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Economy showing signs of modest improvement: SBP Second Quarterly Report

'Half way into FY12, the economy is showing signs of a modest improvement. Preliminary data indicates that the commodity producing sector, especially agriculture, is doing better than expected. Services also seem well-placed to gain from robust retail trade activities; transportation; and increased profitability of the banking sector,' says State Bank's Second Quarterly Report for the fiscal year 2011-12 on the State of the Economy released today.

The Report, which covers the period from July to December FY12, said the ample availability of key staple crops and less than anticipated supply disruptions due to floods, played a key role in containing inflationary pressures during the period under review.

However, it pointed out that despite these positive developments, risks to macro-economic stability have, nevertheless, increased. 'Specifically, the position of the external sector weakened at a rate faster than expected; and the fall in financial and capital inflows exerted pressure both on SBP's foreign exchange reserves and on the Pak Rupee,' it said, adding that this, along with the pickup in government borrowing from SBP, complicated liquidity management. Finally, energy shortages continued to plague production activities, especially in the industrial sector, it added.

'Developments during H1-FY12 indicate that risks to macroeconomic stability are stemming from the external sector and the continued weaknesses on the fiscal side,' it said and added that in terms of the real sector, there has been some improvement since the publication of SBP's Annual Report in December 2011. 'The economy is still expected to grow in the range of 3 to 4 percent. Inflationary outlook has improved slightly on account of supply side factors (food). It is expected that FY12 inflation will fall within the range of 11.0 to 12.0 percent, with a bias towards the lower boundary,' the Report added.

It said that in spite the lower fiscal deficit during H1-FY12, containing the overall fiscal deficit to its revised target of 4.7 percent of GDP seems to be challenging. Quarterly data for previous years has shown that the deficit remains relatively higher in the second half of the year, it said, adding that the achievement of the revised fiscal deficit is dependent on the realization of: (1) the envisaged surpluses from provincial governments, which are likely to be lower than expected; (2) the non-tax revenues, which depend on inflows into the Coalition Support Fund, and the auction of 3G licenses; and (3) strict control over expenditures.

According to the Report, the burden of financing this deficit will fall on the banking system, specifically on commercial banks. Other than growing concerns about the supply of loan-able funds for the private sector, renewed government borrowing from SBP entails rising inflationary expectations in the economy, it said, adding that on external front, although the current account deficit is expected to be in the range of 1.5 to 2.5 percent of GDP, there is an upward bias to this prediction. 'Given the fall in financial and capital inflows, funding this modest current account deficit could be challenging. Market players are increasingly concerned about whether the envisaged foreign inflows will materialize in time. This, together with the scheduled repayment of IMF loans (US$ 1.1 billion) during H2-FY12, may draw down SBP's foreign exchange reserves,' the Report added.

It said that within the commodity producing sectors, major *kharif* crops are likely to achieve their target growth for FY12. The improvement in the production of minor crops and the ample availability of key staple crops has eased inflationary pressures in the food group during H1-FY12, it said, adding that this was primarily responsible for bringing YoY CPI inflation down to single digit (9.7 percent) in December 2011 – at that level for the first time since October 2009. 'However, the declining trend in headline inflation may not persist. Core inflation (non-food, non-energy) has shown no signs of receding, and more than half of the commodities in the CPI basket are still posting double-digit inflation,' it said and added that this stubbornness is attributed to a host of factors including: (1) the periodic upward revision in administered prices, especially that of petroleum products; (2) depreciation of the domestic currency, particularly during the second quarter of the year; and (3) the revival of inflationary expectations with the government borrowing from SBP since November 2011.

The Report said that within aggregate demand, there has been almost no improvement in the investment component, despite the reduction in the cost of borrowing, following the cut in SBP's policy rate. 'Loans to private sector businesses saw an expansion of only 3.5 percent in H1-FY12, compared with 8.4 percent during the first half of FY11. More importantly, fixed investment loans during H1-FY12 saw a net retirement of Rs 8.5 billion, against an expansion of Rs 8.1 billion last year,' it said, adding that the low demand for fixed investment loans is largely due to persistent energy shortages, the unfavorable law and order situation, and excess capacity in the industrial sector.

It said that demand for working capital loans has also been low; these loans saw an expansion of Rs 99.5 billion during H1-FY12 compared to Rs 131.3 in H1-FY11. This was primarily driven by: (1) the textile sector, which required less working capital as cotton prices fell, and these units still carried forward healthy profits from FY11; and (2) the inability of sugar mills to offload their stocks from last year, which constricted seasonal demand for fresh loans,' it said and added that it is pertinent to note that the government had to intervene in the sugar market by purchasing 378,000 tons of sugar through TCP. This helped sugar mills retire some of their bank borrowings, it added.

The Report said that while demand for credit was understandably low, significant government borrowing from commercial banks also ate into the supply of loan-able funds for the private sector. H1-FY12 data indicates that government borrowing for budgetary support more than doubled, compared to the same period last year, it said, adding that although the bulk of this borrowing (Rs 391.0 billion) was needed to partially settle the inter-agency receivables of PSEs in the energy sector, and the payment of subsidies to procurement agencies (popularly known as circular debt), direct borrowing for deficit financing was Rs 365.0 billion, which was higher than last year's borrowing of Rs 308.5 billion.

It said that the greater concern is the composition of government borrowing, which has tilted towards inflationary financing. Q2-FY12 data indicates that the government was unable to meet its self-imposed quarterly limit of *zero* net budgetary borrowing from SBP, the Report said and added that high frequency data shows that government borrowing from SBP picked up from November onwards, and reached Rs 219.2 billion during Q2-FY12. 'This dependence on SBP financing was because of the difficulties encountered in rolling over maturing T-bills in the month of December 2011 – a risk highlighted in SBP's Monetary Policy Statements and Annual and Quarterly Reports,' it added.

It said that the data for consolidated fiscal operations indicates a deficit of 2.5 percent of GDP for H1-FY12. 'This deficit was slightly lower compared to the first half of FY11. The good news is that this came primarily from the revenue side; FBR tax collections reached Rs 840.1 billion during H1-FY12, showing a YoY growth of 27.1 percent,' it said, and added that moreover, SBP profits of Rs 104.0 billion contributed significantly to non-tax revenues. Nevertheless, it is important to note that financing this contained fiscal deficit in H1-FY12 was challenging as compared to H1-FY11, it said, adding that as mentioned earlier, the burden of financing fell squarely on domestic sources, since the expected external inflows did not materialize. Specifically, uncertainty about inflows from the Coalition Support Fund (CSF) and the Eurobond issuances still prevails, the Report added.

The Report said that the slowdown in foreign exchange inflows has also raised concerns about country's balance of payments. Specifically, Q2-FY12 data shows that the overall external account deficit has increased to US$ 1.0 billion compared to US$ 0.8 billion in the first quarter of the year; this takes the H1-FY12 external deficit to US$ 1.8 billion, it said, adding that the composition of the BoP reveals that the current account deficit has widened to US$ 2.2 billion, against an almost nil balance during H1-FY11.

The Report pointed out that within the current account, a positive was the growth in worker remittances, which reached US$ 6.3 billion during the first half of the year. Despite these weaknesses, the size of the current account deficit should not be a major source of concern, given Pakistan's history, it said, adding that the real challenge is financing the current account deficit, as both debt and non-debt inflows have declined.

'Quarterly numbers indicate that financial/capital accounts posted a deficit of US$ 0.4 billion during Q2-FY12, which implies that the overall external deficit had to be financed by drawing down foreign exchange reserves, the Report said, adding that hence, SBP's foreign exchange reserves saw a reduction of US$ 1.9 billion during H1-FY12 to US$ 12.9 billion. This decline in reserves was accompanied by a depreciating Pak Rupee, which lost 4.4 percent of its value during the first half of the year, it added. (The complete text of the Report is available on SBP website: www.sbp.org.pk)

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