push impact was exacerbated by regulatory measures which led to a build-up of inventories. Specifically, the government's decision to reduce dependence on furnace oil in the overall energy mix resulted in a slowdown in overall POL consumption in the country, which did not allow refineries to offload their produce.

The problem of inventory build-up was also observed in the car assembling industry. This issue propped up because of three reasons: (i) the government had barred non-filers from purchasing/registering cars till March 2019 (only cars up to 1300 cc engine capacity were exempted); (ii) as assemblers passed on the impact of additional duties and PKR depreciation on their prices, the demand for cars weakened; and (iii) a rise in interest rates may have priced out some potential buyers from purchasing cars using bank loans. Facing liquidity shortages, local manufacturers had to increase their short-term borrowing by around Rs 15.1 billion in FY19. It is important to mention that car manufacturers typically finance their requirements from customers' prepayments, but weaker sales pushed them to borrow from banks.

Budgetary measures and economic slowdown affected construction-allied industries

The overall construction activity in the country declined by 7.6 percent during FY19, compared to 8.2 percent growth seen last year, and 10 percent growth on average during the preceding 3 years. This weakening was felt heavily on cement and steel manufacturing. For instance, cement domestic dispatches declined during FY19, and production was also down by 3.0 percent, compared to growth of 11.1 percent last year. Though cost push pressures should have contributed to increased borrowing in these sectors, the slowdown in construction activities was quite severe in containing their borrowing requirements.

Among non-manufacturing concerns, the power sector was the biggest user of working capital loans. Although prices of primary fuel supplies (such as crude and FO) rose substantially during the year which contributed to higher financing needs, some liquidity comfort to the sector came from the issuance of Rs 200 billion worth of Sukuk in March 2019 and subsequent payments to various entities in the energy supply chain. Consequently, due to a relatively better cash flow situation, the sector's borrowing increased only marginally during FY19, compared to last year. Moreover, a policy shift away from furnace oil translated into significant decline in thermal power generation from furnace oil during the FY19. However, the impact was much severe in H1-FY19 and contained the short term financing requirement of the sector.

Tough year for consumer financing

After consistently growing for the last six years, consumer financing lost pace and rose by Rs 57.3 billion in FY19, compared to Rs 86.5 billion last year. The major drag came from auto and house financing segments, which suffered due to the government's ban on non-filers from purchasing/ registering assets such as cars and residential properties (above Rs 5 million), several price hikes of cars, and rising interest rates. The anticipation of new product launches and phasing out one popular model also played their part, as some customers may have adopted a wait-and-see approach. Furthermore, anecdotal evidence suggest that since interest rates were on an upward trajectory, the substantial increase in installment amount compelled borrowers to either opt for high equity participation ratio or avoid bank financing altogether. Apart from these factors, the popularity of ride hailing services, which itself was an early contributing factor to the rise in auto financing, also seemed to have reached its saturation level, thereby negatively contributing to the growth in advances. Due to the interplay of these factors, commercial banks received 9.5 percent lower number of applications for auto financing during FY19, compared to last year and the segment could only increase by Rs 22.2 billion in FY19 – around half the expansion witnessed during FY18 (**Table 3.7**).

Table 3.7: Consumer Financing

billion rupees

	FY18	FY19
Total	**86.5**	**57.3**
For transport e.g. cars	43.3	22.2
Personal loans	12.5	13.9
Housing	22.3	10.4
Credit cards	7.4	7.0
Consumer durables	1.1	3.7

Data source: State Bank of Pakistan

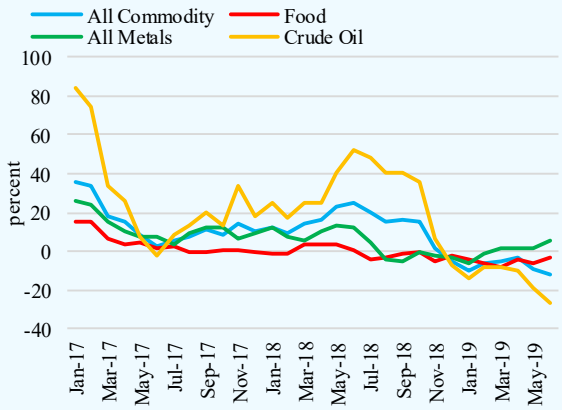
On the other hand, housing finance also suffered in FY19 and rose only by Rs 10.4 billion, compared to Rs 22.3 billion rise last year. In terms of outstanding portfolio, Islamic banks were able to keep their share intact at around 46 percent as of June 2019. However, in flow terms, the increase stemmed mainly from conventional banks where medium-sized players dominated. Nonetheless, the ban on non-filers on purchasing property (above Rs. 5.0 million) kept this segment suppressed during the year. As per industry sources, the increased price levels also eroded the capacity of many households to afford residential units in close vicinity of urban centers. Moreover, as per anecdotal evidence, consistent interest rate hikes during the year significantly raised the installment amount for potential borrowers, many of whom stand disqualified due to the breach of the maximum required debt-burden-ratio.

Compared to other segments, personal loans and consumer durables performed better (**Table 3.7**). The flow of FY19 for consumer durables was historically highest, but price impact mainly explained this phenomenon, as there was more than double-digit inflation in consumer durables during the year. The argument also gets support from the fact that while banks received around 20 percent lower applications, the average loan size of accepted applications more than doubled to Rs 2.8 million in FY19 from Rs 1.2 million last year.

3.4 Inflation

With the moderation in global economic growth – attributed to intensifying trade-related tensions between China and the US, Brexit negotiations, and tight financial conditions across advanced and emerging market economies – commodity prices began to lose steam in FY19. The overall commodity price index (IMF) that remained 16.6 percent higher between July and October 2018, posted a YoY deflation of 6.4 percent between November and June 2019 (**Figure 3.14**). This weakening led to a moderation in consumer price inflation (CPI) across advanced and emerging market economies (EMs) during FY19 (**Table 3.8**). The glaring exception were the countries struggling with BoP stress and pressures on domestic currencies. Pakistan belonged to this league; however, the pressure on inflation here was less severe as compared to that in Turkey, Argentina and Egypt (**Table 3.8**).

Figure 3.14: Global Commodity Price Index



Data source: IMF

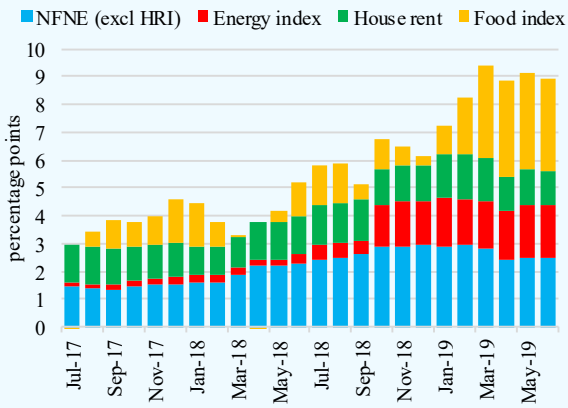
Table 3.8: Inflation and Currency Depreciation in Emerging and Developing Economies

	Depreciation (Avg.)		CPI Avg. Inflation			Depreciation (Avg.)		CPI Avg. Inflation	
	FY18	FY19	FY18	FY19		FY18	FY19	FY18	FY19
Pakistan	-4.8	-19.3	3.9	7.3	Russia	3.2	-10.1	2.6	4.3
Egypt	-16.5	0.7	20.9	13.9	South Africa	5.8	-9.4	4.3	4.6
Turkey	-12.7	-30.8	11.5	19.9	Brazil	-2.7	-14.2	2.9	4.2
India	2.1	-7.8	4.2	3.0	Sri Lanka	-3.7	-10.6	5.3	2.0
Bangladesh	-3.7	-2.3	5.8	5.5	China	4.7	-4.6	1.7	2.2
Malaysia	5.3	-1.3	2.6	0.3	Iran	-12.9	-12.9	8.2	37.6
Indonesia	-2.5	-5.9	3.5	3.0	Thailand	7.6	0.6	0.8	1.0
Philippines	-4.7	-2.6	3.6	4.7	Argentina	-20.8	-48.8	19.6	48.3

Data source: Haver Analytics

Compared to double-digit inflation recorded in these economies, the headline CPI inflation in Pakistan was recorded at 7.3 percent during FY19 compared to 3.9 percent last year. This outcome was within range of forecast made by SBP (**Figure 3.1**). That said, it was the first time in 5 years that inflation surpassed the annual target of 6.0 percent set by the government. Importantly, inflation continued to trend up throughout the year before it plateaued in March 2019 (**Figure 3.15**). Although core inflation predominantly explained the continuously rising trend in inflation during the first 4 months of the year, it was the steep rise in food and energy inflation that deepened inflationary pressures in subsequent months (**Table 3.9**). In terms of dispersion, for the full year, inflation increase was broad based as a majority of the sub-indices (72 out of 89- with about 81 percent share in CPI) posted

Figure 3.15: Composition of YoY CPI Inflation



Data source: Pakistan Bureau of Statistics

higher inflation during FY19 compared to last year. Meanwhile, in terms of distribution, around 41 percent of the items registered inflation in the range of 5-10 percent (**Figure 3.16**), depicting the presence of underlying demand as well as cost push pressures in the economy.

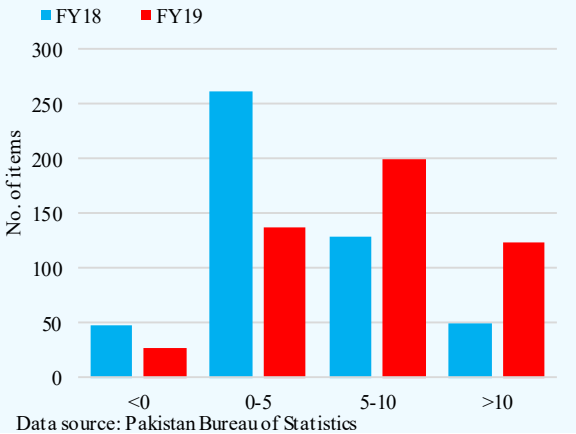
Table 3.9: Average CPI Inflation and Contribution

		Avg. Inflation						Contribution	
	Wt.	H1-FY18	H2-FY18	FY18	H1-FY19	H2-FY19	FY19	FY18	FY19
General	**100**	**3.8**	**4.1**	**3.9**	**6.0**	**8.6**	**7.3**	**3.9**	**7.3**
A. Food	**37.5**	**3.0**	**2.6**	**1.8**	**1.8**	**6.5**	**4.6**	**0.7**	**1.8**
Cigarette	1.4	-16.8	-17.8	-17.3	6.3	16.1	11.2	-0.4	0.2
Wheat flour	4.2	-1.6	-0.4	-1.0	3.1	3.6	3.3	0.0	0.1
Sugar	1.0	-18.9	-13.2	-16.2	-0.9	20.7	9.6	-0.2	0.1
Fresh vegetable	1.7	-3.6	-4.2	-3.9	-4.1	11.6	3.0	-0.1	0.1
Meat/chicken	3.8	5.6	11.3	8.5	11.1	7.1	9.0	0.4	0.4
Milk fresh	6.7	3.8	3.9	3.8	3.8	4.1	3.9	0.3	0.3
Tomatoes	0.4	27.7	-16.9	8.3	-21.9	91.8	16.1	0.0	0.1
Cooking oil	1.8	3.3	2.1	2.7	3.1	7.2	5.2	0.0	0.1
Vegetable ghee	2.1	3.8	1.7	2.7	3.8	7.4	5.6	0.0	0.1
B. Non-food	**62.5**	**5.0**	**5.8**	**5.4**	**8.7**	**9.8**	**9.2**	**3.2**	**5.5**
House rent	21.8	6.8	6.2	6.5	7.1	7.3	7.2	1.2	1.4
Education	3.9	11.1	13.5	12.4	12.1	7.1	9.5	0.5	0.5
Clothing & footwear	7.6	3.8	5.7	4.8	6.9	6.5	6.7	0.4	0.6
Health	2.2	11.4	5.0	8.1	7.4	8.3	7.9	0.2	0.2
Motor fuel	3.0	9.1	13.2	11.2	26.4	19.1	22.5	0.2	0.5
Furnished H.H	4.2	3.0	5.2	4.1	6.9	8.9	7.9	0.2	0.4
Transport services	2.7	0.2	3.2	1.7	15.8	13.4	14.6	0.0	0.4
Motor Vehicle	0.7	3.9	6.5	5.2	12.4	12.4	12.4	0.0	0.1
Misc. goods services	2.8	5.4	6.8	6.1	7.7	9.1	8.4	0.2	0.3
Core (NFNE)	**53.5**	**5.5**	**6.2**	**5.8**	**8.0**	**7.8**	**7.9**	**3.0**	**4.1**

Data source: Pakistan Bureau of Statistics and SBP calculations

Inflationary pressures during the year can be traced to:

Figure 3.16: Inflation wise distribution of CPI Items



Data source: Pakistan Bureau of Statistics

1. Surge in energy prices: Fiscal constraints and the impact of depreciation

A sharp increase in administered prices of motor fuel, natural gas, electricity and CNG (indicative) remained instrumental in strengthening inflationary pressures in the economy during FY19. These adjustments had become almost inevitable for the government in view of growing fiscal constraints (on account of revenue gaps and escalated current expenses) amid heavy depreciation of the Pak rupee. Furthermore, unit values of imported coal also posted a sharp increase of 15.2 percent YoY in rupee terms (**Figure 3.17**).

The largest direct impact came from adjustments in natural gas tariffs, as this alone contributed 0.7 percentage points to the headline inflation during the year. The Oil and Gas Regulatory Authority (OGRA) increased the retail prices of natural gas for various slabs, particularly the slab for which usage is over 500 MMBTU/month, in order to minimize the subsidy element and lower the gap between prescribed and notified tariffs for gas consumption. It is important to note that prices of natural gas were kept unchanged since September 2015, despite significant movement in crude oil

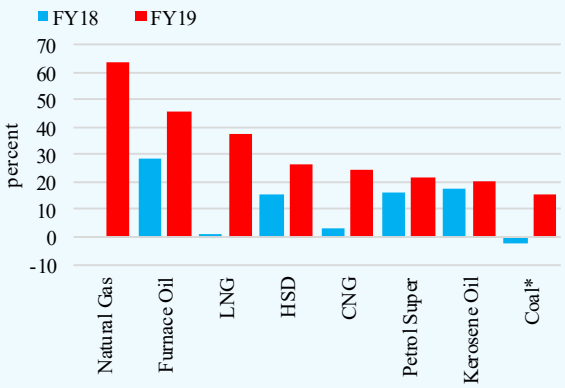
prices, which serves as a benchmark for setting the natural gas tariffs. The differential in prescribed price (as per the guaranteed returns to gas distribution companies) and the notified price added quite a burden to the fiscal accounts – the government has accrued payments worth Rs 56.8 billion only to SNGPL during the financial year 2018. Likewise, CNG prices also increased by 24.4 percent during FY19 compared to 3.4 percent rise last year in response to the upward revision of the sale price of natural gas. [10]

Meanwhile, the electricity price index also registered 4.2 percent inflation during FY19, after staying stable last year. This was an outcome of various price adjustments by Nepra during the year for consumers utilizing more than 300 units. These adjustments were meant to rein in the growing circular debt in the sector by withdrawing the provision of subsidized power supply and passing on the impact of increased capacity payments, T&D losses, low recoveries and net hydel profits.

In case of motor fuels, the trend in global oil prices, exchange rate movement and frequent revisions in the sales tax structure during the year, determined the direction and magnitude of changes in domestic petrol and high speed diesel (HSD) prices (**Table 3.10**). In overall terms, the motor fuel index posted 22.5 percent inflation during FY19, contributing 0.5 percentage points to the overall inflation. However, it is important to note that despite this increase, petrol price in Pakistan is at a level observed in some major net oil exporting countries (**Figure 3.18**).

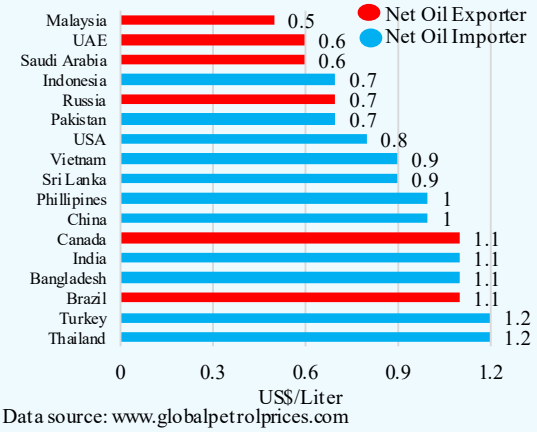
Here, it is important to note that while the direct impact of energy prices in overall inflation was almost 20 percent during the year, its indirect impact was also significant. As shown in **Table 3.11**, 65.1 percent of the commercial and 37.1 percent of the industrial activities are fueled by natural gas, which had shown 64.0 percent CPI-inflation (and 37.4 percent in WPI) during the year. It is possible that due to a significant moderation in domestic

Figure 3.17: Energy Inflation



*unit value of imports
Data source: Pakistan Bureau of Statistics

Figure 3.18: Retail Petrol Prices (as of 29th July 2019)



Data source: www.globalpetrolprices.com

Table 3.10: Fuel Prices- Percent Growth (FY19)

(End Period)	Q1	Q2	Q3	Q4
Saudi Light	5.3	-33.6	26.1	-1.7
PKR depreciation	2.2	10.5	1.4	12.0
Sales Tax-petrol (level)	9.5	8	17	13
Domestic petrol prices	1.5	2.7	-3.1	21.3

Data source: FBR, SBP, PBS and Bloomberg

Table 3.11: Share of Different Fuels in Total Energy Consumption (by Sector) in FY18
percent

	Commercial	Industry	Agriculture	Transport
Electricity	34.9	10.9	98.2	-
Gas	65.1	37.1	-	8.8
Coal	-	43.4	-	-
Oil	-	8.7	1.8	91.2
Total	100	100	100	100

Data source: Pakistan Energy Year Book 2018

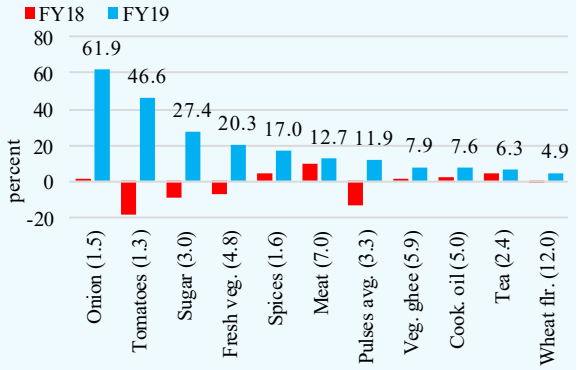
[10] The sale price was increased to 980 per MMBTU via SRO (I) dated 4th October 2018, from 700 per MMBTU (SRO (I) dated 30th December 2016).

demand, traders, manufacturers and transporters might not have been able to completely pass on the impact of high gas prices to their consumers; therefore, the broad-based increase in CPI indicates at least a partial transmission. Transportation costs have certainly gone up, and a pressure on those commodities is clearly visible where supplies are ensured on a daily basis (such as meat, milk and perishable food items). Here, it is important to reiterate that although the overall economic and political cost of energy inflation is quite large, price rationalization is extremely important in this sector not just to run energy-related entities on a sustainable basis, but also to ensure a competitive environment for productive investments.

2. Surge in food inflation: Supply disruptions and weak price controls

Food inflation remained stable during H1-FY19 on account of steady growth in prices of perishable food items amid sufficient supplies, and a subdued inflation in sugar and pulses amid the presence of abundant stocks in the market. However, food inflation recorded a steady and broad-based increase from January 2019 onwards, and clocked in at 8.5 percent during the 4th quarter (**Figure 3.19**). While the impact of increased transportation cost was clearly visible, other factors also played an important role. These included:

Figure 3.19: Major Drivers in Food Inflation in 4th Quarter



Note: weights in parenthesis
Data source: Pakistan Bureau of Statistics

a. *Supply disruptions and Ramazan effect*:

For some perishable food items, pressures on prices emanated from supply shortages. For instance, in case of tomatoes, damages to the local crop and imposition of a ban on import of (disease prone) Indian varieties restricted its supplies in the domestic market, particularly during the last 2 quarters of the year. Pakistan significantly scaled up its imports from Afghanistan, but this did not prove sufficient to pacify the market. Similarly, prices of onions soared during the 4th quarter, primarily on account of some rain-led damages to the summer crop in Balochistan, which accounts for over 27 percent of the total onion production in the country.[11] While supplies remained constrained during the quarter, demand was met through imports.

In case of other perishables, it appears that the seasonal impact of Ramzan on CPI prices was more pronounced in FY19, as compared to last year. Although there should be no significant impact of a seasonal variable on a YoY basis, the timing of price collection data by the PBS seems to have factored in. A case in point is inflation in fruit prices. Prices of fruits typically increase sharply during the first 15 days of Ramazan. This year, these days coincided with the data collection period by PBS surveyors. Last year, the Ramazan-related peak in prices had come during the 3rd week of the holy month; by then, the process of price collection was completed for the month of May.

b. *The impact of depreciation of Pak rupee*:

A higher inflation in some food items emanated from the indirect impact of the depreciation of the Pak rupee. For instance, the inflation in edible oil and ghee is linked directly to the depreciation of the rupee, as international prices of soybean and palm oil hovered around a level throughout the year which was 12.9 and 19.9 percent lower respectively compared to last year. Similarly, the pressure on domestic tea prices has also emanated from the depreciation, as international prices of tea remained

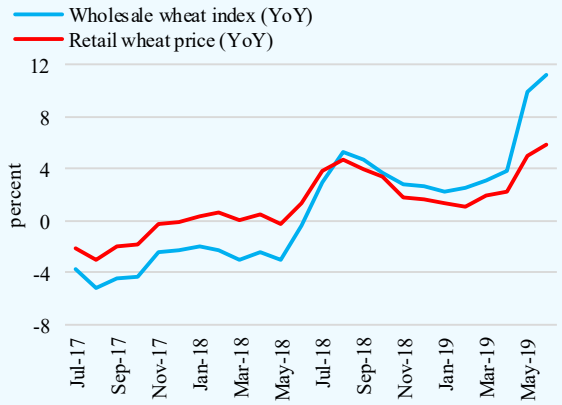
[11] It is important to recall here that Balochistan's crop arrives in the market around May, two months after the harvesting season in Sindh. Data Source: Agriculture Marketing Information Service, Directorate of Agriculture (Economics & Marketing) Punjab, Lahore

18.2 percent lower compared to the last year. Furthermore, higher inflation in pulses and dry fruits can also be attributed to the same factor.

c. ***Weak administrative mechanism for controlling wheat and sugar prices*:**
After staying stable over the past couple of years, wheat prices started to increase by the beginning of FY19. In the first quarter of the year, the demand for wheat remained unusually high due to heavy buying by exporters: wheat exports through formal channels touched 441,000 MT, equivalent to 64.5 percent of the full-year's exports. Reportedly, the size of informal exports was also considerably high during this period. Nonetheless, the size of these exports was not large enough to put pressure on domestic prices, given the available volume of wheat reserves in the country. It appears that the pressure observed in the commodity's wholesale prices was triggered by late intimation of sale price and delayed issuance by the procurement agencies, which created a temporary demand-supply gap in the market.

Later, the impact was further intensified in Q4-FY19, when untimely rains and hailstorms in the peak harvest period sparked concerns about significant crop damages, particularly in southern Punjab. Moreover, the Sindh government lowered its procurement targets for the year in lieu of estimated available stocks, rising financial cost and limited storage capacity of provincial procurement agencies. Importantly, estimates of country-wide carryover stocks are based on the data provided by the procurement agencies as well as estimates of fresh harvest – decisions about export depend upon the deviation of these stocks from the estimated demand. As it turned out, damages to Punjab's crop were higher than expected, which, together with lower procurement targets by the Sindh government and increased sales in the market, resulted in some depletion of wheat stocks held by the procurement agencies. On aggregate, the government agencies procured 33.0 percent less wheat during 2019 compared to last year, and their interventions in the market were not sufficient to stabilize prices. As a result, the wholesale price of wheat remained 8.3 percent higher in Q4-FY19 on YoY basis, which ultimately exerted pressure on the retail price of wheat flour (**Figure 3.20**). To alleviate these pressures, the Economic Coordination Committee (ECC) decided to impose a ban on wheat exports in its meeting held in July 2019. However, in the same meeting, the committee observed that the stock of wheat in the country, at 28 million tons, looked adequate in comparison to the estimated demand of 25.8 million tons. It appears that hoarding practices and/or price collusive behavior in the wholesale market may also have contributed to pressure on wheat prices. Besides, the government also needs to rein in commodity purchases for informal exports.

Figure 3.20: Pressure in Domestic Wheat Market



Data source: Pakistan Bureau of Statistics

The story in the sugar market was not different either; here also, the agencies responsible for price controls were not able to manage the market despite sufficient availability of stocks. The difference is that whereas wheat stocks are held by the government's own procurement agencies, in case of sugar, private mills maintain the stock and inform the government about their inventories. Although the reported volumes suggest that the country's available stocks were sufficient till the arrival of FY20 crop, prices came under tremendous pressure in both the wholesale and retail markets since the commencement of cane crushing season. If estimates of carryover stocks are accurate, then this pressure probably represents the emergence of hoarding opportunities amid lower availability of cane in the market, delayed crushing and anticipation of a decline in sugar production during the season.

This impact was more pronounced in the month of June, when the government announced an increase in GST from 8 percent to 17 percent under the federal budget 2020; the expected increase in prices from July 2019 onwards might have encouraged (non-registered) traders to hoard the commodity. Sugar prices posted 33.5 percent increase during June 2019 on a YoY basis, and 6.2 percent increase on a month-on-month basis. Going forward, for price stability, there is a dire need for an effective mechanism for government agencies to monitor the stocks and ex-factory, prices, and take action against manufacturers' collusive behavior and hoarding practices across the distribution chain.

d. *Regulatory measures*:
For cigarettes, a double digit inflation was recorded in FY19 compared to a sharp deflation last year. Lower base effect amid a change in the duty structure last year predominantly brought higher inflation this year, as the prices of cigarettes normalized (**Table 3.12**).

Table 3.12: Change in FED Structure on Locally Produced Cigarettes

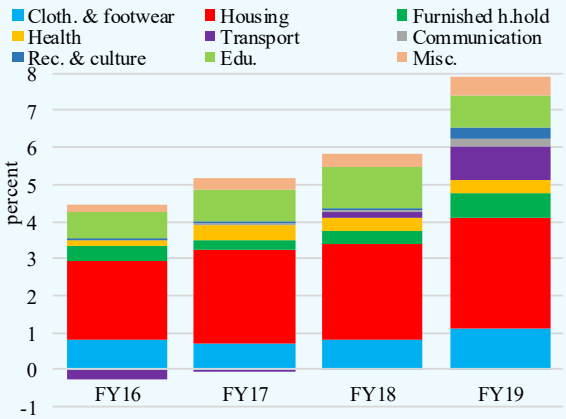
FY18*		FY19**		FY19***	
Price description per 1,000 piece	**Rate of duty/1000 pc**	**Price description per 1,000 piece**	**Rate of duty/1000 pc**	**Price description per 1,000 piece**	**Rate of duty/1000 pc**
If the on-pack printed retail price exceeds Rs 4,500	Rs 3,740	If the on-pack printed retail price exceeds Rs 4,500	Rs 4,500	If the on-pack printed retail price exceeds Rs 5,960	Rs 5,200
If the on-pack printed retail price exceeds Rs 2,925, but less than Rs 4,500	Rs 1,670	If the on-pack printed retail price exceeds Rs 2,925, but less than Rs 4,500	Rs 1,840	If the on-pack printed retail price is less than Rs 5,960	Rs 1,650
If the on-pack printed retail price does not exceed Rs 2,925	Rs 800	If the on-pack printed retail price does not exceed Rs 2,925	Rs 1,250		

*SRO 407(I)/2017 dated 29th May 2017, ** SRO 1150(I)/2018 dated 18th September 2018,*** SRO 608(I)/2019 dated 11th June 2019
Data Source: Federal Board of Revenue

Core inflation: Cost-push pressures dominate

The core inflation component, measured by NFNE, continued its upward trajectory during FY19, indicating underlying demand pressures in the economy. However, component-wise analysis suggests that cost-push pressures also played a substantial role in driving up the NFNE inflation. As shown in **Figure 3.21**, the increase in NFNE came mainly from house rents, transportation services, clothing and footwear, and furnished household equipment.

Figure 3.21: Contribution to NFNE inflation

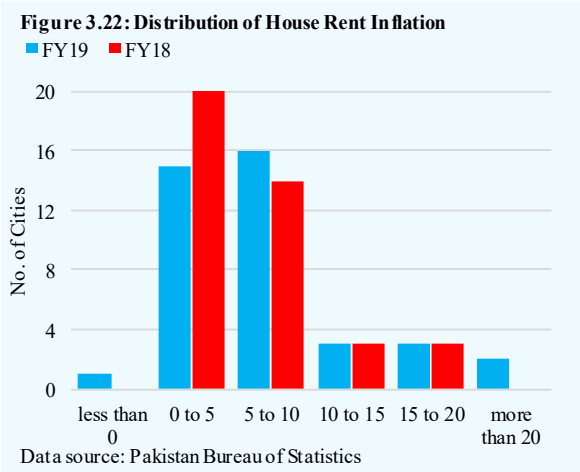


Data source: Pakistan Bureau of Statistics

Non-fuel transport items registered 12.4 percent inflation in FY19 compared to 2.3 percent last year. Items where inflationary pressures were most pronounced included transport services, mainly railway and bus fares, locally assembled cars, and tyres and tubes. In case of transport services, the increase in bus and train fares can be attributed to higher transport fuel prices. Since bus fares are determined by private transporters, their increase was more pronounced (up 28.4 percent). As for the train fares, it appears that the government only partly passed on the impact of higher transport fuel prices, as the fares increased by 16.2 percent on average for various categories.

In case of cars, prices of different variants increased in the range of 10 – 22 percent during the year. Domestic auto assemblers have justified these price hikes with the depreciation of the Pak rupee and the increase in regulatory duties on completely- and semi-knocked down kits and other auto parts

(including tyres). It is important to mention here that the demand for cars remained weak throughout FY19, and therefore could not contribute to inflation in this segment.

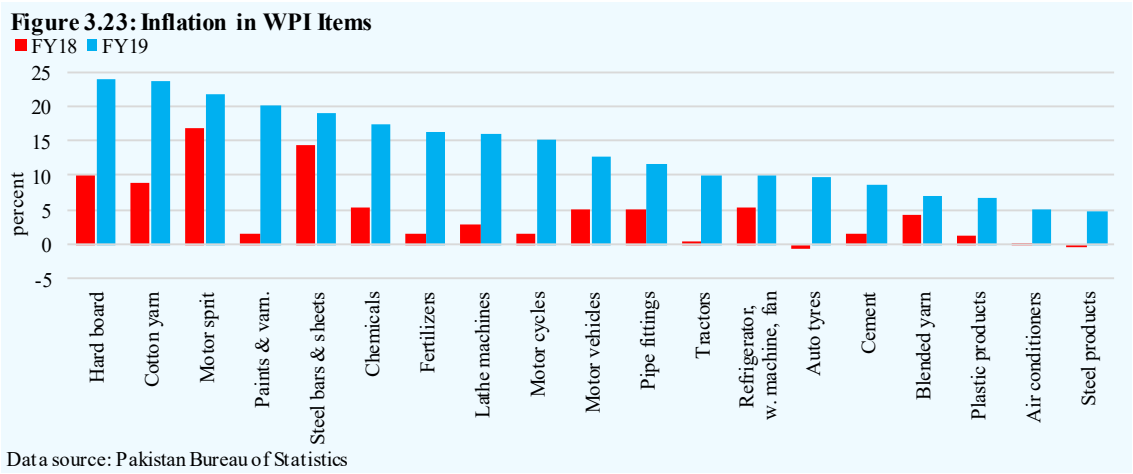


House rents continued to remain a major contributor to the rising core inflation. In FY19 also, around one third of non-food-non-energy inflation came from house rent. Although the average inflation in house rents for the country increased from 6.5 percent in FY18 to 7.2 percent, city-wise data shows that the vibrancy was observed only in a few cities, as in nearly half of the cities the inflation in house rents was less than last year. Furthermore, 24 out of 40 cities recorded inflation of less than 7.2 percent in their house rents. Importantly, 8 out of 40 cities posted double-digit inflation, among which, D.I. Khan and Turbat registered over 20 percent increase during the year (**Figure 3.22**).

Other items

In case of other items within the NFNE basket, the impact of increase in raw material prices played an important role. For instance, the cost of production for the textile industry increased during the year due to a sharp rise in cotton and yarn prices, as well as higher rupee cost of imported machinery, chemicals and other inputs (due to exchange rate depreciation). Similarly, the inflation in footwear also remained higher than last year. This increase was evident in both the imported as well as locally produced footwear (which use imported plastic and rubber). In overall terms, the clothing and footwear group posted an inflation of 6.7 percent, contributing 13.8 percent to the core inflation.

In addition to this sub-group, the impact of rising raw material prices was felt on other items within the NFNE as well. The most glaring impact could be seen on businesses' fuel and transportation costs. Besides, a number of industries, including automobiles, construction and electronic appliances, had to bear with a double-digit increase in domestic prices of steel bars and sheets. This increase was an outcome of both an increase in unit values of imported steel products, as well as the impact of the exchange rate movement. Similarly, a large number of industries were impacted by elevated prices of

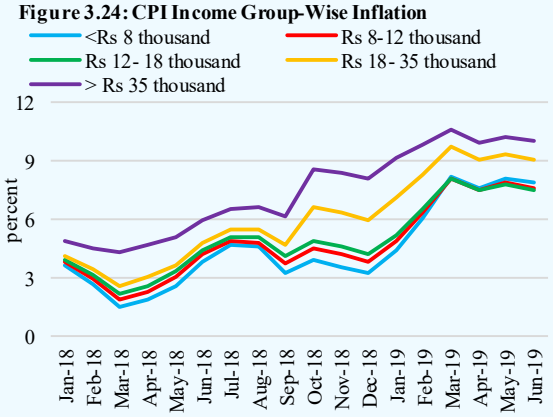


various chemicals. Pakistan mostly relies on imported chemicals that are used in local industries, including textiles, pharmaceuticals, steel melting, personal care items, washing soaps and detergent, and plastic products. In overall terms, the impact of higher input prices was captured by the wholesale price index, which recorded a 12.0 percent increase during FY19, up from the 3.5 percent level last year (**Figure 3.23**). On a YoY basis, WPI inflation remained in double digits during the year – for the first time since November 2013.

Incidence of inflation

After registering a steady behavior up till H1-FY19, inflation incidence on low income groups grew stronger in Q3-FY19, as the inflation doubled from around 3.2 percent YoY in December 2018 to 8.2 percent YoY by March 2019. Since the contribution of food inflation was dominant during H2-FY19, the incidence of inflation fell disproportionately on the low income groups (**Figure 3.24**).

Figure 3.24: CPI Income Group-Wise Inflation



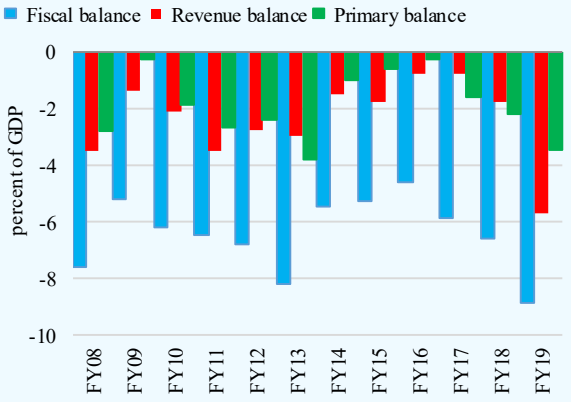
Data source: Pakistan Bureau of Statistics

4 Fiscal Policy

4.1 Overview

An unusual decline in revenue collection and steep rise in current expenditures caused a deterioration in all major fiscal indicators during FY19. The overall budget deficit during the year stood at a historic high of 8.9 percent of GDP, which was also in excess of the 4.9 percent target set in the Budget 2018-19.[1] Meanwhile, the primary and revenue balances worsened substantially, highlighting growing debt stress for the government and a shrinking space for the needed development expenditures (**Figure 4.1**).

Figure 4.1: Major Fiscal Indicators



Data sources: Ministry of Finance and SBP calculations

Admittedly, the deterioration in these indicators could be partly attributed to factors beyond the control of the fiscal authorities, such as a steep rise in interest rates (that escalated the debt servicing burden); the shift in the political regime; legal constraints on the revenue side; and an overall slowdown in the economy. While these factors may well have contributed to the weak fiscal performance during the year, the fact remains that unless the institutional and structural faultlines are corrected, fiscal outcomes will remain excessively vulnerable to business cycle and non-economic factors, leaving a considerable scope for slippages. The case in point is the decline in revenue mobilization during the year, and the stagnation in tax collection.

Compared to a double-digit growth last year, tax revenues recorded a marginal growth of 0.1 percent in FY19 **(Table 4.1)**. On the face of it, this was mainly an outcome of: (i) a decline in PSDP expenditures, which not only led to lower collection from withholding tax on contracts, but also affected revenue mobilization from construction-allied industries; and (ii) court orders to substantially reduce the sales tax rate on major petroleum products and suspend the deduction of withholding tax on mobile phone top-ups. However, a deeper assessment holds responsible the country's fragile revenue structure, characterized by narrow base and excessive reliance on few sources. Specifically, the entire decline in the single-largest revenue source for the government, i.e., sales tax, during FY19 was attributed to lower collections from petroleum; excluding this one item, the growth in sales tax collection rises to 7.2 percent. Similarly, heavy loss incurred by SBP in the fourth quarter wiped out more than a third of overall non-tax revenues collected during the first three quarters. Taken together, the fiscal cost of the decline in revenues under these heads (petroleum and SBP profits), stood at 1.1 percent of GDP.

Besides the tax structure, the budgeting exercise also needs to be rationalized and brought in line with the revenue targets. For instance, the federal government had envisaged a sharp increase in tax revenues without specifying any fresh measures to boost collections. This optimism was centered primarily on an upbeat growth outlook for FY19, better tax administration, and the revenue impact of import compression measures (imposition of regulatory duties and additional customs duty). Given

[1] However, the target was revised up to 7.2 percent of GDP in March 2019.

Table 4.1: Summary of Fiscal Operations
billion Rupees, growth in percent

		Actual		Percent of GDP	
	Budget FY19	**FY18**	**FY19**	**FY18**	**FY19**
A. Total revenue	6,257.3	5,228.0	4,900.7	15.2	12.7
Tax revenue	5,336.0	4,467.2	4,473.4	13.0	11.6
Non-tax revenue	921.3	760.9	427.3	2.2	1.1
B. Total expenditure	8,138.3	7,488.4	8,345.6	21.8	21.6
Current	6,334.0	5,854.3	7,104.0	17.0	18.4
Interest payments	*1,620.2*	*1,499.9*	*2,091.1*	*4.4*	*5.4*
Defence	*1,100.3*	*1,030.4*	*1,146.8*	*3.0*	*3.0*
Development	1804.2	1,584.1	1,178.4	4.6	3.1
Net lending	-0.2	37.6	40.8	0.1	0.1
Statistical discrepancy		12.4	22.4	0.0	0.1
Fiscal balance (A-B)	-1,881.0	-2,260.4	-3,444.9	-6.6	-8.9
Revenue balance	-76.7	-626.3	-2,203.3	-1.8	-5.7
Primary balance	-260.8	-760.5	-1,353.8	-2.2	-3.5
Financing		*2,260.4*	*3,444.9*	*6.6*	*8.9*
External sources		785.2	416.7	2.3	1.1
Domestic sources		1,475.2	3,028.2	4.3	7.9
Banks		1,120.5	2,263.2	3.3	5.9
Non-bank		352.7	765.0	1.0	2.0
Privatization		2.0	0.0	0.0	0.0
Growth					
Total revenue		5.9	-6.3		
Tax revenue		12.5	0.1		
Non-tax revenue		-21.4	-43.8		
Total expenditure*		10.1	11.4		
Current		12.6	21.3		
Development		-6.4	-25.6		

* Including statistical discrepancy

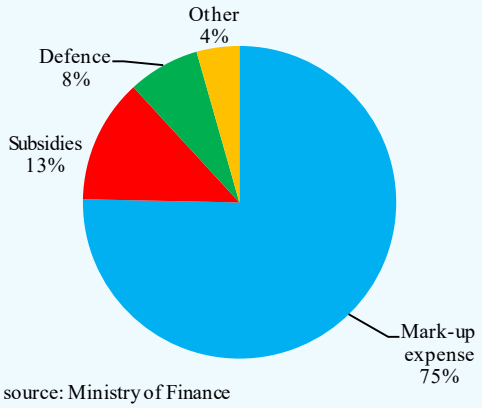
Data sources: Ministry of Finance and SBP calculations

the fact that the economic activities had already lost steam by the time the budget was being finalized and it had become abundantly clear that the macroeconomic stabilization policies would stay in place, the growth assumption of 6.2 percent was optimistic. Furthermore, while it was quite ambitious to expect governance-centric measures to deliver in a short span of time, the impact of import compression measures could have gone either side; revenues can actually fall if these measures lead to a sizable import contraction.

The revenue-led fiscal stress was reinforced by overall weak expenditure controls at both the federal and provincial levels. The current spending of the federal government surged by a quarter in FY19 compared to last year, and also surpassed the targeted spending. Around 60 percent of the YoY increase was due to mark-up payments, which was attributed to higher interest rates and the depreciation of the Pak rupee. In fact, the overrun in the mark-up expense alone explained 75 percent of the slippage in federal current expenditures from the target during FY19, compared to 40 percent last year (**Figure 4.2**). Within the non-interest spending, the burden of energy-related subsidies was heavier than expected, as power generation cost continued to increase (mainly due to capacity

payments[2]) and the government had to compensate for inefficiencies across the power generation and distribution sectors. In addition to these, outlays for public order and safety affairs, defence and pensions also rose susbtantially. Moreover, struggling with suboptimal public financial management, the provincial governments also found it challenging to cope with inherent rigidities in their current expenditures.

Figure 4.2: Composition of Federal Current Expenditures in Terms of Slippages from the Actual Targets during FY19



Data source: Ministry of Finance

Thus, with limited fiscal space available, the federal and provincial governments had to cut down their development spending. Encouragingly, the progress on ongoing CPEC projects was not compromised, as reflected by the higher spending on these projects compared to last year. Nonetheless, the overall control on development spending was insufficient to plug the large fiscal gap stemming from the subpar revenue performance and higher debt servicing. Therefore, the government had to finance the gap by accumulating a record-high level of debt during the year. It is important to note that while mark-up payments are already weighing heavily on limited and uncertain fiscal resources, public financial management could soon become very challenging if debt accumulation continues at such a rapid pace. Therefore, it is important for the government to strictly adhere to its medium-term fiscal strategy[3], which is centered on restoring the public debt sustainability and bringing the fiscal deficit down, in line with the Fiscal Responsibility and Debt Limitation Act, 2017.

Encouragingly, the entire strategy rests on gains from wide-ranging tax policy and administration reforms that, in addition to revenue growth, will also ensure progressivity of the tax system. The federal budget FY20 has already rolled out some of these reforms. For instance, it has eliminated the preferential tax treatment for certain sectors (e.g., sugar, steel and edible oil), and also ended the zero-rating regime for the five export-oriented sectors to generate revenue from their domestic sales. Side by side, to facilitate hassle-free refunds to exporters, the FBR has introduced the Fully Automated Sales Tax e-Refund procedure to dispose-off refund claims within 72 hours of their submission. Another important step was to instruct registered businesses to record CNIC numbers of unregistered buyers and suppliers in their invoices while filing their sales tax returns (**Box 4.1**). Furthermore, the FBR has gradually been increasing the valuation rates of immovable properly to align them with market rates; this is likely to enhance the revenue stream from this high-potential sector. On the expenditure side, the strategy focuses on containing the growth in the wage bill and implementing energy sector reforms to reduce the fiscal and quasi-fiscal burden.

Finally, an important agenda on fiscal reforms should be the capacity building of the provincial authorities, which are responsible for mobilizing revenue via the agriculture income tax, sales tax on services and property taxes, and carrying out crucial spending on important sectors like education, health, social spending and regional infrastructure. However, nine years after the 18th Amendment, the provinces still seem to lack capacity to adequately assume these responsibilities. Their revenue efforts have been unimpressive to say the least, whereas their allocation on social development has been much less than what is required to bridge the existing service delivery gap. Therefore, it requires

[2] For further details, please see Special Section 1: "Why are Power Tariffs in Pakistan Consistently High?", published in SBP's Third Quarterly Report for FY19 on State of Pakistan's Economy.
[3] For details, see "A Roadmap for Stability, Growth, and Productive Employment, published by Government of Pakistan, Finance Division.

strong commitment from the provincial governments to support the fiscal consolidation efforts, bring the needed diversification in the revenue base, and gear themselves up to carry out effective public financial management to improve the quality of public spending.

Box 4.1 FBR's Recent Documentation Measures

Motivation behind the proposed measures

The FBR is actively working to reduce sales of registered businesses to unregistered enterprises/individuals. According to the revenue authority, the share of such transactions in the overall sales of registered enterprises was around 40 percent between July 2014 and March 2019. Furthermore, 50 percent of sales of 17 out of 35 sectors are made to unregistered buyers. The persistently high share of unregistered sales results in further expansion of the shadow economy, all the while hurting the revenue potential of the government authorities. It is also important to note here that, according to the FBR, only 41,484 persons registered for sales tax purposes are actually paying some tax with their returns. For reference, the total industrial electricity connections in the country are more than 300,000. This means that an overwhelming majority of the businesses are operating in the informal economy.

Introduction of the CNIC Condition

As part of the Finance Bill 2019, the federal government proposed an amendment in the Sales Tax Act of 1990. Initially, the registered persons were required to issue a serially numbered tax invoice at the time of the sale of goods. The invoices had to include the name, address and registration number of the supplier and recipient of the goods; the date of issue of the invoice; the description and quantity of goods; value of the sales tax applied; and the price inclusive and exclusive of the GST. According to the amendment, which was to become effective from 1st August, 2019 (but was later delayed), the requirements were elaborated further and the registered persons were instructed to record NIC number or NTN of the recipients unregistered with FBR for sales tax in addition to the details being recorded of the registered recipients. A relaxation from this clause was granted for sales up to Rs 50,000, provided that the recipient is an ordinary customer (i.e. a person who is buying goods for his or her own consumption and not for the purpose of reselling).

The amendment caused significant unrest in the market, with a majority of the businesses taking a stance against it. Protests were arranged by the associations across the country and the government was asked to abolish the CNIC restriction. However, much of the opposition against the reforms arose because of the misunderstanding about the announced measures. In this regard, the following points are important:

- **The CNIC/NTN condition only pertains to sales of businesses that are registered with FBR**. Those firms which are working informally do not need to ask for CNIC details from their purchasers, as they do not file tax returns. However, if those firms procure raw material from a registered firm, then they would have to provide the requisite CNIC details to the supplier.
- **The buyer does not have to be a registered person.** Registered firms can continue to transact with unregistered buyers; the only addition is that they would have to document the CNIC of the buyer in question.
- **Sellers only have to record the NTN/CNIC number on the invoice; physical copies of the identity cards are not required**. According to news reports, some businesses were fearing that they would have to keep photocopies of the recipients' CNIC for record purposes, stating that such a measure would unjustly increase their operating and storage costs. However, no such provision has been proposed in the Finance Act.
- **No action will be taken against the business if the CNIC/NTN details are found to be incorrect upon subsequent inspection**. The following provision is to be made part of the Sales Tax Act upon its revision: *"Provided also that if it is subsequently proved that CNIC provided by the purchaser was not correct, liability of tax or penalty shall not arise against the seller, in case of sale made in good faith."* It was later clarified that no action would be undertaken without the approval of the Chief Commissioner of the respective jurisdiction. Lastly, even if action against the seller is warranted, it would be taken only after necessary action has been taken against the person who provided the non-genuine CNIC. A further clarification released by FBR explained that the NIC/NTN of the buyer with respect to taxable supplies to an unregistered person shall be deemed to have been reported in good faith provided that:

(i) The tax invoice complies with the requirements ofsection 23(b) of the Act;
(ii) Payment made by or on behalf of the unregistered purchaser of the amount of the tax invoice, inclusive of sales tax and applicable further tax, is deposited into the supplier's declared business bank account;
(iii) The NIC provided by the purchaser is found authenticated by NADRA; and
(iv) The NIC/NTN provided is not of the employee of the seller or of his associates as defined under the Income Tax Ordinance, 2001.

- **The documentation clause would not result in the halt of purchasing by end-consumers**. This is because ordinary buyers are exempted from such a condition, provided that the value of their purchases is up to Rs 50,000.
- **The amendment would not result in any price hike**, given that no additional tax measures have been adopted under the Finance Bill 2019.
- **Sales tax filers feel that registered businesses have been unfairly tasked with the burden of identifying the non-filers**. According to FBR, if the documentation efforts are not expanded to identify those individuals that are not paying any taxes, then the tax burden on existing registered enterprises would continue to remain high.

- **The condition would not be enforced on small businesses in the cottage industry**. According to the revised definition followed by FBR, a cottage industry player is one that: does not have an industrial gas or electricity connection; is located in a residential area; does not have a total labor force of more than ten workers; and has an annual turnover from all supplies not exceeding two million rupees.

Conclusion
It is important to note that such structural reforms are unpopular in nature (and were thus delayed earlier) as these might increase businesses' transaction costs, create liquidity issues, and affect overall economic activity in the short term. In particular, the introduction of the CNIC condition for sales tax purposes has faced serious resistance (including threats of lockdowns and protests) from traders across the country. The FBR has since then issued clarification circulars and engaged with the businesses on various forums to help clarify the matters and take feedback. Therefore, it is important to build capacity within the FBR and to further digitize its functions to streamline procedures. Moreover, the authority needs to continue the dialogue with relevant stakeholders for ensuring smooth implementation of policies, and alleviate regulatory and policy mistrust.

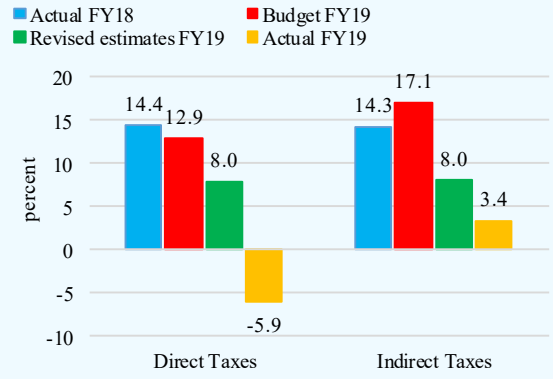
4.2 Revenues

Total revenues declined by 6.3 percent during FY19. This decline stemmed entirely from an unprecedented reduction in non-tax revenues during the year, which was attributed primarily to a sharp decline in transfer of SBP profits to the government. Tax revenues also stagnated as FBR's collection fell significantly short of the target set for the year. Provincial collection improved but its level still remains too low to make an impact.

Tax revenues

FY19 was an election year and fiscal targets were set much earlier (in April 2018), before the interim government took over. At this stage, the FBR had set a revenue target that showed an overall growth of 15.4 percent. Most of the improvement was envisaged in indirect taxes, whereas direct taxes were expected to grow modestly (**Figure 4.3**). According to budget documents, the FBR was expecting higher collection without any new tax measures; its estimates were based on: (i) the government's optimism with respect to the economic growth momentum – the budget committee had envisaged the real GDP growth for FY19 at 6.2 percent against initial estimate of 5.8 percent in FY18; (ii) expected success of the proposed tax reforms, including an improvement in tax base, better administration and compliance; (iii) the persistent impact of asset declaration and tax amnesty scheme and improved regulation of the real estate sector; and (iv) the positive revenue impact of import compression policies and the depreciation of Pak rupee.

Figure 4.3: Growth in FBR Targets and Actual Collection during FY19



Data source: Ministry of Finance

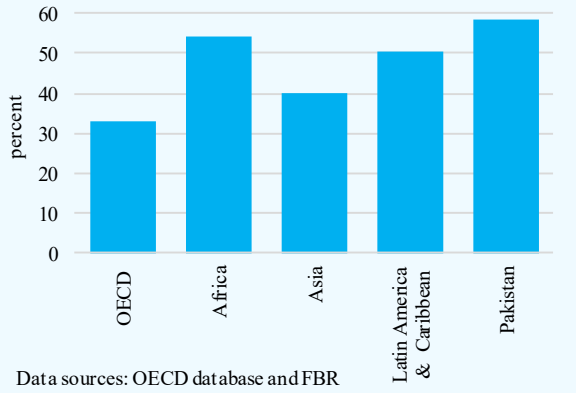
However, as the year progressed, nearly all the government's macroeconomic projections went off-track. Economic activity slowed down considerably right from the start of FY19 with the impact of regulatory and macroeconomic stabilization measures taking hold, and inflation surged more than the targeted 6 percent, necessitating a tighter monetary policy. Naturally with these trends, the overall revenue generation capacity of the economy weakened. Moreover, the revenue impact of tax measures and import compression policies also fell short of target. Making things more challenging, the government had to significantly lower tax rates on various petroleum products following the Court decision, and suspend withholding tax collection on mobile top-ups – these measure were taken in the first quarter. Given the fact that petroleum products constitute almost a third of the indirect tax collection, this decision severely dented the revenue mobilization.

Therefore, by the time the new government took over, achieving the revenue targets had already become quite challenging. The new fiscal managers came up with two supplementary budgets comprising of partial revision in income tax concessions, and the imposition of additional custom duties to compress imports and generate revenue. Moreover, realizing the growing revenue slippages, the government made downward revisions in the revenue targets. However, as things turned out, the supplementary measures proved insufficient and even the revised estimates could not be achieved (**Figure 4.3**). Indirect taxes slowed down considerably, whereas direct taxes declined. Compared to the revised estimates, FBR revenues fell short by Rs 321.5 billion, which turned out to be a major factor in the overall weak fiscal outcome and growing debt sustainability issues during the year.

The key takeaway from the revenue performance is to expedite documentation and taxation efforts, so that the revenues become more diversified and fiscal vulnerabilities be contained. Following points are important:

(i) There is an excessive reliance on indirect taxation in Pakistan, which makes the taxation system not only regressive, but also pro-cyclical (**Figure 4.4**). These taxes are very responsive to the economic activity, especially in the industrial sector. Therefore, any weakening in the industrial activity can have a more pronounced effect on their collection.[4] The composition of indirect taxes is also heavily skewed towards a few items. More than 30 percent of the collection comes from petroleum products, where revenues are very responsive to changes in global crude prices, domestic consumption, and regulatory changes in the tax rates.

Figure 4.4: Share of Indirect Taxes in Total Taxes across Various Regions



Data sources: OECD database and FBR

(ii) The composition of direct taxes is quite suboptimal reflecting lack of sufficient tax effort. The government relies heavily on withholding taxes, which downplays the role of revenue authorities. Furthermore, when these taxes are treated as final and are passed on to final consumers, they gain properties of indirect taxes. Despite a large tax machinery, comprising regional tax officers, nearly 64.1 percent of the income tax is collected via withholding agents such as banks, telecom companies, utility companies and car dealers. As for voluntary payments and collection on demand, their contribution is quite minimal. And even within the voluntary payments, around 90 percent collections are made in the form of advance tax; less than 10 percent comes through return filing.

Provincial authorities need to scale up their efforts in identifying their tax potential, devising adequate policies, and strengthening their capacities for implementation and collection. For instance, provincial tax authorities are responsible for collecting agriculture income tax, but so far they have been unable to devise a mechanism for collection. Similarly, anecdotal evidence suggests that there also exists a large potential for the collection of property income tax. If provincial authorities tap

[4] Qazi and Muhammad (2010) estimated Pakistan's tax buoyancy at 1.25 (Ahmed, Q. M., & Muhammad, S. D. (2010). Determinant of tax buoyancy: empirical evidence from developing countries. *European Journal of Social Sciences*, *13*(3), 408-418). Likewise, a study by IMF also estimated the short-term and long-term tax buoyancy for Pakistan i.e. 0.981 and 0.909, respectively (Dudine, P., & Jalles, J. T. (2018). How buoyant is the tax system? New evidence from a large heterogeneous panel. *Journal of International Development*, *30*(6), 961-991).

high-potential sectors, not only will they be able to reduce their dependence on the federal divisible pool, but will also diversify the revenue base across different sectors of the economy.[5]

Performance of FBR

Within FBR taxes, direct taxes declined by 5.9 percent during FY19 against a growth of 14.3 percent reported in FY18 **(Table 4.2)**. While voluntary payments fell the most, it was the decline in withholding taxes that pushed down the overall direct taxes.

The decline in WHT, having a share of nearly 65.0 percent in direct taxes, came from prominent reductions in the collection from salaries, contracts, cash withdrawals, and telephone. While collection from salaries took a hit from concessions on income tax granted in the FY19 budget, the decline in PSDP spending lowered the collection from contracts **(Table 4.3)**.

Voluntary payments, having a share of 25.7 percent in overall direct taxes, posted a steep YoY decline during FY19. Within voluntary payments, the downside push came from payments via return filing, which had seen an unusual increase last year when a large number of individuals took advantage of the asset declaration and tax amnesty scheme. Although a similar amnesty scheme was also introduced in FY19, its response seemed rather modest. Therefore, the share of collection via advance tax in total voluntary payments again reached 90 percent (**Figure 4.5**).

Collection on demand remained unchanged during FY19 compared to last year. The extension in the deadlines of e-filing during FY19 may have played a role in stagnation under this head.

Table 4.2: FBR Tax Collection

billion Rupees; growth in percent

			Growth	
	FY18	**FY19**	**FY18**	**FY19**
Direct taxes	1,536.6	1,445.5	14.3	-5.9
Indirect taxes	2,307.2	2,383.0	14.0	3.3
Customs duty	608.3	685.6	22.4	12.7
Sales tax	1,485.3	1,459.2	11.8	-1.8
FED	213.5	238.2	7.9	11.6
Total FBR taxes	**3,843.8**	**3,828.5**	**14.1**	**-0.4**
FBR taxes (% of GDP)	**11.2**	**9.9**		

Data source: Federal Board of Revenue

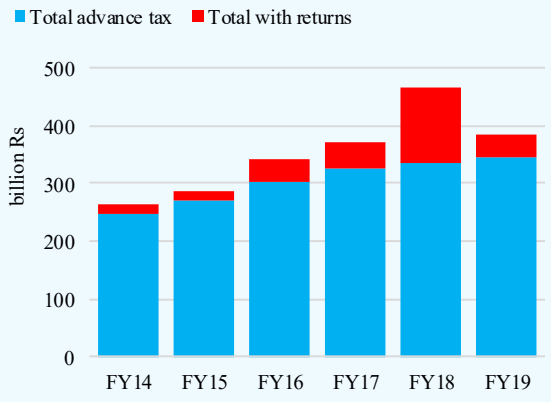
Table 4.3: Break-up of Direct Taxes

billion Rupees; growth in percent

			Growth	
	FY18	**FY19**	**FY18**	**FY19**
Voluntary payments	**467.0**	**384.7**	26.0	-17.6
Collection on demand	**102.9**	**102.9**	10.9	0.0
Withholding taxes	**1,046.9**	**960.7**	11.3	-8.2
of which				
Imports	218.7	221.8	11.0	1.4
Exports	28.3	34.4	16.6	21.8
Contracts	282.9	234.7	9.0	-17.0
Salary	133.4	76.4	19.9	-42.7
Interest & securities	45.6	58.1	7.2	27.4
Cash withdrawal	34.0	31.8	10.3	-6.6
Dividends	57.8	57.2	16.9	-1.2
Electric bills	33.8	35.6	30.9	5.1
Telephone	47.4	17.2	-8.5	-63.7

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

Figure 4.5: Composition of Voluntary Payments



Data source: Federal Board of Revenue

[5] The provincial governments are made responsible for taxation of services, agriculture, and immovable property hence representing a significant share of economic activity and a substantial pool of potential tax revenues.
Reference: Cevik, S. (2018). Unlocking Pakistan's Revenue Potential. *South Asian Journal of Macroeconomics and Public Finance*, *7*(1), 17-36.

Sales tax

Sales tax collection declined by 1.8 percent during FY19 as compared to a growth of 11.8 percent during FY18. As mentioned before, the entire decline came from the POL segment, from which collections reduced by 16.9 percent for domestic sales and 16.2 percent for imported products on a YoY basis **(Table 4.4)**. While POL sales in value terms posted a 6.0 percent growth during the year, a steep reduction in sales tax rates on petroleum products during H1-FY19 led to a contraction in revenues (**Table 4.5**).

Table 4.4: Sales Tax on Domestic and Import Stage

billion Rupees; growth in percent

			Growth	
	FY18	**FY19**	**FY18**	**FY19**
Domestic				
POL Products	299.1	248.5	32.4	-16.9
Cement	24.1	21.6	-18.9	-10.2
Aer. water/beverages	17.7	12.2	-5.5	-30.9
Cigarettes	20.5	23.1	16.9	12.6
Natural Gas	4.9	4.4	-58.0	-10.3
Others	294.8	354.5	-8.7	20.2
Imports				
POL Products	264.2	221.3	24.6	-16.2
Iron and Steel	68.3	69.6	23.5	1.8
Vehicles	66.8	63.0	25.9	-5.6
Plastic resins etc.	45.1	52.1	26.8	15.4
Organic Chemicals	17.6	20.2	31.0	14.9
Total Sales Tax	**1,485.3**	**1,459.2**	**11.8**	**-1.8**

Data source: Federal Board of Revenue

Meanwhile, collection from the cement sector contracted by 10.2 percent during FY19. Similar to last year, this decline was attributed to lower cement dispatches in the domestic market, primarily as the government further cut down its non-CPEC PSDP expenditures. Other than PSDP, factors like the increase in FED (from Rs 1.25/kg to Rs 1.50/kg), proposed limitations on the axle load (to counter overloading transport practice) and absence of any notable crackdown on cement smuggled from Iran, may also have dented domestic demand for cement in FY19.

Table 4.5: Sales Tax Rate Applied on Major Petroleum Products

percent

Motor spirit excl. HOBC				**High speed diesel**			
FY18		**FY19**		**FY18**		**FY19**	
Effective from		***Effective from***		***Effective from***		***Effective from***	
1st July 2017	20.5	1st July 2018	17.0	1st July 2017	33.5	1st July 2018	31.0
1st Aug 2018	23.5	8th Jul 2018	12.0	1st Aug 2018	40	8th Jul 2018	24.0
6th Aug 2019	20.5	1st Aug 2018	9.5	6th Aug 2019	35.5	1st Aug 2018	22.0
1st Sep 2017	17.0	1st Oct 2018	4.5	1st Sep 2017	30	1st Oct 2018	17.5
1st Oct 2017	17.0	1st Nov 2018	4.5	1st Oct 2017	31	1st Nov 2018	12.0
1st Jan 2018	17.0	1st Dec 2018	8.0	1st Jan 2018	25.5	1st Dec 2018	13.0
1st Feb 2018	17.0	1st Jan 2019	17.0	1st Feb 2018	25.5	1st Jan 2019	17.0
1st Mar 2018	17.0	5th May 2019	12.0	1st Mar 2018	25.5	5th May 2019	17.0
1st Apr 2018	21.5	1st June 2019	13.0	1st Apr 2018	27.5	1st June 2019	13.0
1st May 2018	15.0			1st May 2018	27.5		
1st Jun 2018	7.0			1st Jun 2018	17		
12th Jun 2018	12.0			12th Jun 2018	24		

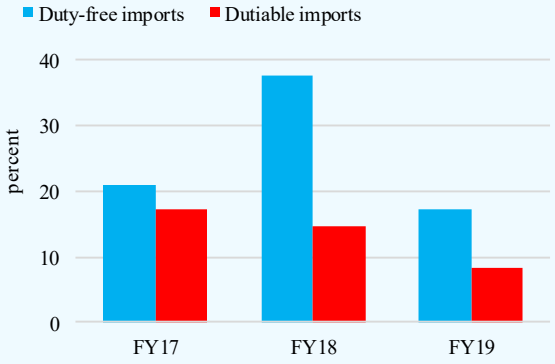
Data source: Federal Board of Revenue

Customs and Federal Excise Duties

The imposition of additional regulatory duties and PKR depreciation (which led to an increase in value terms of imports despite lower quantum) helped customs duties grow by 12.7 percent as compared to 22.4 percent last year. All the major drivers of custom duty collection recorded growth, with the exception of vehicles.

It is important to note that while the overall import values have increased, their growth has slowed down considerably compared to last year. Also, from revenue perspective, the structure of imports has been unfavorable: during the past 3 years, the growth in duty-free imports has outpaced the growth in dutiable imports (**Figure 4.6**). In FY19 also, this trend continued; even in absolute terms, the increase in duty-free imports was higher than the increase in dutiable imports, taking the share of duty-free imports to 32.6 percent in total imports during the year.

Figure 4.6 : Trend in Import Growth with Respect to Custom Duty Collection



Data source: Federal Board of Revenue

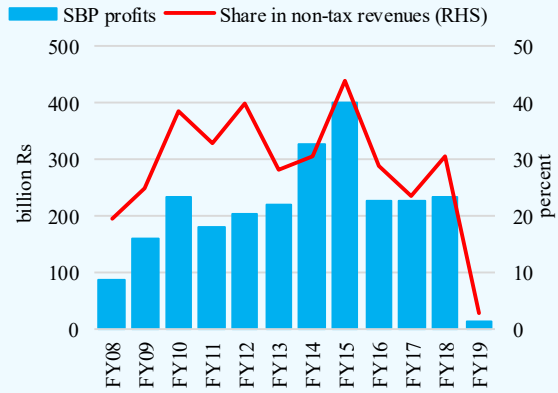
FED collection also increased by 11.6 percent during FY19 compared to a 7.9 percent growth witnessed during FY18. However, a significant part of this collection was recovered from the cigarette industry following an upward revision in the rate of excise; excluding these revenues, FED growth dips to 0.6 percent during the year. This is in contrast to the situation in FY18, where the yearly growth in excise duties was 7.9 percent while FED excluding cigarettes had risen by 11.2 percent (**Table 4.6**). Collections under this head excluding cigarettes contracted during the second and third quarter on a YoY basis, on the back of subdued or declining collection from beverages, natural gas, vehicles and cement segments, indicating the overall slowdown in economic activity in the country.

Table 4.6: Impact of Outliers in Sales Tax and FED Collection
billion Rupees; growth in percent

	Collections		Growth	
	FY18	FY19	FY18	FY19
Sales tax	**1,485.3**	**1,459.2**	11.8	-1.8
o/w POL products	563.2	469.8	28.6	-16.6
Total FED	213.5	238.2	7.9	11.6
o/w Cigarettes	67.1	91.0	1.2	35.5
Sales tax excl. POL	891.1	922.1	3.5	7.3
FED excl. cigarettes	131.6	146.4	11.2	0.6

Data source: Federal Board of Revenue

Figure 4.7: Trends of SBP Profits in Non-Tax Revenue



Data sources: Ministry of Finance and SBP calculations

4.3 Non-tax Revenues

Non-tax revenue declined sharply during FY19, which is largely explained by a steep decline in SBP profits (**Table 4.7**). It is important to note that SBP profits have lately become an important revenue source for the government, as these have constituted nearly one third of non-tax revenues over the past 5 years **(Figure 4.7)**. Since mark-up earned on government debt constitutes the bulk of central bank's earnings, the transfer of SBP profit effectively represents a partial reimbursement of interest payments. In FY19, however, the profit of SBP took a steep plunge as it incurred heavy exchange rate losses on external liabilities.

Moreover, the decline in PSDP spending for two consecutive years (which involves government's lending to public sector institutions), led to lower mark-up payments from PSEs. Most of the decline was visible in collections from National Highway Authority, Wapda, Discos, and Chashma Nuclear Power Plant. The cumulative decline in revenue from these sources more than offset the higher

collections from energy-related components of non-tax revenues, including royalties on gas and oil, discount retained on crude oil and other levies (**Table 4.7**). The increase in these revenues mainly stemmed from a rise in rupee value of crude oil.

Table 4.7: Non-tax Revenues
billion Rupees

	Actual	
	FY18	**FY19**
Mark-up (PSEs & others)	87.8	35.7
Dividends	57.5	60.2
SBP profits	233.2	12.5
Defence	12.8	15.6
Royalties on gas & oil	58.2	87.9
Profits Post Office Dept./PTA	15.9	18.2
Passport & other fees	15.9	23.0
Discount retained on crude oil	9.1	14.0
Windfall levy against crude oil	3.9	7.7
Petroleum levy on LPG	2.1	3.7
Other	264.5	148.7
Total non-tax revenue	**760.9**	**427.3**

Data source: Ministry of Finance

4.4 Expenditures

Even with a steep decline in development spending, total spending grew by 11.3 percent during FY19. The major push came from current expenditures, which grew by 21.3 percent on top of 12.6 percent growth last year **(Table 4.8)**.

Current expenditures

The growth in current expenditures accelerated mainly due to higher interest payments (up by 39.4 percent), primarily attributed to increase in domestic interest rates. Mark-up payments on external debt also increased, but their level remained quite low. Importantly, the government had initially envisaged the debt servicing target that represented an increase of only 6.2 percent over FY18. Given the projected trajectory of inflation and interest rates and the growth in size of public debt stock last year (revised estimates), the government had clearly underestimated the increase in debt servicing for FY19. It was not before March 2019, when the government made significant upward revision in interest payments; however, it was too late by then to devise a counter strategy. The overall mark-up payments during FY19 were 29.1 percent higher compared to expense targeted in the Budget 2018-19. The resultant fiscal stress can be seen from the fact that interest payments alone ate up nearly 55 percent of the total FBR's taxes during FY19.

Table 4.8: Fiscal Spending
billion Rupees; growth in percent

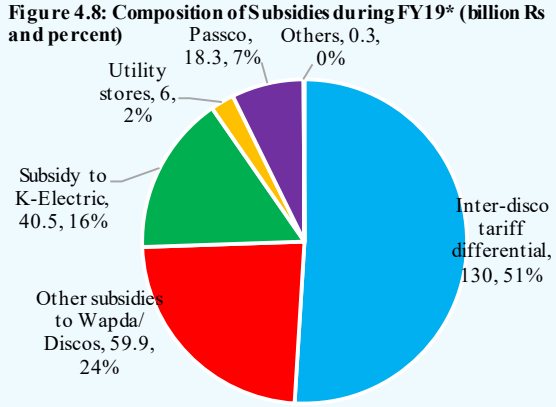
				Growth	
	FY18	**FY19**	**Abs. change**	**FY18**	**FY19**
Current expenditures	**5,854.3**	**7,104.0**	**1,249.8**	**12.6**	**21.3**
Federal	3,789.8	4,776.2	986.4	9.1	26.0
of which					
Interest payments	1,499.9	2,091.1	591.2	11.2	39.4
(i) Domestic	1,322.6	1,820.8	498.2	8.4	37.7
(ii) Foreign	177.3	270.3	93.0	38.3	52.5
Defence	1,030.4	1,146.8	116.4	16.0	11.3
Public order and safety	124.7	171.6	46.9	-2.5	37.6
Others	1134.8	1,366.6	231.9	2.4	20.4
Provincial	2,064.5	2,327.9	263.4	19.6	12.8
Development expenditures	**1,584.1**	**1,178.4**	**-405.6**	**-6.5**	**-25.6**
PSDP	1,456.2	1,008.2	-448.0	-7.7	-30.8
Others (including BISP)	127.8	170.2	42.4	10.4	33.2
Net lending	37.6	40.8	3.1	-393.6	8.3
Total Expenditure*	**7,475.9**	**8,323.2**	**8,47.3**	**8.7**	**11.3**

* Excluding statistical discrepancy
Data sources: Ministry of Finance and SBP calculations

The second big item within the current expenditures was defence, which showed an increase of 11.3 percent compared to last year. The entire increase was recorded in the first three quarters, as there was a YoY decline in defence spending during the fourth quarter. Moreover, the overall defence spending was largely aligned with the targeted spending for the year.

In contrast, subsidy expenditure exceeded the target set for the year by a wide margin. The overall subsidy expenditure increased by 72.8 percent during the year (revised estimates), which mainly represented the government's reluctance to pass on the full impact of financial weaknesses of power generation and distribution to end-consumers (**Figure 4.8**). The overall power generation cost continued to increase in FY19 both due to a rise in capacity payments as well as continued thermal generation from inefficient plants.[6] At the distribution end, Discos were unable to meaningfully control their transmission and distribution losses, and improve recoveries. Therefore, while some increase in power tariffs was allowed during the year to alleviate the fiscal burden, the government continued to compensate for most of the financial challenges faced by institutions across the energy value-chain. It is also noteworthy that subsidies only represent a part of energy sector weaknesses; a big chunk is also accumulated as quasi-fiscal expense in the form of circular debt.

Figure 4.8: Composition of Subsidies during FY19* (billion Rs and percent)



*Revised estimates for FY19
Data source: Budget in Brief (FY20)

Development expenditure

Development spending sharply declined by 25.6 percent as compared to a reduction of 6.5 percent during last year. The steeper decline in development expenditure owes to a sharp reduction in PSDP spending both at the federal and provincial fronts.

The federal development expenditures shrank by 12.9 percent as compared to a 20.6 percent decline last year. Within the development expenditures, a marked weakening was recorded in PSDP expenditures, which after growing at a double-digit pace from FY14 till FY17, dropped for the second consecutive year. Importantly, while the decline in PSDP expenditure in FY18 was primarily attributed to establishment of interim government and pre-election moratorium on PSDP releases during the fourth quarter, the decline in FY19 was spread out across all quarters.

Here, it is worth mentioning that despite a reduction in federal PSDP during FY19, the spending on CPEC-related PSDP projects remained robust. More specifically, spending on some projects including the Peshawar-Karachi motorway (Sukkur-Multan section), KKH Phase-II Havelian-Thakot, and the motorway from Burhan-Hakla on M-I to Dera Ismail Khan increased considerably. Taken together, these three infrastructure projects constituted more than 60 percent of total CPEC-related spending during FY19.

Within non-PSDP development expenditure, expenditure on BISP, one of the biggest social safety nets, expanded by 5.0 percent to Rs 118.7 billion as compared to a growth of 1.4 percent in FY18. This growth was contained in comparison with the previous years (the growth rates in FY16 and

[6] Source: Special Section 1: "Why are Power Tariffs in Pakistan Consistently High?", SBP's Third Quarterly Report for FY19 on The State of Pakistan's Economy.

FY17 were 11.1 and 9.3 percent, respectively), reflecting the impact of fiscal tightening on development expenditure.

4.5 Provincial Fiscal Operations

The provinces adhered to a better fiscal discipline and posted a combined surplus of Rs 190.0 billion during FY19, compared to a deficit of Rs 17.5 billion recorded last year. The main contribution came from Punjab, which provided a record-high surplus during the year. While the other three provinces also recorded surpluses, their contribution was not sufficient to meet the target of Rs 285.6 billion for the year **(Table 4.9)**.

Table 4.9: Provincial Fiscal Operations

billion Rupees

	Punjab	Sindh	KP	Balochistan	Total	Growth
FY19						
A. Total Revenue (i+ii+iii)	1421.2	820.6	489.2	264.9	2995.9	2.0
(i) Provincial share in federal revenue	1167.4	599.7	393.0	237.6	2397.8	8.1
(ii) Provincial Revenue (I+II)	232.4	187.4	50.8	17.5	488.1	-10.9
I. Taxes	192.6	177.9	19.8	11.5	401.8	0.1
II. Non-tax revenue	39.7	9.4	31.0	6.1	86.3	-41.2
(iii) Federal loans and transfers	21.4	33.5	45.4	9.7	110.0	-36.4
B. Total expenditure	1372.4	765.0	472.1	247.6	2857.0	-3.5
Current**	1129.8	656.7	358.3	206.0	2350.8	13.0
Development	242.5	108.3	113.8	41.6	506.2	-42.5
Gap (A-B)	48.8	55.6	17.1	17.3	138.9	-720.8
Financing* (overall balance)	**-122.3**	**-42.1**	**-6.6**	**-19.1**	**-190.0**	**-1183.7**
FY18						
A. Total Revenue (i+ii+iii)	1,412.0	802.8	481.5	242.3	2,938.5	21.0
(i) Provincial share in federal revenue	1,078.8	562.3	363.5	212.9	2,217.4	12.8
(ii) Provincial Revenue (I+II)	259.1	192.7	82.2	14.0	548.1	36.6
I. Taxes	197.5	176.1	18.3	9.4	401.4	24.7
II. Non-tax revenue	61.6	16.6	63.9	4.6	146.7	84.5
(iii) Federal loans and transfers	74.1	47.8	35.8	15.3	173.0	182.9
B. Total expenditure	1,418.6	845.1	447.1	250.1	2,960.9	14.3
Current**	948.8	619.7	329.7	182.5	2,080.7	19.6
Development	469.8	225.4	117.4	67.6	880.1	3.3
Gap (A-B)	-6.6	-42.3	34.4	-7.8	-22.4	-86.3
Financing* (overall balance)	**17.4**	**34.7**	**-10.1**	**-24.4**	**17.5**	**10.5**

*Negative sign in financing means surplus. ** Current expenditure data may not match with those given in Table 4.8 as numbers reported here include the markup payments to federal government.
Data source: Ministry of Finance and SBP calculations

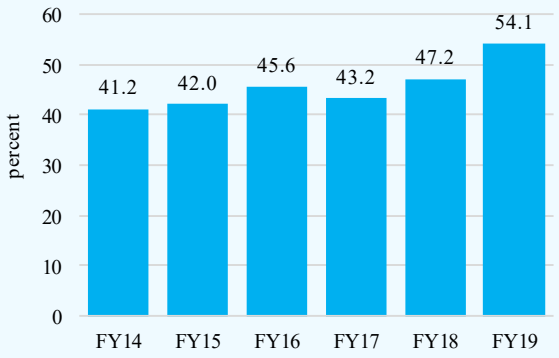
Provincial revenues

Despite the fact that the federal government collected less revenue during FY19, it was able to transfer 8.1 percent more funds to provinces from the divisible pool (**Figure 4.9**). However, this increase was largely offset by a decline in the provinces' own revenue collection and lower receipts of development loans and transfers from the federal government. As a result, total provincial revenues grew by only 2.0 percent during FY19 as compared to 21.0 percent growth recorded last year.

The provincial own revenue collection declined by 10.9 percent as compared to a growth of 36.6 registered last year. This decline was mainly attributed to a sharp reduction in provincial *non-tax* revenues, reflecting delays in payments against profits from hydroelectricity from federal to provincial bodies. Compared to Rs 61.3 billion transferred last year, profit from hydroelectricity

stood at only Rs 21.1 billion in FY19, despite the fact that hydel generation was 14.6 percent higher compared to last year. Khyber Pakhtunkhwa was affected the most since these profits are a major revenue source for the province. It is important to note that presently, an interim arrangement is at work between the federal and KP governments, according to which a notional fixed rate of Rs 1.1 per kWh (indexed at 5 percent per annum) is being charged from power consumers to generate funds to transfer net hydel profits. However, due to liquidity constraints, the federal government was unable to pass the collected funds to the provincial governments.

Figure 4.9: Share of Resources Transferred to Provinces in Gross Revenue Receipts of the Federal Government

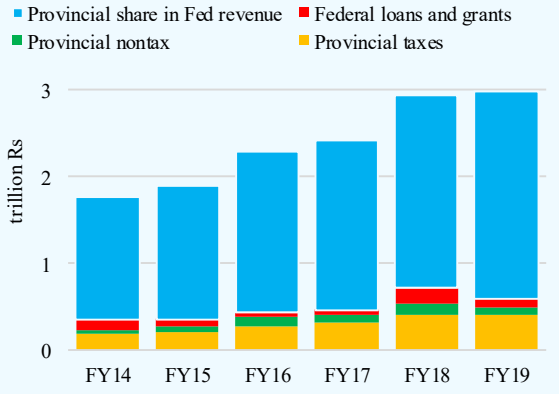


Data source: Ministry of Finance

In contrast, the provincial tax revenues grew by a meagre 0.1 percent during FY19 as compared to 24.7 percent increase recorded last year. This stagnation was explained by a sharp 9.4 percent decline in collections from General Sales Tax on Services (GSTS), which more than offset healthy collections against stamp duties, property taxes, excise duties and other sources. The decline in GSTS probably stemmed from an overall deceleration in the services sector growth during the year.

While the slowdown in the provinces' own revenue collection in FY19 could be linked to overall weak growth momentum, the performance of provincial governments in general has not been impressive since the introduction of the 18th Amendment. It was expected that over time, the provinces will enhance their capacity to collect taxes by modifying their institutional structures and reduce their dependence on federal transfers. Despite the fact that all provinces have dedicated institutions to mobilize revenues, they are still overly reliant on federal transfers (both from the divisible pool as well as development loans and transfers) (**Figure 4.10**). Importantly, these institutions are responsible to collect sales tax on the largest sector of Pakistan's economy, i.e. services, and collect income tax from the agriculture sector. The provincial governments have failed to put in place a workable strategy to improve collection.

Figure 4.10: Composition of Provincial Revenue Base



Data source: Ministry of Finance

At first, it is important to understand that the process of devolution itself is incomplete, as the financial autonomy to raise and spend revenues has not spread out to district levels. This limits the potential of revenue mobilization and also compromises the spending quality. From revenue point of view, there appears to exist an excess fragmentation of agencies within the provincial governments, which complicates the taxation mechanism: (i) the Excise and Taxation Departments, which collect the urban immovable property tax, the tax on professions, the motor vehicle tax, and provincial excises; (ii) the Boards of Revenue, which collect the agriculture income tax, land taxes, stamp duty and other taxes on property transactions; and (iii) the revenue authorities that collect the GSTS (Sindh Revenue Board, Punjab Revenue Authority, KP Revenue Authority, and the Balochistan Revenue Authority). These institutions are responsible for implementing the policies devised by the provincial

finance ministries. All these institutions need to be integrated in order to improve efficiency and make it more convenient for taxpayers.

The provincial governments should also rationalize the incentive structures in these agencies as no serious tax effort is observed on their part so far; these agencies are still relying only on an old tax base that include property taxes, stamp duties and/or motor vehicle tax, and are struggling to tap high-potential sectors.[7] Capacity issues also exist, especially with respect to the collection of the agriculture income tax, which is collected either in the form of a tax on net income, or on land holding, whichever is higher. Lower collection under this head basically represents difficulties in assessing net agriculture income, and identifying individuals with net incomes above the threshold level. Therefore, whatever revenue is collected from agriculture, is based on landholding. As for the services, it appears that the informal nature of a large number of services concerns hinders in collections. Furthermore, due to differences in the GST structure and rates on services between provinces, the taxation mechanism gets very complicated for firms that operate across the country.

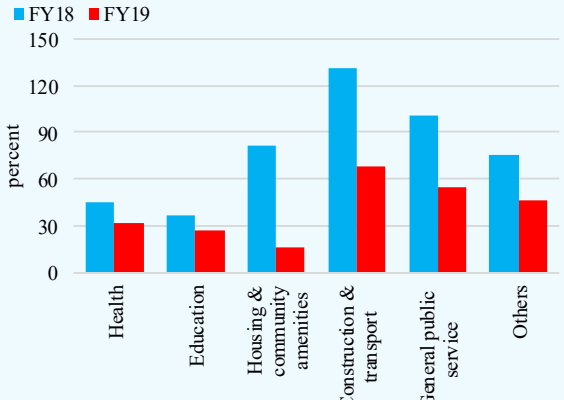
Here, it is important to highlight that agriculture and services, despite having 74.4 percent share in Pakistan's GDP, contribute negligibly to tax collection.[8] Therefore, the provincial governments have a more crucial role to play when it comes to improving the country's tax-to-GDP ratio, expand and diversify the revenue base, and tap revenue resources equitably. These governments have the constitutional authority; all they need is a serious commitment to support the sustainable growth objective, and strengthen their institutions with technical specialization of their staff and systems.

Provincial Expenditures

On the expenditure side, the provinces registered a decline of 3.5 percent during FY19 as compared to an increase of 14.3 percent recorded last year. This decline reflects the provincial governments' efforts to create surpluses to support the fiscal consolidation efforts. Punjab and Sindh tightened their belts more than the other two provinces because they had recorded large deficits last year, and had committed to contributing high surpluses in FY19. However, the entire expenditure control was observed in development spending, as current spending of the provincial governments grew by 13.0 percent during the year.

In the case of Punjab, the targeted development spending was set at half the level recorded in FY18. The government attributed this large cut to the sharp increase in operational expenses related to projects completed in recent years; large scale recruitment over the past few years; and the deferral of funding for subsidies relating to commodity operations and pension liabilities. The envisaged expenditure control was spread out across all the sectors including infrastructure, transport services, education and health **(Figure 4.11)**. While the government achieved its target on the whole, some across-the-sector variations were observed that reflected provincial priorities (**Figure 4.12**). For instance, the government had

Figure 4.11: Trend in Development Spending by Punjab



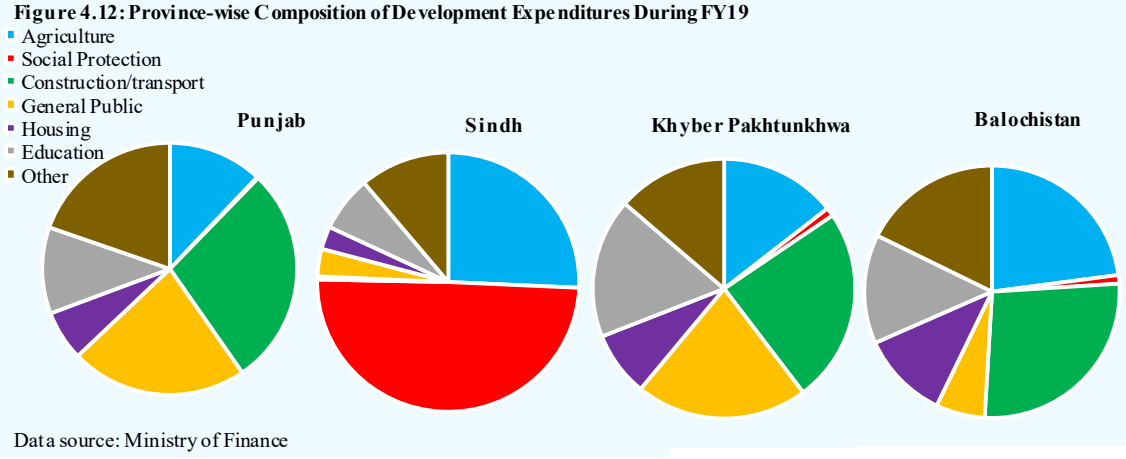
Data source: Ministry of Finance

[7] For instance, in the case of Sindh, 22 percent is collected from six sources: stamp duty, capital value tax, provincial excise duty, motor vehicle tax, property transfer tax, and urban immovable property tax. Source: Sindh Public Expenditure Review, World Bank (2016)

[8] On average, provincial own revenue (provincial tax and non-tax) contributed 1.0 percent of GDP since FY10 (Source: Ministry of Finance)

envisaged the steepest cut in expenditures on construction and transport in the Budget 2019 compared to last year; however, the actual spending was even less. On the contrary, Punjab's spending on education, health and public order and safety was according to the target.

Figure 4.12: Province-wise Composition of Development Expenditures During FY19



Data source: Ministry of Finance

In contrast, Sindh's target of achieving 11.8 percent growth in its development expenditures during FY19 seemed a little out of sync with the consolidation efforts. However, its actual spending stood at only 43.0 percent of the budgeted expenditures. Importantly, Sindh received higher transfers from the government during the year (divisible pool and development loans/grants combined), but the austerity objectives and uncertainty associated with the timing of these transfers did not allow the provincial government to spend according to its plan. Capacity issues with respect to project implementation, overall slow pace of execution of development schemes and delays in the approval of new projects, also led to the government's contained spending. Furthermore, it must be noted that the development outlay of Sindh government stands out among all the provincial governments for its heavy inclination towards two sectors: social spending and agriculture. The share of infrastructure development and transport is not even 1 percent of its development spending; other provinces allocate on average at least a quarter of their development spending outlay for these two sectors. In absolute terms, the province spent less than Rs 500 million on construction and transport. Given the state of infrastructure and public transport in the province, even in its major urban centers, the provincial government needs to reshape its development spending portfolio.

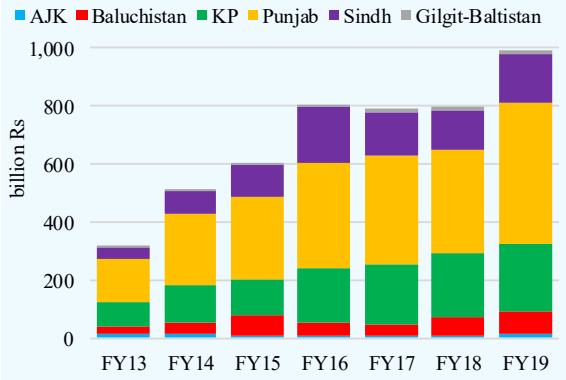
KP had also allocated a higher budget for development spending during FY19, but ended up spending 69 percent of it. Nonetheless, KP turned out to be the only province which was able to maintain the level of its development spending to a large extent. Importantly, out of the actual spending under its Annual Development Plan for the year, the bulk of the improvement was visible in district-level spending, which posted a three-time increase over last year; development spending of the provincial government (excluding foreign project assistance) actually fell during the year. As a result, the share of district-level spending in the total development plan increased from 13.5 percent in FY18, to 17.7 percent in FY19. Another important aspect which singled out KP from the rest of the provinces was the large volume of foreign assistance it received. Over 30 percent of its development projects were financed via foreign project loans, which included Rs 30 billion assistance from the Asian Development Bank; these funds were mainly spent on Peshawar Mass Transit, rehabilitation of roads, and construction of micro-hydroelectric power plants on rivers and tributeries. In addition to loans, foreign grants worth Rs 24.0 billion also supported development works in the province. Within these, the UK/DFID's spending on up-gradation of healthcare facilities and education infrastructure were the most prominent.

Finally, in case of Balochistan, the development spending outlay envisaged in the budget for FY19 was 30.5 percent higher than the spending in FY18. However, only 47 percent of the targeted development spending was realized during the year, with construction and transport recording the highest volume of underspending. On a year-on-year basis, nearly all the expenditure heads posted a decline, except for education. The Balochistan government did not compromise on this sector keeping in view the challenging state of education in the province compared to the other provinces.[9]

From the analysis of provincial development expenditures, two important trends can be identified: first, all the provinces curtailed their expenditures on transport and construction sectors. While these areas are important from the perspective of improving infrastructure in the economy, a temporary compromise can be made for initiating new projects, especially to create room for other important expenditures of social importance. The only concern is with respect to delays in the ongoing projects. For instance, the ongoing bus rapid transit projects in Sindh, Punjab and KP have all missed their completion deadlines (for reasons ranging from insufficient funds to implementation capacities), and reportedly this delay is partly responsible for an increase in project costs. Second, despite heavy cuts in infrastructure spending, all the provinces have struggled to scale up their spending on education and health. It is important to recall here that after the 18th Amendment, spending on these areas is the responsibility of the provincial governments. The federal government transfers over half of its revenues to provinces and can hardly meet its expenditures on debt servicing, defence and other important expenses. However, due to capacity issues and weak provincial revenue collection, the provincial governments have been underspending in these important areas; spending on education currently stands at only 2.4 percent of GDP, whereas spending on health is not even 1 percent. These numbers put Pakistan at a disadvantageous position when compared with 3.4 and 3.6 percent, respectively, for South Asia.[10]

Here it is also important to mention that the provinces are required to show fiscal surpluses to keep the consolidated fiscal deficit under check. Therefore, they had been underutilizing the resources coming from the divisible pool during the past few years, and depositing the excess funds with the banking system. As shown in **Figure 4.13**, the overall deposits of provincial governments have consistently been increasing over the past few years, and touched Rs 1.0 trillion by end-FY19. Putting this in perspective, this amount is even higher than the consolidated development expenditures incurred by the provinces during the year.

Figure 4.13: Deposits of Provincial Governments with Banking System



Data source: State Bank of Pakistan

[9] The literacy rate in the province at around 41 percent is much lower than the literacy rates in Punjab, Sindh and Khyber Pakhtunkhwa (at 62 percent, 55 percent and 53 percent respectively). Source: Balochistan White Paper for FY19.

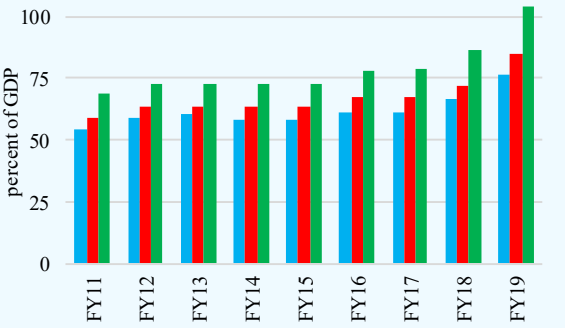
[10] The average government expenditure on education and health portfolios (as a percent of GDP) was 3.4 percent (2017) and 3.6 percent (2016) respectively for South Asia. Source: World Development Indicators

5 Domestic and External Debt

5.1 Overview

The pace of debt accumulation accelerated further in FY19 (**Figure 5.1**). In absolute terms, Pakistan's total debt and liabilities (TDL) increased by Rs 10.3 trillion, which was more than twice the accumulation in FY18. Despite high deficit in FY19, its contribution to the overall debt accumulation was limited to only a third; the rest was attributed to: (i) an upward revaluation of existing stock of external debt following the depreciation of the Pak rupee; (ii) foreign exchange inflows from Saudi Arabia, UAE and Qatar, for balance of payments support; and (iii) government borrowing over and above the budgetary requirements that remained in the deposits with the banking system (**Figure 5.2**).

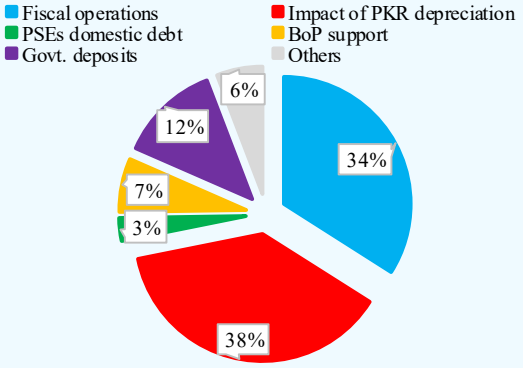
Figure 5.1: Debt Indicators



*As per FRDLA
Data sources: State Bank of Pakistan and Economic Affairs Division

The largest contribution to the TDL came from the gross public debt. Distributed almost evenly across domestic and external sources (**Figure 5.3**), the increase in gross public debt during FY19 was unprecedented and, even after adjusting for the impact of exchange rate-led revaluation, highlights serious concerns on the fiscal front. For one, total debt of the government (gross public debt minus government deposits) reached 76.6 percent of GDP at end FY19 – an increase of 10 percentage points in a year – far above the level prescribed under the (Amended) Fiscal Responsibility and Debt Limitation Act (FRDLA), 2017. In addition to government debt, debt incurred by public sector enterprises (PSEs) continued to move along an upward trajectory, as a number of energy-related PSEs struggled to acquire a semblance of financial viability; PSE debt as percent of GDP increased by another 1.3 percentage points during FY19.

Figure 5.2: Sources of Change in Debt & Liabilities in FY19

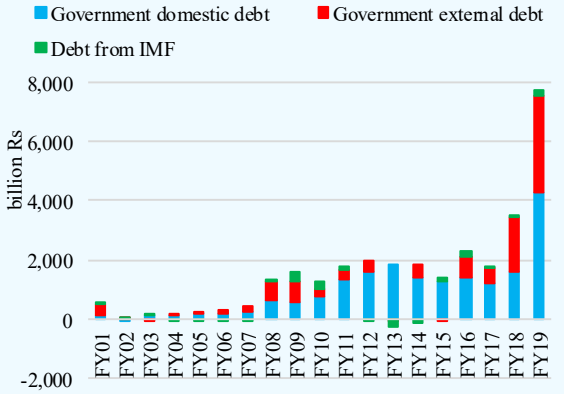


* in FY18, the impact of PKR depreciation stood at 35 percent
Data source: SBP staff calculations

At its core, the deterioration in government debt indicators is primarily an outcome of incomplete structural reforms in fiscal and energy sectors and weak public financial management, which has widened the resource gap for the government. In particular, revenue deficit has steadily been increasing over the last 3 years, implying that the bulk of recent debt accumulation by the government was meant to finance its current expenditures, instead of adding to the repayment capacity of the economy. Similarly, the increase in primary deficit has also contributed, as the government is increasingly falling short of resources to service even the existing debt stock. In this context, an additional setback the government faced in FY19 was the steep rise in interest rates and depreciation

of the Pak rupee, which escalated its debt-servicing burden; mark-up payments alone ate up 47 percent of the total tax revenues. With rising debt burden and its costly servicing, it has become challenging for the government to create space for spending on infrastructure, human capital development, and social protection, which are crucial for developing a competitive economy while achieving sustainable growth.

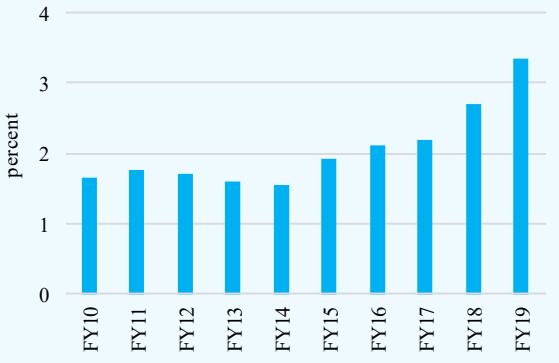
Figure 5.3: Composition of Change in Gross Public Debt



Data source: State Bank of Pakistan & Economic Affairs Division

While addressing these challenges necessitates decisive fiscal reforms, especially on the revenue side, important developments took place in FY19 from debt management perspective. Most notable among these was the re-profiling of domestic debt towards the end of the year. Although the government relied heavily on direct short-term borrowing from the central bank through most of the year, which continued to shorten the average maturity of public debt, it replaced the stock of short-term MRTBs held by the SBP into long-term PIBs of various maturities. This re-profiling was put into effect in the month of June 2019, which took the share of long-term debt (permanent and unfunded) in total domestic debt from 45.8 percent at end FY18, to 73.4 percent at end FY19. While this structural shift would spread out maturity schedule of public debt and help alleviate the rollover risk for the government, debt servicing burden may become costlier to the tune of the spread between yields of 6-month MRTBs and PIBs.[1] Moreover, with expectations of interest rate hikes gradually fading away, commercial banks are also getting more inclined towards locking their funds in long-term instruments. Their participation in PIB auctions improved towards the end of FY19 and their outstanding investment in these instruments, after falling steadily over the past couple of years, posted an increase of Rs 425 billion in H2-FY19.

Figure 5.4: Average Cost of External Debt (actual interest paid as percent of average level of debt)



Data source: SBP staff calculations

As for the management of government external debt, multiple challenges continued to persist. First, the average cost of government external debt has increased with greater mobilization of commercial loans by the government over the past few years (**Figure 5.4**). In FY19 also, the share of commercial loans increased further to 12 percent of the government external debt by the end of the year (up from only 2.4 percent just three years ago).[2] Moreover, with most of the fresh loans being contracted at floating interest rates, future debt servicing is getting more vulnerable to the trends in global interest rates. Second, from sustainability perspective, relevant indicators show a deterioration in both debt bearing capacity and servicing capacity of the country. In fact, servicing of external debt has become a key source of the country's BoP needs

[1] Since 70 percent of the MRTBs are converted into 10-year PIB with floating rate, the mark-up cost would subsequently change in accordance with the movement in overall interest rates in the economy.
[2] A growth of 20 percent in FY19.

down the road. Importantly, there is a need to shore up the level of country's foreign exchange reserves and earnings (exports and remittances) to smoothly pay off debt obligations.

Table 5.1: Summary of Pakistan's Debt and Liabilities
trillion Rupees

	Stock			Percent of GDP		Absolute change	
	FY17	FY18	FY19	FY18	FY19	FY18	FY19
A. Total Debt and Liabilities (sum I to IX)	25.1	29.9	40.2	86.3	104.3	4.8	10.3
B. Gross Public Debt (sum I to III)	21.4	25.0	32.7	72.1	84.8	3.5	7.8
Total Debt of the Government (I+II+III-X)	19.6	23.0	29.5	66.5	76.6	3.4	6.5
I. Government Domestic Debt	14.8	16.4	20.7	47.4	53.8	1.6	4.3
II. Government External Debt	5.9	7.8	11.1	22.5	28.7	1.9	3.3
of which exchange rate impact						1.3	2.8
III. Debt from IMF	0.6	0.7	0.9	2.1	2.4	0.1	0.2
IV. External Liabilities	0.4	0.6	1.7	1.8	4.4	0.2	1.1
V. Private Sector External Debt	1.2	1.7	2.5	4.8	6.4	0.5	0.8
VI. PSEs External Debt	0.3	0.3	0.7	0.9	1.7	0.0	0.3
VII. PSEs Domestic Debt	0.8	1.1	1.4	3.1	3.6	0.2	0.3
VIII. Commodity Operations	0.7	0.8	0.8	2.4	2.0	0.1	(0.1)
IX. Intercompany External Debt	0.4	0.4	0.5	1.3	1.4	0.1	0.1
X. Deposits with banking system	1.8	1.9	3.2	5.6	8.3	0.1	1.3

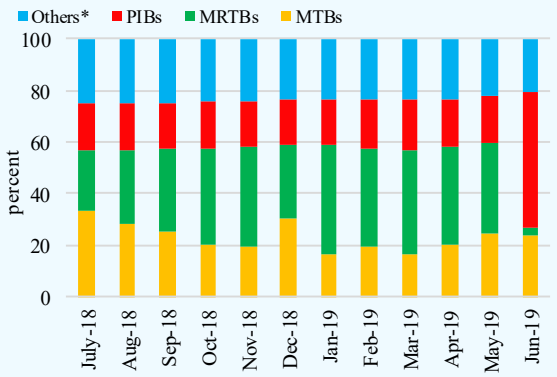
Data source: State Bank of Pakistan

In this context, the 39-month extended fund facility agreement with the IMF will be helpful in plugging the financing gap. On the external front, narrowing of current account deficit during FY19 is quite encouraging, and with ongoing stabilization measures in place (including the flexible exchange rate regime), the BoP situation is expected to improve further. Nonetheless, significant consolidation is needed on the fiscal front, as cuts in development expenditure alone would not be enough to control the size of primary deficit. Focus should be to increase revenues along with reduction in current expenditures to control the pace of the debt accumulation. Moreover, rationalization of energy sector policies and improving the governance of PSEs should also top the reform agenda of the government to cut down PSE debt.

5.2 Domestic Debt

The stock of government domestic debt reached Rs 20.7 trillion at the end of FY19 compared to Rs 16.4 trillion a year earlier (**Table 5.1**). In terms of growth, domestic debt increased by 26.3 percent – more than double the pace in FY18 (**Table 5.2**).

Figure 5.5: Instrument-wise Share in Domestic Debt



* Others mainly include prize bonds and NSS
Data source: State Bank of Pakistan

Changing Dynamics of Government Domestic Debt

In FY19, the government mainly relied on permanent debt, which recorded a marked increase of Rs 7.4 trillion compared to a decline of 0.9 trillion during FY18. This was in contrast with previous years, in which the share of floating debt was the largest.[3] Even until May

[3] In addition, Rs 177.8 billion domestic debt was created on account of Bai-Muajjal of Sukuk.

2019, the government relied mainly on short-term borrowing from the central bank through MRTBs (**Figure 5.5)**. This borrowing from the central bank helped the government to make retirements to the commercial banks. Nonetheless, at the very end of FY19, the central government re-profiled its short-term domestic debt by issuing long-term PIBs to the central bank. As a result, some risk indicators (including the share of domestic debt maturing in 1-year) declined, and average time to maturity improved, which is going to bring-down the need for frequent roll-over of this debt. Furthermore, as this re-profiling was done on floating rates, the direction of interest rates in the future would determine the implications for fiscal and monetary management.

Table 5.2: Government Domestic Debt

billion Rupees; growth in percent

	Stock			Flow		Growth	
	FY17	FY18	FY19	FY18	FY19	FY18	FY19
Domestic debt	14,849.2	16,416.3	20,731.8	1,567.1	4,315.5	10.6	26.3
Permanent debt	5,528.4	4,653.8	12,080.1	(874.6)	7,426.3	(15.8)	159.6
o/w PIBs	4,391.8	3,413.3	10,933.2	(978.5)	7,519.9	(22.3)	220.3
Ijara Sukuk	385.4	385.4	71.0	-	(314.4)	-	(81.6)
Prize Bonds	747.1	851.0	893.9	103.9	42.9	13.9	5.0
Floating debt	6,550.9	8,889.0	5,500.6	2,338.1	(3,388.4)	35.7	(38.1)
o/w MTBs	4,082.0	5,294.8	4,929.6	1,212.8	(365.2)	29.7	(6.9)
MRTBs	2,468.9	3,594.2	571.0	1,125.3	(3,023.2)	45.6	(84.1)
Unfunded debt	2,765.3	2,868.1	3,144.1	102.8	276.0	3.7	9.6

Data source: Ministry of Finance Budget Wing

Government domestic debt from non-bank increased in absolute terms

Government domestic debt owed to non-banks increased by Rs 0.8 trillion during FY19, more than double the increase of Rs 0.3 trillion a year earlier. Non-bank institutions made investments in government securities (mainly PIBs) due to high rate of return. Similarly, higher profit rates in FY19 kept the savings schemes attractive (**Table 5.3**). Net inflows in various NSS increased by Rs 306.3 billion in FY19. A disaggregated analysis shows that gross inflows in major schemes increased; however, considerable retirements led to a fall in net terms in case of Special Saving Accounts (SSA). Since the profit rate on Behbood Savings Certificate (BSC) is high and it is also exempted from withholding tax (WHT), perhaps holders of Special Savings Accounts are switching their funds in BSC.

Table 5.3: National Saving Schemes and Profit Rates

billion Rupees; profit rates in percent

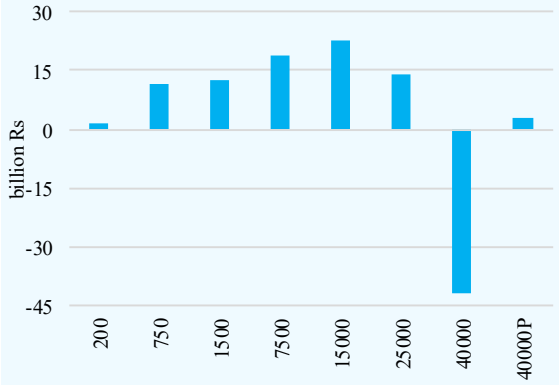
	FY19		Profit rates*	
	Gross inflows	Net Inflows	FY18	FY19
Defense Saving Certificates	135.3	57.3	8.1	12.5
Special Savings Certificate	463.0	31.8	6.6	11.4
Regular Income Certificates	414.6	142.1	7.6	11.2
Behbood Savings Certificates	375.6	119.6	10.8	14.3
Special Savings Accounts	519.1	(132.5)	6.6	11.4
Pensioner's Benefit Account	124.1	43.6	10.1	14.3
NSS	2,357.6	306.3	NA	NA
Prize bonds (including premium prize bonds)	154.5	42.9	NA	NA

*Profit rates at end of fiscal year

Data source: Central Directorate of National Savings

Prize bonds recorded a marginal rise of Rs 42.9 billion in FY19. All denominations recorded net inflows, barring the denomination of Rs. 40,000 prize bonds (**Figure 5.6**). In an effort to enhance documentation of the economy, the government notified withdrawal of Rs. 40,000 denomination national prize bond from circulation on 24th June 2019.[4] The holders of prize bonds were given three options: 1) conversion to premium prize bonds; 2) replacement with special savings certificate/defense savings certificates; or 3) encashment at face value (transfer of proceeds to the bond-holders bank account).[5] As an initial investigation, the trend of shifting towards premium prize bonds of same denomination has emerged. Monthly analysis of the premium prize bonds shows that out of the total investment of Rs 2.8 billion in FY19, more than half of the investments were made in June 2019, perhaps indicating that bond holders opted to convert the old prize bonds with the premium bonds. Some evidence suggests that many bond-holders also preferred to encash these bonds. As a result, a sharp increase in deposits during the last week of June 2019 was witnessed.

Figure 5.6: Net Inflows in Prize Bonds in FY19



Data source: Central Directorate of National Savings

Table 5.4: Pakistan's External Debt and Liabilities

billion US dollars

	End-June Stock			Absolute change					
						FY19			
	FY17	FY18	FY19	FY18	FY19	Q1	Q2	Q3	Q4
Total external debt & liabilities (sum 1 to 7)	**83.4**	**95.2**	**106.3**	**11.8**	**11.1**	**1.3**	**2.5**	**6.8**	**0.5**
External public debt & liabilities (1+2+3)	66.1	75.4	83.9	9.3	8.6	1.0	2.1	5.8	-0.3
External Public debt (1+2)	62.5	70.2	73.4	7.7	3.2	1.1	0.1	2.7	-0.7
1. Government external debt	56.4	64.1	67.8	7.7	3.7	1.2	0.2	2.8	-0.6
i) Long term (>1 year)	55.5	62.5	66.5	7.0	4.0	1.5	0.5	2.8	-0.8
of which									
Paris club	12.0	11.6	11.2	-0.3	-0.4	-0.1	-0.1	-0.1	0.0
Multilateral	27.6	28.1	27.8	0.5	-0.3	-0.5	0.1	-0.3	0.4
Other bilateral	6.3	8.7	12.7	2.4	4.0	2.2	0.5	1.1	0.2
Commercial loans/credits	4.8	6.8	8.5	2.0	1.7	0.0	0.0	2.1	-0.4
Euro/Sukuk global bonds	4.8	7.3	6.3	2.5	-1.0	0.0	0.0	0.0	-1.0
ii) Short term (<1 year)	0.9	1.6	1.3	0.7	-0.4	-0.3	-0.3	0.1	0.2
2. From IMF	6.1	6.1	5.6	0.0	-0.4	-0.1	-0.1	-0.1	-0.1
3. Foreign exchange liabilities	3.6	5.1	10.5	1.6	5.4	-0.1	2.0	3.1	0.4
4. Public sector enterprises (PSEs)	2.7	2.7	4.0	0.0	1.3	0.0	-0.1	0.8	0.6
5. Commercial banks	4.5	4.4	4.7	-0.1	0.3	0.0	0.3	0.1	-0.1
6. Private sector	6.8	9.2	10.4	2.4	1.2	0.2	0.7	0.1	0.2
7. Debt liabilities to direct investors	3.4	3.6	3.3	0.2	-0.3	0.0	-0.5	0.1	0.1

Data source: State Bank of Pakistan and Economic Affairs Division

[4] The main purpose was to enhance documentation of the economy.

[5] SBP-BSC Circular No. CMD/GSSAD/PBU/PB-1/87525/2019 - Withdrawal of Rs. 40,000 Denomination NPBs from Circulation

5.3 External Debt and Liabilities

Total external debt & liabilities (EDL) reached US$ 106.3 billion by end June 2019, an increase of US$ 11.1 billion compared to an increase of US$ 11.8 billion a year earlier (**Table 5.4**).
One-half of this increase in FY19 is owed to BoP support from friendly countries (Saudi Arabia, UAE and Qatar). As pointed out earlier, these inflows are held in the form of deposits with the central bank and it led to an increase in the foreign exchange liabilities of the country. Nonetheless, net revaluation gains (in dollar terms) due to depreciation of major currencies (Euro and Yuan) against the US$ and sizeable amortization controlled the pace of debt accumulation to some extent in FY19.[6] Major part of amortization consists of Euro/Sukuk bond and long-tern commercial loans. The government was also able to retire its short-term debt worth US$ 0.4 billion, compared to net accumulation of US$ 0.7 billion in FY18. Although the government anticipated to raise additional support by launching Pakistan Banao Certificates (PBCs) during Q2-FY19, it managed to raise only US$ 26.0 million from PBCs (for details, see **Chapter 6**).

China's share in gross disbursements continued to dominate

In gross terms, the country received US$ 10.5 billion in FY19 compared to US$ 10.9 billion a year earlier. China's share in these disbursements increased further in FY19 as the country received both commercial and bilateral loans. Gross disbursements from ADB and IDB (short-term) were lower compared to FY18 (see **Table 6.5** in **Chapter 6**).

External debt servicing increased

Pakistan's external debt servicing increased in FY19 (**Table 5.5**). Around two-third of the principal repayments were made to commercial lenders and Euro/Sukuk bond. A large part of these loans were on floating rates, hence the rise in the benchmark rate (i.e. LIBOR) led to a substantial increase in interest payments as well.

5.4 External Debt Sustainability

Analysis of external debt sustainability indicators shows a deterioration in solvency indicators (debt bearing capacity). The most common measure used to assess debt-bearing capacity is the external debt and liabilities to GDP ratio, which increased to 45.0 percent by end-June 2019. (**Table 5.6**). Similarly, other solvency indicators also deteriorated as the pace of external debt accumulation more

Table 5.5: External Debt Servicing

million US dollars

	Principal			Interest		
	FY17	FY18	FY19	FY17	FY18	FY19
1. Public external debt	3,733.8	2,704.2	5,819.6	1,389.5	1,786.5	2,288.2
Paris club	411.8	610.9	639.2	242.0	240.3	229.7
Multilateral	1,255.2	1,316.6	1,378.7	295.3	357.4	439.2
Other Bilateral	788.0	182.0	329.4	198.9	203.3	310.1
Euro/Sukuk global bonds	750.0	0.0	1,000.0	366.4	422.8	502.7
Commercial loans /credits	488.8	488.9	2,097.0	73.0	270.4	423.5
Others	40.0	105.9	375.2	179.7	292.4	382.9
2. External liabilities	0.0	0.0	0.0	86.6	102.8	187.3
3. PSEs debt	289.0	297.8	223.7	35.1	78.5	130.4
4.Scheduled banks' borrowing	0.0	1.0	2.7	23.2	61.3	71.9
5. Private sector debt	416.6	322.7	497.5	165.9	391.2	443.0
6. Total external debt and liabilities (sum 1 to 5)	4,439.4	3,325.7	6,543.5	1,623.9	2,317.5	2,933.4

Data source: State Bank of Pakistan

[6] Euro depreciated by 2.3 percent against US$, while Chinese yuan depreciated against US$ by 3.5 percent in FY19.

than offset the marginal growth in FX earnings. Going forward, further improvement in current account balance and realization of non-debt flows (foreign direct and portfolio investments) is expected on the back of correction in exchange rate and initiation of the IMF extended fund facility. With a rise in FX earnings, debt repayment would become easier and external debt sustainability would improve.

Table 5.6: Indicators of External Debt Sustainability

percent

	Jun-14	Jun-15	Jun-16	Jun-17	Jun-18	Jun-19
Solvency indicators						
Total external debt and liabilities/GDP	25.6	24.2	26.6	27.4	33.5	45.0
Public external debt/GDP	20.2	18.9	20.8	20.5	24.7	31.1
Total reserves/total external debt & liabilities	21.7	28.7	31.2	25.7	17.2	13.6
SBP reserves/total external debt & liabilities	13.9	20.8	24.5	19.3	10.3	6.8
External debt servicing/FX earnings	13.7	10.2	10.4	15.7	13.8	21.0
External debt servicing/export earnings	23.0	18.0	19.4	29.6	24.9	39.1
Liquidity indicators						
Short-term external public debt/PEDL	1.3	1.9	2.8	1.3	2.1	1.5
Short-term external public debt/total reserves	5.2	5.4	7.3	4.1	9.9	8.7
Short-term external public debt/SBP reserves	8.0	7.5	9.3	5.5	16.6	17.4

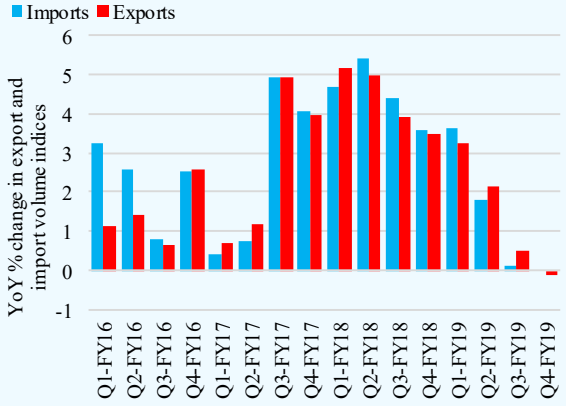
Data source: State Bank of Pakistan Calculations

6 External Sector

6.1 Global Economic Review

As the year FY19 progressed, the global economic and political developments increasingly became less conducive for trade. The global economy started to slow down, with real GDP growth of some of the largest economies moderating significantly, after peaking out by H1-FY19. The growth in trade volumes slumped largely in response to the policy decisions in the United States in areas of trade, monetary policy, and geopolitics, with the world's largest economy getting embroiled in trade disputes with some of its largest trading partners, namely China and the EU (**Figure 6.1**). At the same time, the US' imposition of sanctions on Iran and Venezuela, continuation of OPEC+ oil supply cuts, and the slowdown in the Chinese economy, unsettled the demand-supply dynamics in the global crude oil market and led to volatility in prices.[1] Furthermore, iron and steel exports to the US by major suppliers (including China and the EU, and Vietnam from July 2019 onwards) continued to attract additional tariffs; the resultant market distortions pushed up international prices of the material.[2] In contrast, international prices of food and related items, generally remained soft, amid sufficient global production and tepid growth in demand.

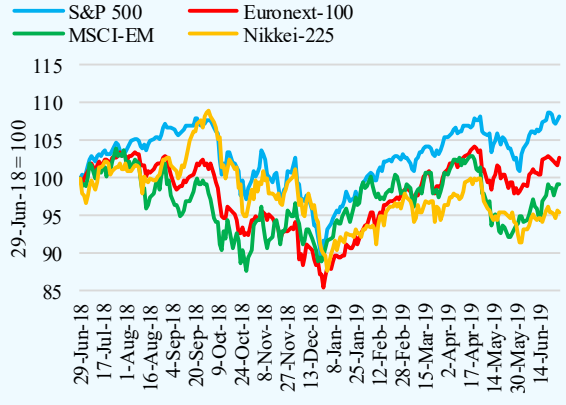
Figure 6.1: Growth in Global Trade Volumes



Data source: World Trade Organization

In the US, the Fed raised its policy rate four times during CY18, in response to upward pressure on prices stemming from an accommodative fiscal policy stance and relatively strong economic growth.[3] The growth spurt was particularly evident in H1-FY19, when real GDP growth in the US averaged 2.8 percent.[4] However, the last of these rate hikes, in December 2018, came as financial markets were already unsettled by the trade war. The rate increase triggered a collapse in global equities, wiping off trillions of dollars worth of market capitalization (**Figure 6.2**). Thereafter, the US economy started to slow down in H2-FY19, with the average real GDP growth dropping to 2.5

Figure 6.2: Scaled Movements in Major Global Equity Indices

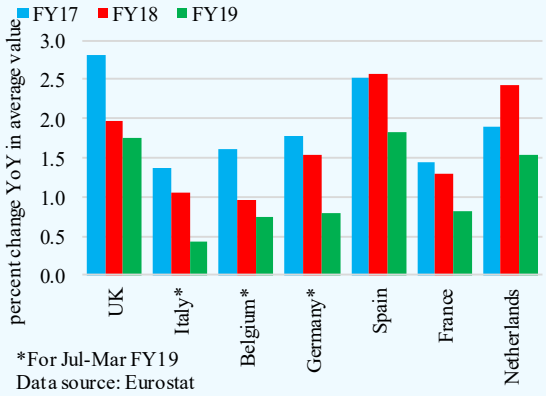


Data sources: Bloomberg & SBP calculations

[1] Oil prices had touched the US$ 80 per barrel by October 2018, before sliding over demand-side concerns. On average, Arab Light crude prices were 12.1 percent higher in FY19 as compared to FY18.
[2] International iron ore prices were, on average, 16.2 percent higher in FY19 as compared to FY18 (source: World Bank).
[3] In US, the fiscal stimulus provided by the tax cut in January 2018 stimulated both fixed investment and employment. As a result, private consumption also increased till H1-FY19. The Fed's preferred inflation metric, Personal Consumption Expenditure (PCE) index, stayed consistently at or above the 2 percent target throughout March 2018 to October 2018 (source: US Bureau of Economic Analysis).
[4] This compares with average real GDP growth of 2.6 percent in H1-FY18 (source: US Bureau of Economic Analysis).

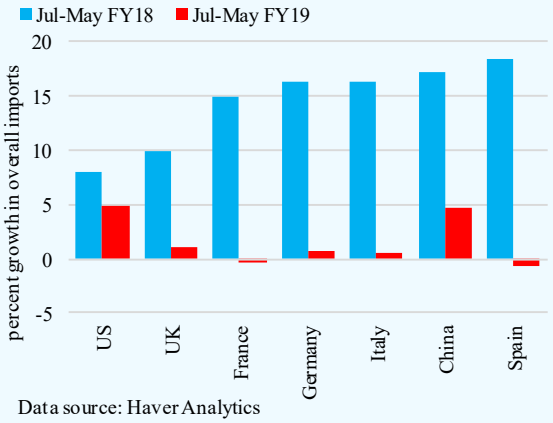
percent. This also led to easing of inflationary pressures in the economy, and prompted the Fed to hold off on further rate hikes.[5] Faced with low inflation, a slowing economy, and increased uncertainty in the global economic outlook, the Fed cut its benchmark rate in July 2019 for the first time since the global financial crisis of 2007-08.

Figure 6.3a: Growth in Real Household Consumption in Major EU Economies



*For Jul-Mar FY19
Data source: Eurostat

Figure 6.3b: Import Demand from Major Economies

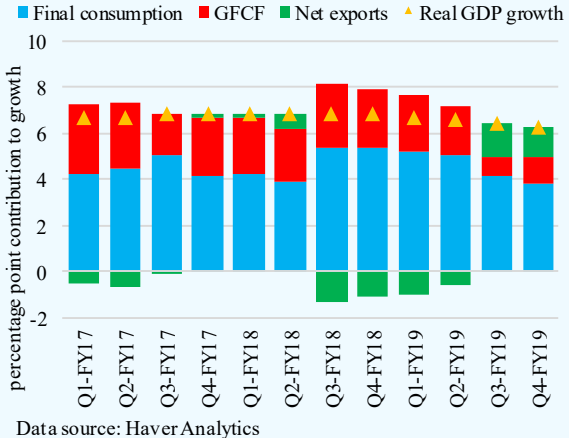


Data source: Haver Analytics

However, for the European Central Bank (ECB), the continuation of easy monetary conditions became necessary, as average real GDP growth in the EU fell to 1.6 percent in FY19 – the lowest in the past five years, and down from 2.5 percent growth recorded in FY18.[6] While factors varied from country to country, a general slowdown in household spending seemed to be common across the major economies (**Figure 6.3a**). As a result, the import demand from the EU dropped, to the detriment of export-oriented emerging markets (**Figure 6.3b**). Meanwhile, the UK struggled to exit from the EU in an orderly manner, despite the passage of three years since the *Brexit* vote. Average real GDP growth fell to 1.4 percent in FY19 from 1.8 percent in FY18; even this growth was higher than expected mainly due to inventory build-up, as businesses stockpiled in anticipation of Britain's exit from the EU.[7]

Within the emerging markets (EMs), growth in China was hit by the ongoing trade dispute with the US. Real GDP growth dropped to 6.2 percent in Q4-FY19 – the lowest since China started disseminating quarterly GDP data in 1992.[8] Buffeted by the trade dispute, China's exports suffered, which in turn had an adverse effect on its demand for imports; this had a ripple effect across the global value chains. Furthermore, fixed investment and personal consumption both started to moderate, as uncertainty gripped consumers and businesses alike about the future prospects of the economy (**Figure 6.4**).

Figure 6.4: Breakdown of Real GDP Growth in China

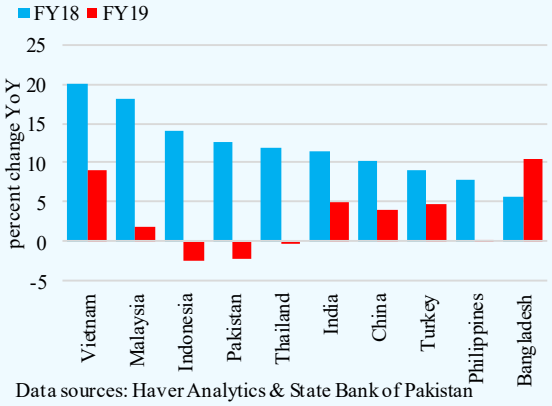


Data source: Haver Analytics

[5] The PCE-based inflation averaged 1.4 percent during H2-FY19, down significantly from 2.0 percent in H1-FY19 (source: US Bureau of Economic Analysis).
[6] Based on provisional GDP growth data for Q4-FY19 (source: Eurostat).
[7] As per the IMF's World Economic Outlook, July 2019.
[8] In FY19, average real GDP growth in China fell to 6.4 percent, down from 6.7 percent in FY18 (source: Haver Analytics).

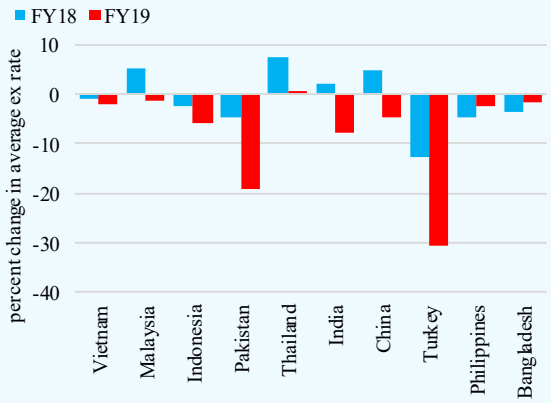
This general economic slowdown across the major economies did not bode well for other export-oriented EMs, many of whom have seen subdued exports growth in FY19 (**Figure 6.5a**).[9] The relatively lacklustre export performance came despite a weakening of EM currencies against the US dollar, with the exception of Bangladesh (**Figure 6.5b)**.

Figure 6.5a: Export Performance of Major Emerging Markets



Data sources: Haver Analytics & State Bank of Pakistan

Figure 6.5b: Performance of EM Currencies Against US



Data sources: Bloomberg & SBP calculations

The future growth momentum of the key players in the global economy depends upon the successful conclusion of the ongoing trade negotiations between: the US and China; the US and the EU; and the UK and the EU. Successful resolution of these negotiations is essential for consumer demand and investment in the advanced economies and for China to bounce back, which would have positive spill-over for exporting emerging economies, such as Pakistan.

6.2 Overview of Pakistan's BoP

The global economic slowdown and high (albeit declining) level of import payments proved particularly challenging for Pakistan's external account in FY19, as the country began the year with a precarious level of foreign exchange reserves.[10] The lack of exchange rate adjustment during FY17 and H1-FY18 – along with increased fiscal expenditure, onset of CPEC-related imports, and rebound in oil prices – had pushed the current account deficit to the unsustainable level of US$ 19.9 billion in FY18. To mitigate the excess demand in the economy, at the outset of FY19, the economic policy focused on four areas: (i) shore up the country's dwindling FX reserves by urgently seeking bilateral financing; (ii) align the exchange rate policy with market fundamentals; (iii) curtail development

Table 6.1: Balance of Payments
million US$

	FY17	FY18	FY19	Change in FY19
CA balance	**-12,621**	**-19,897**	**-13,508**	**6,389**
Trade balance	-26,680	-31,824	-28,164	3,660
Exports	22,003	24,768	24,224	-544
Imports	48,683	56,592	52,388	-4,204
Services balance	-4,339	-6,068	-4,288	1,780
Primary income balance	-5,048	-5,484	-5,697	-213
Sec. income balance	23,446	23,479	24,641	1,162
Workers' remittances	19,351	19,914	21,841	1,927
Capital acc. balance	**375**	**376**	**253**	**-123**
Financial acc. balance	**-10,198**	**-14,300**	**-11,989**	**2,311**
FDI in Pakistan	2,749	3,471	1,667	-1,804
FPI in Pakistan	-251	2,209	-1,419	-3,628
Net incur. of liabilities	8,965	8,855	11,734	2,879
Government	5,040	4,894	3,909	-985
Private (excl. banks)	2,298	2,522	2,110	-412
Banks	1,631	-109	220	329
SBP's reserves	**16,144**	**9,766**	**7,281**	**-2,485**
CA as % of GDP	-4.1	-6.3	-4.8	1.6

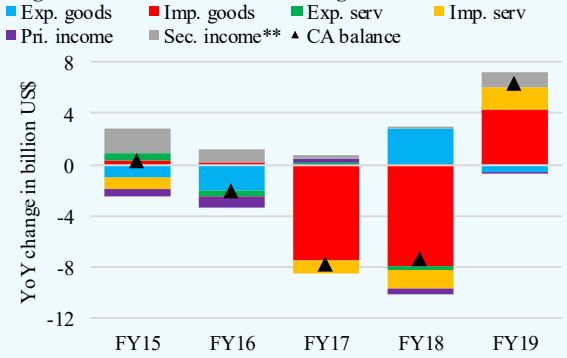
Data source: State Bank of Pakistan

[9] China was the top export destination for 31 countries in the world in 2017, and was among the top 5 export markets for dozens of other countries (source: CIA World Fact book).
[10] As on June 28, 2018, the SBP FX reserves stood at US$ 9.8 billion, adequate to finance 2.1 months of imports.

expenditure; and (iv) tighten monetary policy. Consequently, the current account gap shrunk (**Table 6.1**), largely due to squeezing of import payments (**Figure 6.6**).

The entire decline in import payments in FY19 was recorded in the third and fourth quarters of the year, as imports had risen in H1. In H2-FY19, energy import payments dropped in response to softening global oil prices (which led to a sharp deceleration in their unit prices), and some temporary administrative issues that had curtailed LNG imports in Q3. That said, quantum imports of crude oil and POL products declined throughout the year, in line with reduced demand for fuel from the power and transport sectors (**Section 6.6**).

Figure 6.6: Breakdown of YoY Change in the CA Balance*



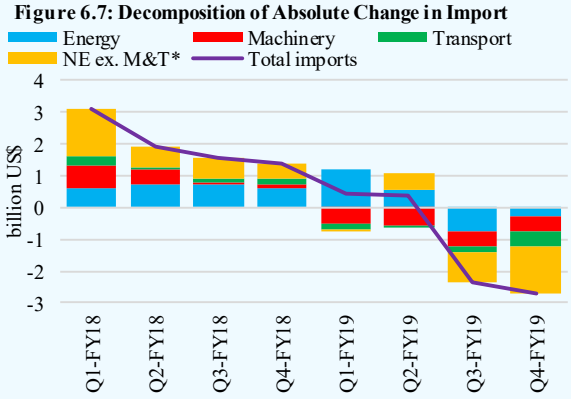
* Positive values indicate improvement & negative values show deterioration **Includes worker remittances
Data source: State Bank of Pakistan

The non-energy import payments also dropped in FY19, with major contribution coming from the machinery and transport segments (**Figure 6.7**). Moreover, the impact of the macro stabilization policy was most directly felt on imports of raw materials for the construction industry, such as iron and steel and old ships for shipbreaking (**Section 6.6**).

The decline in import payments was more than sufficient to offset the drop in export receipts. Soft international commodity prices, absence of export subsidies (on wheat and sugar) during most of the year, and a YoY decline in unit prices of key high value textile products, were responsible for the fall in exports.

At the same time, robust growth in workers' remittances contributed significantly toward reducing the CAD during FY19. Higher inflows from the UK, USA and Malaysia mainly contributed to this growth, whereas inflows from the UAE and KSA also slightly recovered. The higher remittances proved helpful in offsetting an increase in the primary income deficit, which was jacked up by an uptick in interest payments on external loans.

Figure 6.7: Decomposition of Absolute Change in Import



*Non Energy excluding machinery and transport
Data source: State Bank of Pakistan

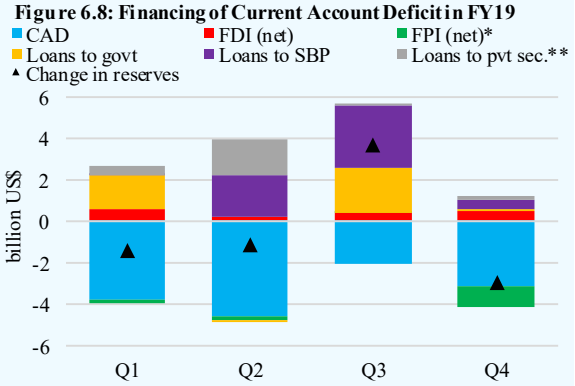
Despite the reduction in the current account gap, financing pressures remained persistent throughout the year. Arranging the required external financing was quite challenging. Overall net financial inflows were lower than last year, due to multiple factors. First, the government repaid a US$ 1.0 billion Eurobond in the fourth quarter (**Figure 6.8**).[11] Second, net FX outflows from the equity market accelerated, as foreign investors remained wary of the country's macroeconomic fundamentals. Third, with the completion of most CPEC-related projects, gross FDI into the power and construction sectors dropped

[11] This compares with an *inflow* of US$ 2.5 billion last year, as a result of issuance of Eurobond and Sukuk.

significantly. In fact, debt repayments by CPEC-related entities pushed up gross outflows from FDI; as a result, net FDI declined by 52.0 percent YoY in FY19.[12]

To arrange the external financing to plug the current account gap and meet the debt repayment obligations of both the public and private sectors, the government had to rely on commercial and bilateral sources – i.e. China (both the government as well as Chinese commercial banks), Saudi Arabia, the UAE and Qatar. The uncertainty in the lead-up to the IMF agreement led to IFIs mostly holding back from their financing (**Section 6.4**). In sum, SBP's liquid FX reserves fell by US$ 2.5 billion in FY19, against a significantly larger decline of US$ 6.4 billion recorded in FY18. However, towards the end of FY19, Pakistan reached an agreement with the IMF for a US$ 6 billion EFF loan facility, which may lead to a revival of IFI funding and capital flows into the country.

Figure 6.8: Financing of Current Account Deficit in FY19

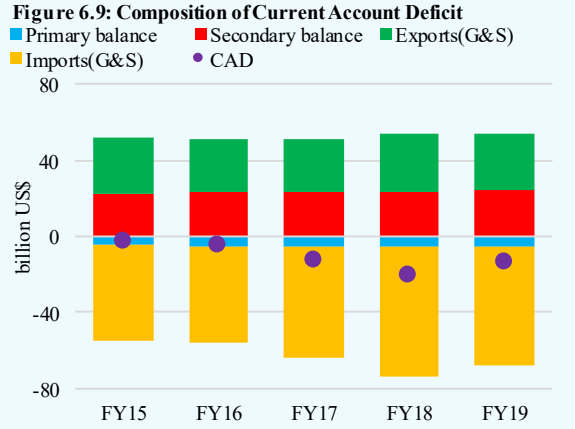


*includes Eurobond/Sukuk ** comprises banks and non-financial pvt sector companies
Data source: State Bank of Pakistan

6.3 Current Account

The current account posted a deficit of US$ 13.5 billion in FY19, which was nearly two-thirds of the deficit recorded last year (**Figure 6.9**). As mentioned before, this improvement came from significant import compression and robust growth in the workers' remittances. Importantly, decline in both merchandise and services imports contributed to this improvement. In contrast, higher interest payments on government loans, on the back of rising global interest rates and substantial medium-term borrowing, added to the CAD during FY19.

Figure 6.9: Composition of Current Account Deficit



Data source: State Bank of Pakistan

Services account

Similar to merchandise trade, services balance improved by US$ 1.8 billion, recording a deficit of US$ 4.3 billion in FY19 (**Table 6.2**). The entire improvement in services trade balance came from the fall in services import, as exports remained stagnant at last year's level. Around 60 percent of the decline in imports came from fall in travel and transportation services.

Table 6.2: Services Trade
billion US$

	FY18		FY19		Change	
	Export	Import	Export	Import	Export	Import
Overall Services	5.3	11.4	5.4	9.7	0.1	-1.7
Of which						
Transport	0.9	4	0.8	3.7	-0.1	-0.3
Travel	0.4	2.3	0.4	1.6	0.1	-0.7
Oth. business serv.	1.4	2.9	1.6	2.5	0.2	-0.4

Data source: State Bank of Pakistan

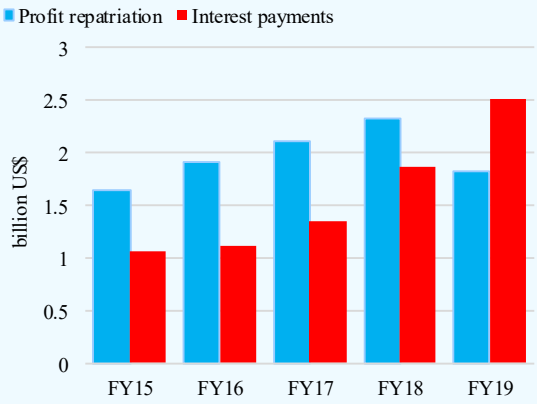
[12] In FY19, non CPEC related FDI declined by 17 percent to US$ 2.0 billion from US$ 2.4 billion realized in FY18. On the contrary, there were outflow in CPEC related FDI in FY19; US$ -267.0 million compared to US$ 1 billion inflow realized in FY18.

The transportation services that constitute around 40 percent share in services imports, decreased by US$ 333.5 million in FY19. Within that, the entire fall came from lower freight charges, resulting from the decline in merchandise imports. The travel services imports declined by US$ 719.6 million, reflecting increased travelling cost due to recent PKR depreciation. Similar to imports, the exports of transportation services declined; however, this was offset by an increase in exports of business services.

Primary income

The primary income account posted a deficit of US$ 5.7 billion during FY19, compared to US$ 5.5 billion last year. The widening of the deficit can be traced to higher interest payments on government loans, as profit and dividend repatriation by foreign companies declined during the period (**Figure 6.10**).

Figure 6.10: Components of Primary Income



Data source: State Bank of Pakistan

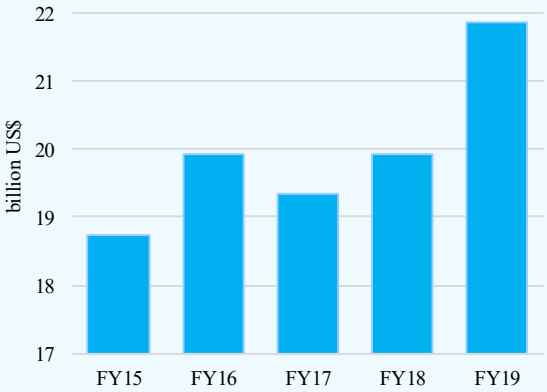
The profit repatriation by foreign companies declined by 21.3 percent during FY19, with almost equal drop in both direct and portfolio investment. Factors such as moderation in economic activities, PKR depreciation and low corporate profitability explain this trend. All major sectors, like food, oil and gas exploration, power, communication, and the financial business, repatriated lower profits as compared to last year. Despite this decline, profit repatriation was more than the net FDI received by the country.

Similarly, interest payment on loans was substantially higher compared to net FX loans into the country. The increase in the interest payments in FY19 was in line with the external borrowing trends during the past few years. Particularly, this higher growth was due to: (i) increased financing need amid high CAD, which the country had faced in FY17 and FY18; (ii) compositional shift toward commercial borrowings, which are relatively costlier than IFIs loans; and (iii) increase in the LIBOR at which most of the loans are contracted.

Workers' Remittances

After a gap of almost three years, the workers' remittances posted a strong growth of 9.7 percent during FY19, reaching a record-high level of US$ 21.8 billion (**Figure 6.11**). This robust growth provided significant cushion for the current account, specifically at the time when inflows in the financial account proved inadequate due to decline in the foreign investments. Importantly, the remittances inflows covered around one-third of the imports. Not surprisingly, Pakistan ranked 8th in terms of absolute remittance inflows during 2018, and in terms of growth, Pakistan's position improved to 8th from 18th last year.[13]

Figure 6.11: Workers' Remittances



Data source: State Bank of Pakistan

[13] Source: World Bank

The growth in remittances from USA, UK and Malaysia during FY19 was more pronounced, while the inflows from Saudi Arabia witnessed an increase after declining for the last two years (**Table 6.3**). Right at the beginning of the financial year, the government had announced a number of measures to incentivize overseas Pakistanis to send remittances through formal channels.[14] These incentives, together with the persistent efforts under the Pakistan Remittance Initiative (PRI), enhanced the remittances inflows from the legal channel. Under the PRI, domestic banks, microfinance banks (MFBs) and exchange companies (ECs) are encouraged to undertake marketing campaigns for attracting the workers' remittances.[15] Moreover, the government facilitated the recipients by exempting from withholding tax any cash withdrawals from PKR accounts that are solely fed by foreign remittances.[16]

Table 6.3: Country-wise Worker Remittances
million US$

	FY18	FY19	Change
USA	2,838.0	3,407.7	569.7
U.K.	2,892.4	3,412.4	520.0
Malaysia	1,148.1	1,551.8	403.6
U.A.E.	4,359.0	4,617.4	258.5
Saudi Arabia	4,858.8	5,003.0	144.3
Other GCC	2,158.3	2,119.1	-39.2
EU Countries	658.1	609.0	-49.0
Others	1,000.9	1,119.6	118.7
Total	19,913.6	21,840.2	1,926.7

Data source: State Bank of Pakistan

To make the process of the remittances transfer more secure and efficient, the government was accommodative to the use of innovative technological platforms. In this regard, Pakistan launched international remittance services using blockchain technology. Under the initiative, Valyou in Malaysia and Easypaisa in Pakistan joined hands to facilitate remittance through e-wallet platforms based on blockchain technology developed by Alipay.

Moreover, remittances from KSA and UAE, being the major source countries, contributed around half of the inflows during the year. Rebound in oil prices led to improved fiscal position and economic activity in GCC countries, which favoured the remittances into Pakistan.[17] Besides, the awareness campaign launched under PRI in labour camps in KSA and UAE may have led to the improved inflows from these corridors.

6.4 Financial Account

The net financial inflows amounted to US$ 12.0 billion in FY19, lower than the last's year amount of US$ 14.3 billion. Foreign direct investment declined considerably while one-off official outflows dominated the overall portfolio investment. However, substantial official debt inflows from friendly countries were sought to finance the current account gap. These inflows, to some extent, supported the country's continuously declining FX reserves.

Foreign direct investment

In FY19, the net FDI inflows dropped significantly by 52.0 percent to US$ 1.7 billion compared to US$ 3.5 billion recorded last year. At the start of fiscal year, the government had envisaged net FDI of US$ 4.1 billion on the assumption that CPEC-related infrastructure development and industrial co-operation projects would continue to attract FDI inflows. However, with the completion of phase-I of CPEC, inflows from China shrunk to only US$ 462 million – recording 77.0 percent YoY decline.

[14] For details, see SBP's First Quarterly Report for FY19 on The State of Pakistan's Economy.
[15] Under the scheme for 'Marketing of Home Remittances', domestic banks/MFBs/ECs were offered incentive for reimbursement of the marketing expenses equivalent to Rs 1 for each incremental US Dollar mobilized on inflows when exceeding 15 percent higher from the last year. Further, to promote remittances through branchless banking, incentive of airtime is increased to Rs 2 against each US Dollar received through M-Wallet.
[16] Amendment made through Finance Supplementary (Second Amendment) Act, 2019.
[17] The fiscal deficit of the GCC region went down from 5.5 percent of GDP in 2017 to 1.7 percent in 2018, while real GDP growth improved to 2 percent from -0.3 percent in 2017 (source: IMF Regional Economic Outlook: Middle East and North America, Afghanistan and Pakistan).

Nevertheless, China continued to dominate the net FDI with 27.7 percent share, followed by the United Kingdom and Hong Kong with 11.1 and 8.7 percent share respectively.

The sector-wise composition shows that the power sector, being the largest recipient of FDI last year, recorded an outflow of US$ 254 million, as one of the Chinese power company repaid the intercompany loan of US$ 530.0 million to its parent company in October 2018 (**Table 6.4**). It is important to note that with the completion of early harvest projects, the CPEC investment is directed towards transmission and distribution. Specifically, the work on energy priority project "Matiari to Lahore ±660kV High Voltage Direct Current (HVDC) Transmission Line Project" is being commenced. This is the country's first private sector transmission and distribution project under CPEC that will transmit more than 4,000 megawatts of coal-based electricity from projects in Sindh to the Punjab in main grid.

Table 6.4: Sector-wise Inflow of Net FDI in Pakistan
million US$

	FY17	FY18	FY19
Power	700	1203	-254
Construction	466	709	335
Financial Business	296	400	286
Oil & Gas Explorations	146	372	323
Pharmaceuticals	-10	16	63
Telecommunications	-91	100	-78
Electrical Machinery	7	22	166
Textile	15	50	77
Others	1,218	599	749
Total	**2,747**	**3,471**	**1,667**

Data source: State Bank of Pakistan

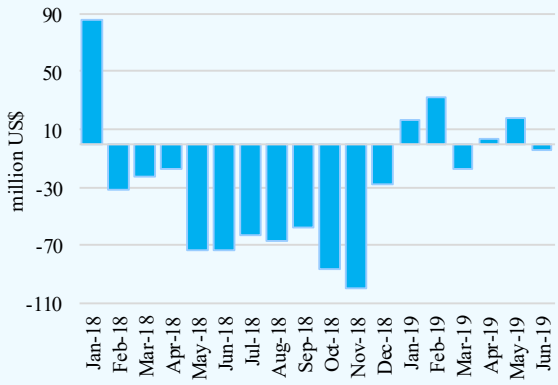
Apart from power and electrical machinery, construction, financial business and oil and gas exploration were able to attract net FDI inflows during FY19. However, the amounts of FDI of the said sectors were lower than the last fiscal year (**Table 6.4**).

The continued stabilization efforts, uncertainty over finalization of the IMF programme and frequent PKR adjustments may have dampened the sentiments of investors during the year. Furthermore, downgrading of Pakistan's credit outlook by S&P and Fitch dented further the foreign investors' confidence.

Foreign portfolio investment

Public sector outflows set the tone of the overall portfolio investment in FY19 as the government retired a Eurobond of US$ 1.0 billion in the month of April 2019. Further, Pakistan Banao Certificates (PBCs) remained ineffective to attract the overseas Pakistani investors. From its launching on January 31, 2019 till end-June FY19, the PBCs managed to attract only US$ 26.0 million. Factors that may have resulted in low demand include a narrow launch strategy with limited marketing, such as a lack of roadshows to attract investors. Moreover, the investors redeeming the certificate in foreign exchange prematurely, barring six months, had to pay a deduction on the principal invested. Also, the timing of the PBCs' launch coincided with the rising trend of US interest rates, which actually instigated portfolio outflows from developing countries.

Figure 6.12: Foreign Portfolio Investment in Pakistani Equities



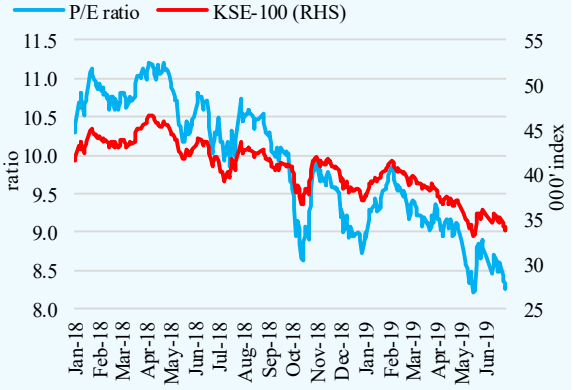
Data source: NCCPL

Meanwhile, the outflows from foreign private investment almost doubled to US$ 415 million in FY19 compared to last year. Substantial sell-offs from portfolio investors were witnessed in the first half of

FY19; however, the trend of foreign selling eased up to some extent in the second half. In fact, in the latter half of FY19 foreign portfolio investors were net buyer of US$ 48.0 million (**Figure 6.12**).

There could be multiple reasons of these portfolio inflows during H2-FY19. First, on the policy front, foreign investors were wary of expected movements in the interest rate and the exchange rate. After the significant increase in policy rate and depreciation of the Pak rupee against the US dollar, investors' confidence on the economic fundamentals may have strengthened. Second, during the course of FY19 the Pakistan Stock Exchange shed almost 9,000 points, which made the Pakistani equities attractive for investors as suggested by price-to-earnings ratio (**Figure 6.13)**.[18] The P/E ratio of equities is continuously declining because of the local investors, who are pulling out funds from the local bourse amid uncertainty in the tax policy. Lastly, after the MSCI dropped UBL and Lucky Cement from the MSCI Global Standard Index, the market was expecting that Pakistan probably would be reclassified to frontier market from emerging market status. However, MSCI in its review held in May 2019 retained the country's place in the MSCI EM Index, largely from buffer and index continuity rules. Coupled with P/E ratio and PKR adjustment, this might have further reinforced the foreign investor's confidence in the Pakistani equity market.

Figure 6.13: Price/Earning Ratio of Pakistani Stock and PSX's Performance

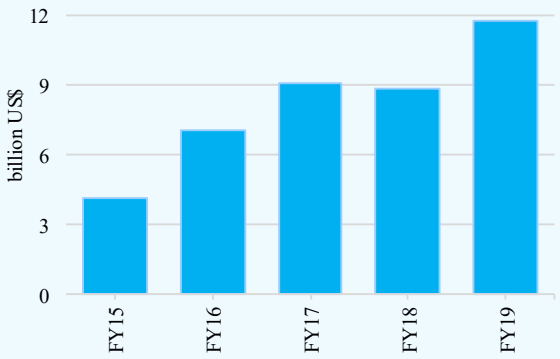


Data sources: State Bank of Pakistan and Bloomberg

Net incurrence of liabilities

The net inflow of FX liabilities into the country witnessed a hefty increase of 36.1 percent and reached to US$ 11.7 billion against US$ 8.9 billion recorded last year. This was mainly due to the inflows realized from bilateral sources, specifically from Saudi Arabia (US$ 3 billion), UAE (US$ 2 billion) and Qatar (US$ 500 million) (**Figure 6.14**). These loans were meant to stabilize BoP pressure originating from substantial external payments. Within external borrowing, net government loans amounted to US$ 3.9 billion, 20.1 percent lower than last year. In the short-term, the retirements were more than the disbursements, as the government realized US$ 1.1 billion against amortization of US$ 1.5 billion. However, in the long-term, the inflows exceeded the retirement as government disbursement stood at US$ 6.5 billion against retirement of US$ 4.4 billion.

Figure 6.14: Net Incurrence of FX Liabilities



Data source: State Bank of Pakistan

In terms of sources, the gross borrowings from China, both bilateral and commercial, continued to dominate the official disbursements (**Table 6.5**). From the total gross disbursement of US$ 10.5 billion, the share of borrowings from China stood at 45.0 percent, which was higher than last year.

[18] A high P/E could mean that a stock's price is high relative to earnings and possibly overvalued. Conversely, a low P/E might indicate that the current stock price is low relative to earnings.

6.5 Exchange Rate and Reserves

As discussed above, the Pak rupee adjustment initiated during FY18 continued, as the rupee depreciated *vis-à-vis* the US dollar by 24.1 percent during FY19. In real terms, the PKR weakened by 15.4 percent in FY19, against a depreciation of 11.2 percent observed last year (**Figure 6.15**). This was mainly due to a sharp 19.8 percent depreciation in NEER. Meanwhile, the Relative Price Index (RPI) increased by 5.6 percent. This indicates that inflation in Pakistan remained higher compared to its trading partners.[19]

Table 6.5: Source-wise Official Government Borrowings*
million US dollars

	FY18	FY19	Change
Total external loans	**10,918**	**10,485**	**-433**
China	4,011	4,721	710
Bilateral	2,311	4,187	1,876
Commercial banks	2,200	2,534	334
Bonds	2,500	-	-
Other commercial banks	1,516	1,564	48
IDB (short-term)	987	820	-167
ADB	871	497	-374
Others	533	883	-350

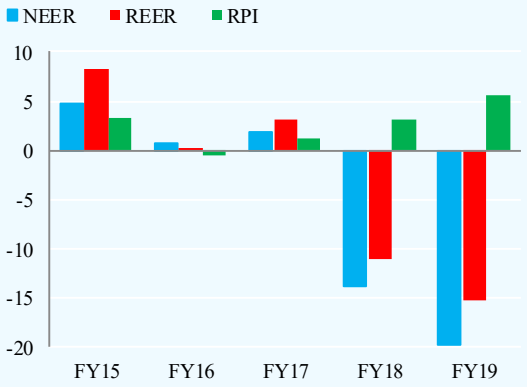
*Gross disbursements
Data source: Economic Affairs Division

Though the real depreciation in the currency may have supported the improvement in the current account during FY19, still in absolute terms, the quantum of the deficit remained high. Amid higher amortization and insufficient investments inflows, the financing of CAD had to be borne by the country's FX reserves. The total liquid FX reserves dropped by US$ 1.9 billion to US$ 14.4 billion, as on end-June 2019. Particularly, repayment of long-term multilateral loans, maturing Eurobond (in April 2019) and repayment of commercial borrowing (in May 2019) depleted the country's forex reserves. These outflows were funded through additional borrowings from the foreign commercial banks and the bilateral sources such as KSA, UAE and Qatar.

6.6 Trade Account (Customs Records)[20]

The trade deficit contracted by a sharp 15.4 percent to US$ 31.8 billion in FY19, after rising 15.7 percent in FY18. The entire improvement came from the import of non-energy products, which shrunk substantially enough to offset a YoY decline in exports and a marginal uptick in energy imports in the year. Also, most of the deficit reduction occurred in the second half (**Figure 6.16**), as (i) the decline in non-energy imports intensified, and (ii) the growth in energy imports decelerated, amid a hefty decline in quantum imports and a softening in global oil prices.

Figure 6.15: Exchange Rate Depreciation(-)/Appreciation(+)



Data source: State Bank of Pakistan

The decline in non-energy imports was mostly driven by two product categories – machinery and transport. Within machinery, the decline was concentrated in power generation and electrical items whose imports had surged during the first phase of CPEC-related power projects. These imports started to normalize in FY19 (**Figure 6.17**), and contributed significantly to the decline in overall imports. Furthermore, the cut in development expenditures, relatively subdued private real estate activity, and businesses holding back on making fresh fixed investments in the wake of a slowing

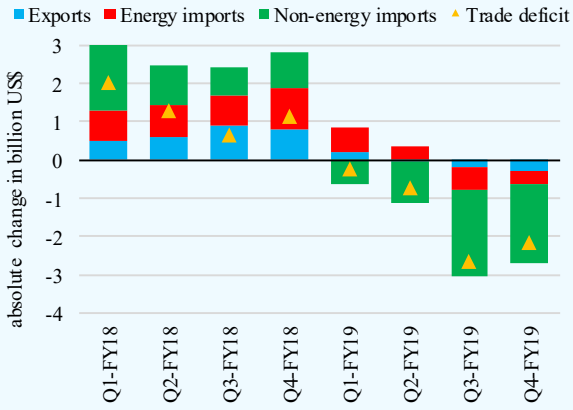
[19] Based on revised REER data by SBP, using the updated trade weights and list of new countries. The new weights are calculated by the IMF on the basis of 2013-15 trade patterns in the global economy. In case of Pakistan, this update led to increase in number of basket currencies to 37 which were previously 25 based on 2010-12 trade data. The new weights reflect the change in trade dynamics for Pakistan. For example, the share of China and other Asian economies in trade with Pakistan has risen considerably.

[20] 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 6.1**. To understand the difference between these two data series, please see Annexure on data explanatory notes.

economy (**Chapter 3**) all contributed to the slump in demand for imported raw materials, such as iron and steel. Imports of home appliances and related components, which are classified under electrical machinery, also declined, as domestic manufacturers and retailers passed on the increase in prices following the PKR depreciation to their customers.[21] Lastly, transport imports were mainly pulled down by a normalization in purchases of aircraft and railway locomotives (including associated parts), and of ships for shipbreaking purposes.

Meanwhile, energy imports stayed virtually flat in value terms in FY19, with heavy declines in quantum imports of crude oil and POL products offsetting the upward pressure from higher international oil prices in the year.[22] The decline in quantums mainly owed to the phasing out of furnace oil (FO) from the country's power generation mix and lower demand for crude oil from refineries as they reduced throughput amid operational hiccups.

Figure 6.16: Decomposing the YoY Change in the Trade



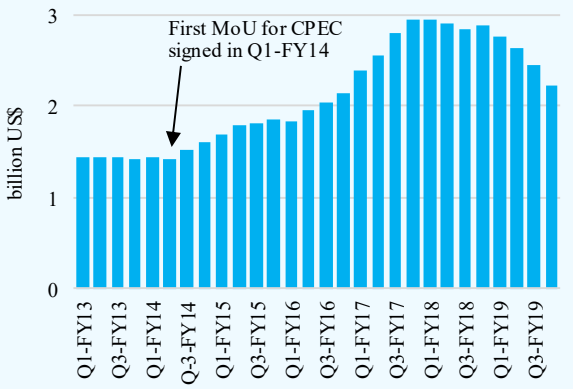
Data source: Pakistan Bureau of Statistics

On the other hand, although exports posted a substantial growth in terms of volume this year, the overall export receipts declined in terms of value. This decline is explained by a reduction in the unit values of the following major exporting products, which otherwise experienced impressive growth in volume terms: apparel (i.e. knitwear and readymade garments), cotton fabric, basmati rice, and leather garments. The fall in unit values of exporting commodities was also experienced by our regional competitors. At the same time, the muted export subsidies on wheat and sugar from Q2 onwards led to a drop in their exports.

Exports

Pakistan's exports decreased by 1.1 percent to US$ 23 billion in FY19, after rising 13.7 percent last year. The decline in values came despite a healthy increase in quantum exports of major products, particularly in the textiles segment (**Table 6.6**). In the non-textile group, the absence of export subsidies on sugar and wheat during most of the year impacted their export quantums, and largely explained the YoY fall in their export values. The export decline also deepened as the year progressed, though this was partially due to the high base effect of H2-FY18, when subsidies had pushed sugar exports to an all-time high.[23]

Figure 6.17: Quarterly Moving Average of Machinery Imports



Data source: Pakistan Bureau of Statistics

[21] For instance, average price of a color TV set was 3.0 percent higher in FY19 as compared to last year. In FY18, average prices of the same appliance had risen by 1.2 percent over FY17. LCD TV imports (both parts and complete sets) declined 44.7 percent to US$ 45.1 million in FY19.
[22] Arab Light oil prices were, on average, 12.1 percent higher in FY19 as compared to FY18.
[23] In both quantum and value terms, sugar exports had reached their historic high in H2-FY18.

Textile exports

Overall textile exports declined by 1.4 percent YoY to US$ 13.3 billion in FY19, after growing by 8.6 percent in FY18. In absolute terms, the largest source of the decline was cotton yarn, whose exports fell by 18.0 percent to US$ 1.1 billion in the year. Among other low value added items, exports of cotton fabric – Pakistan's single largest export item – also dropped 4.6 percent; however, lower unit prices were entirely responsible for the drop in this case, as quantum fabric exports rose significantly over last year. Meanwhile, raw cotton exports declined 65.0 percent to US$ 20.4 million in FY19. Lower quantum exports were almost entirely responsible for the decline; it is worth noting that there was a 15 percent drop in local cotton production in the year, which drastically reduced the exportable surplus available with the country.

Table 6.6: Pakistan's Major Exports

million US$

	FY18	FY19	Abs. change	Quant. impact	Price impact
Food group	**4,797.8**	**4,607.4**	**-190.4**	**-**	**-**
Basmati rice	581.9	634.5	52.6	102.2	-49.6
Non-basmati	1,453.8	1,435.1	-18.7	-30.8	12.1
Wheat	236.3	153.3	-83.1	-100.5	17.5
Sugar	508.3	222.9	-285.5	-269.0	-16.5
Textile group	**13,521.1**	**13,328.2**	**-192.9**	**-**	**-**
Raw cotton	58.2	20.4	-37.8	-36.8	-1.1
Cotton yarn	1,371.9	1,125.4	-246.5	-232.2	-14.3
Cotton fabrics	2,203.6	2,101.8	-101.8	452.7	-527.5
Knitwear	2,711.2	2,899.9	188.7	309.9	-121.2
Bedwear	2,261.1	2,261.8	0.7	227.0	-226.2
Towels	797.4	786.1	-11.3	-48.3	37.0
R.M garments	2,577.2	2,653.7	76.5	1,006.7	-930.2
POL group	**393.6**	**477.2**	**83.5**	**54.8**	**28.8**
Crude oil	190.4	285.4	95.1	73.9	21.2
POL products	147.5	127.8	-19.6	-32.8	13.2
Other manuf.	**3,399.3**	**3,361.6**	**-37.6**	**-**	**-**
Leather	330.2	252.3	-78.0	-61.1	-16.8
Leather manuf.	522.9	485.7	-37.2	-30.1	-7.1
Plastic	238.0	318.6	80.5	51.5	29.0
Pharma	194.9	211.7	16.8	72.2	-55.4
Cement	222.8	271.7	48.9	90.3	-41.4
Total exports	**23,212.0**	**22,958.3**	**-253.7**	**1,700.8***	**-2,090.1***

*Items for which both quantum and price data is available

Data sources: Pakistan Bureau of Statistics data & SBP calculations

Yarn and fabric

Pakistan's yarn exports dropped 18 percent to US$ 1.1 billion in FY19. Here, it is important to highlight the lack of geographical diversification in the country's yarn exports. On average, 68 percent of Pakistan's overall yarn exports have gone to China during the past two years, with another 4.2 percent going to Turkey. During FY19, these two countries were collectively responsible for almost 80 percent of the YoY decline in Pakistan's quantum yarn exports. In case of Turkey, additional duties as well as emerging trends in the country's textile industry, reduced its overall import of yarn, including from Pakistan. At the same time, China's apparel exports to the EU have plummeted, which has reduced its demand for intermediate products, like yarn.[24]

In addition to lower demand from China, domestic factors were also not conducive for yarn exports this year. Local yarn production was flat, whereas demand for yarn by domestic spinning and weaving mills was quite strong, which led to a hefty increase in local yarn prices.[25] Yarn manufacturers therefore preferred to cater to local demand instead of actively pursuing export markets.

At the same time, higher local usage of yarn led to an increase in fabric production,[26] which allowed exporters to ship higher quantities of fabric as compared to last year.[27] However, due to a drop in unit prices, fabric export values declined 4.6 percent to US$ 2.1 billion in FY19. In terms of markets,

[24] According to Chinese customs data, there was a decline of 4.9 percent in exports of garments and clothing accessories (in US$ terms) during Jan-Jun 2019 over the same period last year. Chinese customs authorities do not release quantum export data for garment and clothing items.

[25] Local yarn prices were, on average, 23.6 percent higher in FY19 as compared to FY18.

[26] The strong activity of the spinning and weaving industries, which manufacture cotton fabric from yarn, is not fully reflected in the fabric production data that is prepared and disseminated by the PBS. This is mainly due to the serious gaps in coverage of the companies (along the entire textile value chain) operating in the country, which leads to an underreporting of production of textile items (**Chapter 2**).

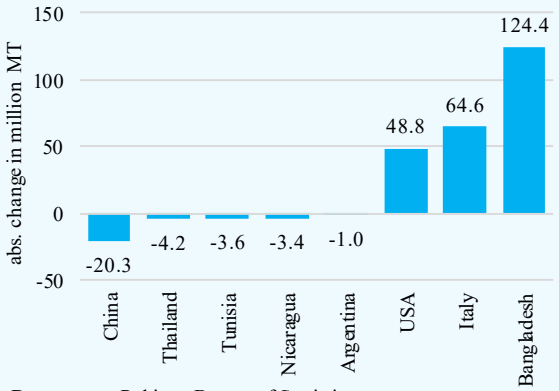
[27] In FY19, quantum fabric exports rose by a healthy 19.3 percent YoY.

hefty increases in fabric shipments to Bangladesh, the US and some European countries was recorded, which offset decline in exports to Argentina, China and Turkey during FY19 (**Figure 6.18**).

Apparel

Pakistan apparel exports (comprising readymade garments and knitwear) rose 5.0 percent YoY to US$ 5.6 billion in FY19; the growth was much lower than the 13.0 percent recorded in FY18. Despite the slowdown in export growth (in value terms), data from customs authorities indicated that Pakistan had exported a record amount (quantity) of apparel in FY19. A favourable domestic policy mix, including the government's duty drawback facility of 4 percent on garments and 3 percent on other textile made-ups (carpets, sleeping bags, etc.),[28] along with continuation of concessionary external financing scheme, played an important role in boosting quantum apparel exports.[29] Nonetheless, following the significant PKR depreciation, the unit value of Pakistan's apparel exports declined by 19.7 percent in US dollar terms; this compares with the 8.0 percent growth in unit values recorded in FY18.[30] Due to the lower unit values, export values of apparel products grew at a much lower pace than last year (**Figure 6.19**).

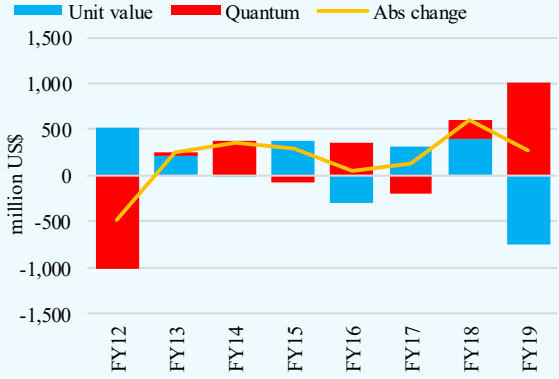
Figure 6.18: Growth in Quantum Fabric Exports to Major Destinations during FY19



Data source: Pakistan Bureau of Statistics

In terms of major markets, demand dynamics tended to vary. In case of the European Union, Pakistan's continued concessionary access to the bloc under the GSP Plus played a major role in keeping apparel exports on a rising trajectory. In fact, Pakistan's quantum apparel exports to the EU grew at the highest pace (6.6 percent) as compared to its major competitors in FY19 (**Table 6.7**). This growth was particularly impressive, because the bloc's quantum apparel imports from all supplying countries actually declined in the year. It is possible that the prevalent higher unit prices in the bloc, amid weakening economic growth, may have dented consumer demand for imported clothing. In this environment, only those exporters managed to benefit that were able to keep their unit prices in check. Pakistan was in this group, as the GSP Plus status and the significant PKR depreciation against the euro allowed exporters to keep their unit prices low, thereby boosting quantum exports to the bloc.

Figure 6.19: Contribution of Unit Value & Quantum Effects to Abs. Change in Pakistan's Apparel Exports



Data sources: Pakistan Bureau of Statistics & SBP calculations

[28] Ministry of Textile and Commerce (Textile Division) notification No.1 (42-B)TID/18-TR-II or Duty Drawback of Taxes Order 2018-21. 50 percent drawbacks to be provided unconditionally and 50 percent upon YoY increase in value exports by 10 percent.

[29] Credit amounting to Rs 10.1 billion was disbursed under the Export Finance Scheme in FY19. This compares with a retirement of Rs 7.8 billion under EFS noted in FY18.

[30] The unit value of export of any item is the value (in US$) received per unit of that item. It is calculated as the value exported of the item during a certain period (month, year etc) divided by the quantity exported of that item in the same period.

In addition, early signs indicate that Pakistan is capturing some of Bangladesh's share in the EU market, after the wage increase for Bangladeshi textile workers came into effect in early 2019. Also, the entire growth in the EU's quantum imports from Bangladesh had come during the Jul-Mar period, with a 0.4 decline noted in Q4-FY19. It is likely that European countries had brought forward their purchases from Bangladeshi suppliers before the minimum wage hike set in. Following the wage increase, the EU's purchases shifted to other low-cost suppliers with duty-free access, including Pakistan. In fact, Pakistan's quantum apparel exports to the bloc rose by a sizable 12.2 percent YoY during Q4-FY19; this was despite a 0.8 percent decline in the EU's overall apparel imports in the quarter.

Table 6.7: Growth in EU's Apparel Imports from Major Countries

	Quantum		Values*		Unit Values*		Currency**	
	FY18	FY19	FY18	FY19	FY18	FY19	FY18	FY19
Bangladesh	10.5	5.3	1.3	10.9	-8.4	5.3	-5.9	3.4
Cambodia	15.8	1.9	5.9	7.5	-8.5	5.5	-1.4	4.7
China	-1.6	-7.6	-6.1	2.5	-4.6	10.9	0.0	-0.2
India	-0.4	-3.2	-3.0	0.0	-2.6	3.3	-7.6	-3.5
Pakistan	11.1	6.6	2.8	8.4	-7.4	1.7	-15.6	-14.6
Turkey	3.8	3.5	2.8	2.2	-1.0	-1.3	-25.0	-28.0
Vietnam	13.3	-4.9	1.5	11.2	-10.4	16.9	-3.0	1.2
Total Imports	**4.6**	**-0.3**	**-0.5**	**5.7**	**-4.8**	**6.0**	**-**	**-**

*In euro terms **Change in domestic currency against euro
Data sources: Eurostat & Bloomberg

However, a different dynamic was in play in the US market: here, the country's overall quantum apparel imports grew at a much higher pace than last year, but Pakistani exporters were not able to adequately benefit from this increase in demand.[31] At the same time, import values also rose, after staying flat in FY18 (**Table 6.8**).

A couple of developments stand out. First, US imports of apparel items from China have yet (as of October 1, 2019) to formally attract the additional tariffs. Nonetheless, the threat of US tariffs being placed on Chinese apparel products has been consistently there, ever since the first round of tariffs went into effect in July 2018. As Chinese apparel manufacturers are heavily integrated in the global textile value chain, it is not feasible for American retailers to immediately shift their purchases to other suppliers. The result was that some US importers accelerated their apparel purchases from China (before apparel products come under the tariff regime), explaining the marked increase in the US' quantum apparel imports from China in FY19. At the same time, some US importers have shifted their purchases to other countries, particularly to Bangladesh and India. As a result, the US' quantum apparel imports from these countries also grew at a higher rate than last year.

Table 6.8: Growth in US's Apparel Imports from Major Countries
percent

	FY18			FY19		
	Quantity	Value	Unit Value	Quantity	Value	Unit Value
Pakistan	6.2	5.32	-0.83	4.8	9.5	4.5
Vietnam	3.6	6.92	3.24	6.6	8.7	2.0
Bangladesh	1.7	0.41	-1.29	7.0	11.9	4.5
China	-0.4	-2.66	-2.26	4.7	2.7	-1.9
Cambodia	10.2	9.89	-0.24	2.5	9.5	6.8
India	2.3	3.2	0.93	5.8	7.6	1.7
World	**0.2**	**1.0**	**0.79**	**4.6**	**5.4**	**0.8**

Data sources: US Office of Textile and Apparel (OTEXA)

Amid this global repositioning, Pakistani exporters could not position themselves accordingly, with the growth in the country's quantum apparel exports to the US decelerating from last year. However, due to an increase in unit prices, Pakistani apparel exporters were able to increase their export revenues from the US market by 9.5 percent YoY (as indicated earlier in **Table 6.8**).

Food exports

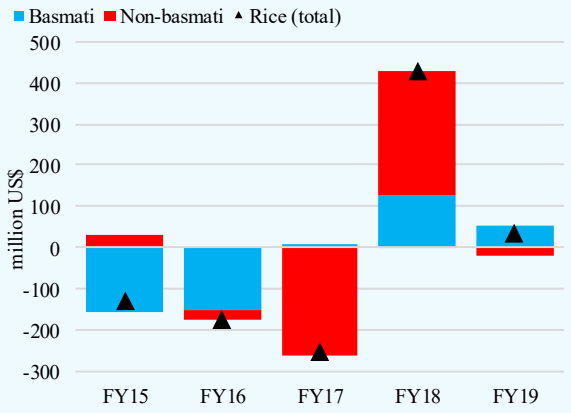
Food exports declined by 4.0 percent YoY to US$ 4.6 billion in FY19, with quantum-led declines in exports of sugar, wheat and non-basmati rice offsetting slight increases in exports of basmati rice and meat products.

[31] Strong demand in the US was reflected by a 2.3 percent growth in retail sales of clothing and accessories in FY19; this compares with a growth of 2.1 percent in retail sales recorded in FY18 (source: US Census Bureau).

Rice

Overall rice exports grew by 1.7 percent to US$ 2.1 billion in FY19, after surging by 26.7 percent in FY18. The slowdown in export growth mainly stemmed from a quantum-led drop in non-basmati rice. In contrast, basmati rice exports continued to grow, with quantums rising sufficiently enough to offset a decline in unit prices (**Figure 6.20**). However, the headline export numbers for the full year do not give the full picture of the developments that took place in H2-FY19.

Figure 6.20: Absolute YoY Change in Rice Export Values



Data source: Pakistan Bureau of Statistics

Detailed export data indicates that a significant shift occurred in the second half of FY19, both in case of basmati and non-basmati rice. Up until H1, the trend in basmati rice exports was similar to last year, where quantum exports to major European markets kept on rising, offsetting the drop in exports to Middle Eastern markets. In case of non-basmati rice, quantum exports had declined heavily in H1, with industry sources stating that China was unloading its stockpile in key African markets and pricing competitors out.[32]

However, in H2, a dramatic shift was noted, when China's own rice purchases – of both basmati and non-basmati varieties – from Pakistan surged dramatically (**Table 6.9**). In fact, it appeared that Pakistani exporters had diverted some of their exports towards China, away from European markets. The surge can be partially traced to an agreement reached between Pakistan and China in November 2018 during the Prime Minister's visit to China, where China had agreed to buy Pakistani rice. Since China typically buys non-basmati rice (for its domestic consumption as well as exports), Pakistan's non-basmati exports witnessed a relatively larger jump in H2. Further impetus to rice exports in H2-FY19 came from the major Middle Eastern markets – Saudi Arabia and the UAE – where Pakistani exporters also shipped higher quantities. However, this increase in H2 was still not sufficient to completely offset the decline in non-basmati exports recorded in H1; as a result, quantum non-basmati exports declined 2.1 percent YoY during FY19.

Table 6.9: Absolute Change in Pakistan's Quantum Rice Exports to Major Destinations

metric tons

	Basmati Rice		Non-Basmati Rice	
	H1-FY19	H2-FY19	H1-FY19	H2-FY19
China	14,978	29,618	14,978	246,991
Netherlands	6,560	-8,205	11,539	19,061
UK	15,942	-26,749	9,376	28,717
Saudi Arabia	-3,691	11,006	6,132	5,878
Belgium	-4,515	-23,941	3,514	32,106
UAE	-2,708	50,435	-3,583	27,143
Indonesia	535	-454	-24,429	-180,249
Madagascar	-16	-20	-187,979	16,050
Total	**49,815**	**48,722**	**-251,298**	**176,377**

Data source: Pakistan Bureau of Statistics

Sugar

Sugar exports decreased by 56.2 percent YoY to US$ 222.9 million in FY19, after rising three-folds in FY18. The drop mainly reflected the impact of withdrawal of federal export subsidies, which led to a 52.9 percent drop in quantum exports in the year.[33] International sugar prices were also trending

[32] According to Chinese customs data, the country's quantum rice exports had risen 299.7 percent YoY during Jan-Dec 2018. During Jan-Jun 2019, its rice exports had risen by a further 92.1 percent YoY.

[33] The Economic Coordination Committee (ECC) had allowed sugar exports of 2.0 million MT over the course of FY18; the quota (and subsidies) were utilized by the end of Q1-FY19.

downward, making it challenging for exporters to sell their product abroad.[34] In terms of destinations, most of the decline in quantum exports was accounted for by Afghanistan and India, where the ongoing geo-political situation also played a role. While the Punjab government did announce an export subsidy in Q3-FY19, it did not lead to a meaningful pickup in exports, as the amount of subsidy was lower than the federal subsidy that had expired earlier in Q1.[35]

Wheat

Wheat exports declined by 35.2 percent to US$ 153.3 million in FY19. The drop was entirely due to a 42.5 percent decline in quantum exports, whereas an 12.9 percent increase in unit prices provided some respite. Exports decreased to major destinations like Bangladesh, Malaysia, Oman, Qatar and Sri Lanka, overcoming the increased exports to Indonesia, Somalia and the UAE. Like sugar, most wheat exports were made in the first quarter, when subsidies were available. They also picked up very slightly in H2-FY19, after the government allowed export of 0.5 million MT of the commodity in November 2018. The quota was split between PASSCO and the Sindh and Punjab governments, with the federal and provincial governments subsidizing the exports by PASSCO and private entities, respectively.

Cement

Cement exports rebounded in FY19, rising by 21.9 percent YoY to US$ 271.7 million. With the increase in installed capacity and the simultaneous slowdown in domestic construction activity, local demand for cement was impacted. This forced manufacturers to look towards foreign markets, particularly South Africa, Sri Lanka, Madagascar and Mozambique.[36] Furthermore, Pakistani exporters were more focused on clinker as opposed to Portland (finished) cement. Being a low value added product that is further processed to produce cement, clinker exports fetched much lower unit prices. However, manufacturers exported sizable quantities of the material, which completely offset the downward pressure from unit prices.

Imports

Pakistan's imports declined 9.9 percent to US$ 54.8 billion in FY19, after recording an increase of 14.9 percent in FY18. The depreciation of PKR is a key explanation for the import contraction, and it was complemented by the macro stabilization efforts (reduction in PSDP spending, a rise in of regulatory duties, and monetary tightening). Furthermore, the completion of early-harvest CPEC projects, normalization of aircraft imports (**Table 6.10**) and a softening global commodity prices (in H2-FY19) were also quite helpful.

The impact of stabilization measures was directly felt on imports of raw materials for construction and transport industries – namely iron and steel (both scrap and finished products), old ships for shipbreaking, and rubber tyres and tubes. The policy decision to phase out furnace oil (FO) from the energy mix also factored in; in absolute (value) terms, FO was the single largest contributor to the decline in overall imports in FY19. Meanwhile, the indirect impact of the policy measures was perhaps felt most on imports of transport fuel products, such as petrol and high speed diesel (HSD). Domestic demand for the fuels slowed down considerably this year amid the pass through of the impact of the PKR depreciation and higher international oil prices to retail prices, reducing the need for their imports.

[34] International sugar prices were, on average, 8.8 percent lower in FY19 as compared to FY18 (source: World Bank).
[35] By end-January 2019, the Punjab government had announced a sliding-scale subsidy of Rs 5.35/kg for sugar mills in the province, up to an expenditure cap of Rs 3 billion and a quantum cap of 0.572 million MT.
[36] As per the All Pakistan Cement Manufacturers Association, domestic surplus capacity rose from 7.6 MT in FY18 to 12.6 MT by end-FY19. Also, local dispatches declined 1.9 percent in FY19, after rising 13.2 percent in FY18.

Table 6.10: Pakistan's Major Imports
million US$

Items	FY18 Value	FY18 Abs. change YoY	FY18 Quantum impact	FY18 Price impact	FY19 Value	FY19 Abs. change (YoY)	FY19 Quantum impact	FY19 Price impact
Energy group	14,430.2	3,506.9	-	-	14,441.4	11.2	-	-
POL products	7,476.1	638.2	-764.0	1,402.2	6,283.9	-1,192.2	-2,194.3	1,002.0
Crude	4,229.4	1,682.3	744.4	937.9	4,570.6	341.2	-559.0	900.2
LNG*	2,454.0	1,141.2	631.5	224.4	3,336.5	882.6	433.6	449.0
Machinery group	11,562.0	-192.6	-	-	8,921.7	-2,640.3	-	-
Power gen	2,663.0	-370.7	-	-	1,262.6	-1,400.4	-	-
Electrical	2,184.3	-137.3	-	-	1,777.6	-406.7	-	-
Telecom	1,532.3	180.5	-	-	1,379.6	-152.8	-	-
Other machinery	3,669.6	314.7	-	-	3,185.0	-484.6	-	-
Agri and chemicals	8,918.2	1,334.8	-	-	8,754.6	-163.6	-	-
Fertilizer	832.8	192.1			798.7	-34.1	-83.2	49.2
Plastic material	2,347.2	427.9			2,221.0	-126.2	36.8	-163.0
Other chemicals	4,492.3	603.5			4,452.0	-40.4	-	-
Transport group	4,388.3	1,061.1	-	-	3,085.9	-1,302.4	-	-
Cars	1,264.3	173.1	-	-	1,040.3	-224.0	-	-
Trucks & buses	639.8	71.2	-	-	496.8	-143.0	-	-
Aircraft & ships	1,141.5	616.8	-	-	694.0	-447.5	-	-
Other transp. Equipt.	349.5	62.1	-	-	85.6	-264.0	-	-
Metals group	5,356.6	944.9	-	-	4,974.2	-382.7	-	-
Iron & steel (Total)	4,023.5	782.0	518.4	263.6	3,690.3	-333.2	-484.2	150.9
Food group	6,184.2	40.8	-	-	5,668.0	-516.2	-	-
Tea	551.9	28.1	-34.9	63.0	571.7	19.8	124.1	-104.3
Palm oil	2,039.7	134.6	172.8	-38.3	1,844.6	-195.1	218.2	-413.4
Pulses	534.9	-417.5	-339.9	-77.7	506.0	-28.9	128.1	-157.0
Textile group	3,664.1	306.4	-	-	3,221.5	-442.6	-	-
Raw cotton	1,077.9	268.0	147.7	120.2	767.5	-310.4	-331.3	20.9
All other items	4,997.5	812.1	-	-	4,671.7	-325.9	-	-
Total Imports	**60,794.7**	**7,884.8**	**-**	**-**	**54,763.0**	**-6,031.7**	**-**	**-**
Import of items with Q/Price data available	27,586.8	3,988.4	1,438.8	2,549.6	25,435.7	-2,151.0	-3,334.0	1,182.9

Data sources: Pakistan Bureau of Statistics & SBP calculations

The decline in imports of power generation and electrical machinery items was expected, and in line with the completion of early harvest CPEC power projects and lower FDI flows to the sector. On the domestic front as well, the government's focus was on clearing the backlog of circular debt (which led to heavy borrowing by energy-related PSEs, as detailed in **Chapter 3**), instead of pursuing new power projects under PSDP.[37]

At the same time, the phenomenal increase in power generation witnessed in recent years started to normalize in FY19, with overall power generation rising 1.7 percent YoY in FY19 (**Figure 6.21**). As a result, the surge in demand for imported fuel for the power sector noted over the past two years – especially for LNG and coal – was largely absent this year, which led to relatively lower increases in import values for both the commodities.

Energy imports

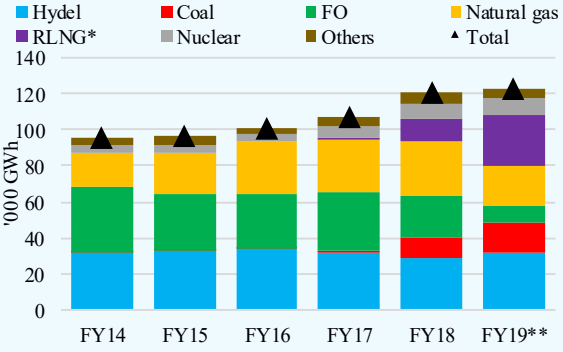
The energy imports stayed stagnant at US$ 14.4 billion in FY19, after growing by 32.1 percent YoY in FY18. In value terms, the slowdown in import growth was entirely a result of a steep drop in

[37] Overall PSDP spending was 25.6 percent lower in FY19 as compared to last year.

quantum imports of POL products and crude oil, which almost completely offset an increase in unit prices of the commodities, as well as a double-digit uptick in LNG imports in the year.[38]

In case of POL products, similar to FY18, quantum imports declined in FY19 as well. However, the reasons were very different. In FY18, local production of POL products had risen significantly after new capacity additions by a few refineries. This had led to a sizable reduction in the import demand for POL products, and simultaneously increased the demand for crude oil imports (**Table 6.11**).[39] However, in FY19, local refineries were unable to significantly alter their production mix after facing a dramatic reduction in FO demand by the power sector.[40] Unable to offload their FO stocks to IPPs, refineries had to cut back on their throughput, which led to a reduction in their demand for imported crude oil. As a result, quantum crude oil imports declined 13.2 percent YoY. However, its impact was offset by a 24.5 percent YoY increase in the commodity's unit prices, which led its import value to increase by 8.1 percent YoY to US$ 4.6 billion in the year.

Figure 6.21: Trends in Source-wise Power Generation



*NEPRA started releasing separate generation data for RLNG after February 2018 **: includes provisional data for June 2019
Data source: NEPRA

With regards to POL products, import values dropped 15.9 percent YoY to US$ 6.3 billion in the year, with lower quantum purchases entirely offsetting the impact of higher unit prices. The drop in quantum imports was most noticeable in FO and HSD. In case of FO, demand had been dropping ever since LNG-based power plants started coming online in FY18. In FY19, this declining trend not only continued, but actually deepened, as an outright ban on FO imports was in place during January to April 2019. As a result, the country did not import *any* furnace oil in 6 of the 12 months in the year.[41] In response, FO import quantums declined by 82.4 percent YoY in FY19 (**Table 6.11**), with import values dropping 78.1 percent.

Table 6.11: Growth in Quantum Energy Imports
percent change YoY

	FY18	FY19
Crude oil	29.2	-13.2
Furnace oil*	-33.1	-82.4
Petrol*	4.9	6.8
High speed diesel*	-1.1	-31.0
LNG	60.9	17.7
Coal	94.9	14.6

Data sources: Pakistan Bureau of Statistics, *OCAC for FY18 data

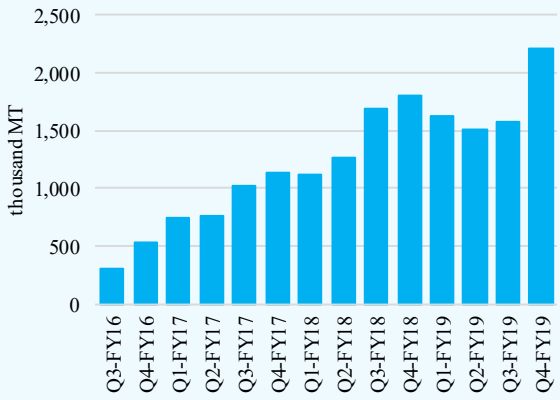
Meanwhile, in case of HSD, imports dropped significantly due to a slump in domestic demand. This was due to three main factors. First, lower machinery imports meant that fewer heavy commercial vehicles (HCVs) had to be deployed to transport the imported machinery upcountry to project sites. Second, the subdued construction activity also meant that fewer HCVs were needed to transport construction materials, such as cement and iron and steel products, from manufacturers to construction sites. And third, as per industry sources, the improvement in the power supply situation,

[38] Arab Light crude prices were, on average, 12.1 percent higher in FY19 as compared to FY18.
[39] In FY18, quantum crude oil imports had surged by 29.2 percent YoY, whereas imports of POL products had declined by 11.2 percent. In the same year, domestic production of POL products had risen by 13.2 percent YoY.
[40] That said, a couple of refineries had undertaken investments to upgrade their facilities, which allowed them to increase their production of petrol. For details, please see SBP's State of the Economy Report for Q1-FY19.
[41] As per data from the Oil Companies Advisory Council (OCAC). That said, the government removed the ban on FO imports in April 2019, to ensure that power plants had ample fuel available during the summer months (which also included Ramazan) to operate smoothly. Subsequently, some FO was imported during May and June 2019.

particularly in urban areas, has led to a reduction in HSD demand from households to operate diesel-powered generators. Due to lower quantums, HSD imports dropped 19.0 percent YoY in value terms. In contrast to FO and HSD, petrol's import values rose 16.0 percent YoY in FY19. In addition to higher unit prices, quantum imports of the fuel were also 6.8 percent higher. Demand for the fuel continued to grow this year, albeit at a lower pace than last year. The mushroom growth in car sales (both domestically assembled and imported) over the past few years (following growing popularity of ride hailing apps and attractive auto financing products by banks), has translated into sustained demand for petrol in the country.[42] Furthermore, the shrinking price differential between petrol and CNG has led consumers to be largely indifferent between the two fuels. Meanwhile, mainly due to refineries operating at lower throughput, domestic petrol production could not rise sufficiently enough in FY19 to cater to the rise in demand for the fuel. The gap in demand had to be plugged with imports.

On the other hand, LNG imports continued to surge, with import values rising 36.0 percent and reaching US$ 3.3 billion in the year. A 17.7 percent YoY increase in quantum imports as well as higher unit prices were responsible for the hefty increase in import values.[43] In fact, LNG emerged as the product whose import values had risen the most in absolute terms in the year (as indicated earlier in **Table 6.10)**. In a span of three years (CY16-18), Pakistan has emerged as the world's 7th largest importer of LNG. The fuel's imports are expected to maintain their upward trajectory, with the government actively working to set up the country's third LNG terminal.[44]

Figure 6.22: Pakistan's Quantum LNG Imports



Data source: Pakistan Bureau of Statistics

The primary demand for LNG originates from the power generation sector, where it (along with coal) is replacing FO in the energy mix. That said, the fuel's imports are also inherently linked with effective coordination between key energy sector stakeholders, namely the Power Division, independent power producers (IPPs), oil refineries, and PSO. Off-base projections for the energy needs of the power sector, along with production outages at LNG-based power plants (either planned or unplanned) can lead to problems across the supply chain. This seemed to be the case during Q3-FY19, when quantum LNG imports actually declined on YoY basis for the first time ever, due to administrative hiccups and outages at a couple of LNG plants. However, once these issues had been resolved, and in anticipation of the rise in demand for feedstock from fertilizer manufacturers and from LNG-based power plants, quantum LNG imports surged in Q4-FY19 (**Figure 6.22**).

Lastly, coal imports rose 13.9 percent YoY to US$ 1.5 billion in FY19. The entire increase was a result of a 14.6 percent uptick in quantum imports, as unit prices of the commodity were lower (in dollar terms) as compared to last year. International coal prices had peaked out in Q1-FY19 and have been descending ever since; for full year FY19, international prices were, on average, flat at FY18 levels. Global demand for coal has fallen recently, as countries like China and Japan are increasingly shifting towards cleaner energy sources, like LNG. Meanwhile, the low international prices

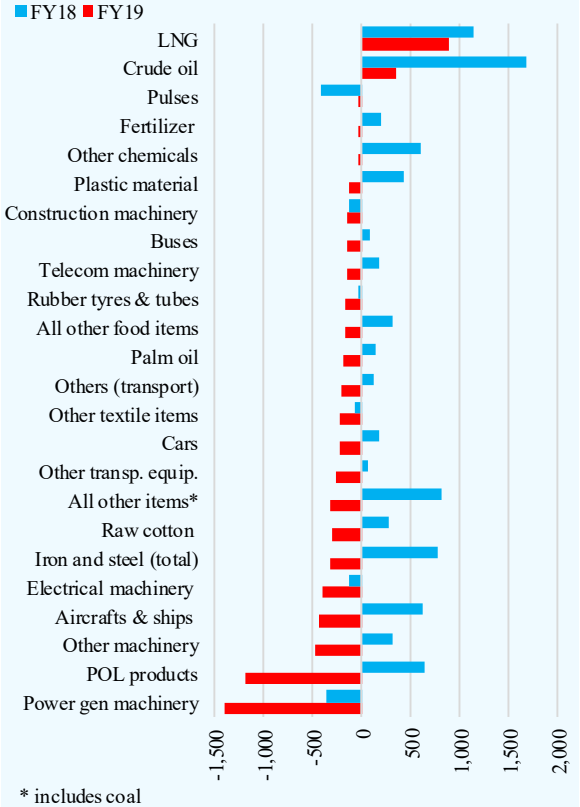
[42] Imported cars, particularly those of 660CC variety, operate exclusively on petrol, given their high fuel efficiency.
[43] Spot LNG prices were, on average, 19.0 percent higher in FY19 as compared to FY18.
[44] During the ECC meeting on July 4, 2019, the government approved some administrative requests of the Port Qasim Authority to expedite the setting up of the country's third LNG terminal (source: http://pid.gov.pk/site/press_detail/11228)

facilitated the Pakistani government's efforts to switch power generation towards coal, with the fuel's share in the country's total power generation rising to 13.3 percent in FY19, from 9.8 percent last year. On the other hand, demand for coal from the cement industry was subdued, given the 3.0 percent drop in cement production in FY19 in the wake of a slowdown in domestic demand.

Non-energy imports

Pakistan's non-energy imports declined 13.0 percent YoY to US$ 40.3 billion in FY19, after growing by 10.4 percent in FY18. While the drop was quite broad-based, some items – such as power generation and electrical machinery, aircraft and railway locomotives – accounted for the bulk of the decline in overall non-energy imports (**Figure 6.23**). At the same time, support came from lower international prices of key food items, namely palm oil, tea and pulses, which more than offset double-digit rises in their quantum imports. Lastly, as mentioned earlier, the slowdown in construction activity lowered the import demand for products associated with the industry, such as iron and steel and old ships for shipbreaking (classified under the transport group).

Figure 6.23: Absolute YoY Change in Non-Energy Imports (million US$)



* includes coal
Data source: Pakistan Bureau of Statistics

The machinery group emerged as the biggest drag on non-energy imports, with import values declining 22.8 percent YoY to US$ 8.9 billion in FY19. Within the machinery group, granular (HS-8) data indicates that most of the decline was noted in items related to power generation and electrical apparatus, such as wind power generation sets, steam boilers, gas turbines and related parts, and nuclear reactors.[45] At the same time, imports of various consumer durables, such as home appliances (TVs, lights and lamps, etc.) also declined, as higher prices in the wake of PKR depreciation suppressed the demand for consumer goods.[46]

The second largest contributor to the decline was the transport group, whose import values dropped by a sizable 29.7 percent YoY to US$ 3.1 billion in the year. As indicated in **Table 6.12**, lower purchases of aircraft, railway locomotives (including associated parts) and old ships for shipbreaking, and the absence of a one-off purchase of a tanker by a local logistics company (in FY18), were largely responsible for the decline. It may be recalled that multiple airlines had applied for commercial licenses with the Civil Aviation Authority (CAA) last year, which had led to an increase in demand for imported commercial aircraft; the absence of fresh local entrants into the aviation sector in FY19 led to normalization of aircraft (completed) imports.

Meanwhile, car imports dropped 17.7 percent YoY in FY19, after rising 15.9 percent in FY18. The

[45] According to the Planning Commission, financial close for two CPEC-related wind power projects was achieved in March 2017, and the plants became operational in June and July 2018.
[46] These products are classified under the electrical machinery category.

entire decline in FY19 came from completely built units (CBUs), whose imports were specifically targeted by the government via increase in customs duties and tightening of regulatory loopholes that had allowed massive misuse of schemes like the gift and baggage schemes by commercial car dealers.[47] This led to a 52.8 percent decline in the number of cars imported in the country in FY19, with most of the decline noted in vehicles of under 800cc.[48] At the same time, demand for locally assembled cars failed to keep up with the momentum noticed over the past two years, as local manufacturers raised car prices multiple times in order to pass-on the impact of the PKR depreciation (**Chapter 2**). The tepid sales growth prompted assemblers to curtail their production as well, which reduced the demand for CKD imports.[49]

The spillover of slowing domestic car production was also felt on imports of rubber tyres and tubes, which fell to half their level of FY18.[50] Similarly, the auto industry's demand for iron and steel sheets also suffered. In response to lower demand from automakers and the slowdown in construction activity, local steel manufacturers curtailed their production, which led to lower demand for imported scrap and old ships for shipbreaking (**Table 6.12**). Demand for finished steel products also suffered, as the brisk expansion in private real estate activity noted until FY18 started to cool down in the wake of regulatory measures to document the economy,[51] upward revision in property valuation tables, and higher prices of materials in the wake of PKR depreciation.[52] As a result of these dynamics, cumulative iron and steel imports dropped 8.3 percent YoY to US$ 3.7 billion in FY19, after rising 21.4 percent in FY18.

Table 6.12: Breakdown of Transport Imports
million US$

	FY18	Abs. Change (YoY)	FY19	Abs. change (YoY)
Transport group	**4,388.3**	**1,061.1**	**3,085.9**	**-1,302**
Aircraft, ships & boats	1,141.5	616.8	694.0	-447.5
Aircraft (compl.)	87.5	79.1	5.0	-82.5
Aircraft (parts)	61.0	10.3	65.8	4.9
Ships for breaking	706.1	310.7	156.3	-549.8
Tanker	275.8	0	-	-275.8
Other. transport equip.	349.5	62.1	85.6	-259.7
Railway loco. & parts	349.1	59.1	89.5	-260.2
Cars	1,264.3	173.1	1,040.3	-224.0
CBU	455.2	23.8	222.0	-233.2
CKD	809.0	149.3	818.3	9.2
Buses & Trucks	639.8	71.2	496.8	-143.0
CBU	242.0	- 74.2	156.0	-86.0
CKD	397.8	145.4	340.8	-56.9
Motorcycles	112.1	16.4	87.3	-24.8
Vehicle Parts & Others	881.0	121.4	681.9	-199.1

Data source: Pakistan Bureau of Statistics

Lastly, Pakistan's food imports benefited enormously from soft global prices, with import values declining by 8.3 percent to US$ 5.7 billion in FY19. Import values of key products, such as palm oil, tea and pulses, were all lower as compared to last year, despite hefty increases in their quantum imports. In fact, the 18.2 percent average reduction in global palm oil prices apparently encouraged edible oil mills to import more of the finished product, as opposed to oil seeds which can be processed to yield edible oil. Specifically, quantum imports of low-euric rapeseed, colzaseed, and sunflower seed were much lower than last year, whereas quantum purchases of palm olien and palm oil were

[47] For details, please see the SBP's State of the Economy report for Q3-FY19.
[48] This compares with a 31.0 percent YoY increase in the number of cars imported in FY18.
[49] Domestic car production declined 3.9 percent YoY in FY19, after rising by 16.5 percent YoY in FY18 (source: Pakistan Automobile Manufacturers Association).
[50] Imports of rubber tyres and tubes (classified under "miscellaneous items"), dropped to US$ 139.4 million in FY19, from US$ 313.8 million in FY18. Around 85 percent of this YoY decline was due to lower quantum imports.
[51] In the FY20 budget, the government has imposed restriction that real estate transactions over Rs 5 million can only take place via banking instruments (crossed cheque, pay order etc). The government has also doubled the rate of applicable taxes (withholding, advance and capital gains) for people not appearing on the FBR's Active Taxpayer List, and revised upwards FBR's property valuation for around two dozen large cities in the country, to bring them closer to market value.
[52] Domestic prices of metal products, such as steel bars and sheets, have risen more significantly in FY19 (19.0 percent) than in FY18 (14.3 percent).

significantly higher.[53] The low import of oilseeds also explains the stagnation in edible oil and ghee production this year.[54]

[53] Oilseed imports are classified under the "All other food items". In FY19, imports under this category declined 7.4 percent to US$ 2.2 billion.
[54] Cumulative production of edible oil and vegetable ghee declined 1.7 percent in FY19, after registering a growth of 8.3 percent YoY in FY18.

7 Factors Constraining Investments in Pakistan: Beyond the Macroeconomics

7.1 Introduction

The objective of this chapter is to present a comprehensive diagnostic of the investment landscape of Pakistan and to identify the binding policy, legal and institutional constraints, which undermine the country's ability to mobilize domestic and foreign investments to a level commensurate with its potential. Thus, digging beyond the conventional macroeconomic factors such as low savings, shallow financial markets, and presence of a large informal economy, the chapter first highlights the legal and operational challenges that domestic and foreign investors face, especially when it comes to dispute settlement mechanisms, policy advocacy efforts and investor retention practices. It then elaborates upon the weaknesses in tax collection machinery, particularly the lack of administrative ease and cumbersome documentation procedures, which have for long kept the regulatory environment unfavorable for operating businesses and restrained prospective investments. The focus then shifts to the private sector, where the importance of growth in small and medium sized firms is emphasized, and the difficulties such firms face in scaling up their operations in Pakistan are elaborated upon. Finally, the chapter reflects upon the ongoing policy reforms that are aimed at making the investment landscape of the country more conducive and facilitating, and stresses upon elements that will be crucial going forward to systematically address the problem of chronic under-investment in Pakistan.

Within this context, the chapter argues that discrepancies in the country's investment policies, laws, and bilateral treaties increase the risk of potential contract enforcement disputes arising between the state and enterprises. Similarly, the noticeable difference in the *dejure* versus *defacto* investment regime results in time- and resource-sensitive operational challenges for the business enterprises. Concerning the private sector, stagnancy in the SME segment is found to be a major reason for the dispersed and inadequate nature of investment activities in Pakistan. In this regard, poor management practices of small enterprises is highlighted as a foremost hurdle to their innovation, diversification and growth strategies. Lastly, the poor state of human capital development, dysfunctional institutional and operational infrastructure, and an unsatisfactory focus of the government on investment retention practices leave the ecosystem deficient in terms of facilitation and attractiveness. Resultantly, both the existing and potential investors find it hard to commence, conduct and expand their business activities in Pakistan.

7.2 Background

The development strategies in most emerging markets (EMs) have been centered on implementing liberal trade and investment policies.[1] Specifically, the consistently high rate of investment in export-oriented sectors is recognized as the most crucial ingredient of East Asia's so-called development miracle. Similarly, the investment-led growth model has yielded enviable results in China, as this enabled the country to secure top position in global manufacturing and export activity over the span of 20 years. Other EMs such as India, Indonesia, Vietnam, Turkey, Chile and Peru have all been focusing aggressively on capital formation in their catch-up endeavors, and have been able to attract heavy investments from both domestic and foreign sources.

[1] This is because investment is considered an integral part of the economic development process. A sustained inflow of directed investments enhances the production capacity of the country, increases employment generation, and helps reduce poverty. Moreover, by spurring innovation and adoption of efficient operational techniques and technologies, it also makes the production processes of the businesses leaner and more effective. Finally, public or private investments in physical and digital infrastructure help create an enabling and facilitative ecosystem that results in higher investment retention, while fueling further interest of potential investors in the economy.

The investment rate in Pakistan, however, has remained chronically low both in absolute terms and in comparison to other emerging and developing economies, and worryingly has been declining over the past decades (**Figure 7.1**). Effectively, Pakistan stands out as the only country in the Asian region with a falling growth potential.[2] According to the World Bank's estimate, the persistence of current investment growth rates will make it extremely challenging for the country to reach middle-income status in the coming three decades – the required rate is at least 25 percent, as against the current rate of around 15 percent.[3] The fact that other countries are growing faster than Pakistan makes the task more uphill than it may appear otherwise, especially with regards to attracting foreign investments.

Figure 7.1a: Chronically Low Investment Rates in Pakistan

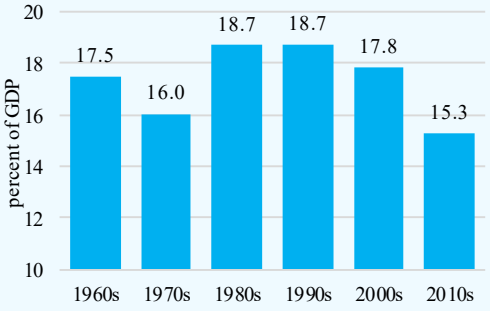
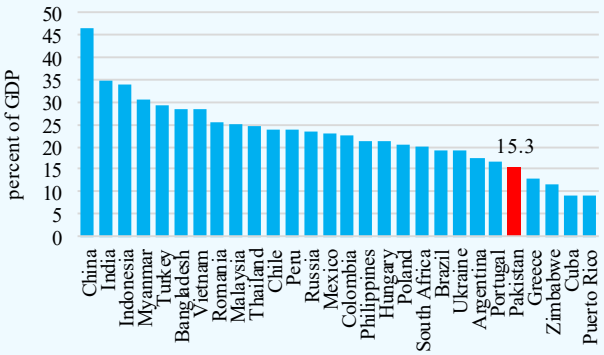


Figure 7.1b: Investment to GDP Ratio in Emerging Economies (2010-2017 average)

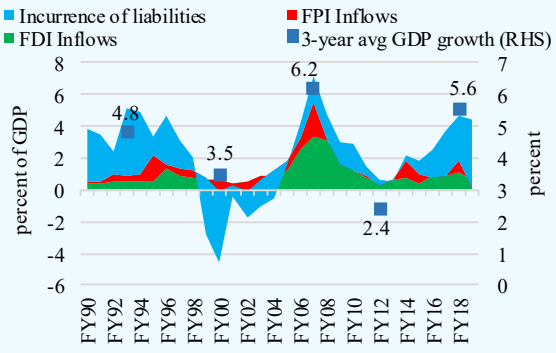


Data sources: World Bank; Haver Analytics

When we look at sources, the underinvestment appears in both the public and private sectors. In case of public investments, structural weaknesses in revenue mobilization emerge as a binding constraint for the required investment in human capital, transport, energy and digitization in the economy. As for the private sector, while the investment climate has not been too favorable given the unstable macroeconomic environment and infrastructure bottlenecks, investment activity has been further constrained by low domestic savings. Therefore, the country has always relied on foreign savings for achieving high growth and job creation.

The fallout of such a structure of investment finance is that the economy's capacity to sustain growth cycles for a long period has weakened steadily. Specifically, consumption-driven spurts have increased the country's demand at a much higher pace than its supply of goods and services, prompting a need for higher imports. Therefore, it is not surprising to see that nearly all of Pakistan's high-growth periods have coincided with high inflows of foreign savings; whenever such inflows have dried up, economic growth has fizzled out. Even the composition of foreign inflows has remained unfavorable, as the country has struggled to attract significant foreign direct investments, with loans and grants constituting

Figure 7.2: Historical Trend of Financial Account Inflows in Pakistan



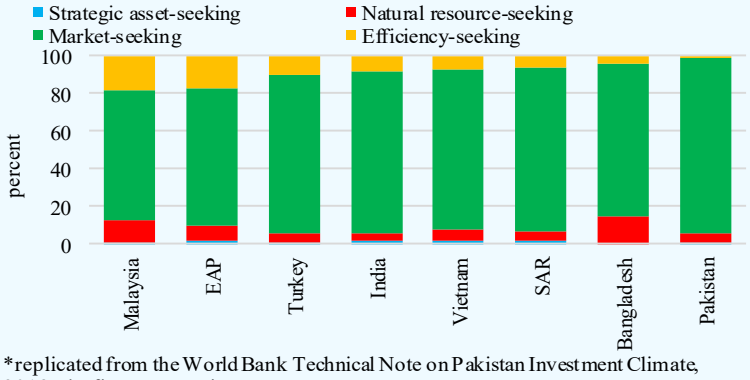
Data sources: State Bank of Pakistan; Haver Analytics

[2] Source: 11th Five Years Plan, Planning Commission, Government of Pakistan, 2013.
[3] Reference: Waheed, Muhammad; Ghumman, Adnan. 2019. Pakistan at 100: Growth and Investment. World Bank, Washington, DC. © World Bank.

the bulk of external inflows (**Figure 7.2**). While this boom-bust nature of Pakistan's growth cycles has been widely discussed, a lesser-known impact of low domestic savings and financial exclusion is the continuously high rate of informal investment activity in the country.[4]

The above discussion raises an important question: what explains persistent underinvestment (both domestic and foreign) in Pakistan, in spite of a liberal trade and investment regime and a large market size? Moreover, it also needs to be explored why – unlike Vietnam, Turkey, Malaysia and India, where a considerable portion of FDI was to seek efficiency – the FDI that has come into Pakistan has predominantly been motivated by market seeking. As may be seen in **Figure 7.3**, Pakistan has the lowest level of efficiency-seeking investment (less than 1 percent) and the highest level of market-seeking investment (94 percent) among comparable countries. It also merits investigation that while existing firms have responded to growing population and income levels in the economy by investing in capacity expansions, the focus on innovation, product diversification and economies of scale has been rather limited. With large enterprises preferring to hold their earnings in cash and, instead of leveraging, using the same to finance their capex needs, the growth in small firms was compromised by limited capital as well as weaknesses in regulatory environment and businesses' structure and management practices. Similarly, even when investible resources were available, these were diverted to less productive sectors of the economy, such as the real estate, due to negligible regulatory oversight and substantial returns. The following sections elaborate on this further.[5]

Figure 7.3: FDI by Motivation Typology 2005-16 - A Regional Comparison*



*replicated from the World Bank Technical Note on Pakistan Investment Climate, 2018; the figures are estimates
Data sources: World Bank; UNComtrade; International TradeAssociaton; fDI Markets

Strategic asset-seeking: Acquiring assets of foreign companies to enhance competitiveness

Natural resource-seeking: Accessing and exploiting natural resources in host country

Market-seeking: Motivated by investor interest in serving domestic or regional markets

Efficiency-seeking: Taking advantage of different factor endowments, culture and work ethics, institutional arrangements, economic policies and market structures

7.3 Legal challenges

Discrepancies between the country's investment policy and investment laws

Pakistan's existing investment policy framework of 2013 is "liberal and fairly open" in terms of facilities that it offers to the prospective investors.[6] Non-discriminatory regulations, openness to FDI in all segments of the economy (except those reserved on account of national security concerns), the possibility of a 100 percent ownership in most of the sectors, and absence of any restrictions on currency convertibility and repatriation of profits attract foreign investors to tap the strong and expanding domestic market of Pakistan. Furthermore, the country's vast network of international

[4] This vibrancy in the informal sector is represented by a large contribution (71.4 percent) of informal sector in providing jobs, a tax gap of around 10 percent of GDP, and a high cash penetration. Source: Pakistan Labor Force Survey 2017-18.
[5] Here it is important to mention that factors that constrain productive capital formation in Pakistan have been common across both domestic and foreign investors. However, due to limited information available with respect to domestic investments, the Chapter draws heavily from surveys that pertain to foreign investments, e.g., OICCI Perception and Investment Survey, World Bank's Doing Business Indicators and World Economic Forum's Global Competitiveness Report.
[6] Reference: World Bank Group Technical Note, "Pakistan Investment Climate (Prosperity Fund Project – 602167): Findings from the Pre-Implementation Scoping and Diagnostic". World Bank, May 2018.

investment and free trade agreements, at least on paper, ensure smooth and efficient dispute settlements, enactment of minimum treatment standards, and provision of protection against expropriation for potential investments.

However, in addition to the investment policy, two main documents define the overall investment regime in Pakistan: the Foreign Private Investment Act of 1976 and the Protection of Economic Reform Act of 1992. It is pertinent to mention here that the investment policy is more of an attraction document, while the two acts together form the legal foundation that govern the investment related matters of the country. The existence of these three concurrently active documents add to investors' confusion about the permissible scope of investment activities and the overall incentive structure in the economy. Furthermore, there are also discrepancies between the acts and the policy on a number of issues such as the nature of sectors open for investment and rules pertaining to minimum domestic input requirements; mechanisms governing the issues of national and equitable treatment of foreign investments; and expropriation and dispute settlement processes (**Table 7.1**). This makes both the existing and potential investors wary of venturing into any capital formation activity.

Table 7.1: Comparison of Main Provisions in Investment Laws and the Investment Policy of Pakistan

	Foreign Private Investment Act of 1976	Protection of Economic Reform Act of 1992	Investment Policy of 2013
Scope of application	Only foreign investors that are already established in the country (post-establishment).	Only foreign investors that are already established in the country (post-establishment).	Both domestic and foreign investors in the pre- and post-establishment phase.
Freedom to invest	List of specific situations where the Government may authorize investment.	Silent.	All sectors and activities are open for foreign investment unless specifically prohibited or restricted for reasons of national security and public safety. Specified restricted industries include: arms and ammunitions; high explosives; radioactive substances; securities, currency, and mint; and consumable alcohol.
Expropriation	Only under due process of law and against adequate compensation in the currency of the country of origin.	No expropriation for any reason on ownership, management and control of any banking, commercial, manufacturing or other company.	Silent.
Fair and equitable treatment and national treatment	Silent.	Silent.	All foreign investors in relation to the establishment, expansion, management, operation, and protection of their investments shall be accorded fair and equitable treatment without discrimination and shall be entitled to treatment "no less favorable" than that granted to national investors in like circumstances.
Local content requirements	The federal Government may make rules for the employment of Pakistani and foreign nationals in foreign investments.	Silent.	Silent.
Dispute settlement	Silent.	Silent.	Recourse to international arbitration in case disputes arising from an agreement when provided contracts and only after exhaustion of the local remedies for a period of 6-months.

Data source: Board of Investment, Pakistan

Dispute settlement mechanisms are found lacking in terms of contract enforcement and expropriation

In Pakistan, investors are provided protection against both the indirect and direct form of expropriation, while allowing for full repatriation of profits. A major contribution towards this liberal environment is granted by the 48 bilateral investment treaties (BITs) that Pakistan has with other

countries.[7] However, investors often complain of not getting all the facilitations identified in the respected BITs. Here, it is also worth mentioning that the recent BITs to which Pakistan is a signatory include clauses on which the country's investment laws and policies are either less accommodating or even silent. This has resulted in Pakistan faring poorly both in absolute and relative terms with regards to the perceived risk of expropriation, currency inconvertibility and transfer restrictions, as can be seen in the risk rankings computed and compiled by Credendo, a European credit insurance group (**Table 7.2**).

Existing investors also complain about the long durations of court proceedings for resolving standardized commercial disputes in Pakistan. According to the 2017 perception and investment survey conducted by the Overseas Investors Chamber of Commerce and Industry (OICCI) of Pakistan, over half of the investors stated that the average time for a dispute settlement in the country was over 5 years, while one-fifth of the respondents said that the time taken for such cases was between three to five years (**Table 7.3**).

Table 7.2: Country Risk Rankings with respect to Direct Investments (Dark Green [1] = Best; Red [7] = Worst)

Expropriation Risk	Currency Inconvertibility Risk	Political Violence Risk
	Pakistan	Pakistan
Pakistan; Bangladesh	Sri Lanka	Bangladesh
Sri Lanka	Bangladesh; Vietnam	India
India; Vietnam	India; Malaysia	Sri Lanka; Vietnam
Malaysia		Malaysia

Data source: Credendo (2019); various country profiles

Table 7.3: Average Time Taken in Pakistan to Resolve a Contract-enforcement Dispute through Courts

	1-6 months	Within 1 year	Within 3 years	Within 5 years	More than 5 years
			Percent of cases		
Filing and service	56	22	12	4	6
Trial and judgement	1	16	26	26	31
Enforcement of judgement	8	26	24	17	25
Total time	0	5	19	19	57

Data source: OICCI Perception and Investment Survey 2017

Furthermore, a few high-profile dispute settlement cases involving the Pakistani government and established foreign investors have raised concerns regarding the contract enforcement and expropriation protection elements of the investment regime. For instance, Pakistan lost an arbitration case in the London Court of International Arbitration last year in a suit filed by the Independent Power Producers for recovery of dues from the government-owned national grid company, National Transmission and Dispatch Company.[8] Similarly, a Saudi-South Korean joint venture in the steel sector, had also filed a case against Pakistan in an international court of arbitration. The disagreement in this case rose upon the refusal of the government to provide natural gas to the firm's plant at concessional rates, which led to plant's closure since 2014. Furthermore, the International Centre for Settlement of Disputes (ICSID) has heard the cases of a Turkish rental power firm, and Australian coal mining enterprise, against Pakistan. Both the firms had filed the complaint regarding breach of the respective bilateral investment treaties and had first tried the national settlement mechanism (going to the Supreme Court) before proceeding to ICSID.[9]

[7] UNCTAD lists 53 BITs that Pakistan has with other countries. Out of those, 4 have been terminated, while 16 are not in force. URL: https://investmentpolicy.unctad.org/international-investment-agreements/countries/160/pakistan?type=bits.
[8] The IPPs have stated that they may resort to an arbitration filing again amidst the current National Accountability Bureau (NAB) investigation into their operational activities and earnings.
[9] In case of the former, the country was directed to pay about US$ 780 million to the affected firm, with a total liability after including interests amounting to US$ 900 million. Shortly after the announcement, Pakistan registered a petition against the decision, which led to an automatic stay on the enforcement of the award. Concerning the latter, the ICSID awarded US$ 5.8 billion to be paid by Pakistani government for turning down the firm's leasing request for mining purposes.

Alongside resulting in a significant financial burden for the country, such cases have weakened credibility perception of the state of governance in Pakistan. In fact, partially nudged by the greater number of settlement disputes won by investors against the nation-states,[10] governments all over the world have started focusing on modernizing and renegotiating their BITs. This is to ensure that the treaties are not only aligned to the national investment policies of the participatory countries, but that they also include sustainable, development-orientated reforms that safeguard investor rights while encouraging responsible investments and comprehensive settlement procedures. The emphasis is on making the investment related laws and policies as explicitly transparent as possible (**Table 7.4**).

Table 7.4: Focus on Transparent Regulations and Sustainable Investments in Modern Bilateral Investment Treaties

Treaty provisions	Example(s)	Inclusion in Earlier BITs (1959-2010) (percent)	Inclusion in Modern BITs (2010-17) (percent)
Preamble	Health, safety, labor rights, environment-friendliness, sustainable development	8	56
Most Favored Nation treatment	Specifying that such a treatment is not applicable to other IIA's ISDS provisions	2	45
Fair and equitable treatment	Explicitly state minimum standard of treatment under the law	1	29
Indirect expropriation	Clarifying what does and does not constitute as an indirect expropriation	5	42
Free transfer of funds	Include exceptions for Balance of Payments difficulties and/or enforcement of national laws	18	74
Public policy exceptions	Include general exceptions such as for the protection of human, animal or plant life or to limit the exhaustion of natural resources	7	43

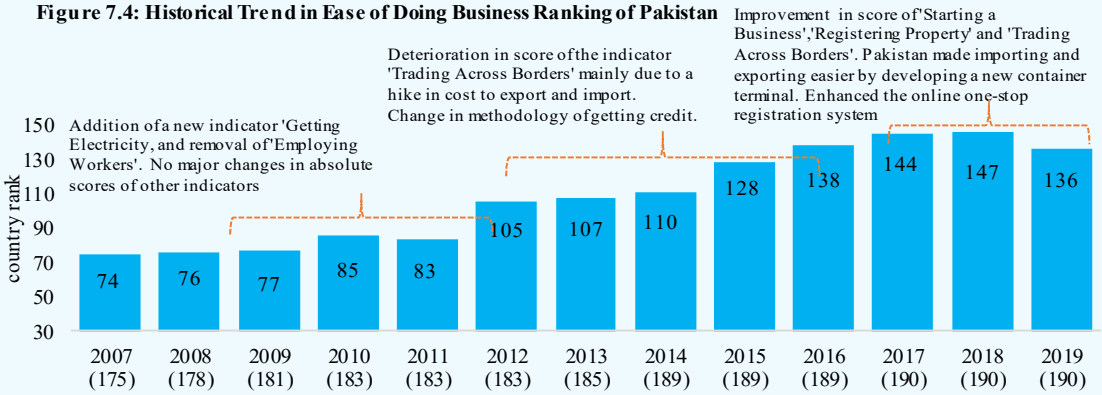
Data source: UNCTAD World Investment Report 2017

7.4 Operational challenges

De jure vs. De facto investment policy

Although Pakistan's investment policy is liberal and draws ample attention, potential and existing investors often state that the actual environment falls short of the promises. This is evident from a very poor ranking of the country in terms of ease of doing business. Over the years, Pakistan has experienced a drop of 62 points in overall ease of doing business (EODB) ranking since 2007 (**Figure 7.4**). Since the ranking is measured relative to other countries, fall in the position does not necessarily indicate an adverse development in doing business environment in the country; rather it may be a sign

Figure 7.4: Historical Trend in Ease of Doing Business Ranking of Pakistan



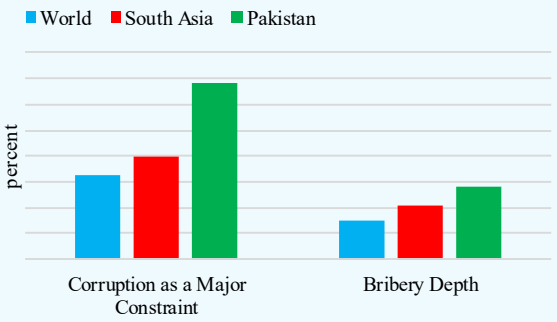
* Figures in parenthesis show total number of countries included in DBI
Data source: Doing Business Indicators, World Bank

[10] From 1987 to 2017, 61 percent of the contract enforcement dispute settlement cases involving investing parties and destination states have been decided in favor of the former. Source: UNCTAD and ICSID.

that other countries have improved their score more relative to Pakistan.[11] However, in case of Pakistan, it appears that the absence of, or delays in, reforms targeting problem areas such as electricity shortages and high costs of trading across borders resulted in the country not posting any meaningful absolute improvement in the rankings during the period under review.

An example of the difference between *de jure* and *de facto* policy is related to operational requirements. The policy states that foreign investors can invest in any of the sectors except those having national security significance, and can start their operational activities prior to receiving the No-Objection Certificate (NOC) from the Interior Ministry. This is a major recent development, as obtaining NOC takes between two to three months. However, the incorporated firms still have to obtain a security clearance certificate that takes at least a couple of months to be processed. Furthermore, there is no standard operating procedure to address complaints of the new businesses systematically. Hence, the investors often have to rely on personal contacts and approach the respective institutions repeatedly to get the issues addressed. Here, incidences of bribery and corruption are also widespread. According to the 2013 World Bank's Enterprise Survey data for Pakistan (the latest available), the percentage of firms identifying corruption as a major constraint and the level of bribery depth (percent of public transactions where a gift or informal payment was requested) is higher than both the regional and world averages (**Figure 7.5**).

Figure 7.5: Level of Corruption Faced by Businesses

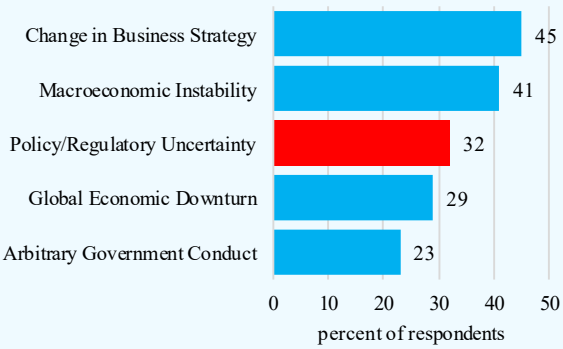


Data source: World Bank World Enterprise Survey (Latest Figures used)

Investment retention becomes difficult due to regulatory uncertainty and inadequate aftercare facilities

There is a vast academic literature that reveals that sector-specific policy uncertainty, beyond the overall macroeconomic stability environment, leads to diminution in investor confidence and interest in an economy. In basic terms, incorporating new information as it becomes available is vital for investment and expansion decisions. As policy uncertainty increases, the capability of the investors to integrate the new information (which now becomes unreliable) in their planning and decision-making is adversely affected. The impact of sudden policy reversals or delays in the announcement or implementation of incentives and tax reliefs can also reverberate for months, and it may take substantial time for investments to recover to the initial levels, especially if the investments are irreversible. In fact, apart from a change in the business strategy, multinational

Figure 7.6: Top 5 Reasons Cited by Investors for Exiting a Country



Data source: World Bank Global Competitiveness Report 2017-18

[11] The ranking also reflects methodological changes, for instance WB removed Employing Workers in 2011 where country ranked at 146, in next year 'Getting Electricity' was being introduced where Pakistan ranked at 166 position. Due to these methodological changes, Pakistan fell from 83 position to 105 in one year.

enterprises regard policy uncertainty as the second biggest reason for exiting a country, surpassed only by concerns of macroeconomic instability (**Figure 7.6**).

In case of Pakistan, too, policy uncertainty is considered a major barrier to investment growth. Frequent changes in the incentive structures, coupled with the introduction of sector-specific policies that are sometimes not regarded favorably by the investors, make the overall investment climate a challenging one. According to the OICCI's 2017 Perception and Investment Survey, investors regarded policy uncertainty and unpredictability as the fourth major reason for declining investment in Pakistan, after security concerns, image problems and increasing tax compliance on tax compliant sectors. Furthermore, there is no monitoring or review mechanism in place to periodically evaluate the effectiveness of the implemented measures in terms of increasing the existing level of or bringing in more capital formation activities.

It is now widely established that investors value grievance handling, information assistance and policy advocacy efforts of Investment Promotion Agencies (IPAs) on a higher scale compared to promotional activities and first-touch trade and investment exhibitions (**Table 7.5**). There is, hence, a greater focus of IPAs nowadays to move from the *transactional* viewpoint (in which interactions are mostly confined to investment attraction and generation phases) towards a *relationship-enhancing* viewpoint (where existing investors are checked upon and their opinions regarding policy matters are sought on a frequent basis) (**Box 7.1**). In this regard, countries make use of Investor Tracking /Customer Relationship Management (CRM) systems, which the Pakistani Board of Investment (BOI) currently does not have. However, recently BOI has started to actively focus on bringing its aftercare services up to par by introducing country-specific desks, launching a grievance-handling portal and conducting priority sector studies.

Table 7.5: Percent of Investors Regarding Investment Promotion Agencies' (IPAs) Activities as Important (or Otherwise)

	Critically Important	Important	Somewhat Important	Not Important
Grievance handling	28	47	21	4
Information assistance	26	47	21	5
Improve business environment	23	46	25	5
Opportunity discussions	17	37	35	10
Trade and investment exhibitions	11	31	42	16
IPA advertising	9	30	41	20

Data source: World Bank Global Competitiveness Report 2017-18

Box 7.1: The Importance of Aftercare Services for Investment Retention

Aftercare services in terms of investment comprise of "all potential services offered at the company level by Governments and their agencies, designed to facilitate both the successful start-up and the continuing development of a foreign affiliate in a host country or region with a view towards maximizing its contribution to the local economic development" (Young and Hood, 1994). This is one of the four major duties that Investment Promotion Agencies (IPAs) are expected to perform, with the other three being investment generation, image building and making use of policy advocacy. As **Table 7.2.1** shows, aftercare services are of three broad types: *administrative services* (facilitating operations of foreign firms in terms of obtaining licenses and permits); *operational services* (enhancing the efficiency and effectiveness of the operations of foreign investors by locating local suppliers and providing training facilities, etc.); and *strategic services* (influencing the future direction and policy planning of the established firms).

Three major factors are often mentioned to highlight the significance of aftercare services. First, it is a more efficient way of utilizing the budget of an IPA, as it focuses on existing investors. Second, and perhaps more important, the full-scale benefits of inward FDI, such as technology transfers and integration of local producers in the GVCs, cannot be achieved without proper focus on the effectiveness of such investments. Third, satisfied and successful foreign investors can be ideal advertisers of the host destination to other potential investors. Despite the apparent advantages, however, very few IPAs are currently adequately focusing on the aftercare services, utilizing instead their resources on the more traditional activities of attraction and image building. According to the 2018 survey of the World Association of Investment Promotion Agencies (WAIPA), aftercare services account for just 10 percent of the total budget allocations of the IPAs on average. Image building (36 percent) and miscellaneous activities (26 percent) are allocated most of the funds (**Figure 7.1.1**).

Table 7.2.1: Type of Aftercare Services Provided by Investment Promotion Agencies (IPAs)

Type of Service	The Aftercare Service Space		
	Short Term	Medium Term	Long Term
Administrative	Obtain visas, import permits, work permits for spouses, operate in free trade zone	Banking and legal services; obtain food, drugs and administration approvals	Agreement with tax authorities, collaborate with public sector on planning and transport
Operational	Find office space, factory, recruit staff, help install ICT equipment, power, etc.	Staff training, new premises, improved connectivity, local supply chains	Local R&D, university collaboration, strong relationships with unions
Strategic	Establish firm so that it operates successfully and performs its mandate	Competition legislation, product development, R&D capabilities	Services that support firms in becoming strategic leaders, centres of excellence

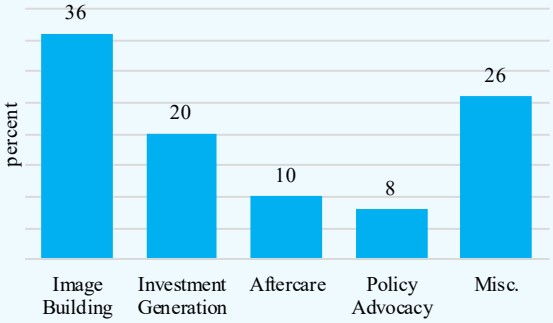
Reference: Young and Hood, 1994

Among the countries having dedicated aftercare initiatives, a few case studies stand out:

(a) *The Investment Aftercare Team in the Republic of Korea*: Active since 1991 under the Korea Trade Investment Promotion Agency (KOTRA), the Investment Aftercare Team of the foreign ombudsman has specialist staff from fields as varied as economics, finance, trade, taxation and law to find solutions to the problems faced by the investors in the country.

(b) *Costa Rican Investment Promotion Agency (CINDE)*: Founded in 1982, the private, non-profit CINDE has been involved in active promotion of foreign investment, local support and post-establishment services. It is considered one of the most successful IPAs in Latin America and across the world, and has been credited in helping attract more than a quarter of the Fortune 500 companies to Costa Rica. The aftercare services provided by the agency include specialized product diversifying and capacity expansion programs, networking and information seminars, and consultation with the investor base about the nature and frequency of issues faced and the way forward.

Figure 7.1.1: Average Budget Allocation of an Investment Promotion Agency (IPA)



Data source: World Association of Investment Promotion Agencies (WAIPA) Annual Survey 2018

(c) *United Kingdom Trade and Investment (UKTI)*: The IPA's Investor Development program provides a full-fledge and free-of-cost aftercare support suite. Assistance ranges from workforce skills and recruitment, innovation and technology support, help with exporting overseas and developing forward and backward linkages with the domestic industrial and services base, etc.

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Young, S. and Hood, N. (1994): "*Designing developmental after-care programmes for foreign direct investors in the European Union*", Transnational Corporations, 3(2), pp. 45–72, UNCTAD.

7.5 The Unfavorable Tax Environment Merits Special Mentioning

The overall tax regime that encompasses tax structure, rates and payment technology, influences investment climate in the country. To promote investment, the underlying aim of a tax policy regime is to set two distinct goals: first, incentivizing potential investors, and second, increasing revenues to finance essential infrastructure for a business-enabling environment. The pro-investment environment entails a tax system that meets some necessary conditions including fairness, adequacy, simplicity,

transparency, and administrative ease. However, tax authorities in Pakistan have largely struggled to create an environment that is conducive to increase the tax-base, lower the distortions, and promote equitable and efficient tax system in the country. Instead, the complex nature of tax system, perception and incidence of corruption, and cumbersome documentation processes put enough fear and intimidation among a number of existing and emerging businesses to keep them from documenting their setups altogether – certainly, some businesses stay off the radar by their own choice to evade taxes. This has led to a steep surge in the country's informal economy over the years.

In this context, a challenging task for policy makers in the country has been to keep the principal trade-off in providing tax relief to investors while maximizing revenue mobilization. Currently, the tax authorities are struggling to improve the tax-to-GDP ratio, which stagnates around 12 percent in last 5 years, among the lowest in the world. The registered income taxpayers documented in the country were 4.8 million in FY17-18, representing mere 2.2 percent share of current population. In case of sales tax, only 0.2 million business concerns are registered with tax regulatory authorities; 68 percent of overall domestic sales tax revenue comes from nine major sectors including POL, electrical energy, cement, aerated water/beverages, cigarettes, fertilizer, natural gas, sugar, and other food products. The share of other major industries/sectors including auto, textile, chemicals and services sector etc. remained insignificant regardless of the size of their activity in the domestic market.

Lack of administrative ease: a major hurdle for investments

The severity of impediments a business faces in dealing with tax-related procedures is reflected in a very low ranking of 173 out of 190 countries in doing business indicator of 'Paying Taxes'.[12] **Table 7.6** compares the different components of Paying Taxes Indicator across major South Asian economies and with the best-scored country i.e., Hong Kong. The absolute score average of paying taxes of Pakistan remained lowest in the South Asian region.

Table 7.6: Absolute Scores of Paying Taxes Indicator of Doing Business in 2019

	Pakistan	India	Bangladesh	Sri Lanka	Hong Kong
Ease of Taxes RANK (out of total 190 countries)	173	121	151	141	1
Score Average (0=worst; 100=best)	47.05	65.36	56.13	59.79	99.71
Payments (number)	47	12	33	36	3
Time (hours)	293.5	275.4	435.0	129.0	34.5
Total tax and contribution rate (% of profit)	34.1	52.1	33.4	55.2	22.9
Time to comply with VAT refund (hours)	84.0	No refunds	58.0	No refunds	No VAT
Time to obtain VAT refund (weeks)	79.0	No refunds	17.9	No refunds	No VAT
Time to comply with corporate income tax correction (hours)	69.0	3.0	37.0	3.0	2.8
Time to complete a corporate income tax correction (weeks)	18.6	0.0	9.3	0.0	0.0
Postfiling index (0-100)	*10.49*	*49.31*	*44.36*	*49.31*	*98.85*

Data source: Doing Business Indicators, World Bank

For instance, according to the latest report of Ease of Doing Business 2019, a medium-sized manufacturing firm is required to pay 47 payments in a single year to different regulatory authorities in the country. Of these, 17 belong to Federal Board of Revenue (FBR), 12 to Employees Old-Age Benefits Institution (EOBI), and 18 relate to different provincial departments and social security institutions. The indicator scored highest in South Asia and remained well above the regional average of 27.6 in a given year.

The worst performance in the paying taxes was recorded in post-filing index that measures the compliance with and efficiency of completing VAT cash refund and tax audit. More specifically,

[12] Doing Business records the taxes and mandatory contributions that a medium- size company must pay in a given year as well as measures of the administrative burden of paying taxes and contributions and complying with post-filing procedures.

a medium-sized firm requires more than 10 days complying with requisites of VAT refunds and 79 weeks obtaining VAT refunds; this is the worst performance in the region after Afghanistan. For businesses, the inordinate delays in tax refunds create liquidity crunch and increase the risks attached to the viability of upcoming ventures. The latest available statistics suggest that as on June 2018, claims of Rs 372.1 billion were pending with FBR against income tax, sales tax and federal excise duties, FBR had issued Rs 83.1 billion of refunds during July 2018 till March 2019 (**Table 7.7**).

The ranking of the country also remained lowest among the peers for other indicators, such as time to comply with corporate income tax correction and time to complete a corporate income tax correction. In addition, it takes around an average of 45 days to dispose a complaint against revenue division /FBR.[13] The substantially low score of post-filing index reflects the hurdles a business must overcome to continue its operations in the country; it also invokes for massive scale of reforms in tax audit and compliance structure.

Table 7.7: Claims Pending with FBR
billion Rupees

Pending Funds (as on Jun 30th 2018)	
Income Tax	241.6
Sales Tax and FED	130.5
Total claims	372.1
Issuance of refunds during Jul 18 to Mar 19	
Income Tax	62.0
Sales Tax	21.2
Total refunds	83.1

Data source: Senate Secretariat

7.6 Small Firms Find it Particularly Hard to Scale Up their Operations

Small and medium enterprises are widely considered major contributors to economic growth and employment generation in any economy. In fact, the success of an economy may be gauged by the involvement of such firms in carrying out re-investment activities and graduating into larger enterprises over time. The experience of countries such as the US, UK, Germany and Taiwan signify the importance of the growth-expansion-maturity cycle of small firms via re-investments towards the overall economic prosperity of the nation. However, in case of Pakistan, small firms have struggled to evolve over the decades and have continued to operate at the same size, "failing to benefit from economies of scale or innovation in technology and hence rendered uncompetitive internationally".[14] While uncertain macroeconomic environment and an insipid industrial performance over the years explain limited growth opportunities for small-sized firms, weaknesses in their own management, unfavorable regulatory environment, limited access to finance and skill gaps are found to be major growth barriers for small-sized firms in the country.

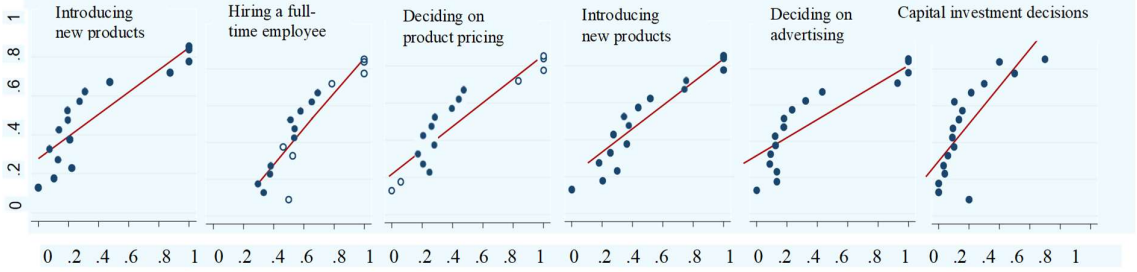
The issue of poor management practices particularly stands out as a major factor for the stagnancy in the performance of small firms. As came out from a systematic face-to-face Management and Organization Surveys in more than 2,000 establishments in Punjab, management practices are less structured in small (and medium sized) firms compared to large firms,[15] especially with respect to decentralization of decision-making, data-driven performance monitoring, target- and incentive-setting, and usage of data for decision-making.[16]

Importantly also, due to a low appetite for risk-taking and poor entrepreneurial expertise amongst the players, expansion is not focused upon as an objective after firms start yielding low but consistent returns. Over time, such enterprises stop investing in upgradation of operational activities,

[13] Federal Tax Ombudsman of Pakistan (FTO)
[14] Afraz, N., Hussain, T., Khan, U., (2013) Barriers to the Growth of Small Firms in Pakistan: A Qualitative Assessment of Selected Light Engineering Industries. IGC Working Paper, pp 5, February 2013.
[15] The study defined large enterprises as employing more than 200 workers, medium and small enterprises as employing 50-199 and 10-49 workers, respectively, and micro establishments as employing less than 10 workers.
[16] Source: Lemos, R., Choudhary, A., Van Reenen, J., Bloom, N., (2016) Management in Pakistan: First Evidence from Punjab, IGC

replacement of outdated machineries, product innovation and skill building of the workforce. Therefore, it is not surprising to observe a strong positive correlation between quality of management practices (and decentralization of decision-making power) and firms' performances in Pakistan in terms of productivity, profitability and growth (**Figure 7.7**).[17]

Figure 7.7: Management Decentralization in Pakistani Firms and its Impact on their Performance



The sample includes all MOPS observations from establishments reporting that the headquarters are at a different location, with no missing responses to the autonomy questions and with at least 11 non-missing responses to management questions (857 observations from 462 establishments). The establishment management score is the unweighted average of the score for each of the 16 questions, where each question is first normalized to be on a 0-1 scale, and averaged across establishments in bins of 0.05. The autonomy measures are also normalized to be on a 0 - 1 scale.
Data source: Lemos, R., Choudhary, A., Van Reenen, J., Bloom, N., (2016) Management in Pakistan: First Evidence from Punjab, IGC

To contextualize the above phenomena, the literature uses the terms liability of *senescence* (whereby old firms resist changing their business model and become inert to transformation) and liability of newness (whereby newer firms face a hard time, as they are yet to establish and legitimize their position in the market) to explain major barriers to growth of the small firms. The interplay of these dynamics gradually drive the overall market toward *obsolescence*, as the product focus, operating methods and growth models become incongruent to the trends witnessed in the international market. This results in firms losing their share in the export market as they fail to integrate with the emerging global value chains, and facing stiffer competition in the domestic economy from better quality imported alternatives. **Box 7.2** highlights some of these matters in detail by focusing on a study on small firms operating in the light engineering and sports-goods industries of Pakistan.

Box 7.2: Barriers to Growth of Small Firms in Pakistan

International literature investigating the reasons behind small firms finding it hard to scale up their operations points toward more or less the same major hurdles that are referred to when talking about the overall ease of doing business environment in an economy. Issues such as energy shortages, corruption, macroeconomic instability, credit market failures, weak institutions, unskilled labor, and infrastructure constraints are frequently cited. However, the market dynamics of each country tend to vary considerably, and this makes it a useful exercise to complement the international studies with domestic surveys.

In this regard, an important study carried out by the International Growth Center (IGC) in 2014 revealed some critical reasons behind the failure of small firms in Pakistan to expand their operational capacities. The authors covered both the domestic market-oriented firms and the exporting firms, by surveying the fan manufacturing and sports good industries respectively. This was done in order to inspect whether different factors affect these firms differently. The barriers found common across the spectrum are as follows:

(i) *Management and Succession Planning*: Management issues are perhaps the biggest hurdle to small firms' growth and expansion in Pakistan. With markets often predominantly informal, and contract enforcement and copyright laws rarely followed, there exists a constant threat of product counterfeiting and labor defection. Thus, owners/senior executives of the firms are inclined to keep business plans to themselves and confine delegation to a minimum.

(ii) *One third of the surveyed manufacturers stated that finding skilled labor force is difficult*: Although Pakistani firms have the advantage of availability of cheap labor, the prevalence of skills deficit considerably offsets the gains from the

[17] Similarly, firms which were larger, older, export-oriented, and with skilled managers and line managers were found to have higher management scores relative to the other firms.

former. Apart from an overall low level of human capital in the country and inadequate number of available modern technical training facilities, seasonality in the operations also plays a substantial role in increasing search and training costs of the firms. This is because seasonal activity leads to small firms having limited capital off-season to maintain production or keep employees on a payroll.

(iii) *42 percent of the firms had not upgraded their machineries during the last decade:* The authors of the study found that the firms had a really low and stagnant level of productivity, and usage of old machineries turned out to be a major contributing factor in this regard. Interestingly, 92 percent of firms were also outsourcing some of the production due to lack of in-house technical expertise. Over-reliance on own funds (as small firms rarely use bank loans for fixed investments) and cost-competition culture means that scope of collaborative research is negligible. Whatever "R&D" is happening in the sector focuses on reverse engineering of imported alternatives and the products of large players (who are relatively more open to investing in new modes of operations).

(iv) *For every firm working in the formal sector, there were 28 informal units:* There is a high degree of informality in the SME segment, particularly the export-oriented sports sector. Small firms focusing on sporting goods are predominantly based in Sialkot. There are roughly 360 formal and over 10,000 informal such businesses in the city. The high degree of informality gives rise to certain challenges for such small enterprises. For instance, a considerable number of firms in the study were registered for sales tax. However, a general complaint was that the suppliers were reluctant to provide receipts to smaller firms (due to the latter's lower negotiating power), thus making them unable to claim for refunds and concessions.

(v) *Manufacturers are not focusing on products that represent over 95 percent of global trade:* Most of the export-oriented firms were found manufacturing products that were not in-sync with the changing demand landscape. For instance, the sports manufactures in the country are still focusing on direct sports equipment manufacturing (such as balls and bags), while the "lifestyle" goods such as apparel and allied-accessories are providing greater margins and growth potential worldwide.

(vi) *None of the firms reported borrowing from the commercial banks for investment purposes:* Small firms hesitate to take out loans from financial institutions and instead rely either on own-money (retained earnings) or on market credit. Market credit mechanism is circular in nature, whereby the manufactures buy raw material from the suppliers on credit and promise to pay the amount when the orders are sold in the market. The wholesalers then buy inventories from the manufactures on credit contingent upon sales to retailers and/or end consumers, and so on. This makes the whole supply chain particularly vulnerable to any demand or supply side shock, in which case a "bull whip" effect arises and disrupts cash flows of all the agents in a sector

Reference:
Nazish Afraz & Syed Turab Hussain & Usman Khan, 2014. Barriers to the Growth of Small Firms in Pakistan: A Qualitative Assessment of Selected Light Engineering Industries, Lahore Journal of Economics, The Lahore School of Economics, Vol. 19 (Special Edition), pages 135-176, September, 2014.

Another important factor constraining the expansion acitvities of small enterprises in Pakistan is that of lack of access to and demand for formal credit channels. Overreliance of small firms on internal (the retained earnings or life savings of the owners/managers) and expensive informal (borrowings from friends and family, credit from supplier and advances from customers, or from the informal market lenders, etc.) financing channels results in these firms not having adequate access to resources to timely upscale their operations. Inefficient operational activities mean that most of the funds from the aforementioned sources are consumed for the working capital requirements, thereby making investments in fixed capital formation challenging. Here, the preference for status quo exhibited by the founders/executives results in their enterprises getting stuck in the existing mode of operation.

The literature here makes a distinction between firms being credit rationed and credit constrained. Being credit rationed implies that firms are getting adequate access to credit from the informal channels, but would happily switch to cheaper formal financing if their awareness regarding it and the banks' preference towards it increases. Being credit constrained, however, indicates that the firms are not getting as much access to credit as they deem adequate for their growth aspirations. In Pakistan, the small enterprises are usually not only credit rationed but also credit constrained. This is in line with the experience of SMEs in countries with a large informal economy.[18] Another study, focusing on SMEs in Pakistan and using the World Bank Enterprise Survey to construct a panel data,

[18] Reference: Banerjee, Abhijit V., and Esther Duflo. "Do firms want to borrow more? Testing credit constraints using a directed lending program." Review of Economic Studies 81.2 (2014): 572-607.

discovered that access to formal credit channels (commercial banks) was consistently linked with the improvement in growth metrics of the firms, while informal channels were seen to impact SMEs' performance negatively and in a greater magnitude than the positive impact of formal borrowing.[19]

Another issue worth mentioning is that small firms do not have access to equity markets to raise financing, which hinders their growth aspirations. Meanwhile, larger enterprises can avail such funding reltively easily and can also treat their bank loan interest payments as business expenses that are tax deductible. This reduces their tax liability and puts them at an advantaged position over the smaller firms, who cannot treat informal lending (which constitutes the major portion of their financing) in the same manner.

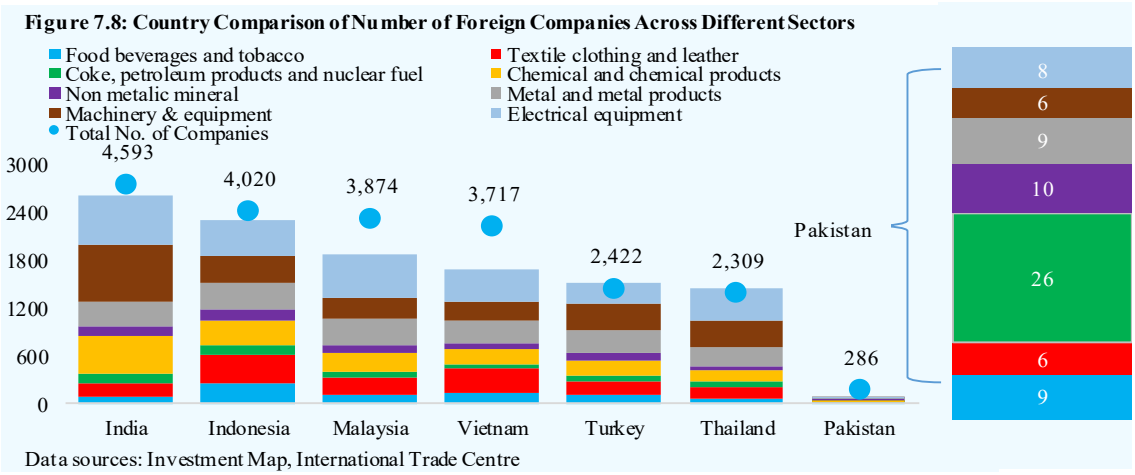
Finally yet importantly, an under-skilled and less productive labor force is a worrying factor hindering the growth and competitivenes of the businesses in the country. However, as both the small and large enterprises are affected by the sub-par level of human capital development, this issue is elaborated upon sepeartely in the next section.

7.7 Inadequate Improvement in Human Capital and Competitiveness Indicators Hinders Innovation and Growth Potential

Human capital is an important determinant for attracting investment in a country. This is because the investors desire a labor force with adequate skills and some relevant exposure of the industry and operating methods to go along with it. This is also the reason why governments and investment promotion agencies across the world are working on providing the domestic labor force with vocational training opportunities and relevant experiences in terms of operating modern machineries. The quality and adaptability of labor force are the principal determinants of a facilitative investment environment in a country. Quality is determined by the education, skills training and overall health standards of the population; while adaptability refers to the ability of workers to evolve their skill sets relevant to the changing structures of the Global Value Chains (GVCs).

Being a nation of 210 million people, Pakistan could have attracted significant foreign investment given the abundance of cheap labor, lucrative investment policies and a strategic geographical position. Unfortunately, the country has remained unable to tap the opportunities: currently only 286 companies of foreign origin are operating in Pakistan, vastly outnumbered by the 2,422 firms working in Turkey and 4,593 firms operating in India. As highlighted earlier in the chapter most of these companies have stakes in consumer businesses (market-seeking activities) and few are involved in

Figure 7.8: Country Comparison of Number of Foreign Companies Across Different Sectors



Data sources: Investment Map, International Trade Centre

[19] Reference: Khan, Salman. "Impact of sources of finance on the growth of SMEs: evidence from Pakistan." Decision 42.1 (2015): 3-10.

mining and quarrying activities (natural resource-seeking activities). Manufacturing of capital goods, heavy machineries & equipment, steel sector, and tech products have not received significant foreign investment that could otherwise bring positive spillovers such as new technologies, improved overall productivity and skilled job creation (**Figure 7.8**).

As things stand, Pakistan falls behind its regional and comparative economies in terms of human capital standards and development. The country ranks 134th (out of 157 economies) and 150th (out of 189 countries) in the World Bank Human Capital Index and the United Nations Human Development Index, respectively. A host of factors, from low expected years of schooling to high rates of malnutrition amongst the children, account for the unsatisfactory performance in the two indices (**Table 7.8**).

Table 7.8: Human Capital Index (HCI) 2018 Score and Ranking - Performance of Pakistan

Component	Score	Ranking#
Survival to Age 5	0.93	142
Expected Years of Schooling	8.8	127
Harmonized Test Scores	339	145
Learning-Adjusted Years of Schooling	4.8	134
Adult Survival Rate*	0.84	93
Not Stunted Rate**	0.55	103
Overall HCI	**0.39**	**134**

Rank out of 157 countries
*Data available for 156 countries; **Data available for 109 countries
Data source: World Bank

Table 7.9: The Global Entrepreneurship Index 2018 – Selected Indicators

Country	Start-up Skills	Risk Acceptance	Networking	Cultural Support	Human Capital	Product Innovation	Overall Score#	Global Rank*
China	0.24	0.47	0.51	0.33	0.52	1.00	0.41	43
India	0.22	0.40	0.14	0.14	0.29	1.00	0.28	68
Philippines	0.43	0.34	0.19	0.29	0.44	0.82	0.24	84
Vietnam	0.28	0.07	0.25	0.24	0.46	0.44	0.23	87
Sri Lanka	0.16	0.07	0.07	0.12	0.31	0.95	0.22	90
Pakistan	0.06	0.02	0.11	0.21	0.10	0.49	0.16	120
Bangladesh	0.04	0.05	0.10	0.21	0.13	0.04	0.12	134

*Rank out of 137 countries; # 0=worst and 1=best
Data source: The Global Entrepreneurship and Development Institute (2017)

Furthermore, according to the 2018 Global Entrepreneurial Index published by the Global Entrepreneurship and Development Institute situated in London, Pakistan ranks at 120th place out of 137 countries – lower than the regional or peer countries barring Bangladesh (**Table 7.9**). While the country has very low scores in all of the sub-indicators, the poor performance in the risk acceptance, start-up skills, and human capital components of the index is particularly worrying. The former two highlight the firms' lack of ambition towards evolving management methods, product focus and growth models, while the latter signifies the low skill-sets and productivity of the economy's labor force.

Table 7.10: The Global Competitiveness Index-2019 (Rank/141)

		Human Capital		**Markets**				**Innovation Ecosystem**	
Economy	Overall Ranking	Health	Skills	Product Market	Labor Market	Financial System	Market Size	Business Dynamism	Innovation Capability
China	28	40	64	54	72	29	1	36	24
Indonesia	50	96	65	49	85	58	7	29	74
Turkey	61	42	78	78	109	68	13	75	49
India	68	110	107	101	103	40	3	69	35
Brazil	71	75	96	124	105	55	10	67	40
Sri Lanka	84	43	66	131	118	87	58	70	84
Iran	99	72	92	133	140	123	21	132	71
Bangladesh	105	93	117	119	121	106	36	121	105
Pakistan	**110**	**115**	**125**	**126**	**120**	**99**	**29**	**52**	**79**

Data source: The Global Competitiveness Report 2019- World Economic Forum

The other major reason behind this dismal state of foreign investment in Pakistan is its fragile institutional and operational infrastructure. As may be seen in **Table 7.10**, Pakistan's standing in the World Economic Forum's Global Competitiveness Index 2019 is better in the *innovation ecosystem* dimension relative to the *human capital* and *markets* dimensions. In fact, Pakistan fares better than most of the regional economies and scores closer to what other populous emerging economies (such as China and Indonesia) achieve. This indicates that the private sector has the innovation capability and the potential to improve their operational practices. However, these are constrained by the overall deficiencies witnessed in the product, labor and financial market ecosystem and the regulatory system of the country.

Table 7.11: Reforms in Different Indicators Mentioned in World Bank Report on Doing Business Indicators

Year	Reform	Impact on DBI
	Starting a business	
2018	Pakistan made starting a business easier by replacing the need to obtain a digital signature for company incorporation with a less costly personal identification number. This change applies to both Karachi and Lahore.	Positive
2019	Pakistan made starting a business easier by enhancing the online one-stop registration system, replacing several forms for incorporation with a single application and establishing information exchange between the registry and the tax authority. This change applies to both Karachi and Lahore.	Positive
	Registering property	
2011	Pakistan made registering property more expensive by doubling the capital value tax to 4%.	Negative
2017	Pakistan improved the quality of land administration by digitizing ownership and land records. This reform applies to Lahore.	Positive
2018	Pakistan (Karachi) improved the transparency of the land registration process by making the fee schedule and list of documents to submit for property registration available online.	Positive
2019	Pakistan (Lahore) made registering property easier by streamlining and automating administrative procedures and by increasing the transparency of its land administration system. Pakistan (Karachi) made registering property easier by increasing the transparency of the land registry.	Positive
	Getting credit	
2017	Pakistan improved access to credit information guaranteeing by law borrowers' rights to inspect their own data. The credit bureau also expanded its borrower coverage. This reform applies to both Lahore and Karachi.	Positive
	Trading across borders	
2011	Pakistan reduced the time to export by improving electronic communication between the Karachi Port authorities and the private terminals, which have also boosted efficiency by introducing new equipment	Positive
2015	Pakistan made trading across border made easier by introducing a fully automated, computerized system, (the Web Based One Customer System) for the submission and processing of import and export documents. This reform applies to both Lahore and Karachi	Positive
2017	Pakistan made exporting and importing easier by enhancing its electronic customs platform. This reform applies to both Lahore and Karachi	Positive
2018	Pakistan made importing and exporting easier by developing a new container terminal and enhancing its customs platform for electronic document submission. These changes apply to both Karachi and Lahore.	Positive
	Paying taxes	
2012	Pakistan increased the profit tax rate for small firms.	Negative
	Protecting minority investors	
2018	Pakistan increased minority investor protections by making it easier to sue directors in case of prejudicial transactions with interested parties. This reform applies to both Karachi and Lahore.	Positive
	Resolving insolvency	
2019	Pakistan made resolving insolvency easier by introducing the reorganization procedure and improving the continuation of the debtor's business during insolvency proceedings. This change applies to both Karachi and Lahore.	Positive

Data source: World Bank Ease of Doing Business Reforms Database

The country's limited fiscal space has left little to invest on areas that could increase the competitiveness of the country, for example education, infrastructure, technical trainings, research institutions etc. In addition, the private sector (mostly local participants) also remained inattentive to the ongoing innovations and tech change in the global markets. Low level of technology transfer and lack of skilled labor and has not permitted the private sector to invest in capital-oriented technologies. In addition, ever increasing competition, globalization and technological progress in other countries has made it difficult for local industry to survive.[20]

7.8 Recent Improvements are Welcome…

In 2019, Pakistan's Doing Business (DB) ranking witnessed a jump of 11 points. This substantial improvement came on the back of major reforms in three broad segments including 'Starting a Business', 'Registering Property' and 'Resolving Insolvency'. Meanwhile FBR, provincial authorities and other federal agencies such as the BOI and EOBI are working collectively to build on this progress; these reforms are highlighted in **Table 7.11.** Encouragingly, for the DB ranking for 2020, Pakistan has been included in the list of Top-20 *improvers* across the globe. Importantly, out of ten areas, Pakistan exhibited improvement in six areas including starting a business, dealing with construction permits, getting electricity, registering property, paying taxes and trading across borders.

Furthermore, BOI is also working on designing a platform to connect with and track the progress of existing investors in the country. The aim is to help improve the agency's aftercare and policy advocacy facilities. BOI has also started initiatives recently to help increase the aftercare infrastructure in the country. The measures include the development of country-specific and thematic desks, whereby specialized teams have been formulated inside the BOI to help investors pertaining to either certain priority sectors or belonging to countries from where FDI inflows have remained or are expected to be high (such as China). The other reform has been the inception of a digital grievance handling portal, which has already catered to 8,531 complaints, of which 8,312 were forwarded to respective institutions and departments such as the FBR and all the remaining 211 BOI-related complaints were resolved. The IPA has also conducted Ernst & Young-aided thematic studies to help identify the key priority sectors of the country (textiles, IT and ITeS, food processing, automotive and auto parts, and logistics sectors). A SWOT analysis was carried out, and the BOI aims to use the knowledge to help address the concerns faced by the local and foreign business community to make the investment climate more conducive for attracting further FDI inflows.

On the taxation front, FBR has already introduced a number of reforms (see **Table 7.12** for detail). Two developments in particular stand out. First, the number of tax-related payments has been reduced from 47 to 21 by enabling electronic filing and payment of all federally administered taxes (both corporate and VAT taxes).[21] Second, the corporate income tax rate for small firms has been reduced (from 25 percent in 2018 to 24 percent in 2019). Contrary to FBR, however, the provincial authorities could not bring any improvement in their tax administration system during the period under review.

The above-mentioned actions are being complemented by the government's focus on shrinking the size of the informal economy in Pakistan. This is being done via two parallel policy drives. Firstly, measures such as restricting purchases of land by non-filers and increasing the valuation rates of immovable properties may help divert the attention away from the non-productive segments such as real estate (which had for long granted a legal way for tax avoidance and abnormal profitability)

[20] As a result of non-conducive environment, a number of industrial undertakings faced complete closure in last few years, including Pakistan Steel Mills; others confronted serious financial and operational issues, like Pakistan Machine Tool Factory, Heavy Mechanical Complex Taxila etc. In addition, the operations of various private sector industrial units also came to a halt due to stiff competition from the Chinese companies.

[21] With electronic payments, the tax is counted as paid once a year irrespective of frequency of payments in a given year.

towards productive avenues. At the same time, tax authorities are actively working to document the

Table 7.12: Reforms in Paying Taxes[22]

Electronic Filing of Declarations
Income tax and sales tax returns filed electronically through FBR web portals
Introduced preparation of declarations in offline mode for income tax returns, sales tax returns and wealth statements
Taxpayers and authorities send and receive correspondence electronically through IRIS
Amended income tax laws: Taxpayers can revise income tax return on his own (section 114(6) of Income Tax Ordinance, 2001)
Online system reduced the time to comply with income tax correction
Impact: Post filing Index
E-Payment of taxes through alternate delivery channels
Payment of taxes through internet banking, ATM, mobile banking and contact canters through ADC
Reduction in income tax payments
Reduction in sales tax payments
Impact: Total number of taxes and contributions paid
VAT refunds
Zero rated supplies - no carry forward period
Online filing of 85 percent of refund claims
Enhancement of scope of Expenditure Refund Systems (ERS)
No triggering of audit queue based on VAT refund claims
Payment of refund through direct bank transfers
Impact: Post filing Index

Data source: FBR

sales by registered businesses in Pakistan to unregistered enterprises/individuals. Initially, the registered persons were required to issue a serially numbered tax invoice at the time of the sale of goods. The invoices had to include the name, address and registration number of the supplier and recipient of the goods; the date of issue of the invoice; the description and quantity of goods; value of the sales tax applied; and the price inclusive and exclusive of the GST. According to the amendment in the Sales Tax Act 1990, the requirements have been elaborated further and the registered persons have been instructed to record NIC number or NTN of the recipients unregistered with FBR for sales tax in addition to the details being recorded of the registered recipients.[23]

To promote SME sector in Pakistan, the government and SBP have embarked upon collaborated efforts and taken various measures. These include: (i) setting up annual targets for SME financing and advising banks to formulate SME finance strategy; (ii) introducing credit guarantee schemes for small and rural enterprises; (iii) announcement of the refinance facility for modernization of SMEs; (iv) continuation of the Prime Minister's Youth Business Loan Scheme to start new businesses; (v) facilitation from SECP's side to SMEs in raising venture capital and private equity funds; and (vi) setting up of facilitation counters at various ministries and the Chamber of Commerce and Industry, etc.

Lastly, to improve the attractiveness of the domestic labor force along the dimensions of quality and adaptability, the government has initiated various programs under the umbrella of both PSDP and CPEC. For instance, the National Vocational and Technical Training Commission (NAVTTC) of Pakistan is in the process of introducing officially defined skill-set categorizations and an assessment criterion for the technical and vocational education and training (TVET) institutes to help improve the placement and skill matching in the domestic labor market. This is expected to help reduce the matching costs of unemployment in the economy and make the TVETs more accountable. Another welcome development has taken place under the CPEC initiative whereby the relevant government institutions are working with Chinese firms hoping to work in Pakistan for technical skill building of the domestic labor force, to enable them to be prepared for work under various programs. This

[22] These measures have been identified by FBR in a presentation publically available at FBR website. EODB ranking of FY2019 did not incorporate these measures. Due to certain cut-off dates, the impact of some of these reforms will likely be missing in the EODB 2020 ranking.

[23] A relaxation from this clause was granted for sales up to Rs 50,000, if the recipient is an ordinary customer (i.e. a person who is buying goods for his or her own final consumption and not for reselling).

includes emphasis on vocational training (such as the construction of Pak-China Technical and Vocational Institute at Gwadar), scholarships and exchange programs for university and college students as mentioned in the Joint-Statement between the two countries, and collaborative efforts with Pakistani technological platforms (such as the AliBaba eFounders Fellowship program with National Incubation Center, Karachi).

7.9 … But More Needs to be Done

While the aforementioned policy measures and reforms currently being implemented are steps in the right direction, there still exist some areas that, if focused upon, would complement the aforementioned efforts in terms of improving the overall investment climate in the country. The following sub-sections elaborate on this further.

Coherent and consistent policy framework is needed

From the policy perspective, there is a need to revisit the investment laws, modernize them in light of the recent best practices, and then frame the investment policy document accordingly. Better yet, the three documents may be merged into a single, comprehensive framework; this would substantially help mitigate the confusion and uncertainty that is faced by both the existing and potential investors.

Another needed measure is the renegotiation of older Bilateral Investment Treaties (BITs) that Pakistan has signed with the other economies in order to bring them up to par with modern standards. As stated in the previous sections, elements such as minimum standard of applicable laws; explicit definitions of direct and indirect expropriation; special applicable clauses during phases involving balance of payments difficulties; and health, labor and local requirement conditions, etc. would lead to lower instances of cases involving dispute settlement between the investors and the country.[24]

There is also a need to increase the coordination between the federal and provincial governments, especially with investments now a provincial concern after the 18th Amendment. This would help minimize frictions resulting from the multiplicity of regulatory jurisdictions. Increased coordination would also help address the problems and facilitate negotiations between the investors and the provincial and federal governments. The IPAs, in this regard, can provide a channel for registering complaints about the regulatory hurdles and contract enforcement faced by the investors and then directing those to the relevant authorities for resolution.

There should be a collaborative implementation of the announced human capital policies

Strong coordination is needed to improve the state of human capital in the country and by extension, labor productivity. As stressed in previous reports, there needs to be an overarching policy to govern the skill-building process from the public domain to keep the progress aligned with the national objectives. Recently, Sindh, Punjab and Khyber Pakhtunkhwa, all have launched labor policies with the objective of increasing jobs, providing a safe and healthy work environment, ensuring gender parity in employment, and training their respective labor force according to the needs of a transitioning economy. This is an appreciable step, but it is important that these policies are also implemented in letter and spirit to realize the envisioned gains.

Furthermore, active promotion of the training programs would be needed to widen their impact, as currently only 8 percent of workers in Pakistan receive some form of on-the-job training from vocational institutes, and much of that is uncertified in nature.[25] A major impediment is the significantly low number of workers with a secondary or a higher secondary education (the Ministry

[24] It is important to emphasize here that the various BITs must align with the investment laws of Pakistan.

[25] Reference: "Skills for Growth and Development – A Draft National Technical and Vocational Education and Training (TVET) Policy"– A Consultation Document of The National TVET Policy Task Group (2014). The document is available on the website of Ministry of Federal Education and Training, Pakistan.
http://www.moent.gov.pk/mopttm/userfiles1/file/Final%20Consult%20Paper%20of%20TEVT%20Policy.pdf

of Federal Education and Professional Training puts the figure at 6.5 percent of the total population), which is a prerequisite for entry into most of the certified vocational training programs in the country.

Clear communication of tax measures is vital for their successful implementation

While it is encouraging to see that the government is in the process of implementing most of the needed reforms with regards to tax policy, it is equally important to emphasize that the government must also significantly enhance its communication efforts to clarify the motivations behind the measures taken, justify the mechanisms of the proposed. Much of the unrest and opposition against proposed measures arises due to a misunderstanding of the provisions and amendments of the policies on the businesses community's end.

Although the FBR issues clarification circulars and interacts with the businesses on various forums and settings to help clarify the matters and take feedback on the respective issues, it is important that such communication channels be further strengthened and made a permanent part of the dialogue between the two parties. One suggestion is to release non-technical, Urdu briefs of the various acts, SROs and policy documents in action. This would help overcome the language barrier, all the while helping to convey the message in as simple a way as possible directly from the source (the tax authorities). This is vital in terms of ensuring smooth adoption and implementation of policies; cementing transparent policy advocacy channels; and in effect reducing the regulatory and policy distrust and uncertainty in the economy.

The focus should be on identifying and incentivizing firms with a high-growth potential

It is important to emphasize that a general focus on SME financing and facilitation can prove to be sub-optimal. As mentioned earlier, most of the SMEs (in Pakistan as well as in other countries) are less productive on average because they are poorly managed and have an operational focus on outdated products. Furthermore, experiences of advanced economies (such as the US and UK) reveal that the major driver for innovation and capital formation activities has not been the SME segment in general but in particular the high-growth enterprises from across the size spectrum: established as well as start-ups; small firms as well as large enterprises.[26] There is also evidence that over-spending and misallocation of funds disproportionally towards small firms can result in the persistently widening total factor productivity gaps in the economies compared to advanced countries.[27]

In other words, while investing in SMEs is widely considered a necessary gamble in terms of achieving economic prosperity, the focus should be on identifying firms having a high-growth potential and then guiding the assistance accordingly. The credit policies and tax incentives, therefore, must be reconsidered in this light to reward firms that demonstrate ambition and incentivize others to increase productivity and meaningful investments to "catch-up" to their more successful counterparts.

Finally, the role of the state must be enhanced to lead investments in important segments of the economy

While the facilitative perspective of government intervention – in terms of correcting "market failures" and leaving the innovative drive to the private sector – is widely held, the role of the public sector in terms of capital formation activities merits a reconsideration. The government, especially in a developing economy such as Pakistan, must also first develop fully the "ecosystem" to make possible the innovative activities envisioned to be carried out by the private investors.

[26] Reference: NESTA (National Endowment for Science, Technology and the Arts). 20110 <Vital Growth: The Importance of High Growth Businesses to Recovery". Research Summary, March. Available online at https://media.nesta.org.uk/documents/vital_growth.pdf (accessed 22 August 2019).

[27] Reference: Chang-Tai, H., Klenow, P., (2009) "Misallocation and manufacturing TFP in China and India." The Quarterly Journal of Economics 124.4: 1403-1448.

Furthermore, the government must assume a role greater than facilitating the operations of the private sector. Historically, in countries that have succeeded in enhancing the level of investments and innovation in their economies, the public sector has taken a leading role in investing in meaningful segments of the economy and developing the crucial infrastructure, which was then used to attract further private sector investments. For example, the rise of Japan during the 1970s and 1980s is attributed to its government's focus on implementing strong horizontal policies, as well as developing a tripartite interplay between the enterprises, academia and the government ministries such as its Ministry of International Trade and Industry (MITI). Of equal importance was the government's initiative of sending citizens abroad to learn about the emerging technologies and develop networks, which were then used to integrate Japanese conglomerates in the value chains of established firms of that era such as IBM, General Electric and Xerox. Similarly, the East Asian "miracle" economies were able to break free from the path dependence of slow growth and under-development and achieve convergence with the advanced economies partly because their public sector adopted a functional approach of leading the industrialization drive and providing protection to domestic industries (picking winners) with the potential to carve out competitive advantage in the global markets. Lastly, the example of China using the state capitalism model and rapidly emerging as a global manufacturing powerhouse also underscores the importance of an effective public sector to guide the investment activities of the private enterprises.[28]

In Pakistan, the initiatives of the Punjab government of digitizing the services sector of the economy under the Punjab Information and Technology Board (PITB) is one such example where the government has not only strived to provide an ecosystem for the potential private sector investors, but has also carried out substantial capital formation activities itself. In fact, PITB-led developments such as digitization of land records, automation of government procurement operations and tax filing procedures, and commencement of electronic education and health provision interfaces, etc. have been positively received by the business community and have contributed positively to the improvement in the country's ranking in the World Bank's doing business indicators. It is important that more such measures are taken by the government in other sectors of the economy to foster an enabling and progressive economic environment.

Taken together, the continuation of reforms already announced and the other desired measures mentioned above can help the government reduce regulatory bottlenecks and address the deep-rooted structural impediments prevalent in the economy, thereby improving substantially the doing business and capital formation environment of the country.

[28] Reference: Mazzucato, M. (2015). The Entrepreneurial State: Debunking Public vs. Private Sector Myths. *Anthem Press*.

Annexure A: Data Explanatory Notes

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

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

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

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

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

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

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of gross 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 financing is calculated by adjusting the government borrowing with its deposits held with the banking system; (ii) changes in the stock of debt also occur due to movements in exchange rates, both PKR and other currencies against US Dollar, which affect 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). Ways and Means Advance allows government to borrow 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 a quarterly auction 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, foreign trade, etc – often do 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 have been 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 depend on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record).

List of Acronyms

A

a/c	account
ACPL	Attock Cement Pakistan Limited
ADB	Asian Development Bank
ADC	Alternate Delivery Channel
ADD	Anti-Dumping Duty
ADP	Automotive Development Policy
AML	Anti-Money Laundering
AMPS	Advanced Mobile Phone System
APCMA	All Pakistan Cement Manufacturers Association
APEDA	Agricultural and Processed Food Products Export Development Authority, India
APP	Asset Purchase Program
ARA	Assessing Reserve Adequacy
ARPU	Average Revenue Per User
ATF	Anti-Terrorist Financing
ATM	Automated Teller Machine
Avg.	Average

B

B2B	Business-to-business
B2C	Business-to-consumer
BB	Branchless Banking
bbl	billion barrels
BEOE	Bureau of Emigration and Overseas Employment
BGD	Bangladesh
BHU	Basic Health Unit
BISP	Benazir Income Support Program
BMR	Balancing, Modernization and Replacement
BOI	Board of Investment
BoJ	Bank of Japan
BoP	Balance of Payments
BOP	Bank of Punjab
BPO	Business Process Outsourcing
bps	basis points
Brexit	Britain's planned exit from the EU
BRI	Belt and Road Initiative
BRIC	Brazil, Russia, India, China
BSC	Behbood Savings Certificate
BULOG	Bureau of Logistics, Indonesia

C

CA	Current Account
CAD	Current Account Deficit
CAGR	Compound Annual Growth Rate
CASA	Current and Saving Account
CBN	Cost of Basic Needs

CBOT	Chicago Board of Trade
CBU	Complete Built Unit
CCAC	Cotton Crop Assessment Committee
CD	Civil Dispensary Custom Duty
CDNS	Central Directorate Of National Savings
CDPI	Centre for Peace and Development Initiatives
CFT	Combating the Financing of Terrorism
CHCC	Cherat Cement Company Ltd
CIDA	Canadian International Development Agency
CINDE	Costa Rican Investment Promotion Agency
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CNIC	Computerized National Identity Card
CoD	Collection on Demand
COD	Cash on Delivery
CPEC	China Pakistan Economic Corridor
CPI	Consumer Price Index
CPL	Cherat Packaging Limited
CPS	Credit to Private Sector
CR	Cold Rolled
CRA	Computer-Related Activities
CRC	Cold Rolled Coil
CSF	Coalition Support Fund
CSPP	Corporate Sector Purchase Program
CY	Calendar Year

D

DAP	Di Ammonium Phosphate
DBI	Doing Business Indicators
DC	Deputy Commissioner
DFI	Development Financial Institution
DFS	Digital Financial Services
DFID	Department for International Development
DG Khan	Dera Ghazi Khan
DGKC	D G Khan Cement Company Ltd
DigiSkills	Digital Skills Training Programme
DMMD	Domestic Market and Monetary Management Department, SBP
DNP	Duty-Non-Paid
DPBs	Deposit Protection Bureaus
DRAP	Drug Regulatory Authority of Pakistan
DSC	Defence Savings Certificate
DSL	Digital Subscriber Line

E

E&P	Exploration and production

EBA	Everything but arms
EDL	External Debt & Liabilities
EC	Exchange Companies
ECB	European Central Bank
EFS	Export Finance Scheme
EIF	Electronic Import Form
EFF	Extended Fund Facility
EVFTA	European Union Vietnam Free Trade Agreement
EM	Emerging Markets
ERRA	Earthquake Reconstruction and Rehabilitation Authority
EOBI	Employees Old-Age Benefits Institution
EDL	External Debt and Liabilities
EU	European Union

F

FAO	Food and Agriculture Organization
FATA	Federally Administered Tribal areas
FBR	Federal Board of Revenue
FCA	Foreign Currency Accounts
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FED	Federal Excise duty
Fed	Federal Reserve
FEE	Foreign Exchange Earnings
FEI	Food Energy Intake
FFC	Fauji Fertilizer Company
FIPI	Foreign Investors Portfolio Investment
FIs	Financial Institutions
FLL	Fixed Local Loop
FMCG	Fast -Moving Consumer Goods
FML	Fauji Meat Limited
FO	Furnace Oil
fob	Free on Board
FRDLA	Fiscal Responsibility and Debt Limitation Act
FTA	Free Trade Agreement
FX	Foreign Exchange
FY	Fiscal Year (July to June)

G

G2P	Government-to-Person
GBP	Great British Pound
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess

GIS	Government Ijara Sukuk
GSM	Global System for Mobile communication
GSP	Generalised Scheme of Preferences
GST	Goods and Services Tax
GSTS	General Sales Tax on Services
GVA	Gross Value Addition
Gw/h	Gigawatt per hour

H

H1-FY	First half of fiscal year
H2-FY	Second half of fiscal year
HCI	Human Capital Index
HDI	Human Development Index
HGDC	Hot Dipped Galavanized Coil
HIES	Household Integrated Economic Survey
HOBC	High Octane Blending Component
HR	Hot Rolled
HRC	Hot Rolled Coil
HRI	House Rent Index
HS Codes	Harmonized System Codes
HSD	High Speed Diesel
HVDC	High Voltage Direct Current
Hydel	Hydroelectric

I

IBA	Institute of Business Administration
IBFT	Interbank Funds Transfer
IBIs	Islamic Banking Institutions
IBIs	Islamic Banking Institutions
IBPAP	Information Technology and Business Process Association of the Philippines
IBRD	International Bank for Reconstruction and Development
ICI	ICI Pakistan Limited
ICRI	International Rice Research Institute
ICSID	International Centre for Settlement of Investment Disputes
ICT	Information Communication Technology
IDA	International Development Assistance
IDB	Islamic Development Bank
IDBP	Industrial Development Bank of Pakistan
IEA	International Energy Agency
IFEM	Inland Freight Equalization Margin
IFI	International Financial Institutions
IH&SMEFD	Infrastructure, Housing & SME Finance Department
ILO	International Labour Organization
IMF	International Monetary Fund
IND	India

INR	Indian Rupee
IoT	Internet of Things
IPA	Investment Promotion Agency
IPO	Initial public offering
IPO-Pakistan	Intellectual Property Organization
IPP	Independent Power Producer
IPR	Intellectual Property Rights
IRSA	Indus River System Authority
ISDS	Investor-State Dispute Settlement
ISOM	Isomerization
IT	Information Technology
ITC	International Trade Centre
ITeS	Information Technology Enabled Services
IVR	Interactive Voice Response

J

JIC	Just in case
JIT	Just in time
JPY	Japanese Yuan

K

KIBOR	Karachi Interbank Offer Rate
KKH	Karakoram Highway
KOHC	Kohat Cement Company Ltd
KOTRA	Korea Trade Investment Promotion Agency
KP	Khyber Pakhtunkhwa
KPITB	Khyber Pakhtunkhwa Information Technology Board
KPT	Karachi Port Trust
KSA	Kingdom of Saudi Arabia
KSE	Karachi Stock Exchange
KYC	Know your customer

L

LARMIS	Land Administration and Revenue Management Information System
LCE	Lahore Centre of Entrepreneurship
LCV	Light Commercial Vehicle
LDI	Long Distance and International
LDO	Light Diesel Oil
LIBOR	London Interbank Offered Rate
LNG	Liquefied Natural Gas
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
LTE	Local Tax Evaded Long Term Evolution (Telecom)
LTFF	Long-term Financing Facility
LTP	Long Term Plan

	LUMS	Lahore University of Management Sciences
M		
	M2	Broad Money
	MAF	Million Acre-Feet
	MBF	Microfinance Banka
	mb/d	Million Barrels Per Day
	MCHC	Mother and Child Health Center
	MCR	Minimum Capital Requirement
	MDGs	Millennium Development Goals
	MENA	Middle East and North Africa
	MENAP	Middle East and North Africa Perspectives
	MFBIs	Microfinance Banks and Institutions
	MFIs	Microfinance Institutions
	MGI	McKinsey Global Institute
	MHz	Mega Hertz
	MIT	Massachusetts Institute of Technology
	ML	Main Line
	MLCF	Maple Leaf Cement
	MMBTU	One million British Thermal Units
	mmcf	Million cubic feet
	mmcfd	Million cubic feet per day
	MNC	Multinational Corporation
	MNC	Multinational Corporation
	MNFSR	Ministry of National Food Security and Research
	MoF	Ministry of Finance
	MOITT	Ministry of Information Technology and Telecommunication
	MoM	Month-on-Month
	MPC	Monetary Policy Committee
	MRL	Maximum Residue Limit
	MRTBs	Market Related Treasury Bills
	MS	Motor Spirit
	MSCI	Morgan Stanley Capital International
	MT	Metric Tonnes
	MTBs	Market Treasury Bills
	MTDS	Medium Term Debt Strategy
	MUFAP	Mutual Fund Association of Pakistan
	MW	Mega Watt
N		
	NA	Not Applicable
	NADRA	National Database and Registration Authority
	NATO	North Atlantic Treaty Organization
	NAVTTC	National Vocational and Technical Training Commission
	NBFI	Non-Banking Financial Institutions
	NCCPL	National Clearing Company of Pakistan Limited

NDA	Net Domestic Asset
NDFC	National Development Finance Corporation
NEPRA	National Electric Power Regulatory Authority
NER	Net Enrolment Rate
NIC	National Identity Card
NFA	Net Foreign Asset
NFC	National Finance Commission
NFDC	National Fertilizer Development Center
NFIS	National Financial Inclusion Strategy
NFNE	Non-Food Non-Energy
NGMS	Next Generation Mobile Services
NHA	National Highway Authority
NIC	National Incubation Centre
NMCHP	National Maternal Newborn and Child Health Program
NOC	No Objection Certificate
NP	Nitro Phosphate
NPK	Nitrogen-Phosphorus-Potassium
NPL	Non-Performing Loan
NRL	National Refinery Limited
NRSP	National Rural Support Programme
NSS	National Saving Scheme
NTC	National Telecommunication Corporation
NTN	National Tax Number

O

O & M	Operation and Maintenance
OCAC	Oil Companies Advisory Committee
OCS	Overseas Courier Services
ODA	Official Development Assistance
OGDCL	Oil and Gas Development Company
OGRA	Oil and Gas Regulatory Authority
OICCI	Overseas Investors Chamber of Commerce and Industry
OLT	Orange Line Train
OMCs	Oil Marketing Companies
OMO	Open Market Operation
OPEC	Organization of the Petroleum Exporting Countries
OPEN	Organization of Pakistani Entrepreneurs
OTEXA	Office of Textiles and Apparel

P

P2P	Peer-to-peer
PAI	Pakistan Automotive Institute
Pak.	Pakistan
PAMA	Pakistan Automotive Manufacturers Association
PARC	Pakistan Agriculture Research Council

PASSCO	Pakistan Agricultural Storage and Services Corporation
PBA	Pensioner's Benefit Account
PBA	Pakistan Banks Association
PBC	Pakistan Banao Certificates
PBS	Pakistan Bureau of Statistics
PCGA	Pakistan Cotton Ginners Association
PCMA	Pakistan Chemical Manufacturers' Association
PDHS	Pakistan Demographic and Health Survey
PEDL	Public External Debt and Liabilities
PEZA	Philippine Economic Zone Authority
P/E	Price-to-Earnings
PFA	Punjab Food Authority
PHC	Punjab Healthcare Commission
PHPL	Power Holding Private Limited
PIA	Pakistan International Airlines
PIB	Pakistan Investment Bond
PICIC	Pakistan Industrial Credit and Investment Corporation
PIOC	Pioneer Cement Ltd
PITB	Punjab Information Technology Board
PKR	Pakistani Rupee
PL	Petroleum Levy
PMG	Premium Motor Gasoline
PMG	Premium Motor Gas
PMRC	Pakistan Mortgage Refinancing Company
PNSC	Pakistan National Shipping Corporation
POL	Petroleum, Oil and Lubricants
POS	Point of Sale
PPCBL	Punjab Provincial Cooperative Bank Ltd.
PR	Pakistan Railways
PRI	Pakistan Remittance Initiative
PRSP	Poverty Reduction Strategy Paper
PSC	Private Sector Credit
PSD	Payment Systems Department
PSDP	Public Sector Development Program
PSE	Public Sector Enterprise
PSEL	Pakistan Services Limited
PSLM	Pakistan Social and Living Standards Measurement Survey
PSM	Pakistan Steel Mill
PSO	Payment System Operator
PSO	Pakistan State Oil
PSP	Payment System Provider
PSPC	Pakistan Security Printing Corporation
PSX	Pakistan Stock Exchange
PTA	Pakistan Telecommunication Authority

	PTCL	Pakistan Telecommunication Company Limited
	PVC	Polyvinyl chloride
Q		
	Q1	First quarter
	Q2	Second quarter
	Q3	Third quarter
	Q4	Fourth quarter
	QQE	Quantitative and Qualitative Easing
	QR	Quick Response
R		
	R&D	Research and Development
	RD	Regulatory Duty
	RDF	refused-derived fuel
	REER	Real Effective Exchange Rate
	rhs	Right Hand Side
	RIC	Regular Income Certificate
	RLNG	Regasified Liquefied Natural Gas
	RON	Research Octane Number
	RPT	Regular Public Transport
	Rs	Rupees
	RSC-CPI	Relatively Stable Component of Consumer Price Index
S		
	SAMA	Saudi Arabian Monetary Agency
	SBP	State Bank of Pakistan
	SDGs	Sustainable Development Goals
	SDRs	Special Drawing Rights
	SECP	Security Exchange Commission of Pakistan
	SEZ	Special Economic Zone
	SIL	Social Innovation Lab
	SIM	Subscriber identity module
	SKDs	Semi knocked down units
	SMART	Strengthening Markets for Agriculture and Rural Transformation
	SME	Small and Medium Enterprise
	SMS	Short Message Service
	SNGPL	Sui Northern Gas Pipelines Limited
	SOE	State Owned Enterprises
	SRO	Statutory Regulatory Order
	S&P	Standard and Poor's
	SSA	Special Saving Account
	SSC	Special Saving Certificate
	SSGCL	Sui Southern Gas Company Limited
	SSP	Single Superphosphate
	STP	Software Technology Park

	STPF	Strategic Trade Policy Framework
	SWOT	Strengths-Weaknesses-Opportunities-Threats Analysis
T		
	T-bills	Treasury Bills
	TCS	Tranzum Courier Services
	TDF	and tyre-derived fuel
	TDL	Total Debt and Liabilities
	TDPs	Temporarily Dislocated Persons
	TDR	Trade Dispute Resolution
	TEVTA	Technical Education and Vocational Training Authority
	TFR	Total Fertility Rate
	TiE	The Indus Entrepreneurs
	TOKTEN	Transfer of Knowledge through Expatriate Nationals
	TPP	Trans Pacific Partnership
	TPSP	Third Party Service Provider
	TWA	Transworld Associates
U		
	UAE	United Arab Emirates
	UK	United Kingdom
	UN	United Nations
	UNCTAD	United Nations Conference on Trade and Development
	UNDP	United Nations Development Program
	UNESCO	United Nations Educational, Scientific and Cultural Organization
	UNICEF	United Nations Children's Fund
	UPU	United Postal Union
	US$	US Dollar
	USA	United States of America
	USAID	United States Agency for International Development
	USDA	United States Department of Agriculture
	UVM	Unit Value of Imports
V		
	VAT	Value Added Tax
	VC	Venture Capital
	VP	Voluntary Payments
	VTCS	Voluntary Tax Compliance Scheme
W		
	WA	Weighted Average
	WAIPA	World Association of Investment Promotion Agencies
	WALR	Weighted Average Lending Rate
	WAPDA	Water and Power Development Authority
	WASA	Water and Sanitation Authority
	WB	World Bank
	WDI	World Development Indicators

	WeBOC	Web-Based-One-Customs
	WEF	World Economic Forum
	WHO	World Health Organization
	WHT	Withholding Tax
	WLL	Wireless Local Loop
	WP.29	World Forum for Harmonization of Vehicle Regulations - Working Party
	WPI	Wholesale Price Index
	WTI	West Texas Intermediate
Y		
	YoY	Year on Year
Z		
	ZTBL	Zarai Taraqiati Bank Ltd.