1 Overview

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Entering the second quarter of FY11 (in October 2010), the pessimism following the catastrophic floods in August started to dissipate. Although many challenges remain, and some new ones have appeared, it is important to take stock of what happened in Q1-FY11, and how things have played out since.

Although the floods dominated Q1-FY11, persistent problem on the fiscal front, which spilled-over in terms of excessive government borrowing from SBP, still continue to plague the economy. Beyond this, the circular debt in the power sector, and a subsequent issue in the government's commodity operations, created challenges for SBP and the banking system that persist even today.

Table 1.1: Selected Economic Indicators

		FY09	FY10	FY11
Growth rate (percent)				
LSM	Jul-Jan	-5.3	3.0	1.0
Exports (fob)	Jul-Feb	3.5	1.9	24.6
Imports (cif)	Jul-Feb	-1.5	-8.2	17.3
Tax revenue (FBR)	Jul-Jan	23.0	10.2	10.9
CPI (12 month ma)	Feb	21.7	12.6	13.9
Private sector credit	Jul-Mar	3.8	4.8	6.7
Money supply (M2)[1]	Jul-Mar	2.1	5.7	9.4
billion US dollars				
Total liquid reserves[2]	End Feb	10.6	15.1	18.1
Home remittances	Jul-Feb	4.9	5.8	7.0
Net foreign investment	Jul-Jan	1.9	0.9	1.2
percent of GDP[3]				
Fiscal deficit	Jul-Dec	2.0	2.7	2.9
Trade deficit	Jul-Feb	7.2	5.4	5.4
Current a/c deficit	Jul-Feb	4.9	1.7	0.05

1. Up to 19th March
2. With SBP & commercial banks
3. Based on full-year GDP in the denominator.

At a macro level, the stalled IMF program centered on the growing fiscal deficit, which forced the government to seek a nine-month extension in the Standby Arrangement (SBA) to September 2011. Only recently (March 15th 2011) have discussions made a partial breakthrough via a *Presidential* Ordinance – fiscal measures were announced to increase revenues and curb expenditures.[1] The revenue measures have focused on removing exemptions on GST and further burdening existing

[1] The government announced various measures amounting to Rs 210 billion. It plans to curtail expenditures by 120 billion (Rs 100 billion cut in PSDP and Rs 20 billon by controlling current expenditure) and generate an additional Rs 90 billion (Rs 53 billion by introducing new tax measures and Rs 37 billion by plugging leakages).

income tax payers.

Although this is a positive step, it reveals just how stubborn the underlying revenue problem is. Increasing the tax base is without doubt the toughest structural reform to implement, and the one that needs the greatest political will. Hence, the sense of stagnation/resistance is understandable; however, one should realize that a more credible break-through in this area, would pave a much easier path for Pakistan's economy going forward.

Another positive in Q1-FY11 was the rising price of high value-added textiles in the international market. The gradual increase in Q1-FY11 accelerated in Q2, as shown by the underlying price of raw cotton.[2] This positive shock; record inflows of worker remittances; disaster relief and Coalition Support Funds, have helped keep the external sector comfortable. This has built Pakistan's FX reserves to record highs; kept the PKR stable; shifted income to the rural sector; and increased private sector credit disbursement. Going forward, pressures could build on the external sector in the last quarter of FY11 (April to June 2011), which could be compounded by the recent trajectory in international oil prices.

In terms of the real sector, SBP's growth projection has not changed from the 2-3 percent range disclosed in Q1-FY11. Although the cotton crop and rice were adversely impacted by the floods, the impact was not as bad as initially anticipated. More importantly, there has been an upside to the floods in terms of the increased area under cultivation for wheat and better recovery from sugarcane. While the wheat production target of 25 million tons appears ambitious, it is expected that Pakistan may actually meet this target.[3] This may also be the case for rice and sugarcane, which will impact the economy in FY12.

However, on the manufacturing side, the acute energy shortage (especially gas) and the prevailing political uncertainty have hampered productive activity – the fertilizer sector has been particularly affected because of inadequate gas supplies. Similarly, some textile units have been forced to suspend operations because of insufficient energy. As the country moves into summer, the power shortage is likely to get worse, while the gas situation should improve as household usage for heating eases.

[2] Cotton prices increased 44percent in Q2-FY11, and between January 2011 and March 7th 2011, there has been a further 56percent increase. This data is an average of 7 markets for FIBER, sourced from Haver Analytics.
[3] This should be put into context: FY10's wheat production was 23.9 million tons.

On another positive note, the boost to the rural economy from high wheat support prices last year continues in the form of higher cotton prices. Anecdotal evidence suggests that rural demand for automobiles was higher than anticipated, making up for slightly below target demand from the urban sector. Having said this, the after-flood reconstruction activity that had been anticipated, has not materialized; the primary reason being the already stretched fiscal accounts and cuts in PSDP. Hence, economic activity in construction (and its affiliated sub-sectors) has been less than anticipated, and is likely to stay this way.

Looking at inflation, the outlook is not heartening. Although our projections for FY11 have eased marginally to 14.5-15.5 we fear that inflationary expectations are becoming engrained. It is important here to make a distinction between *administered* and *non-administered* prices: popular perception regarding inflation tends to focus on administered prices (e.g. retail fuel prices, power tariffs, wheat support price) over which SBP has little control. However, we believe fiscal slippages and excessive use of central bank financing – which the public correctly sees as printing currency notes – has become increasingly instrumental in price/wage-setting behavior. This is where inflationary expectations come into play, in terms of pushing non-administered prices. More simply, the link between SBP financing and non-administered prices is becoming more visible.

Unless, monetary policy can credibly limit government borrowing from SBP, it will be difficult to change inflationary expectations. Furthermore, SBP is aware of the impact of high interest rates on the private sector. In the January 2011 monetary policy decision, SBP surprised the market by opting to hold rates. As explained in our last *Monetary Policy Statement*, there were two reasons for this: one, the comfort on the external sector; and two, an understanding with the government that it would limit its use of central bank financing to levels as of end-September 2010. Going forward, further action on our part would be determined by how these two issues play out, and how inflationary expectations evolve.

On the fiscal side, the unending debate about the RGST (and lack of progress) captures the real problem. Having said this, several revenue measures have been announced in mid-March 2011: (1) a 15 percent flood surcharge on existing income tax payers; (2) GST exemptions on fertilizer, pesticides, tractors, sugar and plant & machinery have been removed; and (3) the Special Excise Duty has been increased from 1.0 percent to 2.5 percent. Although these tentative steps are needed, we still think the government's revenue targets are ambitious, and maintain our projection that the fiscal deficit for FY11 will be in the range of 5.5 percent to 6.5 percent of GDP.

We also remain concerned that recent political support given to populist demands may further undermine the reform process – more specifically, resistance to the pass-through on POL and power tariffs; restructuring of loss-making public sector enterprises (PSEs); and implementing the RGST.

In our view, the consistent cutting in development spending (PSDP) to meet deficit targets, suggests there are only three avenues that Pakistan can take – exceptional steps to increase fiscal revenues; reforming loss-making PSEs; and eliminating end-user subsidies. On the revenues side, although RGST has become the focal point, addressing revenue leakages and glaring exemptions (e.g. agriculture and ineffective taxation of properties) needs serious attention.

As mentioned earlier, the external sector is comfortable. During Jul-Feb FY11, Pakistan's current account deficit was only US$ 98.0 million, against US$ 3,027 million in the corresponding period in FY10. Strong dollar-denominated export growth of 20.3 percent (on the back of high prices of textiles), sluggish manufacturing & consumer demand (reflected in the 12.7 percent growth in imports), and strong remittances (up 18 percent over FY10); are primarily responsible for the improvement. Having said this, net foreign inflows in the *Financial Account* have declined sharply, as the stalled IMF program has stopped inflows from other IFIs and bilateral donors. Nevertheless, the improvement in the current account has pushed Pakistan's FX reserves to record highs, while the PKR remains stable.

Table 1.2: Projections of Major Macroeconomic Indicators

	FY10		FY11
	Actual	**Annual plan targets**	**SBP projections**
growth rates in percent			
GDP*	4.1[P]	4.5	2.0 – 3.0
Average CPI inflation	11.7	9.5	14.5-15.5
Monetary assets (M2)	12.5	-	14.5 – 15.5
billion US Dollars			
Workers' remittances	8.9	9.0	10.0-11.0
Exports (fob-BoP data)	19.6	20.0	23.0-24.0
Imports (fob-BoP data)	31.1	31.7	34.5- 35.5
percent of GDP			
Fiscal deficit	6.3	4.0*	5.5-6.5
Current account deficit	2.0	3.4	1.0-1.5

[R]: Provisional; (*): Overall fiscal deficit target announced in the federal budget; however, this number rose to 5.3 percent of GDP as per announced consolidated federal and provincial budgets.
Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the Budget document for FY11, while their projections are based on provisional estimates of nominal GDP for the year.

1.2 Outlook

Although we do not have formal data for the period Jan-Mar 2011, a preliminary assessment suggests that the external sector will remain comfortable. We remain cautiously optimistic about progress on the fiscal side, as shown by the recent fiscal measures to reduce the gap by Rs 210 billion this fiscal year. On the banking side, the increase in textile lending may slow down as international

cotton prices fall from their recent peak, and seasonal demand for credit eases. We also expect banks to channel increasing volumes of credit to the government, crowding out the private sector further because of a high fiscal deficit and blockages in external assistance.

A point made earlier needs to be emphasized – even though some revenue measures have been taken recently, the targets for the year may still be ambitious. If implementation is weak, this could affect planned external inflows from the IFIs. With fiscal pressures and below-target external funding, domestic financing pressures could increase; this will either crowd out the private sector further, or result in unwelcome borrowing from SBP, which in turn could reverse some of the positive steps taken to date to address the country's macroeconomic problems.

To get better handle on the outlook for Pakistan's economy, we would list four issues that need to be closely monitored: (1) the upside on agriculture in *rabi* FY11; (2) the status of the IMF program and fiscal pressures; (3) the risk-averse behavior of commercial banks; and (4) the price of oil. Clearly, the uncertain investment horizon and an adverse Law & Order situation – related to the fight against extremism – will also strongly influence this outlook.

In our view, despite the staggering humanitarian cost of the August 2010 floods, there is a possible upside for the agriculture sector. Other than better-than-expected wheat production this year, we are also optimistic about cotton, sugarcane and rice in FY12. In fact, recent weather conditions may help – the unexpectedly large snowfall this winter will help our *kharif* crops when the snow melts, while cotton could get a boost with the shift to BT Cotton. Although targets for the next crop have not been firmed up yet, there is a view that the target for FY12 could be as high as 17.0 million bales, against FY11's target of 14.5 million bales and actual output of 11.7 million bales. The possible upside to GDP in FY12 – if this were to happen – could be significant.

Pakistan's discussions with the IMF have been difficult primarily because of socio-political resistance to paying taxes. Hence, it is not surprising that the program is suspended, and even some of the recent tax measures may be viewed as second-best, being one-off in nature. Looking ahead, perhaps measures like the withdrawal of exemptions from GST signal a more inclusive and aggressive intent for the FY12 Budget – recent FBR efforts to identify wealthy non-payers is a good sign in this regard.

The government appears to be working with key stakeholders (Pakistan's political leadership) to implement policies, which may not get the necessary support from

their financial and political constituencies. However, we remain optimistic that multi-partisan efforts will resolve this stubborn economic impediment. We hope that despite these fiscal challenges, the government continues to meet its commitment (to SBP) to stay below its end-September 2010 level of borrowing from the central bank.

Related to the previous point, we expect the government to continue shifting its borrowing needs to commercial banks. In our view, banks would be happy with this, as it reduces their risk-weighted assets, which is especially important given the increase in NPLs. The downside is that banks' appetite for private sector risk appears to have dried up, which is not a good omen for economic growth and employment generation. Commercial banks appear almost to have given up their role as *financial intermediaries*.

Finally, the real fear is the rising price of oil. If political uncertainty remains and spreads further in the Middle East/North Africa (MENA) region, oil prices could increase even more sharply than the recent past. Although this will hurt the global economy quite severely, the impact on Pakistan could be disproportionately larger.

The lack of fiscal space implies that domestic POL prices will have to match international prices, which means further pressure on inflation – especially food inflation. Given the increasing use of imported furnace oil for power generation, tariffs will also have to increase, which could raise social and political pressures. Then there is the issue of the circular debt in both the power sector and commodity financing, which continues to burden the fiscal side.

Beyond this, the impact on the rest of the economy could be as follows: oil prices will hit the external sector (this impact could be compounded with softer cotton prices); POL increases will hit the demand for automobiles and construction (and its affiliated sub-sectors); and rising furnace oil prices will exacerbate the energy shortfall that currently exists.

In the final analysis, one can only hope that the world is not in for another oil price shock.

1.3 Executive Summary

1.3.1 Real Sector

Although floods adversely affected real sector performance in Q1-FY11, recent data indicates evidence of a nascent recovery. The ongoing economic revival in developed markets post the financial crisis has led to tangible improvement in orders for export-based industries; furthermore, inflow of workers' remittances and better agri prices continue to provide impetus to domestic demand.

In the agriculture sector, the *rabi* crop is expected to partially compensate for flood-related losses suffered during the *kharif* season. Barring unfavorable weather, wheat production in particular will benefit from: (1) above-average water levels in reservoirs; (2) provision of high-quality certified seeds to farmers in worst flood-hit areas; and, (3) a bullish global price outlook. Whereas the recovery in agricultural production may be quicker than originally anticipated, it is unlikely to be broad-based. Excluding the wheat crop, agricultural growth for FY11 could remain below target since many challenges created by the floods are yet to be overcome.

LSM production registered positive growth from December 2010 onwards for the first time in four months. Improvement in automobiles and sugar mainly contributed to LSM recovery. However, many industries continue to face operational constraints which have hampered production in recent months. Most notably, gas supply shortages have affected the value added textiles, fertilizers and chemicals sectors, which are vital towards sustaining the improvement in LSM performance.

It is expected that revival in the commodity producing sector will also support growth in the services sector through the remaining FY11. Activity in *transport, storage and communication* may dampen in response to higher prices for high-speed diesel (HSD). However, this will be more than offset by an increase in demand for services due to record wheat production and country-wide rehabilitation efforts after the floods.

Going forwards, some of the key risks to real sector performance originate from persistent energy shortages, rising prices for oil and industrial inputs as well as further reductions in development spending due to fiscal constraints.

1.3.2 Prices

Flood related supply shocks, rise in global prices and monetization of the fiscal deficit continued to exert pressure on prices, keeping inflation in double digits during H1-FY11. However,YoY inflation, moderated somewhat during Jan-Feb 2011, on account of wearing-out of flood related rise in food inflation and delays in increasing domestic retail fuel prices in line with international oil prices.

Inflationary pressures are likely to remain strong through the rest of FY11 since continuation of the IMF program would require additional revenue generation measures and upward adjustments in power tariffs . These actions would initally add to inflation. As such, despite recent moderation in inflation, SBP expects end year inflation in the range of 14.5-15.5 percent.

1.3.3 Money and Banking

Broad money supply (M2) expanded by 7.7 percent during the first eight months of FY11 as compared to 5.7 percent in the corresponding period last year. There was a visible improvement in the composition of money supply since lending to the private sector gained traction in Q2-FY11 and the external account position improved significantly.

However, government borrowing continued to fuel demand-side pressures in the economy and accounted for majority of the increase in Net Domestic Assets (NDA). Since key structural reforms agreed with the IMF were delayed, funding from other multilateral donors was temporarily withheld. Flood related expenditure and rising oil prices exerted an additional toll on the public finance position. Consequently, the government relied heavily on borrowing from scheduled banks.

In spite of strong credit demand from the public sector, money markets remained comfortably liquid in Q2-FY11. The number and average size of OMO (Open Market Operation) injections decreased significantly; in fact, SBP occasionally stepped in to mop-up excess liquidity. Among other factors, liquidity conditions improved due to retirement of commodity loans following the government's decision to export surplus wheat stocks, and due to retirement of loans by oil refineries.

Consequently, banks were in a comfortable position to lend to the private sector in Q2-FY11. Demand for trade finance and working capital loans was particularly strong amongst industries facing higher input prices, most notably the textile sector. On the flip side, loans for fixed investment declined sharply.

1.3.4 Fiscal

The overall fiscal position worsened during H1-FY11 as the budget deficit increased to 2.9 percent of GDP from 2.7 percent in the corresponding period of the previous year**.** Flood and security related expenses more than offset the substantial growth in non-tax revenues during the second quarter of FY11. Thus, despite the recently announced budgetary measures, the fiscal deficit for FY11 could exceed the target of 5.3 percent of GDP.

More worryingly, financing of this fiscal deficit has become more challenging since external funding from IFIs and multilateral donors has dried up in view of suspended IMF program. In this situation, the government is relying heavily on borrowings from the banking system – this not only exert pressure on short-term interest rates but also adversely impacts inflationary expectations.

1.3.5 External

Pakistan's external accounts posted a surplus of US$1.6 billion during Jul-Feb FY11 compared to a surplus of US$ 0.5 billion in the corresponding period of the previous year. The improvement in the country's external accounts is owed to contraction in the current account deficit, which declined to US$ 0.1 billion during Jul-Feb FY11 from US$ 3.0 billion in the corresponding period last year. As against the current account, financial account surplus declined significantly during the period under review.

Although current transfers and services contributed significantly to the improvement in the current account balance, the most encouraging development during Jul-Feb FY11 was the 23.7 percent growth in exports. Going forward, the current account could deteriorate slightly on account of rise in imports, which may increase in response to higher international commodity prices, especially of oil.

As against the current account, the financial account deteriorated in H1-FY11 due to fall in both investments and loans. Improvement in financial account is dependent on the resumption of the IMF program. Nevertheless, despite the fall in financial flows, surplus in overall external account led to increase in forex reserves to a record level and also kept the exchange rate stable.