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1 Overview and Outlook

The analysis in this report is confined to the period July-March FY12.

Although Pakistan's economy has shown some recovery in terms of GDP growth, key macro indicators still remain weak. Specifically, while inflationary pressures have eased compared to last year, inflation expectations are entrenched; the deterioration in the external account has been less adverse than expected, but financing the current account deficit remains challenging; and lastly, despite strong growth in tax collection, there are pressures on the fiscal account. Furthermore, energy shortages and low investment continue to compromise the economy's capacity for growth.

According to the recently released official National Income Accounts, economic growth is 3.7 percent during

FY12 – higher than the 3.0 percent realized in the previous year, but less than the target of 4.2 percent.¹ Nevertheless, this performance is notable, given the considerable damage to the cotton crop due to floods in August 2011; ongoing energy shortages; the rise in international oil prices; and security concerns.

This growth has also been more broad-based with a larger contribution from the commodity producing sectors compared to FY11. Moreover, as in the past, growth has been driven by a sharp increase in domestic consumption (both private and public), which was

Table 1.1: Selected Economic Indicators

		FY10	FY11	FY12
<u>Growth rate (percent)</u>				
LSM	Jul-Mar	0.4	-0.6	1.1
Exports (fob-PBS)	Jul-Mar	5.2	26.0	-3.0
Imports (cif-PBS)	Jul-Mar	-3.9	15.6	14.7
Tax revenue (FBR)	Jul-Mar	11.6	12.2	25.5
CPI (period average) ¹	Jul-Mar	9.4	14.0	10.8
Private sector credit	Jul-Mar	4.7	7.1	6.4
Money supply (M2)	Jul-Mar	6.0	9.4	8.1
<u>billion US dollars</u>				
Total liquid reserves ²	31 st Mar	15.0	17.7	16.5
Home remittances	Jul-Mar	6.6	8.0	9.7
Net foreign investment	Jul-Mar	1.2	1.3	0.4
<u>percent of GDP³</u>				
Fiscal deficit	Jul-Mar	4.2	4.3	4.3
Trade deficit	Jul-Mar	4.6	3.8	5.0
Current a/c deficit	Jul-Mar	1.8	0.0	1.3
¹ Base year-FY08				
² With SBP & commercial banks				
³ Based on full-year GDP in the denominator				
Source: State Bank of Pakistan				

¹ One may keep in mind that GDP growth for FY11 was revised upward from 2.4 percent (provisional estimates) to 3.0 percent, which means a base-effect has come into play.

partially offset by a decline in domestic investment and external demand. The continuous decline in investment for the fourth consecutive year, is a source of growing concern, as it will stifle the long term growth of the economy.

Energy shortages continue to constrain growth and conservation efforts alone cannot bridge the shortfall. During Jul-Mar FY12, power generation recorded a marginal increase, with no notable rise in gas supplies. At the same time, and despite efforts to resolve the circular debt problem, liquidity constraints in the power sector have worsened due to higher international oil prices.

While these challenges will continue to shape the outlook for the economy, it is important that GDP data should reflect the changing nature and composition of the country's economic activities. Pakistan Bureau of Statistics (PBS) is already in the process of rebasing the national income accounts. We expect that PBS would also consider releasing GDP estimates on a quarterly basis, which is now a norm in emerging markets. It will help get a more accurate and timely picture of the real economy, which will allow for more proactive policy corrections.

While low investment and energy shortages have direct growth implications, the persistently high fiscal deficit remains a major risk to the macro-economy. Current information suggests a budget deficit of 4.3 percent of GDP for Jul-Mar FY12, and it appears that the budgetary gap for the full year will exceed the revised target of 4.7 percent. Overall revenues are lower than expected.²

Furthermore, though the growth in current expenditure is lower compared to the previous year, the government has enhanced its development spending.³ While such spending should improve the country's long-term growth prospects, this also creates financing pressures. At the same time, despite efforts to reform public sector enterprises, the operational efficiency of key PSEs (e.g. PIA, Pakistan Railways and Pakistan Steel) has not improved. This continues to add to the country's fiscal burden.

In terms of financing this gap, the government relied more on domestic sources as external financing dried up. The government borrowed Rs 847.5 billion in Jul-

² While FBR tax collection posted strong growth, other revenues were less than expectations. For example, auction of 3G licenses got delayed, receipts of coalition support fund did not materialize, and provinces posted lower than expected surpluses.

³ During Jul-Mar FY12, the consolidated figure shows that Rs 421 billion has been utilized as development spending. Although this is only 57.1 percent of the annual target, during the corresponding period of FY11, only 38.5 percent of the full year target had been used. In effect, the government has sharply increased development spending.

Mar FY12 from domestic sources, compared to Rs 700.1 billion in the corresponding period of FY11.⁴ Lately, this has been increasingly skewed towards borrowing from the central bank.

Such borrowing is inflationary and a risk to macro-stability. Currently, two Acts – namely the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) and the newly amended SBP Act (2012) – provide guidelines on overall debt stocks and borrowing from the central bank, respectively. As things stand, adherence to these limits has not been met. For example, while the government was set a net quarterly limit of zero for its borrowings from the central bank, it has borrowed Rs 70.8 billion during Q3-FY12; it also borrowed Rs 227.9 billion during the second quarter.

The large fiscal deficit has resulted in a sharp increase in Pakistan's debt. Government domestic debt recorded an increase of Rs 1.2 trillion during Jul-Mar 2012 to reach Rs 7.2 trillion. Furthermore, there is greater reliance on short term borrowing. This is creating liquidity management problems for the central bank, and *rollover* and *interest rate* risks for the government.

This challenge can be gauged from the T-bill auction calendar for Q4-FY12. The target amount for the fourth quarter is Rs 995 billion; of that, Rs 964.3 billion is simply to rollover maturing T-bills. With a change in banks' preference towards 3-month T-bills, it is expected that the maturity profile of the existing debt may shorten further, which would, in turn, make SBP's liquidity management even more difficult.

So far, SBP has been providing liquidity support to the market to ensure the smooth functioning of the financial markets and payment systems. Although this is meant to be temporary liquidity support, it appears to have become a permanent feature. Needless to say, these injections have inflationary implications.

Although inflationary pressures have eased as compared to last year, inflationary expectations are still entrenched, and headline CPI inflation remains in double digits.⁵ More importantly, the diffusion of inflation across different commodity

⁴ This excludes borrowing of Rs 391 billion to partially settle the payables in the energy and commodity sectors.

⁵ Inflation had rebounded to double digit after receding to below 10 percent for only one month. The re-surge in inflation was expected (passing on of higher international oil prices and the revision in gas tariffs; government borrowing from the central bank accelerated during the quarter; and increased energy shortages in the winter worsened aggregate supply).

groups has increased. In this context, increase in government borrowing from SBP may further stoke inflationary expectations.

With the government's growing appetite for funding, banks have little incentive to finance the private sector. At the same time, demand for private sector credit is likely to be dampened this year, as loans to private businesses increased by only 1.8 percent in Jul-Mar FY12 – the lowest growth rate in the past 10 years. The slowdown is concentrated in working capital and trade financing.⁶ However, there are indications that fixed investment loans have bottomed out.

Finally, in the external sector, developments in Q3-FY12 were less adverse than we had expected. Larger inflows of remittances and a lower trade deficit, explain this relative improvement. Having said this, the current account deficit during Jul-Mar FY12 is US\$ 3.1 billion, compared to a deficit of US\$ 10.0 *million* in the corresponding period last year. More importantly, the expected inflows under Coalition Support Fund (CSF); the auction of 3G licenses; and arrears from PTCL privatization, did not materialize during the quarter. Nevertheless, foreign exchange reserves fell to US\$ 16.4 billion by end-March 2012, from US\$ 18.2 at end June 2011. SBP's reserves declined throughout FY12, whereas FX reserves of scheduled banks increased during this period.

The lower trade deficit during Q3-FY12 is particularly welcome when seen in the context of domestic energy shortages; international oil prices; and the sluggish recovery in global demand.

Looking forward

As mentioned earlier, persistent inflation and pressure on the fiscal and current accounts, remain the key challenges for the economy.

Given the recent trend in CPI inflation, SBP has revised its forecast downward by 0.5 percentage points (see **Table 1.2**). On the other hand, despite the lesser than expected pressures on external account in Q3, SBP maintains its forecast for the current account deficit for the year.

Finally, in terms of the fiscal deficit range, the upside risk dominates given efforts to resolve the circular debt problem; continuing losses in public sector enterprises;

⁶ This is due to decline in cotton prices, partial settlement of circular debt, government support to sugar industry, retirement under foreign currency loans following depreciation of the Rupee against the US Dollar.

impediments in CSF; and the realization that receipts from the auction of 3G licenses is unlikely to be materialized this fiscal year.

Afterthought⁷

If one looks objectively at Pakistan's economy, it is clear that the system is facing serious challenges. The list is familiar: fiscal pressures that require an increasing volume of domestic financing; an energy shortage that entails economic and social costs; low investment that is undermining future growth; issues with law and order; and the neighboring war in Afghanistan.

At the risk of making too fine a point on the matter, Pakistan's economic data appears to suggest two things: first, that

Pakistan has fallen behind its neighbors in South Asia; and two, even this below-potential growth is quite impressive when seen in the context of the challenges mentioned above. In our view, the latter point is not widely appreciated.

There is a growing sense that Pakistan's undocumented economy (the informal sector) is vibrant, and that official data understates the level of economic activity that can be seen. In effect, there seems to be a disconnect.

This disconnect becomes more obvious when one observes the economic plight of EU countries, which are barely able to contain the fall-out of the debt crisis that could threaten the very existence of the Euro. Since countries like Greece; the UK and Spain are now officially in recession, the telltale signs of a recession are worth listing:

Table 1.2: SBP Projections of Major Economic Indicators

	FY12		
	FY11	Targets	SBP Projections
<u>Growth rates in percent</u>			
GDP	2.4	4.2	3.7 ¹
Average CPI Inflation	13.7	12.0	10.5-11.5
Monetary assets (M2)	15.9	-	13.0-14.0
<u>Billion US Dollars</u>			
Workers' remittances	11.2	12.0	13.0-13.5
Exports (fob-BoP data)	25.4	25.8	24.0-25.0
Imports (fob- BoP data)	35.8	38.0	40.0-40.5
<u>Percent of GDP</u>			
Fiscal deficit	6.6	4.7 ²	5.5-6.5 ³
Current account deficit	-0.1	0.6	1.5-2.5

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the budget document for FY12, while their projections are based on FBS provisional estimates of nominal GDP for the year.

¹ This shows PBS provisional estimates, instead of SBP's projections.

² This is the revised fiscal deficit target for FY12; original target was 4.0 percent of GDP.

³ Upper end of the range assumes slippages in FBR tax revenues, zero receipts from 3G licenses, shortfall in Coalition Support Fund, balance budget of provincial governments, and overrun in expenditures.

⁷ This section contains the thoughts of Dr Mushtaq A Khan, Chief Economic Adviser, SBP.

- Curtailed consumer demand (especially for consumer durables), as uncertainty takes hold;
- The resulting closure of small businesses;
- A slump in demand for luxury services like restaurants; cinema and overseas travel;
- A reduction in retail volumes and normal traffic flows;
- Construction activity slows down; and
- A growing number of unemployed mingling with a shrinking number of buyers in markets and shopping malls.

We do not really see this in Pakistan. Granted this is anecdotal as there is little hard data to verify this view, but anecdotal evidence is often the most current source of information to gauge how the economy is actually performing.

It is a stylized fact that the informal sector in Pakistan is buoyant, and is generating jobs; incomes; and demand for goods and services. This, in turn, is spilling over into the real sector that is documented. Hence, as discussed in Chapter 2, there are clear signs that construction is up, which is helping ancillary sub-sectors like steel; cement; chemicals; wood; glass; paints; etc.

Many would argue that a vibrant informal sector is a blessing, as it is driving formal economic activities, and keeping Pakistan from a full blown recession as seen in Europe. Furthermore, the increasingly precarious social safety net that is stoking public anger in Europe, may not be relevant in Pakistan where the extended family and community steps in to take care of the elderly, the unemployed, and the destitute. Although we would concede these points, it is important to keep things in perspective.

While social institutions like the extended family; mosques; neighborhood charities; ethnic/community organizations; etc., are robust and sustainable sources of social and economic uplift, the role of the state (beyond official safety nets) cannot be eliminated. More specifically, physical infrastructure and other public goods (e.g. security; law enforcement; judicial services and contract enforcement; recreational spaces; etc.) would be undersupplied by private organizations, which are required to promote sustainable economic activities. If the mind-set of absolute self-sufficiency becomes more entrenched, it may segment the economy.

As shown by the growing strength of Asian countries in the global economy, seeking larger markets that allows for economies of scale and specialization is necessary for economic prosperity. In this context, despite innate resistance, Pakistanis must accept documentation and the need to pay their taxes. Only this

will ensure the state has the resources to create and maintain the type of the platform needed for higher and sustained economic growth.

2 Real Sector

2.1 Real GDP

Preliminary estimates for FY12 GDP (based on Jul-Mar data) indicate that the economic growth improved over last year, but still fell short of target.⁸ At the very onset of FY12, the economy faced headwinds in the form of floods and a persistent energy crisis which had diluted hopes of achieving

the targeted growth rates. Further down the year, growing uncertainty over the global economic outlook saw a fall in external demand, and FDI inflows remained weak. Furthermore, volatility in global commodity prices – particularly for energy-related products led to a sharp growth in imports. Given these challenges, the 3.7 percent growth in GDP this year is reasonable.

This growth was supported by a better harvest, pick up in construction and increase in value addition from the *finance and insurance* sub-sector. Specifically, despite losses to the cotton crop; decline in wheat production; and lower fertilizer usage, growth in major crops exceeded the target. Similarly, construction was more active as post-flood reconstruction and infrastructure building became priorities.

FY12 GDP growth was led mainly by consumption expenditure, which was stimulated by supportive government policies;⁹ as well as higher remittance inflows. Consumption expenditures in FY12 are estimated to have grown by 8.2 percent (in real terms), compared to just 2.6 percent in FY11. On the upside, this invigorated production in consumer goods and the construction industry.

Table 2.1: GDP Growth (at 1999-2000 base)

In percent

	Growth			Contribution to growth	
	FY11	FY12 ^T	FY12	FY11	FY12
Agriculture	2.4	3.4	3.1	0.5	0.7
Industry	0.7	3.1	3.4	0.2	0.9
Services	4.4	5.0	4.0	2.3	2.1
GDP (factor cost)	3.0	4.2	3.7	3.0	3.7

T: Target

Source: Pakistan Bureau of Statistics

⁸ The official growth numbers are in line with SBP's projections of 3.0-4.0 percent growth, as stated in Second Quarterly Report for FY12.

⁹ This includes higher subsidies, and consumption-promoting policies, such as relaxation of import age of used cars and lower taxation.

However, a significant portion of this demand is being met by imports, especially in the case of sophisticated manufactured goods. Reportedly, local manufacturers are facing high energy-related costs, which make it difficult to beat import prices.

Although some investments are being made to improve energy efficiency, these remain sporadic and concentrated in a few large scale industries. In fact, investment spending in the economy is insufficient across all sectors. Overall, investment declined by 10.2 percent this year – for the fourth straight year since the recession of FY08. We believe that, although surplus capacities exist in some sectors (particularly LSM), there is still large potential for efficiency-boosting investments in all areas.

2.2 Agriculture

The agriculture sector performed better this year. Livestock, with the highest share in agriculture GDP, remained the largest contributor to growth (Table 2.2).¹⁰

Major crops, mainly the *kharif* crops (e.g., rice, cotton, sugarcane, maize) also

contributed to agricultural growth. The yields of the minor crops, on the other hand, suffered from multiple shocks: first due to rains in July 2011, and then from exceptionally low temperatures in February 2012.

Since the discussion on *kharif* crops has already been covered in the Second Quarterly Report for FY12, the focus of this section is on wheat, which is the largest crop of the *rabi* season.¹¹

Wheat

Wheat contributes 13 percent of the total value addition by the agricultural sector, and is cultivated over 37 percent of the total crop area. At end-March 2012, the

Table 2.2: Growth in Agriculture (at 1999-2000 base)
In percent

	share in Agri	Growth		Contribution to agr. growth	
		FY11	FY12	FY11	FY12
Agriculture		2.4	3.1		
Major crops	31.9	-0.2	3.2	-0.1	1.0
Minor crops	10.1	2.7	-1.3	0.3	-0.1
Livestock	55.1	4.0	4.0	2.1	2.2

Source: Pakistan Bureau of Statistics

¹⁰ The livestock sub-sector includes the value of livestock and its products (milk, meat, eggs, hides and skins, wool & hair). The output estimates of livestock and their products are based on fixed inter-census growth rates; the last census was conducted in 2006.

¹¹ The *rabi* season begins in October and continues till April. Other *rabi* crops are gram, tobacco, rapeseed, barley and mustard, which altogether account for less than 0.5 percent of value addition by agriculture.

crop has reached its maturing stage and preliminary estimates suggest total production of 23.5 million tons, compared with 25.2 million tons realized in the previous year (**Table 2.3**). Not only was the area under wheat cultivation lower this year, but crop yields also declined because of lower fertilizer use and water shortages.¹² Therefore, even the incentive of higher wheat support prices fell short in enhancing production towards achieving the target of 25 million tons. More specifically:

Table 2.3: Major Crops

production in million tons (for cotton in million bales);

	% share in value addition			% growth
	in FY11	FY12	FY11	
Wheat	14.2	23.5	25.2	-6.7
Rice	42.3	6.2	4.8	29.2
Cotton	22.3	13.6	11.5	18.3
Sugarcane	11.7	58.0	55.3	4.9
Maize	2.25	4.3	3.7	16.2

Source: Pakistan Bureau of Statistics

1. *Farmers were cash strapped*: Due to a steep fall in the prices of the cotton crop, and inordinate delays in payments from sugar mills, farmers were short of liquidity. Furthermore, liquidity was constrained by high fertilizer prices. As a result, off-take of urea and DAP dropped significantly below *rabi* 2011 levels¹³ – the year when alluvial soil had curtailed the need for fertilizer use to some extent.

2. *Water shortage*: The wheat crop was also struck by a water shortage, particularly in Sindh, during this season (**Table 2.4**). Not surprisingly, production declines were concentrated in Sindh. The total water availability was even lower than the minimum level projected by Indus River System Authority (IRSA).¹⁴

Table 2.4: Water Situation During Rabi

million acre feet

	Rabi 2012	Rabi 2011	% change
Punjab	17.6	18.7	-6.0
Sindh	10.1	14.5	-30.2
Khyber Pukhtunkhwa	0.6	0.5	16.7
Balochistan	1.1	0.9	27.8
Total	29.4	34.6	-15.0

The receding level of irrigation water was due to dry conditions in the country, and a longer spell of low temperature that reduced river flows during the *rabi*

¹² Area under wheat cultivation dropped by 3 percent because (a) some parts of Southern Sindh remained inundated due to floods of June 2011, (b) delays in the harvesting of sugarcane, and (c) some farmers in Southern Punjab opted for early sown cotton variety instead of wheat.

¹³ The off-take of urea and DAP showed declines of 14.2 percent and 31.2 percent respectively over the last *rabi* season. The *rabi* season extends from October till March.

¹⁴ IRSA states the minimum water availability for the two agriculture seasons. IRSA projected minimum water availability of 29.8 MAF for *rabi* 2012.

season. Demand, on the other hand, continued to grow. Hence, Tarbela and Mangla – the largest water reservoirs – reached their dead level by 12th March 2012, which was several weeks earlier than their normal depletion date.

Encouragingly, despite lower production, overall wheat availability is adequate; domestic consumption is around 22 million tons, whereas the country already has a carryover stock of 3.9 million tons from the previous crop.¹⁵ However, this situation may create a potential challenge for the government. Specifically, the government has set a wheat procurement target at 7.7 million tons for the current crop, which is higher than actual procurement of 6.2 million tons last year. Hence, with the currently high levels of carryover stock, the settlement of commodity loans for the new season may not be possible without incurring an additional fiscal cost, as current international prices of wheat are considerably lower than the government's support price.¹⁶ In case procurement remains below target, the domestic price of wheat may fall further, thereby squeezing farmers' margin.

Minor crops

Minor crops (which represent 11 percent of the value addition in agriculture sector) suffered multiple shocks, particularly in Sindh: firstly, the July 2011 floods damaged chilies, onion, and tomato crops; this was followed by another setback, when exceptionally severe winter conditions resulted in losses to banana, chilies and tomatoes. As a result, minor crops posted a decline of 1.3 percent in FY12, compared to growth of 2.4 percent in the previous year.

2.3 Industrial Sector

Industrial sector surpassed its growth target of 3.1 percent for FY12, mainly due to higher-than-targeted growth in mining and construction industries. LSM production, on the other hand, remained below-target, mainly due to severe energy shortages (**Table 2.5**). Interestingly,

Table 2.5: Growth in Industry (at 1999-2000 base)

In percent

	share in Ind.	Growth		Contribution to indus. growth	
		FY11	FY12	FY11	FY12
Industry		0.7	3.4		
Large scale	46.9	1.1	1.8	0.5	0.8
Small scale	21.0	7.5	7.5	1.4	1.5
Mining & quarrying	9.4	-1.3	4.4	-0.1	0.4
Construction	8.5	-7.1	6.5	-0.6	0.5
Elec. & gas distt.	8.6	-7.2	-1.6	-0.7	-0.1

Source: Pakistan Bureau of Statistics

¹⁵ Carryover stock is of end-March 2012.

¹⁶ See Section on Commodity Operation in **Chapter 3**.

although the small-scale industries also suffered from energy shortages – perhaps more severely than the large scale sector – their growth contribution remains the highest.¹⁷

Large Scale Manufacturing

The better performance of LSM was surprising as it came against the backdrop of continued energy shortages that constrained growth in a number of industries (e.g., textile, fertilizer, leather, soda ash, caustic soda, steel, and glass) and increased competition from imported substitutes. We believe that spillover benefits from improved agriculture, higher construction activities, and strong demand for consumer goods led to some recovery in LSM.

Sector-wise developments:

Key developments in specific sectors (textiles, auto, fertilizer, and construction materials) are discussed in annexures at the end of this chapter. However, trends in other major sectors are covered in the following paragraphs.

The *food, beverages and tobacco industry* has performed well on the back of a better harvest, strong domestic demand, and greater exports to Afghanistan (Table 2.6).

Over the past year, five new beverage plants have opened in Khyber Pukhtunkhwa.¹⁹ Similarly, oil and ghee exports to Afghanistan have also been higher. Furthermore, the demand for wheat flour increased as the government allowed formal export to Afghanistan in Q4-FY11.

Table 2.6: Selected Indicators of Food, Beverages and Tobacco Industry (Jul-Dec)¹⁸

Item	Share in food index	Export to production ratio (%)		Export share of Afghanistan (%)	
		FY11	FY12	FY11	FY12
Veg. oil & ghee	27.3	5.9	10.6	97.4	99.9
Cigarettes	17.2	0.0	0.1	0.0	0.0
Wheat flour	8.2	6.1	18.1	98.9	91.1
Beverages	7.3	1.6	2.7	98.0	96.8
Tea	3.1	1.0	1.6	0.0	32.2
Juices, syrups, squashes	1.7	82.1	91.7

Source: Pakistan Bureau of Statistics

¹⁷ The small scale manufacturing consists of informal activities which are difficult to measure on annual basis. PBS has therefore assumed a *constant* annual growth rate of 7.5 percent in value addition from this sector. This growth number is based on surveys of Small and Household Manufacturing Industries. The last survey was conducted in 2006-07.

¹⁸ Export data was extracted from HS-code level files (sourced from PBS). Following are the reference codes: Vegetable oil & ghee: 1516.2010, 2020 & 1517.1000; cigarettes: 2402.2000; wheat flour: 1101.0010; beverages: 2201.1020, 9000 & 2202.1010-9000; tea: 902.1000, 2000, 3000, 4010, 4020, 4090; and juices, etc.: 2009.1100-2009.9000, & 2106.9020.

¹⁹ The government also reduced excise duties on beverages in FY12 Budget.

In the *pharmaceutical industry*, the government reduced the custom duty on raw material imports (in most cases from 10 percent to 5 percent) which made exports more competitive.²⁰ In the domestic market, an upward revision of some medicine prices also led to improved margins.

It is widely held that the import of consumer durables is impeding the domestic industry (**Table 2.7**). In the case of *home electronics*, smuggling of Korean and Indian TV sets (via the Dubai-Afghan Transit Trade route) and under-valuation and under-invoicing of Malaysian and Chinese air conditioners have put the local industry under stress.²² In the lower-end of the market, the demand for fans has fallen substantially because of extreme load-shedding in Punjab.²³

Leather footwear and allied industries posted a YoY decline in Q3-FY12 on

account of power shortages and increasing competition from imports. We expect production to remain under pressure because the footwear industry is largely based in Punjab which appears to be facing the brunt of the power shortage.²⁴

Table 2.7: Consumer Durables Demand Indicators²¹

	Share in QIM	YoY Production (Jul-Mar) Growth in %		Imports to production ratio (Jul-Dec) in %	
		FY11	FY12	FY11	FY12
Transport	5.4				
Car	4.0	16.1	8.8	..	27.2*
Motor cycle	0.9	20.1	3.4
Bicycle	0.1	-23.1	-30.0	50.5	86.8
Motor tyre	0.4	9.6	-25.4	42.3	72.1
Electronics	0.8				
Refrigerator	0.3	-2.4	6.8	1.3	2.1
Air cond.	0.1	-11.9	4.3	19.9	26.7
TV	0.2	28.6	-25.9	0.0	0.0
Fans	0.1	-9.5	-13.5	18.9	22.0
Other	0.8				
Footwear	0.7	21.1	6.2	30.0	25.7
Sew. mach.	0.1	-3.4	-10.3	257.8	207.9
Overall	6.9	14.6	3.2		

Source: Pakistan Bureau of Statistics. *Jul-Nov.

²⁰ Although a drug scandal in Q3-FY12 did lead to some scepticism in Afghan and Tajik export markets, the industry believes that the impact would be limited.

²¹ Import data was extracted from HS-code level files (sourced from PBS). Following are the reference codes: Bicycle: 8712.0000; Motor tyre: 4011.1000-4000; Refrigerator: 8418.2100-2900; Air conditioner: 8415.1010-1020; Television set: 8528.7211-7212; Fans: 8414.5110-5990; Footwear: 6403.2000, 6403.5900, 6404.2000, and 6405.1000; Sewing machine: 8452.1090-2900.

²² It may be noted here that the electronics industry is highly protected as the average import duty on CBUs is 35 percent.

²³ Chinese rechargeable fans appear to be a better substitute under the circumstances, and are rapidly making way in the domestic market. Such fans are not being manufactured locally.

²⁴ The data for leather footwear provided by the PBS covers Punjab's production only.

Soda ash and caustic soda suffered on account of natural gas shortages in winter. These industries are rapidly converting to coal-based power, which will run on local coal. We expect a recovery in Q4, as some of these arrangements become effective.

Construction

According to preliminary estimates for FY12, the construction industry reported 6.5 percent growth compared to a 7.1 percent *decline* in FY11. This growth was well above the target of 2.5 percent.

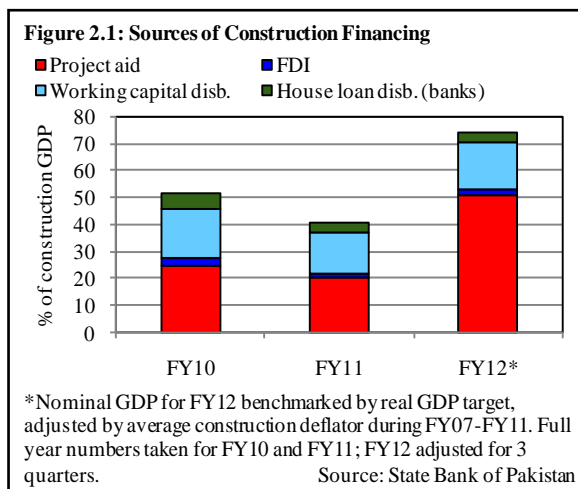
With the end of winter, construction activity gained further momentum, particularly in March. As a result, cement sales reached a record high of 2.6 million MT in March 2012 – showing a YoY growth of 10.6 percent over March last year. Moreover, some building material producers, whose production had been declining until the last quarter, posted positive growth in Q3-FY12 (**Annexure 4**).

Higher inflows of project aid and larger fund releases under the public sector development program, suggest greater activity in public sector projects (**Figure 2.1**).²⁵

However, the sustainability of private sector construction activities is doubtful, as the financial sector continues to maintain a cautious stance towards both residential mortgages and commercial construction.²⁶

2.4 Services Sector

The 4.0 percent growth in the services sector was lower compared to 4.4 percent in the previous year – it was also below the target of 5.0 percent. Improved performance of *finance and*



²⁵ During H1-FY12, PSDP releases were higher by 65.6 percent YoY, compared to -28.9 percent decline seen in H1-FY11. Q3-FY12 data is not yet available.

²⁶ While disbursements for working capital to construction industry and for house-building loans posted positive YoY growth in Q3-FY12, the growth seems anemic when adjusted for around 19 percent average inflation in construction costs this year.

insurance and transport, storage and communication sub-sectors was more than offset by weaker growth in *public administration and defence* (**Table 2.8**)

Table 2.8: Growth in Services (at 1999-2000 base)

In percent

	share in services	Growth			Contribution to services growth	
		FY11	FY12 ^T	FY12	FY11	FY12
Services		4.4	5.0	4.0		
Transport, storage & communication	18.0	0.9	4.5	1.3	0.2	0.2
Wholesale & retail trade	32.0	3.5	5.0	3.6	1.1	1.1
Finance & insurance	8.9	-1.4	0.2	6.5	-0.1	0.6
Ownership of dwellings	5.1	1.8	3.5	3.5	0.1	0.2
Public admin. & defence	12.4	14.2	6.0	2.6	1.6	0.3
Social & community services	23.6	6.9	7.0	6.8	1.6	1.6

Source: Pakistan Bureau of Statistics

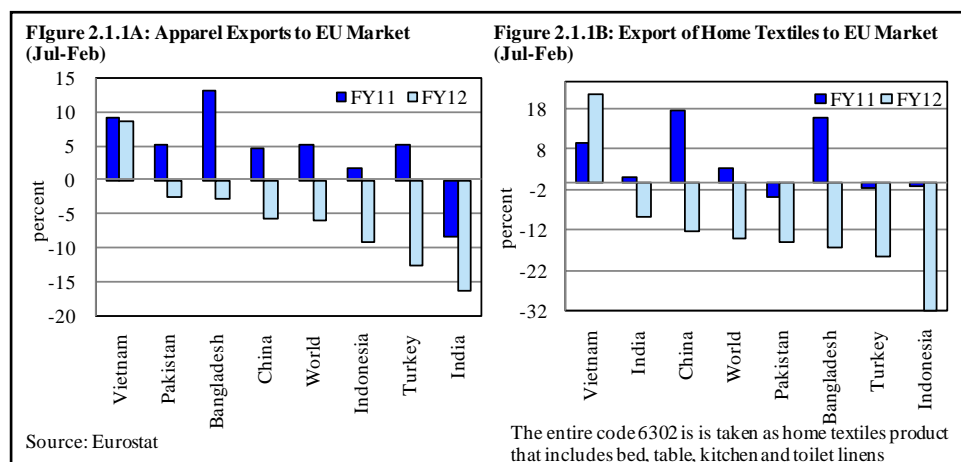
In overall terms, the banking sector and mutual funds have posted strong profits, which is driving growth in FY12. We expected stronger growth in transport as corroborated by higher fuel consumption, as well as increase in domestic sales of vehicles. However, an offsetting factor to this could be the continual losses being run by PIA and Pakistan's Railways.

Weaker growth in the *public administration and defense* is probably due to lower flood-related spending this year, compared to FY11. The FY11 was also characterized by a substantial increase in salaries for public sector employees.

Annexure 1: Understanding the Decline in Textile Exports²⁷

The global economic slowdown struck Pakistan's textiles industry once again in FY12, following the modest recovery in the previous two years. Consumer sentiments in US and EU remained bearish, causing a decline in textile related purchases as buyers switched to low-end products. Up till March 2012, global textile exports declined by 9.4 percent. Seen in context of the 7.6 percent decline in FY09 – the worst of the global recession – the FY12 decline is indeed enormous. In addition to this global slump, anecdotal evidence suggests that shortage in energy is not allowing local manufacturers to meet delivery deadlines, which undermines the future relationship with these export markets.

Nevertheless, the decline in Pakistan's apparel exports was modest compared with key competitors like Bangladesh, India and Turkey that also export to the EU (see **Figure 2.1.1**)²⁸.



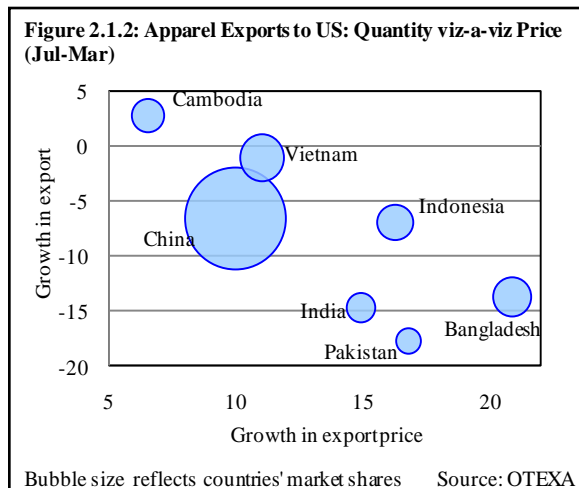
Garment exports from India and Turkey which entail higher value-added products faced double-digit declines. The demand for Pakistan's low value-added exports was less adversely affected, as consumers switched from high-price to low-price products. In the home-textile market too, the decline in Pakistan's exports was smaller than the overall decline in EU imports.

²⁷ The section has been authored by Ms Asma Khalid (asma.khalid@sbp.org.pk).

²⁸ Due to worsening debt crisis and low consumer confidence through most of the period, sales and import of textile & clothing declined sharply; most notably in France, Netherlands and Germany.

US imports for textiles also remained depressed throughout the period Jul-Mar FY12, with declines evident in both apparel as well as home textiles. In home textiles, Pakistan's exports fared better compared to China, Turkey and Bangladesh.

In contrast, however, Pakistan's garment exports to the US suffered a strong blow compared with almost all our major competitors. This was mainly because of a sharp increase in unit prices (see **Figure 2.1.2**); and the fact that the fall in apparel demand in the US was concentrated in cotton products.²⁹



Looking specifically at fabric exports, the entire decline is explained by the imposition of safeguard duties by Turkey effective from July 2011³⁰. Excluding Turkey, Pakistan's fabric exports actually increased, thanks to a sharp increase in demand from Bangladesh.³¹

²⁹ Overall US demand for apparel (quantity) declined by 7.8 percent during Jul-Mar FY12; import of cotton apparel declined by 16.9 percent, whereas import of non-cotton apparels *increased* by 3.9 percent.

³⁰ During Jul-Dec 2011, fabric exports to Turkey declined by 66.0 percent.

³¹ As mentioned in the Annual Report 2010-11, this was due to revision in rules of origins by EU for availing the generalized system of benefits (GSP) that now allows Bangladeshi garment manufacturers to use Pakistani fabric.

Annexure 2: Automobiles³²

An apparent pickup in sales of passenger cars provided a boost to the auto industry. However, while growth in sales of locally assembled cars has accelerated in the current fiscal year, we believe this is due to one-off factors (e.g. tax incentives, and the Punjab Government's 'Yellow Cab' Scheme). Excluding the impact of these developments, growth during the first three quarters of FY12, in fact, has slowed compared with last year.³³

In our opinion, this deceleration is due to supply-side developments in the overall market for cars (both, imported and local): (1) competition from an increase in the supply of used cars imported from Japan (this has implications for the demand for locally assembled cars); and (2) a disruption to the global supply-chain of auto parts due to recent floods in Thailand.

One-off factors boost sales

- (1) *Government demand*: Pak Suzuki Motors saw the largest increase in production and sales; with demand under the 'Yellow Cab' scheme playing a significant role.³⁴
- (2) *Tax incentives*: growth in car sales was also supported by a cut in General Sales Tax (GST) from 17 to 16 percent, and the elimination of Special Excise Duty (SED) for FY12. This held off car purchases in the latter stages of FY11.³⁵

Supply-side factors in the market for cars

- 1) *Imports of used cars*: in the backdrop of rising domestic prices, locally assembled cars faced stiff competition from imports of used Japanese cars; these have increased six-fold over the last year.³⁶ Despite being up to 5 years old, anecdotal evidence suggests that these cars compete well against their locally assembled counterparts on price, as well as interior features.
- 2) *Shortage of imported parts*: the recent floods in Thailand disrupted the global supply-chain of Completely Knocked Down (CKD) kits. This affected local

³² This section has been authored by Mr Bilal Khan (bilal.khan@sbp.org.pk).

³³ Sales of locally assembled cars during the first three quarters of FY12 were 15.3 percent higher than the same period last year; the corresponding figure for FY11 was 13.1 percent. However, excluding the impact of the 'Yellow Cab' Scheme and tax incentives, our estimates show a slowdown in sales growth to less than 2 percent this year.

³⁴ Over the course of FY12, 20,000 units are to be sold under this scheme.

³⁵ Consumers held off on buying cars till Jul 11 to benefit from the tax relief; we estimate the impact of this to be around 3,500 units.

³⁶ Almost 34,500 used cars were imported during the first three quarters of FY12; primarily as a result of relaxations of restrictions on age from 3 to 5 years.

assemblers like Honda Atlas. After suspending production for the past few months, the firm has partially resumed operations.

Outlook

The local car industry is likely to undergo additional changes on the supply-side, as some models are to be phased out by the end of this fiscal year to comply with Euro-II emissions standards. Furthermore, as the government has imposed a ban on imports of CNG kits due to safety concerns, assemblers are currently operating on inventories.

We believe imported used cars will continue to benefit from these developments, particularly in the under-1500cc segments.³⁷ Nevertheless, we expect some pickup in sales of locally assembled cars - particularly as Honda Atlas returns to pre-flood levels of production.

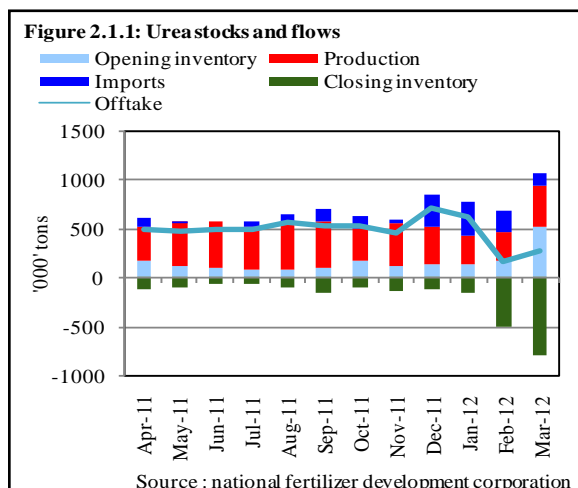
³⁷ These accounted for around 90 percent of used car imports during the first three quarters of FY12.

Annexure 3: Fertilizer³⁸

There has been a strange turn of events in the fertilizer industry over the past nine months. The shortage of urea in the kharif season of 2011 has morphed into a glut, with the opening inventory for April 2012 at around 800,000 tons, which is more than a month of sales for the entire industry (**Figure 2.1.1**).

Another 300,000 tons of urea is due to be imported for this year's kharif season, while domestic manufacturers struggle to sell their produce

(i.e. if they manage to produce at all, given the ongoing gas shortages).



The progression of events that led to this scenario deserves mention. Firstly, the cost of natural gas to old fertilizer plants rose by around 200 percent, after the imposition of the gas infrastructure development cess (GIDC) in December.³⁹ Manufacturers partially passed on this increase in cost in the form of higher prices. This, in itself, did not affect demand initially. However, following the collapse in cotton and potato prices, and the expected reduction in wheat prices,⁴⁰ farmers held off on buying fertilizer at the end of this rabi season, and the demand for urea has fallen.⁴¹

For the rabi season, the government had also authorized the import of a total of 1.2 million tons of urea. The import itself was ill-timed, with the shipments starting to come in at the end of December, the month during which demand for fertilizer has historically been the greatest. Furthermore, the government's official sale price for urea was Rs 1,300 per bag earlier in the year,⁴² which effectively undercut the

³⁸ This section has been authored by Syed Ozair Ali (syed.ozair@sbp.org.pk).

³⁹ The only plants exempt from this increase were fertilizer plants with fixed price contracts. These were Engro's and Fatima's new units.

⁴⁰ Despite the increase in support price, smaller farmers fear that they will have to sell their produce at a lower price due to the expected excess of wheat in the market.

⁴¹ Urea sales declined by 61 percent for the month of February and by 38 percent for the month of March.

⁴² The government's official sale price was raised to Rs1,600 per bag in mid-March 2012.

local industry. With a Rs 500 per bag difference between the price of imported urea and domestically produced urea, two things happened: (i) domestic manufacturers were priced out of the market at the end of the rabi season; and (ii) the price arbitrage created incentives for black marketing and market manipulation. Therefore, as we have indicated in our previous reports, this price gap needs to be eliminated.

In the middle of April 2012 (and in the middle of this glut), the government authorized the import of another 300,000 tons of urea for the kharif season, much to the frustration of the fertilizer industry. The commodity is supposed to be sold at Rs 1,600 per bag, which could cannibalize the sale of domestic manufacturers yet again. Domestic manufacturers cannot cut their prices too sharply due the increase in the cost of gas, and uncertainty regarding gas supplies. Furthermore, the government has refused to allow urea exports.

The import of urea is expected to have a fiscal impact of Rs 11 billion;⁴³ a foreign exchange impact of \$150 million; and will add to the surplus of urea stock in the country. Thus, without a rebound in crop prices, which can revive the demand for fertilizer, the outlook for the industry is not heartening.

⁴³ The actual subsidy passed on to the farmers is expected to be Rs5 billion if the entire stock of imported urea is sold at the official price of Rs1600 per bag. Since it is more likely that farmers will purchase this urea at Rs1800 per bag, the amount of subsidy passed on to farmers is expected to be less than Rs4 billion out of the total subsidy bill of Rs11 billion.

Annexure 4: Building Material Industries⁴⁴

Following a strong pick-up in construction activity, a demand-led increase in building material prices is driving growth and fresh investments. After declining continuously since October 2010, building materials industries are finally showing signs of a fragile but broad-based recovery. Although overall building materials index (BMI)⁴⁵ is still reporting decline, adjusting for the now near-defunct PSM yields more optimistic results: for four straight months, the non-PSM BMI index has posted positive YoY growth.⁴⁶ The key developments are summarized below:

1. Higher demand is pushing up prices, which in turn is driving production. Such price adjustments were much needed in some cases, where firms had been facing a high-cost, low-demand situation.⁴⁷
2. Restructuring is taking place in many industries which is expected to improve production in the medium- to long-run. The following factors are driving the structural change:
 - (a) The steel sector is adapting to the shrinking role of Pakistan Steel Mills and a growing ship-breaking industry (see **Box 4.1**).
 - (b) In energy intensive industries (glass, steel, and cement), old and inefficient units are facing closures, while new investments in large-scale production facilities as well as integration of production processes (in steel) are taking place.⁴⁸
 - (c) Consumers are becoming more aesthetically aware, which has increased competition in wood and paints industry. Chipboard is substituting plywood because of its multiple color and design options, as well as lower

⁴⁴ This section has been authored by Ms Tamkinat Rauf (tamkinat.rauf@sbp.org.pk).

⁴⁵ The building materials index is computed by the SBP using Pakistan Bureau of Statistics data. BMI includes cement, steel, glass-sheet, chipboard, plywood, and solid and liquid paints. BMI has 16.7 percent share in overall LSM index –making it the second largest industry group, after textiles.

⁴⁶ YoY growth in non-PSM BMI in Dec-Mar FY12 averaged at 1.5 percent (overall BMI: -2.4); compared to average 6.0 percent decline in Jul through Nov FY12 (overall BMI: -7.9).

⁴⁷ Higher energy-related costs were the major reason. For example, glass-sheet manufacturers had to use furnace oil during gas-outages, which nearly doubled production cost. Due to the resulting financial difficulties, one glass plant temporarily shut down last year.

⁴⁸ *Cement*: 3 million MT capacity added in FY12; whereas during FY10-FY11, smaller, inefficient plants of nearly equal combined capacity shut down. *Glass-sheet*: two new plants are set to come online. *Steel*: some rolling mills are setting up their own melt shops. One cold-rolling and galvanization plant came online in 2011, while another cold-rolling mill is set to be commissioned in 2012. Tuwairiqi Steel Mills have also reached financial close and will start producing soon.

price. In decorative paints, increasing value-addition is allowing for price increase,⁴⁹ despite the enhanced competition. High prices are attracting new investors.⁵⁰

Box 4.1: Re-organization in private steel industry

The steel industry is undergoing a huge transition, necessitated by changing economic dynamics: (i) Financial meltdown of the Pakistan Steel Mills created a gap in billets and hot-rolled steel market, leading to imports. (ii) Ship-breaking industry grew rapidly over the past two years, supplying cheaper raw material amid high global steel prices.^{51,52} Because most of the ship scrap (70-90 percent) is used by the rolling industry, the intermediate steel melting industry is facing low demand. (iii) Frequent outages of electricity and gas have badly affected business. While financially strong units manage to bear the cost of alternate power arrangements, smaller mills find it difficult to survive.

The industry is making adaptive investments. Firstly, integrated plants are coming online, which are more energy efficient. Secondly, the private sector is entering high-value market segments, such as cold-rolled and galvanized products, which were previously dominated by the PSM.

Given the high cost of setting up a business and uncertainty of electricity and gas supply, this is a difficult transition for the industry. Thankfully, some hope appeared in March 2012 when the government made a long overdue adjustment in the tax structure of the industry, which will ease effective steel products prices.⁵³ This in turn, will hopefully provide some demand stimulus.

⁴⁹ Value-added services include color creation at point-of-sale and professional color advice, etc.

⁵⁰ Over the past two years, at least two new players entered the market. More cautious investors are testing the market by initially importing products.

⁵¹ A large number of ships were discarded globally in FY10 when global trade hit a nadir. 836 vessels were imported for scrapping that year. Although scrap ships import has declined since FY10 (142 ships imported in FY11; 33 ships in Jul-Dec FY12), a large stock of scrap ships is still available with the industry.

⁵² World Bank data shows that global steel prices have risen almost consistently since FY10. March 2012 hot-rolled prices are 33.3 percent higher than June 2009 prices; while rebar prices are higher 34.7 percent.

⁵³ SROs 332 and 333(I)/2012 dated March 31, 2012, revised the amount in sales tax payable on purchase of steel products from Rs. 5,960/MT to Rs. 6,306/MT. The steel industry pays sales tax at a rate of Rs. 6 per unit of electricity consumed. In 2008, the FBR revised the tax rate from Rs. 4.75 to Rs. 6, but left the reimbursable amount unchanged. As a result, while upstream users were charged Rs. 6,306/MT by the steel industry, the reimbursable amount was 5.5 percent lower. This anomaly has now been addressed.

Special section: 3G Mobile Spectrum Auction - Issues & Prospects⁵⁴

In the absence of external inflows, the revenues to be generated from the auction of 3G licenses were highly awaited for financing Pakistan's external and fiscal deficits. According to the schedule announced by PTA, during January 2012, the auction for 3G mobile spectrum had to be held on March 29, 2012. However, the auction has been postponed and is not likely to be held during FY12.

In the absence of the sense of urgency to secure the receipts during the fiscal year, PTA now has enough time to improve the terms and conditions of the auction to solicit more interest and to optimize the future stream of revenues for the government. In this regard, the main findings of our analysis, concerning the rollout of 3G mobile services in Pakistan, are discussed in the following points:

- The auction of 3G mobile spectrum, has the potential of generating significant revenues for the government.⁵⁵ At the base price of US\$ 210 million, the minimum amount that could be generated from the auction is US\$ 630 million.
- Growth in cellular revenues could be declining due to intense price war amongst cell companies. There is a need to break this trend by introducing value added services via 3G technology, in the form of high speed internet access and video streaming.
- Although demand for mobile internet – the key feature of 3G – is low in Pakistan and the revenue from internet usage contributes a small share in total cellular revenues, the 3G business case for firms has two other components: (a) The possibility of losing high valued customers by cell companies, who opt out of 3G (b) Gaining market share from companies that are unsuccessful in the auctions. These factors together make a strong business case for 3G despite low internet demand at this stage.
- Cell companies have already upgraded their infrastructure and the rollout of 3G will not require much additional investments, except for the payment of license fees.
- 3G is technically more efficient, hence cell companies will be able to provide services to existing subscribers and increase demand for such services (supply creates its own demand).

⁵⁴ This section has been authored by Sabina Khurram Jafri (sabina.kazmi@sbp.org.pk).

⁵⁵ Discussions with cell companies and financial sector suggest that most of the companies have made their business plans and have lined up funds for the roll out of 3G mobile services. The foreign ownerships of the domestic mobile companies also reflect the ability of some of the companies to arrange funds for investing in 3G technology from their parent companies.

- In view of the low mobile internet demand in the country, the success of 3G depends upon a competitive environment in the industry. In the absence of competition, we believe firms will not have incentives to offer competitive services at affordable prices.
- Cheap 3G handsets and availability of mobile applications in *Urdu* is necessary for the pickup in demand for 3G services.
- The demographics of Pakistan's population, with a large share of young adults hints at the possibility of strong demand for 3G services for infotainment purposes. This, however, depends upon the pricing policies of the firms that introduce new applications, the quality of service, and the pace of marketing of 3G services.
- The stimulation of cellular revenues is likely to be gradual as firms are currently focusing on retaining their subscriber base and improving the quality of services.

Conclusion

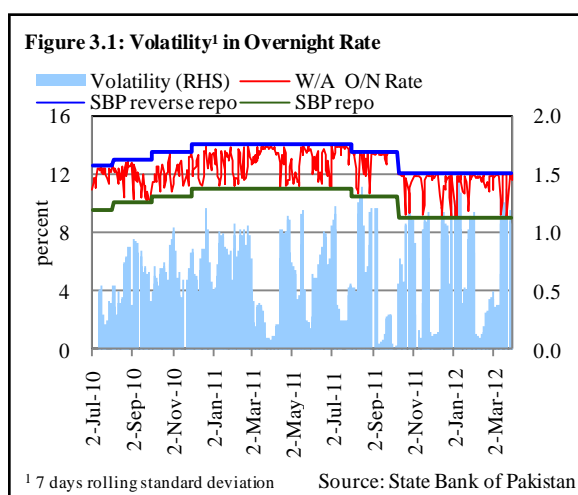
In view of the low mobile internet demand in the country, the success of 3G depends upon a competitive environment in the industry. In the absence of competition, firms may not have the incentive to offer services at affordable prices. In this context, the provision in the Information Memorandum issued by PTA, allowing one firm to bid for two licenses (out of three that will be auctioned), appears to be against the spirit of competition in the industry.

In addition, to generate more and consistent stream of revenues from the auction, the payment for licenses may be staggered (after an initial payment of 50 percent of bid price), instead of the one-time upfront fee as mentioned in the information memorandum.

3 Inflation and Monetary Policy

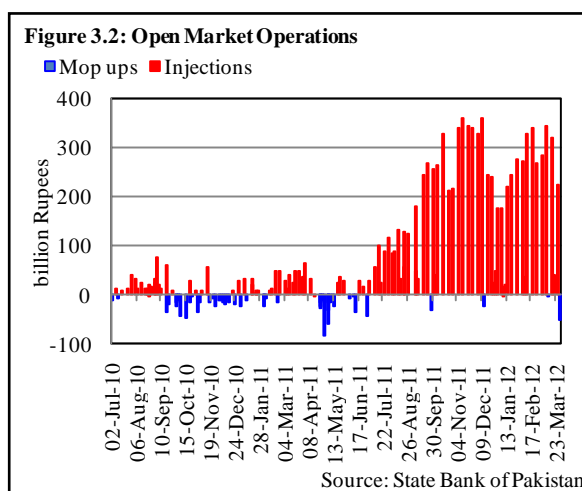
3.1 Overview

The central bank has maintained its policy rate unchanged since the last cut in October 2011, despite pressure on the external account and a surge in government borrowings from the central bank during this period. Early indications that inflation in FY12 will be lower than the target of 12.0 percent provided support to this policy stance. SBP was also hopeful that the government would show some fiscal restraint and the pressures on external account would be manageable, with some flexibility in exchange rate.



However, monetary management proved quite challenging. While the external deficit led to contraction in domestic liquidity, growing government appetite for funds put an additional squeeze on Rupee liquidity in the market. Despite continuous liquidity injections from SBP through open market operations, the weighted average overnight rate remained volatile during the last two quarters (**Figure 3.1 & Figure 3.2**).

The fact that SBP liquidity support was needed, despite



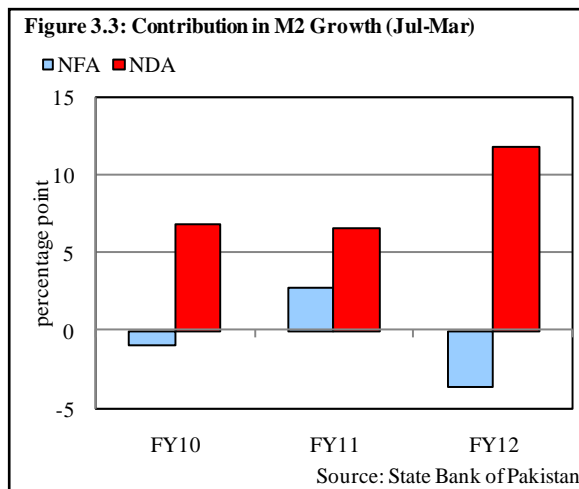
growth in bank deposits and subdued demand for private sector credit,⁵⁶ reflects the sheer volume of government appetite for funds. In net terms, the government borrowed Rs 343.7 billion (adjusted for circular debt settlement) from commercial banks during Jul-Mar FY12 compared to Rs 332.8 billion in the corresponding period of FY11. Not surprisingly, banks had little incentive to finance private sector investments.

Commercial banks were not the only source of funding; the government also borrowed Rs 199.1 billion from SBP during Jul-Mar FY12. As a result, the government could not adhere to its commitment of zero budgetary borrowing from SBP in the third quarter of FY12, as specified in the amended SBP Act 2012 and repeatedly mentioned in SBP Monetary Policy Announcements.⁵⁷

This acute dependency on bank borrowing was because expected inflows under Coalition Support Fund (CSF), proceeds from the auction of 3G licenses, and arrears from PTCL's privatization, have not materialized so far. In this situation, if SBP had curtailed liquidity support to the market, this would simply have shifted government borrowing from commercial banks to SBP.⁵⁸ We need to realize that this state of affairs is a reflection of structural weakness in the fiscal account, which requires a credible strategy to either reduce fiscal deficit or to solicit external financing.

3.2 Monetary Aggregates

The continuing pressure on the external and fiscal accounts also had its bearing for growth in monetary aggregates. Unlike Jul-Mar FY11, when both domestic and foreign assets contributed to growth in money supply, this year M2 growth of 8.1 percent came entirely from domestic sources – foreign assets have continuously



⁵⁶ Deposits of the banking sector grew by 7.5 percent during Jul-Mar FY12 compared to 7.2 percent during the same period last year.

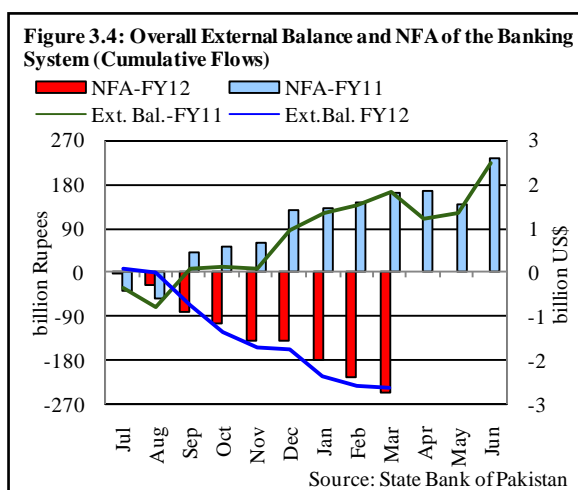
⁵⁷ For details, see section on **Fiscal Sector**.

⁵⁸ It is important to note that temporary liquidity support from SBP for an extended period is like inflationary finance, but by reducing short term liquidity problem, SBP facilitated borrowing from commercial banks. This is clearly visible from increased volume of OMOs in recent months.

drained market liquidity due to the drawing down of foreign exchange reserves (**Figure 3.3**).

Net Foreign Assets (NFA)

Due to rising pressure on the external account, NFA of the banking sector continued to contract during Jul-Mar FY12 (**Figure 3.4**). On a cumulative basis, overall NFA fell by Rs 244.4 billion, against an *expansion* of Rs 162.5 billion during the corresponding period of last year. As shown, the pressure on NFA was higher during Q3-FY12.



SBP managed excessive volatility in the exchange rate emanating from developments in the external account.⁵⁹ Specifically, SBP provided forex support of US \$275 million (in net terms) during Jul-Mar FY12, against net purchases of US\$ 2,850 million last year (**Table 3.1**). As a result, SBP's NFA experienced a contraction of Rs 200.1 billion which is in sharp contrast to the expansion of Rs 169.0 billion in the corresponding period of FY11.

Table 3.1: Net Intervention in Forex Market

million US \$		
	FY11	FY12
Q1	225	600
Q2	1225	-275
Q3	1400	-600
Jul-Mar	2850	-275

Source: State Bank of Pakistan

Net Domestic Assets (NDA)

The NDA of the banking system saw an expansion of 13.4 percent during Jul-Mar FY12, compared to 7.3 percent last year (**Table 3.2**). This acceleration in NDA growth was mainly attributed to budgetary borrowings as well as lower retirement

⁵⁹ See Chapter 5 on External Account for more details.

in commodity loans. The major factors affecting NDA of the banking sector are briefly reviewed in the following discussion.

Table 3.2: Changes in Monetary Aggregates

flows in billion Rupees, growth in percent

	FY11			FY12		
	Jul-Dec	Jan-Mar	Jul-Mar	Jul-Dec	Jan-Mar	Jul-Mar
Broad money (M2)	518.4	24.4	542.8	379.4	166.0	545.4
<i>M2 growth</i>	9.0	0.4	9.4	5.7	2.3	8.1
NFA	126.8	35.7	162.5	-139.9	-104.5	-244.4
<i>NFA growth</i>	23.2	5.3	29.8	-17.9	-16.3	-31.3
SBP	104.2	64.8	169.0	-122.6	-77.4	-200.1
Scheduled banks	22.5	-29.0	-6.5	-17.3	-27.0	-44.3
NDA	391.7	-11.3	380.3	519.3	270.5	789.8
<i>NDA growth</i>	7.5	-0.2	7.3	8.8	4.2	13.4
SBP	130.5	-38.7	91.7	237.6	143.6	381.2
Scheduled banks	261.2	27.4	288.6	281.7	126.9	408.6
of which						
Government borrowing	261.2	-61.0	200.2	691.9	148.7	840.6
For budgetary support	308.5	9.5	318.0	756.0	176.7	932.8
SBP	92.4	-107.2	-14.8	117.3	81.8	199.1
Scheduled banks	216.1	116.7	332.8	638.7	95.0	733.7
Commodity operations	-49.9	-71.7	-121.6	-63.5	-29.4	-92.9
Non government sector	179.9	79.9	259.8	-87.3	144.2	56.8
Credit to private sector	163.4	66.5	229.8	193.5	7.0	200.5
Credit to PSEs	15.7	13.9	29.6	-281.5	137.2	-144.3
Other items net	-49.4	-30.3	-79.7	-85.3	-22.4	-107.7

Source: State Bank of Pakistan

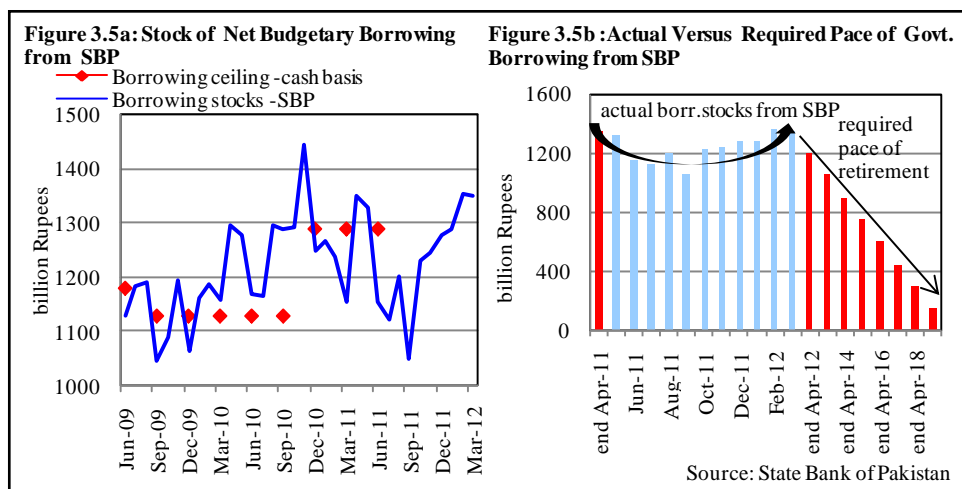
Government borrowing for budgetary support

As mentioned earlier, drying up external flows, in the face of rising fiscal deficit, shifted the burden of financing onto domestic resources. Given the government's limited control over non-bank sources of borrowing, the onus fell squarely on the banking system. As a result, government budgetary borrowing from the banking system reached to record high level of Rs 932.8 billion during the period under review. Within the banking system, although a large part of the borrowing was financed by commercial banks, the government also resorted to inflationary borrowing from SBP (**Table 3.2**).

Realizing the severe consequences of deficit monetization for the overall economy, in March 2012, the legislative councils – both the National Assembly and the Senate – approved limits on government borrowing from the central bank. Specifically, a new section in the SBP Act was introduced, which states that: (1) federal government borrowing from SBP should be brought to zero at the end of each quarter; (2) the outstanding stock of government borrowing as of 30th April 2011 shall be retired within 8 years; and (3) the Finance Minister shall provide a

detailed justification to the Parliament if the quarterly limit on federal government borrowing is breached.

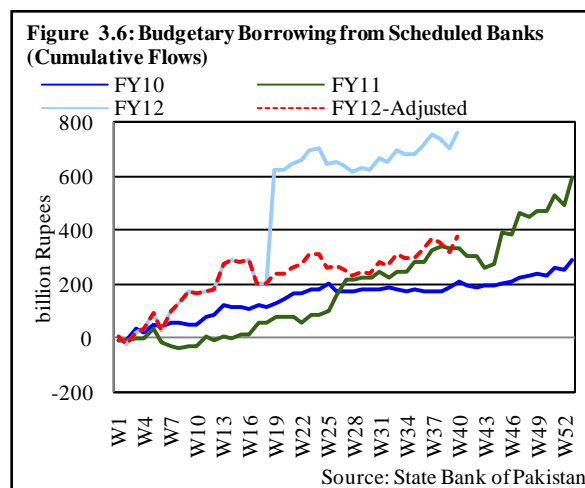
These restrictions on government borrowing from SBP are not entirely new. In the past, the government had made commitments with SBP to keep its borrowing within agreed limits, which were often a part of IMF programs (**Figure 3.5a**). This time, the government has made these limits a part of SBP Act itself.



Although recent data indicate that the government could not meet its target of zero quarterly borrowing from SBP for the end-March quarter, we expect this situation to improve as the government fulfills its commitment in letter and spirit.

As for retiring outstanding borrowing from SBP, the government has to retire about Rs 150 billion each year to meet its commitment – this also assumes no additional borrowing from SBP during the next eight years (**Figure 3.5b**). It is evident that strict discipline in government spending, and concerted efforts to increase tax revenues would be required to achieve this target.

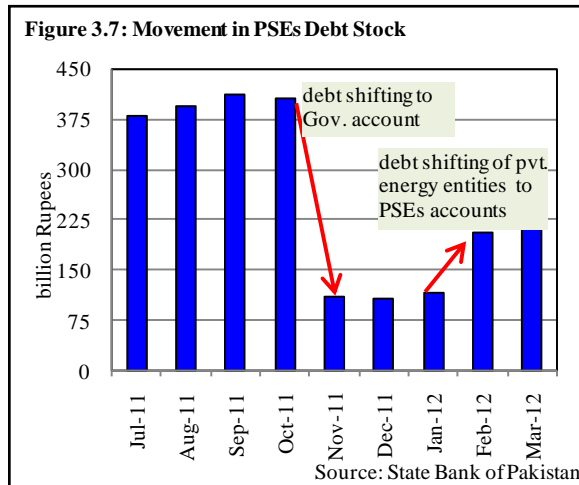
Besides SBP, government



borrowing from commercial banks reached Rs 733.7 billion during Jul-Mar FY12, which was more than twice the borrowings of last year. A significant portion of this is attributed to a one-off measure to partially settle the circular debt in Q2-FY12.⁶⁰ Adjusting for this one-off settlement, government borrowings from commercial banks turned out to be Rs 343.7 billion; marginally higher when compare with Rs 332.8 billion of last year (**Figure 3.6**).

Credit to public sector enterprises

Partial settlement of the circular debt led to a sharp reduction in outstanding borrowing of PSEs, and created room for more borrowing. Furthermore, the measure also favorably impacted the private sector, as debt liabilities of Rs 93.4 billion were shifted from cash strapped private sector energy entities to PSEs (power holding company) in February 2012. Resultantly, PSEs borrowing reached Rs 137.2 billion in Q3-FY12 (**Figure 3.7**), while the accumulated data for Jul-Mar FY12 still indicate net contraction in PSEs' borrowing by Rs 144.3 billion, compared with an expansion of Rs 29.6 billion during the same period last year.



Commodity Finance

Commodity loans witnessed net retirement of Rs 92.9 billion during Jul-Mar FY12, compared to a retirement of Rs 121.6 billion last year. The lower repayments under wheat financing, and additional borrowing for the procurement of sugar and fertilizer, reduced the pace of retirement usually seen in the months from July till March of every year.

Moreover, for the upcoming wheat season, the government has not only increased the procurement target, but also revised the support price from Rs 950 to Rs 1,050 per 40 Kg. This would entail an additional borrowing requirement of Rs 202.1 billion during the on-going procurement season (**Table 3.3**). But we expect the

⁶⁰ For details, please see Second Quarterly Report for FY12.

Table 3.3: Participation of Government Agencies in Wheat Procurement Business

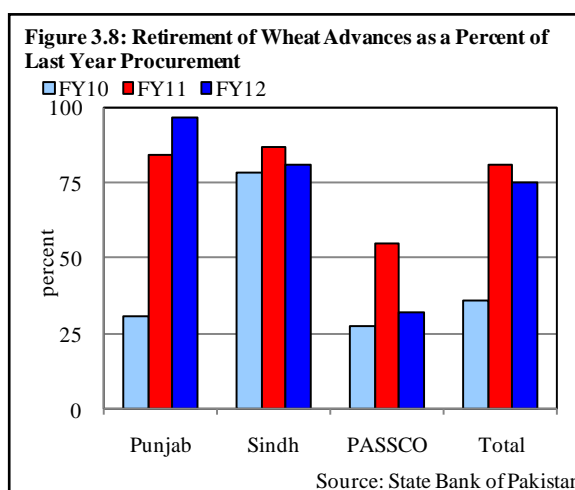
Procurement Agencies	Quantitative Targets			Financing Requirement*			Actual Procurement		Actual Financing	
	million tons			billion Rs			million tons		billion Rs	
	FY10	FY11	FY12	FY10	FY11	FY12	FY10	FY11	FY10	FY11
Punjab	4.0	3.5	4.0	95.0	83.1	105.0	3.720	3.2	83.9	68.7
Sindh	1.5	1.3	1.3	35.6	30.9	34.1	1.497	1.4	34.0	31.2
Baluchistan	0.1	0.07	0.1	2.4	1.7	2.6	0.068	0.1	1.0	0.0
KPK	0.3	0.4	0.3	7.1	9.5	7.9	0.300	0.2	7.1	4.5
PASSCO	1.6	1.5	2.0	38.0	35.6	52.5	1.127	1.3	21.7	28.6
Total	7.5	6.8	7.7	178.1	160.8	202.1	6.7	6.2	147.8	133.0

*based on support price and available targets

Source: State Bank of Pakistan

actual borrowing requirements to be less as shown by the difference between procurement targets and actuals in FY10 and FY11.⁶¹

Agency-level data indicate that Food Department of Punjab has repaid almost 100 percent of the loans acquired in the last procurement season.⁶² On the other hand, Food Department of Sindh and PASSCO could not retire a sizeable portion of their dues, which may complicate their procurement this season (Figure 3.8).



Private Sector Loans

Despite some ease in the weighted average lending rate following the policy rate cut in October 2011, credit expansion to the private sector decelerated to 6.4 percent during Jul-Mar FY12, compared to 7.6 percent last year. Within private sector credit, loans to private businesses increased by only 1.8 percent, which is the lowest growth rate in past 10 years (Figure 3.9).

⁶¹ It is pertinent to mention here that the consortium of commercial banks have agreed to provide Rs 175.0 billion for wheat procurement this year.

⁶² However, the Food department of Punjab has over 2.0 MT of wheat in stock and Rs 121.0 billion outstanding advances against wheat.

The segment-wise breakup of loans indicate that the deceleration was concentrated in working capital and trade loans, while fixed investment loans staged a recovery in Jul-Mar FY12 (**Table 3.4**).

Loans to manufacturing units remained depressed:

Loans to the manufacturing sector decelerated sharply in Jul-Mar FY12 over the corresponding period last year. The slowdown was broad-based, as all major industries including textile, sugar, rice, cement, machinery & equipment, were impacted (**Table 3.5**). In the textile sector, substantial retirements of past loans, lower cotton prices, and subdued export performance, contributed to the slowdown in loan demand this year. In the cement sector, a sharp rise in retail prices augmented revenues of the cement sector, which reduced demand for working capital loans.

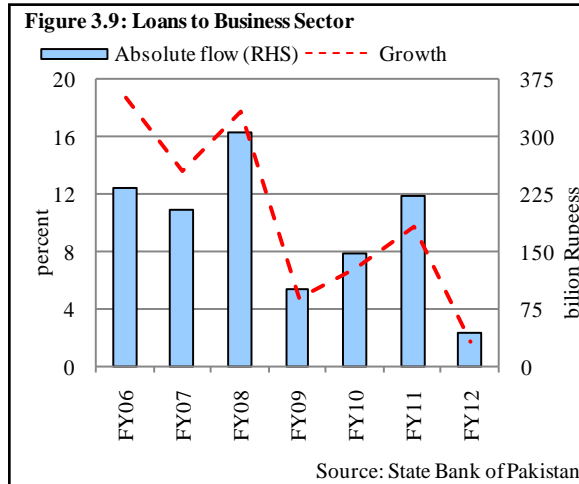


Table 3.4: Flows in Business Sector Loans
in billion Rs

	Q1		Q2		Q3		Jul-Mar	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Business Sector Loans	-30.4	-95.3	220.6	181.3	31.9	-43.2	222.1	42.9
Working capital	-32.7	-46.2	164.0	145.7	24.9	-62.3	156.2	37.2
Seasonal financing	-34.6	-70.8	107.6	70.1	52.4	22.8	125.4	22.0
Rice	-4.5	-10.7	26.4	22.8	-2.0	-6.4	19.9	5.7
Sugar	-27.4	-35.4	11.5	-4.8	68.9	45.0	53.0	4.8
Cotton	-2.7	-24.7	69.6	52.1	-14.5	-15.8	52.5	11.5
Fixed investment	-4.8	-22.4	12.9	14.0	-7.5	20.6	0.6	12.2
Trade financing	7.1	-26.8	43.7	21.7	14.1	-1.4	64.9	-6.4

Source: State Bank of Pakistan

Government intervention alters working capital needs: During Jul-Mar FY12, the government actively intervened in the fertilizer and sugar sectors, which have affected the credit flows to these sectors. In case of sugar, the seasonal flows of working capital during Dec-Mar FY12 was Rs 51.6 billion, against Rs 83.5 billion during the same period last year. Since sugar mills were not willing to offload their stocks in the market due to a drop in domestic sugar prices, this constrained their ability to borrow this year.

Table 3.5: Source of Deceleration in Manufacturing Loans (Jul-Mar)

in billion Rs

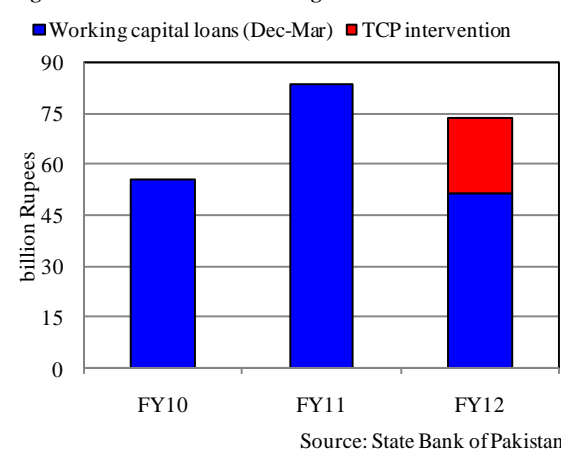
	FY08	FY09	FY10	FY11	FY12
Overall Manufacturing	193.1	88.4	95.0	205.3	65.0
Food products & beverages	23.4	33.5	44.3	82.4	22.8
<i>Rice processing</i>	19.8	13.7	16.5	17.7	7.5
<i>Sugar</i>	4.0	17.2	29.7	62.0	8.8
Textiles	94.2	1.4	32.9	105.5	16.4
Spinning, weaving & finishing of textiles	71.8	2.0	31.1	93.9	16.4
<i>Spinning</i>	41.8	9.1	19.6	52.5	15.8
<i>Weaving</i>	13.6	-5.7	6.7	25.9	-0.3
<i>Finishing</i>	16.5	-1.4	4.7	15.5	0.9
Coke & refined petroleum products	15.6	5.5	2.2	2.0	8.8
Chemicals & chemical products	17.3	26.0	14.3	-2.1	9.7
<i>Fertilizers</i>	7.1	22.2	9.8	-0.9	8.8
Non-metallic mineral products	3.8	10.2	-0.2	4.3	-8.0
<i>Cement</i>	2.3	8.1	-0.3	4.7	-11.0
Basic metals	3.8	-3.3	-2.0	1.0	7.9
Machinery & equipment	3.2	-0.7	1.8	4.0	0.8

Source: State Bank of Pakistan

Furthermore, the sugar crushing season was also delayed. To rectify this situation, the government intervened in the market by purchasing 4.75 million tons of sugar through TCP. This not only stabilized the market price, but also improved the cash flows of the industry (**Figure 3.10**).

In the case of fertilizer, the government's decision to import urea increased the working capital requirements of the industry. The availability of 1.45 million tons of imported urea at a subsidized rate increased supply of urea in the country and fertilizer companies were unable to off-load their domestic products in the market. This in turn created demand for short term loans from fertilizer manufacturers.

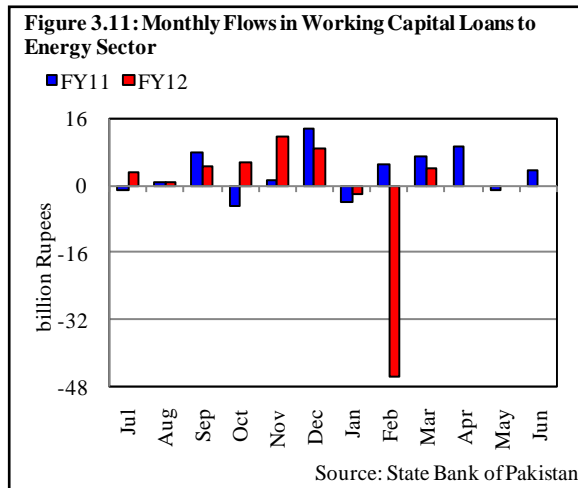
Figure 3.10: Flow of Funds to Sugar Sector



Source: State Bank of Pakistan

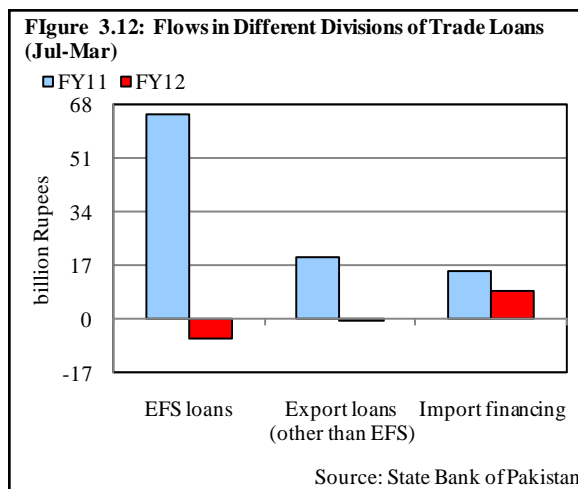
Adjustments in loans of private energy entities explain a part of slowdown in working capital

requirements: Loans to the energy sector saw a net retirement of Rs 7.8 billion in Jul-Mar FY12, against an expansion of Rs 25.6 billion last year. This retirement is concentrated in the month of February 2012. This is attributable to one-off adjustment of IPPs' receivable mentioned earlier (**Figure 3.11**).



Broad based retirements in trade financing loans

The demand for trade financing loans, especially export financing remained subdued during Jul-Mar FY12. Besides slowdown in exports, the rupee depreciation against major currencies made the foreign currency denominated loans costlier, which led to retirement of Rs 33.6 billion of import loans during the same period (**Figure 3.12**).



Fixed investment loans appear to have bottomed out

Despite an overall deceleration in loans to private businesses, some recovery in fixed investment loans was seen during Jul-Mar FY12. The frequency distribution clearly indicates that the upturn in fixed investment loans is broad-based; not only did the number of sectors experienced

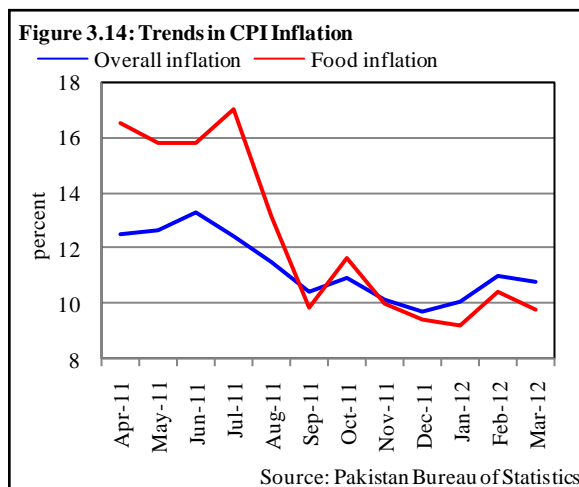
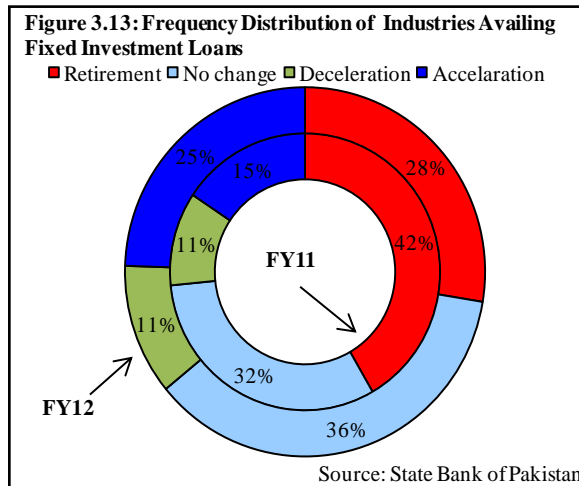
retirement fall but more sectors are now also availing long term loans (**Figure 3.13**).⁶³

3.3 Inflation

Headline inflation remained above 10 percent for Q3-FY12, after briefly receding to below double-digits in December 2011 (**Figure 3.14**). This rebound was largely expected since the fundamentals behind the persistence of inflation have not changed. Energy costs rose with the increase in international oil prices and the revision in gas tariffs; government borrowing from the central bank accelerated during the quarter; and energy shortages in the winter impacted aggregate supply.

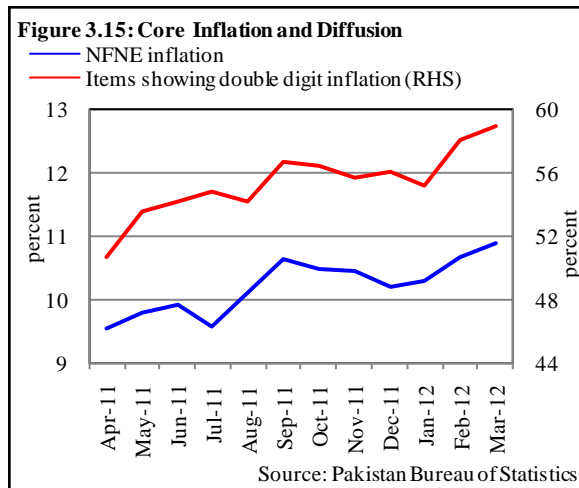
As we have highlighted in our earlier reports, the trend in core inflation, as measured by *non-food non-energy* (NFNE) inflation, remained a source of concern. Secondly, the diffusion of inflation across different commodity groups has increased to its highest level since the formulation of the new index (**Figure 3.15**). We believe this reflects the degree to which inflation expectations have become ingrained in the economy.

The trend in core inflation is also worrying because of the likely implications if Pakistan experiences another flood later this year. Overall inflation is likely to be



⁶³ The sectors that showed the renewal demand for fixed investment loans included road transport, iron & steel industries, electric equipments and edible oil & ghee and many others.

higher this time around if NFNE inflation persists around its current level, and food inflation spikes due to yet another disruption in supplies. NFNE inflation was lower than its current level during the last two floods.⁶⁴ Secondly, such a supply shock will only add to the persistence in overall inflation, by further reinforcing households' inflationary expectations.



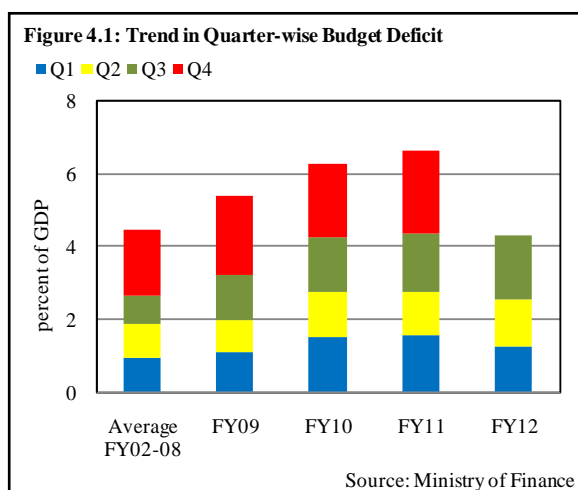
Finally, the increase in government borrowing from the central bank (i.e., the printing of currency notes) may further stoke inflationary expectations. International oil prices and the rupee exchange rate are other factors that will determine the trend in inflation going forward.

⁶⁴ NFNE inflation was 8.39 percent in Aug 2010 and 9.57 percent in Jul 2011.

4 Fiscal Operations and Public Debt

4.1 Fiscal Operations

Another fiscal year is about to end without any significant change in the fiscal structure of the economy. Current information suggests a budget deficit of 4.3 percent of GDP for Jul-Mar FY12 which is the same level as last year. To put this in perspective, the government had targeted to contain fiscal deficit to 4.7 percent of GDP for FY12, which is significantly lower from 6.6 percent realized in the previous year.



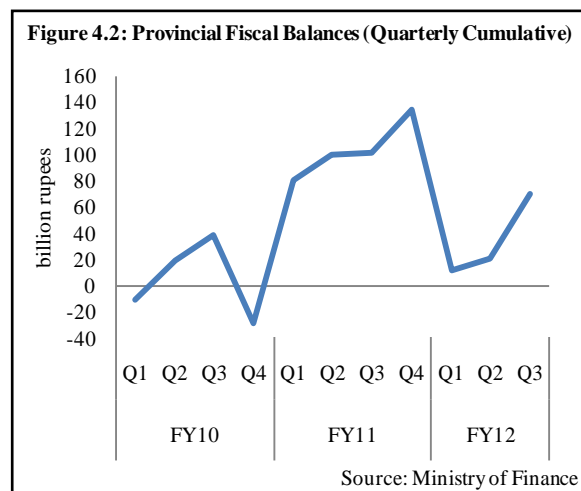
Given that fiscal pressures are highest during the last quarter (**Figure 4.1**), the budgetary gap for the full year is likely to exceed the target. However, a number of developments will determine whether the deficit will exceed the last year's level. For example:

1. The budget for FY12 was based on an ambitious outlook for tax revenues; receipts from coalition support fund; and earnings from the auction of 3G spectrum licenses. While FBR has been able to achieve 25.2 percent YoY growth in tax collection during Jul-Mar FY12, this may not be sufficient to meet the annual target.⁶⁵ Similarly, receipts from 3G licenses and the coalition support fund have not materialized as expected. Furthermore, revenues from petroleum development levy are at Rs 38 billion for the first three quarters, which is far lower than the annual target of Rs 120 billion.⁶⁶

⁶⁵ By the end of third quarter, FBR has been able to mobilize only 65.7 percent of its annual target – falling behind from its average collection of 69 percent in past years. In this situation, meeting the annual target for tax collection seems quite challenging for FBR.

⁶⁶ PDL is currently charged on quantity consumed (per liter) with fixed rate of Rs 10 on Motor gasoline, Rs 14 on HOBC, Rs 6 on Kerosene and Rs 3 on Light Diesel Oil. However, in order to mitigate the impact of high global oil prices, the government has been mostly charging less than the

2. With this uncertainty surrounding revenues, some restraint in terms of current expenditure was expected, especially as the government plans to fully utilize development expenditure allocated in the budget.⁶⁷ However, current spending, including subsidies to the power sector, payments to flood victims, and general government expenditure, etc. are now testing the government's resolve to show fiscal restraint during the remaining part of FY12.
3. On the other hand, provinces, which were expected to show a surplus of Rs 125 billion for the year, are unlikely to meet the target. The provinces could manage to post a surplus of only Rs 69.9 billion during Jul-Mar FY12, which is significantly less than the Rs 101.8 billion surplus recorded in Jul-Mar FY11 (**Figure 4.2**).



The more worrying aspect is the way the deficit is being financed. Specifically, faced with limited external financing, the government has relied heavily on domestic sources, particularly the banking sector during H1-FY12. Although non-bank borrowing showed a sharp rise in the third quarter, its continuity is uncertain in the months ahead.

Moreover, the self imposed limit of 'zero' net quarterly borrowing from SBP was breached for the second time by the government at the end of Q3-FY12.⁶⁸ The government borrowed Rs 70.8 billion from SBP during Q3-FY12, in addition to Rs 227.9 billion borrowed during the second quarter of FY12. As shown in **Table 4.1**, total borrowing from SBP stood at Rs 195.6 billion in Jul-Mar FY12.

fixed rate. Yet demand for petroleum products was sluggish due to higher prices than the last year and widely conversion of coasters and buses to CNG.

⁶⁷ Last year's deficit of 6.6 percent of the GDP was despite large cuts in the development expenditure (actual development spending was 70 percent of the original allocation in the budget).

⁶⁸ See more on government borrowing in **Chapter 3**.

This over-reliance on deficit monetization and the rising share of short-term borrowing suggests that the current fiscal situation is not sustainable, particularly due to rising rollover risks and persistent inflationary expectations. Under a recent initiative, the government is now focusing on raising more privatization proceeds instead of measures to enhance fiscal revenues.⁶⁹

4.2 Expenditure

Total expenditure grew by 15.6 percent during Jul-Mar FY12, against 12.4 percent growth during Jul-Mar FY11. This higher growth was driven by increased development spending that showed a rise of around 50 percent (**Table 4.2**).

Unlike to previous years, both the federal and provincial governments utilized larger amounts for developmental projects. Although such spending should improve the country's long term growth, it will create financing pressures in the last quarter of the year.

Table 4.1: Composition of Financing for FY12

billion rupees				
	Q1	Q2	Q3	upto Q3
Financing	257.2	275.3	362.3	894.9
External	-4.4	38.4	13.4	47.4
Domestic	261.6	237.0	348.9	847.5
Non Bank borrowing	142.1	54.4	207.2	403.7
Bank borrowing	119.5	182.5	141.8	443.8
SBP	-103.5	227.9	70.8	195.2
Scheduled Banks	223.0	-45.4	71.0	248.6

Source: Ministry of Finance and SBP.

Table 4.2: Break of Expenditure (Jul-Mar)

	billion rupees		As % of target	
	FY11	FY12	FY11	FY12
Total expenditure	2,278.5	2,634.3	69.9	70.8
Current	1,909.8	2,154.1	75.8	72.4
<i>Of which</i>				
Interest payment	507.4	624.5	72.6	78.9
Defense	335.1	348.0	75.8	70.3
Social services *	39.3	36.5		
Development	282.2	421.0	38.5	57.1
PSDP	246.5	375.6	40.4	58.7
Other (including BISP)	35.7	45.4	79.9	46.8
Net lending	70.5	6.9		

* Includes expenditure on health, education, recreation and social protection

Source: Ministry of Finance

⁶⁹ The Cabinet Committee on Privatization (CCOP), in the third week of March 2012, approved to sell 2.5 percent government's shareholdings in Pakistan Petroleum Limited (PPL). The government intends to sell-off parts of its share holdings in other public sector entities as well, .e.g., NBP, Kot Addu Power Company, State Life Insurance, Pak-Arab Refinery Company, etc..

4.3 Revenue

Growth in total revenue was 16.3 percent during Jul-Mar FY12, compared with 6.7 percent last year. However, even with this high growth, revenue receipts are 60.6 percent of their annual target and there is only one quarter left (**Table 4.3**).

This growth was mainly because of taxes; non-tax collection remained sluggish primarily due to below target receipts under coalition support fund. The transfer of SBP profits – another important head of nontax revenues – however, remained higher during Jul-Mar FY12 compared to the corresponding period of FY11.

Table 4.3: Tax and Non-tax Revenues (Jul – Mar)

	Billion rupees		% of Target	
	FY11	FY12	FY11	FY12
Total revenue	1495.3	1739.4	62.0	60.6
Tax revenue	1117.6	1371.6	62.8	63.8
of which				
Petroleum levy	56.6	38.2	51.5	31.8
Nontax revenue	377.7	367.9	59.7	51.1
of which				
Interest & dividend	36.3	40.3	30.5	32.9
SBP profit	125.0	154.0	67.6	77.0
Defence	68.5	7.3	51.3	6.2
Dev surcharges on gas	21.9	14.7	73.0	58.9
Discount retained on crude oil	17.0	15.8	141.3	62.8
Royalty on oil/gas	40.9	45.3	86.1	94.3

Source: Ministry of Finance, Federal Board of Revenue

FBR taxes

FBR has been able to show 25.5 percent YoY growth in tax collection during Jul-Mar FY12, which is a marked improvement over the 12.2 percent growth realized in the corresponding period of FY11. An analysis of the past three quarters shows that it was greatly helped by the import component of sales tax and direct taxes (**Table 4.4**).

Table 4.4: FBR Tax Collection during Jul-Mar FY12

billion rupees

	Net Collection		Annual target		Growth %	
	FY11	FY12	FY11	FY12	FY11	FY12
Direct taxes	381.6	478.7	626.9	743.6	11.5	25.4
Sales tax	422.7	568.4	633.4	836.7	13.9	34.5
Import related	212.0	312.9	-	-	22.6	47.6
Domestic	210.7	255.5	-	-	6.3	21.3
Federal Excise	89.1	84.8	137.4	165	5.5	-4.80
Import related	12.4	6.6	-	-	31.6	-46.5
Domestic	76.7	78.2	-	-	2.3	-1.9
Customs Duty	126.8	148.5	184.9	206.4	13.5	17.2
Total	1020.1	1280.4	1558	1952.3	12.2	25.5

Source: Federal Board of Revenue

Although this growth is promising, it should be viewed with caution as tax collection was Rs 131.3 billion short of the cumulative target for the first three quarters. Interestingly, unlike the past, when FBR used to revise its annual target downwards during the course of the year, this year's target remains unchanged.

The annual target of Rs 1,952 billion for FBR tax collection assumes some improvement in procedures to minimize evasion. Specifically, the target looks to include 700,000 new taxpayers into the tax net which would contribute Rs 70-80 billion as additional revenue. However, FBR has only collected less than Rs 1 billion so far from new taxpayers.

The annual target also assumes that GST on services would be collected by the FBR. However, benefiting from the 18th Amendment, the Sindh government decided to collect GST on services by using its own systems. Thus, the GST on services collected by Sindh is another reason for the gap between FBR's target and actual tax collection.

4.4 Provincial Fiscal Accounts

The provinces were required to show a combined surplus of Rs 125 billion in the budget FY12. With three quarters already gone, the surplus has reached Rs 69.9 billion – only 56 percent of the annual target (**Table 4.5**).

Punjab has posted the lowest surplus among all provinces, while Sindh has shown the highest. The fiscal position of Sindh has been supported mainly by its decision to collect sales tax on services by itself. Other provinces have not shown much progress in raising revenues after the 18th amendment, which stresses that

Table 4.5: Provincial Finances for Jul-Mar
billion Rupees

	Punjab		Sindh		KP		Balochistan		Consolidated	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Total revenue	338.8	411.5	209.5	263.8	153.9	158.9	92.3	97.8	794.6	932.0
Share in federal revenues	296.3	355.1	182.8	205.3	100.9	123.3	74.4	78.5	654.5	762.2
Taxes	21.7	27.8	18.2	26.7	2.0	2.4	0.8	.8	42.8	57.6
Non-tax revenues	17.0	19.0	5.0	10.8	19.9	2.8	1.3	3.3	43.2	35.9
Federal loans & transfers	3.9	9.6	3.5	20.9	31.0	30.4	15.7	15.2	54.1	76.2
Total expenditure	320.2	406.7	199.7	235.8	109.2	137.7	63.7	81.9	692.7	862.1
Current	267.8	317.8	170.5	202.0	86.9	101.9	51.3	65.3	576.6	687.1
Development	52.4	88.8	29.2	33.8	22.2	35.8	12.3	16.5	116.1	174.9
Overall balance	18.6	4.8	9.9	27.9	44.7	21.2	28.6	15.9	101.8	69.9
<i>As % of GDP</i>	<i>0.10</i>	<i>0.02</i>	<i>0.05</i>	<i>0.14</i>	<i>0.25</i>	<i>0.10</i>	<i>0.16</i>	<i>0.08</i>	<i>0.56</i>	<i>0.34</i>

Source: Ministry of Finance

provinces mobilize their own resources.

Table 4.6: Debt Profile

billion Rupees

	End Period Stock		Abs. Change					
			FY11			FY12		
	Jun-11	Mar -12	Q1	Q2	Q3	Q1	Q2	Q3
Total debt & liabilities	12,146.0	13,248.8	556.4	282.7	70.7	322.7	363.4	416.6
Total debt	11,524.5	12,712.7	577.1	308.3	256.6	324.9	420.4	442.9
Domestic	6,428.6	7,474.5	288.8	367.5	182.0	232.8	334.9	478.2
Government	6,017.0	7,207.2	304.7	335.9	167.9	207.6	641.7	341.0
PSEs	411.5	267.3	-15.9	31.6	14.1	25.2	-306.8	137.2
External	5,095.9	5,238.2	288.3	-59.2	74.6	92.2	85.5	-35.3
Total liabilities	621.5	536.1	-20.7	-25.7	-68.9	-2.2	-56.9	-26.3
Domestic	399.5	306.5	-27.5	-22.9	-71.7	-2.8	-60.9	-29.3
External	222.0	229.6	6.8	-2.9	2.8	0.6	3.9	3.0
Memorandum								
Public debt ¹	10,995.5	12,289.5	587.2	288.8	231.8	268.1	729.3	296.7
Adjusted public debt ²	10,995.5	11,898.5	587.2	288.8	231.8	268.1	338.3	296.7

¹Public debt includes government domestic and external debt, borrowing from IMF and external liabilities. This does not tally with the public debt numbers reported by the Ministry of Finance, as the latter does not include military debt, short-term multilateral debt and external liabilities.

² Adjusted public debt excludes the impact of one-off circular debt settlement in November 2011.

Source: State Bank of Pakistan

4.5 Public Debt

A higher fiscal deficit and settlement of circular debt led to a sharp Rs 1.3 trillion increase in the public debt burden during Jul-Mar 2012, which reached at Rs 12.3 trillion as of end-March 2012

(Table 4.6). This increase in public debt was led by a surge in government domestic debt that posted a historic Rs 1.2 trillion rise during Jul-Mar 2012.⁷⁰ As expected, withering external inflows and amortization of IMF debt resulted in US\$ 1.6 billion decline in the external debt stock during Jul-Mar 2012, compared to the end-Jun 2011 position. Short term borrowing –

Table 4.7: Government Domestic Debt

billion Rupees

	End Period Stock		Change in FY12		
	Jun 2011	Mar 2012	Q1	Q2	Q3
Domestic	6017	7207.2	207.6	641.7	341
Permanent	1124.4	1553.6	56.2	281.9	90.9
Floating	3235.4	3926.9	106.5	325.9	259.1
Unfunded	1655.8	1725.4	44.8	33.9	-9.1
Foreign currency instrument	1.4	1.4	0	0	0

Source: Ministry of Finance and State Bank of Pakistan

⁷⁰ This includes one-off settlement of Rs 391 billion of circular debt in the power and commodity sector during the second quarter of the year.

particularly 3-month T-bills, was the main source of financing for the government during Q3-FY12 (**Table 4.7**).⁷¹

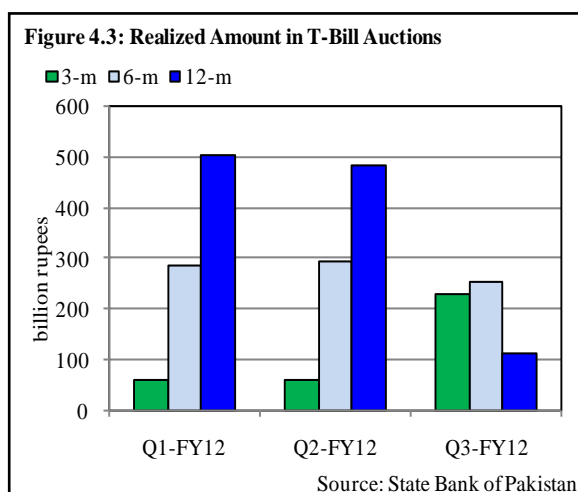
Government Domestic debt

Floating debt

Within domestic debt, around 75 percent of the increase during Q3-FY12 was contributed by floating debt (i.e., the issuance of government paper). However, as witnessed in Q2-FY12, commercial banks' investment in T-bills remained short of the target for Q3-FY12. As a result, government borrowing from SBP continued during Q3-FY12 as well.

Commercial bank investment in government securities is determined by various factors: (a) liquidity conditions in the market; (b) banks' view on the policy rate; (c) trading in the secondary market; and (d) the need to correct mismatches in asset-liabilities, etc. Since Q2-FY12, tight liquidity conditions in the market have been constricting bank's ability to invest in government paper. In addition, with the stability in policy rate since October 2011 and persistence in inflation expectations, banks are now anticipating policy rate to remain unchanged (or in extreme case may even increase). This change in sentiments has impacted banks' behavior in two ways: Firstly, banks have limited incentive to trade securities in the secondary market.

Resultantly, commercial bank investment in government paper has slowed down. Secondly, banks are now more interested in 3-month T-bills during Q3-FY12, instead of longer tenor paper, which was the case during first two quarters of FY12 (**Figure 4.3**).



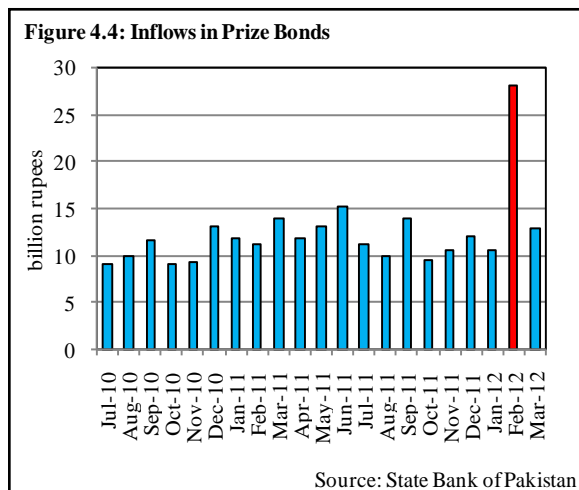
Permanent debt

In line with the rising borrowing needs of the government, the stock of permanent debt recorded a substantial Rs 429.1 billion increase during Jul-Mar 2012, raising

⁷¹ The 3-month securities had 38.6 percent share in the total realized amount of T-bills during Q3-FY12, against an average 7.3 percent share during H1-FY12.

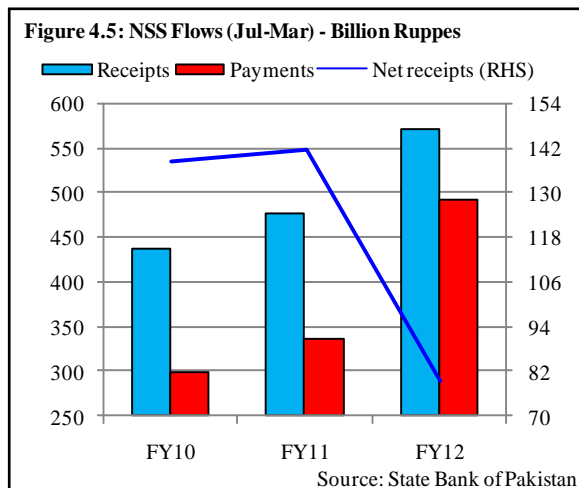
its share in domestic debt to 21.6 percent at end-Mar 2012 from 18.7 percent at end-June 2011. This includes Rs 195 billion 5-year PIBs issued for the settlement of the circular debt during Q2-FY12. In addition to PIBs, government also raised Rs 108.4 billion through the issue of 3-years Ijara Sukuk during Jul-Mar 2012.

At the same time, the stock of prize bonds also recorded a sizeable Rs 41.3 billion increase during Jul-Mar 2012 over the end-June 2011 stock. Around 42 percent of this increase was registered in the month of February 2012. This was due to the launch of a new Rs 25,000 denomination prize bond by Central Directorate of National Savings (CDNS) in February 2012, which attracted heavy inflows during this month (**Figure 4.4**).



Unfunded debt

Despite higher investment in NSS, net receipts in unfunded debt recorded a decline during Jul-Mar 2012 compared to Jul-Mar 2011 (**Figure 4.5**). This was due to heavy payments to institutional investors, following the government's decision that barred institutional investment in these schemes in April 2011. Interestingly, despite downward adjustments in NSS rates in the months of October 2011 and January 2012, fresh receipts did not register a major decline.



Interest payments on domestic debt

Interest payments on domestic debt recorded a sharp 25.7 percent YoY increase during Jul-Mar 2012. Banks' focus on 12-month T-bills, during H1-FY12, provided some relief to the government in terms of lower interest payments on floating debt during the third quarter (**Table 4.8**). However, with the recent shift in banks' preferences towards 3-month T-bills, along with the interest payments on PIBs, which were raised for the settlement of circular debt, the debt servicing burden is likely to post a sharp growth in the final quarter of FY12.

Table 4.8: Interest Payments

billion rupees

	Jul-Mar		FY12		
	FY11	FY12	Q1	Q2	Q3
Permanent Debt	65.4	112.4	33.0	27.1	52.3
Floating Debt	248.3	258.0	77.0	99.7	81.3
Market Treasury Bills	124.9	131.9	34.8	58.9	38.2
3-Months	28.5	8.6	5.0	2.1	1.5
6-Months	27.6	95.6	23.7	52.9	19.0
12-Months	68.8	27.7	6.1	3.9	17.7
Market Related Treasury Bills	123.4	126.1	42.2	40.8	43.1
Unfunded Debt	145.3	206.8	55.4	59.0	92.3
Total Domestic Debt	459.0	577.1	165.3	185.9	226.0

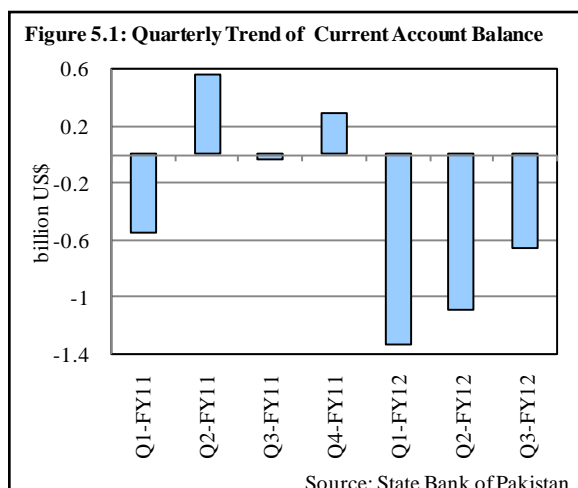
Source: State Bank of Pakistan

5 External Sector

5.1 Overview

The most significant development in Pakistan's external account has been the less than expected deterioration during the third quarter (**Figure 5.1**).

Specifically, the current account deficit for Q3-FY12 came out at US\$ 0.7 billion, which was significantly lower than the individual deficits in the preceding two quarters (**Table 5.1**). Larger flows of remittances and a lower trade deficit during the quarter explain this improvement.



Nonetheless, on a cumulative basis, the external account deficit reached US\$ 2.7 billion during Jul-Mar FY12 compared to a *surplus* of US\$ 1.8 billion during corresponding period of FY11. As highlighted in our earlier reports, the FY11 surplus was owed to one-off factors and sustaining it, as such, was difficult.⁷²

In the current account, the expected receipts under Coalition Support Fund (CSF) have not realized so far. The financial & capital accounts also recorded a lower surplus in Jul-Mar FY12. While there was an increase in project grants,⁷³ proceeds from the auction of 3G licenses, and arrears from PTCL's privatization, did not materialize during this period.

Accordingly, Pakistan's foreign exchange reserves and exchange rate remained under pressure during Jul-Mar FY12. Gross reserves declined by US\$ 1.7 billion

⁷² Pakistan's current account balance recorded a surplus in FY11 after remaining in deficit for six consecutive years. This extraordinary performance was due to unexpected rise in cotton prices which led to record export earnings and kept the trade deficit in check. Inflows under the coalition support fund (CSF) also contributed towards the improvement of the current account.

⁷³ Project grants in the capital account increased from US\$ 89.0 million during Jul-Mar FY11 to US\$ 167 million during Jul-Mar FY12.

to reach US\$ 16.5 billion by end-Mar 2012, whereas the exchange rate depreciated by 5.2 percent from end-June 2011 level.

5.2 Current Account

Despite deteriorating less than expected during Q3-FY12, the current account for Jul-Mar FY12 recorded a deficit of US\$ 3.1 billion – significantly larger than a deficit of US\$ 10.0 million in the corresponding period last year.

The worst hit was the *trade account*, where the deficit reached US\$ 11.7 billion during Jul-Mar FY12, from US\$ 8.2 billion in Jul-Mar FY11. This was primarily due to a sharp rise in imports, which overshadowed the modest growth in exports.

The deficit in *Services* almost doubled to US\$ 2.1 billion during Jul-Mar FY12 compared to the same period last year, mainly due to the absence of the Coalition Support Fund (CSF) inflows.⁷⁴ Having said this, the government remains optimistic that US\$ 400 million will be realized in FY12.

Current transfers, in contrast,

Table 5.1: Summary of External Accounts

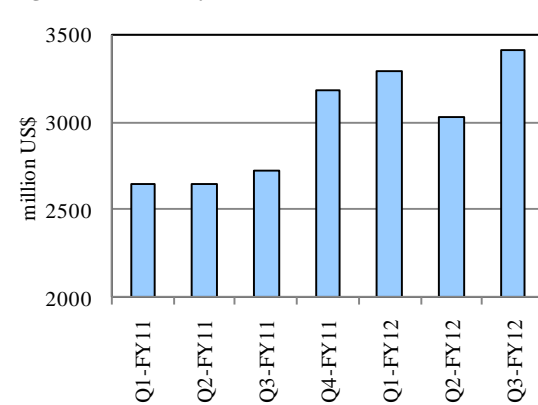
billion US Dollar

	FY11		FY12		
	Jul-Mar	Jul-Mar	Q1	Q2	Q3
A-C/A balance	0.0	-3.1	-1.3	-1.1	-0.7
i) Trade balance	-8.2	-11.7	-4.2	-3.7	-3.8
<i>Exports</i>	17.7	18.3	6.1	5.9	6.3
<i>Imports</i>	25.8	30.0	10.3	9.7	10.0
ii) Services account	-1.1	-2.1	-0.7	-0.6	-0.8
iii) Income account	-2.2	-2.3	-0.6	-0.9	-0.7
iv) Current transfers	11.4	12.9	4.2	4.2	4.5
<i>Remittances</i>	8.0	9.7	3.3	3.0	3.4
B-Financial/Capital balance	1.8	1.0	0.6	0.0	0.4
i) FDI	1.2	0.6	0.3	0.3	0.1
ii) FPI	0.2	-0.1	0.0	-0.1	0.0
iii) Others	0.4	0.5	0.3	-0.1	0.3
C-Errors & omissions	0.0	-0.6	0.0	0.0	-0.6
Overall balance	1.8	-2.7	-0.8	-1.0	-0.9
FX reserves (31 st Mar)	17.6	16.5			
Exchange rate (Rs/US\$) (31 st Mar)	85.9	90.7			

P: Provisional

Source: State Bank of Pakistan

Figure 5.2: Quarterly Worker's Remittances



Source: State Bank of Pakistan

⁷⁴ The government had received US\$ 743 million under CSF during FY11.

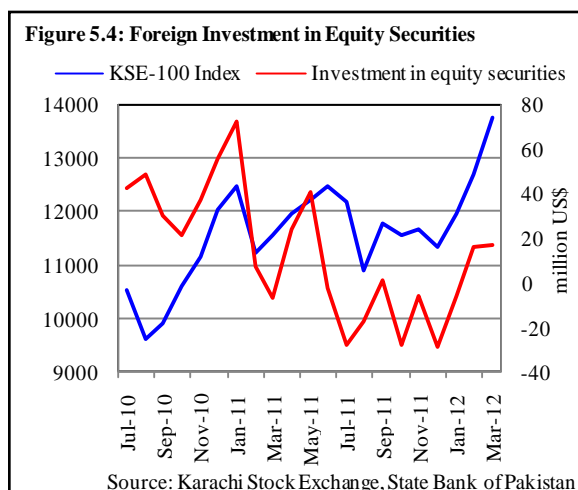
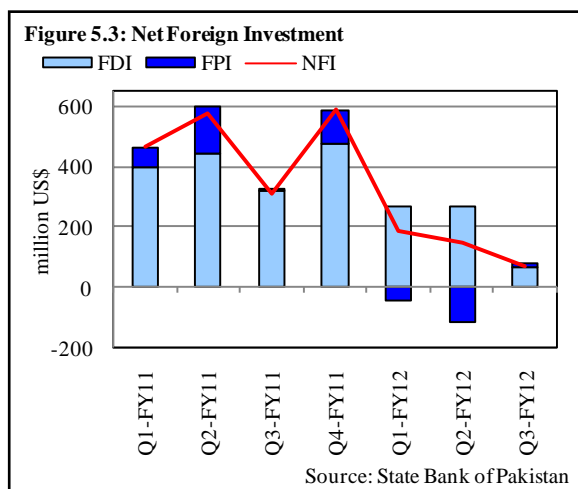
continued to provide much needed support on the back of a 21.2 percent growth in workers' remittances. The strong recovery in the third quarter suggests that the annual inflow of remittances could exceed US\$ 13.0 billion by the end of FY12 (**Figure 5.2**).

5.3 Financial & Capital Account

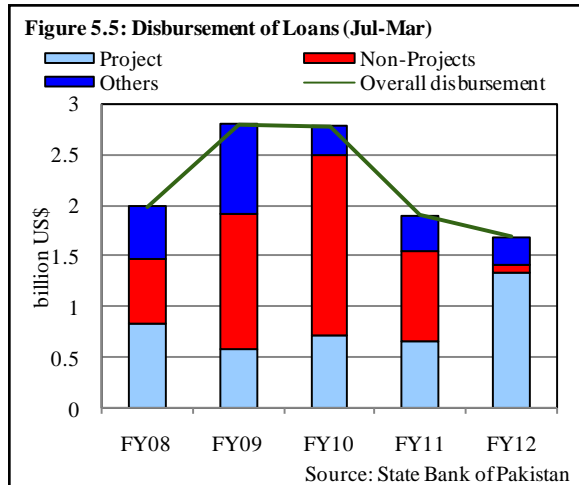
The financial & capital accounts registered a lower surplus of US\$ 1.0 billion during Jul-Mar FY12, compared to a surplus of US\$ 1.8 billion during the corresponding period last year. A YoY fall of 66.0 percent in net foreign investment was one of the key reasons behind this decline.

Foreign direct investment contracted sharply from US\$ 1.2 billion in Jul-Mar FY11 to US\$ 0.6 billion during Jul-Mar FY12 (**Figure 5.3**). The continuing fall in foreign investment during the last few years is taking a toll on the financial account. Domestic constraints are a major deterrent to foreign investment into Pakistan. It may be noted that foreign investment flows to regional economies have recovered from the global slowdown following the financial crisis (**Box 5.1**).

Foreign inflows in equity and government securities also remained subdued this year. However, the recent uptrend in the KSE-100 index encouraged some foreign investment in the Karachi Stock Exchange (KSE) during Q3-F12 (**Figure 5.4**). Pakistan has a long history of receiving *project & non-*



project loans from International Financial Institutions (IFIs) like the World Bank and the Asian Development Bank.⁷⁵ However, such inflows have declined in recent years (Figure 5.5). The IFIs seem reluctant to extend such support in the absence of a letter of comfort from the IMF as Pakistan is currently not under any program with the Fund.⁷⁶



5.4 Foreign Exchange Reserves and Exchange Rate

Pakistan's foreign exchange reserves reached US\$ 16.4 billion by end-March 2012, from US\$ 18.3 billion at end June 2011. SBP's reserves declined throughout FY12, whereas reserves of scheduled banks increased during this period (Table 5.2).

Table 5.2: Pakistan's Foreign Reserves Position (end period)
billion US Dollar

	Q4-FY11	Q1-FY12	Q2-FY12	Q3-FY12
SBP	14.8	13.7	12.9	11.8
Commercial Banks	3.5	3.7	4.0	4.6
Total Reserves	18.3	17.3	16.9	16.4

Source: State Bank of Pakistan

The depletion of SBP's reserves is understandable as the central bank remained a net seller of

US\$ 828.8 million in the FX market during Jul-Mar FY12. In addition, SBP repaid US\$ 720.0 million (interest and principal) to the IMF during the year.⁷⁷

The FX reserves of scheduled banks on the other hand increased, mainly on account of the retirement of FE-25 loans by traders as the depreciation of the Pak Rupee made these loans costlier. Pressure on the Rupee also encouraged a build-up in foreign currency accounts (FCA).⁷⁸

⁷⁵ A project loan is strictly for a specific project and it cannot be used for other purposes. A program loan on the other hand may not only be limited for specific projects but also for overall economic development. For instance a project loan is granted for improving infrastructure or building a dam etc, while a program loan is for social services, i.e. reducing poverty.

⁷⁶ IMF generally issues letter of comfort to countries which enter into a program with the Fund.

⁷⁷ Repayments to the IFIs generally do not enter into the interbank FX market.

⁷⁸ FE-25 deposits increased by US\$ 752.0 million during Jul-Mar FY12 compared with a rise of US\$ 349.5 million during the corresponding period last year.

On the whole, the Rupee depreciated by 5.7 percent on a YoY basis against the basket of currencies of trading partners. However, the resulting gains were more than offset by domestic inflationary pressures. Hence, in real terms, the Rupee appreciated by 1.7 percent during this period (**Figure 5.6**).

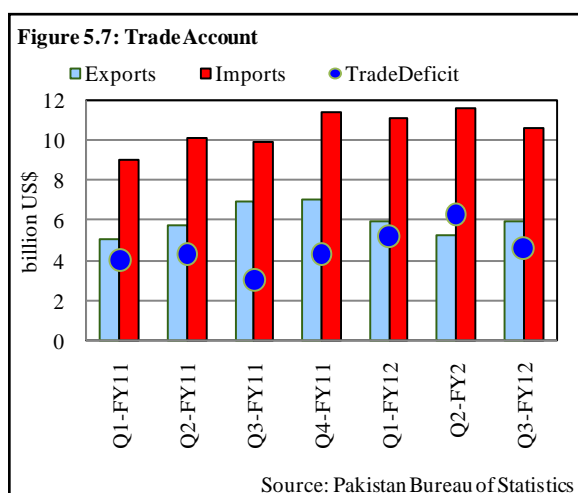
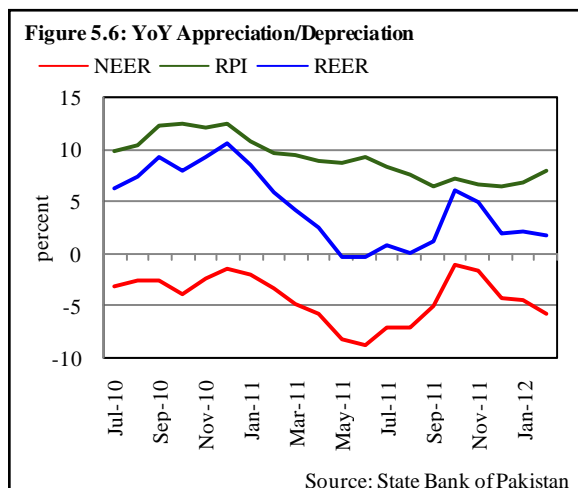
5.5 Trade Account

Pakistan's trade deficit expanded by 42.6 percent YoY during Jul-Mar FY12, to reach US\$16.1 billion compared to US\$11.3 billion during the corresponding period last year.

The overall number, however, masks the relative improvement in Q3-FY12, when the deficit declined by 26.6 percent on a QoQ basis, after showing a persistent rise for three previous quarters (**Figure 5.7**). It remains to be seen if this trend continues in the final quarter of FY12.

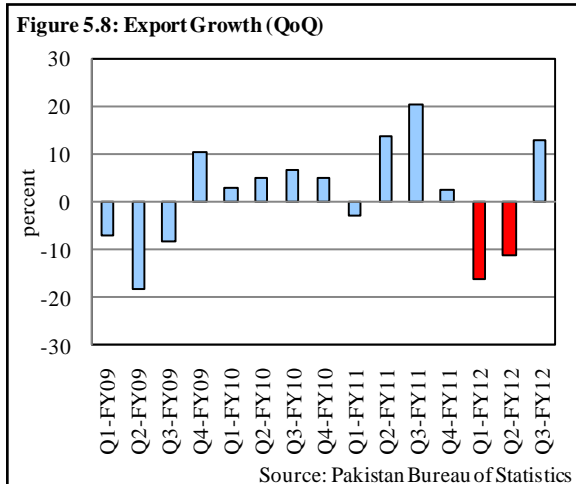
Exports

On a cumulative basis, exports recorded a YoY decline of 3.2 percent during Jul-Mar FY12, in contrast to the 26.1 percent growth witnessed the corresponding period last year. A major decline was observed in textile, followed by food and petroleum groups.



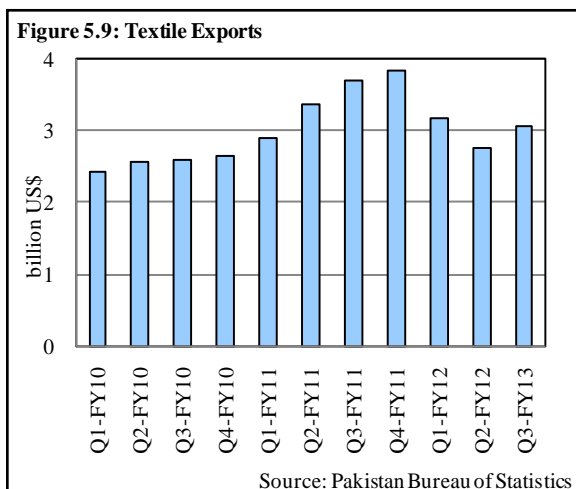
However, an encouraging development is the increase of 13.0 percent in Q3-FY12 over the preceding quarter (**Figure 5.8**). This is particularly welcome when seen in the context of persistent domestic energy shortages, the sluggish recovery in global demand, and domestic security concerns.

Even if a part of this recovery is seasonal, this is mainly driven by an increase in quantum. Moreover, this upturn has been observed in both textile and non-textile categories.



Textiles

Textile exports fell by 9.5 percent during Jul-Mar FY12 on YoY basis, in contrast to a rise of 31.5 percent during the corresponding period of last year. This decline is mainly due to a fall in quantity whereas unit value has had positive impact (**Figure 5.9**).



In overall terms, the decline in textile exports was contributed by both low-value added (i.e., cotton yarn, raw cotton, cotton fabrics and synthetic textile); and high value added categories (i.e. knitwear, bed wear, towels and readymade garments). In the case of low value added textiles, the price impact played a dominant role; whereas in high-value added textiles, the negative quantum impact led to the decline in textile exports (see **Table 5.3**).

Furthermore, a cross-country analysis of textile export (based on quantum) suggests that Pakistan's apparel exports have performed better in the EU market compared to its competitors (**Annexure 1**).

One explanation, is that Pakistan generally exports low value added items, which are relatively less responsive to income changes – i.e., demand is not badly hit even if the country (export destination) is struggling economically.

Non-Textiles

Non-textile exports recorded a rise of 4.8 percent during Jul-Mar FY12, compared to a 19.6 percent growth in the corresponding period of last year. While exports of *other manufactures* remained strong at 20.9 percent growth, exports *petroleum* groups declined 20.3 percent, respectively, mainly due to a decline in their quanta (**Figure 5.10**).

Despite a strong showing during Q3-FY12, *rice exports* recorded a decline of 5.0 percent during Jul-Mar FY12 compared to a 2.2 percent decline during Jul-Mar FY11.

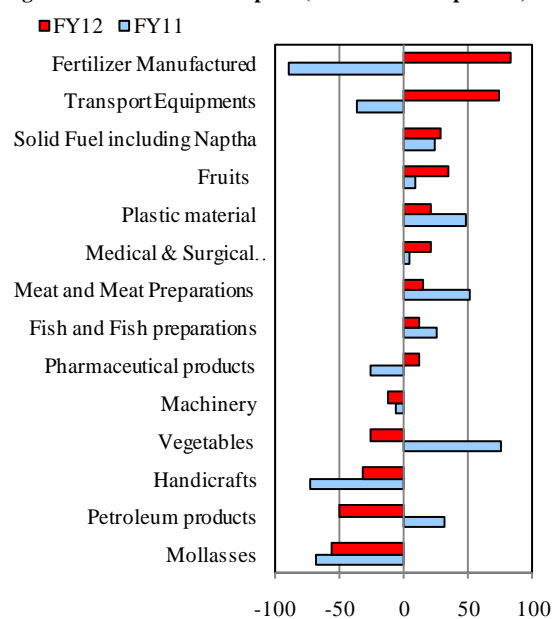
This was driven by lower quanta of both basmati and non-basmati rice, despite the increase in unit values (**Table 5.4**). According to the Rice Exporters Association of Pakistan (REAP), exports of basmati rice fell as Iran (which was the third

Table 5.3: Major Textile Exports Price & Quantum Impact (YoY) (Jul-Mar FY12) – million US\$

	Abs. change	Qty	Price
Textile Group	-939.1		
<i>Of which</i>			
Raw cotton	85.4	189.0	-103.7
Cotton yarn	-424.3	-115.9	-308.3
Cotton fabrics	-85.1	-0.4	0.3
Knitwear	-198.3	-415.1	216.8
Bed wear	-191.9	-309.2	117.3
Towels	-39.7	-99.6	59.9
Readymade garments	-34.8	-305.6	270.8
Art silk & synthetic textiles	-20.3	-101.5	81.2

Source: Pakistan Bureau of Statistics

Figure 5.10. Non-Textile Exports (YoY Growth in percent)



Source: Pakistan Bureau of Statistics

largest rice market for Pakistan in FY11) decided to import from India because of significantly lower prices.

In the coming months, Pakistan's non-basmati rice exports could slowdown, due to the bumper crop expected in Vietnam (one of the largest exporters in the world). On the other hand, basmati rice exports may improve once Indian stocks deplete.

Table 5.4: Non-Textile Exports (Jul-Mar FY12)
million US\$

	Quantum Impact	Price Impact
Rice	-231.8	152.2
Petroleum products	-345.9	63.6
Leather garments	-47.8	-0.3
Cement	-10.2	-15.7
Pharmaceutical products	-9.5	22.0
Gloves	-21.9	14.5
Fruits	6.9	69.0
Leather gloves	40.9	-3.8
Plastic material	30.2	33.3
Solid fuel	-30.6	129.0

Source: Pakistan Bureau of Statistics

In *other manufactures*, export of sports goods increased after the introduction of better quality products in sport garments. Medical and surgical instrument exports have also registered a rise, mainly due to minimum export prices in this sector which have increased export earnings by US\$30 – 40 million. Previously, the unit value of medical and surgical instruments had been lower due to stiff competition among Pakistani exporters. However, after the imposition of the minimum export price, following an initiative from Medical and Surgical Instruments Association of Pakistan, exporters were able to sell their products at higher prices in the international market. Their quality and marketing strategy have also improved accordingly.

Pakistan has already started cement exports to India, and it is expected that unit value and quantum will increase in the coming months. Pakistan has a price advantage in the Indian market, as the landed cost of cement in India is Rs 30 to 40 per bag higher than Pakistan, but still below retail prices in India.

The export of *petroleum products*, on the other hand, fell as the local refineries imported lower quantities of crude oil due to high prices in international markets, and the persistent circular debt problem.

Imports

On a cumulative basis, imports have increased by 14.7 percent during Jul-Mar FY12, compared to 15.6 percent during Jul-Mar FY11. A quarterly analysis suggests a slowdown in import growth to 7.0 percent on a YoY basis during Q3 FY12, from 14.8 percent and 23.1 percent in the preceding quarters (**Table 5.5**).

Excluding petroleum, import growth remained significantly lower than last year, and even turned negative during the third quarter of FY12. A significant part of the deceleration in imports during Q3-FY12 was driven by a decline in the import quantum of crude oil, sugar, palm & soybean oil, **raw** cotton, synthetic fiber and iron & steel. The price impact, on the other hand, remained high and positive for almost all key imports.

Table 5.5: Import Performance (FY12)

	YoY Growth (%)			% Contribution in Growth		
	Q1	Q2	Q3	Q1	Q2	Q3
Food	7.2	-11.6	2.1	4.0	-12.0	7.0
Machinery	-12.9	23.0	8.3	-8.5	20.0	15.0
Transport	5.2	-5.4	2.5	1.2	-2.1	1.7
Petroleum	62.6	22.5	33.3	70.6	46.7	127.1
Textile	-0.9	-1.3	-38.4	-0.3	-0.5	-51.5
Agri. & Chem.	24.0	39.6	-4.2	17.3	36.5	-10.1
Metals	6.3	12.6	1.1	1.9	5.2	1.1
Misc.	-9.7	-3.2	-9.5	-0.9	-0.5	-3.5
Total	23.1	14.8	7.0	100	100	100

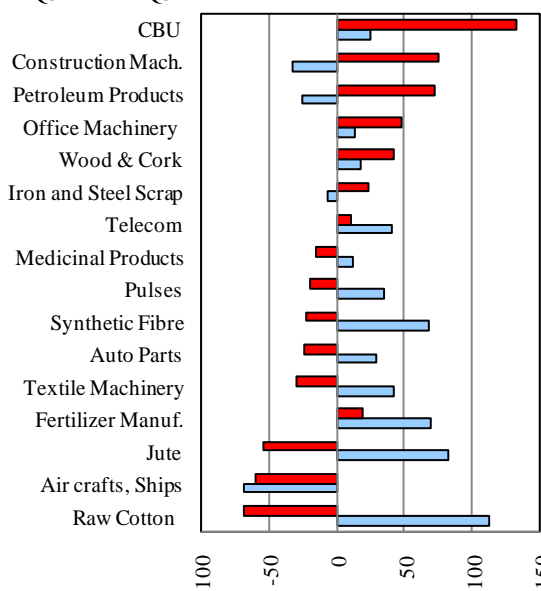
Source: Pakistan Bureau of Statistics

This decline in import quantum does not necessarily reflect any slowdown in domestic demand. For example, better domestic harvest of cotton and sugar lowered the demand for their imports, whereas some recovery in the ship breaking industry brought down the imports of iron & steel. Similarly, the decline in the import of palm and soybean oil was due to higher levels of domestic inventories. In the case of crude oil, the inventories and continuing circular debt problem forced refineries to lower crude imports.

Food imports recorded a YoY growth of 1.7 percent during Q3 FY12, which was significantly lower than 60.6 percent growth during the same period last year. One reason for the deceleration was the ample availability of domestic sugar that ruled out the possibility of any imports this year. In the previous year, substantial imports of

Figure 5.11: Import Performance (YoY Growth in percent)

■ Q3-FY12 ■ Q3-FY11



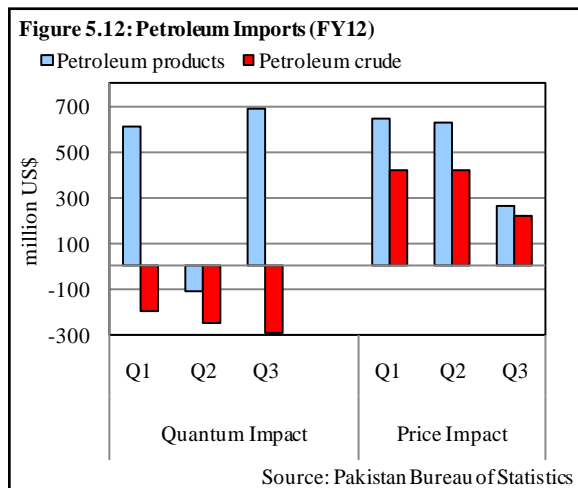
Source: Pakistan Bureau of Statistics

sugar had inflated the food import bill.

Raw cotton imports recorded a YoY decline during Q3-FY12 on account of a good domestic cotton crop (**Figure 5.11**).

As expected, due to increasing oil prices in the international market, petroleum imports increased by 37.7 percent during Jul-Mar FY12 compared to 10.1

percent in the corresponding period of previous year. In Q3-FY12 alone, import of petroleum products increased by 72.8 percent. This increase was because of a rise in quantum and unit values. The rise of crude oil imports on the other hand was caused entirely by the price effect, as the quantum actually declined (**Figure 5.12**).



The imports of CBUs (cars), construction machinery, office machinery, and telecom, recorded YoY increases during Jul-Mar FY12. In particular, the imports of road motor vehicles recorded a rise of around US\$200 million during Jul-Mar FY12 compared to US\$113.7

million increase during the same period last year (**Table 5.6**). This can be attributed to a rise in the import of motor cars which account for 75 percent of the rise in imports of road motor vehicles. According to market sources, Pakistan imported around 34,500 units of used cars during Jul-Mar FY12, compared to 6,000 units during same period last year. This was mainly due to the increase in the age limit from three years to five years for used cars.

Table 5.6: Road Motor Vehicles (Jul-Mar)

million US\$	FY10	FY11	FY12
Road Motor Vehicles	844.4	958.1	1,161.6
of which:			
Motor Cars	378.4	446.0	599.4

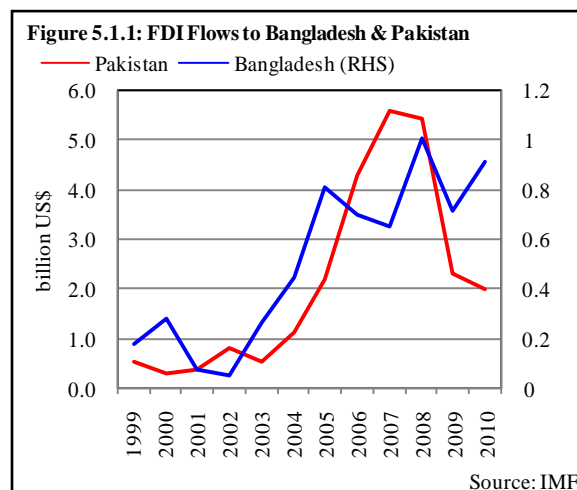
Source: Pakistan Bureau of Statistics

Box 5.1: Pakistan's Dying FDI – What's Wrong With Us?

According to the recent World Economic Outlook by the IMF, FDI flows to developing economies are expected to recover strongly from US\$ 280.0 billion in 2009 to US\$ 364.0 billion in 2011. This is true for a number of South Asian economies, particularly for

Bangladesh which shares a number of features with Pakistan. In contrast, foreign investment in Pakistan has been falling persistently (**Figure 5.1.2**).

It seems that domestic factors such as energy shortages, macroeconomic instability, law & order situation etc are hampering FDI in Pakistan. According to World Economic Forum's Global Competitiveness Report 2011-12, Pakistan is lagging its counterpart in terms of competitiveness. Macroeconomic environment (which includes fiscal discipline, inflation, interest rate spread and



country credit rating) is one of the worst in Pakistan; it stands at 138th position out of 142 countries. Bangladesh stands at 75th position. Similarly, the business cost of terrorism is very high in Pakistan (the second worst in the world after Somalia). The overall ranking of Bangladesh is 108 while Pakistan is at 118th position.⁷⁹

Table 5.1 1: Sector and Source-wise FDI during last 15 years

share in percent

	FDI by sector		FDI by source	
	Bangladesh	Pakistan	Bangladesh	Pakistan
Telecom	28.8	27.6	USA	27.0
Petroleum, Power and Oil & Gas	24.8	24.6	UK	24.2
Financial business	7.0	18.5	UAE	6.2
Textile	10.5	1.4	Singapore	4.3
Cement	2.6	1.1	China	6.7
Others	26.3	26.8	Others	31.6

Source: Board of Investment, Bangladesh, State Bank of Pakistan

⁷⁹ The Global Competitiveness Report of 2007-08 ranked Pakistan at 92nd position while Bangladesh was at 107th position.

Acronyms

BOP	Balance of Payment
BISP	Benazir Income Support Program
BMI	Building Materials Index
CCOP	Cabinet Committee on Privatization
CDNS	Central Directorate of National Savings
c.i.f.	Cost, Insurance and Freight
CKD	Completely Knocked Down
CNG	Compressed natural gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
DAP	Diammonium Phosphate
EFS	Export Financing Scheme
EU	European Union
FBR	Federal Board of Revenue
FCA	Foreign Currency Accounts
FCY	Foreign Currency
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FRDL	Fiscal Responsibility and Debt Limitation
f.o.b	Free on Board
FX	Foreign Exchange
FY	Fiscal Year
GIDC	Gas Infrastructure Development Cess
GDP	Gross Domestic Product
GST	General sales tax
HS-code	Harmonized-system code
IFFs	International Financial Institutions
IMF	International Monetary Fund
IPPs	Independent Power Producers
IRSA	Indus River System Authority
KSE	Karachi Stock Exchange
LSM	Large Scale Manufacturing
M2	Broad Money Supply

MoM	Month on Month
MRTBs	Market Treasury Bills for Replenishment for Cash
MTBs	Market Treasury Bills
NBP	National Bank of Pkaistan
NEER	Nominal Effective Exchange Rate
NDA	Net Domestic Asset
NFA	Net Foreign Asset
NFNE	Non-Food Non-Energy
NSS	National Savings Scheme
OMOs	Open Market Operations
PASSCO	Pakistan Agricultural Storage and Services Corporation
PBS	Pakistan Bureau of Statistics
PIA	Pakistan International Airlines
PKR	Pak Rupee
POL	Petroleum, Oil and Lubricants
PPL	Pakistan Petroleum Limited
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSM	Pakistan Steel Mills
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Ltd
Q	Quarter
QIM	Quantum Index of Manufacturing
QoQ	Quarter on Quarter
REAP	Rice Exporters Association of Pakistan
REER	Real Effective Exchange Rate
SBP	State Bank of Pakistan
SED	Special Excise Duty
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
US	United States of America
UK	United Kingdom
WPI	Wholesale Price Index
YoY	Year on Year