1 Overview

Policy makers were hopeful that the country would put up a better economic performance in FY12 after last year, which was a difficult one for the economy, not only due to the devastating floods that hit the country early in the fiscal year, but also due to the lack of external financing and energy shortages.

Table 1.1: Selected Economic Indicators

		FY10	FY11	FY12
Growth rate (percent)				
LSM	Jul-Oct	-1.7	-2.9	2.1
Exports (fob)	Jul-Nov	-8.3	15.8	7.6
Imports (cif)	Jul-Nov	-23.0	17.3	20.2
Tax revenue (FBR)	Jul-Sep	0.7	11.2	29.7
CPI (12 month ma)	Dec	13.9	12.9	12.0
Private sector credit	Jul-Nov	1.1	2.3	2.5
Money supply (M2)	Jul-Nov	3.8	5.3	2.3
billion US dollars				
Total liquid reserves[1]	29th Dec	15.0	17.1	16.9
Home remittances	Jul-Nov	3.8	4.4	5.2
Net foreign investment	Jul-Nov	1.0	0.7	0.3
percent of GDP[2]				
Fiscal deficit	Jul-Sep	1.5	1.5	1.2
Trade deficit	Jul-Nov	2.7	2.2	2.7
Current a/c deficit	Jul-Nov	1.0	0.3	0.9

1. With SBP & commercial banks

2. Based on full-year GDP in the denominator

Unfortunately, as in FY11, the country was hit once again by floods in the early months of FY12. This, coupled with adverse developments in the external account, has somewhat dented prospects for FY12.

On a positive note, the floods in FY12 were not as severe as those in FY11. While there was some damage to cotton and minor crops in lower Sindh, it was largely compensated for by the improvement in cotton production in Punjab. Latest estimate of Cotton Crop Assessment Committee put crop size at around 12.6 million bales against the Annual Plan target of 12.8 million bales.

Moreover, the agriculture sector could get a boost from improved wheat and rice production, but this may not translate into increase in farm incomes. Stronger global crop production has put downward pressure on crop prices: cotton prices are down by more than 50 percent from their peak in Mar 2011, while domestic sugarcane growers are struggling to secure fair returns due to the global slump in sugar prices. Though the support price for wheat has been increased to Rs 1,050 /40 kg, the government is yet to announce its procurement targets. The government's borrowing needs will stretch further if it sets too ambitious a target.

This, in turn, could create complications in terms of coverage, forcing some farmers to sell wheat to middlemen at lower than the support price.

A decline in aggregate farm income could have negative implications for the manufacturing sector, particularly for the consumer durable industry. Fortunately, manufacturing activity has been largely unaffected by floods this year. Large-Scale Manufacturing (LSM) registered a growth rate of 2.1 percent (as of Jul-Oct 2011), which is on track towards the full year target of 2.0 percent. The largest sub-sectors (textile, food, cement, POL, pharmaceuticals, etc.) have posted decent growth rates. Going forward, however, growth prospects are relatively uncertain. Textiles could suffer from falling demand and low international prices; the recent growth in cement is largely driven by the base-effect, as floods had kept cement demand subdued during Q1-FY11; fertilizer production that is already constrained by gas shortages can slowdown further ; and the POL sector could be undermined by the circular debt issue.

Consistent with the performance of LSM sector during Jul-Oct FY12, credit demand by the private sector has remained sluggish. Credit to the private sector as of end-Nov 2011 increased by 2.5 percent against 2.3 percent last year. Loans to private businesses (advances), which show a contraction of Rs 9.1 billion against an expansion of Rs 73.6 billion in the same period last year, are more worrying.[1] In terms of the distribution of loans to private sector businesses, sugar and telecommunication experienced the sharpest slowdowns because of a delayed crushing season (sugar) and possible saturation in the telecom business.[2] Cement and IPPs on the other hand, recorded significant increases. As in the past, most of the loans were availed to meet working capital requirements, while fixed investment loans remained depressed.

FY12 is the second consecutive year in which widespread floods adversely impacted economic growth, besides bringing distress and devastation to the country. Although the government was quick to respond with immediate relief early this fiscal year, the institutional and physical infrastructure needed to cope with such natural calamities needs improvement. The government, therefore, must adopt special safeguards to minimize the potential loss to life and property. This will be difficult, however, given that the government is already resource-strapped.

Recent fiscal figures, however, show that the government has been making some

[1] Credit to private sector includes private sector advance, investment and bill discounted.
[2] See chapter 3, table 3.4.

headway towards improving its finances. The budget deficit for the first quarter of FY12 was 1.2 percent of GDP, compared with 1.5 percent during the same quarter last year. This reduction in the budget deficit was caused primarily by the 29.7 percent growth in FBR revenues, on the back of increased tax collection efforts and higher revenues from imports. Non-tax revenues also recorded impressive growth of 50.4 percent.[3] However, on the basis of seasonal trend in FBR revenues, the amount collected up to end-Dec 2011, falls short of the amount needed to meet the annual target of Rs 1,952.3 billion.[4] Meeting end-year revenue targets would also depend upon the realization of CSF and sale of 3G licences (around Rs 150.0 billion), in absence of which, it would be difficult for the government to contain the fiscal deficit within its annual target.[5]

Moreover, the federal government has budgeted a surplus of Rs 125.0 billion on part of provinces, however, due to 52.8 percent increase in their expenditures, provinces managed only Rs 11.6 billion surplus up to Q1-FY12, which was 85.7 percent lower than the corresponding period last year. Any short fall in the contribution by the provinces would make achievement of the fiscal deficit target more challenging.

Lack of external funding has put the burden of financing the deficit disproportionately on the banking system, which has led to crowding out of private sector and is acting as a disincentive for banks to perform their role of financial intermediation. Government borrowing from the banking system up to end-Nov 2011 was Rs 736.8 billion, against Rs 336.1 billion in the corresponding period last year. This amount includes Rs 391.0 billion borrowed from the banks to retire PSE debt, which has now been transferred on to the government's books. Unfortunately, PSEs continue to hemorrhage as a credible restructuring plan has not been put into action. As a result circular debt issue is likely to persist.

The government's efforts to keep its borrowing from SBP in check during the initial months of FY12, helped in keeping demand-driven inflationary pressures at bay, which was supplemented by the easing of food prices. As a result, YoY CPI inflation declined to single digits (9.7 percent) in Dec 2011 after remaining in

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[3] During Q1-FY12, major increase in non-tax revenues was recorded on account of increase in transfer of SBP profits, dividend income on government investments and miscellaneous receipts (license fees, sale proceeds of assets etc.). Non-tax revenues are generally more volatile than tax revenues.

[4] As per FBR data, Rs 840.1 billion has been collected up to end-Dec 2011.

[5] In the budget 2012, government announced fiscal deficit target of 4.0 percent, which was later raised to 4.7 percent to incorporate the impact of flood-related expenditures and expected short fall in revenues.

double digits for the last two years. While the increase in energy prices, recent weakening of the Pak Rupee and the base effect may increase inflation in the coming months, the end-year average inflation is likely to fall close to 12.0 percent as projected earlier.

While SBP has shown its willingness to relax its policy to support the private sector as it did in Jul and Oct 2011, it cannot add to the stress on the economy arising from weaknesses in other sectors. The most recent policy decision to keep the policy rate unchanged was influenced among others, by the weakness in external accounts during Q1-FY12.

Pakistan was fortunate in FY11 that its current account ended up in a surplus and, despite the drying up of FDI and other foreign investments; there was a net increase in its FX reserves. Given the rigidities in the trade account and the vulnerability of the financial account, sustaining this performance in FY12 was always going to be difficult. Nevertheless, the pace at which the current account deteriorated during the first quarter of FY12 took many by surprise. Specifically, the current account deficit for Sep 2011 alone was over US$ 1.0 billion.

In the past, Pakistan has sustained larger current account deficits without losing its foreign reserves due to healthy inflows in the financial account. Unfortunately, owing to both domestic weaknesses and the international financial upheaval, financial flows have almost dried up, adding to the country's economic vulnerability. While some financial inflows are expected, a part of the current account deficit is likely to be financed through reserves as was the case during Jul-Oct FY12. This has important implications for monetary management and price stability.

The government is, however, optimistic that the 3G telecom license fee will be realized. In addition, due to recent developments, there is still optimism that parts of the CSF, bilateral assistance from the US, and the privatization proceeds of PTCL will be received. Furthermore, currency swap arrangements, which were recently formalized with the central banks of Turkey and China, will also facilitate bilateral trade and investment, easing the stress on the country's reserves.

Nevertheless, SBP remains vigilant that pressure on the Rupee is not translated into market speculation, which could become self-fulfilling. Striking a balance in managing a flexible exchange rate driven by economic fundamentals *and* by market speculation (within the context of sharp currency movements in the global economy) is challenging. SBP will continue to monitor the forex market closely to remove any excessive volatility in the Rupee.