



Review of the Economy First Quarter 2017-18

About IPR

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Executive Summary

The economy's performance was mixed during Q1 FY18. Economic growth improved and public finance was strengthened by rapid increase in tax collection. Essential risks and vulnerabilities to the economy remain. Both fiscal and current account deficits will exceed targets. Reserves have fallen despite increase in external debt. Government attributed the runaway increase in current account deficit to growth inducing machinery imports. Machinery import, however, did not grow during the quarter. Import of power generation equipment fell by 17%. July-October 2017 current account deficit, on the other hand, grew by 120% YoY. Pakistan is permanently dependent on external savings and the economy is exposed to continuous loan rollover and re-pricing risks. Recent correction in Rupee value may reduce imports and the deficit. Central bank estimates foreign exchange financing gap of USD 12 Billion in FY 18. IPR estimates that the gap will be higher.

Next year's foreign financing gap is a major economic risk. Along with other factors, the above weaknesses prevent sustained and long-term growth of the economy:

- **Growth:**

- GDP growth is expected to improve from last year.
- Manufacturing led by LSM has grown and agriculture production has improved. Exports too have seen revival on the back of significant incentives.
 - During Q1, Large Scale Manufacturing grew by 8.36%. The growth was in most sectors. Fertilizer production fell.
 - Factors affecting LSM are improved power supply, better security, low interest rates, low inflation, and past years' investments
- Agriculture growth estimates are positive:
 - Cotton, rice, sugarcane, and wheat production are expected to grow.
 - Factors behind growth are: higher fertilizer offtake, some increase in area, higher credit and mechanization, support price for wheat

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- Public investment and CPEC spending, public and private have grown. In a positive development, public sector development will be over 6% of GDP
- Electricity generation increased YoY for the quarter by 14.8%
- IMF estimates GDP to grow by 5.6%, while ADB estimates 5.5%. GoP growth target is 6%

Meanwhile, Pakistan has made no progress in moving up the technology ladder, in reducing cost of doing business by governance improvements, and in providing access to credit to small and medium businesses. There is not even talk of structural reforms or for dealing with the political economy. Political uncertainty has increased, though even before, there was no sign that decision makers planned to address structural issues.

● Fiscal Sector:

- Overall, government's fiscal consolidation measures have been successful, despite recent slippage.

Revenue

- Government's tax collection improved greatly in recent years and again during the quarter
- FBR tax revenue exceed expectations, growing by 22.4% during the quarter. This follows growth of 20% in fiscal 2015-16 and 17.6% in 2016-17. Direct Tax revenue grew by 23.9% during Q1.
- YoY federal taxes overall grew by 16.3% as Other taxes and non-tax revenue fell.

Expenditure

- Proportionate expenditure is so far within the budget, though spending on markup is above budget. Q1 spending usually is not a good indicator of the full year. GoP must keep an eye on current expenditure.

Fiscal Sector Issues

- The fiscal sector has had several enduring concerns:
 - Large deficit has increased indebtedness, especially external borrowing
 - Rationalization of PSDP to contain the deficit will affect growth
- FY 18's fiscal deficit will exceed target of 4.1%. Q1's deficit was 1.2% of GDP. This is understated as GDP estimate is very high.
- The deficit is understated also because it does not include up to Rs. 700 Billion of outstanding circular debt.
- No government has addressed structural issues in the fiscal sector:

- PSDP spending includes many prestige projects. There is need to focus on improving services to businesses and citizens
 - There has been continued increase in power sector circular debt, despite low energy prices
 - Continued subsidy to the power sector and PSEs
 - Structural issues with tax policy and administration: high reliance on indirect taxes and within Direct Tax on withholding tax. Rigidities in administration that precludes expansion of tax net. Inability of provinces to collect tax on agriculture. Extensive exemptions and hints of anti-export bias.
- **External Sector:**
 - This sector carries the most risk for the economy and is growth constraining.
 - SBP estimates July-October current account deficit at 4.4% of GDP, against target of 2.6% for the year.
 - Foreign exchange reserves declined to USD 12.6 Billion in November 2017, compared to USD 18.4 in November 2016. Reserves recovered to 14.6 Billion in December in 2017 (from borrowing).
 - YoY external debt and liabilities in September 2017 grew by USD 9.3 Billion in one year from 30 September 2017. They grew by over USD 2 Billion during the quarter.
 - YoY government external debt grew by USD 4.5 Billion by September 2017 and by USD 767 Million during Q1.
 - Debt servicing (principal and markup) was USD 2.1 Billion (USD 1.6 Billion for government debt) during Q1. FY 17's debt servicing was USD 8.157 Billion 53% above 2015-16. FY 18's debt servicing will exceed last year's payments. Coupled with import growth, CPEC and other obligations, this means major increase in foreign financing needs.
 - After decline of three years, exports grew by 10.8% during the quarter. Imports grew by over 22%, resulting in growth of 29.8% in trade gap for the quarter. According to SBP, YoY July-October (fob) trade gap increased by 41%.
 - Exports revived after grant of fiscal incentives by government. Recent correction in value of Pak Rupee may give it further boost.
 - Import of several products increased. These include crude and refined oil and LNG/LPG. Import of Chemicals, Metals, Transport equipment, and edible oils grew. Machinery imports stayed level YoY. Import of power generation, construction, and office machinery fell, while import of textile, agriculture machinery and transport (CBU and CKD) and telecom equipment increased.
 - YoY July-November 2017 FDI grew by 57% over the previous year. FDI would fall short of government's target of 4,138 Million, though will increase substantially from last year.
 - Remittances, which fell by 3% last year, has grown by 2.2% during July-October. Government has targeted an increase of 7%.
 - Drastic increase in current account deficit has put pressure on BoP and resulted in draw down of reserves.

A proactive and concerted effort to increase competitiveness is needed to move to new products that have higher value addition and processing.

Review of the Economy

First Quarter 2017-18

This document reviews Pakistan's economic performance for the period July-September 2017-18, FY 2018. It assesses major indicators against targets set at the beginning of the year and highlights areas of promise and concern.

1. Targets:

- Real growth rates for FY 2018¹
 - GDP 6%
 - Industry, manufacturing, and LSM: 7.3%, 6.4%, 6.3% %
 - Agriculture: 3.5%
 - Services: 6.4%
- Savings and Investment: 14.6% and 17.2% of GDP, respectively²
- Fiscal Deficit: 4.1% of GDP³
- Inflation: 6%
- Forex Reserves: Four months of imports, i.e. USD 16.3 Billion based on import estimate in Annual Plan FY 18⁴
- Public Debt: Net public debt to GDP below 60%⁵
- Balance of Payments⁶
 - Current Account Balance: Deficit of USD 8.9 Billion or 2.6% of GDP
 - Exports (fob): 6.8% growth or USD 23.1 Billion
 - Imports (fob): 7.6% growth or USD 48.8 Billion
 - Remittances: USD 20.7 Billion
 - Debt Servicing:

¹ Planning Commission, Annual Plan 2017-18, Pages 7 and 8

² Ibid

³ Finance Minister's Budget speech to the Parliament, Page 13

⁴ Ibid and Page 90 of Annual Plan 2017-18

⁵ Finance Minister's Budget speech to the Parliament, Page 13

⁶ Planning Commission, Annual Plan 2017-18, Pages 88, and 90 to 92.

Target Vs Q1 Actuals

Figure 1- Summary of Economic Performance Q1 FY 19 Major Indicators

Indicators	Target 2017-18	Actual Q1	Actual 2016-17
Real GDP Growth FY 18			
• GDP	6%	--	5.3%
• Industry	7.3%	--	
○ LSM	6.3%	8.4%	4.9%
○ Manufacturing	6.4%	--	5.3%
○ Construction	12.1%	--	9.0%
○ Power generation & distribution	12.5%	N/A ¹	3.4%
• Agriculture	3.5%	--	3.5%
• Services	6.4%	--	5.9%
Savings	14.6%	--	13.1
Investment	17.2% of GDP	--	15.8
Fiscal deficit	4.1% of GDP	1.2%	5.8%
Inflation	6%	3.4%	4.1%
Forex Reserves, net	Four months import	13,856.9M, 30/9 Three months import	16,143.5M, 30/6 Three months import
Public Debt	<60%/GDP	61.4%, 30/9 ² (% understated because of very high GDP growth rate est. of >50%)	67.2%
Balance of Payments ³			
• Current Account Balance	-8.9 B, 2.6%	-5.0B, 4.4%	-12.4B, 4.1%
• Exports fob	23.1 B, 6.8%	5.2 B, 10.8%	21.9B
• Imports fob	48.8 B, 7.6%	9.2B, 29.8%	48.6B
• Remittances	20.7 B, 7.3%	6.4B, 2.2%	19.3B
• FDI	4.1B, 57.6%	1.1B, 57.2%	2.6B
• External Debt Servicing ⁴ In USD Billions	3.9B	1.6B, 2.1B	6.4B, 8.2B

Source: Annual Plan, Budget in Brief, and Budget speech for targets, SBP and PBS data for actuals

1. Power supply to DISCOs grew by 14.8% in Q1, YoY

2. Public debt/GDP, actual fell sharply in Q1 because of flawed estimate of GDP, which shows annualized growth of >50%,

3. Q1 figure for current account balance is for July-October 2017

4. External debt servicing includes repayment of interest and principle. Target is for government debt only. Actuals Q1 and FY 17 have two figures. The first is repayment on government debt and the second for the economy. Target @ PKR/USD rate of 105

2. Macroeconomic performance:

The economy's mixed profile continued in the quarter. On the positive side, growth kept its momentum. IMF forecasts the economy to grow by 5.6%. ADB makes a similar estimate of 5.5%⁷. But, with it, serious vulnerabilities continued, especially because of the economy's inability to deal with the structural twin deficits. Fiscal deficit for the quarter was 1.2% of GDP against an annual target of 4.1%. Current account deficit of 4.4% (for July-October) already exceeded the annual target of 2.6% of GDP. (Note: this estimate uses GDP for specific period, i.e. for July-October 2017). PBS data shows imports for Q1 grew by 22% and trade deficit by 29%⁸. According to SBP, July-October (fob) trade deficit grew by 41%⁹.

So far, GoP has attributed the runaway current account deficit to growth boosting machinery imports. However, during Q1 FY 18, when YoY current account deficit worsened by 120%, import of machinery did not grow. Import of power generation, construction, and office machinery fell by double digits.

The economy has financed the current account from increased external indebtedness. Total external debt and liabilities increased by USD 9,290 Million in one year (3%/GDP), between September 2016 and September 2017. In Q1, debt and liabilities grew by USD 2,071 Million. Total external debt and liabilities were USD 85,052 Million in September 2017. However, there is no room for despondency. The economy has the ability to turn around if all leaders show firm intent.

Foreign exchange reserves came under pressure and fell by a large margin. External borrowing raised it somewhat in December. Net SBP foreign reserves were as follows¹⁰:

- November 2016: USD 18,368.8 Million
- June 2017: USD 16,143.5 Million
- November 2017: USD 12,660.5 Million
- 8 December 17: USD 14,666.3 Million

Ballooning foreign financing is a major risk for the economy. Recently, the Central Bank Governor stated that Pakistan faced a gap of USD 12 Billion, but gave no indication of how this would be met¹¹. IPR estimates that the gap would be higher. Rightly the exchange market reacted. GoP has not indicated how it will meet the gap. Experts point to dire consequences including risks to the country's sovereignty¹².

Pakistan is permanently dependent on external savings for foreign exchange. The economy is exposed to continuous loan rollover and re-pricing risks¹³.

⁷ Business Recorder, ADB highlights economic vulnerabilities, 27 September 2017

⁸ PBS, External Trade statistics, Monthly Summary of Foreign Trade

⁹ SBP, Information compendium to Monetary Policy Statement, November 2017

¹⁰ SBP, Liquid Foreign Exchange Reserves

¹¹ Express Tribune, Islamabad faces external financing gap of around \$ 12 Billion, Shahbaz Rana, 20 December 2017

¹² The News, Pakistan needs \$ 32bn to fund external account next year, Mehtab Haider, 19 December 2017

¹³ SBP, State of the Economy, Annual Report 2016-17

On the positive side, an expansionary monetary policy coupled with steady exchange rate during the quarter (corrected in December) and some agriculture and industry revival have stimulated growth. Continuous growth in public sector investment and CPEC development projects also have given impetus.

Meanwhile, Pakistan has made no progress in moving up the technology ladder, in reducing cost of doing business by governance improvements, and in providing access to credit to small and medium businesses. There is not even talk of structural reforms or for dealing with the political economy¹⁴. These factors prevent sustained and long-term growth of the economy.

They are the result of years of economic decision making that prioritizes firefighting to solve immediate problems, but does not show resolve to deal with structural issues. The problems point to an economic structure that does not allow the economy to substantially increase investment. It is the result of a political economy that favours the privileged at the expense of everyone else.

2A. Economic Performance GDP Growth:

The economy grew by 5.28% in 2016-17. The growth target for FY 18 is 6%. To gauge economic performance for first quarter 2017-18, we look at key growth determinants. These are industry, especially LSM, as well as agriculture and services. We will also analyze investments, private credit, and capital imports. Though it is early to say, initial estimates suggest that the economy would grow at a rate higher than last fiscal. Though below forecast, agriculture production has grown. LSM has grown at a rate higher than the target.

Industry: In 2016-17, Industry contributed about 21% to total GDP. The share of manufacturing in total was about 13.5% with LSM's share of about 10.7% of GDP¹⁵. The Annual Plan 2017-18 targeted industry to grow by 7.3% with 6.3% increase in LSM.

In fact, year on year LSM growth for Q1 was 8.36%. LSM growth for the corresponding period last year was 1.9%¹⁶. Most major LSM industries grew during the quarter, especially food and beverages, nonmetallic minerals, automobiles, and iron and steel products. Pakistan manufacturing's mainstay of textiles also grew by a small margin of 0.21%. Production of fertilizer declined (see Table 1). There is insufficient data to show the pace of growth of manufactures other than LSM and for other Industry components (mining, energy, and construction).

When it comes, real manufacturing growth will come from good policies and structural reforms. Immediately, Chinese public and private investment and PSDP is stimulating the

¹⁴ See Misperceived Inequality, V. Gimpelson and Daniel Treisman, January 2016 for an excellent analysis on why inequality is tolerated. Also covered in The Economist "Why is America more tolerant of inequality than many rich countries?", 18 December 2017

¹⁵ MoF, Pakistan Economic Survey, Table 1.2 Statistical Appendix

¹⁶ Pakistan Bureau of Statistics, Quantity Indices of Manufacturing for September 2017 and September 2016.

economy and manufacturing. There are reports of delay in some major projects¹⁷ and concern about security of Chinese citizens¹⁸. If successful, operation of SEZs and industrial parks can give a major boost. A lot depends on Pakistan’s ability to quickly complete construction of industrial parks. Several things will matter: their location, the support services (including one window), logistics, their overall management, and ability to target “backward” industries from other economies that are one or two steps higher in technology. Thus far, Chinese have invested in infrastructure projects, not in manufacturing.

Lower interest rates and continued low international commodity prices have helped growth. SBP’s discount rate stays at 5.75%¹⁹.

Table 1
Change in Quantum Index of Manufacturing
July-September 2017-18 over 2016-17

Manufacturing Items	Weight	% Change	YoY Growth Impact
		Jul-Sep	Cumulative
Textile	20.915	0.68	0.21
Food, Beverages, & Tobacco	12.370	10.12	1.48
Coke & Petroleum Products	5.514	13.74	0.93
Pharmaceuticals	3.620	2.12	0.19
Chemicals	1.717	4.73	0.12
Non-Metallic Mineral Products	5.364	12.35	1.37
Automobiles	4.613	29.43	2.07
Fertilizer	4.441	-5.84	-0.41
Leather Products	0.859	9.95	0.15
Rubber Products	0.262	1.28	0.01
Iron & Steel Products	5.392	47.00	1.79
Electronics	1.963	2.67	0.05
Paper & Board	2.314	9.80	0.35
Engineering Products	0.400	25.97	0.01
Wood Products	0.588	6.78	0.00
Cumulative impact July-Sep			8.32

Source: Adapted from PBS QIM for September 2017

¹⁷ Dawn, Three CPEC projects hit snags as China mulls new financing rules, 5 December 2017. Some reports suggest this was done on concerns about graft in procurement.

¹⁸ Washington Post, China warns citizens in Pakistan of possible terror attacks, 8 December 2017

¹⁹ Express Tribune, Monetary policy: SBP leaves key interest rate unchanged at 5.75%, 24 November 2017

Agriculture growth: FY 18 growth target for agriculture is 3.5%. Growth in major crops was mixed during the first quarter. Cotton production in FY 18 is expected to increase by 18% from last fiscal to 9.7 Million bales (480 lbs). This still would be below 2014-15 production of 10.6 Million bales (480 lbs.). Rice production is estimated to also grow from last year. Production is estimated to be 7.31 MT against a target of 6.8 MT²⁰.

Sugarcane production is expected to be above the target of 68.5 Million Tons²¹. Output for 2016-17 was estimated to be 73.6 million tons last fiscal and is expected to grow slightly. The US Department of Agriculture estimates marginal growth in sugar production over last year²².

The aggregate of cotton, rice, and sugarcane has a share of 52% in total agriculture production.

Wheat production is projected to equal or slightly exceed last year's production of 25.6 Million tons (there is variance between production estimates, the Federal Committee on Agriculture estimates last year's wheat production at 26.4 MT). However, USDA estimates that area under production may have declined somewhat. The FCA has set a target of 26.46 MT for fiscal 2017-18. Production may fall short of target²³.

Production of oilseeds is estimated to increase by 17.4%²⁴. Their overall production volume and contribution to agriculture is limited. These positive developments are confirmed by SBP's Monetary Policy Committee which notes increase in "on-going trend of investment in mechanization, higher uptick in agricultural credit and unchanged support price for wheat at the time of its sowing"²⁵. The above increase will contribute to GDP growth.

In addition to above overall positive picture for agriculture, Government will count on increase in livestock, forestry, and fishing to achieve 3.5% growth. At the macro level, however, agriculture productivity is low, and volatility is endemic. Production remains contingent on international prices, weather conditions, and virus affecting production. Without investment in water infrastructure, improvement in water use and service delivery, and quality research, extension services, and policy interventions, sustained growth of farm produce remains uncertain. There isn't enough analysis why production levels vary year to year.

The power sector: Despite good improvement, power supply was again a constraint on economic activity. For the period July-September 2017, total power supply was 36,679 GWh. This was 14.8% higher than the power supply for the same period in 2016. Government's plans for increase in generation capacity has begun to show. Coal fired 1320 MW Sahiwal plant is in operation. So is Chashma IV. Whether addition to generation capacity is enough to ensure

²⁰ Pakistan Today, Rice crosses govt production target, 15 October 2017 and USDA, Foreign Agriculture Services, World Agriculture Production, November 2017

²¹ Associated Press of Pakistan, Govt fixes production targets for Kharif crop 2017-18, 21 April 2017.

²² <http://www.indexmundi.com/agriculture/?country=pk&commodity=centrifugal-sugar&graph=cane-sugar-production>

²³ Targets and production estimates based on data from Federal Committee on Agriculture of the Ministry of National Food Security and Research and of USDA, FAS.

²⁴ USDA, FAS World Agriculture Production November 2017, Table 10

²⁵ Monetary Policy Committee, State Bank of Pakistan, Monetary Policy Statement, November 24, 2017

reliable power supply in the country is open to question. There is no improvement in DISCO level governance, which despite low oil prices is a major reason for circular debt increase. Similarly, though government has invested in transmission lines, it is not clear if this is enough to create a reliable T&D system. Decline in import of generation equipment suggests that capacity growth may slow down for a while.

Other Headwinds: In addition, other headwinds stall growth. These have encumbered Pakistan's economy for some years. Despite strong resolve by the state, security in Pakistan is still a challenge. It would likely be so for the near future. Social tensions, protests and sit-ins, and regional instability continue to thwart economic activity.

For the medium-term, it is important to remember that sustained growth needs strong macro fundamentals, enhancement in productivity through investment in human resource, ease of doing business, and improved infrastructure. These factors crowd in private investment. Most social indicators show Pakistan well behind other emerging economies. More significantly, there is no thought given to job growth for the two million young Pakistanis entering the job market each year. We need a programme of workers' skills training.

Public investment in infrastructure has grown, though we would like it to be based on judicious selection of projects with high economic returns. As discussed before, macro fundamentals are still vulnerable. Indebtedness is a especial concern. Some external debt is for investment. At other times, it is to repay past loans. Foreign debt servicing (principal and interest) grew by 36.5% in 2016-17. It will grow further this fiscal.

Improvement in domestic savings is necessary to increase investment and to contain indebtedness. To meet government's plan for increase in investment to 20% of GDP, the economy must rely on external savings by 5% to 7% of GDP. At current GDP value, this means additional about USD 15 to 20 Billion per year. Pakistan must very significantly increase FDI as incurring further debt is unsustainable.

2B. Investment

The Annual Plan sets a target of 17.2% of GDP and 14.6% for total investment and national savings in fiscal year 2017-18. Each year the economy misses the savings and investment targets. So, the Annual Plan FY 18 rightly reduces its estimates for the year. It is still above last year's actuals of 15.8 and 13.1% of GDP for investment and savings respectively.

2C. Import of Machinery

Machinery grew by double digits in the last two fiscal years. However, it reached a plateau during July-September 2017 with an increase of 1.8% over the same period previous year. Import of power generation machinery fell by 17% during the quarter after increasing since 2015-16. Import of office and construction and mining machinery also fell (Table 2).

According to SBP, flow of credit to private sector for energy sector declined by 33% in July-September 2017-18²⁶.

Table 2			
Machinery Imports			
July-September			
USD Million			
	2016-17	2017-18	Growth %
Power Generation Machinery	836	697	-17
Office Machinery	148	100	-33
Textile Machinery	116	146	27
Construction & Mining	118	101	-15
Electrical Machinery	449	468	4
Telecom	274	334	22
Agriculture Machinery	24	32	37
Other Machinery	766	902	18
Total	2,731	2,780	1.8
Source: Trade Statistics, Ministry of Commerce based on PBS data ²⁷			

Since 2014-15, Pakistan has imported generation machinery of almost USD 7 Billion. According to CPPA/NEPRA, total capacity stands at 28,100 MW. Total working capacity in 2014 was 19,565 MW²⁸. (NEPRA's State of the Industry Report 2016 gives total installed capacity of 25,374 MW as of December 2016 against 23,702 in 2014)²⁹. It appears that Pakistan is on track to increase power generation by 13,000 MW by 2020 (10,700 MW under CPEC and 2,400 MW LNG). It is to be seen if decline in power machinery is temporary or is a precursor of a trend.

2D. PSDP Releases

PSDP spending has been according to expectation. Rupee PSDP releases up to 8 December 2017, over five months into the fiscal year, are 29% of budget. Total release, including foreign assistance, was 30.5%³⁰. Releases up to 8 December 2017 should have been close to 50. However, work in the new fiscal year is slow to take off and the pace is expected to pick up. Selected sectoral releases are in Table 3. Release of funds for roads and motorways is highest. This is a stated priority of the government. Roads also are a major part of CPEC's public sector programme.

²⁶ SBP, Quarterly Performance Review of the Banking Sector (July-September, 2017), Table 2

²⁷ Comparative Imports of Selected commodities July-Dec 2016-17 and July-Dec 2015-16
http://www.commerce.gov.pk/wp-content/uploads/2017/01/Comparative_Imp_Selected_Comodities_July-Dec_2016.pdf

²⁸ CPPA, Energy data for comparative periods.

²⁹ NEPRA, State of the Industry Report 2016, Table 4.

³⁰ Planning Commission, Status of PSDP releases

Table 3
PSDP Releases 2017-18

Rs. Billion

	Budget Full Year		Releases 2017-18 Up to 08-12-2017	% Released
	2016-17	2017-18		
HEC	21.5	35.6	11.6	32.5
Health	24.9	48.7	2.7	5.5
PAEC	27.6	15.1	3.1	20.5
Railways	41.0	42.9	9.4	21.9
Water Sector	31.7	36.7	10.4	28.3
NHA	188.0	325.7	111.7	34.2
Power	130.0	63.0	18.5	29.4
Others	335.3	433.3	137.9	31.8
Total	800.0	1001.0	305.3	30.5

Source: Planning Commission, Status of PSDP Releases as on 8.12.2017

Releases do not necessarily mean that money has been spent. There is time lag between release and booked expenditure and therefore variance with information compiled by Finance Ministry. Public investment is important to increase economic productivity and to crowd in private investment. While it is encouraging to see a 25% increase in total federal PSDP budget this fiscal (from Rs. 800 Billion in 2016-17 to Rs. 1,001 Billion in 2017-18), IPR notes flawed government priorities.

Water sector is a special concern. The sector needs essential and urgent policy and investment intervention by government. Against this year's budget for water sector of Rs. 36.5 Billion, the sector had Rs. 43.5 Billion in 2014-15. From being water stressed, Pakistan is emerging as a water scarce country. This could pose a greater challenge to the country than power does at present. It has begun to affect seriously our agriculture. It could likely lead to friction among provinces as well as with neighbouring countries. A critical sector is denied due allocation. Together with health and education, the three sectors are important determinants of growth and productivity. More importantly, they could defuse the time bomb posed by the youth bulge. This is in contrast to disproportionate increase in allocation for highways. The economic return on grand highways projects is yet to be proven in Pakistan.

For it to be an engine of growth, public investment needs well considered project selection as well as quality governance. Public investment increases output and jobs as well as helps efficiency all around. However, public projects at inflated costs, with further cost and time overruns, and the presence of prestige projects in the portfolio, reduce economic impact.

As stated before, government's macro-economic framework sets a target of 17.2% as the investment to GDP ratio. The target for total fixed investment is 16.1%. Of this, public investment is 4.5% (federal and provincial) and private is 11.2%. The actual for 2016-17 was 15.8% total and 14.2% fixed investment. Public sector investment was 4.3% and private sector 9.9%.

The fixed investment target of 15.6%, depends on private investment of 11.2% of GDP. Last year, private investment was 9.9% of GDP. Stagnant machinery imports suggest stable to declining overall investments including private investment (Table 2 above). SBP data shows decline in bank credit to private sector (discussed in later paragraphs)³¹.

FDI has seen healthy increase during the quarter, growing by 57% July-November 2017 over the corresponding period last year³².

2E. Bank Credit

A look at net assets of the banking system shows increase in borrowing by government. During fiscal 2017-18, net government borrowing for budgetary support was Rs. 526 Billion up to 1 December 2017, an increase of 6% over the stock as of 30 June 2017³³. Loans to private sector declined. The decline results from fall of working capital loans. Fixed capital loans grew³⁴. Loans to agriculture/agribusiness, textiles and apparels increased.

3. Public Finance

Details of fiscal operations released by Finance Ministry show mixed signs³⁵:

- Budget deficit for the first quarter was 1.2% of GDP³⁶. Actual deficit will likely exceed target deficit of 4.1% for the fiscal year³⁷.

Revenue

- Total first quarter FY 18 federal tax revenue of Rs. 824.5 Billion is over 20% above revenue for the same period FY 17, which was 686.2 Billion³⁸. Budget estimate of Rs, 4,330 Billion for federal taxes for FY 18 is 18.7% above last fiscal's actual collection of Rs. 3,647.5 Billion³⁹.
- FBR tax collection has done even better. Year on year increase for Q1 FY18 is 22.3% above last year's revenue for the same period. The budget estimate of Rs. 4,013 Billion is

³¹ SBP, Quarterly Performance Review of the Banking Sector (July-September 2017), Page 5 and Monetary Policy Information Compendium November 2017, Page 18

³² BOI, Foreign Investment Inflows to in Pakistan, by country and sector, July-November 2017-18

³³ SBP, Provisional Data on Monetary Aggregates as on December 1st, 2017

³⁴ Op. Cit 30

³⁵ MoF, Fiscal Operations

³⁶ Ministry of Finance, Summary of Consolidated Federal and Provincial Budgetary Operations, July-December 2016-17, Table 1

³⁷ MOF, Budget Speech by Finance Minister, May 2017

³⁸ MoF Fiscal Operations, July-September 2017, Table 4 and Budget in Brief Table 8

³⁹ Ibid

more than 19% above last fiscal's actuals. It is important to view increase in FBR revenue in perspective. In 2015-16, FBR taxes registered an unprecedented increase of more than 20% over the previous fiscal. In FY 17, FBR revenue increased a further 17.6%.

- Q1 FY 18 FBR's direct tax collection has been commendable. First quarter direct tax revenue was up 23.9% above same period last fiscal.
- Budget estimate 2017-18 for Other Taxes is 11% above last year's actual. However, actual collection for Q1 was 2.5% below the corresponding period last year⁴⁰. Gas infrastructure development cess fell greatly.

Federal government's non-tax revenues have been a concern for some years. Q1 FY 18 collections are 10% below the same period last year. This head will be well short of target as it has been for three years. There are known reasons why this is so. Budget making has been unrealistic in this head⁴¹. Dividend and profits from oil companies have fallen with low oil prices. Also, profits from the State Bank of Pakistan have fallen. Pakistan would likely miss the target of Rs. 979.8 Billion, even if markup and energy prices rebound.

**Table 6
FBR Tax Collection**

						Billion Rs.
	Budget 17-18	July-Sep 16-17	Jul-Sep 17-18	% Growth 15-16	% Growth 16-17	%Growth 17-18 Q1
Direct Tax	1,594.9	231.6	286.9	15.7	12.7	23.9
Indirect Tax	2,418.1	393.4	477.9	23.2	5.1	21.4
Total	4013.0	625.0	764.8	20.2	8.0	22.4
Other Federal Taxes and Non-Tax Revenue						
	Budget 17-18	July-Sep 16-17	Jul-Sep 17-18	% Growth 15-16	% Growth 16-17	%Growth 17-18
Other Tax	317.5	61.2	59.7	18.7	8.0	-2.5
Non-Tax	979.8	99.8	89.9	-17.4	28.3	-10.0
Total	5,310.3	786.0	914.4	11.4	11.1	16.3
Source: MoF, Fiscal Operations						
Note: Growth rate for 15-16 and 16-17 are annual figures. For 17-18 first quarter.						

⁴⁰ Op.Cit 33 Table 4

⁴¹ ibid

Expenditure

- With respect to expenditure, total Q1 current and development expenditure of the federal government is within proportional budget. The first quarter expenditure is usually slow to begin and not a good indicator of full year performance. Yet as we see below, there is cause for concern.
- Total federal expenditure for Q1 FY 18 increased by 14.7% over the same period last year and current expenditure grew by about 11.6%. Federal PSDP booked expenditure for July-September 2017 is 56% above the amount spent during the same period last year.
- GoP must keep an eye on trend of current expenditure. Budget 17-18 estimates decline in current expenditure over 2016-17 by 3.7%, whereas Q1 increase is 11.6%. Debt servicing is especially higher than estimate.

Deficit

- The year's fiscal deficit target is 4.1%. The deficit for July-September is Rs. 440.8 Billion, 1.2% of GDP, which proportionately exceeds GoP's target of 4.1% of GDP for the year. Deficit for July-September 2016-17 was 1.3% of GDP, when the year's deficit was 5.8% of GDP.
- Target deficit is contingent on provincial surplus of Rs. 347 Billion⁴². So far, the provincial surplus is Rs. 51.5 Billion⁴³. Last year, provinces generated a deficit of Rs. 163 Billion against a target of Rs. 337 Billion⁴⁴. It appears that the combination of revenue shortfall (especially from non-tax revenue) and lower than estimated provincial surplus will lead to a fiscal deficit that is higher than the target.
- Debt servicing spending is considerably more than proportionate budget. First quarter's markup payment is 33% of annual budget. This trend could continue as GoP has incurred more debt, including external debt. During July-September 2017 government borrowed an additional Rs. 637.4 Billion. Central government domestic debt grew by Rs. 526.3 Billion up to September 2017. Central government external debt increased Rs. 111.1 Billion for the period⁴⁵. In November 2017, GoP again floated a sukuk bond for USD 1 Billion and USD 1.5 Billion Eurobond at 5.625% and 6.875% markup respectively⁴⁶.
- Other heads: MoF's fiscal operations do not give details of organizations in receipt of subsidy. However, the quarter's subsidy expenditure is equal to 38% of the budget for the year. Importantly, power circular debt has climbed again. Total liabilities stand at Rs. 750 Billion. Of this, government's direct payable is Rs. 421 Billion and the rest Rs. 327 Billion

⁴² Budget in Brief, Page 51

⁴³ MoF Fiscal operations

⁴⁴ MOF, Fiscal operations 2015-16

⁴⁵ SBP, Central Government Debt Provisional (In Billion Rupees), September 2017

⁴⁶ Reuters UPDATE, Pakistan says to issue \$1 billion sukuk bond within hours

are bonds of the Power Holding Private Ltd⁴⁷. The issue of circular debt will remain until government does not reduce line losses and bills and recovers amount due from consumers. Otherwise, increase in generation capacity will increase circular debt. Without governance improvement, the power sector's sustainability will be questionable. That this has happened during a period of low energy prices and three surcharges to help meet the deficit, is surprising. Government has the tariff rationalization surcharge, debt servicing surcharge, and Neelum Jhelum surcharge. Subsidy for other PSEs also will remain as they have neither been reformed or privatized.

Table 7			
Federal Government Debt and Liabilities			
			Rs. Billion
	June 2017	September 2017	Increase July-Sep 2017-18
Total Domestic Debt	14,829.2	15,375.5	546.3
Long-term	8,298.4	7,806.9	-491.5
Federal Government Bonds	4,778.4	4,237.5	-540.9
PIBs	4,391.8	3,850.8	-541.0
Prize Bonds	747.1	777.6	30.5
Unfunded Debt	2,765.3	2,784.3	19
NSS	2,630.6	2,650.6	20
Foreign Currency Loans	4.7	4.7	0
Short Term	6,550.9	7,568.6	1,017.7
Market Treasury Bills	4,082.0	4,827.9	745.9
External Debt	5,918.7	6,029.8	111.1
Long term	5,826.2	5,928.6	102.4
Short Term	92.5	101.2	8.7
Total Federal Government Debt	20,767.9	21,405.3	637.4
Pakistan's Total Debt and Liabilities	25,062.1	25,819.9	757.8
Source:			
1. SBP, Central Government Debt Provisional, September 2017			
2. SBP, Pakistan's Debt and Liabilities Profile Provisional (In Billion Rupees), September 2017			
There is a statistical error in the Table's sub-totals, not in the total debt figure.			

⁴⁷ Business Recorder, Stock of circular debt 20 percent higher, Mushtaq Ghumman 21 November 2017

- Several other expenditures are likely to weigh on the budget. These include continued expenditure on the pressing need for border and internal security and on settlement of IDPs.
- Of the Rs. 441 Billion deficit financing for July-September 2017-18, government sourced only Rs. 8 Billion externally. Of the balance Rs. 433 Billion from internal sources, GoP has financed Rs. 24.5 Billion from non-banking sources and Rs. 408 Billion from bank⁴⁸.

While the economy is showing signs of recovery, it is critical that GoP manage the twin fiscal and current deficits. This is a major challenge that needs immediate action.

Public Debt

Federal government debt increased by Rs. 637.4 Billion in the first quarter. Of this amount, Rs. 111.1 Billion is from external sources. Within domestic debt, short term debt grew by Rs. 1,017.7 Billion during the quarter (mostly MTBs), while long term debt decreased by Rs. 491.5 Billion⁴⁹. Including PSEs debt, support from IMF, non-government, and debt liabilities, the stock of Pakistan's total debt and liabilities was Rs. 25,819.9 Billion, an increase of Rs. 757.8 Billion in July-September 2017-18.

4. Balance of Payment

After free falling for three years, dollar exports grew by 10.8% in Q1 FY 18. In 2014-15, exports declined 8% from the previous year. In 2015-16, they fell by a further 12.4% and then took another hit of 1.6% in 2016-17⁵⁰.

Imports grew by 22% during the quarter. The trade deficit for the quarter increased to over USD 9 Billion, 29.8% above the same period last year⁵¹. SBP data shows growth in July-October (fob) trade deficit to be 41%.

FY 17's trade deficit of USD 36.3 Billion was 11.9% of GDP, the highest ever⁵². SBP has voiced concern stating that "it must be acknowledged that while imports are essential ... there is a need for equivalent increase in foreign exchange earnings to finance these imports and thereby maintain the external sector's stability"⁵³ Since then, the deficit has grown further. Deficit for July-November 2017 grew to over USD 15 Billion, 28.5% above the same period last year⁵⁴.

However, exports have recovered by 10.8% for the quarter (10.5% July-November). Export increased in all sectors. The export package seems to have helped. That may have allowed exporters to compete on price, as unit value for a number of products fell. Growth in export of

⁴⁸ MOF, Fiscal operations, Table 10

⁴⁹ SBP, Central Government Debt Provisional, September 2017

⁵⁰ All figures based on PBS and MoC data.

⁵¹ PBS, Monthly summary of foreign trade

⁵² SBP, Annual State of the Economy Report 2016-17, Page 74 and Figure 6.9

⁵³ SBP State of the Pakistan Economy Q2 FY 17, Page 5

⁵⁴ PBS, Trade Summary November 2017

some major textile export items such as cotton yarn, knitwear, and readymade garments came with a fall in unit value. Bedwear and synthetic grew with increase in unit value.

Two observations are important. Pakistan's exports continue to be locked in low value added textile. Second, that Pakistan follows a price competitive strategy. This strategy means that there will always be new low-cost entrants to compete on price and that our exporters must reduce prices further. This is true especially during periods of slow growth in trade. This strategy results in frequent fiscal incentives to exporters. Their inability to upgrade products entails an expense on tax payers. It is important to build export by diversifying into new products and by pursuing a product differentiation strategy within textiles.

However, what is surprising is a lack of serious analysis about the reasons for the up and down movements. A proactive and concerted effort to increase competitiveness is needed to move to new products that are value added and processed.

Among imported goods, petroleum products grew rapidly. The increase was in all items, crude, refined, and LNG/LPG. Also, import of transport vehicles increased by 38.2%, both CBU and CKD. Import of fertilizer, plastics, and iron and steel also grew. Contrary to GoP's explanation for rising current account deficit, import of machinery has not increased. In fact, import of power generation machinery, office and construction machinery fell by double digits.

The impact of falling exports on current account deficit is significant. Declining exports and growing imports means that external debt finances Pakistan's BoP. Debt sustainability will be a concern in coming years.

The Annual Plan sets a target of 2.6% of GDP (USD 8,991 Million) for the annual Current Account deficit⁵⁵. SBP data shows that the current account deficit of 4.4% (USD 5,013 Million) for the period July-October 2017 is already more than GoP's annual estimate⁵⁶, breaching greatly the target. The current account deficit is 120% higher than for the same period last year. SBP states that "to finance the current account gap, the country had to scale up external borrowings (Figure 6.4). Most of these borrowings comprised commercial loans, including short-term ones, which exposed the economy to both rollover and re-pricing risks."⁵⁷ SBP counsels limiting import and stimulating exports.

⁵⁵ PC Annual Plan Page 90

⁵⁶ SBP Summary Balance of Payments as per BPM6 – October 2017 (using GDP for the period)

⁵⁷ SBP, The State of Pakistan Economy Annual Report FY 17, Page 72

Table 8
Trend of International Trade
July-September 2017-18 compared with July- September 2016-17

Exports					
Million USD, %					
Commodity	July- Sep 2016-17	Share in total export %	July-Sep 2017-18	Share in total export %	Change in value %
Food Group	631.7	13.5	742.4	14.4	17.5
Textiles	3,018.3	64.7	3,257.1	63.0	7.91
Petroleum & Coal	35.9	0.8	72.1	1.4	100.73
Other Manufactures	766.8	14.8	831.1	16.1	8.39
Chemicals and Pharmaceuticals	204.4	4.0	255.7	4.9	25.08
Engineering Goods	45.1	0.9	53.6	1.0	18.91
Others	213.5	4.6	268.9	5.2	25.95
Total	4,666.3		5,171.7		10.83
Imports					
Million USD, %					
Commodity	July-Sep 2016-17	Share in total import %	July-Sep 2017-18	Share in total import %	Change in value %
Food	1,359.5	11.6	1,622.0	11.4	19.4
Machinery	2,730.1	23.4	2,779.7	19.5	1.8
Transport	695.1	6.0	960.9	6.7	38.2
Petroleum	2,356.0	20.2	3,167.7	27.1	34.5
Textile	689.2	5.9	667.0	4.7	-3.2
Chemicals	1,763.4	15.1	2,101.4	14.7	19.2
Metal	927.2	7.9	1,343.5	9.4	44.9
Miscellaneous	282.7	2.4	338.9	2.4	19.9
Others	867.2	7.4	1,278.9	9.0	47.5
Total	11,670.4		14,260.4		22.2
Trade Deficit	7,004.1		9,088.7		29.8
Source: Ministry of Commerce Statistics, based on PBS data ⁵⁸					

⁵⁸ Ministry of Commerce, Trade Statistics, September 2017

Home remittance is an important external financing source for Pakistan, which could mitigate the impact of fall in exports on the current account deficit. This too has been on a plateau for more than a year. Remittance fell by 3% last fiscal year and have grown by 2% during the quarter. GoP has targeted an increase in remittances of 6.8% in 2017-18 over last year's actual⁵⁹. Last year's actual was USD 19,917 Million⁶⁰.

FDI inflows increased during the year and somewhat eased the Balance of Payment. The Annual Plan targets USD 4,183 Million as FDI for 2017-18⁶¹. This is almost twice more than last fiscal's actual of USD 2,411 Million⁶². FDI received for five months, July-November 2017-18 is USD 1,146 Million⁶³. This is 57% above the corresponding period last year. As expected, FDI has increased from China. Although private flows are hard to predict, especially with CPEC investment due, FDIs in 2017-18 will perform better than last year, though may fall short of target substantially.

Increase in external debt has financed the increase in trade deficit. External debt and liabilities increased by USD 9.29 Billion in one year from September 2016. Government debt grew by an alarming USD 4.5 Billion. Borrowings by banks grew by USD 1,863 Million, and private sector borrowing increased by USD 2,213 Million⁶⁴. Table 9 gives increase in external debt and liabilities. The last two columns give debt accumulation for the year October to September and during July-September 2017.

On 30 September 2017, foreign currency reserves stood at USD 16,243 Million, \$ 2,310 Million lower than September 2016 reserves of 18,553 Million. Reserves fell further to USD 12.6 Billion in November 2017. Since then borrowings have brought the reserves back to 14 .6 Billion on 8 December 2017. Correction in Rupee and imposition of regulatory duties (a practice with which this Institute does not agree), could dampen imports.

⁵⁹ PC, Annual Plan Page 90

⁶⁰ SBP Summary Balance of Payments as per BPM6 – October 2017.

⁶¹ Annual Plan 2017-18, Page 90

⁶² BOI Foreign Investment inflows in Pakistan(\$Millions)

⁶³ Ibid

⁶⁴ SBP Pakistan's External Debt and Liabilities - Outstanding

Table 9
Increase in External Debt and Liabilities
July-September 2017

Million USD

	Amount				
	30 Sep 2016	30 June 2017	30 Sep 2017	Increase from Sep 2016	Increase Jul-Sep 2017
A. Public External Debt	62,399	66,103	67,012	4,613	909
1. Government	52,767	56,430	57,197	4,521	767
Long term	50,938	55,547	56,237	5,299	690
Short term	1,738	882	960	--778	78
2. From IMF	6,132	6,109	6,209	77	100
3. Forex Liabilities	3,592	3,564	3,606	14	42
B. Public Sector Enterprises	2,779	2,706	2,994	215	288
C. Banks	2,956	4,507	4,981	2,025	474
Borrowing	1,916	3,291	3,779	1,863	488
Deposits	1,040	1,216	1,203	163	-13
D. Private Sector	4,514	6,416	6,727	2,213	311
E. Debt liabilities to investors	3,114	3,248	3,339	225	91
Total External Debt & Liabilities	75,762	82,981	85,052	9,290	2,071
% GDP	24.9	27.3	25.1	2.7	0.6
Official Reserves	18,553	16,242	16,243	-2,310	1
GDP Billion USD	304.3	303.8	339.2		
Source: SBP⁶⁵					

There are several structural and competitiveness factors that stop Pakistan from becoming a major source of exports. If exports do not increase, Pakistan may have to continue to borrow to finance imports. This will become a particular concern if energy prices also increase at this

⁶⁵ SBP Pakistan's External Debt and Liabilities-Outstanding

time. We hope that these imports would soon stimulate the economy and increase exports. For the present, Pakistan's debt sustainability is a major concern.

Pakistan may also review if its tariff structure supports exports. We may reorient our approach to tariff policy from one where import tariff is viewed as a source of public finance to one that supports exports. Such a review would reduce average tariff rates and do away with protection that carry high economic cost.

Table 10
Summarized Balance of Payments

	Annual Plan 2017-18	Actuals July-Oct 2017-18	Actuals July-Oct 2016-17	% Change
1. Current Account	-8,991	-5,013	-2,259	-121
Exports	23,097	7,652	6,882	11.1
Imports	48,829	17,415	13,800	26.2
Trade Balance	-25,731	-9,763	-6,918	-41.1
Remittances	20,673	6,445	6,302	2.3
2. Capital and Financial Account Balance	10,374	2,064	3,127	
FDI	4,183	937	501	
FPI	1,080	-176	1,168	-
Net Foreign Assistance	3,684	1,055	1,274	
Other investment	4,740	138	101	
3. Errors & Omissions	0	451	-71	
4. BoP deficit/surplus	1,384	-2,498	797	

Most BoP indicators have worsened, especially the trade deficit. The fragile current account is accompanied by a financial account that is equally unbalanced and a BoP in deficit.

5. Inflation

GOP's Annual Plan for 2017-18 targets a 6% inflation rate⁶⁶. Based on government's fiscal consolidation measures, a stable Rupee, and fall in international commodity prices, inflation has been well under control for the last three years. However, inflation may increase with recent adjustment in Rupee value.

For the period July 2017 to November 2017, average year on year CPI was 3.59% compared to 3.92% for the corresponding period previous year. For the same period, rate of growth in Sensitive Price dropped to 1.14% from 1.51%, last fiscal. WPI growth rate dropped to 1.69% from 3.05% in the previous. In November 2017, core inflation that includes items other than food and energy was 5.5% compared to 5.3% in November 2016. Core inflation (non-food non-energy) is higher than CPI, SPI, and WPI⁶⁷. This suggests revival in overall demand in the economy.

Food inflation has grown at a rate below overall CPI. In November 2017, year on year food inflation was 2.4%. Onion (187.02%), Tomatoes (107.51%), Rice (14.10%), Eggs (12.94%), Betel Leaves & Nuts (11.34%), Tea (10.73%), Meat (7.26%), Honey (7.24%), Readymade Food (6.38%) and FreshFruits(6.27%).

Non-food Items that increased in price include: Drugs & Medicines (15.00%), Education (12.40%), Motor Fuel, (11.81%), Kerosene Oil (10.23%), Tailoring (7.89%), Medical Tests (7.14%) Construction wage, Rates (6.97%), Personal Equipments (6.77%), Cleaning and Laundry (6.58%) and House Rent, (6.49%).

	Averages Changes %			YoY Changes for November %		
	2017-18	2016-17	2015-16	2017	2016	2015
CPI	3.59	3.92	1.86	3.97	3.81	2.73
SPI	1.14	1.51	-0.26	2.13	0.61	2.06
WPI	1.69	3.05	-2.73	2.86	2.56	-1.67

Source: Reproduced Table from PBS Monthly Review of Price Indices November 2017

⁶⁶ Planning Commission, Annual Plan 2017-18, Page 10 (Annexure II)

⁶⁷ Pakistan Bureau of Statistics, Monthly Review of Price Indices, November 2017, Table 1 and Table 1.1

Table 5
Inflation in Major Food Items, Commodities, and Services, November 2017

YoY

	Weight in CPI	Inflation %
General CPI	100.00	3.97
Food Group	34.83	3.44
Wheat flour	4.16	-0.35
Rice	1.58	14.1
Meat	2.43	7.26
Chicken	1.36	-11.73
Milk (fresh)	6.68	3.72
Cooking oil	1.75	3.42
Vegetable ghee	2.07	3.80
Fresh fruits	1.86	6.27
Pulses	0.95	Range: -20.3 to -28.4%
Onion	0.52	187.02
Tomatoes	0.41	107.51
Vegetables	1.66	-6.57
Sugar	1.04	-25.6
Tea	0.84	10.7
Cigarettes	1.39	-16.37
Clothing and Footwear	7.57	3.80
Cotton cloth	1.73	3.96
Readymade garments	0.97	4.15
Tailoring	0.88	7.89
Housing, Electricity, Gas	29.41	4.85
House rent	21.81	6.49
Electricity	4.40	0.00
Gas	1.57	0.00
Health	2.19	9.99
Drugs and Medicines	1.27	15.0
Doctors' fee	0.59	4.72
Transport	7.20	4.61
Motor Fuel	3.03	11.8
Transport Services	2.70	0.16
Communication	3.22	1.23
Recreation & Culture	2.02	0.38
Education	3.94	12.4
Restaurants and Hotels	1.23	6.38
Misc. Goods and Services	2.75	5.85

Source: PBS, Monthly Review of Prices, Annexure A, November 2017