

THE STATE OF PAKISTAN'S ECONOMY

**Second Quarterly Report
for the year 2010-2011 of the
Central Board of State Bank of Pakistan**



State Bank of Pakistan

CENTRAL BOARD OF DIRECTORS

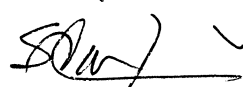
Mr. Shahid H. Kardar	Governor & Chairman
Dr. Waqar Masood Khan	Member
Mr. Zaffar A. Khan	Member
Mirza Qamar Beg	Member
Mr. Asad Umar	Member
Mr. Waqar A. Malik	Member
Ms. Sahar Z. Babar	Corporate Secretary

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
April 08, 2011

Dear Mr. Chairman,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the Second Quarterly Report for the year 2010-11 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

Yours sincerely

Shahid H. Kardar
Governor


Mr. Farooq H. Naek
Chairman
Senate
ISLAMABAD

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
April 08, 2011

Dear Madam Speaker,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the Second Quarterly Report for the year 2010-11 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

Yours sincerely

Shahid H. Kardar
Governor

Dr. Fehmida Mirza
Speaker
National Assembly
ISLAMABAD

ACKNOWLEDGMENT

I would like to thank Mohib Kamal Azmi, who was the Publication Manager for this Quarterly Report. The entire staff of Economic Policy Review Department (EPRD) assisted in putting it together. Going forward, Sector Specialists contributing to these publications will be listed by their area of specialization.

Dr. Mushtaq Khan
Chief Economic Advisor – Policy Development

<i>Contents</i>	<i>Page No.</i>
1. Overview	1
1.1 Overview	1
1.2 Outlook	4
1.3 Executive Summary	7
2. Real Sector	11
2.1 Overview	11
2.2 Agriculture Sector Performance	12
2.3 Large Scale Manufacturing	15
2.4 Services	18
3. Prices	21
3.1 Overview	21
3.2 Consumer Price Index	24
3.3 Wholesale Price Index	24
3.4 Sensitive Price Indicator	25
4. Money and Banking	27
4.1 Overview	27
4.2 Monetary Aggregates	28
4.3 Private Sector Credit	29
4.4 Non-Performing Loans	30
4.5 Money Market	30
5. Fiscal Developments	33
5.1 Overview	33
5.2 Expenditures	34
5.3 Revenues	36
5.4 Domestic Budgetary Financing	38
5.5 Government Domestic Debt	40
6. External Sector	43
6.1 Overview	43
6.2 Current Account Balance	45
6.3 Financial Account Balance	48
6.4 Foreign Exchange Reserves and Exchange Rate	50
6.5 Trade Account	52

1 Overview

1.1. Overview.

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.

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

Table 1.1: Selected Economic Indicators

		FY09	FY10	FY11
<u>Growth rate (percent)</u>				
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
<u>billion US dollars</u>				
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
<u>percent of GDP³</u>				
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.

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 billion 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.

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

Table 1.2: Projections of Major Macroeconomic Indicators

	FY10		FY11
	Actual	Annual plan targets	SBP projections
<i>growth rates in percent</i>			
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
<i>billion US Dollars</i>			
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
<i>percent of GDP</i>			
Fiscal deficit	6.3	4.0*	5.5-6.5
Current account deficit	2.0	3.4	1.0-1.5

^P: 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.

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 initially 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.

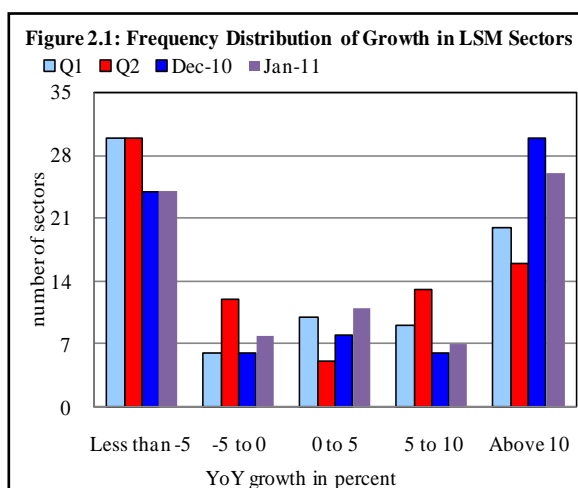
2 Real Sector

2.1 Overview

The latest available economic data indicates that the economy has fared better than expected in the aftermath of the most devastating floods in the history of Pakistan. A mild recovery is discernable, supported mainly by improvement in external demand and rise in domestic economic activity.

Specifically, while the ongoing recovery in advanced economies brought about a revival in export industries; the rise in farm-income¹, strong growth in the remittances, higher loan disbursements and transfer payments² stimulated consumption demand. As a result, number of LSM sectors posted positive growth in December 2010 and January as the index increased by 2.5 percent and 0.8 percent YoY. (see **Figure 2.1**).

More importantly, it appears this recovery is sustainable given: (1) prospects of a record wheat crop; (2) increase in *phutti* arrivals at the ginning factories during Jan-Feb FY11 amid growing textile export orders;³ (3) a sharp rise in loan disbursements to private businesses in December and January;⁴ (4) expected increase in construction activities in the northern areas, March 2011 onwards; and (5) improvement in trade-related and financial services.



¹ Due to higher prices of cotton, rice and sugarcane.

² For instance, Rs 31.0 billion were disbursed through *Watan cards* to flood affected families during Jul-Dec FY11 (for details, please see **Chapter 5**).

³ Farmers are offloading cotton which they had held back in Q1-FY11 to fetch better prices.

⁴ Disbursements to private business sector increased by 32.4 percent in Dec-Jan FY11 over Dec-Jan FY10.

Persistent energy shortages and escalation in global commodity prices (especially oil) are some of the threats that can suffocate this nascent recovery. Rise in oil prices and various industrial input prices due to supply disruptions and strengthening demand in emerging economies, have already generated concerns over inflation and the external imbalance. The situation becomes all the more serious as the growing fiscal deficit has precluded possibility of any government stimulus, and monetary easing is not possible because of persistence in inflationary pressures. The external imbalance could also amplify, particularly, in the absence of financial inflows that hinge on the resumption of the IMF program. With opportunities and threats more or less balanced, the SBP has maintained its initial forecast for GDP growth at 2.0 to 3.0 percent.

Table 2.1: Performance of Major Crops

Crops	FY09	FY10 ^P	FY11 ^T	FY11 ^E	YoY growth in FY11
Area under cultivation (000 hectares)					
Cotton	2,850	3,106	3,200	3,142	1.2
Sugarcane	1,029	943	1,070	1,047	11.0
Rice	2,963	2,883	2,708	2,642	-8.4
Wheat	9,046	9,105	9,045	-	-
Gram	1,092	1,050	1,122	-	-
Maize	1,062	950	1,010	-	-
Production ('000 tons; cotton in '000 bales of 170.09 kg each)					
Cotton	12,060	12,914	14,010	11,700	-9.4
Sugarcane	50,045	49,373	53,665	49,400	0.1
Rice	6,954	6,883	6,048	5,949	-13.6
Wheat	24,032	23,917	25,000	25,000 ^f	4.5
Gram	740	571	619	-	-
Maize	3,548	3,477	3,452	-	-
Yield (Kg/hectare)					
Cotton	720	707	745	633	-10.4
Sugarcane	48,635	52,357	51,000	47,182	-9.9
Rice	2,347	2,387	2,228	2,252	-5.7
Wheat	2,657	2,627	2,764	-	-
Gram	696	544	552	-	-
Maize	3,341	3,660	3,419	-	-
P: Provisional, T: Target; E: Provisional estimates; f: SBP forecast. Source: Ministry of Food & Agriculture estimates released on November 1, 2010.					

2.2 Agriculture Sector Performance

Agricultural performance during *rabi* FY11 is likely to compensate for some of the flood related losses sustained during *kharif* (see **Table 2.1**). Improved prospects for *rabi* stem from better availability of water and higher prices of most agricultural produce – particularly wheat.

The country is likely to see a record wheat crop of 25 million tons - barring unfavorable weather at the time of harvest. In addition to water, the availability of high yield certified seeds, and a bullish price outlook (that saw an increase in the area under cultivation) bode well for the outlook for wheat. The government's

decision to provide seeds free of cost in the areas worst hit by the flood, further supports our positive outlook for wheat.

While a faster than anticipated recovery in agriculture is a welcome development, it does not imply that the adversities of the floods have been entirely overcome; FY11 growth in agriculture apart from wheat will still be substantially lower than the target (see **Table 2.1**).

Agriculture Credit

Agri-credit disbursement fell by 4.4 percent in H1-FY11 compared with a 6.9 percent increase in the same period last year. This fall in disbursements is largely due to a decline seen in one specialized bank⁵ which more than offset the rise in disbursements made by commercial banks.

This divergence between commercial and specialized banks' agri-credit performance must be seen in the context of a sharp rise in the latter's NPLs; they increased to 18.8 percent by Dec- 2010 from 15.6 percent in Dec-2009. This reflects the exposure of specialized banks to the farm sector that was worst hit by the flooding.

More disturbingly, the decline in credit to the farm sector was stronger in the case of

subsistence (small) farms (see **Table 2.2**). This is due to both demand and supply factors: rising prices of agri produce have resulted in improved cash flows for small farmers, reducing their demand for bank credit; while on the supply-side, commercial banks remain risk averse in the face of rising NPLs.⁶

Table 2.2: Sector -wise Agri-credit Disbursement Growth percent

	FY08	FY09	FY10	FY11
Subsistence holding	-3.5	10.7	3.0	-15.1
Economic holding	1.3	6.1	14.2	-6.1
Above economic holding	84.8	-18.1	10.1	-8.7
Farm credit	7.0	4.4	6.6	-12.0
Small farm	-16.9	45.5	12.7	10.9
Large farm	333.9	21.8	6.1	13.5
Non-farm credit	147.5	26.0	7.4	13.0
Total	25.9	10.2	6.9	-4.4

⁵ ZTBL posted a fall of 31.0 percent in credit disbursement during Jul-Dec FY11 compared with 9.7 percent growth in the corresponding period last year. The share of ZTBL in total disbursements also fell from 28.6 percent to 20.6 percent.

⁶ See **Chapter 4**.

In addition, lower demand for bank credit, particularly in the case of sugar, is also the result of a partnership between sugar mills and farmers, whereby the former provide high yield variety seeds and in turn secure raw materials (see **Box 2.1**). This arrangement is likely to lower fluctuations in sugarcane output by lessening conflicts between growers and millers.

Looking forward, agri-credit could improve in the coming months due to expected increase in fertilizer off-take for wheat, and early sowing of *kharif* crops—as farmers are optimistic due to high prices—particularly for cotton.

Box 2.1: Private Sector and Agriculture Extension

The private sector in Pakistan is a significant source of advisory services to farmers.¹ According to growers, private sector recommendations are useful, up to date, timely, accurate and consistent with their farm situation. These companies supply fertilizers and high yield varieties of seeds, as well as provide credit. This reduces farmers' demand for institutional credit. Following are a few examples:

- (a) Local sugar mills provide high quality seeds, fertilizer, new growing techniques and introduce high yield varieties, with the contract that growers will sell their produce to the mill. This is not only beneficial to farmers in terms of higher output, but mills are also able to secure supplies of raw material.
- (b) Some high yielding maize/corn varieties were introduced by Pioneer Seed Company. In addition, they provided training to farmers on new planting methods and provided assistance on how to control pest attacks.
- (c) Dairy companies are providing not only veterinary assistance, but also training dairy farmers on fodder production, hygiene, milking practices and construction of cowsheds.

The increasing cooperation between farmers and key market players in the private sector bodes well for the agri growth in coming years.

Source: The role of private sector in agriculture extension; rural development news 2010.

Fertilizer

Fertilizer off-take for Jul-Dec FY11 declined 13.6 percent over the corresponding period of the previous year (see **Table 2.3**). This decline was entirely in Q1-FY11, due to floods and a high base set in Q1-FY10 when farmers bought aggressively owing to lower prices. Subsequently, some pick-up was seen in Q2-FY11, which is likely to continue due to the bright outlook for wheat crop.

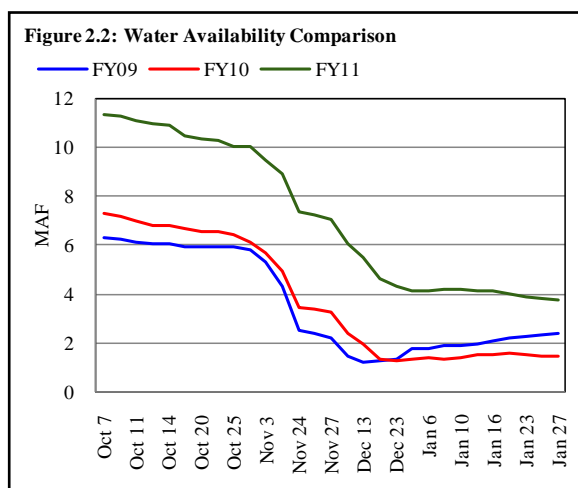
Both DAP and urea, saw lower off-takes in H1-FY11 compared with last year. In the case of DAP, this is probably due to a surge in prices. Average DAP prices rose by 41.2 percent during H1-FY11.

Water Availability

Canal headwater availability for the *rabi* season increased to its highest level since FY11 due to heavy monsoon rains. This improvement in water availability was instrumental in increasing the area sown under wheat in the canal fed areas, that accounts for approximately 87 percent of the total area under wheat cultivation.

The area under wheat also increased in non-irrigated (*barani*) areas due to enhanced soil moisture from heavy monsoon rains. Wheat yields are also likely to have benefited from winter rains throughout the country.

Collective storage at major reservoirs, at the beginning of *rabi* FY11 was about 4 million acre feet (MAF) higher than the corresponding period of FY10 (see **Figure 2.2**). Even by end-January 2011, water storage at major reservoirs was around 3.6 MAF as compared to only 1.4 MAF last year.



2.3 Large-scale Manufacturing

After recording flood-related production declines for four consecutive months, LSM posted positive growth in December 2010 onwards despite chronic energy shortages and weak textiles performance. Recovery in LSM was expected given the improvement in sugar⁷ and robust growth in automobiles loans during Oct-Nov 2010, which had strengthened

Table 2.3: Fertilizer Off-take (Jul-Dec)

million tons				
	FY09	FY10	FY11	% change in FY11 over FY10
Urea				
Jul-Sep	1.33	1.67	1.15	-30.7
Oct-Dec	1.46	1.84	1.93	4.9
Jul-Dec	2.79	3.51	3.09	-12.0
DAP				
Jul-Sep	0.13	0.62	0.35	-42.7
Oct-Dec	0.48	0.60	0.64	7.7
Jul-Dec	0.61	1.21	1.00	-18.0
Total				
Jul-Sep	1.46	2.28	1.51	-34.0
Oct-Dec	1.94	2.44	2.57	5.6
Jul-Dec	3.40	4.72	4.08	-13.6

⁷ Improvement in the sugar owed to better recovery rate on account of high moisture content.

expectations of a rise in automobile production in subsequent months.⁸ Not surprisingly therefore, a large part of LSM growth in Dec-Jan FY11 was contributed by these two sectors (see **Figure 2.3**).

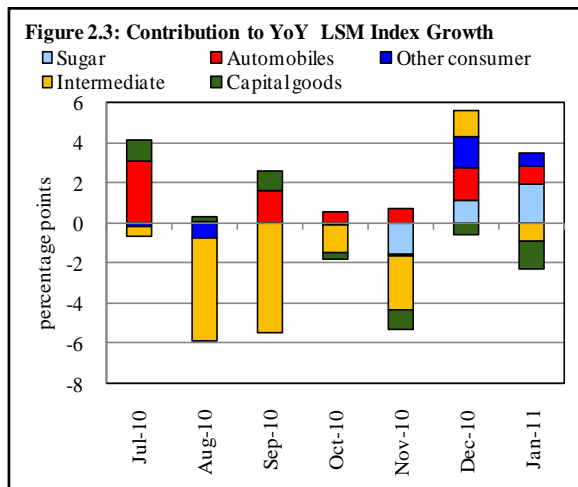
Textiles sector suffered heavily from the loss of cotton crop while other industries that are heavily dependent on gas were adversely affected by shortages in gas supply. Fertilizer industry, in particular, could not operate at full capacity, from December to February, due to planned gas curtailments. Similarly, a large number of value-added textile units reportedly had to close down in Punjab due to severe gas shortages resulting in production and employment losses.⁹

Issue facing low value-added textile was the rise in cotton prices. Production in low value added sectors (i.e., spinning and weaving) was expected to increase October 2010 onwards, following easing of restriction on cotton exports by India. However, Indian government extended these restrictions, due to which, local textile manufacturing suffered input shortages.

Going forward, there are prospects of further improvement in some LSM sub-sectors. For instance, demand for consumer durables is likely to remain strong on the back of a potential record wheat crop and from higher wheat prices. Automobiles demand, in particular, could strengthen due to increase in rural incomes.

Rise in automobile sales, in turn, is expected to strengthen demand for petroleum products, especially motor spirit.

However, given capacity constraints, production of motor spirit cannot increase

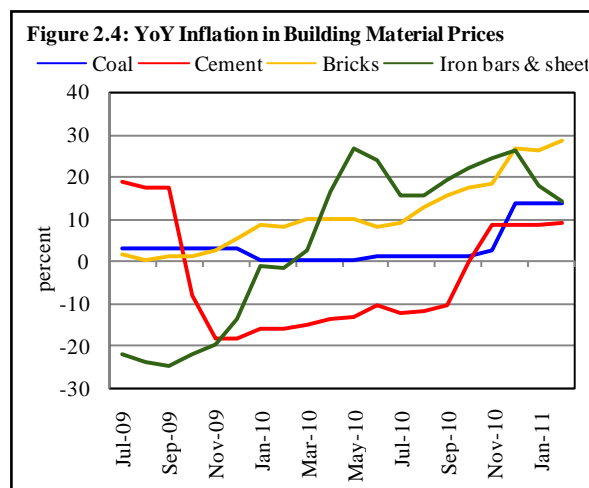


⁸ During Oct-Nov FY11, banks disbursed Rs 12.4 billion for the purchase of automobiles compared with Rs 3.2 billion in Oct-Nov FY10. However, disbursements declined by 54 percent YoY during Dec-Feb FY11.

⁹ Anecdotal evidence suggests that almost 30 percent of textile units in Faisalabad have closed down due to multiple crises, including gas load shedding.

significantly and the additional demand is likely to be met through imports. Production of other petroleum products, especially HSD and furnace oil, is likely to remain strong as the recovery in gross refining margins (GRMs) during FY11 has slightly improved financial conditions of local refineries. Rise in capacity utilization levels during January and February 2011 supports this argument.

As far as the cement sector is concerned, it is expected that once the construction sector resumes activities in the post-winter season, production of cement and steel (in the private sector) would increase.¹⁰ Domestic cement manufacturers are eyeing at expected initiation of private construction projects (spring onwards) as any impetus from the public sector seems highly unlikely.¹¹ A key downside risk, however, is the supply-related rise in international coal and steel prices that are strengthening domestic price pressures on building materials (see **Figure 2.4**).¹²



In overall terms, demand for manufacturing goods appears to be strong in both the domestic and international markets, but supply-related commodity price pressures, can potentially weaken domestic demand. Domestic production is also vulnerable to energy shortages, which have worsened in recent months due to severe winters in the northern region.¹³

The resilience of local manufacturing sector will once again be tested in the summer when household and commercial demand for electricity will widen the

¹⁰ Construction activities typically decline in winters, Nov-Jan, and pick up February onwards.

¹¹ Given fiscal limitations and cut in budgeted PSDP.

¹² Due to severe floods in Australia and coal mine accidents in other key coal producing countries, world coal supplies have declined sharply January 2011 onwards.

¹³ According to news reports, textile firms in Faisalabad and adjacent areas received gas for only 3.5 days a week throughout January and February 2011 and this availability has been further reduced to only 2 days, 25th February onwards.

demand-supply gap. Production processes particularly, in metals and automobile sector depend heavily on uninterrupted power supplies.

2.4 Services

Unlike commodity producing sector, services are likely to show good performance during FY11 (see **Table 2.4**). In particular, country-wide rehabilitation and relief operations after the floods would contribute in the form of special payments to flood affectees, which will show up in *community & social services* sub-sector. The activities in *wholesale and retail trade* have remained sluggish during H1-FY11 due to decline in manufacturing and flood-related crop/livestock losses, although there is anecdotal evidence that trade activity is up in recent months. The expected record wheat production in *rabi* FY11, and modest rise in manufacturing activities during H2-FY11 point towards a recovery in the months

Table 2.4: Indicators of Services Sector Performance
percent growth unless mentioned otherwise

	Q1		Q2		H1	
	FY10	FY11	FY10	FY11	FY10	FY11
Wholesale & retail trade						
Credit to wholesale and commission trade	-4.8	-4.4	3.6	5.8	-1.3	1.2
Credit to retail trade	-3.2	5.3	13.0	-3.0	9.4	2.1
FDI in trade	-53.8	-39.6	-53.4	-37.3	-53.2 ^a	-43.9 ^a
Manufacturing growth	0.5	-2.3	4.3	-3.2	1.7	-1.6
Import growth	-29.8	19.0	1.3	20.1	-16.3	19.6
Transport storage & communication						
Cargo handling at Ports	8.7	13.3	32.5	-1.1	20.2	5.7
Telecom imports	-60.0	33.2	-25.3	68.2	-47.6	51.0
Commercial vehicles sale	-3.9	5.5	24.8	-5.4	14.7 ^a	-1.0 ^a
Transport group imports	3.7	13.9	22.2	-4.1	13.3	3.8
Communication services export	135.6	-18.3	343.6	11.7	199.2 ^b	-4.7 ^b
Finance & insurance						
Advances at 12% and above	81.4	7.7	85.9	85.0	83.6	81.3
Deposits at 8 % and above	54.7	55.3	53.5	51.8	54.6	53.6
Interest Rate Spread – stock (Dec)	7.3	6.0	7.4	7.5	7.4	7.6
Interest Rate Spread - incremental (Dec)	6.5	7.5	6.4	6.7	6.3	6.8
a. Jul-Jan; b. Jul-Nov						
* Expected profit						

ahead. *Finance & insurance* is also likely to show improvement over the previous year as volumetric gains coupled with wider spread have improved bank

profitability.¹⁴ Indicators for *transport, storage & communication*, however, do not present a positive picture. Initial data received from Port Qasim and KPT shows decline in export related cargo handling of rice and cement.

¹⁴However, a part of the contribution of *finance & insurance* in real value addition will be sharply contracted due to higher inflation in FY11 relative to the preceding year.

3 Prices

3.1 Overview

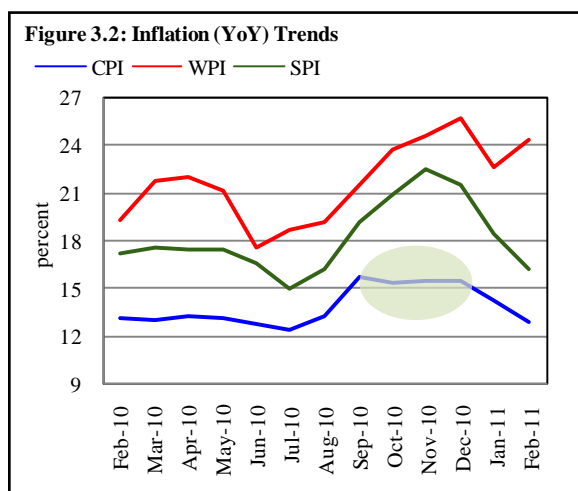
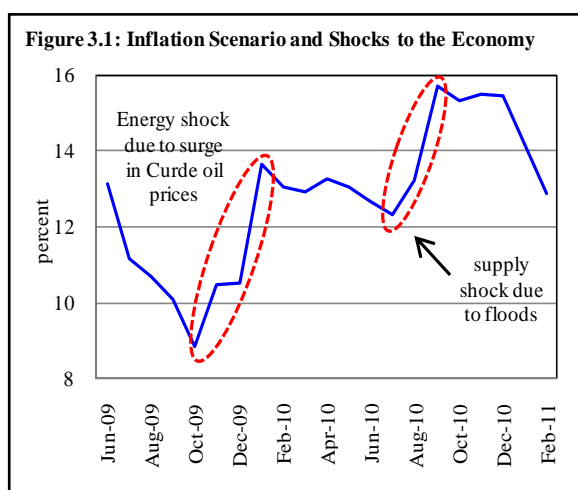
Inflationary pressures remained strong during H1-FY11, driven by the combined impact of flood-related supply shock, monetization of the fiscal deficit and rising global commodity prices (see **Figure 3.1**).

Although YoY inflation moderated somewhat during the initial two months of H2-FY11 (see **Figure 3.2**), this was largely due to

wearing out of flood related rise in food inflation and delays in increasing domestic retail fuel prices in line with the international oil prices. This trend is therefore unlikely to be sustained in the months ahead.

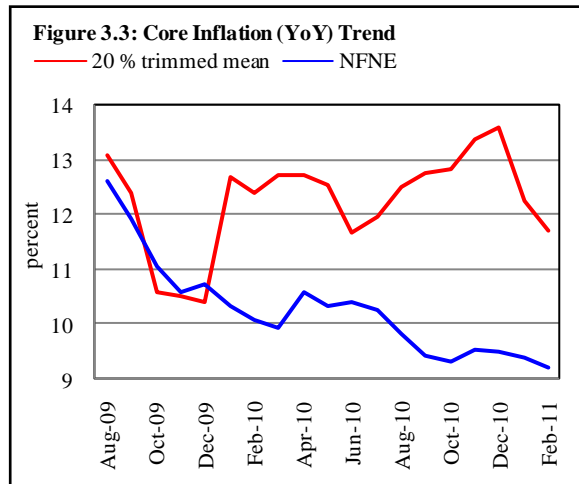
Moreover, the need to resume the IMF program would require additional revenue measures, and upward adjustment in power tariffs. These measures would initially add to inflationary

pressures. As such, despite moderation in inflation during Jan-Feb 2011, SBP's inflation forecast is in the range of 14.5-15.5 percent.

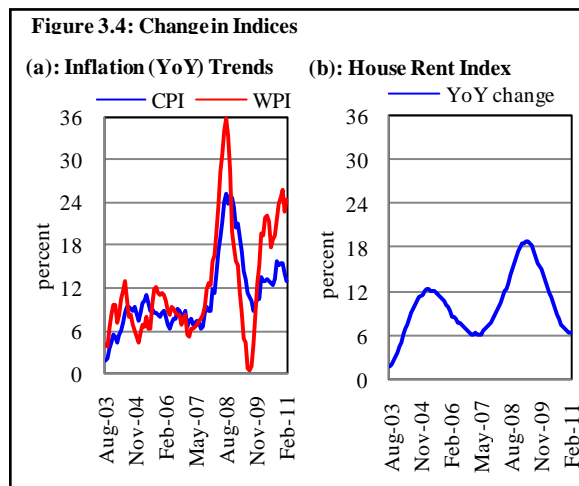


What this essentially means, is that while the period average CPI inflation for Jul-Feb FY11 is 14.3 percent, SBP expects inflationary pressures to edge up in the months ahead. Credence to this assessment is lent by the following observations:

- Although core inflation (excluding food and energy components from the headline CPI or non-food non-energy –(NFNE) is in single digit for the last seven months, this shows that inflationary pressures are principally coming from food and energy. Unfortunately, the surge in these prices have strong second-round effects. At the same time, core inflation measured by the trimmed method remains in double digit, reflecting strong inflationary pressures (see **Figure 3.3**). However, the downward trend is heartneing.



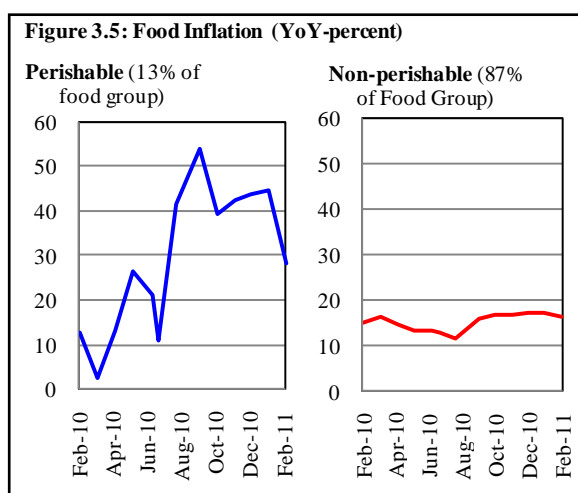
- The impact of rising international commodity prices is evident in the WPI (which reflects production costs) (see **Figure 3.4-a**). As this impact seeps into the CPI inflation with a lag, CPI non-food inflation is likely rise in the coming months.



- Global commodity prices are likely to remain firm due to: (a) unrest in North Africa and the Middle East; (b) supply shortages due to adverse weather in a number of important commodity producing/consuming countries; (c) depletion of inventories of key agricultural commodities (cotton, wheat etc.)

and metals (copper, iron ore) to multiyear lows; and (d) depreciation in the value of the dollar against major currencies.

- As mentioned above, pass-through of rising international oil prices is inevitable. Upward adjustments in POL prices will hit transportation costs which in turn will impact most food prices.
- The expected reversal of the declining trend in the house rent index (HRI)¹ in coming months because of an increase in the prices of construction materials (see **Figure 3.4-b**).²
- Any fiscal policy slippages that manifest in central bank financing, will also fuel inflationary pressures.
- It is important to note that while the surge in perishable food prices due to the floods eased somewhat in November 2010, external demand for vegetables and fruits³ will keep upward pressure on food prices.
- Non-perishable food inflation is also an issue (see **Figure 3.5**). Since non-perishable food items have 87.5 percent weightage in the food group, even a small rise in this group could overshadow any decline in the prices of perishable food commodities.



¹ A reversal in HRI would have significant impact due to its 23.43 percent weight in CPI basket.

² Anecdotal evidence suggests that wages have generally risen in informal markets, particularly for construction workers.

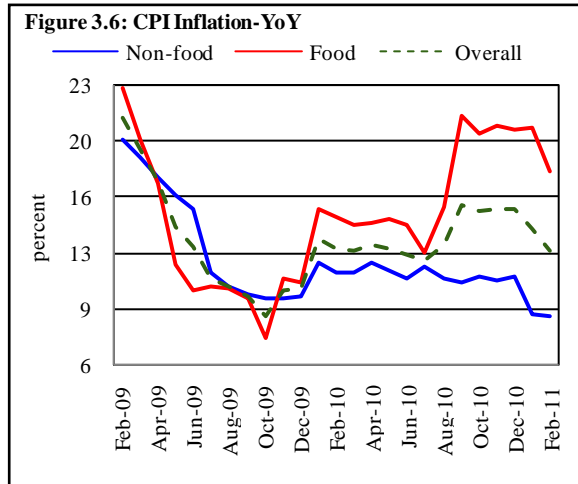
³ Exports of fruits & vegetables saw 9.2 percent YoY growth in January 2011.

3.2 Consumer Price Index (CPI)

Headline CPI inflation eased somewhat to 12.9 percent YoY in Feb 2011 from 14.2 percent in the preceding month. This improvement was primarily attributed to a slowdown in food inflation, which was also supported by a marginal fall in non-food inflation.

The decline in non-food inflation was principally driven by the fall in HRI, which was further supported by the postponement of fuel price increases. This led to fall in the *fuel & lightening* and *transport & communication* sub-groups inflation. *Fuel & lightening* inflation dropped to 9.1 percent while *transport & communication* declined to a 12-month low of 12.3

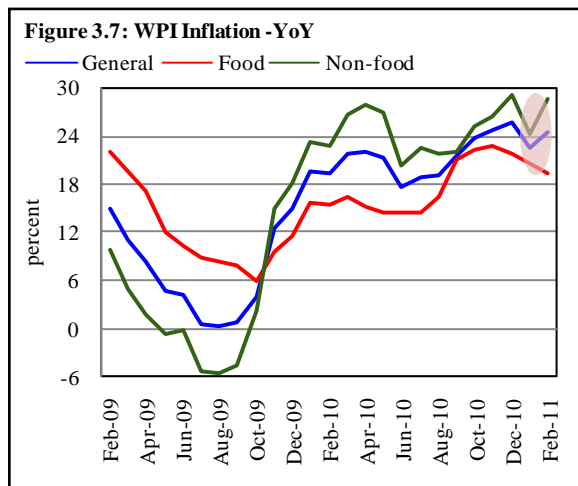
percent. Consequently, non-food inflation fell to 8.9 percent, which is the lowest non-food inflation since Feb 2008 (see **Figure 3.6**).



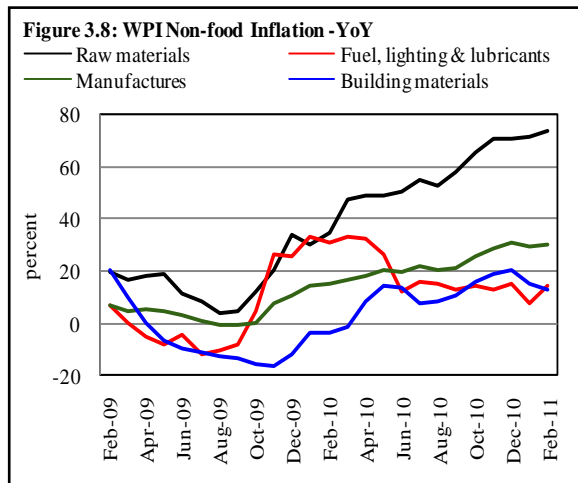
3.3 Wholesale Price Index (WPI)

In contrast with CPI, WPI bounced back to 24.4 percent YoY in Feb 2011, after showing a decrease in Jan 2011 (see **Figure 3.7**). Although WPI food inflation declined for the third consecutive month in a row, surge in non-food groups of WPI contributed to this rise.

WPI non-food inflation rose to 28.0 percent YoY in Feb 2011 from 24.2 percent in Jan 2011. All sub-groups of WPI non-food witnessed acceleration in inflation, except, *building materials*. In particular, a rising trend in *raw materials* is still unabated; this sub-group registered a record inflation of 73.6



percent YoY during Feb 2011 compared with 71.1 percent in the preceding month (see **Figure 3.8**). This sharp rise was mainly a function of surge in international prices of cotton and sugarcane. While, impact of higher sugarcane prices is already been passed on to the consumers, the impact of record cotton prices would gradually push-up retail prices of all types of textile products



3.4 Sensitive Price Indicator (SPI)

SPI inflation declined for the second consecutive month, from 21.5 percent in Jan 2011 to 16.2 percent YoY in Feb 2011. This easing is mainly due to seasonal improvement in the supply of perishable food items, which have a significant weight in SPI basket.

4 Money and Banking¹

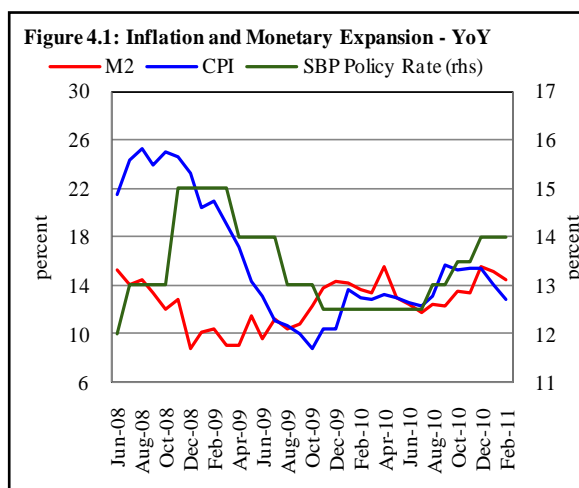
4.1 Overview

Fall in non-bank and external financing led government to rely increasingly on the borrowing from the banking system, particularly SBP through most of H1-FY11. Reluctance of the government to take politically difficult decisions to curtail the fiscal deficit, laid the responsibility of managing the difficult economic situation disproportionately on SBP.

The persistent increase in demand pressures from monetization (of the fiscal deficit) called for a proactive policy response from the SBP. Hence, SBP announced three successive 50 bps hike in the policy rate during H1-FY11. Subsequently, however, restrained exercised by the government in curtailing its borrowings from the SBP and accompanied improvement in the external accounts allowed SBP to keep the policy rate unchanged in the next two policy announcement (see **Figure 4.1**).

Although the government has kept its borrowing from SBP in check so far, it has only been partially successful in undertaking necessary revenue generation and expenditure reduction measures. These measures are not only important for curtailing the fiscal deficit,

but also crucial for the resumption of the suspended IMF program. The importance of the IMF program is clear; it is vital not only in terms of its implications for balance of payments, but also for resumption of external financing from other multilateral agencies. In the absence of this external



¹ The analysis in this chapter is based on monetary survey data up to 26th Feb 2010; monthly data on advances and loans available until Jan 2010; quarterly data on Non-Performing Loans (NPLs) up to the quarter ended Dec 2010; and money market data up to end-Feb 2010, unless otherwise specified.

financing, the government may resort to monetize its deficit, which would fuel inflation and force SP to raise rates.

4.2 Monetary Aggregates

Expansion in broad money (M2) accelerated with a growth of 7.7 percent during the first eight months of the current fiscal year compared to 5.7 percent in the same period last year (see **Table 4.1**).

Both the net domestic assets (NDA) and net foreign assets (NFA) of the banking system contributed to this growth. The growth in NFA reflects an improvement in the country's external accounts, while the expansion in NDA shows a pickup in demand for private sector credit and a rise in government borrowings.²

Government borrowing for budgetary support

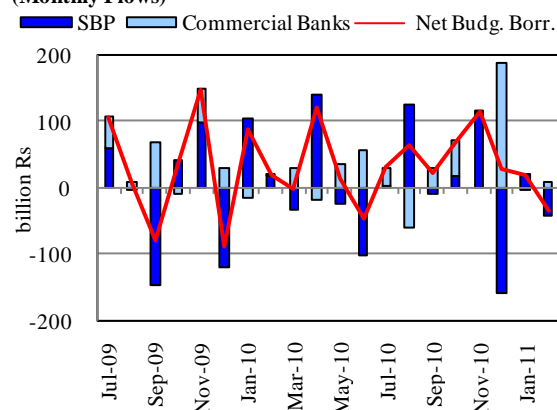
Government borrowing from the banking system increased 16.2 percent during Jul-Feb FY11. As stated earlier, a fall in non-bank and external financing was primarily responsible (see **Figure 4.2**).

Within the banking system, the bulk of budgetary financing during Jul-Feb

Table 4.1: Monetary Aggregates (Jul-Feb 2011)
flows in billion rupees, growth in percent

	Flows		Growth rates	
	FY10	FY11	FY10	FY11
Broad Money (M2)	294.7	444.6	5.7	7.7
NFA	-45.9	146.2	-9.3	26.8
SBP	-25.6	147.1	-8.4	38.8
Scheduled banks	-20.4	-0.9	-10.6	-0.5
NDA	340.6	298.5	7.3	5.7
SBP	168.0	92.2	18.6	9.3
Scheduled banks	172.6	206.2	4.6	4.9
<i>of which</i>				
Government borrowing	186.6	233.3	9.2	9.6
For budgetary support	240.1	325.2	14.3	16.2
SBP	60.1	71.8	5.2	5.9
Scheduled banks	179.2	253.4	34.7	31.6
Commodity operations	-52.1	-94.7	-15.5	-22.9
Non government sector	226.9	230.6	7.1	6.8
Credit to private sector	137.9	208.8	4.7	6.9
Credit to PSEs	89.2	21.5	33.5	6.1
Other items net	-72.9	-165.4	-12.5	-27.7

Figure 4.2: Budgetary Borrowing from Banking System (Monthly Flows)



² For details on factors contributing to the improvement in the net foreign assets, please see chapter 6 on balance of payments.

FY11 were met from scheduled banks. A disaggregated analysis, however, shows that the government was relying more on SBP borrowing till November 2010, and it was only in the latter half of December 2010 that the government retired a large part of its debt to SBP. In addition, the government became more aggressive in T-bill auctions, accepting amounts in excess of announced targets.

Credit to public sector enterprises

Credit to public sector enterprises (PSEs) declined sharply during Jul-Feb FY11 to Rs 21.5 billion from Rs 89.2 billion last year.³ This was due to retirements by an oil refinery and a state owned oil marketing company amid lackluster overall demand.

Commodity operations

Overall commodity loans fell by Rs 94.7 billion during Jul-Feb FY11, which was on account of retirement of advances for wheat procurement. The cabinet decision to allow wheat exports facilitated this retirement and a contraction in wheat advances can be expected to continue for the next few weeks.⁴ Although overall commodity loans registered a fall, financing was extended for sugar imports via TCP.

4.3 Private Sector Credit

Private demand for credit picked-up during Jul-Feb FY11. The outstanding stock of loans to the private sector increased by Rs 208.8 billion compared to Rs 137.9 billion in the same period last year. This was largely due to an increase in seasonal demand for working capital and trade related loans. More than half of private sector credit went to the textile sector (see **Table 4.2**) reflecting higher input prices, especially that of raw cotton.

Table 4.2: Private Sector Advances - Flows (Jul-Jan)
billion rupees

	FY10	FY11
Manufacturing	84.1	177.1
Textiles	45.9	116.3
Rice	19.5	22.0
Edible oil	-5.4	9.9
Cement	2.1	6.3
Basic metals	-1.0	3.3
Fabricated metals	0.8	0.3
Sugar	0.3	15.7
Fertilizer	5.8	-5.1

In addition to textiles, the impact of rising input prices on credit demand was also visible in other industries such as sugar, rice and basic metals.

³ The sharp rise in credit off-take last year reflects the issuance of privately placed term finance certificates (PPTFCs).

⁴ For details see First Quarterly Report of FY11.

4.4 Non-Performing Loans

Asset quality of the banking system deteriorated further during the first half of the fiscal year. Gross NPLs increased by Rs 58.0 billion to reach Rs 517.9 billion by end-Dec 2010, compared with an increase of Rs 34.1 billion in the same period last year. Not surprisingly, over one-third of this increase in NPLs came from the textile and energy sectors.

Nevertheless, NPLs to loan (infection) ratios for the textile and agri-business recorded improvement over the start of the fiscal year, as well as the previous quarter (see **Table 4.3**). The

improvement in the ratio for the textile sector is attributed to an increase in advances to sector during Q2-FY11. In addition, improvement in textile exporters' margins on account of increase in export prices, also enhanced their ability to retire some of their loans. On the other hand, the improvement in the ratio for agri-business reflects better repayment capacity following the rise in agricultural incomes due to the increase produce prices (e.g. cotton, sugarcane).

Table 4.3: NPLs to Advances Ratio: Selected Sectors
percent

	Jun-10	Sep-10	Dec-10
Chemicals	6.5	7.8	7.6
Agribusiness	7.5	8.4	6.4
Textile	23.2	25.2	22.2
Cement	15.7	15.3	16.0
Sugar	15.6	21.9	16.9
Shoes & Leather	12.9	13.3	12.5
Automobile	19.0	22.1	23.5
Electronic & Transmission	7.7	7.9	9.0

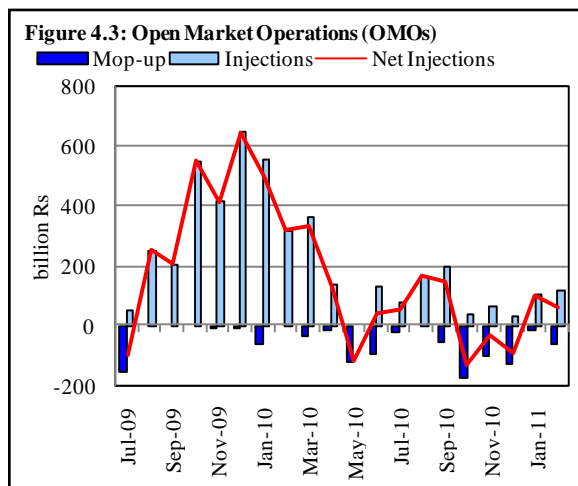
In contrast to textiles and agri-business, the infection ratio deteriorated for the auto sector primarily due to net retirement of loans during the period under review (see **Table 4.3**).

4.5 Money Markets

Liquidity Management

Liquidity conditions in the money market remained fairly comfortable during Jul-Feb FY11 on account of government borrowings from SBP and growth in bank deposits. Concerned about the consistency of market liquidity and SBP monetary policy stance, the central bank drained this excess liquidity not only through auctions, but also mopped up a significant amount through open market operations (OMOs) and repos.

To keep the interbank money market liquidity condition in line with the monetary policy stance, SBP mopped up Rs 540.2 billion during Jul-Feb FY11 compared with Rs 227.8 billion during the same period last year; whereas injections in the market by SBP remained low (see **Figure 4.3**). Moreover, commercial banks deposited Rs 673.2 billion with SBP under overnight repo facility (floor for interest rate corridor) compared to Rs226.7 billion during the corresponding period last year.



Primary Market

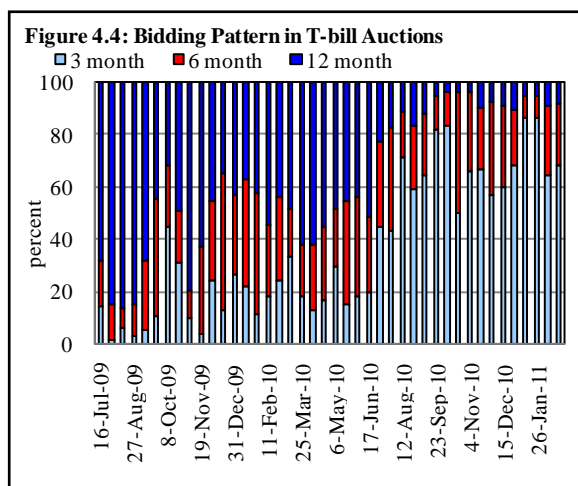
Treasury Bills

The government accepted Rs 180.8 billion (net of maturities) during Jul-Feb FY11 against a net target of Rs 89.5 billion (see **Table 4.4**). With drying up external financing and the fall in non-bank sources, government was left with little option but to borrow heavily from the banking system. Earlier in the fiscal year, when prospects of external financing were good, government had rejected all bids in auctions of longer tenure PIBs due to high rates demanded by banks.⁵ Banks on the other hand, were

Table 4.4: Treasury Bills Auction Profile (Jul-Feb)

billion rupees

	Maturities	Target	Offer	Accepted
FY09	1161.3	1320.0	2219.1	1276.0
FY10	512.3	740.0	1763.1	789.8
FY11	1790.5	1880.0	3204.0	1971.3



⁵ The rejection of these bids was despite higher than target offers by banks; they offered Rs 138.1 billion in the five PIB auctions held during Jul-Feb FY11.

anticipating an increase in interest rates and therefore were more interested in shorter term T-bills (see **Figure 4.4**).

Pakistan Investment Bonds

A PIB auction target of Rs 105.0 billion was set for Jul-Feb FY11 against maturities of Rs 27.4 billion. The government, however, rejected all bids in the first two auctions (July and August 2010) due to high returns demanded by banks. In subsequent auctions, in an effort to retire SBP borrowings, the government accepted Rs 53.0 billion, but this was still lower than target.

GOP Ijara Sukuk

Against a target of Rs 80.0 billion for the two Sukuk auctions held in the Jul-Feb FY11 period,⁶ Rs 89.0 billion were accepted. The government received offers of Rs 122.5 billion, which reflects strong liquidity position of Islamic banks and their investment appetite for this asset class.

⁶ The auctions were held in Nov and Dec 2010.

5 Fiscal Developments

5.1 Overview

Although fiscal indicators showed some improvement in the second quarter of FY11 with substantial growth in non-tax revenues, the overall fiscal position during H1-FY11 deteriorated. Consequently, the fiscal deficit increased to 2.9 percent of GDP from 2.7 percent in the same period last year (see **Table 5.1**).

Persistent growth in expenditures driven primarily by flood relief activities and failure to implement tax

reforms, have rendered the fiscal imbalance unsustainable. As such, achieving the deficit target of 4.7 percent set for FY11 seems highly unlikely in the absence of a clear strategy to increase the tax base by bringing untaxed sectors into the tax net; there is also a need to rationalize electricity tariffs and subsidies on POL product.

Financing the deficit has become all the more challenging in the absence of external financing due to non-observance of IMF conditions on fiscal consolidation. The government, as a result has resorted to heavy borrowing from the banking system, which in turn has not only exerted pressure on short-term interest rates, but also has adverse implications for inflationary expectations, private sector credit and overall macroeconomic stability.

The only way out for the government is to show political will to prioritize its expenditure heads and implement tax reforms aimed at removing tax exemptions e.g., taxing agriculture and services. Even if this does not deliver immediate tax revenues, it would close the door for tax avoidance.

Table 5.1: Fiscal Situation - A Snapshot

	FY10		FY11		H1	
	Q1	Q2	Q1	Q2	FY10	FY11
YoY Growth (in percent)						
Total revenue	11.0	7.4	-6.3	22.1	9.0	8.8
Tax revenue	7.9	19.7	6.2	12.2	14.0	9.5
Nontax revenue	18.8	-17.6	-35.5	51.5	-2.2	6.9
Total expenditure	24.5	18.0	3.9	21.4	21.1	12.7
Current	14.2	16.1	8.8	22.8	15.2	15.9
Development and net lending	100.8	64.5	-45.8	17.3	80.3	-13.2
as percent of GDP						
Fiscal balance	-1.5	-1.2	-1.6	-1.3	-2.7	-2.9
Revenue balance	-0.6	-0.4	-1.0	-0.4	-1.0	-1.4
Primary balance	-0.6	-0.1	-0.7	-0.3	-0.7	-1.0

5.2 Expenditures

As noted in SBP's first Quarterly Report for FY11, the restraint in spending exercised during this period was unsustainable. There were risks that spending limits at the federal and provincial level would be breached; this materialized in Q2-FY11 (see **Figure 5.1**). The ratio of total expenditures to GDP rose to 8.6 percent in H1-FY11, which was relatively lower than the level observed in the same period last year (see **Table 5.2**).

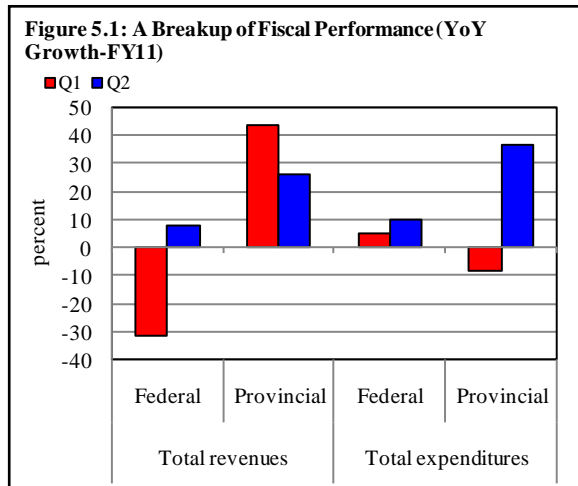


Table 5.2: Assessment of Expenditures

YoY growth

	FY11		H1		H1-FY11	Percent of GDP	
	Q1	Q2	FY10	FY11	YoY Growth	FY10	FY11
Total Expenditures	676.3	803.7	1313.2	1480.0	12.7	9.0	8.6
Current Expenditures	566.7	660.0	1058.6	1226.8	15.9	7.2	7.1
of which							
Interest payments	161.6	148.8	294.2	310.4	5.5	2.0	1.8
Domestic	146.6	129.8	262.0	276.4	5.5	1.8	1.6
Foreign	14.9	19.0	32.2	33.9	5.4	0.2	0.2
Grants to others	39.1	59.4	133.7	98.5	-26.3	0.9	0.6
Defense	93.1	121.8	166.0	215.0	29.5	1.1	1.3
Running of federal government*	39.2	57.1	78.1	96.4	23.4	0.5	0.6
Provincial	147.7	203.2	284.8	350.8	23.2	1.9	2.0
Development and net lending	62.8	145.1	239.4	207.8	-13.2	1.6	1.2
Development	59.4	85.1	224.7	144.5	-35.7	1.5	0.8
PSDP	43.1	81.7	175.6	124.9	-28.9	1.2	0.7
Other development expenditure	16.3	3.3	49.1	19.6	-60.1	0.3	0.1
Net lending	3.4	60.0	14.7	63.4	330.1	0.1	0.4
Un identified expenditure	46.8	45.4	15.1	45.4	200.2	0.1	0.3

*The running of the federal government expenditure is adjusted for federal government expenditure on flood rehabilitation efforts.

At the federal level, about 69.5 percent of the increase in spending was driven by *defense, running of the government and net lending activities*.¹ Expenses under the *running of the government* head increased 23.4 percent YoY, mainly reflecting the impact of higher salaries and allowances for federal government employees in the FY11 budget.² Additionally, flood relief measures claimed an unbudgeted 2.7 percent of consolidated public expenditures during H1-FY11.³

At the provincial level, both current and development spending recorded a hefty increase in Q2-FY11 which largely offset transfer of resources to provinces under the 7th NFC award.⁴ Due to a sharp rise in expenditures, the consolidated fiscal surplus of provinces dropped from 0.5 percent in Q1-FY11 to 0.1 percent of GDP during Q2-FY11. As the government moves forward with its agenda to transfer key ministries to provinces under the 18th Amendment, the fiscal balance could deteriorate further in the absence of strict discipline on spending.⁵

Development spending has remained conspicuously low in H1-FY11. Although some improvement was visible on a quarterly basis in Q2-FY11, the overall level of spending was 18.3 percent lower than average PSDP spending recorded during July-December in the years FY06-10. In nominal terms this implies that real spending is sharply down. Distressingly, spending for PSDP as percent of GDP is at the same level as expenditure on war on terror, and provision of loans and subsidies to the power sector during H1-FY11.

¹ Net lending was primarily to power sector: the disbursement of subsidies and loans to this sector alone contributed 7.9 percent to total expenditures during H1-FY11. Due to closure of canals, demand for thermal power generation was higher in Q2-FY11, leading to an abnormal increase in inter-disco tariff differentials and receivables for WAPDA & PEPCO.

² Government announced a 50 percent and 15 percent increase in the salaries and pensions of federal government employees respectively in the federal budget for 2011.

³ Reportedly under the *watan card* scheme government has disbursed Rs. 31 billion in H1-FY11, whereas the provision of funds for Rabi crop for the flood relief measures stood at Rs 8 billion in this period.

⁴ Up to 57.5 percent of the divisible pool of resources will be transferred to provinces. Multiple criteria will be adopted for the distribution of resources. Concerns over payment of net hydel profit to KP and Punjab, distribution of gas development surcharge and imposition of GST on services were also resolved.

⁵ Already during Q2-FY11 five ministries namely Zakat and Usher, Population Welfare, Youth Affairs, Local Government and Rural Development and Special Initiatives were devolved to provinces.

5.3 Revenues

Total revenues increased by 8.8 percent YoY to Rs. 989.6 billion during H1-FY11 (see **Table 5.3**). Majority of this increase was attributable to: (1) advance income tax payments under the head of *direct taxes*; and, (2) growth in taxes on *goods and*

Table 5.3: Composition of Tax and Non-Tax Revenues (Jul-Dec)
billion rupees

	Collection		Absolute Growth				
	FY10	FY11	FY07	FY08	FY09	FY10	FY11
Tax revenue	659.2	721.6	98.3	6.6	148.8	52.4	62.4
Direct taxes	211.4	239.1	72.4	-12.2	46.4	0.6	27.7
Taxes on property	2.8	3.8	-1.5	0.3	0.5	0.3	1.0
Taxes on goods and services	301.2	339.7	19.7	29.2	65.4	28.6	38.5
Taxes on international trade	71.2	80.6	-0.8	0.9	11.9	-2.2	9.3
Petroleum levy	51.9	35.4	8.1	-10.7	21.5	23.0	-16.4
Other taxes	20.7	23.0	0.5	-0.8	3.0	2.0	2.3
Non-tax revenue	250.7	268.0	18.6	4.2	60.1	23.1	17.3
Profit of PTA/PO	0.0	0.0	-10.4	0.0	0.0	0.0	0.0
Interest (PSE and others)	4.6	5.0	-3.4	10.6	-11.2	1.0	0.4
Dividends	26.5	17.5	6.5	-1.4	2.0	-7.8	-9.1
SBP profits	135.0	80.0	35.3	8.1	24.6	63.1	-55.0
Defense	3.2	66.9	-19.3	-24.9	27.9	-27.0	63.7
Development surcharges on gas	10.0	17.4	6.5	-3.7	-3.6	1.5	7.3
Discount retained on crude oil	2.5	10.5	0.0	0.0	6.0	-3.5	8.0
Royalties on oil/gas	22.6	26.6	3.9	7.4	4.3	-3.2	3.9
Others	46.1	44.1	-0.4	8.3	10.0	-1.0	-2.0
Total revenue	909.9	989.6	116.9	10.8	208.9	75.5	79.7

Source: Ministry of Finance

services and *international trade* due to the increase in Rupee imports.

However, revenues from the *petroleum development levy*⁶ declined YoY as prices of POL products have been higher on average in H1-FY11 resulting in weaker sales of High-Speed Diesel (HSD) and Kerosene.

Growth in non-tax revenues dampened somewhat, largely due to a decline in transfer of SBP profits. Receipts under the head of *dividends* showed a decline for

⁶ Per liter petroleum levy was fixed at Rs. 10 for Motor gasoline, Rs. 14 for HOBC, Rs.6 for Kerosene and Rs. 3 for Light Diesel Oil. Since December 2011, these amounts have been adjusted downwards to manage ex-depot sales price for end-consumers in the wake of rising crude oil prices.

the second consecutive year, due to lower earnings of public sector institutions and delay in dividend income receipts from these institutions. Receipts under the head of *defense*, however, increased appreciably in H1-FY11 compared to the same period in the last five year as US\$ 743 million were received on account of logistics support.

FBR Tax Collections

Within overall revenues, FBR tax collections registered a growth of 13.7 percent YoY during H1-FY11, as compared to 5.1 percent in the corresponding period of the previous year (see **Table 5.4**). Although this increase appears to be significant, FBR will have to collect Rs. 942.7 billion in H2-FY11 to meet its end-year target. This amounts to a growth of 26.3 percent over collections in H2-FY10. Although tax collection tends to improve significantly during the second half of a fiscal year, this target may be difficult to achieve.

Table 5.4: FBR Tax Collection (net) (Jul-Dec)
billion rupees; growth in percent

	Net collection		Growth		Average growth of the last		% of annual target	
	FY10	FY11	FY10	FY11	5 years	10 years	FY10	FY11
Direct taxes	211.4	240.9	0.5	13.9	21.9	14.0	37.4	36.7
Indirect taxes	370.8	420.8	7.9	13.5	15.0	11.7	49.4	56.0
Sales tax	242.9	282.6	11.8	16.4	17.3	15.0	48.6	44.6
FED	56.7	58.1	5.8	2.6	19.2	7.1	37.1	41.2
Customs	71.2	80.0	-2.1	12.3	6.8	7.7	43.9	46.2
Total collection	582.2	661.7	5.1	13.7	17.3	12.4	42.2	41.2

Source: Federal Board of Revenue

Although increase in tax collection is a welcome development, heavy reliance on imports to generate tax revenues is not encouraging, as this is a captive payer.

Some of the key developments related to FBR taxes in H1-FY11 are: (1) income tax collection was higher since advance voluntary payments increased substantially (up Rs 20.1 billion), reflecting rising corporate sector profitability; (2) collection of income taxes on demand declined, suggesting that FBR was unable to effectively utilize its new audit system; (3) growth in withholding tax collection decreased marginally; and (4) revenues from customs duty increased by 12.3 percent YoY, mainly due to imports of vehicles and edible oil.

5.4 Domestic Budgetary Financing

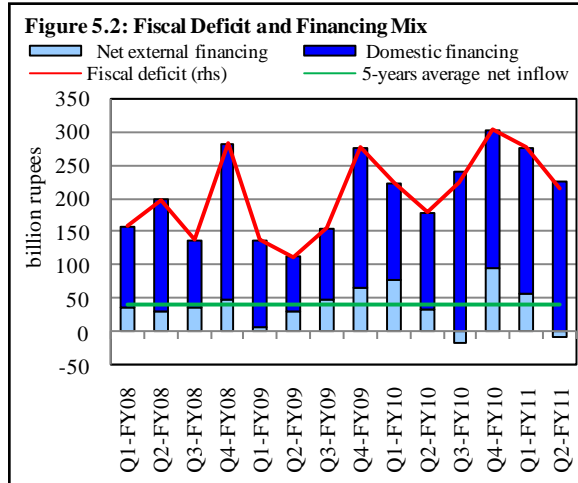
The government relied heavily on domestic resources to finance the fiscal deficit during H1-FY11 (see **Table 5.5**), whereas net inflows from external sources merely amounted to Rs. 47 billion during H1-FY11, compared to Rs. 110.3 in H1-FY10.

Table 5.5: Deficit Financing
billion rupees, percent

	FY11		H1		Percent share	
	Q1	Q2	FY10	FY11	FY10	FY11
Total financing of budget	276.2	214.2	403.3	490.4	100.0	100.0
External resources (net)	56.9	-9.9	110.3	47.0	27.3	9.6
Internal resources (net)	219.3	224.1	293.0	443.4	72.7	90.4
Banking system	121.0	165.1	107.2	286.0	26.6	58.3
SBP	118.3	-38.3	-63.9	80.1	-15.8	16.3
Scheduled banks	2.6	203.3	171.0	205.9	42.4	42.0
Non-bank	98.4	59.0	185.8	157.4	46.1	32.1
NSS	33.8	31.7	98.0	65.5	24.3	13.4
Others*	64.6	27.3	87.8	91.9	21.8	18.7

*Others include non-bank borrowing through MTBs, PIBs, Prize bonds, etc.

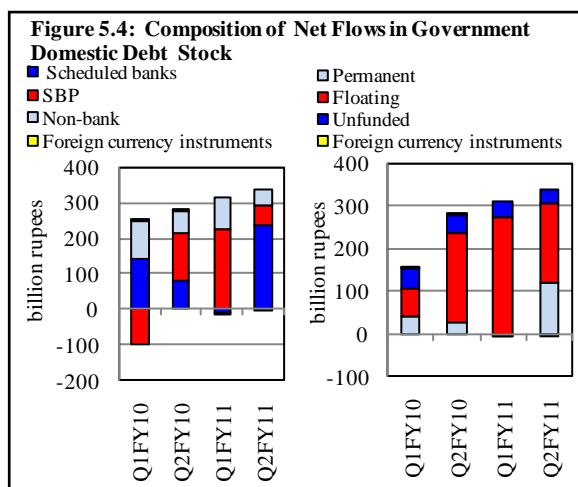
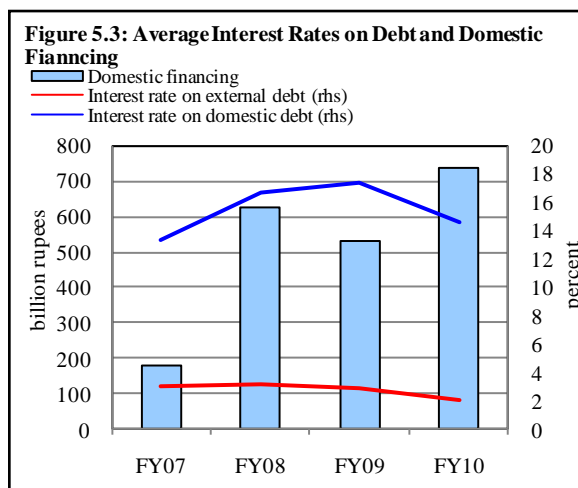
A historical analysis of the budget financing mix reveals that inflow of external financing witnessed till Q1-FY11 was closer to the historical average of the last five years (see **Figure 5.2**). However, by Q2-FY11, key structural reforms agreed with the IMF had not been implemented, as a result of which the sixth tranche under the IMF SBA was delayed. Although the tranche did not include funds for budgetary support, the delay raised concerns amongst other multilateral institutions, making it difficult for the government to borrow externally in Q2-FY11. As a result, the government had to rely on domestic sources for finance.



However, not all the domestic sources of finance could be availed by the government as the government committed to avoid deficit monetization in Q2-FY11, and non-bank borrowing through NSS instruments also declined in response to rising market interest rates. Non-bank investors showed greater interest in *other* securities, particularly *Ijara sukuk* issued in Q2-FY11, primarily to meet portfolio diversification requirements.

This took some pressure off scheduled banks to finance the deficit in Q2-FY11

Nevertheless, the government had to rely on borrowing from scheduled banks. Government borrowing exceeded MTB auction targets in Q2-FY11 and banks successfully increased bid-rates further in all tenors.⁷ The decision to finance the deficit from domestic sources, however, comes at the cost in terms of debt servicing burden; even after accounting for rupee depreciation, the wide differential between interest rates on domestic and external debt makes it cheaper to borrow externally (see **Figure 5.3**).

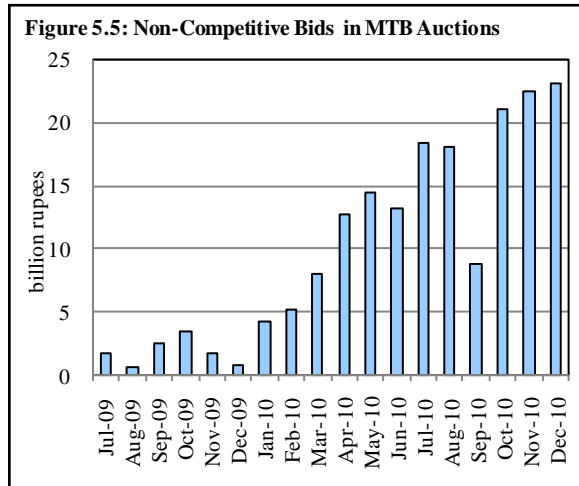


⁷ The average bid rates for 3-Month, 6-Month and 12-Month bills recorded 4.6, 5.5 and 6.4 percent increase in Q2-FY11 over Q1-FY11.

5.5 Government Domestic Debt

As a result of government borrowing in H1-FY11, total domestic debt & liabilities increased by 1.3 percentage points to 35.4 percent of GDP in December 2011.⁸

Trends show an increasing reliance on short-term floating debt, particularly from the banking sector, which is characteristic of underdeveloped debt markets (see **Figure 5.4**). In response, SBP introduced some important initiatives in H1-FY11 to facilitate non-bank investment in government floating & permanent debt securities through non-competitive bids.⁹ The volume raised through non-competitive bids in MTB auctions has recorded a consistent increase from July 2009 when SBP allowed non-competitive bids in MTBs (see **Figure 5.5**).



Some of the key highlights in H1-FY11 are as follows:

Floating debt (T-bills)

- Around 72 percent of the total increase in government debt stock was contributed by floating debt instruments during H1-FY11.
- In overall terms, 3-Month T-bills captured 62.9 percent in the total amount raised in MTB auctions during H1-FY11 – a higher share of shorter tenor securities implies continued upward pressure on debt servicing costs in the near term, which will affect current expenditures and the fiscal deficit.

⁸ This increase is primarily attributable to domestic government borrowing, since PSE debt and liabilities decreased during H1-FY11.

⁹ The specific measures were: (a) Introduction of electronic bond trading platform from January 2010 to improve pricing mechanism in the secondary market; and, (b) to diversify the debt market, SBP also allowed participation of individuals and small institutional investors in both MTBs and PIB auction by non-competitive bids through its circulars FSCD Circular No.07 & 18, dated June 06, 2009 and December 04, 2010.

Permanent debt (PIBs)

- In overall terms, the stock of permanent debt recorded a 14.5 percent increase by end-December 2010 over the end-June 2010 stock.
- A new three-year issue of *Ijara sukuk* bond was launched in November 2010, after a gap of thirteen months. During Q2-FY11 a sum of Rs. 89 billion was raised through this issue.
- Net inflows via PIBs also increased by Rs. 16.8 billion during H1-FY11.

Unfunded debt

- Stock of unfunded debt showed a weak 4.7 percent growth in H1-FY11 over June FY10.
- Rates of return on NSS instruments were revised upwards in October 2010 and January 2011 in response to an increase in the benchmark discount rate. Consequently, some improvement in gross inflows was visible in Q2-FY11, but the delayed discount may be responsible for the anemic growth.
- However, with the exception of SSCs and BSCs, both the net and gross inflows to almost all unfunded instruments recorded YoY declines in H1-FY11. Participation by institutional investors, in particular, has been affected due to rising interest rates, undermining incentives to lock funds in long term maturity instruments.

Interest payments on government domestic debt

- Interest payments on government domestic debt recorded 7.2 percent YoY growth during H1-FY11, as compared to the 6.7 percent YoY growth registered during the same period last year.
- Although YoY increase in interest payments did not change substantially in H1-FY11, their composition has undergone a significant shift towards T-bills recently from NSS.

6 External Sector

6.1 Overview

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 owes to the significant fall in the current account deficit, since the financial account surplus declined considerably during Jul-Feb FY11 compared to the same period last year (see **Table 6.1**).

Table 6.1: Summary of External Accounts (Jul-Feb)

billion US Dollar

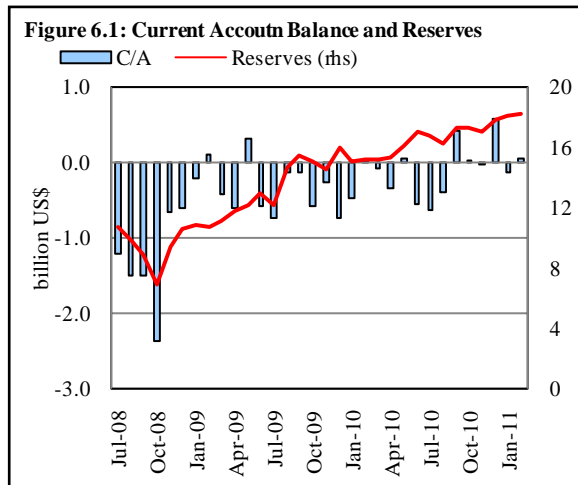
	FY10	FY11	Abs. Change	Percent Change
A-C/A Balance	-3.0	-0.1	2.9	96.8
<i>i) Trade Balance</i>	-7.6	-7.2	0.4	5.3
<i>Exports</i>	12.5	15.5	3.0	23.7
<i>Imports</i>	20.1	22.6	2.6	12.8
<i>ii) Invisible Balance</i>	4.5	7.1	2.5	55.7
<i>Remittances</i>	5.8	7.0	1.2	20.3
B-Financial/Capital Balance	3.0	1.4	-1.6	-53.7
<i>i) FDI</i>	1.3	1.0	-0.3	-21.8
<i>ii) FPI</i>	-0.3	0.2	0.5	176.3
<i>iii) Other Investment</i>	2.0	0.1	-1.9	-93.7
C-Errors & Omissions	0.5	0.2	-0.2	-50.4
D-Overall Balance	0.5	1.6	1.1	212.7

All the sub heads of the current account contributed to the decline in the current account deficit with the largest contribution coming from current transfers that increased by US\$ 1.6 billion followed by US\$ 0.7 billion improvement in the services account.

Notwithstanding the contributions of the current transfers and services accounts, the most encouraging development during Jul-Feb FY11 was the 23.7 percent growth in exports despite a host of impediments. Growth in exports appears to be a function of rising unit prices following global economic recovery. The performance of the exports so far suggests that if this trend continues, Pakistan would be able to post a new record for exports in FY11.

Unlike the current account, macroeconomic issues and government's failure to convince IFIs of its commitment to reforms, took its toll on the financial account. While foreign long term loans declined drastically from US\$ 1.7 billion last year to only US\$ 342 million, investments improved somewhat only due to absence of the US\$ 600 repayments related to Sukuk, that had caused the investments to decline in the previous year. Resultantly, the financial and capital account surplus fell to US\$ 1.4 billion during Jul-Feb FY11 from US\$ 3.0 billion in the corresponding period last year.

This surplus nevertheless, helped in improving the country's overall reserves, which reached all time high of US\$ 18.1 billion as of end Feb 2011 (see **Figure 6.1**). With ample flows on account of remittances and export proceeds entering the inter-bank forex market, the pressures on the rupee were relatively subdued during Jul-Feb 2011, consequently rupee depreciated by only 0.24 percent compared to 4.5 percent in the same period last year.



At its current pace, FY11 current account deficit is likely to be less than 2.0 percent of the GDP, which is a remarkable achievement given that just two years back the deficit was almost 6 percent of GDP. However, there is no room for complacency as the existing decline is mainly due to transitional reasons. The trade deficit is down due to rise in unit prices of traditional exports and could stagnate once prices normalize. Similarly, imports, which were relatively subdued till the end of the previous fiscal year due to slowdown in domestic economic activity and fall in global commodity prices, have been rising since July FY11 and could surge with the further escalation in world price especially that of oil.

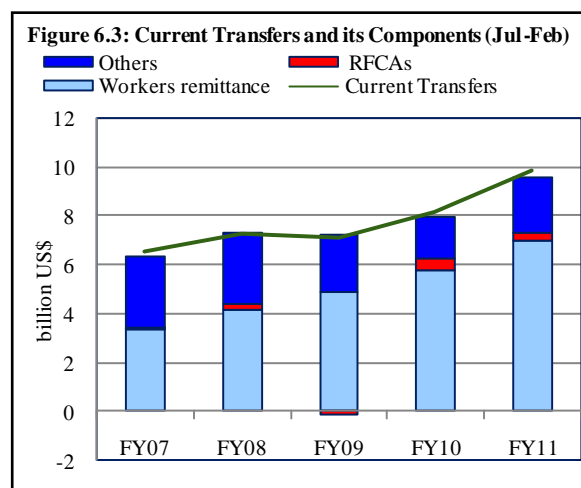
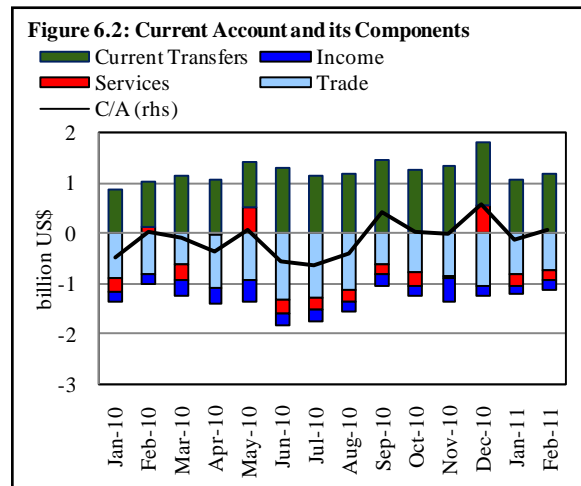
Improvement in the services account owes to logistic support, which have been notoriously unreliable lest for their timing. Similarly, current transfers could also suffer from the ongoing turmoil in the Middle East. To make matters worse the slowdown in financial account inflows appears to be more of medium to long-term nature. Rise in the investment inflows is linked to improvement in law and order, political and macroeconomic stability, while the inflow of foreign loans is dependent on the credibility of the government to undertake politically sensitive reforms.

Thus when the deterioration in the current account occurs, the financial account in its present state may not be able to support it, and the country would have to fall back on its reserves which are currently lending stability to the exchange rate.

This situation was faced a few years back and had forced the country to approach the IMF.

The Stand-by Arrangement agreed with the IMF in Nov 2008 is presently in a suspended state as Pakistan has not been able to fulfill its commitments. While the conditions imposed by IMF are no doubt politically difficult, they are nevertheless necessary to put the economy on a sound footing. Brining IMF on board is important not only because it would revive inflows from the IMF and other donors who seek IMF endorsement, but it would also restore foreign and domestic investor confidence in government's economic policies.

Past experience has shown that deferring unpopular decisions only aggravates the problems and increases the cost to the economy.



6.2 Current Account Balance

Though the year started on a negative note with current account deteriorating by 18.0 percent during the initial two months of FY11, later months saw significant improvement. In September, current account recorded a surplus of US\$ 419 million and again of over US\$ 500 million in December. Consequently the current account deficit for Jul-Feb was just US\$ 98 million against US\$ 3.0 billion in the corresponding period last year (see **Figure 6.2**).

Trade account¹, which is the largest component of the current account and largely dictates the overall performance of the current account contracted by 5.3 percent during Jul-Feb FY11 against a 20.1 percent contraction a year before. More importantly, while last year's improvement in trade account was due to a significant decline in import bill, this year's improvement was the result of strong export growth that considerably offset the impact of 10.2 percent growth in imports.

As against the small contraction in trade account during Jul-Feb FY11, services account deficit contracted by a hefty 43.7 percent mainly reflecting the impact of US\$ 743 million receipts under logistic support. However, even after excluding logistic support related receipts, services account deficit shows 16.3 percent improvement. This was due to better performance of transportation, travel other business services sub-groups.

Although all sub-heads of the current account contributed to the improvement in current account in absolute terms the largest contribution came from the current transfers. Continued strong growth in workers' remittances and inflows on account of flood relief led current transfer to grow by 20.7 percent during

Table 6.2: Country-wise Workers' Remittances (Jul-Feb)
million US\$

Countries	FY10	FY11	Share (%)	Contribution (%age points) in growth
Gulf region:	3294.1	4010.1	57.6	12.4
Bahrain	101.0	103.0	1.5	0.0
Kuwait	297.1	308.8	4.4	0.2
Qatar	243.3	198.9	2.9	-0.8
Saudi Arabia	1148.9	1563.0	22.4	7.2
Sultanat-e-Oman	185.5	209.4	3.0	0.4
U.A.E.	1318.3	1627.1	23.4	5.3
U.S.A.	1173.2	1298.3	18.6	2.2
U.K	596.3	770.9	11.1	3.0
Canada	71.6	127.6	1.8	1.0
Germany	57.5	67.5	1.0	0.2
Japan	4.3	3.0	0.0	0.0
Norway	24.8	24.8	0.4	0.0
Others	564.3	661.1	9.5	1.7
TOTAL	5786.1	6963.3	100.0	20.3

Fig 6.4 (a): Remittances (Jul-Feb) billion US\$

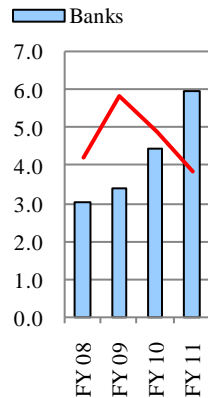
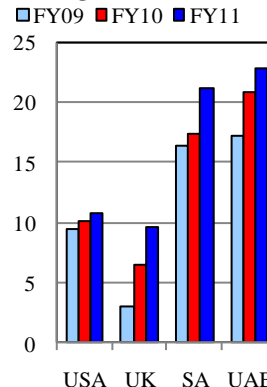


Fig 6.4 (b): Remittances Through Banks (Jul-Feb)



¹ For detailed discussion on trade see **sub-section 6.2**. Trade date in section 6.2 will not tally data used here as the two are based on data from two different sources.

Jul-Feb FY11 (see **Figure 6.3**).

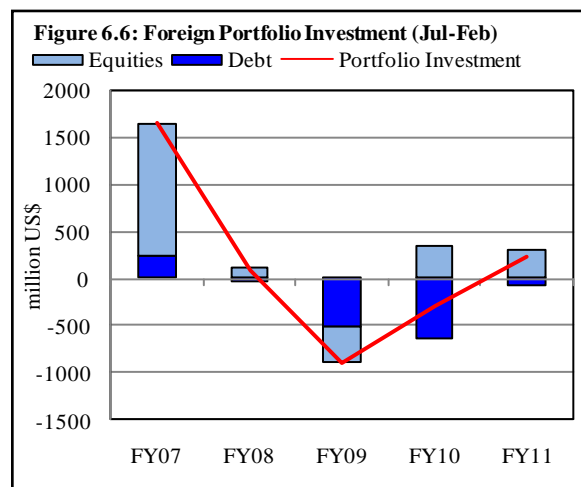
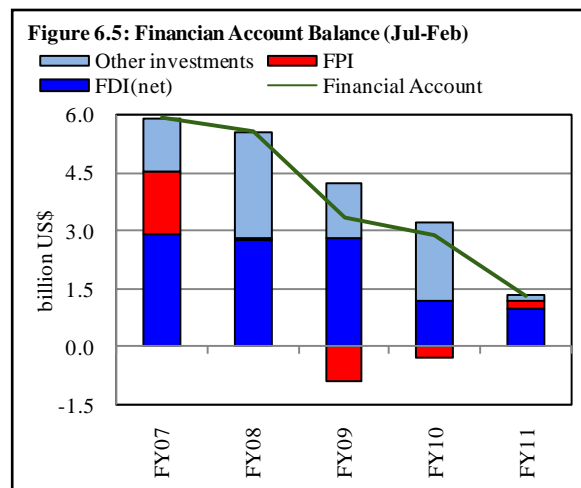
Workers' Remittances

continued to perform strongly during Jul-Feb FY11, posting growth of 20.3 percent on top of 17.6 percent last year. This was the first time when monthly remittances surpassed US\$900 million figure in three out of seven months.

Country wise data shows that 57.0 percent of the remittances originated from the Gulf region followed by USA and United Kingdom (see **Table 6.2**). Within the Gulf region, UAE remained the largest contributor followed by Saudi Arabia. Encouragingly in case of the UAE, remittances from Dubai bounced back following the country's partial recovery from the economic downturn. Thus, as against the decline of 14.6 percent last year, remittances from Dubai increased by 33.6 percent during Jul-Feb FY11.

Channel-wise data shows that remittances through banks have increased consistently since FY09 whereas through exchange companies have declined (see **Figure 6.4 a**).

This switching of channels is attributed to number of reasons. Initially, it was perhaps the crackdown by the law enforcement agencies on some of the big exchange companies such as Zarco, and Khanai & Kalia exchange companies discouraged remitters to use this channel. However, more recently joint efforts by the SBP and the government to facilitate remitters has increased the inflows through the banks. Some of these initiatives include: (1) real time Inter Bank

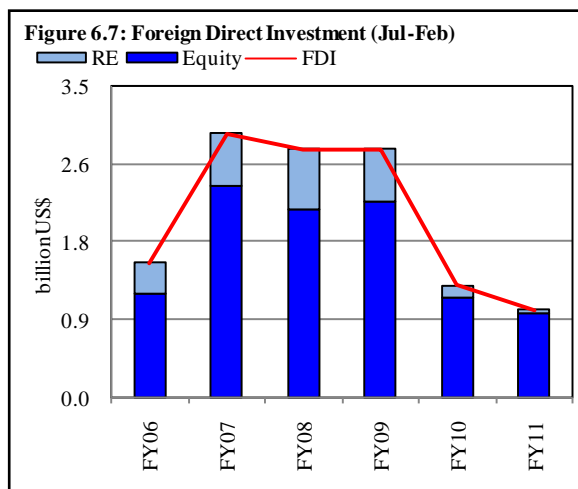


Fund Transfer (IBFT) facility²; (2) cash over counter facility³ and (3) direct debit facility in the beneficiary's bank account. During the past two years PRI has also established around 200 highways (bilateral arrangements with the banks/money changers) and have resolved issues with the labors and overseas agents to enhance remittances through formal channels.

6.3 Financial Account Balance

The declining trend in the financial account balance since FY09 continued during Jul-Feb FY11 as well. The entire decline in the financial account balance was on account of fall in other investment liabilities (loans) since the foreign investment flows improved slightly during this period.

Steep decline in other investments largely owed to absence of one off SDR allocation that had inflated the other investment liabilities in the previous year. However, even after adjusting for the SDR allocation, other investments remained subdued compared to the previous year mainly due to lower net loan inflows and substantial increase in non repatriation of export bills (see **Figure 6.5**).



Net Foreign Investment (NFI) recorded YoY increase of 33.5 percent during Jul-Feb FY11. Within NFI, while foreign direct investment continued to perform poorly for the 2nd consecutive year, foreign portfolio investment recorded a net inflow of US\$ 232 million compared to net outflow of US\$ 304 million in the corresponding period last year. This improvement was entirely on account of lower outflows under debt securities compared to the same period last year⁴ (see **Figure 6.6**).

² In IBFT, beneficiary's bank has an arrangement with the exchange companies/banks abroad. The remitter can transfer funds through these exchange companies and banks to beneficiary's bank account instantly.

³ A beneficiary can receive cash from the bank even without having an account by showing national identity card along with the specific code provided by the sender from abroad.

⁴ This was due to Sukuk bond payment worth US\$ 600 million in January, 2010.

Given that the improvement in portfolio investment is not due to increase in equity investment is rather disappointing as generally there has been a recovery in capital flows to emerging markets during CY10. The foreign portfolio equity investment in emerging economies is forecasted to reach US\$ 186 billion by end of CY 2011, up from an average of US\$ 62 million per year during 2005-2009.⁵

Similarly, FDI to South and South-East Asian economies rose by 18 percent in CY10.⁶ Surge in profits of foreign affiliates due to improved economic condition in the region significantly increased the level of reinvested earnings. Despite these encouraging developments in the region, factors like weak economic growth, poor security situation, circular debt and energy crises have limited the profitability of foreign investors in Pakistan. This is reflected by the sharp fall in reinvested earnings that accounted for 36 percent fall in FDI flows during Jul-Feb FY11(see **Figure 6.7**).

Table 6.3: SBP Reserves

million US\$

	FY11		
	Jul-Sep	Oct-Dec	Jan-Feb
Inflows	3595.3	4039.6	2623.3
Purchases	315	1225	950
Loans & Grants	595.8	180.2	390.6
ADB	60.8	72.9	20
IMF	453.4	1.1	1.2
Others	2,685	2,634	1,283
USA-Logistic Support	0	743	0.3
Forward maturities	1,969	1,283	906
Interest on dep./discount	53.3	33.1	15.1
Miscellaneous receipts	662.7	575.4	361.5
Outflows	3333.1	3663.7	2055.9
Inter-bank sales	90	0	0
Debt Servicing	365.1	431.2	199.2
IMF	91.8	124.2	84.2
ADB	84.8	177.4	44.7
others	188.5	129.6	70.3
Others	2,878	3,233	1,856
<i>of which</i>			
Forward maturities	1,944	1,709	1,525
Defence	147.9	331.4	44.3
Miscellaneous payments	197.2	379.5	286.9
Net change in reserve	262.2	375.9	567.4

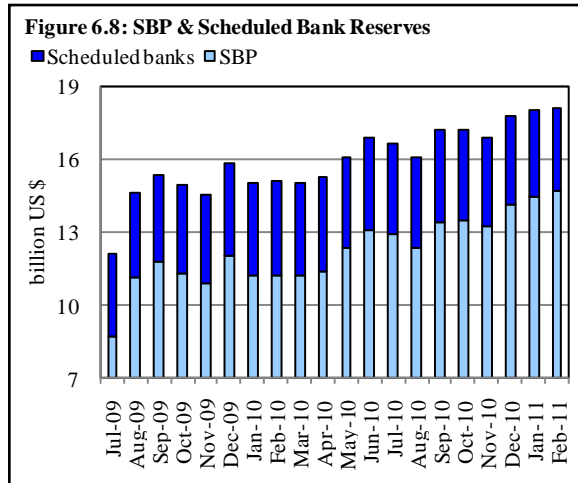
Source: DMMD

⁵ "Capital Flows to Emerging Market Economies" IIF research note, October 4, 2010.

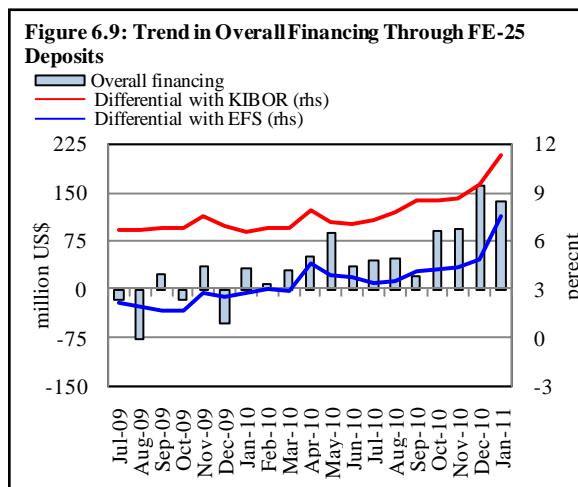
⁶ Major countries that recorded inflows in this region include Singapore, Hong Kong, China, Indonesia, Malaysia and Viet Nam. "UNCTAD Global Investment Trend Monitor NO.5, January 17,2011."

6.4 Foreign Exchange Reserves and Exchange Rate

The improvement in the country's external accounts was reflected in the buildup of foreign exchange reserves, which reached a new peak of US\$ 18.1 billion by end Feb-FY11 (see **Figure 6.8**). The rise in the overall reserves improved the reserves adequacy ratio measured in weeks of imports from 28.2 weeks as at end-June 2010 to 28.6 weeks as of end February 2011.



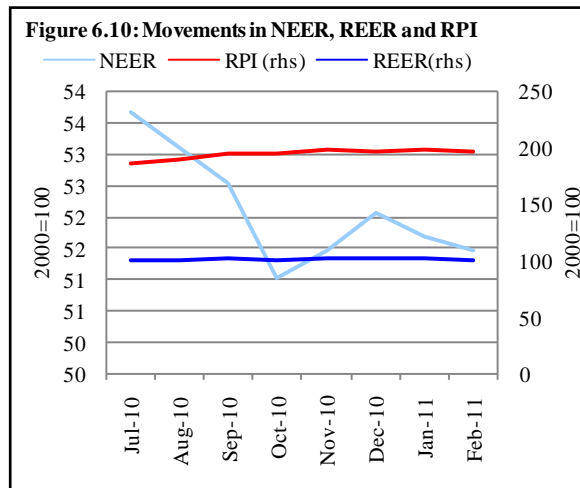
Monthly analysis shows that the SBP reserves recorded positive growth throughout Jul-Feb FY11, except for November 2010 which recorded net outflow of US\$ 390.9 million. This was on account of debt servicing to the multilateral and bilateral donors. Specifically, the debt servicing payment to IMF and the ADB constituted almost 66 percent of the total debt serving in the November 2010 (see **Table 6.3**). However, foreign exchange reserves received a boost in December and January due to inflow of coalition support fund.



As against the SBP reserves scheduled banks reserves declined by US\$ 378 million during Jul-Feb FY11. Although the scheduled bank's reserves benefited from robust performance of the workers' remittances, trade related outflows more than to offset their impact, resulting in net outflow. Along with import payments, import loans also depleted their reserves. Rise in the trade related loans were influenced by increasing differential between foreign currency lending rates and EFS and benchmark KIBOR rate (see **Figure 6.9**).

Owing to strengthening of the country's external accounts Pak rupee exhibited relative stability against the US dollar during Jul-Feb FY11. Thus as against a depreciation of 4.5 percent during the previous year, Pak rupee depreciated by only 0.24 percent during Jul-Feb FY11.

Besides the improvement in the country's external accounts, rupee's relative stability also owes to the weakening of the US dollar against other the major world currencies.



In terms of Nominal Effective Exchange Rate (NEER), rupee depreciated by 6.4 percent during Jul-Feb FY11, which was offset by 6.7 percent rise in relative prices, consequently, Real Effective Exchange Rate (REER) appreciated by 0.4 percent during Jul-Feb FY11 against 1.9 percent in the corresponding period last year (see **Figure 6.10**).

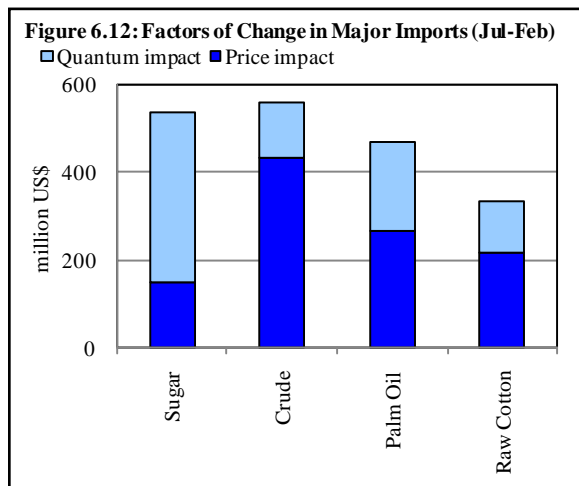
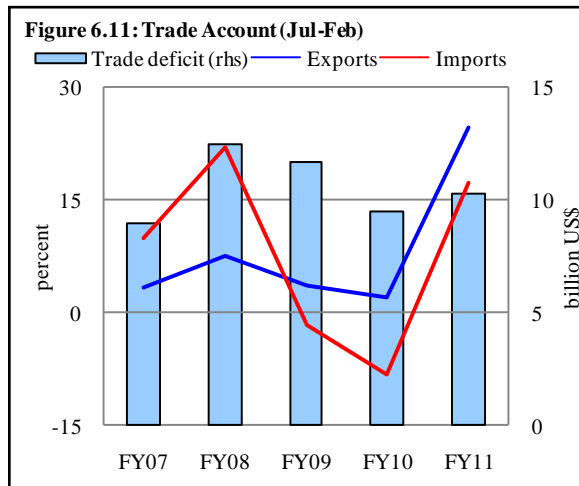
Trade Account⁷

Despite the decent growth in exports, trade deficit widened by 7.9 percent during Jul-Feb FY11 and touched the level of US\$ 10.3 billion (see **Figure 6.11**). This deterioration in trade account is mainly due to an increase of US\$ 3.8 billion in the import bill which more than offset the rise of US\$ 3.0 billion in export earnings.

Analysis of import indicates that more than 50 percent of increase in the import bill during Jul-Feb FY11 originated from high imports of sugar, crude oil, palm oil, petroleum products and raw cotton. On one hand, rising international prices of these commodities translated into higher import prices. On the other hand, increased import quantum of these commodities due to domestic shortages and high demand further inflated the import bill (see **Figure 6.12**).

In case of exports, both textile and non-textile sectors contributed to overall export growth; however the role of textile sector was more prominent (see **Figure 6.13**).

Increased export quantum amid improved external demand⁸ and rising export prices facilitated the textile exporters. In case of rise in non-textile exports, food, petroleum and other manufactures groups recorded positive growth numbers. Higher export prices due

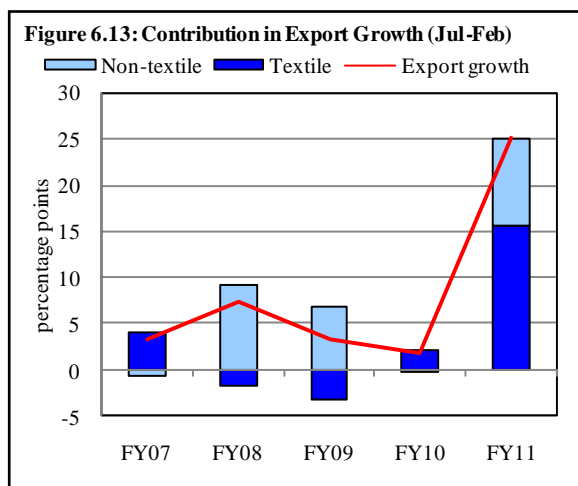


⁷ Discussion in this section is based on FBS data.

⁸ US textile and apparel imports in terms of value from the world increased by 22.8 and 17.6 percent respectively during Jul-Dec FY11.

to rising international commodity prices, improved demand in traditional markets and discovery of new markets were the main factors behind the decent performance of the non-textile sector.

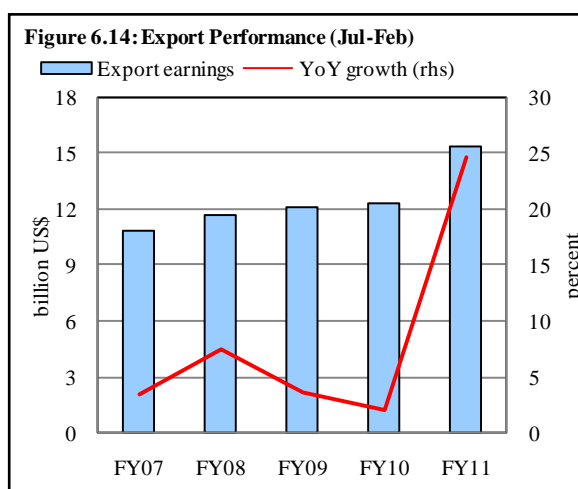
Going forward, trade deficit is likely to widen as rising international commodity prices especially that of petroleum products and palm oil would inflate imports. Shortages of some key commodities such as sugar and cotton would put additional burden on the import bill. Although exports are also expected to grow at a decent pace amid improving external demand and higher export prices however; import growth is likely to outpace export growth in remaining months of FY11.



Exports

Remarkable growth in textile exports accompanied by a decent performance of non-textile exports led to a 24.6 percent YoY rise in overall exports during Jul-Feb FY11 as compared to a modest rise of 1.9 percent during the same period last year. While the rise in textile exports is a function of improved external demand and export prices, improved performance of

non-textile products is attributed to market diversification and increased export prices. Due to strong performances of textile and non-textile sectors, export earnings broke the level of US\$15.0 billion for the first time for Jul-Feb period (see **Figure 6.14**). If this trend continues, export is likely to hit a new record in FY11.



Textile group

Following the improved demand in US and EU (major importers of textile products), textile exports increased by 28.8 percent during Jul-Feb FY11. In absolute terms, textile exports touched the level of US\$ 8.6 billion as both low-value and high value sectors contributed. Despite the shortfall in cotton production, raw cotton and yarn exports were higher than last year's level due to better export prices.

Table 6.4: US Textile and Apparel Demand (Jul-Dec)
growth in percent

	Textile		Apparel	
	FY10	FY11	FY10	FY11
Bangladesh	2.1	38.3	-9.5	26.8
China	-9.1	31.2	-1.3	20.6
India	-9.3	27.0	-7.2	13.1
Pakistan	-10.7	7.8	-13.5	17.1
World	-12.0	22.8	-12.4	17.6

As far as high value added sector is concerned, anecdotal evidence suggests that high value sector was facing both demand and supply side issues during the last two years. On the demand side, economic slowdown in both US and EU had led to fall in export orders, however with the gradual improvement in demand; exports of major textile and apparel exporters including Pakistan have increased during the first half of FY11 (see **Table 6.4**).

Table 6.5: Product Analysis of Textile Sector (Jul-Feb)
YoY change in percent

	Qty	Value	Unit value
Low-value products			
Raw Cotton	-45.3	12.9	106.2
Cotton Yarn	-20.1	44.9	81.3
Cotton Fabrics	7.9	33.3	23.5
Art Silk and Synthetic Textiles	44.7	64.2	13.5
High-value products			
Hosiery (Knitwear)	19.0	26.7	6.5
Bedwear	-2.8	16.5	19.9
Towels	0.1	7.1	7.0
Readymade Garments	21.6	33.7	10.0

On the supply-side, issues such as liquidity constraints, shortage of raw material and prolonged power shortages were adversely impacting the production process. Some of these issues were partially addressed, particularly the shortage of raw material after the imposition of restrictions on exports of cotton yarn. Anecdotal evidence suggests that some major exporters have installed their own power generating units to mitigate power shortages. The rise in international cotton prices also kept the export price impact positive during the period under study.

Product-analysis show that unit value of all the major products of textile sector increased during the period due to rising international cotton prices. Although in terms of quantum, raw cotton and yarn recorded a fall but sharp rise in unit values more than offset the impact of falling quantity (see **Table 6.5**). In case of high value products, with the exception of bedwear, which recorded a fall in terms of quantum, all other products recorded a rise in terms of both unit values and quantum (see **Table 6.5**).

Non-Textile Sector

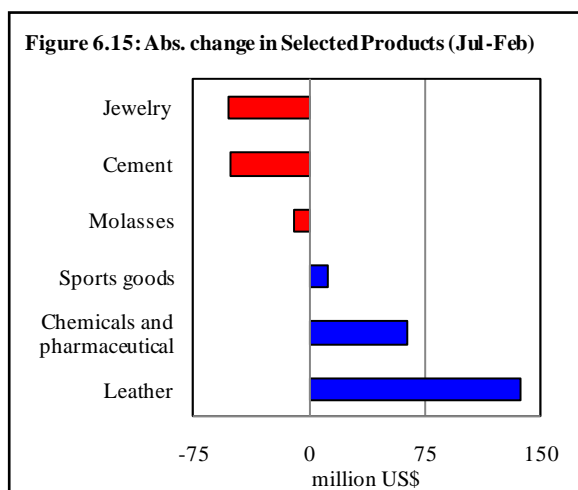
Analysis of non-textile exports shows that all the major groups i.e. food, petroleum and other manufactures posted positive growth numbers during the period under review.

In food group, main impetus came from fish and meat exports, recording a YoY growth of 27.8 and 52.6 percent respectively. In case of fish, exports were driven by increased quantum. Anecdotal evidence suggests that bulk of these exports were to Egypt. As regard the rise in meat exports, it increased mainly on the back of increased export quantum to Saudi Arabia. Higher unit values also facilitated the exporters. Rice exports failed to record a substantial rise mainly on account of declining export quantum. The shortfall in rice production largely explains the low export quantum.

The strong performance of petroleum group is entirely a function of higher export prices as quantum of petroleum product declined during the period under review.

In other manufactures group, exports of leather, chemicals and sports goods recorded a rise; however this rise was partially offset by negative growth in exports of cement, jewelry and footwear (see **Figure 6.15**). The rise in leather, chemicals and engineering goods was a function of improved external

demand in traditional markets, discovery of some new markets and relatively better export prices. On the other hand, the decline in cement exports was in line



with the declining demand in Middle East countries. Moreover commissioning of new cement capacities in India led to fall in exports to India during the period under review. Competition from Saudi Arabia is also an explanatory factor of low cement exports. Exports of molasses remained subdued due to low sugar production, whereas jewelry exports recorded a fall amid low external demand.

Imports

High import prices along with increased import quantum led to 17.3 percent YoY growth in imports during Jul-Feb FY11 in contrast to a fall of 8.2 percent during the same period last year. Although quantum impact was positive in FY10 as well, but negative price impact had more than offset the impact of rise in quantum. In FY11 however, both price and quantum impact together brought a positive change in the import bill (see **Figure 6.16**).

Group-wise analysis shows that with the exception of transport group, all other major groups recorded a substantial rise during the period under review (see **Figure 6.17**). Food group played the dominant part in inflating the import bill. Textile group also recorded a substantial rise amid shortfall in domestic cotton production. Higher cotton prices further put upward pressures on the import bill. Similarly, relative higher crude oil prices inflated the petroleum group imports.

Analysis of food group reveals that main contribution came from sugar, palm oil and pulses (see **Table 6.6**). Domestic shortages of sugar

Figure 6.16: Sources of Change in Import bill (Jul-Feb)

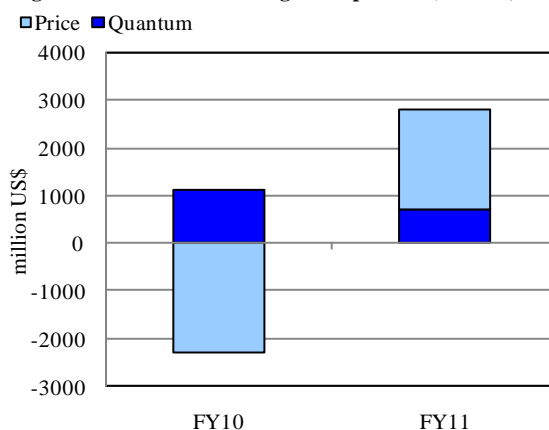
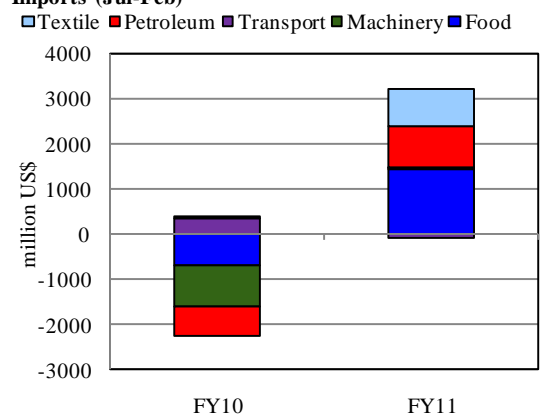


Figure 6.17: Group-wise Contribution in Abs.change in Imports (Jul-Feb)



led to reliance on imported sugar. In case of palm oil, on one hand, reduction of import duty⁹ led to increased import quantum, on the other hand rising palm oil prices put additional pressure on the import bill.

Petroleum group imports increased by US\$ 908 million during Jul-Feb FY11 in contrast to a fall of US\$ 650 million during the same period last year. The dominating factor behind this surge is the rising import price impact. Average import prices during Jul-Feb FY11 were US\$ 577/MT as compared with average import prices of US\$494/MT during FY10.

Textile group imports recorded a substantial increase of 74.7 percent amid increased import quantum and rising import prices. The domestic shortfall of cotton¹⁰ due to devastating floods meant more dependence on imported cotton; rising international cotton prices further inflated the import bill.

Machinery group imports registered a growth of 0.3 percent during Jul-Feb FY11 with main impetus coming from textile and telecom machinery. Textile machinery import has been on a rise since September 2009¹¹ following the elimination of import duty. The inclusion of textile machinery under the Long Term Financing Facility (LTFF)¹² also facilitated the importers of textile machinery. Telecom imports also recorded a substantial rise amid increased demand of cellular phones.

Table 6.6: Sources of Change in Food Imports (Jul-Feb)
million US\$

	Quantum impact	Price impact	Total change
Milk Products	8.5	30.9	39.4
Dry Fruits	6.1	-0.9	5.2
Tea	39	1.2	40.2
Spices	10.2	17.1	27.3
Palm Oil	197.6	217.1	414.8
Sugar	373.4	163.2	536.6
Pulses	79.1	40.4	119.5

Transport group imports fell by 7.3 percent mainly due to fall in the category of aircrafts, ships & boats and other transport equipments. Road motor vehicles imports on the other hand grew by 14.1 percent amid high domestic demand.

⁹ Import duty on crude palm oil was reduced from Rs. 8,000/MT to Rs. 7,000/MT.

¹⁰ Estimates indicate that cotton production will fall short by 1.2 million bales MT.

¹¹ SRO 809(I)/2009 dated 19th September 09, allows reduction of import duty on textile machinery from 5 percent to zero.

¹² SMEFD Circular Letter No. 03 of 2010.

Agricultural and chemical group imports also recorded a fall during Jul-Feb FY11. This decline is largely attributed to fall in fertilizer imports. Increased domestic production explains the drop in import of this category.

Acronyms

ADB	Asian Development Bank
BoP	Balance of Payments
bps	Basis Points
BSC	Bahbood Saving Certificate
BT Cotton	Becillus Thuringiensis Cotton
C/A	Current Account
CPI	Consumer Price Index
CY	Calendar Year
DAP	Di-Ammonium Phosphate
EFS	Export Finance Scheme
EU	European Union
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
FDI	Foreign Direct Investment
FE	Foreign Exchange
FED	Federal Excise Duty
FIBER	Floating Inter Bank Exchange Rate
FSCD	Financial Market Strategy & Conduct Department
f.o.b	Free on Board
FOREX	Foreign Exchange
FPI	Foreign Portfolio Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GoP	Government of Pakistan
GRM	Gross Refining Margin
GST	General Sales Tax
HRI	House Rent Index
HSD	High Speed Diesel
IBFT	Inter Bank Fund Transfer
IFIs	International Financial Institutions
IIF	Institute of International Finance
IMF	International Monetary Fund
KP	Khyber Pakhtunkhwa

KPT	Karachi Port Trust
LSM	Large Scale Manufacturing
MAF	Million Acre Feet
MENA	Middle East/North Africa
MoM	Month-on-Month
MT	Metric Ton
MTBs	Market Treasury bills
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFC	National Finance Commission
NFI	Net Foreign Investment
NFNE	Non Food Non Energy
NPLs	Non Performing Loans
NSS	National Savings Scheme
OMOs	Open Market Operations
PIBs	Pakistan Investment Bonds
PKR	Pak Rupee
PO	Post Office
POL	Petroleum, Oil and Lubricants
PPTFC	Privately Placed Term Finance Certificates
PRI	Pakistan Remittance Initiative
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
REER	Real Effective Exchange Rate
RFCAs	Residents Foreign Currency Accounts
RGST	Reformed General Sales Tax
RHS	Right Hand Side
SBA	Stand-By Arrangement
SBP	State Bank of Pakistan
SDRs	Special Drawing Rights
SMEs	Small and Medium Enterprises
SMEFD	Small and Medium Enterprises Finance Department
SPI	Sensitive Price Index

SRO	Statutory Regulatory Order
SSCs	Special Saving Certificates
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
WPI	Wholesale Price Index
YoY	Year on Year