Pakistan

Growth decelerated in fiscal 2018 despite revived agriculture. Expansionary fiscal policy markedly widened the budget and current account deficits and drained foreign exchange. Until macroeconomic imbalances are alleviated, the outlook is for slower growth, higher inflation, pressure on the currency, and heavy external financing needed to maintain even a minimal cushion of foreign exchange reserves. Recurrent crises in the balance of payments require that firms become more export competitive.

Economic performance

For fiscal year 2018 (FY2018, ended 30 June 2018), the estimated GDP growth rate has been revised downward from earlier 5.8% to 5.2%. Growth therefore slowed from 5.4% a year earlier, with revisions indicating slowdowns in industry and services (Figure 3.20.1). Lower growth in industry mirrored weaker growth in large-scale manufacturing, which is almost half of the sector, from 5.4% in FY2017 to 5.0%, as well as a slowdown in construction despite a strong revival in mining and quarrying. Growth in services decelerated from 6.5% in FY2017 to 5.8% last year. Growth in agriculture accelerated, by contrast, from 2.1% in FY2017 to 3.7% on an uptick in minor crops and cotton ginning.

On the demand side, growth in private consumption—which provides on average 81% of GDP and was the largest contributor to growth in FY2018—found support in low inflation and interest rates. Fixed investment in FY2018 reflected higher public investment in infrastructure and energy, especially under the China–Pakistan Economic Corridor (CPEC) project, including electric power projects. Meanwhile, private investment declined slightly despite low interest rates. Net exports weighed on growth as imports grew considerably faster than exports to meet rising demand for oil and capital products, notably to support infrastructure projects.

Average consumer price inflation decelerated from 4.2% in FY2017 to 3.9% as food inflation fell from 3.8% to 1.8%, and despite other inflation accelerating from 4.4% to 5.4% on strong domestic demand, rising global commodity prices, and a lagged effect of exchange rate adjustment (Figure 3.20.2). To counter rising inflation expectations, the State Bank of Pakistan, the central bank, gradually raised from January to May 2018 its policy rate by 75 basis points to 6.50%.

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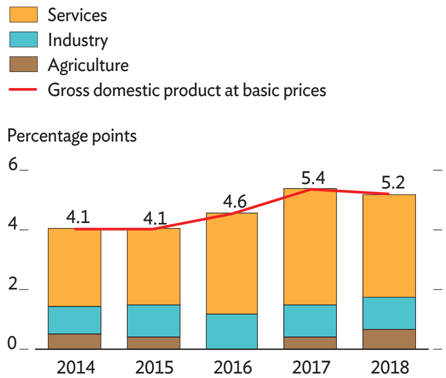
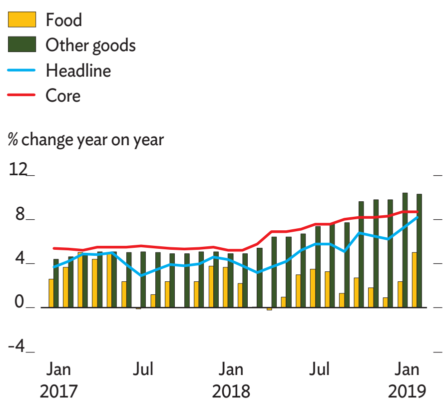
3.20.1 Supply-side contributions to growth



Note: Years are fiscal years ending on 30 June of that year.
Source: Ministry of Finance. *Pakistan Economic Survey 2017–18*. http://www.finance.gov.pk.

3.20.2 Inflation



Note: Inflation snapshot (FY2008 = 100).
Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 14 March 2019).

With expansionary fiscal policy, the consolidated federal and provincial budget deficit surged from the equivalent of 5.8% of GDP in FY2017 to 6.6% in FY2018, which was higher than expected (Figure 3.20.3). Revenue declined slightly from 15.4% of GDP in FY2017 to 15.2% last year, despite tax revenues rising to equal 13.0% of GDP. Nontax revenues fell by 0.8 percentage points to 2.2% of GDP in FY2018 as receipts from the Coalition Support Fund declined and despite higher central bank profits. Expenditure rose from 21.3% of GDP in FY2017 to 21.8% on higher interest payments, defense spending, and federal government subsidies, as well as a sizable increase in provincial current expenditure, which was expected in an election year. To contain the rising budget deficit, development expenditure, equal to 5.3% of GDP in FY2017, was cut to 4.6%.

Gross public debt rose from the equivalent of 67.0% of GDP at the end of FY2017 to 72.5% a year later, above the 60% threshold stipulated in the Fiscal Responsibility and Debt Limitation Act (Figure 3.20.4). The fiscal deficit was financed largely by borrowing from the central bank and external sources. Domestic borrowing for budgetary support was, at 4.2% of GDP in FY2018, twice the amount borrowed from external sources. External financing comprised multilateral and bilateral loans, as well as inflows from the issuance of a $2.5 billion eurobond in November 2017. External public debt including liabilities increased by $9.2 billion to $75.4 billion in FY2018, rising from 21.7% of GDP in FY2017 to 26.6%.

Private sector credit expanded by PRs775.5 billion, or 14.9% in FY2018, as lower government borrowing from commercial banks left more liquidity available to the private sector (Figure 3.20.5). This was despite credit to state-owned enterprises sustained at PRs254.7 billion, slightly above the FY2017 amount, reflecting their weak finances and need for continued government support.

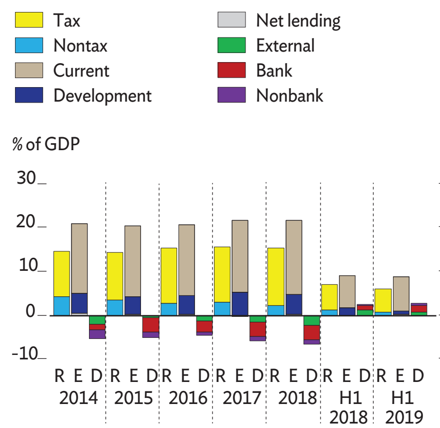
A large trade deficit drove the current account deficit to $19 billion, equal to 6.1% of GDP in FY2018 and significantly above the 4.1% deficit a year earlier (Figure 3.20.6). Exports rebounded from near stagnation at only 0.1% growth in FY2017 to 12.8% in FY2018 on rising exports of textiles, chemicals, leather, and food—and are benefiting from currency depreciation. Import growth slowed from the equivalent of 18% of GDP in FY2017 but, at 15% in FY2018, still outpaced export growth on higher imports of metal, vehicles, machinery, and petroleum, Pakistan's major imported commodities. The service account balance worsened by another 32%, following a 27% decline in FY2017, reflecting in part discontinued receipts under the Coalition Support Fund. Growth in remittances reversed a 2.8% decline in FY2017, but weak 1.4% growth had little impact against the persistent trade deficit (Figure 3.20.7).

3.20.1 Selected economic indicators (%)

	2019	2020
GDP growth	3.9	3.6
Inflation	7.5	7.0
Current account balance (share of GDP)	–5.0	–3.0

Source: ADB estimates.

3.20.3 Government budget indicators

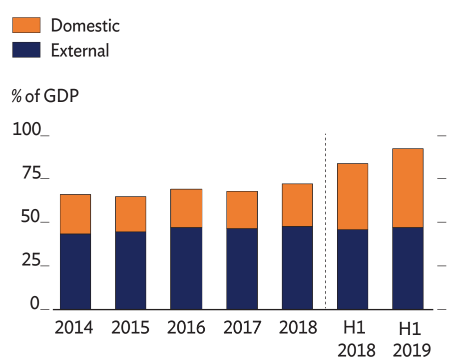


D = deficit financing, E = expenditure, H = half, R = revenue.

Note: Years are fiscal years ending on 30 June of that year.

Sources: Ministry of Finance. *Pakistan Economic Survey 2017–2018; Pakistan Summary of Consolidated Federal & Provincial Budgetary Operations, July–September 2018.*

3.20.4 Public debt



H = half.

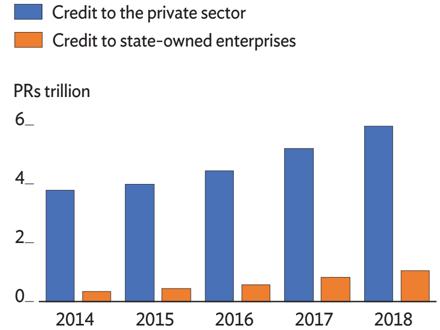
Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan, Economic Data. http://www.sbp.org.pk (accessed 14 March 2019).

Also contributing to the current account deficit were a higher income deficit with increased repatriation of profits by foreign firms and rising interest payments.

Financial inflows increased by $3.1 billion to $13.3 billion in FY2018, mainly under portfolio investment despite a fall in loan disbursements and near stagnation in foreign direct investment (Figure 3.20.8). Foreign exchange reserves, under pressure, declined by $6.3 billion to $9.9 billion at the end of FY2018, sufficient to finance less than 2 months of imports of goods and services. These external pressures caused the Pakistan rupee to depreciate by 11.7% against the US dollar from December 2017 to the end of June 2018, when the exchange rate was PRs121 per $1 (Figure 3.20.9).

3.20.5 Credit to the nongovernment entities



Note: Years are fiscal years ending on 30 June of that year.

Sources: State Bank of Pakistan, *Monetary Policy Compendium*, Jan 2019; *Monthly Statistical Bulletin*, *Jan 2019* (Table 2.6 Monetary Aggregates).

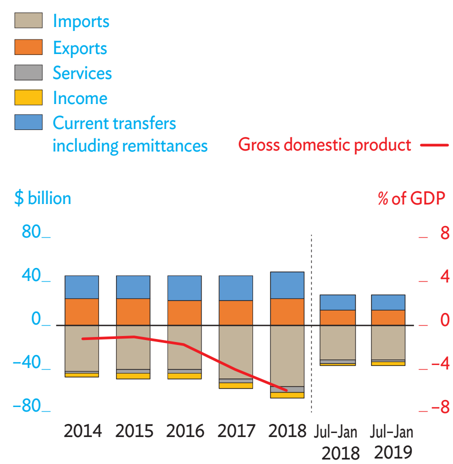
Economic prospects

GDP growth is forecast to decelerate further to 3.9% in FY2019 as macroeconomic challenges continue and despite steps to tighten fiscal and monetary policies to rein in high and unsustainable twin deficits. To meet its large financing needs, the government is discussing a macroeconomic stabilization program with the International Monetary Fund in addition to arranging financial assistance and oil credit facilities from bilateral sources. Continued fiscal consolidation in FY2020 will keep growth subdued at 3.6%.

The supply side is already showing signs of slowdown. Agriculture is expected to underperform the 3.8% growth target for FY2019 after water shortages struck as wet season crops were being sown. Large-scale manufacturing reversed 6.6% growth in the first half of FY2018 to decline by 1.5% in the same period of FY2019 as domestic demand contracted and rising world prices crimped demand for raw materials. Contraction hit all key categories, including a 0.2% decline in textiles. A slowdown in agriculture and industry as domestic demand shrinks will keep growth in services subdued. A government structural reform package announced in January 2019 is expected to support agriculture, facilitate new business openings, and continue to expand capacity in some industries to the forecast horizon. Stabilization policies and rising inflation are likely to contain growth in private consumption and investment, while public sector development spending has already slackened. With exchange rate flexibility and declining imports, net exports are expected to contribute to growth.

Average inflation accelerated sharply from 3.8% in the first 8 months of FY2018 to 6.5% in the same period of FY2019, led by a surge in nonfood inflation to 9.1% that reflected currency depreciation and a significant increase in gas tariffs for consumers and industry in the first half. Food inflation remains relatively moderate at 2.6% thanks to

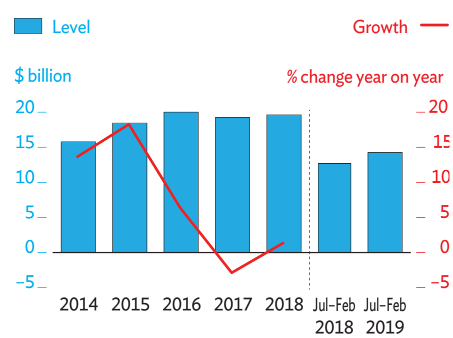
3.20.6 Current account components



Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 25 February 2019).

3.20.7 Remittances



Note: Years are fiscal years ending on 30 June of that year.

Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 14 March 2019).

sufficient stocks of food staples. In response to intensifying inflationary pressures, the central bank gradually raised, in four rounds from July 2018 to January 2019, its policy rate by 375 basis points to 10.25%. Despite tighter monetary policy and lower international oil prices, inflation is expected to rise sharply to average 7.5% in FY2019, driven up by continued heavy government borrowing from the central bank, hikes to domestic gas and electricity tariffs, further increases in regulatory duties on luxury imports, and the lagged impact of currency depreciation by more than 10.7% since July 2018. Inflation will remain elevated at 7.0% in FY2020.

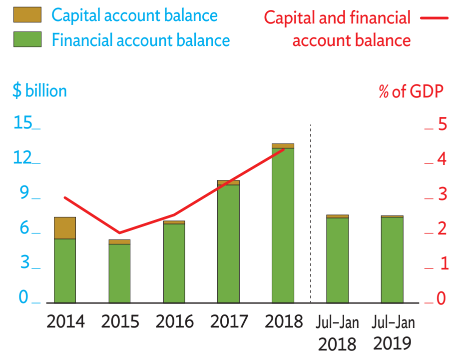
A supplementary consolidated government budget for FY2019, adopted in September 2018, envisages a decline in the budget deficit to 5.1% of GDP in FY2019, mainly by cutting development expenditure excluding CPEC projects, but it also included measures to enhance revenue and extend relief to the poor. Growth in tax collection weakened from a robust 16.4% in the first half of FY2018 to only 2.7% a year later. The Federal Board of Revenue targets tax collection equal to only 11.6% of GDP in FY2019, taking into account reduced sales taxes on major petroleum products, drag on the collection of withholding tax from contracts, contraction in general sales tax revenue as imports slow, and the overall slowdown in the economy. Including nontax revenue, total revenue declined by nearly 2.4% in the first half of FY2019.

Budget expenditure increased by 5.5% in the first half of FY2019 over the same period a year earlier as current spending rose for interest payments and defense. Lower revenue collection and higher current expenditure pushed the budget deficit from the equivalent of 2.3% of GDP in the first half of FY2018 to 2.7% a year later. This situation will make it a challenge for the government to achieve the reduction in the budget deficit it targets for FY2019. A second supplementary budget, adopted on 6 March 2019 without information on the projected deficit, focuses on an economic reform package envisaging incentives and measures to encourage investment and exports, enhance the ease of doing business, and strengthen export-oriented activities.

In the first 8 months of FY2019, the government borrowed more from the central bank and less from commercial banks, freeing up liquidity with which commercial banks boosted credit to the private sector by 18.9% over the same period of FY2018. This sharply increased net domestic assets and nearly doubled broad money growth to 2.8%.

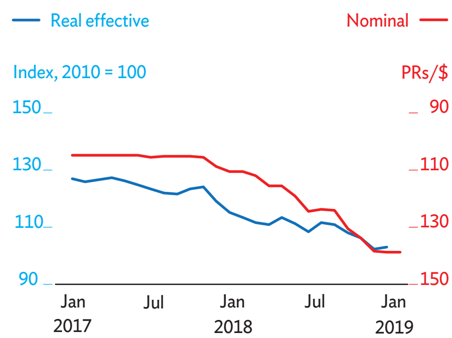
The current account deficit is expected to ease in FY2019 but will remain high at the equivalent of 5.0% of GDP because of the large trade deficit. It will narrow further to 3.0% in FY2020 with easing macroeconomic pressures on the external accounts. Export growth plunged from double digits in the first 7 months of FY2018 to 1.6% in the same period of FY2019.

3.20.8 Capital and financial account balance



Note: Years are fiscal years ending on 30 June of that year.
Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 14 March 2019).

3.20.9 Exchange rates



Source: State Bank of Pakistan, Economic Data. http://www.sbp.org.pk (accessed 14 March 2019).

It is expected, however, to strengthen in the remaining months of this fiscal year and further in FY2020 as the lagged impact of currency depreciation kicks in, along with the incentive package for export-oriented industries announced in January 2019. Imports fell by 0.8% in the first 7 months of FY2019 from the same period of FY2018, with imports other than oil 5.7% lower because of slower domestic economic activity, currency depreciation, and an increase in import duties for nonessential items. Remittances are expected to revive—having already risen by 10% in the first 7 months of FY2019 over the same period of FY2018—as the Pakistan rupee depreciate further, economic activity holds broadly steady in the Middle Eastern oil-exporting countries (major destinations for Pakistani migrants), and the government takes measures to facilitate remittances through official channels.

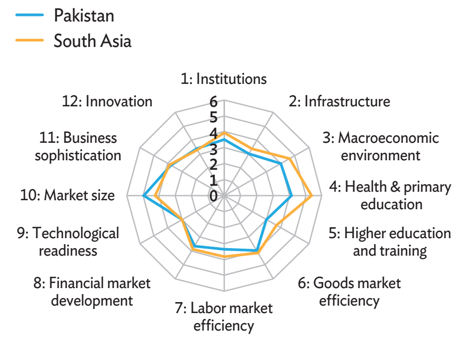
The government's diaspora bonds—issued in January 2019 with terms of 3 and 5 years and an attractive return of over 6%—aim to tap resources from overseas Pakistanis. Inflows that do not incur debt, such as foreign direct investment, are expected to be lower in FY2019 as several CPEC energy projects near completion. Financing a high current account deficit in FY2019 will require substantial borrowing, as in the first 7 months of the year, and use much of the bilateral lending support announced in the early months of 2019 to finance the deficit in the balance of payments. Foreign exchange reserves, depleted to $8.1 billion in February 2019, will likely remain stressed at the end of FY2019.

Policy challenge—improving business competitiveness

Pakistan ranks 107 of 140 economies on the Global Competitiveness Index 2018. It is classified as inhabiting the first stage of development among 35 factor-driven economies—that is, economies heavily reliant on unskilled labor and natural resources. The country's persistently low score and ranking on the index is reflected in its companies' struggles to compete in international markets and in weak export opportunities, which spark recurring crises in the balance of payment.

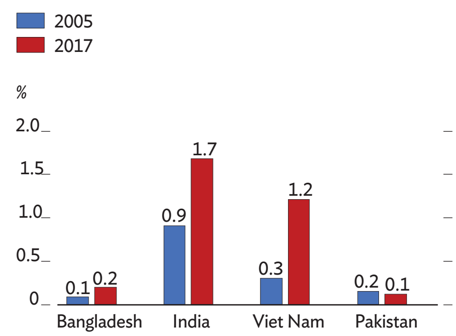
Pakistan lags behind the South Asia regional average on most index indicators (Figure 3.20.10). Business competitiveness in Pakistan suffers under a challenging macroeconomic environment and adverse terms of trade, significantly eroding production and exports. Pakistan's exports, such as they are, remain largely primary products whose lack of sophistication and diversification condemn them to declining shares in world markets (Figure 3.20.11). Agricultural commodities, textiles, and other manufactures with little value added comprise over 80% of exports.

3.20.10 Pakistan vs. South Asia: GCI Scores 2018



Source: Global Competitiveness Index 2017–2018, World Economic Forum.

3.20.11 Share in total world exports



Source: WTO Annual Reports. http://www.wto.org.

The high cost of doing business is a key factor limiting firms' ability to compete. Access to affordable capital is constrained by a shallow and underdeveloped capital market. Manufacturing firms face high corporate tax rates, taxes on dividends and retained earnings, cascading taxes levied on intercorporate dividends, and a super tax levied on retained reserves. The effective corporate tax rate of up to 49% is significantly higher than taxes on international competitors. High custom duties on machinery imports raise the cost of investment, and high tariffs on raw materials and intermediate inputs erode the price competitiveness of both exporters and domestic industries facing stiff competition from imports. Similarly, high tariffs and undependable electric power add to production costs.

Pakistan's cumbersome customs and clearance procedures, and the poor quality of its logistics and infrastructure, remain constraints on its capacity for just-in-time supply chain management. Investing in infrastructure and improving trade facilitation could boost participation in world markets, but the absence of industry-wide facilities to test and certify compliance would still leave many exporters disadvantaged.

Macroeconomic stability is needed to create an environment that inspires business confidence and is conducive to investment and trade. Facing twin deficits in fiscal and current accounts, the government has long been bedeviled by difficult policy choices that pit improved tax revenues against enhanced competitiveness. Moreover, with an anti-export bias in tax and exchange rate policies, and high government borrowing that crowds out private investment, firm competitiveness erodes even though recent currency depreciation supports exports.

The government is currently preparing its 5-year Strategic Trade Policy Framework with the objective of boosting export competitiveness. All elements of a competitiveness framework are under consideration, including measures taken at the border and others behind it. The framework will address issues that hinder not only export competitiveness but also the creation of a more competitive domestic industry. As a first step, the Prime Minister announced in March 2019 a more liberal e-visa policy for foreign visitors from 175 countries.