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LETTER OF TRANSMITTAL

April 13, 2013

Dear Madam Speaker,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the First Quarterly Report for the year 2012-13 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With warmest regards,

Yours sincerely,

Dr. Fehmida Mirza
Speaker
National Assembly
ISLAMABAD

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With warmest regards,

Yours sincerely,

Syed Nayyar Hussain Bukhari
Chairman
Senate
ISLAMABAD

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1 Overview

The analysis in this report is confined to the end of the first quarter, and mainly covers the period July-September FY13.

Overview

Expecting an improvement in economic growth, Pakistan's policymakers set a GDP growth target of 4.3 percent for FY13, which is higher than the 3.7 percent realized in the previous year.¹ At the same time, they envisaged a more stable macroeconomic environment with lower inflation, fiscal consolidation, and a sustainable external account for the year.

By the end of the first quarter of FY13, most of the country's macro indicators did show some improvement: headline CPI inflation had fallen; the current account had posted a surplus; and the fiscal deficit remained at par with the corresponding quarter of FY12.

As in FY12, strong remittances and fiscal spending supported domestic demand, with some faint signs of investment activity beginning to take hold. The latter can be seen in higher machinery imports, increased production of capital goods, and a slight increase in fixed investment loans during the quarter.

Table 1.1: Selected Economic Indicators (Jul-Sep)

	FY11	FY12	FY13
<u>Growth rate (percent)</u>			
LSM	-2.5	3.2	1.0
Exports (fob)	14	17.4	3.9
Imports (cif)	19	23.1	-2.4
Tax revenue	6.2	28.9	10.3
CPI (period average) ¹	13.4	11.5	9.1
Private sector credit	-1.6	-2.8	-2.5
Money supply (M2)	0.6	-0.3	0.7
<u>billion US dollars</u>			
Total liquid reserves ²	17	17.3	14.9
Workers' remittances	2.6	3.3	3.6
Net foreign investment	0.5	0.2	0.2
<u>percent of GDP³</u>			
Fiscal balance	-1.5	-1.2	-1.2
Trade balance	-1.4	-1.8	-1.5
Current account balance	-0.3	-0.6	0.1

¹ Base year FY08

² This represents end-period reserves of SBP & commercial banks.

³ Based on full-year GDP in the denominator.

¹ The Annual Plan identified agriculture and a revival in large scale manufacturing, as key drivers of growth in FY13.

As highlighted in the *Annual Report FY12*, persistent structural problems continue to burden Pakistan's economy. Specific reforms are still needed in the energy sector; to improve the functioning of public sector enterprises (PSEs); and enhance revenue generation.

With domestic debt increasing by Rs 482 billion in Q1-FY13 (compared to Rs 208 billion in Q1-FY12); our concerns about the impending debt trap remain.² Furthermore, despite a clear signal from SBP to support private investment (the benchmark rate was reduced by 150 bps during the quarter), net credit expansion remains anemic. We believe commercial banks are still risk averse about lending, while private borrowers could be delaying their investment plans because of domestic uncertainty.

Looking at the real sector, supply disruptions have dampened growth prospects for FY13. Specifically, lower cultivated areas for the cotton crop and monsoon rains in September 2012, reduced the rice and cotton crops.³ Furthermore, persistent energy shortages continued to hold back industrial growth.

By contrast, the sugarcane crop performed well with a harvest of 62.6 million tons, which is higher than the 59 million target.⁴ Although we do not have hard numbers for minor crops, the relative stability in the price of perishable foods, suggests that supply was not adversely impacted and adequate for domestic consumption.⁵

Supply-side disruptions also impacted large-scale manufacturing in the country. As an example, reduced availability of natural gas impacted the fertilizer sector, while domestic car production suffered due to the import of second-hand automobiles and the phasing out of certain models to comply with international standards. These factors weighed down LSM growth during the quarter to 1.0 percent, from 3.2 percent last year. Excluding these two sectors, manufacturing growth was higher and more broad-based.⁶

² This increase in domestic debt does not tally with the quarter's fiscal deficit, because government deposits in the banking system have increased by Rs 170.5 billion during the quarter.

³ Although the rains in FY13 were less severe compared to the previous two years, they caused local flooding in districts of Southern Punjab, Upper Sindh and Eastern Balochistan, damaging the cotton and rice crops specifically. Pakistan's rice crop is expected to miss the target by 1.5 million tons (or 78 percent of the target), while initial estimates for cotton put the crop size at 13.3 million bales (of 170 kg), which is lower than the target of 14.5 million bales.

⁴ Fearing heavy rains this year, farmers preferred sugarcane as it is more resilient to floods.

⁵ Minor crops suffered last year due to floods and extreme winter, which pushed up food inflation.

⁶ Excluding cars and fertilizer, LSM growth improves to 3.5 percent in Q1-FY13, compared to 2.9 percent in Q1-FY12.

In particular, food processing, capital goods and building materials recovered strongly over the corresponding quarter of FY12. This trend was supported by a marginal increase in fixed investment loans; higher imports of machinery; and fresh investments in textile; paper; glass; steel; and food-processing. Although a vibrant construction sector (driven by the private sector) appears to be underpinning Pakistan's manufacturing growth⁷, this is somewhat surprising as the above-mentioned sectors are quite energy intensive.⁸ In overall terms however, a more meaningful industrial revival will require urgent solutions to overcome the on-going energy shortage.

As we have flagged before, the solution to the energy shortfall lies in decisive structural reforms. In the case of natural gas, the under-pricing of gas for household users is contributing to the shortages, while power generation fell much below capacity due to the continuing circular debt problem. Reforms in the energy sector are necessary not only for Pakistan's industrial revival, but also to cap fiscal spending.⁹

Given the sharp rise in domestic debt last year, and the corresponding increase in interest payments, fiscal pressures in FY13 are likely to remain. This pressure to borrow was brought about because of a slowdown in tax collection (**Chapter 4**).

However, the realization of US\$ 1.12 billion under the Coalition Support Fund (CSF) in August 2012, and a surplus of Rs 85.4 billion posted by provincial governments (against the *full-year*

Table 1.2: Fiscal Developments

billion Rs	Q1-FY12	Q1-FY13
Major receipts		
Tax collection	409.0	451.3
CSF inflow	1.8	107.3
Provincial surplus	3.9	85.4
Major payment		
Servicing of domestic debt	164.8	299.4

⁷ A steady growth in construction is evident from a consistent rise in cement dispatches; increased production of building materials; and higher imports of iron and construction machinery. The decline in PSDP during the quarter, suggests that the private sector is driving this growth. Within the private sector, construction loans for *commercial* projects continue to decline (for the second consecutive year), but advances for residential projects are picking up. One must also acknowledge that residential construction is often financed from undocumented sources. Except for ancillary inputs (in construction) that come from formal companies, most construction activities fall in the informal sector.

⁸ In our discussions with representative firms, we have learnt that in the paper, steel and glass sectors, businesses have shifted to self-generated power to maintain their manufacturing activity.

⁹ It may be noted that energy-related subsidies have risen sharply in recent years, i.e., from 7.5 percent of the current spending in FY10, to 14.9 percent in FY12.

target of Rs 80 billion) kept the fiscal deficit for the quarter at 1.2 percent of GDP, unchanged compared to Q1-FY12 (**Table 1.2**).

As these appear to be exceptional developments, it is important to gauge what could have happened if they had not taken place. Without CSF, the fiscal deficit in the quarter would have been Rs 389.5 billion, against a realized gap of Rs 283.8 billion. Although the aggregate provincial surplus has exceeded the full year target, we do not expect this level of support for the remaining three quarters of the year.¹⁰ This raises concerns about the federal government's borrowing needs for the remaining part of FY13.

Looking at tax collection, the annual target of 27.9 percent growth for FY13, was contingent on improving the efficiency of the tax machinery, rather than introducing any new taxes.¹¹ So far, efforts to improve tax compliance have not yielded results, as FBR tax collection during Q1-FY13 grew by only 7.9 percent, compared to 29.7 percent last year.

Furthermore, fiscal spending was higher compared to the same period of last year, mainly due to a steep rise in interest payments. Interest payments alone now make up over 38 percent of overall current spending, compared to 27.0 percent in Q1-FY12. The resulting lack of fiscal space is undermining the government's ability to revive economic growth.

As in FY12, the burden of financing the fiscal deficit has fallen primarily on domestic sources, as external financing was not forthcoming (**Table 1.3**). Within domestic sources, the reliance on non-bank fell during the quarter, despite greater revenue mobilization through NSS. Interestingly, higher returns on NSS and a larger investor base, allowed

Table 1.3: Financing of Fiscal Deficit

Billion Rs

		Q1	Q1
	FY13(BE)	FY12	FY13
Overall deficit	1,105	257.2	283.8
Financing:			
External resources	135	-4.4	-1.6
Internal resources	970	261.6	285.4
Banking system	484	119.5	151.5
Non-bank	487	142.1	133.9

¹⁰ Having said this, we take some comfort from the provincial surpluses, and hope this is an indication of the capacity of provincial governments and the potential from fiscal devolution.

¹¹ In contrast, the high growth in tax collection during FY12, was mainly due to the removal of sales tax exemptions in March 2011.

the government to realize Rs 154.4 billion (in net terms) through NSS during Q1-FY13¹² – much higher than the Rs 54.3 billion mobilized in Q1-FY12. This mobilization through NSS was partially offset by a net retirement under NBFIs' investment in government securities – so in overall terms, non-bank sources did not finance a larger share of the government's borrowing needs.¹³

As a result, financing from the banking system increased in Q1-FY13 compared to the corresponding quarter last year. But this figure conceals a change in its composition, since the government borrowed Rs 564 billion from commercial banks (the highest in a single quarter) and retired Rs 412 billion of its debt with the central bank. Although the growing reliance on commercial banks is disturbing (as it could crowd out the private sector), this shift had some positive implications for the government:

- a) It improved the maturity profile of T-bill holdings, as commercial banks reduced their holding of 3-month T-bills from 26.4 percent (of their total holding) at end-June 2012, to just 7.1 percent as of end-September 2012;¹⁴
- b) The retirement of central bank borrowing also enabled the government to meet the limit of zero borrowing during the quarter, as set under the amended SBP Act of 1956; and
- c) The fiscal authorities were able to retire expensive debt with slightly cheaper debt.

In fact, the shift in government borrowing from commercial banks (to retire SBP debt), absorbed Rupee liquidity from the system, which was already under pressure because of weak deposit growth and the fall in SBP's NFA. To counter this, the central bank continued to provide liquidity through open market operations (OMOs) to ensure the smooth functioning of the money market.

As a result, the market did not show any signs of pressure on interest rates. We are mindful of the fact that while the first quarter is typically characterized with

¹² In April 2012, the government allowed institutional investment in NSS as long as the funds were pensions, gratuity, superannuation, contributory provident funds and trusts.

¹³ In our view, to make NSS more efficient in primary mobilization of household savings, the authorities should streamline and rationalize its product offerings, so that they do not undermine other investment options that already exists (e.g., investment in T-bills and PIBs).

¹⁴ Commercial banks that already favored risk-free lending to the government over private sector placement, have become more aggressive (or risk averse) as expectations of further cuts in the policy rate took hold. Predictably, they invested more in 6 - 12 month T-bills, Sukuk and PIBs.

seasonal retirement of private sector credit,¹⁵ loan off-take in the subsequent quarters is usually high. Although we expect credit off-take to increase in response to the policy rate cuts, this will only be possible if the government scales down its borrowing from commercial banks.

We realize the demand for financing by the federal government has perhaps allowed commercial banks to become complacent, which means they are not intermediating between private savers and borrowers. This repeated concern of the central bank remains one of several factors that incentivized SBP to reduce its policy rate by 150 bps in August 2012, and then cut it twice by 50 bps each, in October and December 2012.

Although the external sector gained from a smaller trade deficit and higher remittances, it was the inflow of US\$ 1.12 billion under CSF (in August 2012) that turned the current account into a surplus. Though small, the current account surplus of US\$ 0.34 billion in Q1-FY13, follows a deficit of US\$ 1.34 billion in the corresponding quarter of FY12.¹⁶ This enabled the economy to withstand the weakness in the financial account due to nominal inflows under foreign direct investment and foreign loans.

The trade deficit (based on SBP data) contracted during the quarter due to a larger decline in imports compared to the fall in exports. The fall in import costs is driven by lower prices and lower quantum. Falling international prices of palm oil, raw cotton and crude oil, contained overall imports; however, the most significant quantum decline was witnessed in urea because of greater domestic availability after last year's excessive imports. On the other hand, the import of machinery and the quantum of petroleum imports increased during the quarter.

Due to the relative comfort in the external account, the Rupee remained fairly stable during Q1-FY13 – it depreciated by just 0.25 percent against the US Dollar during Q1-FY13, compared to 1.7 percent in the corresponding quarter of FY12. However, SBP's FX reserves fell by US\$ 445 million (in net terms) during the

¹⁵ Loans to private sector businesses saw a net retirement of Rs 39.6 billion in Q1-FY13 against a net retirement of Rs 95.3 billion during the corresponding period last year. Moreover, fixed investment loans (i.e. loans of more than one-year maturity) increased by Rs 5.6 billion during the quarter, compared to a net contraction of Rs 22.4 in Q1-FY12.

¹⁶ If CSF money is taken out of the equation, the current account would have posted a deficit of \$ 774 million in Q1-FY13.

quarter, largely due to repayments of US\$ 479 million to the IMF.¹⁷ As a result, SBP's FX reserves fell to US\$ 10.4 billion by end-September 2012.

Q1-FY13 also witnessed a consistent fall in headline inflation. After remaining in double-digits for more than two years, annualized CPI inflation fell to 9.15 percent in Q1-FY13, compared to 11.48 percent in Q1-FY12. At the same time, SBP's survey of consumer confidence suggests some softening in inflation expectations.

A more detailed analysis shows that supply-side factors are largely responsible for the fall in inflation. Most of the decline can be attributed to better availability of food items (e.g., perishable commodities, refined sugar, pulses) and lower *administered* prices (e.g., lower tariff on piped-gas and CNG).¹⁸ However, the change in price of other household items is rather mixed. For example, while categories like *footwear & clothing* and *restaurants & hotels* have posted consistently high inflation, *furnished household equipment* has shown a significant decline in inflation. This suggests consumer demand is easing, or at best remains stable. The dominant impact of supply-side factors in falling inflation is understandable, as market agents generally adjust their prices more quickly to supply shocks, than to changes in demand conditions.

Outlook

With a below-target harvest of rice and cotton already realized, the projection for agricultural growth depends on the upcoming wheat crop. The government has increased the wheat support price from Rs 1,050 to Rs 1,200 per 40 kg, to ensure ample sowing. Although wheat sowing was delayed in some areas due to the late harvesting of sugarcane, timely rains and relative stability in input prices are expected to help the crop. Nonetheless, the drag from rice and cotton is large enough, so as to pull down overall growth in agriculture to 3.5 percent, which is below the target of 4.0 percent.

In the industrial sector, LSM growth is expected to pick-up as the strong growth in sugarcane is likely to translate into higher sugar production, while a more stringent policy on used car imports will benefit the domestic auto sector. The expected commissioning of a cold-rolling steel mill, and a new motorcycle tyre plant later this year, should further support LSM growth. In overall terms, we see real GDP growth for FY13 to fall within a range of 3.5 – 4.0 percent. However,

¹⁷ Since IMF loans are the liability of the central bank, their repayments do not *directly* impact the FX market. However, a persistent decline in SBP's FX reserves does impact market sentiments.

¹⁸ Food and energy together account for 47 percent of the CPI basket.

the key economic challenges remain: the continuing energy shortages; and frequent interruption of commercial activity because of law and order conditions.

As far as inflation is concerned, upside risks stem from the recent increase in wheat support price (which has pressured wholesale and retail markets), and the pass-through of recent PKR weakness. However, SBP takes some comfort from quarterly data, which shows that inflation has also been falling quite broadly in the CPI basket; one must also note that retail energy prices have remained stable during the quarter under review. The impact of lower gas tariffs and the stability in house rents and food prices, are expected to keep FY13 inflation below the annual target of 9.5 percent, despite the expected increase in food inflation. We therefore project average inflation to be in the range of 8-9 percent in FY13.

In the fiscal sector, the annual target for tax collection has become more challenging because of a sluggish formal economy and a reduction in imports. At the same time, uncertainty about the receipts from 3G licenses and Etisalat still prevails, which has been offset somewhat due to substantial inflows under CSF.¹⁹ On the expenditure side, we expect subsidies to exceed the budgetary allocation, with the result that the overall budget deficit may fall in the range of 6.5 – 7.5 percent of GDP for FY13.

The external sector has so far been manageable, as the current account got considerable support from CSF inflows. For the remaining part of the year, while additional CSF inflows appear unlikely, a smaller trade deficit and strong remittances should keep the current account deficit in check. We project the current account deficit to remain modest at less than 1 percent of GDP. The financial account, on the other hand, is likely to remain weak as chances of a revival of external inflows remain slim.

In closing, structural problems in Pakistan's economy persist and manifestations like the debt trap; loss-making PSEs; and a narrow tax base, will continue to challenge policymakers. Without concrete steps to address the energy shortage, the losses of PSEs and generate additional tax revenues; the private sector will remain reluctant to take up the challenge of driving the country's economic growth.

¹⁹ The federal government realized US\$ 1.8 billion through CSF during Jul-Dec FY13. In contrast, there was no inflow under this head during the entire FY12.

2 Real Sector

2.1 Overview

Initial data for FY13 suggests that the economy is likely to miss the growth target for another year due to supply disruptions. Monsoon rains and local flooding in upper Sindh, lower Punjab and Eastern Balochistan damaged the cotton and rice crops, and gas shortages disturbed manufacturing activities in the country: a significant decline in fertilizer production has more than offset the growth in many industries.

Nonetheless, some support to growth will come from the expected increase in sugar production (due to an above-target sugarcane harvest); an increase in wheat cultivation on the back of higher support price; and construction activities.

Table 2.1: Targets for the Agriculture Sector

	% Share in VA (FY12)	Growth		FY13 Target
		FY11	FY12	
Agriculture	100.0	2.4	3.1	4.0
Major crops	31.9	-0.2	3.2	3.8
Minor crops	10.1	2.7	-1.3	4.5
Livestock	55.1	4.0	4.0	4.2
Fishing	1.8	1.9	1.8	2.0
Forestry	1.1	-0.4	0.9	2.0

Source: Planning Commission

Table 2.2: Production of Major Crops

million tons, million bales for cotton

	% Share in major crops (FY12)	Production			Max output in last 10 years
		FY11	FY12	FY13 target	
Cotton	24.6	11.5	13.6	14.6	14.3
Sugarcane	11.7	55.3	58	59	63.9
Rice	15.4	4.8	6.2	6.9	7
Wheat	39.2	25.2	23.5	25.5	25.2

Source: Planning Commission

2.2 Agriculture¹

For FY13, the government has set a target of 4.0 percent for the agriculture sector, higher than the 3.1 percent growth realized in FY12 (**Table 2.1**).² To begin with, the target was challenging as this would have required a strong performance by *all*

¹ At present, as Crop Reporting Service in each province is responsible for collecting information on crops, the consolidated data for the country is not available. The Pakistan Bureau of Statistics aggregates these numbers, but only after a considerable delay.

² The prospects for a better performance are based on a recovery in minor crops, and a further boost to major crops, on top of a strong growth recorded in the previous year.

major crops (**Table 2.2**).³ This was not possible because of considerable damage to the cotton and rice crops from the monsoon rains and flash floods in September 2012. The sugarcane crop, however, performed reasonably well.

Cotton

The Cotton Crop Assessment Committee estimates the harvest at 13.3 million bales of 170 kg – below the target of 14.6 million bales and lower than 13.6 million bales realized in FY12 (**Table 2.3**).

Table 2.3: Cotton Crop for FY13 (million bales)

	Target	Assessment	Deviation from target
Punjab	10.5	9.6	-0.9
Sindh	4.0	3.6	-0.4
Baluchistan	0.1	0.1	0.0
Pakistan	14.6	13.3	-1.3

Source: Cotton Crop Assessment Committee

The area under cultivation declined compared to the last year due to: (1) shortage of water at the sowing time;⁴ (2) delays in harvesting of the preceding wheat crop;⁵ (3) lower cotton prices in the previous season; and (4) the shift in preference of farmers towards sugarcane.⁶

The cotton crop was hampered further due to late arrival of monsoon rains. The crop suffered the most from flash floods and heavy rains in Southern Punjab.⁷

Rice⁸

The plantation of the *irri* variety ends in July, but it continues till August for *basmati* rice.⁹ This year, a shortage of irrigation water delayed the crop sowing season.

³ The target for individual major crops was set either near, or above, the maximum production realized during the last 10 years.

⁴ The water availability during kharif (before monsoon rains) was 15 percent lower, compared to the corresponding period of the last year.

⁵ The extreme cold weather in *rabi* extended the ripening stage for the wheat crop.

⁶ Farmers who were expecting heavy rains this year, preferred sugarcane crop which is more resilient to floods.

⁷ The major affected areas include: DG Khan, Rajanpur, Muffargarh, Rahim Yar Khan, Bahawalpur and Bahawalnagar in Southern Punjab. These districts produced 4.9 million cotton bales in FY12. According to Suparco, heavy monsoon rains led to a loss of 0.43 million bales

⁸ Punjab is the major producer of rice, followed by Sindh and Balochistan. More than 90 percent of *basmati* rice production is concentrated in Punjab. The key districts include: Gujranwala, Hafizabad, Sheikhpura, Nankana Sahib, Sialkot, Mandi Bahauddin, and Gujrat. For *irri* rice, Sindh contributes over 60 percent of the total produce, and major districts are Shikarpur, Larkana, Qambar, Kashmore and Jacobabad.

⁹ Farmers, particularly in lower Sindh, also grow hybrid varieties, which generally provide attractive yields compared to *irri* rice. The sowing of this variety usually completes in July.

The FY13 target for rice production was set at 6.9 million tons – a 12.0 percent increase over last year.

However, initial estimates put the rice crop at 5.4 million tons (**Table 2.4**). Heavy rains in September 2012 damaged the rice crop in the districts of Jafferabad and Naseerabad in Balochistan; and Jacobabad, Shikarpur, Kashmore and Qambar in upper Sindh.¹⁰ The losses were more extensive in areas where the crop was still in its growing phase, since water shortages had already delayed the sowing phase.¹¹

Table 2.4: Rice Production

area in 000 hectare and production in 000 tons

	2012-13 crop		2011-12 crop	
	Area	Prod	Area	Prod
Sindh	511	1,689	636	2,260
Punjab	1,700	3,461	1,714	3,277
Balochistan	37	120	171	529
KP	52	99	50	95
Total	2,300	5,369	2,521	6,066

Source: Provincial Crop Reporting Centers

One major concern for Pakistan is the gradual reduction in the production of *basmati* rice. While a part of the decline was replaced with other varieties (mainly the hybrid rice), the overall rice production continues to fall. As shown in **Table 2.5**, the area growing *basmati* rice in Punjab has fallen further this year.¹² Given the higher premium on *basmati* rice, this trend is a serious concern.

Table 2.5: Rice in Punjab

area in 000 hectare and production in 000 tons

	Basmati		Other		Total	
	Area	Production	Area	Production	Area	Production
2008-09	1,548	2,602	430	1,041	1,978	3,643
2009-10	1,414	2,475	518	1,238	1,932	3,713
2010-11	1,334	2,365	433	1,019	1,767	3,384
2011-12	1,121	1,889	593	1,388	1,714	3,277
2012-13	984	1,743	716	1,718	1,700	3,461

Source: Agriculture Statistics of Pakistan, and Crop Reporting Center, Punjab

Sugarcane

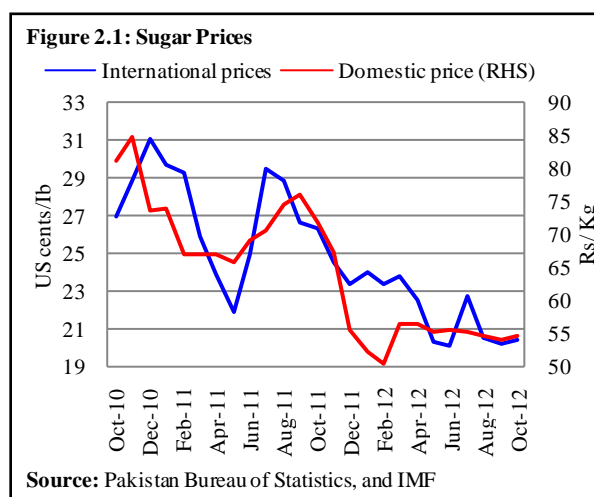
The rains have benefited the sugarcane crop this year. Preliminary indications suggest sugarcane production of 62 million tons, against the target of 59 million tons.

¹⁰ According to Suparco, heavy rains damaged around 0.4 million tons of rice, mainly in Sindh.

¹¹ The harvesting of *irri* variety usually begins in September, whereas for other finer varieties this starts in October and November.

¹² Compared to *irri* rice, the hybrid variety generally receives lower prices in the market due to higher percentage of broken rice and variation in grain size.

Farmers have, however, suffered due to the fall in domestic prices (**Figure 2.1**). Furthermore, they could not recover their investment in time since sugarcane harvesting was delayed due to the late announcement of minimum purchase prices in the provinces.^{13, 14} This also delayed the crushing season by sugar mills. There are also reports that mills have not yet fully cleared farmers' dues against the cane



procured last year. Despite these supply-chain issues, sugarcane will support agri growth and also help Pakistan's exports.

Wheat

The wheat crop is currently at its sowing stage. Although the sowing of wheat was delayed in some areas due to late harvesting of sugarcane; timely rains, relative stability in input prices, and increase in wheat support prices from Rs 1,050 to Rs 1,200 per 40 kg, are expected to help the crop.

2.3 Large Scale Manufacturing

FY13 started off with some visible improvement in large-scale manufacturing. Importantly, the key sub-sectors of *capital goods* and *building materials* posted a strong growth over the same quarter last year (**Table 2.6**). But structural and policy issues in a few important industries – namely, fertilizer, cars, and home electronics – pulled down overall growth, resulting in a *deceleration* of 2.2 percentage points in LSM growth in Q1-FY13 over the same period last year.¹⁵ However, after excluding fertilizer and automobiles, LSM growth is better than last year, which supports our view that demand conditions remain broad-based.

¹³ We have reasons to believe that sugar Mills are purchasing sugarcane cheaper than the announced price of Rs 170/40kg this year.

¹⁴ Provincial governments generally announce indicative minimum price for the purchase of sugarcane in the later half of September. This year, the announcement was delayed till end-October 2012.

¹⁵ Fertilizer, automobiles, and home appliances have an aggregate weight of 11.4 percent in the LSM.

The biggest drag on LSM growth in Q1-FY13 stemmed from the fertilizer sector. Production during this quarter fell by 27.0 percent YoY – to nearly half of the industry's capacity – as the supply of natural gas was intermittent. The allocation of natural gas, which serves as a feedstock for fertilizer, has been a point of contention since FY11, when the commissioning of two new plants added to demand on an already strained network – what is disturbing is that the problem appears to be getting worse. The demand-supply gap has become so large that the industry is not even receiving its pre-FY11 share of the fuel: fertilizer production in Q1-FY13 was the lowest in the past five years.

Table 2.6: LSM YoY Growth (Jul-Sep)
percent

Commodity Group	Wt.	FY11	FY12	FY13
Consumer goods	41.1	2.8	7.7	3.6
Capital goods	3.3	4.2	-31.3	14.0
Building materials	12.3	-9.9	-5.0	7.9
Other intermediates	43.3	-5.9	3.7	-5.5
Overall LSM	100.0	-2.5	3.2	1.0
<i>less fertilizers</i>	93.7	-2.3	3.0	3.0
<i>less cars & fertilizers</i>	89.7	-3.0	2.9	3.5

Source: Pakistan Bureau of Statistics; SBP calculations

Unlike the supply-side issues in fertilizer, problems in the automobiles sector – the second major hindrance to LSM growth – were more varied. Specifically, the production of cars, jeeps and motorcycles *fell* by 8.9 percent during Q1-FY13 compared to a *rise* of 8.9 percent in Q1-FY12. Accordingly, sales also declined by a 29.5 percent YoY during the quarter, compared to 26.6 percent growth last year. However, a deeper analysis reveals the contraction in sales might not be as severe if one accounts for the following three factors:¹⁶

- (1) Relaxation in the allowable age for used car imports, led to an influx of imported cars into the country. Import of used cars during Jul-Nov FY13 increased to 25,005 units, compared to only 16,203 units in the same period last year.
- (2) The Punjab government's 'Yellow Cab' scheme in FY12 accounted for 20,000 cars last year; which did not play a role in FY13. Adjusting for this one factor, the quarter's sales of domestically produced automobiles actually show 10 percent growth.

¹⁶ Adjusting for the yellow cab scheme and the discontinuation of two models in the small car segment, Q1-FY13 sales shows a decline of 5.1 percent compared to a rise of 7.9 percent in Q1-FY12.

- (3) In the small car segment, the production of two out of three models was phased out completely this year in order to comply with Euro II standards. These two cars models (Cuore and Alto) together had a 44 percent average market share during the period FY09-FY11.

In overall terms, the contraction in automobile production should not be viewed negatively.

In the case of consumer electronics, the domestic production of major household items like air-conditioners and television sets is declining, and even while construction picks up, the production of accessories like lighting fixtures remains stagnant. Although imports have increased to meet this gap, it has not offset the decline in domestic production. **Box 2.1** discusses this anomaly in more details.

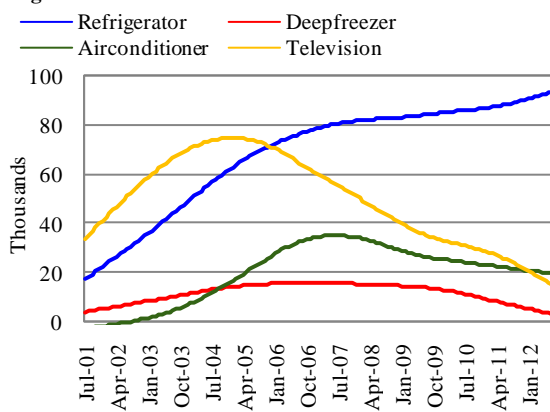
2.1: The Consumption Conundrum – the case of home electronics

Consumption demand indicators are elusive. Although imports of consumer durables, setting up of new food processing industries, and sustained growth in construction activity spell out high consumption demand, but on the other hand, we see automobile and home electronics production – arguably the most sensitive tickers of consumer demand – plummeting to negative growth.

In home electronics, the long-term production trend of three out of four large items has been declining for some years now (**Figure 2.1.1**). In fact, it appears that deep freezer and television production is almost being phased-out. Indeed,

over the past decade, a few multinational manufacturers did pack up electronics business, especially as new technologies came out, because they did not want to invest further. For example, the production of television sets has been declining since early 2000s when the LCD technology was introduced, which investors rendered too expensive a production venture for a small market like Pakistan. Similarly, the import of energy saving lamps in the second half of 2000s dented the local bulb-manufacturing industry.

Figure 2.1.1: Trends of Home Electronics Production



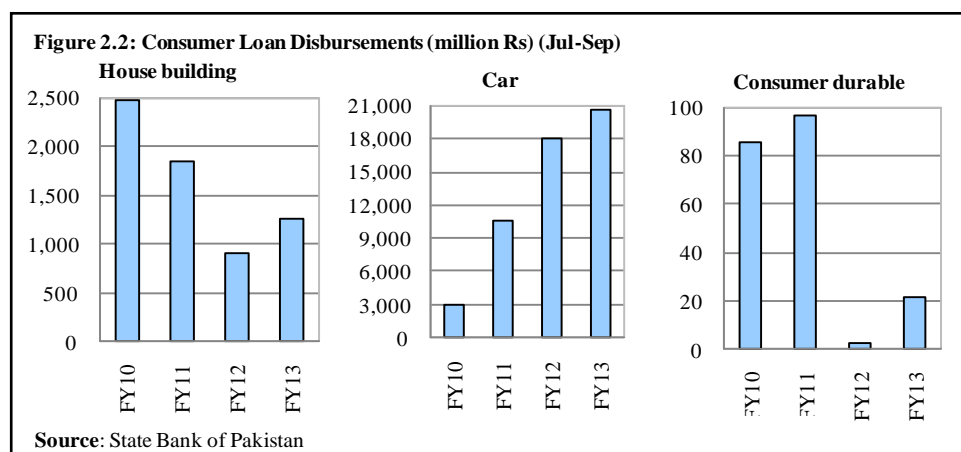
Source: Pakistan Bureau of Statistics, analyst calculations

But whether household demand is declining is another story. Several indicators point otherwise. For instance, production of other consumer durables (such as vehicles and refrigerators) increased over the same time frame and imports have also been on the rise.

Import competition is cited by business owners as one reason for the decline in local electronics demand. Indeed, despite high custom duties, imports of televisions, electric fans, air conditioners,

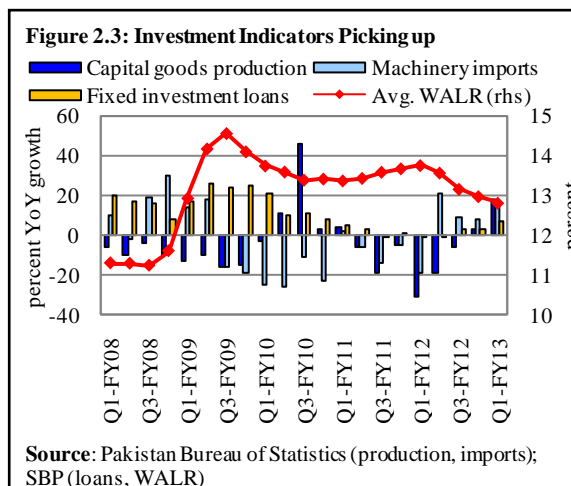
and lighting have increased over the past few years. Anecdotal evidence also points to large-scale smuggling of these goods from neighboring countries.

Finally, in the case of energy intensive items (air conditioner and deep freezer), it is possible that extensive electricity shortages together with rationalization of tariffs over the past few years have led to an enduring change in consumer behavior.



Apart from these few ‘pull-down’ factors, most other industries are showing some improvement over the corresponding quarter of FY12.

For instance, pick-up in private construction activity – evident from higher cement dispatches and import of iron and construction machinery – appears to be an important driver of Pakistan’s manufacturing growth. In particular, production of building materials (with a combined weight of 12.3 percent in LSM) has shown a rise of 7.9 percent YoY during the quarter.¹⁷ Encouragingly, this sector now seems insulated from the energy shortages: we have learnt that most plants in glass and steel have gradually shifted to self-generated power to maintain



¹⁷ While formal companies supply primary building material (e.g., cement, steel); most construction activities still fall under the informal sector.

their production volumes. It is important to recall here, that cement plants had already shifted to coal in early 2000s.

In the case of consumer goods industries, one factor that likely had some positive bearing on demand this quarter could be the monetary easing that began in August 2011. With lowering of lending rates, the decline seen in consumer financing, during the past year, particularly for house building and consumer durable, appears to be bottoming out (**Figure 2.2**).

Another positive development is a noticeable rise in investment which is reflected in higher fixed-rate loans, machinery imports, and the domestic production of capital goods (**Figure 2.3**). There are two drivers for this demand:

1. Capital goods production is mainly being led by derived demand from the agriculture sector (tractors and farm equipment), and by higher demand for commercial vehicles.

2. Lower interest rates allow firms to restructure their loan portfolio more favorably. As firms retire expensive loans, financing costs – which eat into gross profits – also decline. This creates room for new investment spending at more affordable rates. In the LSM sector, fresh investments have been concentrated in textile, paper, glass, steel, and food processing. Furthermore, arranging alternate power sources remains a priority in Pakistan's manufacturing sector (**Table 2.7**).

Table 2.7: Selected Machinery Imports (Jul-Sep)

million US\$

Item	FY11	FY12	FY13
Textile machinery	103.3	97.0	116.2
Generators	72.8	53.2	75.7
Steel	5.2	7.2	8.7
Packaging	6.4	4.6	6.9
Boilers	1.5	5.1	6.2
Food processing	4.7	5.8	5.9
Paper-making	15.3	3.3	4.3
Transformers	6.7	1.3	3.3
Glass making	0.8	0.4	1.6

Source: State Bank of Pakistan

Going forward, a number of expected developments bode well for industrial growth:

1. The pickup in textile exports from September 2012, is benefitting cotton yarn production.
2. A stricter policy for used car imports announced in November 2012, will provide relief to domestic manufacturers. Moreover, the large car segment is

also set to benefit from a new model that will reportedly be released in Q3-FY13.¹⁸

3. A good sugarcane crop is expected this year, with sugar production expected to be 4.8 million tons – this amounts to a 4.8 percent increase over last year.
4. The commissioning of a large cold rolling steel mill and Tuwairiqi Steel Mills (which will provide raw material for rolling mill industry) in Q2-FY13, and consistent growth in ship-breaking, will enhance steel supply in the country.
5. Commissioning of a new motor cycle tyre plant in Q3-FY13, should improve local market share in the tyre market. The motorcycle industry will also benefit from a reduction in duties on imported components.

However, challenges remain: for one, the gas supply situation which generally worsens during the winter as domestic demand typically increases; sectors that could suffer include fertilizer, glass, paper, and textiles. As we had highlighted in the *Annual Report FY12*, structural reforms are needed in the energy sector, as deficiencies in this sector have become a major bottleneck to our industrial production. In addition to improving the operational efficiency of energy-related PSEs, we recommend rationalization of electricity and gas prices to encourage energy conservation. Side by side, government must continue to add capacities in both conventional and alternate fuels, for a long-term solution to energy constraints.

¹⁸ Although producers will benefit from this stricter import policy, consumer welfare will fall as their choice become limited.

3 Inflation and Monetary Policy

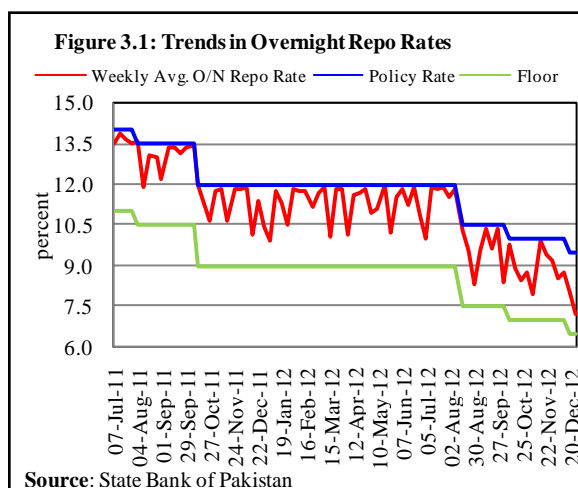
3.1 Overview

The key development in Q1-FY13 was a consistent fall in inflation. After remaining in double-digits for more than two years, headline inflation fell to 9.1 percent in Q1-FY13, compared to 11.5 percent in Q1-FY12. At the same time, SBP's survey of consumer confidence corroborates some softening in inflation expectations.

The reduction in inflationary pressures, together with some support from the much-delayed Coalition Support Fund (CSF) on the external account, allowed the central bank to cut interest rates.¹ SBP reduced its policy rate by 150 bps to 10.5 percent in August 2012, followed by two more cuts of 50 bps each in October and December 2012 (**Figure 3.1**).

Despite these signals, market liquidity remained tight throughout the first quarter. While the fiscal authorities borrowed extensively from commercial banks, market liquidity was squeezed when the government retired a part of its debt to SBP. To put this in perspective, while the government borrowed a record Rs 564 billion during Q1-FY13 from commercial banks, it retired Rs 412 billion to SBP – effectively absorbing this amount from the banking system.²

More importantly, the retirement of SBP debt enabled the government to meet the limit of zero quarterly central bank borrowing, as set under the amended SBP Act of 1956.



¹ The investment to GDP ratio, which has been declining since FY07, reached a low of 12.5 percent in FY12 (see SBP's Annual Report for FY12).

² These borrowings are on the basis of *actual cash* realized by the government through debt issuance in the primary auctions. These numbers may not tally with monetary aggregates shown in **Table 3.1** as the latter also includes the impact of any subsequent change in the market value of the government borrowings.

It may be acknowledged that commercial banks assume credit risk while lending to the private sector, whereas lending to government is risk-free and improves the banks' risk-weighted assets. In this situation, a large demand for budgetary finance incentivizes commercial banks to remain indifferent to the private sector. This concern was one of several factors that allowed SBP to further ease its monetary policy in FY13.

However, as the expectation of further cuts in the policy rate took hold, commercial banks started lending more aggressively to the government, particularly investing in 6-12 month T-bills, PIBs and Sukuk. Accordingly, the maturity profile of government borrowing from banks improved slightly during the quarter. Specifically, the share of commercial banks' investment in 3-month T-bills has declined from 26.4 percent of their total T-bills holdings at end-June 2012, to just 7.1 percent as of end-September 2012.³

Table 3.1: Monetary Aggregates (Jul-Sep)

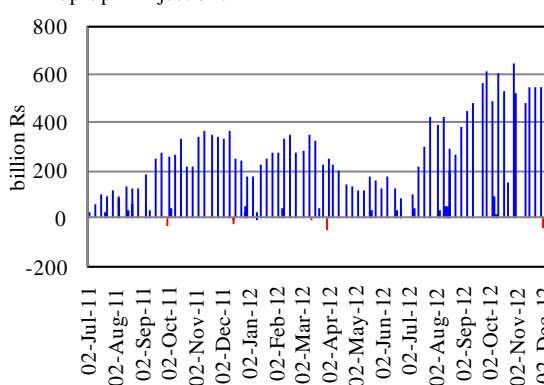
flows in billion Rs, growth in percent

	Cumulative Flows		Growth	
	FY12	FY13	FY12	FY13
Broad money (M2)	-21.0	54.0	-0.3	0.7
NFA	-82.7	11.8	-10.6	2.2
SBP	-53.3	-4.3	-8.7	-1.1
Scheduled banks	-29.4	16.0	-17.7	11.6
NDA	61.8	42.2	1.0	0.6
SBP	120.8	101.7	11.6	6.8
Scheduled banks	-59.0	-59.4	-1.2	-1.1
<i>of which</i>				
Government borrowing	179.6	159.0	5.9	3.7
For budgetary support	184.4	152.5	7.1	4.0
SBP	-101.9	-399.4	-8.5	-23.4
Scheduled banks	286.3	551.9	20.4	26.4
Commodity operations	-2.8	9.0	-0.7	2.1
Non government sector	-63.4	-69.4	-1.8	-1.9
Credit to private sector	-88.7	-84.9	-2.8	-2.5
Credit to PSEs	25.2	15.5	6.5	6.0
Other items net	-54.4	-47.4	8.3	5.9
Memorandum Item: Government borrowing on cash basis				
Banking System	160.8	151.5	-	-
SBP	-103.5	-412.1	-	-
Scheduled banks	264.3	563.6	-	-

Source: State Bank of Pakistan

Figure 3.2: SBP Intervention

■ Mop-up ■ Injections



Source: State Bank of Pakistan

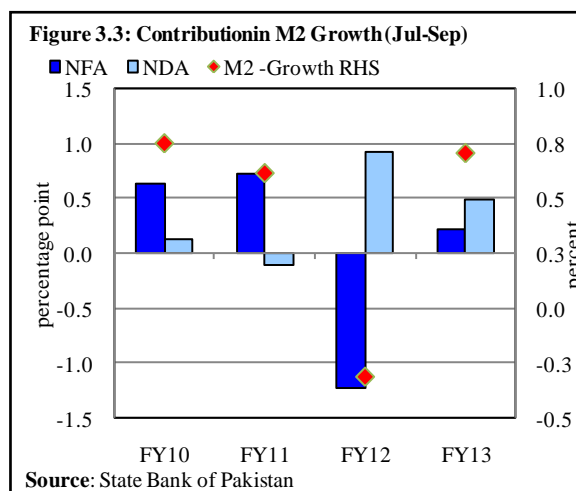
³ In Q1-FY13, net acceptance of 3-month treasury bills recorded a fall of Rs 447.7 billion, in contrast, 6 months and 12 months T-bills attracted Rs 587.7 billion and Rs 270.5 billion respectively.

The retirement of SBP debt absorbed market liquidity, and reduced the growth in banks' deposits; furthermore, the drain in SBP's NFA further pressurized interbank liquidity. SBP therefore stepped-in to provide liquidity through open market operations (OMOs) (**Figure 3.2**). This provision of liquidity along with the reduction in policy rate pushed down the 6-month Karachi interbank offer rate (KIBOR) – a benchmark for pricing loans to private sector businesses –which saw a reduction of 256 bps during Jul-Nov FY13. Similarly, the weighted average lending rate (WALR) on fresh loans, has also seen a decline of 222 bps during Jul-Nov FY13.

Although private sector credit remained sluggish in overall terms during the quarter, there are some encouraging signs. Specifically, loans to private sector businesses saw a net retirement of Rs 39.5 billion in Q1-FY13, lower than the net retirement of Rs 95.3 billion witnessed during the corresponding period last year. Most of the current retirement can be traced to working capital loans and trade financing, but fixed investment loans (i.e. loans with a maturity of more than one year) increased by Rs 5.6 billion during the quarter compared to a net contraction of Rs 22.4 in Q1-FY12. The latter appears to support some improvement in the LSM sector.⁴

3.2 Developments in Monetary Aggregates⁵

Broad money supply (M2) grew by 0.7 percent during Q1-FY13 compared to a contraction of 0.3 percent during the corresponding quarter of FY12. Both NFA and NDA of the banking system contributed to M2 growth (**Figure 3.3**), whereas in the previous year, the contraction in NFA overshadowed the visible rise in NDA.



⁴ Excluding cars and fertilizer, LSM grew by 3.5 percent during Jul-Sep FY13 compared to 2.9 percent during the same period last year.

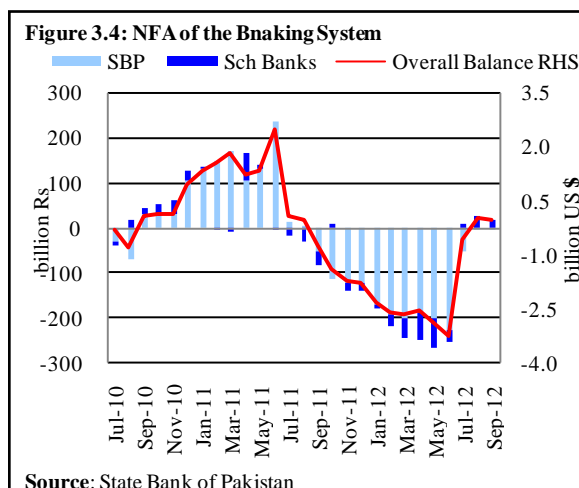
⁵ Discussion in this section is strictly restricted to the first quarter of the year.

Net Foreign Assets (NFA)

After witnessing a persistent fall in FY12, the banking system's NFA increased during Q1-FY13 (**Figure 3.4**).

Within the banking system, commercial banks led the expansion in NFA, as the growth in workers' remittances and some increase in portfolio investment, added to their FX holdings.

On the other hand, SBP's NFA contracted by 1.1 percent during the quarter, despite the receipt of US\$1.1 billion on account of CSF in August 2012 (**Figure 3.4**).



Net Domestic Assets (NDA)

The growth in NDA of the banking system decelerated to 0.6 percent during Q1-FY13, from 1.0 percent in Q1-FY12 (**Table 3.1**).

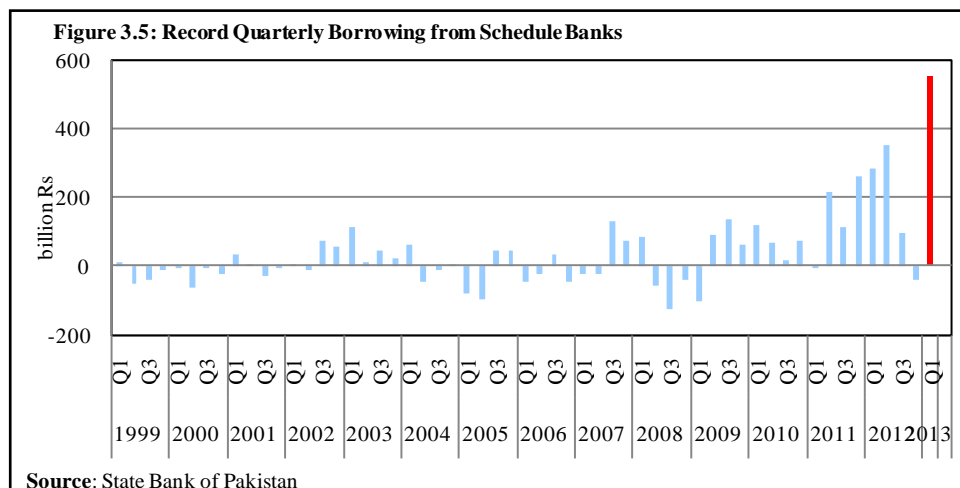
Government Borrowing for Budgetary Support

Overall government borrowing for budgetary support was lower in Q1-FY13 relative to the same quarter last year (**Table 3.1**). However, this number masks a major shift in borrowing sources, i.e., the government borrowed heavily from commercial banks during the first quarter to retire its debt with the central bank.

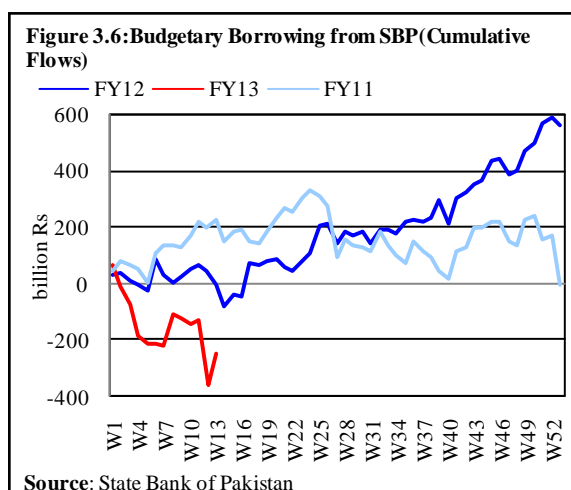
Thus, the government's reliance on commercial banks increased despite CSF money and higher mobilization through non-bank financing (NSS).⁶ Specifically, the government borrowed Rs 564 billion (on cash basis) from commercial banks during the quarter – the highest ever for a single quarter (**Figure 3.5**).

Because of this, the government comfortably met the limit of zero quarterly borrowing from the central bank as stipulated under the amended SBP Act. In fact, the government retired Rs 412 billion of its debt held by SBP (**Figure 3.6**).

⁶ In net terms, the government received Rs 154.4 billion from national saving schemes during the quarter, which was much higher than Rs 54.3 billion secured in Q1-FY12.



In order to mobilize more funds from commercial banks, the federal government often accepted larger amounts in the auction than the announced target (**Table 3.2**). Banks were also keen to lend to the government despite a net contraction in their deposits during the quarter.⁷ The resulting tightness in the market forced SBP to provide liquidity through OMO injection, so that the money market could function smoothly.



Credit expansion to public sector enterprises (PSEs) fell to Rs 15.5 billion during Q1-FY13, compared with Rs 25.2 billion in the corresponding period last year. Almost all of this credit was availed by an oil marketing company and a public sector steel mill.⁸

⁷Banks' total deposits fell by 0.5 percent in Q1-FY13.

⁸ The oil marketing company borrowed Rs 14 billion during Q1-FY13, of which Rs 12 billion was availed to meet the working capital needs. The loan to public sector steel mill was a part of the bailout package approved in Jul 2012 by Economic Cabinet Committee (ECC). It was a term loan

Table 3.2: T-bills Auctions

billion Rs

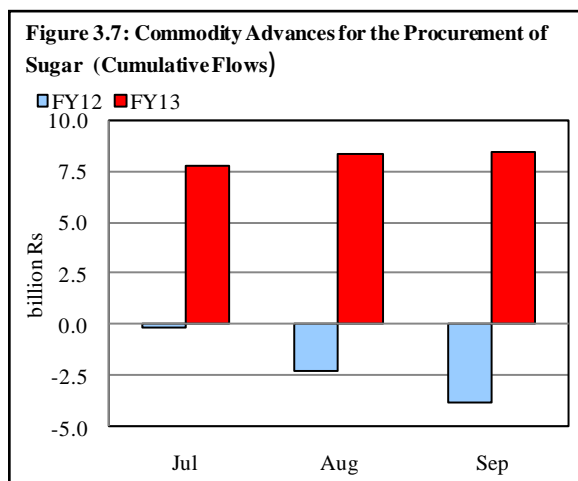
	FY12			FY13		
	Net Target	Net Offered	Net Accepted	Net Target	Net Offered	Net Accepted
Jul	88.5	213.1	142.2	3	360.5	228.6
Aug	54	191.7	123.4	-14.6	14.7	-25.1
Sep	12.9	206.7	78.8	24.4	545.4	207.1
Total	155.4	611.5	344.4	12.8	920.6	410.6

*Net of maturity amounts

Source: State Bank of Pakistan

Commodity Finance

Commodity financing posted an increase of Rs 9.0 billion in Q1-FY13 compared to a net retirement of Rs 2.8 billion in Q1-FY12. This is explained by slower retirement of wheat advances extended during the previous season, and fresh borrowing of Rs 17.6 billion availed by the Trading Corporation of Pakistan (TCP) for the procurement of sugar and fertilizer (**Figure 3.7**).



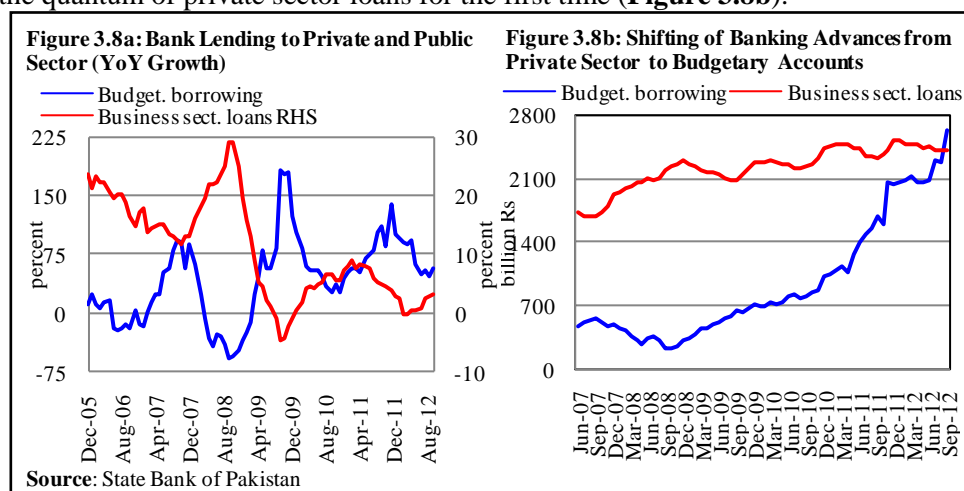
The retirement of wheat financing remained subdued because flour mills procured higher stocks directly from farmers instead of buying from the government;⁹ the food department of Balochistan could not start procurement on time, and increasing receivables on account of subsidies and sales proceeds to be paid by various government departments. Given the self liquidating nature of commodity loans, the gradual increase in the outstanding amount in recent years, has been pointing towards another circular debt problem.

secured to finance the LC opening for raw material import and to meet current expenditures of the company.

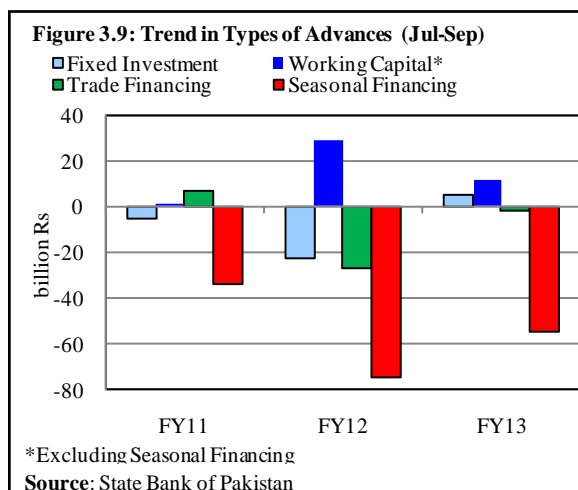
⁹ In general, whenever flour mills procure higher stocks directly from farmers, this delays the release of wheat stock from provincial food departments in subsequent months.

Private Sector Credit

Despite the decline in lending cost, growth in credit to the private sector remained sluggish. The structural issues, such as energy shortages, the law and order situation, and some sector-specific constraints, suppressed credit growth. From the banks' perspective, the availability of risk-free government securities, coupled with credit quality concerns, continued to limit the supply of credit to the private sector. This behavior has significantly changed their asset composition. As a result, in August 2012, the outstanding stock of government borrowing exceeded the quantum of private sector loans for the first time (**Figure 3.8b**).



Since the first quarter of the year is a retirement season, private sector credit in Q1-FY13 recorded a net contraction of Rs 84.9 billion – slightly lower than in the corresponding quarter of last year (**Table 3.3**). Within overall credit, loans to private sector businesses saw a lower retirement of Rs 39.5 billion in Q1-FY13, against Rs 95.3 billion in first quarter of previous year. Subdued lending in the preceding season, and some pickup of fresh loans explain the lower repayments in the year.



Further analysis suggests that most of the retirement came from working capital loans and trade financing. In contrast, the volume of fixed investment loans recorded a modest increase during the period of analysis (**Table 3.3**).

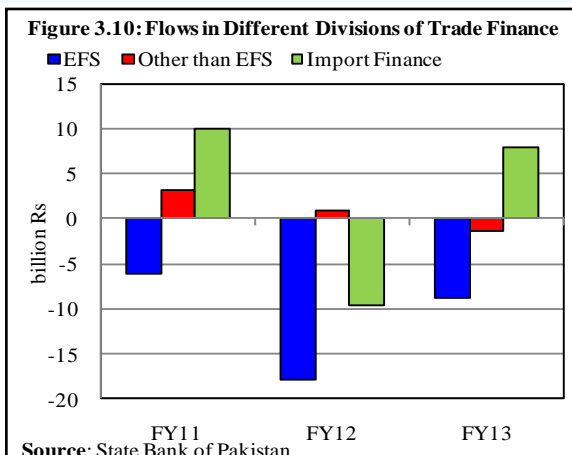
Table 3.3: Private Sector Loans (Jul-Sep)
billion Rs

	Overall Loans		Working Capital		Fixed Investment		Trade Financing	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Business Sector Loans	-95.3	-39.6	-46.2	-43.2	-22.4	5.6	-26.8	-2.2
Agriculture	6.3	6.7	6.5	5.1	0.1	1.7	-0.2	-0.1
Manufacturing	-81.0	-47.4	-61.7	-46.1	-7.1	0.5	-12.2	-1.7
Food and Beverages	-55.0	-42.1	-51.8	-42.6	-2.9	4.5	-0.3	-3.9
<i>Sugar</i>	-36.4	-24.7	-35.4	-28.5	-1.9	2.9	0.9	0.8
Textiles	-44.5	-25.0	-28.7	-16.2	-3.1	-6.1	-12.6	-2.6
Spinning	-31.7	-11.9	-20.6	-12.2	-5.9	-1.1	-5.3	1.3
Weaving	-6.8	-4.4	-7.1	-2.0	3.1	-2.0	-2.8	-0.4
Carpets and Rugs	0.2	5.7	0.0	5.7	-0.1	1.1	0.3	-1.1
Refined Petroleum								
Products	9.6	0.2	10.5	-2.2	-1.9	2.3	1.0	0.0
Fertilizers	-4.5	7.7	-3.2	10.1	-0.4	-1.3	-0.9	-1.0
Plastics Products	0.0	4.5	0.2	0.2	-0.1	2.2	-0.1	2.2
Cement	0.7	-3.2	-0.6	-0.7	0.6	-0.5	0.8	-1.9
Basic Metals	6.7	3.8	5.4	1.4	0.8	-0.2	0.5	2.6
Electrical Machinery	2.7	0.3	1.6	-0.9	0.3	-0.1	0.8	1.2
Electricity Apparatus	1.8	-1.1	3.5	-0.8	-2.4	-0.2	0.7	-0.1
Ship breaking	-0.8	2.5	-0.2	1.1	0.0	0.0	-0.6	1.4
Electricity Generation	8.0	0.9	10.3	-0.8	-2.1	1.7	-0.2	0.0
Construction	-3.2	-0.6	-1.8	-1.7	-1.6	0.9	0.2	0.1
Commerce and Trade	-5.2	0.6	-1.7	1.7	0.0	2.2	-3.4	-3.3
Retail Trade	-2.7	3.2	-1.7	0.9	0.5	2.0	-1.5	0.4
Trans. Storage and Comm.	-6.7	-1.8	3.7	-1.7	-9.8	0.0	-0.5	-0.1
Telecommunications	-8.6	-2.1	2.7	-1.2	-11.3	-0.8	-0.1	-0.1

Source: State Bank of Pakistan

The seasonal repayment of loans for sugar, rice and cotton explains the bulk of the retirement. The decline in raw material prices and structural issues (i.e., energy and large inventories) partly explain the lower disbursements, especially in the textile sector. Within the sugar sector, which is the second largest sector availing

Fixed investment loans also showed an increase during Q1-FY12. This expansion however, is concentrated in sectors like agriculture, sugar, petroleum, plastic products and retail trade.



Within trade financing, contraction in export loans overshadowed the expansion in import financing during the quarter (**Figure 3.10**). Demand for import loans largely came from ship breaking, iron & steel, and plastic industry.¹⁰

In consumer loans, all categories, except personal loans, witnessed a lower net retirement during Q1-FY13. Moreover the loans for credit cards witnessed a net expansion during the period under review (**Table 3.4**).

3.3 Inflation

Headline inflation declined sharply in the first month of the quarter, and continued decreasing over the next two months. Average inflation for the quarter was 9.15 percent, compared to 11.48 percent for the same period last year (see **Figure 3.11**). Sharp falls in the prices of a few commodities (e.g. piped gas, pulses, and perishables) pulled down the inflation, but inflationary pressures seem to be easing more broadly (see **Figure 3.12**).

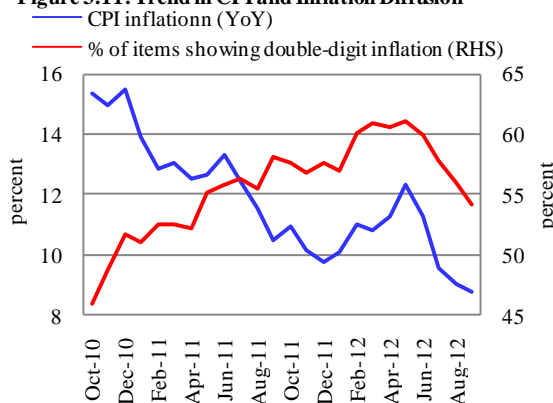
However, both measures of core inflation (non-food non-

Table 3.4: Loans to Consumer Sector (Jul-Sep)

billion Rs	Cumulative Flows	
	FY12	FY13
Consumer financing	-4.7	-1.7
House building	-1.9	-1.1
Auto loans	-2.3	-0.2
Credit cards	-1	1.3
Personal loans	0.6	-1.7

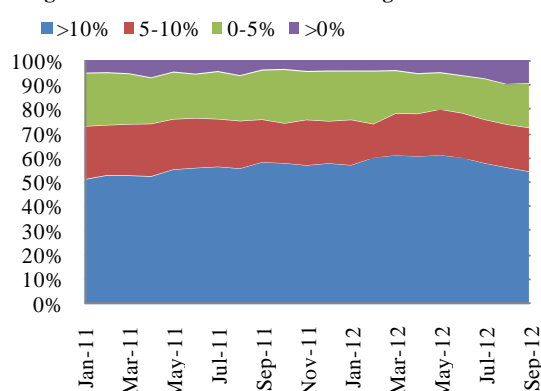
Source: State Bank of Pakistan

Figure 3.11: Trend in CPI and Inflation Diffusion



Source: Pakistan Bureau of Statistics

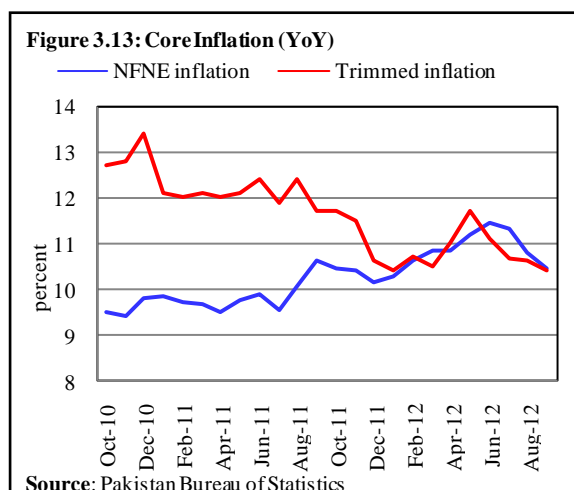
Figure 3.12: Distribution of Price Changes



Source: Pakistan Bureau of Statistics

¹⁰ The commencement of a polyester film plant created fresh credit demand for all types of financing i.e., running capital, import financing and long-term loans in the plastic industry.

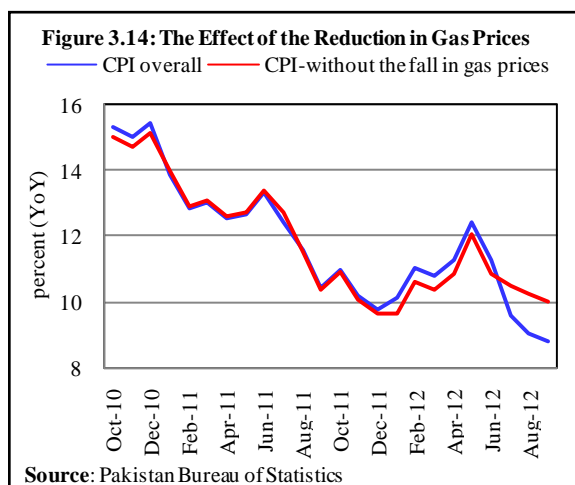
energy inflation and trimmed inflation) have not fallen as sharply as the fall in aggregate inflation (see **Figure 3.13**). Within NFNE inflation, changes in house rents have remained stable at roughly 7 percent, while inflation in other groups has either declined gradually or remained stable. At the same time, SBP's consumer confidence survey has indicated that inflationary expectations have started to ease. The quarter has also been marked by stability in energy prices, which has a strong impact on inflation expectations.



The easing of inflationary expectations may also be attributed to the relative stability in food prices over the past year. The prices of pulses and sugar, in particular, have either declined substantially, or remained stable.

The reduction in gas tariffs

A large part of the decline this quarter can be attributed to the reduction in gas tariffs (see **Figure 3.14**). Although OGRA decreased tariffs for all households, the decrease was greater for higher consumption slabs (see **Figure 3.15**).¹¹ This meant that the decline in gas prices in the CPI basket was roughly 49 percent on a month-on-month basis. However, a large majority of households consume less than 300 cubic meters of natural gas. Although the calculation is statistically consistent, the 49 percent decline may not be representative of the average urban household. If the government



¹¹ The index is calculated using a simple average of the five slabs.

were to reverse this decision at some future date, then the increase in inflation may be just as sharp as this decline was, and again not be representative of the average household.

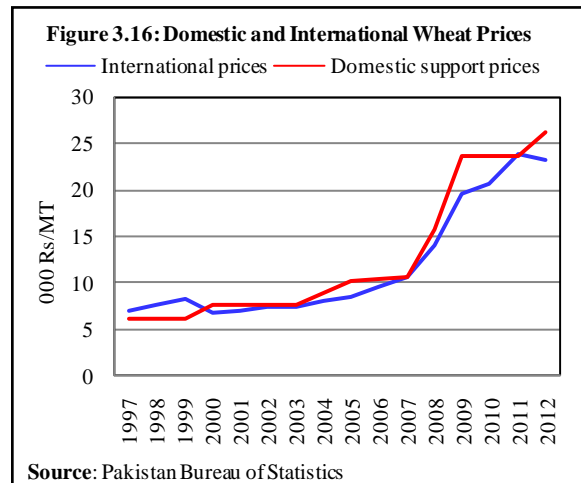
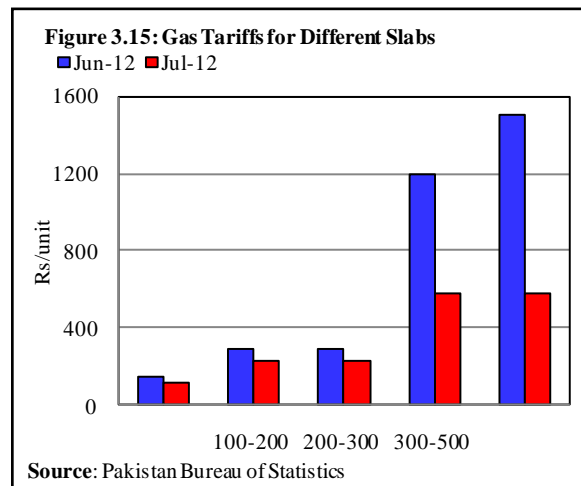
Wheat support prices

The recent trend in wheat prices, however, has been concerning. With the rise in international prices, and the increase in domestic support prices, wheat prices in local retail and wholesale markets have already started inching up.¹²

We believe that the increase in the wheat support price will impact food inflation in the near future, given the importance of wheat as part of the staple diet, and as an input for some of the manufactured food items.

The increase in the support price was not a surprise. According to our analysis, changes in the international price of wheat cause changes in the government's support price. Moreover, the wheat support price has been higher than the international wheat price in 12 out of the last 13 years (**Figure 3.16**).

International wheat prices have risen sharply in Q1-FY13 due to droughts in Australia and the US. In line with our expectations, the government increased the support price of wheat by Rs150 per 40kg to Rs1200 per 40kg in November 2012. The subsequent increase in retail



¹² Wheat prices rose by almost 5 percent on a month-on-month basis in September – the largest monthly increase in two years.

wheat prices and the acceleration in food inflation may pose the greatest risk to managing inflation in the near future.

Outlook

However, the reduction in administered prices for piped gas and CNG, and the stability in house rents, will continue to dampen inflation going forward. Therefore, we expect energy prices to remain largely stable and, due to the increase in the wheat support price, we believe that food inflation will accelerate. The trend in inflation will consequently depend on the trend in administered prices in the near future. The other risks to inflation emanate from the external front, where the impact of the exchange rate on domestic prices will be critical.

Although we expect food inflation to reverse its trend and start increasing in future months, we also expect headline inflation to remain below the government's target of 9.5 percent for the year. That is simply because average inflation for the first half of the year was 8.3 percent, and prices would have to increase much faster than anticipated to breach the 9.5 percent target for the full year.

4 Fiscal Policy and Public Debt

4.1 Fiscal Operations

The overall budget deficit for Q1-FY13 increased slightly to Rs 283.8 billion from Rs 257.2 billion in the first quarter of last year (**Table 4.1**). As a percentage of GDP, the deficit remained unchanged at 1.2 percent, compared to Q1-FY12.¹

The key development this quarter was the sharp increase in interest payments, which can be explained by a significant rise in domestic debt in recent years. These payments alone now constitute over 38 percent of the overall current spending, and have consumed more fiscal space, which the government could have utilized to stimulate the domestic economy. Therefore, our concerns regarding the looming debt trap stays, as the government domestic debt has increased by Rs 482 billion in Q1-FY13, compared to Rs 208 billion in Q1-FY12.

Fiscal management became more challenging following a slowdown in tax collection during the quarter. However, a large inflow of US\$ 1.12 billion in August 2012 under the Coalition Support Fund (CSF), and a hefty surplus of Rs 85.4 billion posted by the provinces (compared to a *full-year* target of Rs 80 billion) helped the government contain the fiscal deficit.^{2,3}

Table 4.1: Summary of Public Finance
billion Rs

	BE FY13	Q1 FY12	Q1 FY13	Growth (%)
Total revenue	3,376	533.6	692.1	29.7
Tax revenue	2,626	409.0	451.3	10.3
Non-tax receipts	750	124.7	240.8	93.2
Total expenditure	4,480	790.9	975.9	23.4
Current	3,430	656.6	812.4	23.7
Development	1,050	87.7	74.9	-14.6
Unidentified		46.6	88.7	90.6
Overall deficit	1,105	257.2	283.8	10.4
<i>Financing through:</i>				
External resources	135	-4.4	-1.6	
Internal resources	970	261.6	285.4	
Banking system	484	119.5	151.5	
Non-bank	487	142.1	133.9	
<i>As % of GDP</i>				
Overall fiscal deficit	4.7	1.2	1.2	
Revenue deficit	0.2	0.6	0.5	
Primary deficit		0.4	-0.1	

Source: Ministry of Finance

¹ The overall fiscal deficit for FY12 was 8.5 percent of GDP. This deficit includes the one-off payment of Rs 391 billion (1.9 percent of GDP) for PSEs' debt settlement. Excluding this one-off, the deficit narrows to 6.6 percent of GDP (see *SBP's Annual Report* for FY12).

² Financing numbers shown in **Table 4.5** provide actual budgetary position of provinces.

³ There was no inflow under Coalition Support Fund during the entire FY12 (see *Chapter 5 on external sector*); similarly, provinces posted a small surplus of Rs 3.9 billion in Q1-FY12.

Given the exceptional nature of these inflows, it remains to be seen what would have happened in their absence. Excluding CSF inflows, fiscal deficit for the quarter would have reached Rs 389.5 billion, against the realized deficit of Rs 283.8 billion (up by 37.2 percent). Furthermore, though we see the better performance of provinces as the potential from fiscal devolution, we do not expect such surpluses in the remaining three quarters, since this has already exceeded the full year target.

As expected, the burden of financing this deficit fell entirely on domestic sources – particularly on the banking system – as external sources of finance were not forthcoming. Nevertheless, government was able to meet the quarterly limit on budgetary borrowing from the central bank which is stipulated under the revised SBP Act. The government, in fact, retired a total of Rs 412 billion to SBP during Q1-FY13.⁴ The burden on commercial banks, however, increased quite sharply.⁵

Revenue

Total revenues grew sharply by 29.7 percent during Q1-FY13, following the 33.4 percent growth in Q1-FY12. However, the underlying reasons are quite different: while the surge in Q1-FY12 was driven by a sharp growth (28.9 percent) in tax revenues, the rise in FY13 was on account of substantial inflows under the CSF (Table 4.2).⁶

Table 4.2: Tax and Non-tax Revenues (Jul-Sep)
billion Rs

	FY12	FY13	Absolute Δ
Tax Revenue	409.0	451.3	42.3
Direct Taxes	127.6	136.5	8.9
Taxes on goods & services	204.3	213.1	8.8
Excise duty	28.8	22.8	-6.0
Sales Tax	175.5	190.3	14.8
Taxes on int'l trade	42.5	50.8	8.4
Other taxes	18.9	28.0	9.0
Petroleum Levy	15.6	22.8	7.2
Nontax Revenue	124.7	240.8	116.1
Interest and dividends	14.5	16.0	1.5
SBP profits	54.0	50.0	-4.0
Defence (incl. CSF)	1.8	107.3	105.5
Dev. surcharge on gas	5.7	3.9	-1.8
Royalties	15.0	14.8	-0.2
Miscellaneous	33.7	48.9	15.2
Total Revenue	533.6	692.1	158.4

Source: Ministry of Finance

⁴ These borrowings are on the basis of *actual cash* realized by the government through debt issuance in the primary auctions. We have excluded the impact of any subsequent change in the market value of the debt, either due to accrued interest or change in the secondary market price.

⁵ In net terms, the federal government borrowed Rs 564 billion (on cash basis) from commercial banks in Q1-FY13, compared to Rs 264 billion in Q1-FY12.

⁶ Hence, non-tax revenues registered a growth of 93.2 percent during the quarter, following a rise of 50.4 percent during Q1-FY12.

Tax revenue could grow only by 10.3 percent during Q1-FY13,⁷ compared to 28.9 percent in the corresponding quarter of FY12. More importantly, the slowdown is concentrated in FBR tax collections, which make up a dominant part of the total tax collection.⁸

Unlike FY12, the federal budget for FY13 relies more on increasing tax compliance to achieve the full-year tax target of Rs 2,381 billion.⁹ Any shortfall in subsequent quarters would make the annual target more demanding.

The task for FBR became more complicated with a fall in inflation during the first quarter. This, together with elimination of federal excise duties (FED) in the Federal Budget for FY13, led to a decline of 1.7 percent in tax collection from domestic businesses, compared to 15.8 percent growth last year (**Table 4.3**).¹⁰ Furthermore, falling international prices of petroleum products during the first quarter of FY13, reduced the growth in import taxes.¹¹

At the same time, the growth in direct tax collection also slowed to 11.4 percent during Q1-FY13, compared to 30.1 percent last year. A number of factors explain this slowdown: the reduction in the number of income tax slabs and rates; and increase in exemption limit of withholding tax on cash withdrawal from banks.¹²

Table 4.3: FBR Tax Collection (Jul-Sep)

	Billion Rs		% Growth	
	FY12	FY13	FY12	FY13
Taxes on imports	148.8	166.6	41.7	12
Sales tax	104.1	111.9	62.8	7.4
FED	2.2	2.5	-44	12.7
Custom Duty	42.5	52.3	14.4	23
Tax on domestic businesses	107.4	105.6	15.8	-1.7
Sales tax	81.2	85.6	16.4	5.5
FED	26.2	20	14.1	-23.8
Total indirect taxes	256.3	272.3	29.6	6.2
Direct taxes	124.5	138.8	30.1	11.4
Total tax collection	380.8	411	29.7	7.9

Source: Federal Board of Revenue

⁷ This is considerably lower than the 27.9 percent growth envisaged for the year as stated in the FY13 budget.

⁸ FBR collections, which are over 95 percent of total tax revenues, showed a YoY growth of only 7.9 percent in Q1-FY13, compared with 29.7 percent during the same period last year.

⁹ The federal budget for FY13 provides a number of tax relief and incentives (e.g., increase in exemption limit on income tax, reduction in maximum tariff, rationalization of sales tax etc.). This means, achieving the full year target requires FBR to improve tax compliance and to plug leakages.

¹⁰ As a part of strategy to phase out excise duties, the fiscal authorities eliminated FED on 10 items (including base lube oil, lubricating oils, filter rods, and skin care products) in the Federal budget for FY13. It may be noted that the government had already abolished FED on 15 items in FY12 budget.

¹¹ Tax collection from imports saw a lower growth of 12.0 percent in Q1-FY13 compared to 41.7 percent in Q1-FY12.

¹² The budget for FY13 enhanced the exemption limit from Rs 25,000 to Rs 50,000 for withholding tax on cash withdrawal from commercial banks.

Expenditure

The pressure on expenditures increased during Q1-FY13, as overall spending grew by 23.4 percent, which is significantly higher than 16.9 percent last year (**Table 4.4**). These are some of the key observations relating to the expenditure account:

- The increase in current expenditures was mainly due to the rise in federal spending, which grew by 39.7 percent during Q1-FY13, compared to 4.1 percent in Q1-FY12. The acceleration can be traced to substantial interest payments on the country's domestic debt.¹³ Indeed, over 50 percent of current spending of Federal government during Q1-FY13 was channelled for interest payments only; this ratio was only 40.2 percent for FY12 (**Figure 4.1**). This rising debt burden is now dominating the government's fiscal accounts.
- Overall development spending, on the other hand, fell during the quarter under review. Although the provinces increased their development outlays, this was more than offset by a decline in development spending by the federal government.
- A noteworthy development is the increase in *unidentified* expenses which almost doubled to Rs 88.7 billion during the Q1-FY13, from Rs 46.6 billion in the corresponding quarter of FY12. Theoretically, unidentified expense

Table 4.4: Break-up of Expenditures (Jul-Sep)

	Billion Rs		% Growth	
	FY12	FY13	FY12	FY13
Current	656.6	812.4	15.9	23.7
Federal	436.4	609.7	4.1	39.7
General public service	292.8	458.7	6.7	56.6
Interest payments	177.3	312.8	9.7	76.5
Pension	27.9	34.3	94.7	22.7
Grants	47.8	39.0	6.9	-18.4
Other services	39.8	72.5	-26.1	82.3
Defense	107.2	117.4	15.1	9.5
Public orders & safety	14.5	15.3	22.2	5.7
Others	21.9	18.3	-44.7	-16.1
Provincial	220.2	202.6	49.1	-8.0
Development	87.7	74.9	39.7	-14.6
PSDP	78.9	68.3	82.9	-13.4
Federal	47.3	30.3	73.7	-35.8
Provincial	31.6	38.0	98.7	20.2
Others dev & net lending	8.8	6.5	-55.3	-25.9
Total	744.3	887.2	18.2	19.2
Unidentified expenses	46.6	88.7	-0.6	90.6
Overall expenses	790.9	975.9	16.9	23.4

Source: Ministry of Finance

¹³ The domestic debt of the government has almost doubled from Rs 4.6 trillion at end-June 2010 to Rs 8.1 trillion at end-September 2012.

reflects statistical discrepancies that one could expect in quarterly accounts; but such expenses should remain in a narrow range. The increase in this expense head during the quarter is fairly abnormal.¹⁴

Provincial fiscal operations

A key feature of the provincial accounts is the sharp increase in the combined surplus from just Rs 3.9 billion in Q1-FY12 to Rs 85.4 billion in the first quarter of FY13. This surplus is more than the *full-year* target of Rs 80.0 billion. The combined revenues of the provinces increased by 32.0 percent, which was mainly due to greater transfers from the divisible pool, and better tax mobilization by provinces. Current expenses of the provincial governments, on the other hand, fell by 7.9 percent during the quarter (**Table 4.5**).

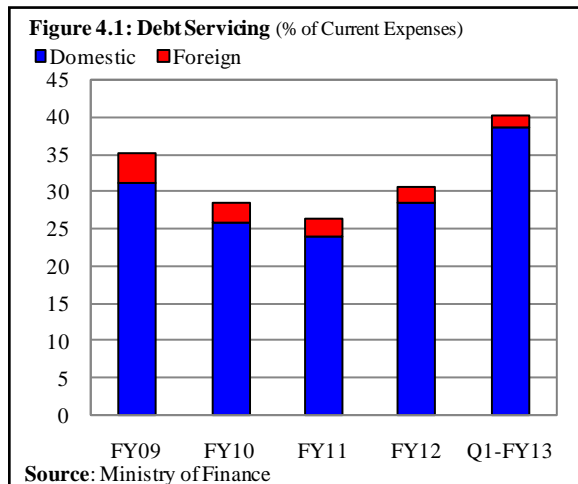


Table 4.5: Provincial Fiscal Operations (Jul-Sep)
billion Rs

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Total revenue	120.3	159.3	68.5	103.5	45.5	51.3	33.1	38.9	267.4	353.0
Share in federal revenue	94.3	128.7	55.2	73.0	33.1	43.3	27.9	32.8	210.5	277.8
Taxes	9.2	10.8	8.9	16.3	0.9	0.9	0.2	0.2	19.2	28.2
Non-taxes	10.4	12.3	0.3	9.2	7.9	1.3	0.3	1.6	18.8	24.4
Federal loan & transfers	6.5	7.6	4.1	5.0	3.6	5.8	4.7	4.3	18.9	22.7
Total expenditure	117.0	105.8	77.5	66.1	42.5	49.9	18.7	22.7	255.8	244.5
Current	100.4	87.6	73.8	61.7	32.5	37.9	17.5	19.2	224.1	206.5
Development	16.6	18.2	3.8	4.4	10.1	12.0	1.2	3.4	31.6	38.0
Overall balance	3.3	53.6	-9.0	37.4	3.0	1.4	14.3	16.2	11.6	108.5
Financing *	-1.1	-30.5	-0.6	-29.6	10.5	-10.4	-12.8	-15.0	-3.9	-85.4

* Numbers of overall balance and financing do not match due to statistical discrepancies. The financing numbers give actual budgetary position of provinces.

The Punjab government posted the highest surplus of Rs 30.5 billion, largely reflecting the greater transfer from the divisible pool during the quarter, and a

¹⁴ Interestingly, *unidentified* expenses for the full year of FY12 were Rs 69.8 billion.

decline in current spending. Tax efforts by this province, however, will take time to yield results as the newly formed Punjab Revenue Authority faces challenges in capacity building, registering taxpayers, and dealing with inter-provincial issues.¹⁵

The Sindh government also posted a surplus of Rs 29.6 billion. A reduction in current spending and the doubling of its own tax revenues in Q1-FY13 drove this surplus. Surpluses were also shown by the KPK and Balochistan governments, despite an increase in their expenses during the quarter.

4.2 Total Debt & Liabilities

Continuing fiscal imbalances led to a sharp rise of Rs 535.4 billion in Pakistan's public debt during Q1-FY13, pushing the total stock to Rs 13.5 trillion by end-September 2012 (Table 4.6). In line with recent trends, external inflows remained weak, while Treasury bills held by the banking system contributed significantly to the growth in debt.

Table 4.6: Debt Burden (Absolute change)

billion Rs

	June-12	Sep-12	Q1-FY12	Q2-FY12	Q3-FY12	Q4-FY12	Q1-FY13
Total Debt & liabilities	14,587.0	15,148.1	341.4	439.3	439.9	836.5	561.1
Total Public Debt	12,924.3	13,459.7	268.2	734.3	296.6	634.6	535.4
Total Debt	13,921.6	14,470.8	343.5	496.0	466.4	707.5	549.1
A. Domestic - Govt.	7,638.3	8,120.1	207.7	646.4	341.0	431.0	481.9
B. Domestic - PSEs	281.1	296.7	25.2	-306.8	137.2	13.8	15.7
C. External	6,002.3	6,053.9	110.6	156.3	-11.9	262.6	51.6
Total Liabilities	665.4	677.3	-2.1	-56.7	-26.4	129.0	11.9
D. Domestic	438.1	447.1	-2.8	-60.9	-29.3	131.6	9.0
E. External	227.3	230.2	0.6	4.2	2.9	-2.5	2.9

Source: State Bank of Pakistan

On a positive note, the maturity profile of the incremental debt improved somewhat over Q1-FY12, as the government was able to mobilize more resources through longer-term instruments (e.g., Sukuk, Pakistan Investment Bonds (PIBs), National Saving Schemes (NSS)). Furthermore, most of the T-bills issued were also of longer duration (e.g., 6-12 months).¹⁶

¹⁵ The Punjab Revenue Authority Act was passed by provincial assembly on 21st June 2012, and approved by the Governor of the Punjab on 26th June 2012.

¹⁶ During Q1-FY13, government mobilized a total of Rs 270.2 billion through Sukuk, PIBs and Saving Schemes, substantially higher than Rs 89.5 billion during the corresponding quarter of FY12.

The fiscal authorities were also able to replace expensive debt with slightly cheaper debt when they borrowed Rs 564 billion (on cash basis) from commercial banks during Q1-FY13, and retired Rs 412 billion to the central bank.

The government continued to face interest payment pressures in Q1-FY13, reflecting the impact of fresh borrowings during FY12. However, the benefits of an improvement in the maturity profile of the country's debt are contingent on the extent of borrowings and the resulting increase in domestic debt during the forthcoming quarters.

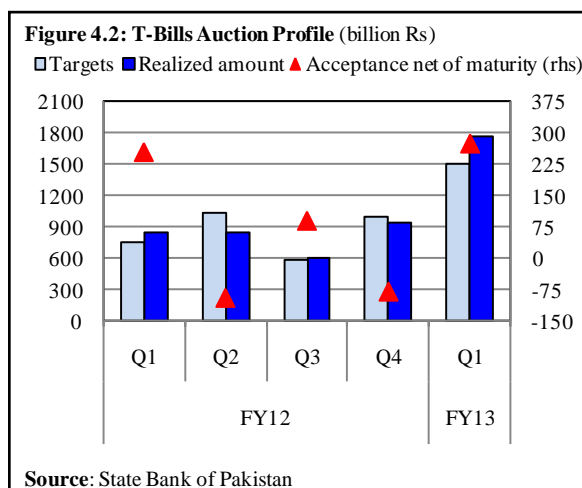
Composition of Government Domestic Debt

Floating debt: Continuing the trend observed in FY12, a large share of government borrowing during Q1-FY13 was met through floating debt (i.e., T-bills).

The eagerness of commercial banks to invest in longer term T-bills also allowed the government to retire its debt to the central bank.¹⁷

With this focus on shifting the debt away from SBP, the primary auction targets were set at fairly high levels during Q1-FY13. Nevertheless, the bids from commercial banks were well above targets, indicating banks' preference to lend to the government. Hence, the net amount the government raised in the T-bill auctions during Q1-FY13, was 64.8 percent higher than the net amount raised in all of FY12 (**Figure 4.2**).

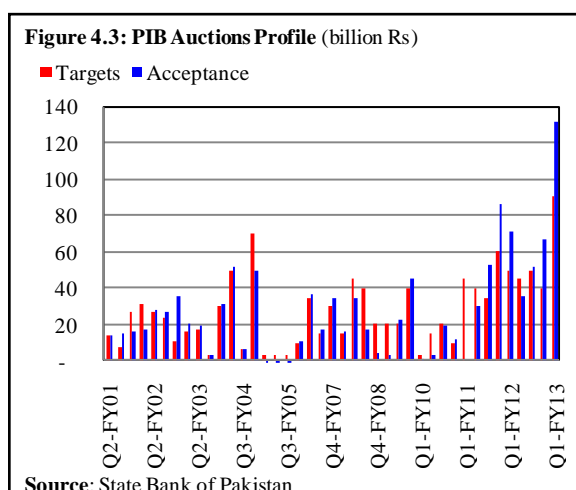
Following the cut in policy rate during Q1-FY13, banks also shied away from 3-month securities, with the share of 3-months T-bills in the total stock falling from 26.4 percent in end-June 2012, to just 7.1 percent as on end-September 2012.



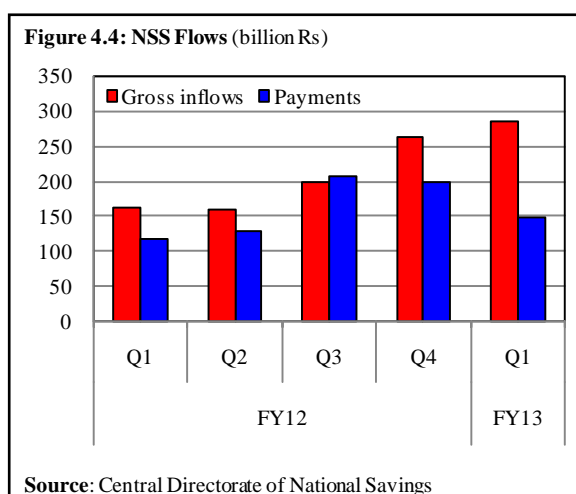
¹⁷ Resultantly, the stock of debt held by SBP fell to 19.5 percent of the government domestic debt stock at end-September 2012, compared to 23 percent at end-June 2012.

Permanent debt: Expecting further cuts in the policy rate, banks preferred longer-term securities, and the government set PIB auction targets at historically high levels during Q1-FY13 (**Figure 4.3**). Hence, the total amount accepted by the government in PIB auctions during Q1-FY13, was 59 percent of the entire amount raised during FY12.

In addition, the government also raised Rs 47 billion through Ijara Sukuk bonds during this period. Even here, banks offered a Rs 111 billion, against an auction target of Rs 45 billion. However, as this *sukuk* was the last auction against the asset identified for issuing this debt, the government could not exceed the target by a significant margin.¹⁸



Unfunded debt: Net inflows into NSS remained strong as in April 2012, the government allowed some institutional investors to participate in these schemes;¹⁹ and rates of return on NSS were increased in April and July 2012, which spilled-over into FY13. Furthermore, as evident from **Figure 4.4**, payments under NSS have tapered off after peaking in Q3-FY12; it may be recalled that the ECC in April 2011, barred institutional investors from investing in NSS, which inflated NSS repayments. However, as



¹⁸ In December 2011, government decided to raise funds through *sukuk* offering against its asset of M3 highway. So far in the five auctions, the government has raised Rs 233.8 billion against the target of Rs 195 billion.

¹⁹ In April 2012, the government allowed institutional investment comprising of individual funds (such as pension, gratuity, superannuation, contributory provident funds and trusts etc.) in NSS.

the bulk of the resulting repayments have already been made, net mobilization by NSS is likely to remain strong in forthcoming quarters.

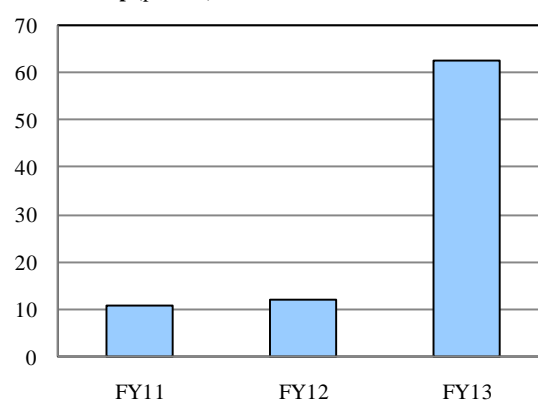
Interest payment on domestic debt

In line with the growth in Pakistan's debt, interest payments on domestic debt posted a substantial increase during Q1-FY13 (**Figure 4.5**). More specifically, the sharp increase in the stock of T-bills last year, resulted in significant additions in debt servicing payments in Q1-FY13.

The recent improvement in the maturity profile of domestic debt, and the cuts in

policy rate, may offer some relief to the government.²⁰ However, given the extent of borrowing and the resulting increase in domestic debt during Q1-FY13, this could be a temporary respite.

Figure 4.5: YoY Growth in Interest Payments on Domestic Debt - Jul-Sep (percent)



Source: State Bank of Pakistan

²⁰ According to estimates, a 100 bps reduction in the weighted average T-bill rates alone would save around Rs 37 billion in servicing the debt raised during the current fiscal year. Certainly, a larger than the target deficit of 4.7 percent of GDP would eat into this benefit.

5 External Sector

5.1 Overview

The current account showed a *surplus* of US\$ 0.34 billion in Q1-FY13, from a *deficit* of US\$ 1.36 billion in the corresponding quarter of FY12 (**Table 5.1**). While the steady growth in workers' remittances and a gradual contraction in the trade deficit supported the external account during the Q1-FY13, the inflow of US\$ 1.12 billion under Coalition Support Fund (CSF) in August 2012, proved to be the swing factor. Excluding this, the current account would have posted a deficit of US \$ 774 million in Q1-FY13.

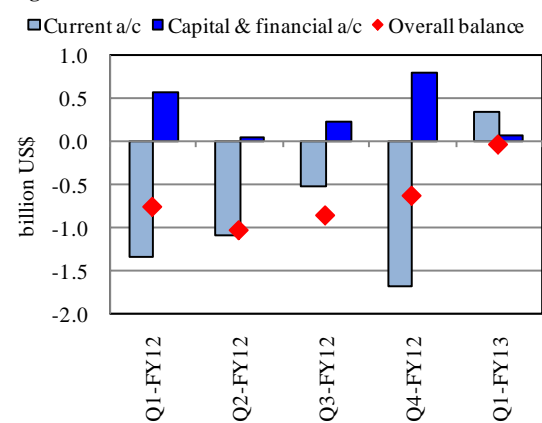
According to SBP data, the *trade deficit* fell during the quarter due to a greater decline in imports compared to exports. The contraction in imports is driven by both lower prices and lower quantum. While declining global prices of palm oil, raw cotton and crude oil helped in containing imports, greater domestic availability of urea led to a lower import quantum. However, the import of machinery and the quantum of petroleum imports have gained pace during the quarter.

Table 5.1: Summary of External Accounts (Jul-Sep)

billion US dollar	FY12	FY13
Current account balance	-1.4	0.3
(i) Trade balance	-4.2	-3.7
Exports	6.1	6.0
Imports	10.3	9.7
(ii) Services account balance	-0.7	0.2
CSF inflow	0.0	1.1
(iii) Income account balance	-0.6	-0.7
(iv) Current transfers	4.3	4.5
Remittances	3.3	3.6
Financial & capital balance	0.6	0.1
(i) FDI	0.3	0.1
(ii) FPI	-0.04	0.1
(iii) Others	0.4	-0.2
Errors & omissions	0.0	-0.4
Overall balance	-0.8	-0.02
Foreign liquid reserves (30 th Sep)	17.3	14.9
Exchange rate (30 th Sep)	87.4	94.8

Source: State Bank of Pakistan

Figure 5.1: External Account



Source: State Bank of Pakistan

The *capital & financial* account, on the other hand, deteriorated due to the persistent decline in fresh loans. Nonetheless, the surplus in the current account helped contain the overall external deficit to just US\$ 28.0 million during Q1-FY13 – the lowest quarterly deficit in five quarters - compared to a deficit of US\$ 759 million in Q1-FY12 (**Figure 5.1**).

Table 5.2: Inflows under CSF

million US\$

FY07	1,242
FY08	655
FY09	912
FY10	1,294
FY11	743
FY12	--
Q1-FY13	1,118

Source: State Bank of Pakistan

Consequently, the Rupee-US Dollar parity remained fairly stable during Q1-FY13. Specifically, the Rupee weakened by just 0.25 percent against the US Dollar during Q1-FY13 compared to a 1.7 percent depreciation in the corresponding quarter of FY12. However, the central bank's liquid foreign exchange reserves fell by US\$ 445 million during the first quarter to reach US\$ 10.4 billion by end-September 2012, which was mainly due to the payment of an IMF loan installment.¹

5.2 Current Account

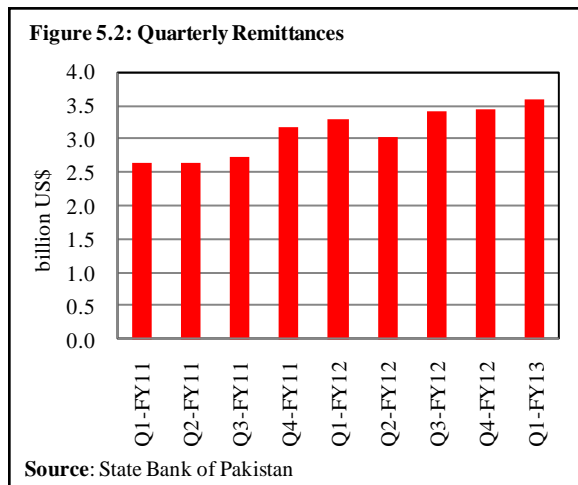
The following developments led to a turnaround in the current account:

1. *Inflow under CSF*: As mentioned earlier, Pakistan received US\$ 1.12 billion as part of the CSF.² The country had been receiving, on average, one billion US Dollars annually (**Table 5.2**), but FY12 was an exception, since there was no such inflow.
2. *Contraction in the trade deficit*: The trade deficit fell to US\$ 3.7 billion during Q1-FY13, compared to US\$ 4.2 billion in the corresponding quarter last year (for a detailed analysis, see the section on the **trade account**).

¹ Since IMF loans are meant to strengthen a country's reserve position, they are the liability of the central bank and do not have any bearing for the financial account (such loans are treated as below-the-line transactions). Hence, the repayment of such loans impacts only the reserve position of the central bank (i.e., they do not impact the financial account). In contrast, all other loans are liability of the government (i.e., they are treated above-the-line), and their repayment affects the financial account of the country.

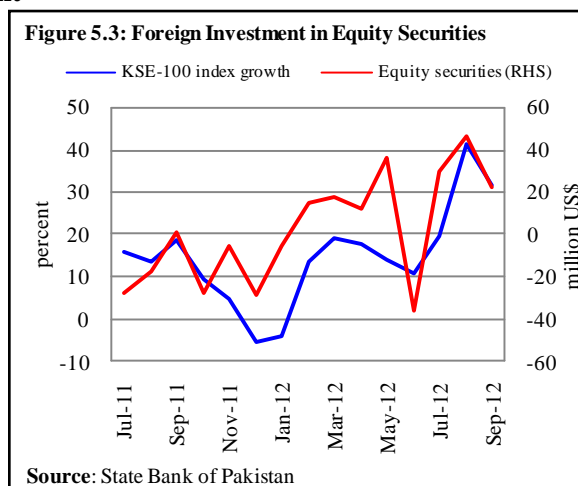
² CSF receipt is a reimbursement for expenses that Pakistan has incurred while providing logistic support to Coalition forces in the war in Afghanistan.

3. *Steady growth in remittances:* Workers' remittances continued to grow strongly despite the uncertain outlook for the global economy (**Figure 5.2**). The inflow of US\$ 3.6 billion in Q1-FY13 surpassed US\$ 3.3 billion realized in the corresponding period last year. Monthly inflows remained more than US\$ 1 billion throughout the quarter, and August 2012 saw a record inflow of US\$ 1.3 billion. A country-wise breakdown suggests that inflows from Saudi Arabia were the largest contributor, followed by inflows from the UAE and the USA.



5.3 Capital & Financial Account

Pressure on the capital and financial accounts continued in Q1-FY13: the surplus receded to only US\$ 74 million from US\$ 633 million in Q1-FY12. Major inflows (net foreign direct investment and loans) fell sharply during the period under review. In particular, the outflows from the telecom sector more than offset the net inflows in the oil & gas exploration sector.³



Declining fresh foreign loans are also pressuring the financial account. With a decrease in the volume of new loans,⁴ and almost no change in amortization, long term loans also recorded net

³ The overall FDI inflows fell to US\$ 123 million in Q1-FY13 from to US\$ 263 million in the corresponding period last year.

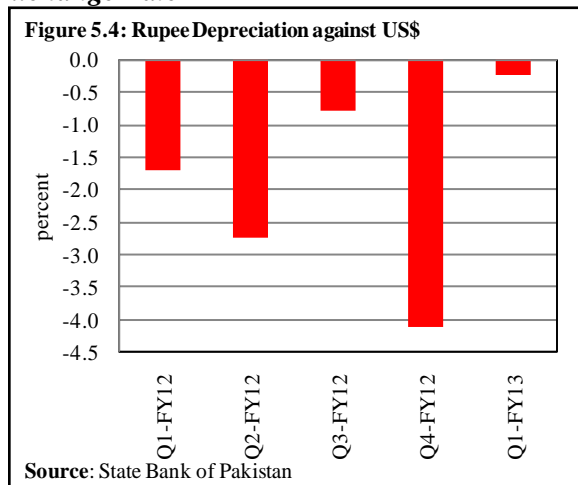
⁴ Disbursement of fresh loans declined from US\$ 455.0 million in Q1-FY12 to US\$ 365.0 million in Q1-FY13.

outflow of US\$ 27 million in Q1-FY13, compared to *inflow* of US\$ 28 million in the corresponding period last year.

Foreign investment in Pakistan's stock markets, however, experienced a major change with an *inflow* of US\$ 96 million in Q1-FY13, which is in contrast to an *outflow* of US\$ 45 million in Q1-FY12. This shift reflects the improved performance of the KSE-100 index during the quarter (**Figure 5.3**).

Foreign Exchange Reserves & Exchange Rate

Despite an improvement in the overall external account, Pakistan's liquid foreign exchange reserves had fallen to US\$ 14.9 billion by 30th September 2012, from US\$ 15.29 billion at end-June FY12. The decline in SBP's FX reserves was because of higher debt servicing payments to the IMF. Foreign exchange reserves of the scheduled banks, however, remained unchanged at US\$ 4.5 billion.



With the improvement in the country's overall balance, and the weakening US Dollar against major global currencies,⁵ the Rupee-Dollar parity remained more stable during Q1-FY13, compared to the corresponding quarter of last year (**Figure 5.4**).⁶

Nevertheless, the nominal effective exchange rate (NEER) suggests that the Rupee depreciated by 2.1 percent against a representative basket of currencies during Q1-FY13.⁷ However, the intended competitive gains to exports were partially offset by higher domestic inflation, compared to countries included in the index. In effect, the Rupee still showed a *real* depreciation of 1.6 percent during Q1-FY13, compared to a real appreciation of 2.8 percent in the corresponding quarter last year.

⁵ The US dollar depreciated by 2.3, 3.7 and 2.3 percent against Euro, GBP and Yen respectively by the end of Q1-FY13.

⁶ The Rupee traded within the range of Rs 94.0-95.0 against the US Dollar during Q1-FY13.

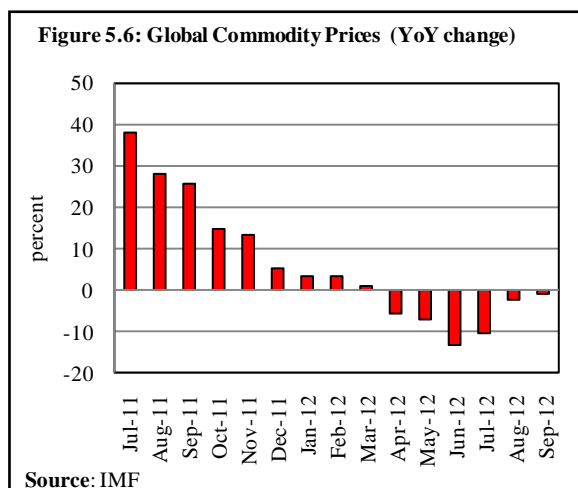
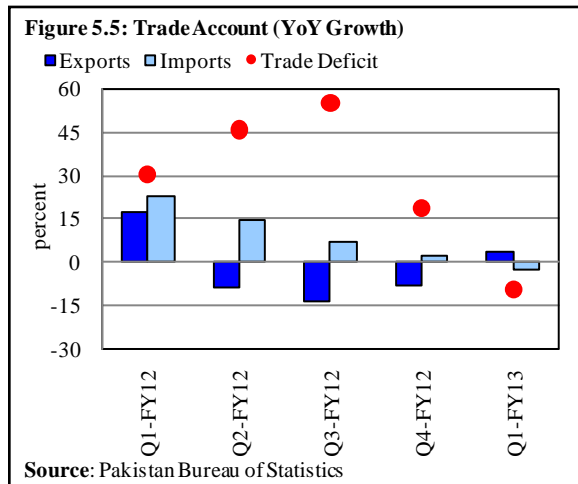
⁷ NEER is a broader index for tracing performance of the Rupee against a basket of currencies of Pakistan's major trading partner and competitors.

5.4 Trade Account⁸

The country's trade deficit eased considerably during Q1-FY13 (**Figure 5.5**).⁹ Both, a decline in imports, and a rise in exports, contributed to this improvement. Specifically, imports fell by US\$ 264.4 million, whereas exports rose by US\$ 225.2 million.

Except for machinery and petroleum groups, imports of all other major groups recorded a fall. While the greater availability of urea in the domestic market (due to the last year's imports) explains decline in import quantity this year, it was lower global commodity prices during Q1-FY13 that led to a greater contraction in the import bill (**Figure 5.6**).

However, these prices have been inching up in recent months. Having said this, it will be the trend in oil prices, which would determine the outcome of the trade deficit in FY13.¹⁰



⁸The analysis is based on provisional data provided by the Pakistan Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers posted in the section of *Balance of Payments*. While BoP data indicates a marginal YoY contraction in exports during Q1-FY13, the PBS data shows a growth of 3.9 percent over the same period.

⁹ Trade deficit saw a contraction of 9.6 percent in Q1-FY13 compared to an expansion of 30.5 percent in Q1-FY12.

¹⁰ POL imports account for around 35 percent of the total import bill.

Exports, on the other hand, managed to post a nominal growth of 3.8 percent – sharply lower than the 17.4 percent growth in Q1-FY12. Even this moderate growth can be traced to a sharp increase of US\$ 562.9 million in jewelry exports during Q1-FY13.¹¹ Excluding this one-off item, export revenues are much lower than last year. Textile exports, on the other hand, are recovering, but the focus remains low-value added items.

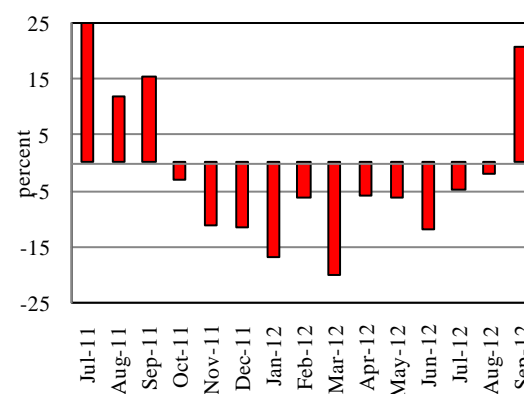
5.4.1 Exports

Exports grew by 3.8 percent during the first quarter of FY13. This increase was driven mainly by a sharp YoY rise of 20.8 percent in September 2012 (**Figure 5.7**), almost entirely on account of jewelry exports. Excluding this, Q1-FY13 exports actually fell by 5.8 percent on YoY basis (**Figure 5.8**).

Within non-textiles, items such as gloves, electrical machinery, and cement recorded higher YoY growth during Q1-FY13 (**Table 5.3**).

Cement exports continued to rise for the fourth consecutive quarter. This is in contrast to the first half of FY12, when duties on the import of cement by Afghanistan, and enhanced production capacity in Saudi Arabia, had suppressed cement exports from Pakistan. However, exports to India through land routes have increased in recent quarters, and have led the rise in overall cement exports.

Figure 5.7: Trend in Exports (YoY Growth)



Source: Pakistan Bureau of Statistics

Figure 5.8: Jewelry Exports and International Gold Prices



Source: indexmundi.com; and Pakistan Bureau of Statistics

¹¹ Discussion with the jewelry exporters revealed that this rise reflects the off-loading of gold stocks by local investors, to gain from relatively higher prices during September 2012.

Wheat exports declined to US\$ 29.3 million during the first quarter of FY13, compared to US\$ 93.6 million last year. This trend may change in the coming months as the global demand-supply gap has widened due to adverse weather conditions in Russia and Kazakhstan.¹² Hence, a sufficient carryover stock in Pakistan offers an opportunity to export more wheat in FY13. However, this will depend on the size of the forthcoming domestic harvest.¹³

Rice exports also saw a decline during Q1-FY13: both *basmati* and *irri* rice fell by 34.4 and 11.5 percent (on YoY basis) respectively. More importantly, lower export can be traced to a fall in quantum, as international prices remained higher in Q1-FY13, compared to the same period last year. Indeed, Pakistan's rice exports have been unable to recover after being priced out of the Iranian market.¹⁴

Exports of **meat & meat preparation** continued to grow and recorded a YoY rise of 27.0 percent during Q1-FY13 on top of the 30.0 percent increase during the same period last year. The steady increase in such exports is on account of higher demand from the Middle East, which was supported by better quality standards observed by Pakistani exporters.

Table 5.3: Non-Textile Exports (Jul-Sep)				
	Value in million US\$		YoY Growth (%)	
	FY12	FY13	FY12	FY13
Food	993.4	906.9	38.5	-8.7
Rice	422.0	316.9	-10.9	-24.9
Fish	59.1	63.4	12.1	7.3
Fruits	64.4	63.8	41.3	-1.0
Meat & preparation	46.5	59.0	30.0	27.0
Wheat	93.6	29.2	-	-68.8
Other Manufacture	1,140.1	1,643.0	19.5	44.1
Jewelry	167.3	730.1	26.3	336.5
Cement	112.0	146.5	-4.6	30.8
Leather	163.4	141.8	5.2	-13.2
Plastic material	111.3	101.3	75.2	-9.0
Sports Goods	76.5	75.8	1.4	-0.9
Medical Inst.	74.3	72.8	25.5	-2.0
Total Exports	5,939.1	6,764.4	17.4	3.8
Non-textile	2,761.2	2,906.9	27.5	5.3
excl. Jewelry	2,593.9	2,176.8	27.6	-16.1

Source: Pakistan Bureau of Statistics

¹² Russia and Kazakhstan contribute around 12 percent of the world wheat production.

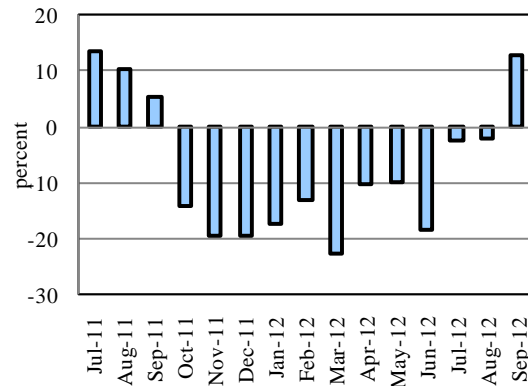
¹³ The outlook for the FY13 wheat crop is positive in view of an increase in wheat support price, better availability of water, higher fertilizer off-take, and favorable temperatures (see **Chapter2**).

¹⁴ India and Vietnam are offering lower prices compared to Pakistan.

Textile group

Textile exports grew by 2.5 percent during Q1-FY13 – still considerably lower than the 9.9 percent growth, which was witnessed in the corresponding quarter of FY12. However, monthly data indicates that these exports have finally shown a positive growth in September 2012 after falling continuously for almost a year (**Figure 5.9**).

Figure 5.9: Textile Exports (YoY Growth)



Source: Pakistan Bureau of Statistics

The growth in exports of low value added items steered this gradual recovery. In cotton yarn, the higher quantum pushed exports,¹⁵ while in cotton fabrics, a rise in unit values led to higher export revenues (**Table 5.4**).

Table 5.4: Major Textile Exports Price & Quantum Impact (Jul-Sep)

million US\$

	FY12			FY13		
	Absolute change	Qty	Price	Absolute change	Qty	Price
Textile Group	285.9			79.5		
Raw cotton	47.4	44.0	3.3	-29.4	-23.5	-5.9
Cotton yarn	9.8	-11.8	21.6	154.3	227.6	-73.3
Cotton fabrics	105.7	33.9	71.8	25.4	-39.8	65.1
Knitwear	62.8	-49.2	112.0	-58.8	-55.5	-3.3
Bed wear	27.5	-53.7	81.2	-77.8	-45.1	-32.7
Towels	8.3	-26.3	34.7	11.1	31.7	-20.7
Readymade garments	23.9	-80.8	104.7	32.2	50.2	-18.0

Source: Pakistan Bureau of Statistics

The export of high-value added items, on the other hand, fell during Q1-FY13. The decline was due to lower volumes and lower prices for knitwear and bed-wear. However, this was somewhat offset by an increase in the exports of readymade garments and towels.

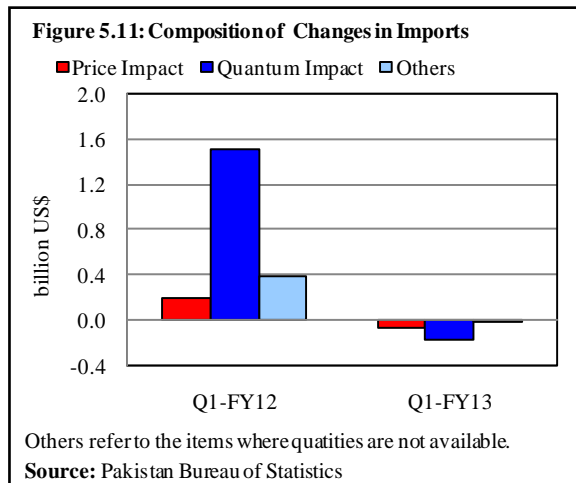
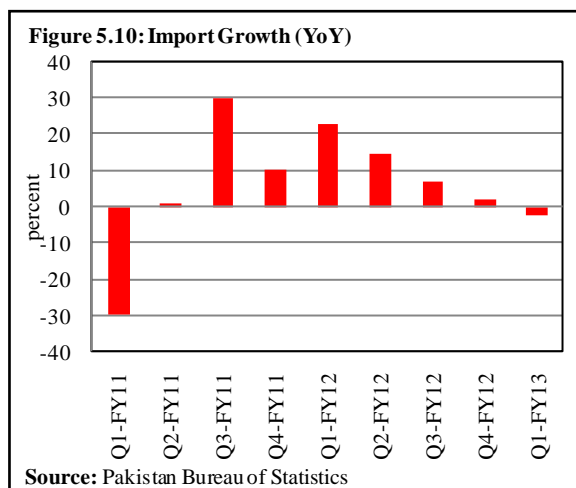
¹⁵ While the global demand for cotton yarn is on the rise, the production capacity in Pakistan also saw some improvement last year when the textile industry imported more efficient machinery that wastes lesser cotton in the spinning process.

The outlook for textiles is positive due to the opening of duty-free access to EU markets from January 2013. Pakistan has a price advantage over its competitors (mainly India and Bangladesh) in 19 of the total 75 categories eligible for preferential treatment.¹⁶

5.4.2 Imports

Imports fell for the first time (on a YoY basis) in the past two years (**Figure 5.10**). More importantly, the decline is quite broad-based. With the exception of machinery and petroleum, imports in all other groups have declined. As shown in **Figure 5.11**, the fall in imports was due to lower prices as well as lower quantities.

The lower import quantum this quarter, can be traced to the decline in fertilizer imports. Domestic availability of urea was better, due to higher imports in FY12.¹⁷ A steep fall in palm oil prices also helped contain the import bill during the quarter. In addition, lower imports under *aircrafts, ships and boats, synthetic fibre and artificial silk yarn, and plastic material* reduced the country's import bill for Q1-FY13.



Import of petroleum products, on the other hand, rose by 4.6 percent (YoY basis) in Q1-FY13 – but this was sharply lower than the 62.6 percent increase in the Q1-

¹⁶ Some of these categories include woven cotton fibres, jackets & vests of wool, ladies' denim trousers, floor & dish clothes, curtains etc.

¹⁷ Since Pakistan imported 2.6 million tons of fertilizer during FY12 – more than twice the 1.2 million tons in FY11 – the domestic stock position, particularly of urea, was comfortable during Q1-FY13.

FY12. Undoubtedly, the easing in international oil prices helped restrict the country's spending on imported oil.

Food group imports declined by 6.2 percent YoY during Q1-FY13, with the largest fall recorded in sugar. Lower imports of tea, spices and palm oil were also recorded, due to falling international prices.¹⁸

Fertilizer imports fell by 40.3 percent during Q1-FY13 compared to a rise of 33.8 percent during the corresponding period last year. A fall of 45.5 percent (on YoY basis) in import quantum during the quarter more than offset the 10.9 percent rise in import unit vales (**Figure 5.12**).

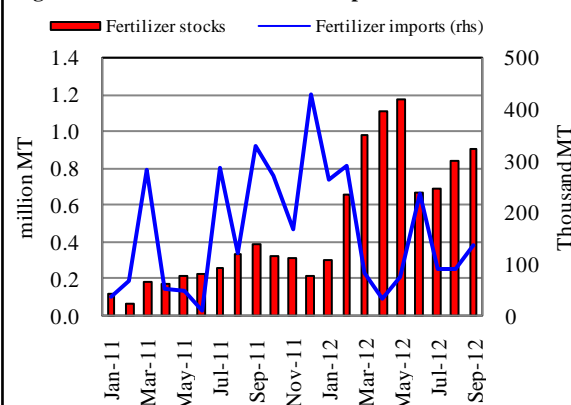
Encouragingly, *machinery* imports posted a rise of 13.3 percent during Q1-FY13, in contrast to a decline of 12.9 percent during Q1-FY12. Category-wise data reveals that imports of power generation, textiles, construction, and telecom machinery increased, whereas imports of office and agricultural machinery fell.

Table 5.5: Import Performance (Jul-Sep)

	YoY Growth		Contribution in Growth	
	percent			
	FY12	FY13	FY12	FY13
Food	7.2	-6.2	4.0	29.3
Machinery	-12.9	13.3	-8.5	-60.4
Transport	5.2	-2.5	1.2	4.7
Petroleum	62.6	4.6	70.6	-66.1
Textiles	-0.9	-13.6	-0.3	31.7
Chemical	24.0	-18.9	17.3	133.1
Metal Group	6.3	0.4	1.9	-1.0
Miscellaneous	24.5	-17.7	2.2	15.7
Total Imports	23.1	-2.4	100.0	100.0

Source: Pakistan Bureau of Statistics

Figure 5.12: Fertilizer Stocks and Imports



Source: Pakistan Bureau of Statistics

¹⁸ Palm oil prices fell by 10.4 percent during Q1-Y13 in the international market.

Acronyms

BE	Budget Estimate
CNG	Compressed natural gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
ECC	Economic Coordination Committee
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FPI	Foreign Portfolio Investment
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
IMF	International Monetary Fund
KIBOR	Karachi Interbank Offer Rate
Kg	Kilograms
KP/KPK	Khyber Pukhtunkhwa
KSE	Karachi Stock Exchange
LC	Letter of Credit
LSM	Large Scale Manufacturing
M2	Broad Money Supply
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NSS	National Savings Scheme
OGRA	Oil and Gas Regulatory Authority
OMOs	Open Market Operations
PBS	Pakistan Bureau of Statistics
PIB	Pakistan Investment Bond
POL	Petroleum, Oil and Lubricants
PSEs	Public Sector Enterprises
Q	Quarter
RHS	Right Hand Side

Rs	Rupees
SBP	State Bank of Pakistan
SUPARCO	Space and Upper Atmosphere Research Commission
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
UAE	United Arab Emirates
US/USA	United States of America
WALR	Weighted Average Lending rate
YoY	Year on Year