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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 Second 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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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 second quarter, and covers the period July-December FY13.

Some of the positive developments in Q1-FY13 could not be sustained during the second quarter. Although the current account still posted a surplus in the first half of FY13, the second quarter posted a deficit; the downward trend in inflation in the first five months of FY13 appears to have halted in December; and the federal government sharply increased its reliance on SBP financing to fund its fiscal deficit.

Seasonal rains have been less disruptive than the previous years, but localized flooding has hit the cotton and rice crops. Although sugarcane is comfortably above target (which should also help the manufacturing sector), in overall terms, agriculture growth is likely to be below the 4.0 percent that was targeted at the start of the year. However, with LSM growth expected to be above target (specifically steel and POL), SBP projects real GDP growth will remain in the range of 3.5 to 4.0 percent for the full year.

Table 1.1: Selected Economic Indicators

		FY11	FY12	FY13
<u>Growth rate (percent)</u>				
LSM	H1	-2.0	1.0	2.1
Exports (fob-PBS)	H1	18.9	3.6	7.5
Imports (cif-PBS)	H1	19.4	18.7	-3.3
Tax revenue (FBR)	H1	13.7	27.1	5.7
CPI (period average) ¹	H1	14.3	10.9	8.3
Private sector credit	H1	5.4	6.2	3.1
Money supply (M2)	H1	9.0	5.7	8.0
<u>billion US dollars</u>				
Total liquid reserves ²	31st Dec	17.2	17.0	13.9
Home remittances	H1	5.3	6.3	7.1
Net foreign investment	H1	1.0	0.3	0.7
<u>percent of GDP³</u>				
Fiscal deficit	H1	2.7	2.6	2.6
Trade deficit	H1	2.7	3.4	3.0
Current a/c balance	H1	0.0	-1.0	0.1

¹ Base year-FY08

² With SBP & commercial banks

³ Based on full-year GDP in the denominator

Source: State Bank of Pakistan

Having said this, concerns have been raised about the consistent fall in the country's FX reserves, which is primarily driven by lumpy repayments to the IMF. In fact, for the first time since H1-FY05, the country's *Financial Account* posted a deficit, which reflects on-going repayments with little fresh money coming into

the country.¹ Foreign investment has increased but levels are low, which is understandable given global conditions and the uncertain domestic environment.

The real sector is showing a mixed picture. As one of the key drivers in Pakistan's economy, the cotton crop is expected to be 8.0 percent below target (at 13.3 million bales), while rice is 22.0 percent below target (see **Chapter 2**). Although the impact of sugar on the manufacturing sector is not yet visible, the 5.0 percent above-target production has created an exportable surplus, and should boost the LSM sector in the second half of FY13.² The critical wheat crop (given its weight in major crops and its impact on food inflation) is likely to be below target despite the increase in wheat support prices in November 2012.³

With the agriculture sector below target, Pakistan's manufacturing sector has posted an improvement, and is likely to continue with this trend. Heavyweights like fertilizer, POL and steel manufacturing, have shown strong growth, but with some qualifications. The fertilizer sector did not pull down LSM growth as it did in the first quarter, since it was able to use its imported inventories and then gear-up domestic production to meet seasonal demand – the sector also fared well because of better availability of natural gas. Production capacity in steel, on the other hand, increased with the commissioning of new energy-efficient plants, while glass and paper products gained as they shifted towards alternate energy sources.

Looking at other areas of the manufacturing sector, allied sub-sectors that support construction activities, have shown consistent growth. This supports our view that residential construction remains strong since FY12, while PSDP spending on construction is also appreciably up this year. Ambitious housing projects sponsored by local investors, appear to be responding to the demand for housing across the country. We also believe remittances are feeding the construction drive.

Lacking hard data on services, wholesale/retail trade may have dipped because of lower import volumes and below-target agriculture. Furthermore, falling interest

¹ Inflows and outflows to the IMF are not in the Financial Account, as they are treated below the line in the BoP.

² Against an initial export target of 700 thousand tons, this limit was increased to 1,200 in November 2012, when the authorities were sure that domestic production would be high enough to satisfy the domestic market and to export.

³ In fact, a detailed look at inflation reveals that wheat support prices could be the swing factor for the recent up-tick in headline inflation (see **Chapter 3**). Other than being a staple food item, domestic wheat prices strongly influence food inflation and expectations of future inflation.

rates and the one-off loss incurred by Pakistan Telecommunication Company Ltd (PTCL) in H1-FY13, could put downward pressure on *finance & insurance* and *telecommunications*.

In overall terms, aggregate demand appears to be the same as in the previous quarter, shored up by remittances and fiscal spending. We would like to state that the reduction in the trade deficit in H1-FY13 is not necessarily a reflection of weak domestic demand. As will be discussed later, Pakistan's imports have been contained by exogenous factors and one-off domestic developments. In fact, the strong inflow of worker remittances that has helped the current account post a surplus, is directly driving household spending (see **Chapter 5**). We expect remittances to remain strong and may exceed the full year target of US\$ 14 billion.

As in the first quarter, bank lending to the private sector does not appear to have picked-up much. However, headline numbers can be misleading: compared to H1-FY12 when credit to the private sector increased by Rs 194 billion, the first half of this fiscal year only posted a net expansion of Rs 105 billion. This fall is driven by commercial bank lending to non-bank financial institutions (NBFIs), which saw a net retirement of Rs 78 billion in the first half of FY13, probably on account of recent changes in the tax rules.⁴

Within private sector credit, loans to private businesses that account for the bulk of private sector credit, showed an expansion of Rs 146.5 billion, compared to Rs 86.1 billion in the corresponding period last year. This lends some support to our view that banks have started shifting their attention to the private sector.

This assessment gets further support from how the pattern of federal government borrowing from the banking system has changed in Q2-FY13. As shown in **Table 3.1**, while aggregated numbers show the government has borrowed less from the banking system this fiscal year, there has been a sharp shift away from commercial banks to SBP in Q2-FY13. As a result, the government has breached the zero quarterly borrowing limit from SBP during the second quarter of FY13.⁵

The fiscal picture explains the federal government's compulsion to borrow. Although the consolidated fiscal deficit in H1-FY13 is likely to be 2.6 percent of

⁴ As per section 15 (61) of Finance Act 2012, dividend received from Money Market Funds and Income Funds shall be taxed at the rate of 25% for tax year 2013 and at the rate of 35% for tax years 2014 and onwards. Up to 2012 this rate was just 10 percent.

⁵ As per the SBP Act, the Federal government's debt to State Bank as on 30th April 2011 has to be retired in eight years (i.e. 2019). Since April 2011, however, the Federal government's outstanding debt to SBP (up to end-December 2013) actually increased from Rs 1,445 billion to Rs 1,575 billion.

GDP (which is the same as in H1-FY12), the US\$ 1.8 billion inflow on account of Coalition Support Fund (CSF) made all the difference.^{6,7} In terms of revenue collection by FBR, the first half of FY13 witnessed an increase of only 5.7 percent, against a 27.1 percent increase in the same period last year.⁸ The lack of new tax measures in the FY13 Budget; a slew of tax exemptions; leakages; and a sluggish formal economy, could explain the poor growth of tax revenues. Furthermore, current expenditures of the federal government grew by 30.9 percent in H1-FY13, compared to 6.6 percent last year; the main drivers behind this year were interest payments and energy-related subsidies.

On a positive note, the provincial governments were able to do better in the first half of FY13. Against a full-year target to generate a surplus of Rs 80.0 billion, the combined provincial accounts posted a surplus of Rs 96.5 billion in the first six months of FY13 (against Rs 11.8 billion in the first half of FY12). There are two underlying factors: one, provincial governments were able to increase their revenues due to the collection of sales tax on services; and two, the provinces only received their share (from the *divisible pool*) late in the second quarter of FY13, not leaving them enough time to execute their spending plans.⁹

It remains to be seen if the provincial governments are able to post surpluses for the remaining part of FY13. If they are unable to do so, there will be growing pressure on the federal government to narrow the on-going consolidated fiscal deficit, or simply borrow more from banking system.

In terms of the underlying financing, taking out the one-off energy payments in FY12, the federal government actually increased its borrowing from the banking system from Rs 302 billion in H1-FY12, to Rs 558 billion in the same period this year.¹⁰ In overall terms, Pakistan's domestic debt increased by Rs 691 billion in the first half of FY13 (an increase of 9 percent over June 2012) compared to Rs 854 billion in the first half of FY12.

⁶ CSF funds came in two installments: the first was US\$ 1.12 billion in August 1, 2012 (Rupee equivalent was Rs 106 billion); the second was US\$ 688 million in December 28, 2012, which translated into Rs 66 billion.

⁷ The final nominal GDP number for FY13 is likely to be different from the beginning-of-the-year projection put out by the Federal government

⁸ Part of this sharp fall is due to the fact that sales taxes (on services) collected by the Federal government has been shifted to provincial governments.

⁹ Both Sind and Punjab received almost 30 percent of their Q2-FY13 transfers from the federal government on 31st December 2012 (see **Table 4.5**).

¹⁰ Taking out the positive impact of the CSF inflows this year, the government may have required Rs 730 billion in H1-FY13.

Having said this, Pakistan's external public debt actually fell by US\$ 1.9 billion during the half year (of which US\$ 1.3 billion was owed to the IMF). Repayments without fresh inflows did put pressure on the country's BoP and exchange rate, which ideally should be countered by running a much larger current account surplus.¹¹

In terms of trade flows, the picture in H1-FY13 was quite benign. Falling import quantum and softer commodity prices, meant that Pakistan's import bill actually fell by 3.3 percent in H1-FY13, compared to a 18.7 percent *increase* in the same period last year (PBS data).

Domestic production of rubber tyres reduced the country's import needs quite sharply (a quantum fall of 33 percent), while the additional production capacity in steel, kept import requirements about the same as last year. The real saving in the first half of FY13 was the 57 percent fall in imported fertilizer, which reduced the country's import bill by US\$ 451 million (the savings from palm oil during this period was US\$ 239 million). Lastly, supporting our view that construction activities remain robust, *construction & mining machinery* imports increased by 40 percent in the first half of the year.

Looking at exports, textiles increased by 8.6 percent as manufacturers were able to draw down inventories from last year – in the first half of FY12, textile exports fell by 4.9 percent. Part of this improvement can also be traced to the duty free access granted to Pakistan by EU in November 2012. Jewelry exports spiked in September 2012, but this is largely because of a sharp increase in the price differential between the domestic and Dubai market.

Remittances continued to shore-up the domestic economy, posting inflows of US\$ 7.1 billion in H1-FY13, compared to US\$ 6.3 billion last year. While the full-year remittances last fiscal was US\$ 13.2 billion, we are confident that remittances will exceed US\$ 14 billion for this fiscal year. If so, this should sustain the pattern of domestic demand the country has witnessed in the past several years.

Despite a current account surplus of US\$ 218 million in the first half of FY13 (against a deficit of US\$ 2.4 billion in H1-FY12), scheduled repayments to the IMF pulled down SBP's FX reserves by US\$ 1.8 billion. The fall in reserves has

¹¹ This simply reflects the micro underpinnings of balancing a household budget. Excessive borrowing that increased debt servicing, eventually squeezes disposable income and requires austerity measures to balance cash-flows.

occasionally exerted pressure on the Rupee-Dollar parity, coinciding with monetary policy decisions and IMF repayments.

Outlook

The outlook for the economy is strongly influenced by the perceived vulnerabilities in the external sector. Clearly, it is not the size of the current account imbalance, but the fall in FX reserves that is dampening sentiments. We however feel that even with scheduled repayments to the IFIs, SBP's FX reserves would be adequate to meet all forex obligations.

On the inflation front, the downward trend in YoY headline CPI stopped in November 2012, and has reversed since. Although SBP still feels the average inflation rate for the year will remain in the range of 8 to 9 percent, we believe the impetus for this change can be traced to wheat support prices announced in November 2012, while the recent weakening of the Rupee could add to inflationary expectations. Supplementing this change in sentiments is the growth of reserve money, which posted an increase of 11.0 percent in H1-FY13, against 5.8 percent in the corresponding period last year. The increase this year was driven almost entirely by government borrowing.

With provincial surpluses above the full-year target, we see growing fiscal pressures for the remaining part of FY13. Although spending patterns may ease somewhat during the next caretaker government, non-discretionary spending could push the fiscal gap to within 6.5 to 7.5 percent of GDP for FY13.

Table 1.2: SBP Projections of Major Economic Indicators

	FY12	FY13	
		Annual Plan Targets ¹	SBP Projections
Actual			
Percent growth			
GDP	3.7	4.3	3.5-4.0
CPI inflation	11.0	9.5	8.0-9.0
Monetary assets	14.1		15.5-16.5
Billion US\$			
Workers' remittances	13.2	14.0	14.0-15.0
Exports (fob-BoP)	24.7	25.8	25.0-25.5
Imports (fob-BoP)	40.1	42.9	40.0-40.5
Percent of GDP			
Fiscal deficit	8.5 ³	4.7	6.5-7.5 ²
Current account deficit	2.0	1.9	0.0-1.0 ²

¹ Targets on fiscal and current account deficit to GDP are based on nominal GDP projections from the government's budget document for FY13.

² SBP's projected ratios are based on our own projections for nominal and real GDP in FY13.

³ The fiscal deficit in FY12 includes the one-off accumulated power subsidy that was paid in November 2011.

Source: State Bank of Pakistan

With growing resource needs to finance the government's day-to-day operations (e.g. debt servicing), we are less optimistic that much-needed structural reforms of PSEs and the energy sector, will take place in FY13.

Non-economic factors like the poor law-and-order situation continue to hamper commercial activity. The frequency of nationwide strikes and law & order incidents in the main cities of the country, have reduced the number of working days in the first half of FY13 compared to previous years.¹²

Despite these negatives, the resilience of the informal sector appears to be pushing the formal economy forward. Construction activities remain strong, and there are indications of foreign interest in joint-projects in Pakistan's real estate sector.¹³ This is helping large-scale manufacturing, which could counter the weather-driven losses in the agricultural sector. We also see the increase in lending to private businesses as positive, which is likely to gain momentum during the rest of the year.

In the remaining part of FY13, we do not see pressure from Pakistan's trade account. Soft commodity prices and strong remittances, should keep the current account contained within 1 percent of GDP deficit. If key commodity prices remain soft in the second half of FY13, even a current account surplus is possible.

However, intangibles appear to be dominating Pakistan's economic outlook. With a caretaker government paving the way for general elections in May 2013, domestic investors are understandably reluctant to take a long-term view. So while this uncertainty cannot be denied, the government must prioritize addressing stubborn structural problems in public sector enterprises and the energy sector; similarly, concrete steps are required to enhance revenue collection in an equitable manner.

¹² Proxy indicators such as bomb blasts, suicide attacks and number of bomb related fatalities, which may have led to disruption in economic activity, show significant increase from the previous year. Detailed information in this regard is available at the South Asia Terrorism Portal or at www.satp.org.

¹³ Some large local entities have embarked on ambitious residential projects across the country, which are beginning to attract overseas interest.

2 Real Sector

2.1 Overview

Data for the first half of the year supports our initial assessment that the economy is unlikely to meet its target in FY13. We maintain a forecast of real GDP growth at 3.5 – 4.0 percent, but expect a slight shift in the composition of growth, with greater contribution from industry. This assessment is based on the revival in construction; an improvement in LSM during the 2nd quarter; and the capacity additions in steel, petroleum, tires, and chemicals.

However, this improvement is expected to be offset by a decline in cotton production, which weighs on our agriculture forecast for the year. The reported increase in area under wheat cultivation seems insufficient to achieve the target of 25.5 million tons. We also expect growth in services to remain below target, mainly due to lower earnings in the financial and telecom sectors.

2.2 Agriculture

As highlighted in the First Quarterly Report, flooding caused by heavy monsoon rains in September 2012, in Southern Punjab and Northern Sindh, adversely impacted *kharif* crops, leading to a decline in cotton and rice production (**Table 2.1**). However, rainfall across the country during the same period benefitted minor crops, and compensated for lower irrigation water in Punjab for the sowing of wheat.¹

That is one of the reasons for the expected increase in wheat production compared to last year: the increase in area under

Table 2.1: Production of Major Crops

million tons, million bales for cotton

	Share in Major Crops	FY12	FY13 Target	FY13 ^P
Cotton	24.6	13.6	14.5	13.3
Sugarcane	11.7	58	59	62
Rice	15.4	6.2	6.9	5.4
Wheat	39.2	23.5	25.5	NA

Source: Planning Commission; Provincial crop reporting centers, Cotton Crop Assessment Committee

Table 2.2: Irrigation Water (Oct-Dec)

million acre feet

	2011	2012	% change
Punjab	11.4	10.7	-5.9
Sindh	5.7	7.8	37.0
Balochistan	0.4	0.4	12.5
KP	0.6	0.3	-50.3
Total	18.0	19.2	6.5

Source: Suparco

¹ In overall terms, the availability of irrigation water was better during the current *rabi* season compared to the previous year (see **Table 2.2**).

cultivation, higher fertilizer offtake (particularly in the month of December),² and a relatively moderate winter,³ are some of the other reasons (**Table 2.2**). The increase in fertilizer offtake can be traced to the increase in wheat support price (by Rs 150 per 40 kg), which has also increased the area under cultivation. That is significant as cultivated area had been declining after peaking in 2009-10. Having said this, the increase may be insufficient to meet the government's wheat production target of 25.5 million tons, even if we assume record yields that were realized in 2010-11 (**Table 2.3**).⁴

Table 2.3: Performance of Wheat Crop

area in 000 hectare; production in 000 tons; yield tons/hectare

	Punjab			Sindh			Pakistan
	Area	Production	Yield	Area	Production	Yield	Total
2004-05	6,379	17,375	2.72	887	2,509	2.83	21,612
2005-06	6,483	16,776	2.59	933	2,750	2.95	21,277
2006-07	6,433	17,853	2.78	982	3,409	3.47	23,295
2007-08	6,402	15,607	2.44	990	3,411	3.45	20,959
2008-09	6,836	18,420	2.69	1,031	3,540	3.43	24,033
2009-10	6,914	17,919	2.59	1,092	3,703	3.39	23,311
2010-11	6,691	19,041	2.85	1,144	4,288	3.75	25,214
2011-12 ^P	6,486	17,702	2.73	1,049	3,664	3.49	23,517
2012-13	6,537 ^P	--	--	1,061 ^P	--	--	25,500 ^T

T: Target; P: Preliminary

Source: Agriculture Statistics of Pakistan; and Provincial crop reporting centers

Preliminary data suggests that minor crops have performed well during the *Kharif* season primarily due to timely rains in September 2012. In particular, adequate rainfall improved the yield of pulses, bajra, jawar and corn. The prospects for the *Rabi* season, particularly for gram and masoor, are also positive due to soil moisture and rains in February 2013.

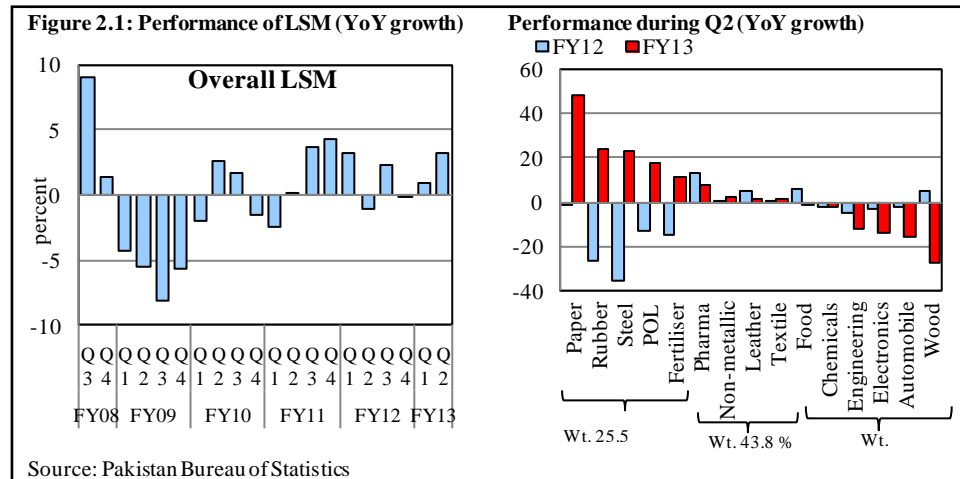
2.3 Large Scale Manufacturing

LSM grew by 3.3 percent on a YoY basis in Q2-FY13, mainly on the back of a turnaround in intermediate goods like rubber, POL, steel, fertilizers and paper (**Figure 2.1**). These industries witnessed capacity enhancements, as well as greater capacity utilization. Cement production accelerated, as construction

² Fertilizer off take saw a YoY increase of 25.5 percent in December 2012, compared to 14.2 percent growth in December 2011.

³ Extended harsh winter (with temperature below 4°C) slows crop growth.

⁴ During FY13, total area under wheat crop increased by 0.6 percent to 8.7 million hectare in FY13.



gathered pace on the back of an increase in public works during the quarter (see **Section 2.4**).⁵ In contrast, consumer durables continued to struggle with import competition, which led to a large production decline in automobiles and electronics. As a result, overall LSM growth during Jul-Dec FY13 reached 2.1 percent, compared to 1.0 percent last year.

The following factors explain the recovery of intermediate goods:

- Three new steel plants were commissioned in Karachi during 2012 (one in H2-FY12, and two in H1-FY13), which improved steel production in the country.⁶
- New capacity was added in the paper, rubber and steel industries during FY07-09. However, despite the import of the required machinery, these projects faced delays due to financial constraints, and only became fully functional this year (**Table 2.4**).
- Improved gas supplies to fertilizer manufacturers lifted the industry's

Table 2.4: Import of Machinery
million US\$

	FY04-06	FY07-09	FY10-12	H1-FY12	H1-FY13
Steel rolling	21.1	44.6	41.8	3.8	2.2
Stone and glass	16.0	17.0	5.5	2.2	2.6
Rubber	140.4	156.1	197.2	43.2	34.0
Construction	228.7	418.3	138.1	15.6	23.1
Paper	100.6	141.3	101.5	8.3	10.2

Source: State Bank of Pakistan

⁵ In terms of YoY growth, cement sales in the local market accelerated from 5.4 percent YoY in Q1-FY13, to 9.6 percent in Q2-FY13.

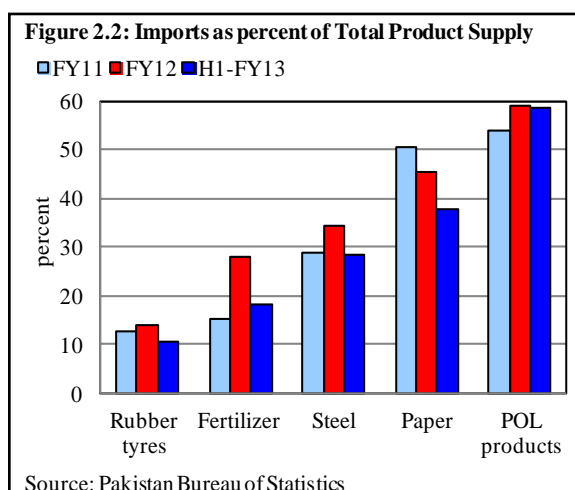
⁶ New plants are joint ventures with Saudi Arabia, Japan and International Finance Corporation. Two of the steel plants are running on captive power and are also contributing to the national grid.

capacity utilization from 55.4 percent in Q1-FY13, to 69.5 percent in the second quarter;⁷

- (iv) In the petroleum refining sector, higher margins, and a better product mix, (a shift towards high value added products such as petrol and diesel), improved the cash flows of local refineries.⁸ Furthermore, the partial resolution of the circular debt situation, also enabled firms to import more crude oil, and increase capacity utilization, and⁹
- (v) Improved energy management (at the firm level) also contributed towards easing production constraints. The paper and steel industries are two cases in point;¹⁰ anticipating a reduction in natural gas supplies, these industries invested in alternate energy arrangements (e.g., coal and furnace-oil fueled plants)¹¹.

As a result, the production of these intermediate goods also reduced dependence on imports (**Figure 2.2**).

Having said this, LSM growth was contained by the decline in the production of consumer durables, especially automobiles, which fell by 25 percent during H1-FY13. A part of the reduction can be explained by the sales of cars under the yellow cab scheme during the same period last year, which inflated the production during H1-FY12. Imported used cars have also



⁷ Source: National Fertilizer Development Corporation

⁸ Composition of refining has changed in favor of petrol and diesel, which typically incur higher margins, especially compared with the furnace oil.

⁹ Crude oil imports during H1-FY12 grew by 19.1 percent YoY, compared to a decline of 21.1 percent in H1-FY12.

¹⁰ It must be recalled that cement plants had already shifted from gas-fired plants to coal-fired plants back in mid-2000.

¹¹ Although alternate fuels are expensive and raise production costs significantly, domestic goods are still fairly price competitive. For example, shifting to coal or furnace oil reportedly increases paper production costs up to 30-40 percent; and domestic paper prices increased by approximately 30 percent YoY during Jul-Nov FY13 compared to a 2 percent decline in imported paper prices (in Rupees). But per kilogram average price of domestic paper prices in November 2012 was only one Rupee higher than the imported variety.

priced out local competition in the small car category (defined as 1000cc and below) and established a niche in that segment, adding to the drop in local production (**Table 2.5**). Furthermore, this decline also reflects the discontinuation of non-Euro II compliant models, as noted in our previous quarterly report.¹²

Table 2.5: Consumer Car Market

units	H1 FY12	H1 FY13
i. Local car sales	63,038	45,022
ii. Used car imports	20,953	29,263
Total (i+ii)	83,991	74,285

Source: Pakistan Bureau of Statistics and All Pakistan Motor Dealers Association

Going forward, LSM growth is likely to pickup in H2-FY13, as domestic automobile production increases to make-up for the stricter import policy on used vehicles.¹³ Sugar production should also improve over last year because of a good sugarcane crop. Millers have estimated sugar production at 5.0 million tons realized during FY13, which is 7.9 percent higher than 4.6 million tons in FY12. Finally, new capacities and improved production processes, are expected to come online during the remaining part of FY13:

1. The single largest refinery in the country has already entered its pre-commissioning phase in H1-FY13. This refinery will increase Pakistan's crude oil refining capacity by around 47 percent;¹⁴
2. A new plant for the manufacturing of motorcycle tyres is expected to start production by the end of Q3-FY13; and
3. The largest soda ash manufacturer in Pakistan is shifting its fuel composition from gas to coal, which will help improve its capacity utilization.

2.4 Construction

A sharp increase in public sector development spending in the second quarter – a disbursement of Rs 183.2 billion, compared to Rs 127.8 billion in Q2-FY12 – was one of the major drivers for the growth in construction activities. Anecdotal evidence suggests that private construction is also strong, on the back of robust

¹² As mentioned in *SBP Third Quarterly Report for FY12*, production of an 800cc and a 1000cc car has been phased out. Together, these two had a share of around 15 percent in total cars production in Pakistan.

¹³ Ministry of Commerce, via SRO 1441 (I) / 2012 dated 12th December 2012, has reduced the age limit on imported used vehicles from five to three years, which means only newer used cars would be imported.

¹⁴ With a refining capacity of 120,000 barrels per day, this newly commissioned plant will increase Pakistan's refining capacity from existing 12.3 million tons to 18.0 million tons per year. However, there are some concerns whether commercial banks would be willing to increase their exposure to the oil and gas sector.

Table 2.6: Construction Indicators

percent growth	Q1		Q2	
	FY12	FY13	FY12	FY13
i. Local cement dispatches	11.8	5.4	4.5	9.6
ii. Steel products	17.3	-13.5	-8.2	10.9
iii. Construction & mining mach imp	-23	45.6	15.6	32
iv. Building manufacturing index	-5.4	4.7	-8.6	3.7
BMI excl PSM	-5	7.9	-4.8	5.6
v. Development spending	39.7	-14.6	-1.2	41.6
vi. Price of bricks	16.4	10.1	18.4	3.7
vii. Price of cement	19.7	16.5	13.2	19.7
viii. Price of steel bars/sheets	17	6.4	17.3	1.5

Source: Pakistan Bureau of Statistics and State Bank of Pakistan

growth in remittances, and the price stability of bricks and steel.¹⁵ As a result, the quantum of cement sales increased by 9.6 percent YoY in Q2-FY13, up from 4.5 percent in Q1-FY13 (**Table 2.6**).

Services

Preliminary data indicates that the services sector will miss the 4.6 percent growth target set by the government for FY13. This assessment is based on the slowdown in agriculture, the decline in import volumes and falling banking spreads.

In the *finance and insurance* subsector, the policy rate cuts have reduced banking spreads, which has kept net interest income under pressure (**Table 2.7**). As a result, commercial bank profits, which had grown by over 100 percent in H1-FY12, have *declined* by 3.1 percent this year.

The trend in *wholesale and retail trade* depends mainly on the margins earned through domestic and imported goods. We have mixed signals on the performance of this sector: although the increase in domestic manufacturing (with a 44 percent share in wholesale and retail trade) is likely to support trading activity,¹⁶ the contribution from major crops and imports (especially palm oil) is likely to remain weak.

¹⁵ Increased domestic production of steel, and softer international prices, explain the trend in steel prices. Brick prices rose sharply last year due to the imposition of a 17 percent sales tax, which has not happened in FY13.

¹⁶ During the last three years, manufacturing had an average share of 44 percent in the gross value addition of wholesale and retail activities.

Table 2.7: Financial Performance of the Banking Industry

	Billion Rupees			Percent growth	
	H1-FY11	H1-FY12	H1-FY13	H1-FY12	H1-FY13
Interest earned	321.3	386.6	409.0	20.3	5.8
Interest expenses	173.9	212.1	237.6	22.0	12.0
Net interest income	147.4	174.5	171.4	18.4	-1.8
Net interest income after provision	108.0	152.7	150.1	41.4	-1.7
Fees, commission & brokerage income	22.1	23.6	27.8	6.7	17.6
Dividend income	3.8	7.5	10.8	97.4	43.4
Income from dealing in foreign currencies	11.2	12.7	10.5	13.6	-16.8
Other income	12.9	12.6	24.2	-2.2	92.6
Total non - interest income	50.0	56.4	73.3	12.9	30.0
Total non-interest expenses	105.4	117.1	135.3	11.1	15.5
Profit after tax	29.5	59.6	57.7	101.9	-3.1

Source: State Bank of Pakistan

Meanwhile, an improvement in the financial performance of PIA bodes well for the *transport, storage and communication* sector (**Table 2.8**). The airline has posted a gross profit of Rs 0.8 billion in the first quarter of FY13 (due to lower fuel costs), but ended up incurring an overall loss of Rs 4.4 billion on account of higher finance and distribution costs. Nonetheless, this loss is only half of what the airline incurred last year. More encouragingly, the airline has been reporting an operating surplus since October 2012.¹⁷

However, the performance of *telecommunications* will largely depend on earnings of cellular service providers, as the largest telecom firm (PTCL) has so far posted a significant loss this year; an operating loss of Rs 0.7 billion during Jul-Dec FY13, compared to a profit of Rs 2.8 billion in the same period last year. This was mainly due to a

Table 2.8: Financial Performance of PIA during Q1

billion Rs.	FY12	FY13
Revenue	27.8	27.8
Cost of services	28.7	27.0
<i>Aircraft fuel</i>	15.8	14.9
Gross profit	-0.9	0.8
Distribution cost	1.3	1.7
Administrative expenses	2.0	1.9
Other provisions	0.3	0.1
Exchange losses - net	1.4	0.3
Other operating income	0.1	1.9
Loss from operations	-5.8	-1.3
Finance cost	2.5	3.0
Loss after tax	-8.6	-4.4

Source: Pakistan International Airlines

¹⁷ During November 2012, the corporation earned an operating profit of Rs 738 million as against the loss of Rs 1.3 billion last year.

one-off cost incurred under the voluntary separation scheme, which alone accounted for a Rs 9.8 billion loss in Q1-FY13.^{18,19}

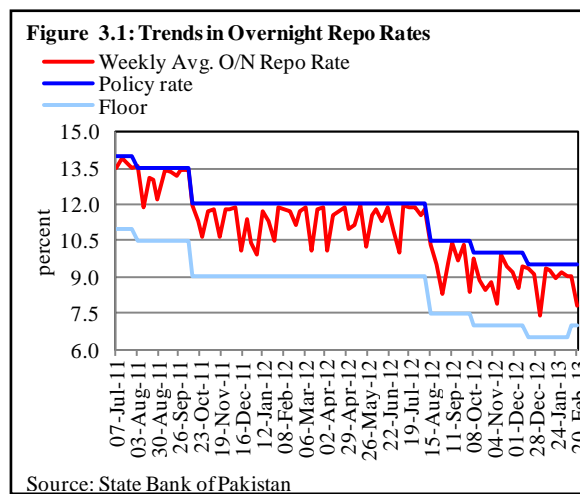
¹⁸ PTCL has offered the second Voluntary Separation Scheme (VSS) to its employees, the first one been implemented in 2008. The objective of this scheme was to optimize human resources in line with the current business needs by offering attractive package.

¹⁹ However, a large part of this loss was compensated by a record profit (of Rs 8.6 billion) earned in Q2-FY13.

3 Inflation and Monetary Policy

3.1 Overview

An improvement in key macroeconomic indicators – the fall in headline inflation; a surplus in the current account balance; and a net retirement in borrowing from central bank– created some room for SBP to relax its monetary stance.¹ The policy rate was reduced by a cumulative 250 bps to single digits in three successive monetary policy announcements during the first half of the year.² However, the policy space has withered to some extent, as the economy enters the second half of the year. Cognizant of emerging risks, especially to inflation and in the external sector, SBP decided to keep the policy rate unchanged at 9.5 percent in its monetary policy announcement of February 2013 (**Figure 3.1**).³



Headline inflation, which had been declining since the beginning of the current fiscal year, reached a low of 6.9 percent in November 2012 (YoY). Accordingly, average inflation for the first half of FY13 fell to 8.3 percent against 10.9 percent in the corresponding period last year. This visible decline was primarily because of the stability in food prices, downward revisions in the price of piped gas and CNG, and softening inflationary expectations.

¹ Investment rate (investment as percent of GDP) has reached a low of 12.5 percent during FY12.

² A 150 bps cut in policy rate was decided in August 2012, which was followed by two more cuts of 50 bps each in October and December.

³ While the upper limit of interest rate corridor has been kept unchanged at 9.5 percent, the lower limit has been increased by 50 bps. As a result, interest rate corridor has narrowed from 300 bps to 250 bps. This will not only reduce the volatility in weighted average overnight rate, but also increase mid rate by 25 bps. For details, please see DMMD Circular No. 02 of 2013 dated February 08, 2013.

In our view however, the declining trend in inflation seems to have bottomed out; YoY headline inflation increased to 7.4 percent in February 2013. This reversal can be explained by the increase in wheat support prices, and the continuous expansion in money supply.⁴

Broad money supply expanded by 8.0 percent during H1-FY13, compared to 5.7 percent during the same period last year. While the growth in money supply is consistent with the reduction in SBP's policy rate, the primary driver was, once again, budgetary borrowing for deficit financing.⁵ The contribution of private sector credit in monetary expansion remained low.

Deficit financing from the banking system grew by 13.6 percent in H1-FY13, against 29.1 percent last year (**Table 3.1**). The lower growth in H1-FY13 can be

Table 3.1: Monetary Aggregates –H1

flows in billion Rs, growth in percent

	Cumulative Flows				Cumulative Growth	
	Oct-Dec (Q2)		Jul-Dec (H1)		Jul-Dec (H1)	
	FY12	FY13	FY12	FY13	FY12	FY13
Broad money (M2)	400.4	558.4	379.4	612.4	5.7	8.0
NFA	-57.2	5.4	-139.9	17.2	-17.9	3.2
SBP	-69.3	-55.6	-122.6	-59.9	-20.0	-15.2
Scheduled banks	12.1	61.0	-17.3	77.1	-10.4	55.8
NDA	457.6	553.0	519.3	595.3	8.8	8.4
SBP	116.9	170.6	237.6	272.3	22.9	18.1
Scheduled banks	340.7	382.4	281.7	323.0	5.8	5.8
of which						
Government borrowing	512.3	319.2	691.9	478.3	22.9	11.2
For budgetary support	571.7	365.6	756.0	518.1	29.1	13.6
SBP	219.2	183.2	117.3	-216.2	9.8	-12.7
Scheduled banks	352.4	182.4	638.7	734.3	45.6	35.1
Commodity operations	-60.8	-47.8	-63.5	-38.8	-16.0	-8.9
Non government sector	-23.9	214.3	-87.3	144.8	-2.5	4.0
Credit to private sector	282.2	189.5	193.5	104.5	6.2	3.1
Credit to PSEs	-306.8	24.8	-281.5	40.3	-72.6	15.7
Other items net	-30.8	19.5	-85.3	-27.9	13.1	3.5

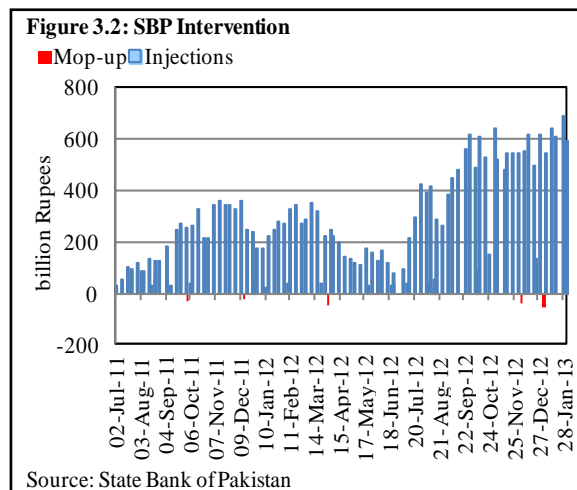
Source: State Bank of Pakistan

⁴ Despite all these developments, average inflation for FY13 is likely to remain within the target of 9.5 percent.

⁵ In absolute terms, broad money supply saw an expansion of Rs 612.4 billion during H1-FY13, while government borrowing for budgetary finance stood at Rs 518.1 billion.

attributed to *one-off events* like the adjustment of circular debt in H1-FY12, and the realization of CSF in H1-FY13. Within the banking system, the government mostly relied on commercial banks for financing, and actually retired a part of its borrowing to the SBP during H1-FY13. The latter may help contain inflationary expectations, but the sharp rise in government borrowing from commercial banks, is not only reducing the supply of funds for the private sector, but also complicating liquidity management.⁶

In addition to government borrowing, SBP intervention in the foreign exchange market and debt servicing for external loans (other than the IMF), also absorbed Rupee liquidity from the market. In this situation, SBP injected substantial liquidity into the system to ensure smooth functioning of the money market. As shown in **Figure 3.2**, by end of H1-FY13, the volume of OMOs has exceeded Rs 600.0 billion.



The provision of adequate market liquidity was also necessary to ensure that cuts in the policy rate, lowered the cost of borrowing for the private sector. As a result, following the cuts in the discount rate, the weighted average lending rate (on fresh loans) witnessed a decline of 206 bps during H1-FY13 to 11.1 percent by end December 2012. There are some indications that credit to the private sector is responding to the decline in borrowing costs. Specifically, loans to private sector businesses grew by Rs 146.5 billion during H1-FY13, compared to Rs 86.1 billion in H1-FY12.⁷ Simultaneously, consumer financing also expanded by Rs 6.0 billion during H1-FY13, after a long period of net contractions.

⁶ Budgetary borrowing during H1-FY13 impacted market liquidity in two ways. First, the amount of budgetary borrowing from commercial banks (Rs 734.3 billion) was higher than the increase in bank deposits (Rs 450.1 billion) during H1-FY13; however liquidity constraints eased in Q2-FY13, when banks mobilized more deposits and the government restricted itself to rolling over its maturing debt. Second, the net retirement to SBP by borrowing from commercial banks effectively absorbs liquidity from the market – once again this trend reversed in Q2-FY13, when the government started borrowing from SBP.

⁷ In sharp contrast to this, net credit to private sector witnessed an expansion of Rs 104.5 billion during H1-FY13 compared to 193.5 billion in H1-FY12. This slowdown was primarily attributed to

3.2 Developments in Monetary Aggregates

Broad money supply (M2) expanded by Rs 612.4 billion during the first half of FY13, compared to Rs 379.4 billion in H1-FY12 (**Table 3.1**). Quarterly changes in M2, indicate that monetary expansion was concentrated in the *second* quarter of the year, and was largely driven by: (1) government borrowing from the central bank; (2) an increase in loans to the private sector, especially for working capital and fixed investments; and (3) a rise in commercial bank assets held abroad.

3.2.1 Net Foreign Assets (NFA) of the Banking System

Despite the weak balance of payments position of the country, the banking system's NFA grew by Rs 17.2 billion during H1-FY13, in sharp contrast to a net contraction of Rs 139.9 billion in H1-FY12 (**Table 3.1**). This year's expansion was driven entirely by commercial banks: more specifically, from the growth in worker remittances; increased portfolio investment; and the net retirement of foreign currency (FE-25) loans.

In contrast to commercial banks, the net contraction in the NFA of SBP reflects pressure on its foreign exchange reserves. Specifically, SBP's liquid FX reserves saw a decline of US\$ 1.8 billion during H1-FY13, despite the realization of Coalition Support Funds in August and December 2012.⁸ SBP interventions in the forex markets; some institutional repayments (other than the IMF), and weak financial inflows, led to the contraction in SBP's NFA during H1-FY13.

3.2.2 Government Borrowing for Budgetary Finance

The fiscal authorities borrowed Rs 518.1 billion from the banking system during H1-FY13, compared to Rs 756.0 billion in H1-FY12. Two factors mainly explain the decrease in borrowing: firstly, government borrowing in H1-FY12 included Rs 391.0 billion of the power sector circular debt and procurement agencies' loans, which were taken on to the government's books; and, secondly, the inflow of US\$ 1.8 billion under CSF in H1-FY13 helped contain the overall fiscal deficit to Rs 624.7 billion.⁹

Within the banking system, the government relied heavily on commercial banks and borrowed Rs 734.3 billion during the first half of FY13 (**Figure 3.3**). Quarterly data indicate that most of this borrowing took place in Q1-FY13. In the

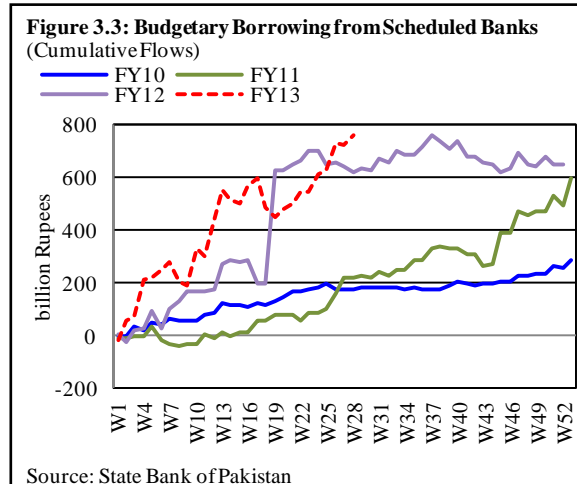
a net contraction of Rs 78.3 billion in credit to NBFCs during H1-FY13 against an expansion of Rs 24.3 billion in H1-FY12.

⁸ The logistic support funds of US \$ 1.12 billion and US \$0.69 billion received in August and December 2012 respectively.

⁹ It is important note that the fiscal authorities have received defense receipts (including CSF) of Rs 176.8 billion during H1-FY13 against the annual target of Rs 150.6 billion.

second quarter, the government primarily focused on rolling over the maturing debt (**Table 3.2**), which allowed banks to accommodate seasonal private sector credit requirements.

Simultaneously, the government retired Rs 216.2 billion to SBP during H1-FY13. The entire retirement was concentrated in Q1-FY13, while the government actually borrowed Rs 183.2 billion (in net terms from SBP) in Q2-FY13.



Credit to Public Sector Enterprises (PSEs)

Credit to PSEs rose by Rs 40.3 billion in H1-FY13, compared with a substantial retirement of Rs 281.5 billion in H1-FY12.

As discussed earlier, the retirement last year was due to the shifting of PSEs' debt on to the government.¹⁰ This year, the expansion was largely driven by: (1) a bailout package for the Pakistan Steel Mills Limited; (2) lending to power sector holding company; and (3) borrowing by Pakistan International Airline Company to repay its long-term loans.

Commodity Financing

Loans for commodity operations recorded a net retirement of Rs 38.8 billion during H1-FY13, compared to Rs 63.5 billion in the corresponding period last year.¹¹ The reduction in net retirement is mainly attributed to Trading Corporation

Table 3.2: Government Borrowing from Commercial Banks

billion Rs.	Q1-FY12	Q2-FY12	Q1-FY13	Q2-FY13
PIBs	66.4	36.4	130.5	62.9
SUKUK	70.3	47.0
T-bills (net of maturity)	255.8	-96.5	276.4	-64.0

Source: State Bank of Pakistan

¹⁰ Adjusting for *one-off* settlement of Rs 312.0 billion reveals that the loans to PSEs indicate an increase of Rs 30.5 billion during H1-FY12.

¹¹ In November 2011, the government released Rs 78.0 billion on account of accumulated subsidies and receivables to two of the federal procurement agencies (PASSCO and TCP). Adjusting for this settlement indicate that loans for commodity operations register an increase of Rs 14.4 billion during H1-FY12.

of Pakistan's (TCP) borrowing needs for the import of fertilizer in FY13.¹² On the other hand, outstanding loans to wheat procurement agencies fell, as the Punjab Food Department aggressively offloaded its wheat stocks in October and onwards (Table 3.3).¹³

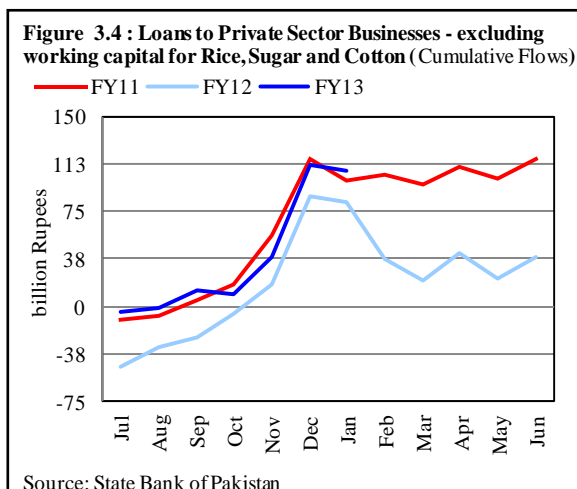
Table 3.3: Quarterly Flows in Commodity Financing Loans
billion Rs.

	FY11		FY12		FY13	
	Q1	Q2	Q1	Q2	Q1	Q2
All commodities	-26.0	-23.9	-2.8	-60.8	9.0	-47.8
Wheat	-22.4	-35.9	-7.4	-24.0	-8.5	-57.3
Sugar	-3.2	16.1	-3.8	-16.7	8.4	-3.2
Fertilizer	-0.1	0.4	9.2	-8.7	9.1	13.2

Source: State Bank of Pakistan

3.3 Loans to Private Sector

With the pickup in credit demand from November 2012 onwards, the cumulative growth in lending to private sector businesses for H1-FY13 increased to 6.0 percent from 3.5 percent in the corresponding period last year. Apart from the usual seasonal demand for the procurement of rice, sugar and cotton,¹⁴ loans to other sectors also gathered pace during H1-FY13 (Figure 3.4).



From the supply-side, banks were able to meet the increased credit demand of the private sector due to better liquidity conditions. This was because of the strong growth in bank deposits;¹⁵ greater reliance on SBP financing during Q2-FY13 augmented liquidity in the banking system; and stepped up OMOs.

¹² During H1-FY13, TCP imported 0.3 million tons of urea from international markets.

¹³ The Punjab Food Department offloaded around 1.5 million tons of wheat stocks in the market during second quarter of FY13, against 0.9 million tons in same period last year.

¹⁴ Seasonal financing refers to the working capital loans for the procurement of inputs in sugar, textile and rice processing industries, which usually starts in September/October of every year.

¹⁵ Banks' deposits grew by Rs 478.1 billion in Q2-FY13, while government borrowing increased by Rs 182.4 billion over the same period, freeing up liquidity. This was because the government focused on rolling over maturing debt in the second quarter of the year.

All three categories of private sector loans – working capital, fixed investments and trade financing – expanded during H1-FY13 (**Table 3.4**). Working capital loans gathered momentum from October 2012 onwards, with seasonal demand from textile, rice and sugar processing industries (**Figure 3.5 and 3.6**).

Table 3.4: Credit Flows – H1

billion Rupees

	Overall Loans		Working Capital		Fixed Investment		Trade Financing	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Business Sector Loans	86.1	146.5	99.5	108.7	-8.5	23.7	-5.1	14.1
Agriculture	8.9	12.8	9.2	10.4	-0.6	1.8	0.3	0.5
Manufacturing	53.3	94.0	43.1	70.8	4.6	12.1	5.5	11.0
Food and beverages	-18.2	3.7	-22.6	-11.7	-1.6	9.0	5.9	6.4
<i>Dairy products</i>	-2.6	4.7	-2.4	0.5	-0.5	3.7	0.3	0.6
<i>Sugar</i>	-40.5	-16.8	-40.2	-23.8	-1.3	4.1	1.0	2.9
<i>Rice processing</i>	15.2	23.7	12.1	17.6	0.1	0.1	3.0	6.0
Textiles	30.8	65.2	35	55.6	1.7	3.9	-5.9	5.7
Spinning	21.2	39.4	23.9	35.7	-0.5	-1.2	-2.2	5.0
Weaving	1.4	6.2	-1.3	3.9	2.6	1.1	0.0	1.2
Finishing	5.7	10.9	6.2	8.3	-0.3	4.2	-0.2	-1.6
Made-up textiles	-1.0	8.3	0.4	4.8	0.8	0.4	-2.3	3.2
Fertilizers	2.6	-4.9	5.5	0.9	-2.4	-2.8	-0.4	-3.0
Ship breaking	2.2	5.1	-0.3	2.7	0.0	0.0	2.5	2.4
Electricity gas and water supply	29.8	9.6	35.4	5.4	-2.8	3.6	-2.8	0.6
Production of electricity	30.5	8.8	32.5	5.3	0.8	2.9	-2.9	0.7
Commerce and trade	1.6	12.4	5.0	9.3	-0.3	3.5	-3.1	-0.4
Real Estate, renting and	-2.7	4.0	4.4	-1.8	0.6	4.9	-7.7	1.0
Other private business	3.1	9.0	3.7	10.8	-0.6	-1.3	0.0	-0.6

Source: State Bank of Pakistan

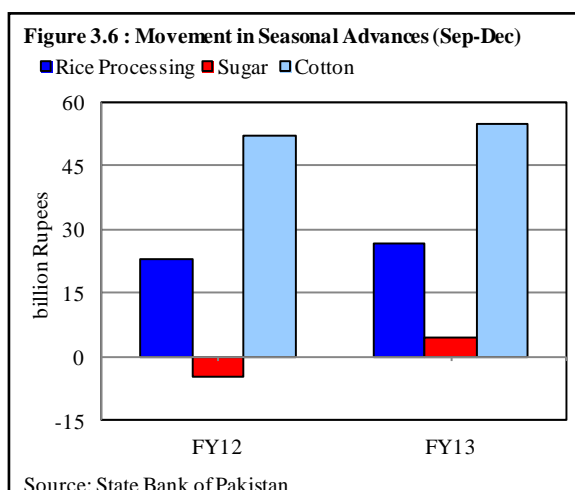
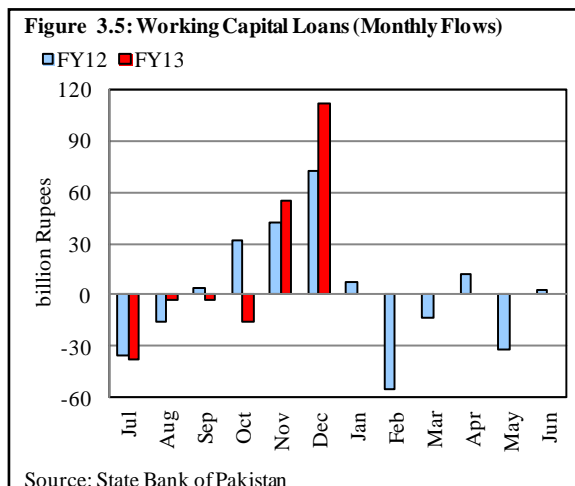
Although there was an expansion in credit supply to all components of the textile value chain, the increase in working capital is not entirely due to the seasonal demand for cotton procurement. The average price of cotton in both domestic and international markets, was lower in H1-FY13 compared to the corresponding period last year;¹⁶ implying that seasonal credit demand should have fallen as

¹⁶ In the international market, the average price of cotton during H1-FY13 was at 73.3 cents (US) per lbs as compared to 100.4 cents per lbs in FY12. Similarly, the average domestic price of cotton was Rs 5,898.3 per 37.32 Kg in H1-FY13 compared to Rs 6,066.9 per 37.32 Kg during H1-FY12.

well.¹⁷ However, anecdotal evidence suggests that a part of the working capital loans was used to overcome the industry's exposure to energy shortages.

Meanwhile, credit demand from the sugar sector picked up with the start of the crushing season. Although the overall number indicates a net retirement during H1-FY13, it is lower compared to the last year.¹⁸ As a part of the crushing season, loans to sugar processing mills are expected to peak during the third quarter of the year.

Concurrently, working capital loans to agriculture, ship breaking, and commerce and trade, also picked up during the first half of the year. In addition to the increase in working capital loans, fixed investment loans also expanded by Rs 23.7 billion during H1-FY13 against a net contraction of Rs 8.5 billion in H1-FY12. This renewed interest in long-term loans (i.e. loans with a maturity of more than a year) is encouraging, and seems to be a response to the rate cuts during the first half of the year (**Figure 3.7**). The expansion in term lending is broad-based, since a number of sectors, including manufacturing, commerce & trade, and real estate, have availed fixed investment loans. Within manufacturing,



¹⁷ According to Pakistan Cotton Ginners' Association data, 9.9 million cotton bales were sold in the market during H1-FY13, which were lower than 10.3 million bales for H1-FY12 (www.pcgga.org).

¹⁸ In the absence of fresh borrowing, net retirement should have been higher in H1-FY13 compared to H1-FY12.

food-related industries have borrowed to enhance their production capacity and also to strengthen their supply chains.¹⁹

Similar to the trend in working capital and fixed investment loans, trade financing also expanded by Rs 14.1 billion during H1-FY13 against a net contraction of Rs 5.1 billion in H1-FY12 (**Table 3.5**).

Composition of trade financing indicates that the increase was entirely driven by export financing, as loans for import financing witnessed a net contraction in H1-FY13. Moreover, within export financing, the expansion was concentrated in EFS loans. In fact, a reduction of 150 bps in EFS rate, and increased uncertainty about the effective cost of borrowing in foreign currency (FE-25 loans), has made EFS loans more attractive (**Figure 3.8**). As a result, EFS loans rose by Rs 21.1 billion during H1-FY13.

Finally, consumer loans registered a modest increase in H1-FY13, for the first time in five years. The expansion is

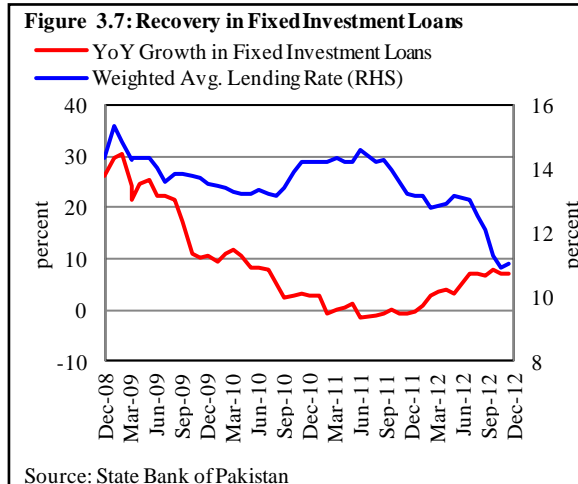
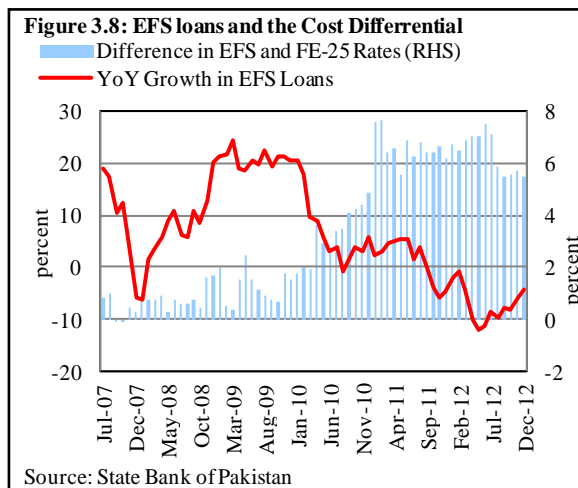


Table 3.5: Flows of Advances under Trade Finance- H1
billion Rs.

	FY12	FY13
EFS	6.3	21.1
Other than EFS	5.1	-0.02
Import financing	-16.4	-7.0
Overall	-5.1	14.1

Source: State Bank of Pakistan



¹⁹ For example, a major conglomerate utilized long-term loans to increase the production capacity of its dried milk plant. Similarly, some sugar mills also borrowed to upgrade their own power generation capacities.

evident in personal loans, credit cards and auto loans (**Figure 3.9**). The disbursement of personal loans increased by Rs 5.9 billion in H1-FY13, mainly after one public sector bank doubled the limit of its advance salary loan scheme, from Rs 0.5 million to Rs 1.0 million in September 2012.²⁰

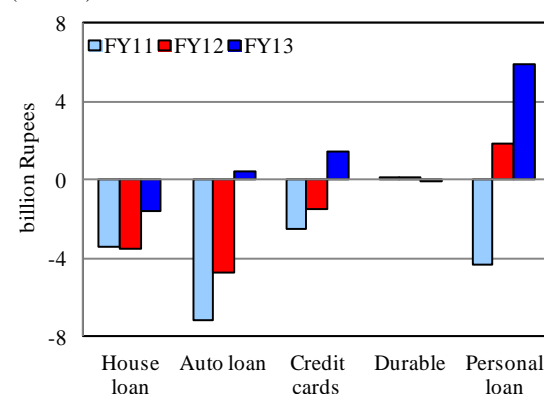
3.4 Inflation

Headline inflation continued to fall in Q2-FY13, declining to an average of 7.5 percent for the quarter (**Figure 3.10**). This is a considerable decrease from Q2-FY12, when inflation for the quarter was 10.3 percent. Inflation for the month of November was recorded at 6.9 percent – the lowest since August 2007.

A part of the fall in inflation in November can be attributed to the decrease in CNG prices, following a Supreme Court order that disputed the then mechanism for setting CNG prices. Nevertheless, non-food non-energy (NFNE) inflation also declined to single digits in November, marking the first time in 15 months that NFNE inflation has fallen below 10 percent.

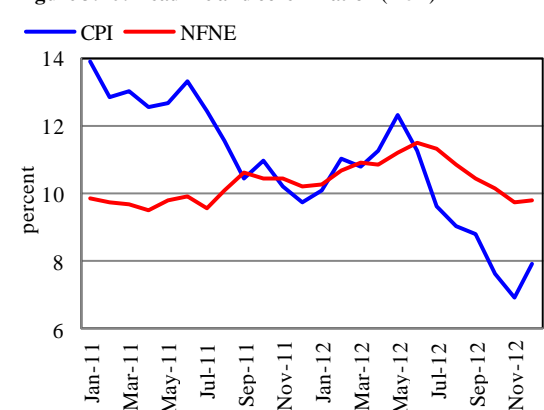
The general decline in inflation during H1-FY13, and indeed over the past 24 months, can be attributed to the decrease in administered prices (i.e. prices set by the government); the stability in global food and oil prices; and the relative stability in the Rupee-Dollar parity up until recent months. **Box 3.1** discusses the

Figure 3.9: Flows in Different Categories of Consumer Loans (Jul-Dec)



Source: State Bank of Pakistan

Figure 3.10: Headline and core inflation (YoY)



Source: Pakistan Bureau of Statistics and SBP

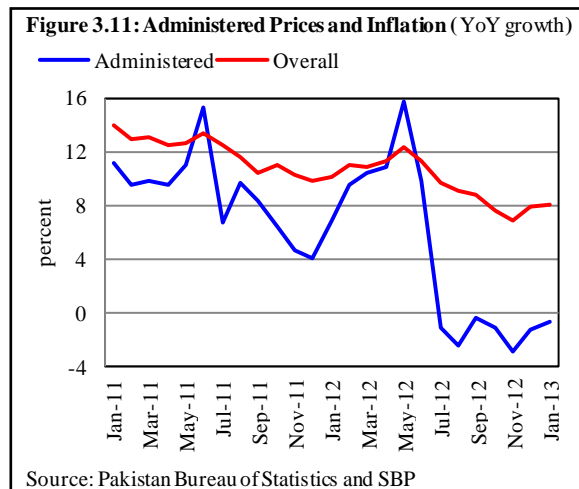
²⁰ Adjusting the loan of Rs 8.0 billion made by this large public sector bank, the personal loan category showed an expansion of only Rs 0.8 billion during last two months of H1-FY13.

decline in inflation over the last two years in some detail, emphasizing the role of these factors on the level and trend of inflation in the country.

The role of administered prices

The *First Quarterly Report FY13* discussed the impact of one of these factors – administered prices. The cut in the price of piped gas in July 2012, which caused a sharp fall in inflation in the month, is an example of the impact administered prices can have (**Figure 3.11**). In general, the prices of these commodities, which account for roughly 12.2

percent of the CPI basket, have been decreased or held stable in recent months, pulling headline inflation down with it. As **Figure 3.1.9** in **Box 3.1** illustrates, changes in administered prices eventually also impact the prices of other commodities in the basket. A plausible explanation for this is that key commodities like wheat, sugar, petrol, and natural gas, act as anchors for people’s inflationary expectations.



Global commodity prices dampening domestic inflation

The government has been able to keep these prices stable because global prices have not been volatile. An example is the price of oil, which has hovered around US\$110 per barrel – almost unchanged from the same period last year (**Figure 3.12**). That has allowed electricity tariffs to remain unchanged since May 2012, and POL prices to remain stable.²¹

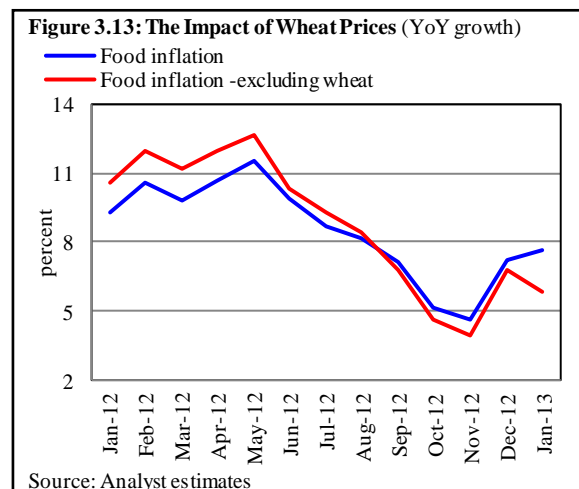
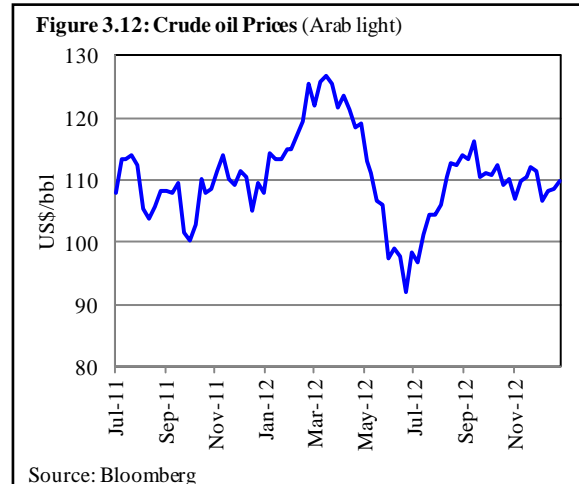
The only exception to this trend has been wheat prices, which have increased in the global market, and were reflected in higher wheat support prices in November 2012. In fact, our analysis indicates a strong causal link between global prices and

²¹ We believe that international oil prices are unlikely to increase sharply in the future. The US Energy Information Administration has forecasted international oil prices to remain stable over the next three years. Specifically it forecasts a slight decrease in WTI crude oil prices from US\$94.12/bbl in 2012 to US\$92.81/bbl in 2013, and a decrease in Brent crude oil prices from \$111.65/bbl in 2012 to \$109.33/bbl in 2013. In effect, domestic energy prices are expected to remain relatively stable, and continue to act as a drag on inflation.

retail food prices in the country.²² Given that global food prices have remained subdued over the past few years, and in the absence of any significant supply shocks to the production of perishable food items (e.g. floods), domestic food inflation has subsided.

Risks from wheat prices, and the external sector

The rising retail price of wheat, and its link with food inflation, (Figure 3.13) is one of the risks to inflation in the short-run. The other major risk is the recent depreciation of the Rupee. With almost 25 percent of manufacturing costs directly impacted by the exchange rate,²³ the depreciation of the Rupee is a significant factor for cost-push inflation. As we show in Figure 3.1.8 in Box 3.1, the link between changes in the Rupee-Dollar parity seems more important than changes in the nominal effective exchange rate, when it comes to explaining non-food inflation. This makes intuitive sense, as the Rupee-Dollar parity is closely monitored by the average Pakistani, and perhaps anchors how domestic producers and traders set their prices.



Nevertheless, we expect average inflation for the year to remain between 8-9 percent, since the impact of the exchange rate may take time to filter down to retail

²² Hanif, M Nadim. "A Note on Food Inflation in Pakistan." Pakistan Economic and Social Review. 50 (2012): 2. Print

²³ Choudhary, M. Ali, M. Nadim Hanif, Sajawal Khan, Muhammad Rehman. "Procyclical Monetary Policy and Governance." SBP Research Bulletin. 8 (2012): n. page. Print

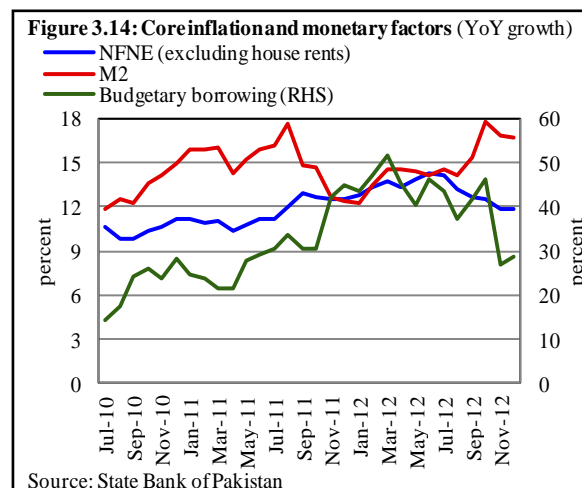
prices;²⁴ furthermore, domestic energy prices are expected to remain relatively stable for the rest of FY13.

Budgetary borrowing is a growing concern

As now and beyond FY13, we remain concerned about the impact of budgetary borrowing on inflation. Our analysis has revealed a very strong correlation between core inflation (excluding house rents) and the increase in budgetary borrowing from the banking system (**Figure 3.14**). Interestingly, the relationship between M2 growth and this measure of inflation is less pronounced in the short-run at least.

Two important points need to be made here: (1) while

government borrowing has a direct impact on the growth of money supply, it is not the sole determinant behind M2 growth; and (2) to get a better handle on demand factors and what could be underpinning inflationary expectations, one must focus on core inflation.



Under normal circumstances, a country's money supply will increase as the private sector borrows or if the country's FX reserves rise. In looking at Pakistan, we have found that the expansionary impact of government borrowing has been neutralized by weak private sector borrowing and the drawdown of the country's reserves – yet inflationary expectations have remained strong. In effect, it is not the growth in money supply per se that determines the inflationary outlook, but the quantum of government borrowing, especially from the central bank. As discussed in **Box 3.1**, we find that the link between broad money growth and core inflation is not as strong as the link between budgetary borrowing (from the banking system) and core inflation.

In closing, we believe the role of inflationary expectations, which are strongly influenced by the quantum and consistency of government borrowing, is the likely

²⁴ As we noted in our *Annual Report for FY12*, there is a significant correlation between non-food inflation and exchange rate depreciation, with a three month lag for the latter.

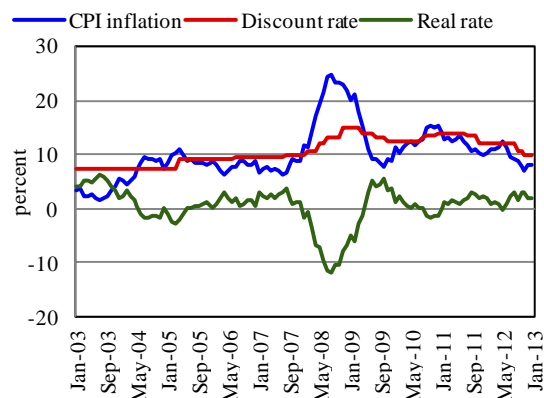
cause for the strong correlation here. Therefore, any *sustained* decrease in inflation will need to be accompanied by a fall in government borrowing from the banking system.

Box 3.1: Why has inflation come down over the past two years?

The declining trend in inflation over the past two years cannot be attributed to a single factor. Rather, the recent decline may be traced to a combination of favorable circumstances and policy decisions, which we will discuss in this section. It's necessary to take a step back and evaluate the historical and structural linkages between these factors and inflation.

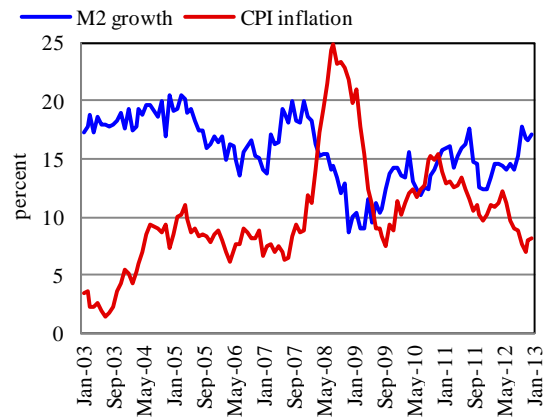
Monetary Policy and Inflation:

While theory dictates a strong causal link between the growth in monetary supply and headline inflation, the *strength* of this link has been a matter of some debate in Pakistan. For its part, the State Bank has managed its policy rate carefully, to ensure that real rates (i.e. adjusted for inflation) remained positive for the last two years in order to rein in inflation (**Figure 3.1.1**).

Figure 3.1.1: Real Discount Rate

Source: Pakistan Bureau of Statistics and SBP

The ultimate objective of using the benchmark interest rate to control inflation is to suppress domestic demand by limiting monetary expansion. Despite an insatiable government appetite for funds, SBP has been able to control monetary expansion at an average of 15 percent over the past two years, which is *slightly above* its 5-year (2008–2012) average of 14 percent. In that sense, SBP's monetary management has been prudent, if not cautious. However, inflation has remained above its 10-year average over the past two years – a fact that merits an explanation (**Figure 3.1.2**).

Figure 3.1.2: Monetary Growth and Inflation

Source: Pakistan Bureau of Statistics and SBP

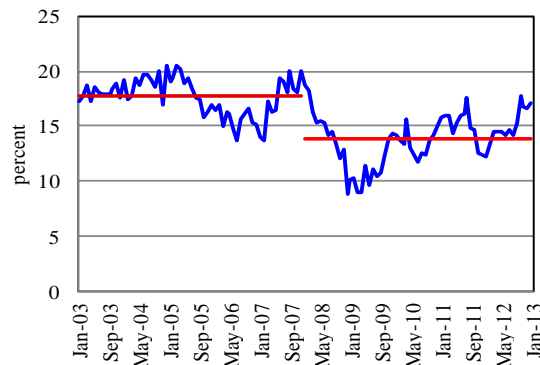
Splitting up the last 10 years (January 2003 – January 2013) into two parts of five years each is informative. While average inflation was relatively low for the first five years (at

roughly 7 percent), monetary expansion (M2 growth) was at an average of 18 percent. In the next five years, average inflation was at roughly 13 percent, but monetary expansion *slowed down* to an average of 14 percent (**Figures 3.1.3 and 3.1.4**). One possible explanation is that monetary expansion has a very long lag, and only impacts headline inflation in the medium-to-long run. However, as we will discuss later, since price setting in

Pakistan is quite frequent, the monetary overhang should filter down to inflation rather quickly. In terms of the apparent quandary, the period 2003 – 2007, posted strong M2 growth because of the rapid increase in FX reserves and strong private sector borrowing – this was also the period when the fiscal gap was relatively contained. During the latter 5-year period, reserves had started falling and private sector demand for credit started contracting. Furthermore, in the last two years, the government fiscal deficit had increased quite sharply.

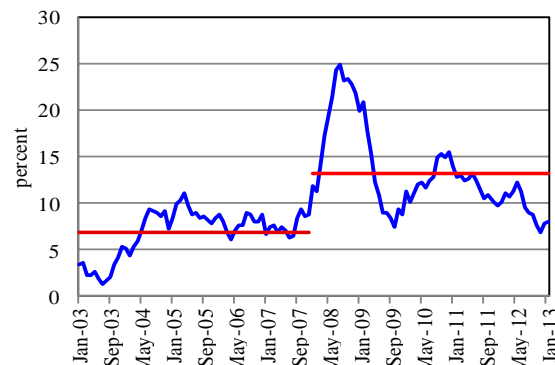
As shown in **Figure 3.1.5**, budgetary borrowing from the banking system grew by an average of 10 percent in the first five years (2003-2007), but then grew by an average of 35 percent in the next five years. This growth in government borrowing has a strong correlation with NFNE inflation (excluding house rents);²⁵ in fact, the correlation

Figure 3.1.3: Monetary growth and 5 year averages



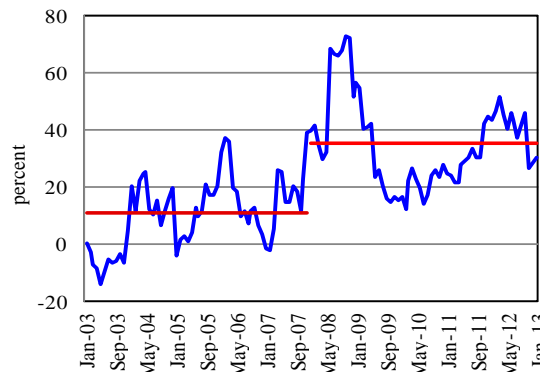
Source: State Bank of Pakistan

Figure 3.1.4: CPI inflation and 5 year average



Source: Pakistan Bureau of Statistics

Figure 3.1.5: Net Budgetary Borrowing & 5 year average



Source: State Bank of Pakistan

²⁵ No such links exists with growth in M2.

coefficient is 0.93 if both series are smoothed-out (using a three-month moving average), and if the growth in net budgetary borrowing is lagged by three months (**Figure 3.1.6**).

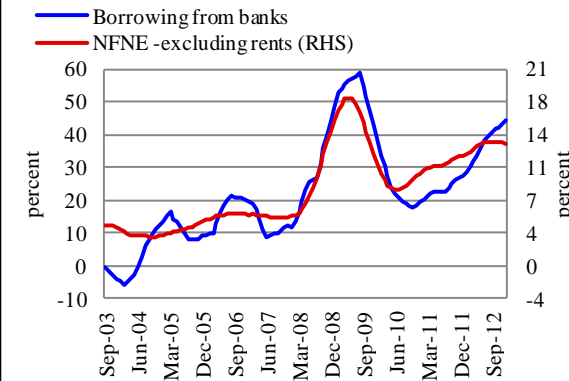
We believe this result is due to three factors: (1) the anchoring of inflationary expectations to government borrowing for deficit financing; (2) the channeling of government spending to boost consumption (as noted in the *Annual Report FY12*);²⁶ and (3) the fact that prices are revised roughly every quarter by most firms in the country, which is far more frequent compared to other countries. In terms of the latter, this shortens the impact of interest rate signals, as retail prices quickly adjust to policy changes.

As we discussed earlier, the link between government borrowing and inflation has become even more pronounced over the past two years.²⁷ This only underscores the importance of containing fiscal borrowing from the banking system in order to achieve a sustained decline in inflation. *The source of monetary expansion seems to have a stronger link with inflation, than monetary expansion per se.*

The link between exchange rate and inflation

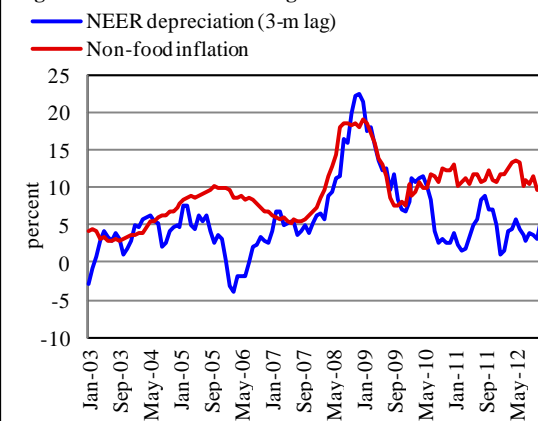
The structure of the economy determines the link between the exchange rate and inflation. With energy prices (POL and electricity) closely linked to the exchange rate, roughly a quarter of manufacturing costs have a direct exchange rate pass-through (imported energy and raw

Figure 3.1.6: Budgetary borrowing & Core Inflation (YoY growth)



Source: State Bank of Pakistan

Figure 3.1.7: Nominal Exchange Rate and Non-Food Inflation



Source: Pakistan Bureau of Statistics and SBP

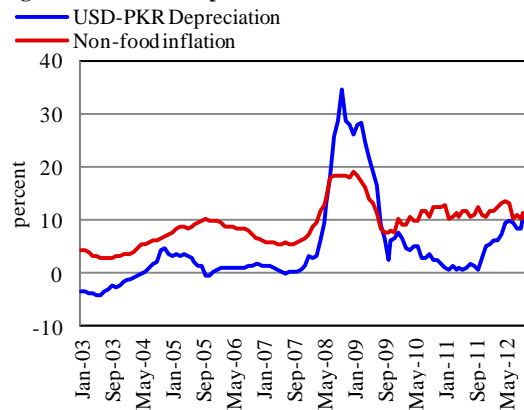
²⁶ Government spending for consumption creates immediate demand for goods and services, whereas any spending for investment activities will affect demand with a greater lag.

²⁷ It is important to repeat that it is not the size of the fiscal gap per se, but the financing mix that influence inflationary expectations. The worst option in terms of feeding such expectations, is the volume of central bank financing.

materials).²⁸ Since Pakistan's manufacturing sector revisits its pricing very frequently, it is unsurprising that the 10-year correlation coefficient between nominal effective exchange rate depreciation (with a 3 month lag) and non-food inflation, is roughly 0.62 (**Figure 3.1.7**).

The relationship between the exchange rate (more specifically the Rupee-Dollar parity) and inflation is more nuanced than just through "imported" inflation. The 10-year correlation coefficient between the depreciation of the Rupee-Dollar parity and non-food inflation, is very high at 0.83 (**Figure 3.1.8**). The *direct impact* indicates that inflationary expectations must be playing a role, and this is potentially anchored to the Rupee-Dollar parity.

Figure 3.1.8: Dollar Depreciation and Non-food Inflation



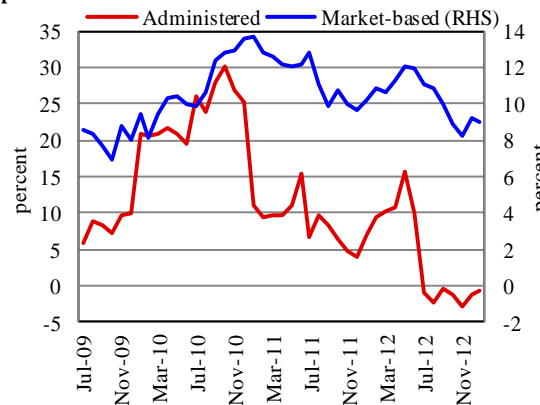
Source: Pakistan Bureau of Statistics

The role of administered prices

A simple way to cushion the exchange rate impact on retail prices is to control the retail prices directly. The commodities whose prices are controlled (or "administered") by the government, constitute 12.2 percent of the CPI. The most important of these are wheat; sugar; electricity; petrol; diesel; CNG; LPG; and piped gas. These commodities are a critical part of the CPI, not just because of their direct contribution (which we detailed earlier), but also because they are used as inputs in manufacturing, particularly in processed food items. Also, the impact they have on people's expectations (via the media coverage these prices get), cannot be denied.

Therefore, it is not surprising to

Figure 3.1.9: Changes in administered prices and market-based prices



Source: Analyst Estimates

²⁸ Choudhary, M. Ali, Saima Naeem, Abdul Faheem, Nadeem Hanif, Farooq Pasha. "Formal Sector Price Discoveries: Preliminary Results from a Developing Country." SBP Working Paper Series. 42. (2011). Print

note a high degree of correlation between the change in administered prices (with a 3-month lag) and the change in other market-based prices (**Figure 3.1.9**).²⁹ The lag period is also consistent with our earlier findings, which indicate that pricing decisions are revisited every quarter.

Global commodity prices

A final consideration for understanding domestic inflation is the state of global commodity markets, which are beyond the government's control. As a small open economy, the prices of most food and energy items are strongly linked with global prices.

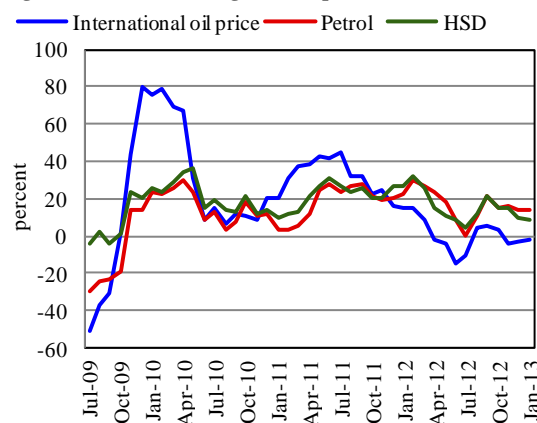
Energy prices, in particular, have moved almost in sync with international oil prices since FY09, when domestic POL prices were explicitly linked with international prices (**Figure 3.1.10**). Similarly, domestic food prices are strongly linked with international food prices, albeit with a lag of 4 - 5 months (**Figure 3.1.11**). This is consistent with our findings in the *First Quarterly Report FY13* that changes in international wheat prices *cause* a change in domestic wheat support prices, which is the most important food price benchmark set by the government.

Putting it all together:

So what can explain the fall in inflation over the past 24 months?

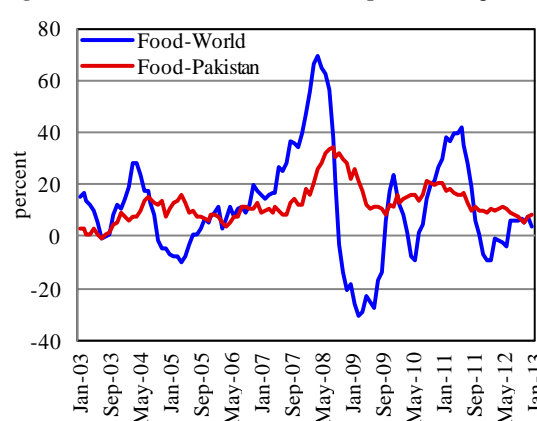
Firstly, international commodity prices have remained stable, with both global food and energy prices hovering within a well contained band. This has allowed for some measure of stability in domestic food and energy prices, which has contributed to the decline in food and energy inflation over the past two years.

Figure 3.1.10: YoY Changes in fuel prices



Source: Pakistan Bureau of Statistics

Figure 3.1.11: Global and domestic food prices (YoY growth)



Source: Haver Analytics and PBS

²⁹ Correlation coefficient during this period was roughly 0.62.

Secondly, the inflation in administered items has decreased sharply during this period, with the government reducing the prices of natural gas and CNG, and not revising upwards the base electricity tariffs since May 2012, while keeping POL prices relatively stable.

Together, these two factors have eased headline inflation, with core inflation gradually starting to recede. With the growth in net budgetary borrowing from the banking system also declining slightly,³⁰ and the Rupee-Dollar parity remaining quite stable until recently, inflation has retreated slowly over the past two years.

However, a few developments in recent months have raised concerns for the country's inflation outlook. Firstly, there is the risk that budgetary borrowing from the banking system will increase in the remaining part of FY13, with the federal government very likely to miss its annual revenue target. Secondly, the Rupee has depreciated against the Dollar and other major currencies in recent months. Finally, the government has raised the support price for wheat.

As we pointed out earlier, the impact of these changes usually takes a quarter to materialize across the basket. Although this implies that average inflation for the year will fall comfortably below the government's target of 9.5 percent, managing inflation may be more challenging in FY14.

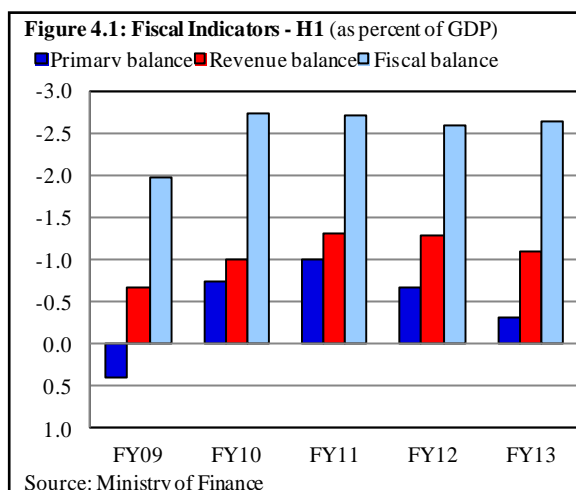
A finer point to note at the end of this analysis is the role of inflationary expectations, which have been a recurrent theme in SBP's publications. Quite a few of these observations do not have orthodox theoretical underpinnings as in Neo-Classical economics; instead they imply that inflationary expectations may be the driving factor in Pakistan's economy. We have found the following: (1) the link between the Rupee-Dollar parity and non-food inflation is stronger than the link between the nominal effective exchange rate and inflation; (2) a much stronger correlation between core inflation (excluding house rents) and budgetary borrowing, rather than broad money growth; and (3) the impact of changes in administered prices on the broader basket of commodities, implying that people's expectations about future inflation can be strongly influenced by sustainable changes in administered prices. The fact that most of these relationships were strongest with a three month lag between inflation and the other variables, is also consistent with our survey findings that prices are revised roughly every quarter in Pakistan.

³⁰ Although the growth in net budgetary borrowing from the banking system has declined in recent months, it remains high at 30 percent for January 2013. However, this is a reduction from H1-FY13's average growth of 37 percent.

4 Fiscal Policy and Public Debt

4.1 Fiscal Policy

The overall fiscal deficit in H1-FY13 is likely to remain the same (2.6 percent of GDP) as in H1-FY12.¹ However, both the primary and revenue deficits decreased during the period under review, which is largely attributed to CSF receipts of Rs 172 billion, and a surplus of Rs 96.5 billion in provincial budgets (**Figure 4.1**).^{2 3}



With no further CSF inflows in the pipeline for the rest of the year, and the likelihood that provinces would spend their cash balances in the third quarter, meeting the annual budget deficit target of 4.7 percent of GDP seems very unlikely.

This challenging fiscal situation can be traced to the following factors: (a) the sluggish growth in tax revenues, which grew by only 12.0 percent during the first half of the year, compared with 25.4 percent in H1-FY12 (**Table 4.1**); (b) mounting interest payments on domestic public debt, which increased from Rs 363.5 billion in H1-FY12 to Rs 508.0 billion in H1-FY13; and (c) inappropriate financing mix of the budget deficit with heavy reliance on expensive domestic sources due to drying up of external funds.

During H1-FY13, the entire budget deficit was financed through domestic sources, particularly the banking system, which has implications for inflation and available funding for the private sector. The resource mobilization through non-bank sources declined during this period mainly because institutional investors reduced

¹ The final nominal GDP number for FY13 is likely to be different from the beginning-of-the-year projection put out by the Federal government.

² Despite the improvement, the revenue balance is still negative, which is against the revenue surplus requirement in the FRDL.

³ CSF receipts were \$1.12 billion in August 2012, and \$0.69 billion in December 2012.

their holdings of treasury bills.⁴ Investment in national saving schemes, however, increased significantly in H1-FY13 (see **section 4.2** for detail).

Revenue

Although total revenue collection grew by 28.8 percent in H1-FY13, the growth in tax collection was only 12.0 percent. The major reason for this was the slowdown in federal tax revenue collection, which grew by just 8.6 percent in H1-FY13, compared to 25.0 percent in the corresponding period of last year (**Table 4.2**). Even this growth was supported primarily by the receipts from the Petroleum Development Levy, as the growth in FBR tax collection was even lower. Provisional numbers for FBR taxes show a growth of only 5.7 percent in H1-FY13, compared with 27.1 percent last year. Under these circumstances, achieving the end-year tax collection target (of Rs 2,381 billion) will be a formidable task for FBR.⁵

This task will be even more challenging given the slowdown in sales tax and direct tax collections. Sales tax, which is the single largest source of revenue for the government, grew by only 1.7 percent in H1-FY13, compared with 36.0 percent in the corresponding period last year. Apart from the inability to introduce a broad-based value added tax, tax collection was undermined by the number of exemptions granted to various industries; tax evasion, and fake claims for refunds

Table 4.1: Summary of Public Finance –H1 (billion Rs.)

	BE		% growth		
	FY13	FY12	FY13	FY12	FY13
Total revenue	3376	1135.3	1461.8	14.7	28.8
Tax revenue	2626	904.6	1012.7	25.4	12.0
Non-tax receipts	750	230.6	449.1	-14.0	94.7
Total expenditure	4480	1667.8	2086.5	12.7	25.1
Current	3430	1399.2	1721.7	14.1	23.1
Development	1050	231.0	277.8	11.1	20.3
Unidentified		37.6	87.0	-17.1	131.3
Overall deficit	1105	532.5	624.7	8.6	17.3
<i>Financing through:</i>					
External resources	135	34.0	-1.4		
Internal resources	971	498.5	626.1		
Banking system	484	302.0	557.9		
Non-bank	487	196.5	68.1		
<i>As % of GDP</i>					
Overall fiscal deficit	4.7	2.6	2.6		
Revenue deficit	0.2	1.3	1.1		
Primary deficit	0.8	0.7	0.3		

Note: The overall, revenue and primary deficits in H1-FY12 became 4.5 percent, 3.0 percent and 2.5 percent when Rs. 391 paid for PSEs debt consolidation in November 2011 are included

Source: Ministry of Finance

⁴ With falling interest rates on treasury bills, the equity market has become an attractive alternate. Moreover, some banks had been routing investments through mutual funds, because the tax rate on mutual funds was significantly lower than that on banks' income. However, with the reduction of the gap between the two tax rates in FY13 budget, banks now have little incentive to channel their money through mutual funds.

⁵ FBR has recently revised its target downward to Rs 2,191 billion; however, achieving this target may also be challenging.

and rebates. Surprisingly, FBR has recently cut tax rates on certain products (including beverages, cement, and sugar), which have been important sources of revenue in the past; it also removed the 1 percent withholding tax on manufacturing entities, further affecting overall tax collection. Moreover, sluggish growth in the domestic production of sugar, consumer electronics, auto products, and a fall in imports, have adversely impacted revenue collection of the Federal government. One must also realize that FBR no longer collects sales tax on services, which has been devolved down to the provincial governments (Sindh started in FY12, and Punjab launched it in FY13).

Table 4.2: Tax and Non-tax Revenues – H1

	Rs billion		% growth	
	FY12	FY13	FY12	FY13
Tax Revenue	904.6	1,012.7	25.4	12.0
Direct Taxes	312.9	331.3	30.9	5.9
Taxes on goods & services	439.3	446.0	29.3	1.5
Excise duty	53.7	53.8	-4.5	0.2
Sales Tax	385.7	392.2	36.0	1.7
Taxes on international trade	94.2	108.0	17.0	14.6
Other taxes	37.9	69.8	41.3	84.4
Petroleum Levy	20.3	57.6	-42.7	183.8
Nontax Revenue	230.6	449.1	-14.0	94.7
Interest and dividends	24.0	26.4	6.6	10.1
SBP profits	104.0	100.0	30.0	-3.8
Defence	4.6	176.8	-93.1	3,715.6
Dev. surcharge on Gas	8.9	7.6	-48.5	-15.3
Royalties	26.4	29.8	-0.7	12.8
Miscellaneous	62.7	108.6	14.7	73.2
Total Revenue	1,135.3	1,461.8	14.7	28.8
<i>Memorandum</i>				
Federal Taxes	867.4	942.0	25.0	8.6
Provincial taxes	37.2	70.7	33.9	89.7

Source: Ministry of Finance

The other important source of revenue collection is direct tax. Growth in direct tax collection declined from 30.9 percent in H1-FY12 to 5.9 percent in the same period this year because: (a) FBR could not bring more people into the tax net; (b) income tax brackets were rationalized to benefit small taxpayers; and (c) the taxable limit on cash withdrawals from banks, was doubled to Rs 50,000.

As a result, there was a shortfall of about Rs 154 billion in tax collection during the first half of the year.⁶ However, this shortfall was more than offset by non-tax revenues mainly due to the receipt of Coalition Support Funds.

⁶ As per seasonal trend 44.4 percent of annual tax revenues are usually collected in the first half of a year; however, this year tax collection was 38.6 percent of the target.

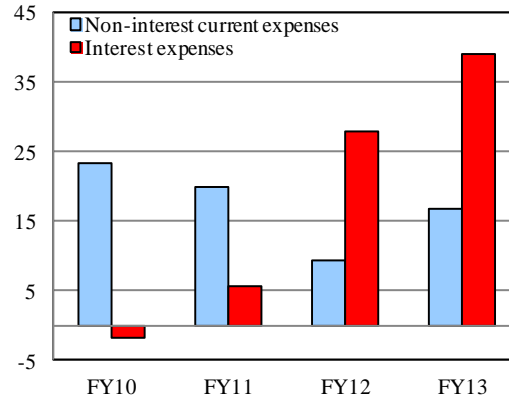
Expenditure

The persistent budget deficit during the past several years, coupled with deficit financing from expensive domestic sources, has resulted in a sharp rise in interest expenses (**Figure 4.2**). Domestic interest payments have increased from 22.2 percent of the current expenditure in H1-FY11 to 26.0 percent in H1-FY12 and then to 29.5 percent in H1-FY13. This rise signals the growing unsustainability of the fiscal account, with the increased risk of entering a debt-deficit spiral.

The other major fiscal outflow is subsidies to loss-making PSEs and the power sector. The fiscal authorities envisaged a total subsidy bill of Rs 208.6 billion in the FY13 budget, but about 80 percent of this amount has already been spent in the first half of the fiscal year. Absence of decisive reforms in PSEs, the persistent circular debt in the power sector and outstanding receivables under commodity financing, will necessitate further subsidy payments. It thus appears likely that total subsidies will significantly exceed the budgeted amount once again.

Expenditures like pension payments, defense, and PSDP remained under control; however the sharp increase

Figure 4.2: Components of Current Expenditures - H1
(% growth)



Source: Ministry of Finance

Table 4.3: Break-up of Expenditures – H1

	Rs billion		% growth	
	FY12	FY13	FY12	FY13
Current	1399.2	1721.7	14.1	23.1
Federal	948.2	1253.3	8.3	32.2
General public service	630.7	919.4	13.9	45.8
Interest payments	397.2	552.6	28.0	39.1
Pension	63.8	74.1	52.4	16.1
Grants	82.7	94.6	-28.4	14.4
Other services	87.1	198.2	1.0	127.5
Defense	243.3	256.6	13.2	5.5
Public orders & safety	31.6	33.5	19.6	6.2
Others	42.7	43.8	-47.1	2.7
Provincial	451.0	468.4	28.5	3.9
Development	231.0	277.8	11.1	20.3
PSDP	206.7	251.5	65.6	21.7
Federal	117.3	129.0	75.8	10.0
Provincial	89.4	122.5	53.8	36.9
Others dev & net lending	24.3	26.3	-70.8	8.3
Unidentified	37.6	87.0	-17.1	131.3
Total	1667.8	2086.5	12.7	25.1

Source: Ministry of Finance

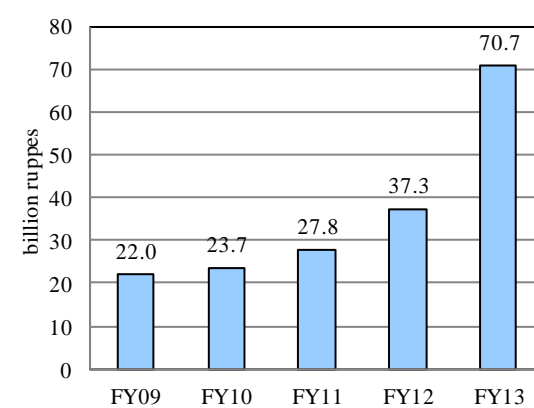
in unidentified expenditures is another cause for concern (**Table 4.3**). The compilers of Pakistani fiscal accounts were unable to identify the Rs 87.0 billion in H1-FY13, which makes a thorough analysis of fiscal outlays rather difficult.

Provincial fiscal operations

Provincial resource mobilization during the first six months of the current year resulted in sharp growth in their tax revenues, increasing by 89.7 percent to Rs 70.7 billion in H1-FY13

(**Figure 4.3**). As mentioned earlier, part of this growth came from the collection of sales tax on services by Punjab and Sindh, which was earlier mobilized by FBR. Although it was a new tax for both provinces, the growth in tax collection by them (110.1 and 79.0 percent, respectively) shows that provinces are perhaps better placed to mobilize this type of tax, as compared to FBR.

Figure 4.3: Provincial Tax Collection

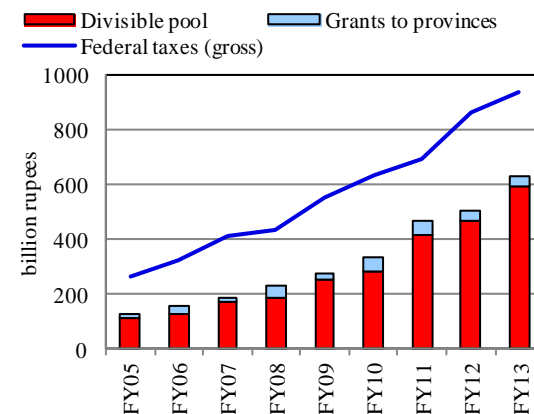


Source: Ministry of Finance

Provinces also received higher amount of funds in H1-FY13 from the federal government as their share from divisible pool plus additional grants (**Figure 4.4**).⁷ Thus their overall revenues grew by an impressive 30.2 percent in the first half of the year, compared with 10.0 percent during the corresponding period last year.

Interestingly, despite the high growth in revenue, provincial

Figure 4.4: Federal transfers to Provinces -H1



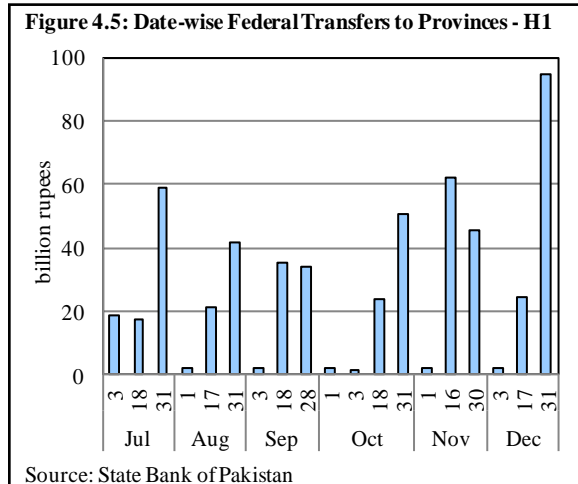
Source: Ministry of Finance

⁷ Interestingly, transfers to provinces from divisible pool in H1-FY13 were 27.1 percent higher than that in H1-FY12 despite low growth in FBR taxes. These transfers also include some arrears from the previous year.

expenditures did not increase in step. Growth in total expenditures by provinces was only 9.2 percent in H1-FY13, compared with 31.4 percent last year. The growth in both current and development expenditures were considerably lower in the period under review.

As a result, provinces showed a surplus of Rs 96.5 billion by the end of H1-FY13 (**Table 4.4**). However, from the

pattern of federal transfers to provinces we can infer that they had a balanced budget until 30th December 2012.⁸ On 31st December 2012 they received Rs 94.8 billion which is almost equal to their surplus recorded for H1-FY13 (**Figure 4.5, Table 4.5**).



⁸ Provinces had a surplus of Rs 85.4 billion in Q1-FY13. It appears that they had a deficit of almost the same amount until second last day of Q2-FY13.

Table 4.4: Provincial Fiscal Operations – H1 (billion Rs.)

	All provinces	Punjab	Sindh	KPK	Balochistan
<u>FY13</u>					
Total revenue	740.9	340.4	213.9	112.4	74.2
Share in federal revenue	592.2	278.6	154.1	96.4	63.2
Taxes	70.7	36.0	32.3	1.9	0.5
Non-taxes	34.5	16.8	13.6	2.2	1.9
Federal loans and transfers	43.5	9.0	13.9	11.9	8.7
Total expenditure	598.6	274.1	168.3	100.5	55.7
Current	476.1	218.7	139.1	75.4	43.0
Development	122.5	55.3	29.3	25.1	12.7
Overall balance	142.3	66.4	45.6	11.9	18.5
Financing *	-96.5	-39.6	-20.5	-14.2	-22.1
<u>FY12</u>					
Total revenue	568.9	248.6	158.8	97.6	64.1
Share in federal revenue	466.0	214.6	124.2	74.6	52.7
Taxes	37.3	17.2	18.1	1.6	0.5
Non-taxes	23.8	13.6	2.9	6.7	0.6
Federal loans and transfers	41.9	3.2	13.6	14.7	10.4
Total expenditure	548.4	256.8	154.6	87.4	49.5
Current	458.9	207.7	144.0	66.0	41.3
Development	89.4	49.1	10.6	21.5	8.3
Overall balance	20.6	-8.2	4.1	10.1	14.5
Financing *	-11.8	9.1	-11.6	3.8	-13.1

* Numbers of overall balance and financing do not match due to statistical discrepancies.

Source: Ministry of Finance

Table 4.5: Transfers of Funds in Provincial Accounts with SBP

(Billion Rupees)

Punjab		Sindh		KPK		Balochistan	
Fund transfer date	Amount	Fund transfer date	Amount	Fund transfer date	Amount	Fund transfer date	Amount
Q1	98	Q1	65.6	Q1	45	Q1	23.1
03.07.2012	10.3	03.07.2012	5	03.07.2012	3.3	18.07.2012	1.4
18.07.2012	8.2	18.07.2012	4.7	18.07.2012	2.9	30.07.2012	3.7
31.07.2012	29.7	31.07.2012	16.1	31.07.2012	9.5	17.08.2012	1.7
17.08.2012	11	17.08.2012	5	01.08.2012	2.1	31.08.2012	7.5
31.08.2012	17.8	31.08.2012	9.9	17.08.2012	3.4	17.09.2012	1.1
17.09.2012	21	18.09.2012	7.5	31.08.2012	6.5	28.09.2012	7.7
		28.09.2012	17.3	03.09.2012	2.1		
				18.09.2012	6		
				28.09.2012	9.4		
				Q2	57.2		
				01.10.2012	2.1		
				18.10.2012	3.9		
Q2	144.6	Q2	79.3	31.10.2012	8.5	Q2	29.2
03.10.2012	1.7	18.10.2012	6.4	01.11.2012	2.1	18.10.2012	2
17.10.2012	11.7	31.10.2012	12.8	16.11.2012	11.4	31.10.2012	7.4
31.10.2012	21.9	16.11.2012	16.7	30.11.2012	7.2	16.11.2012	2.5
16.11.2012	31.9	30.11.2012	11.2	03.12.2012	2.1	30.11.2012	7.1
30.11.2012	20.3	17.12.2012	6.7	17.12.2012	3.6	17.12.2012	2
17.12.2012	12.2	31.12.2012	25.4	31.12.2012	6.3	31.12.2012	8.1
31.12.2012	44.9						
Total (Jul-Dec)	242.6		144.9		102.2		52.3

Source: State Bank of Pakistan

4.2 Total Debt & Liabilities

Pakistan's public debt increased by Rs 108.7 billion during Q2-FY13, reaching Rs 13.6 trillion as of end-December 2012. The pace of accumulation in Q2 was, slower compared to Q1-FY13, when the debt had increased by Rs 535.4 billion (**Table 4.6**). The data shows that the domestic debt created during the first quarter of FY13, was greater than the federal government's financing requirements for the period. In Q2-FY13 therefore, the government opted to finance part of its needs by drawing down its bank deposits, which reduced the need for fresh borrowing.⁹

Table 4.6: Debt Burden

billion Rs	End Period		Change in FY13	
	Stock			
	Jun-12	Dec-12	Q1	Q2
Total Debt & liabilities	14,587	15,235	561	87
Public Debt	12,924	13,568	535	109
Total Debt	13,922	14,600	549	129
A. Domestic - government	7,638	8,329	482	209
B. Domestic - PSEs	281	322	16	25
C. External	6,002	5,949	52	-105
Total Liabilities	665	635	12	-42
D. Domestic	438	400	9	-47
E. External	227	236	3	5

Source: State Bank of Pakistan

In the case of Pakistan's external debt, repayment of IMF loan and the absence of fresh disbursements, led to a US\$ 2.2 billion decline in *external debt & liabilities* during H1-FY13.¹⁰

Nevertheless, both debt repayment capacity indicators deteriorated during the period under review, on account of heavy interest payments on domestic debt and sluggish foreign exchange earnings.¹¹

⁹ The extent of fiscal deficit i.e., Rs 340.8 billion, during Q2-FY13, was much larger than the rise in domestic debt stock (Rs 208.6 billion) during this period, as the government resorted to the use of its deposits with the central bank instead of raising funds through borrowing. Government deposits with the central bank inflated after receiving a significant CSF payment of around 106 billion in Q1-FY13 along with the large amount of debt raised from commercial banks. The availability of this amount reduced government's borrowing requirements during the second quarter of FY13.

¹⁰ The Rupee value of the fall in external indebtedness was, however, a bit muted due to 2.6 percent depreciation in the value of Rupee vs. US Dollar on end-December 2012 compared to end-June 2012.

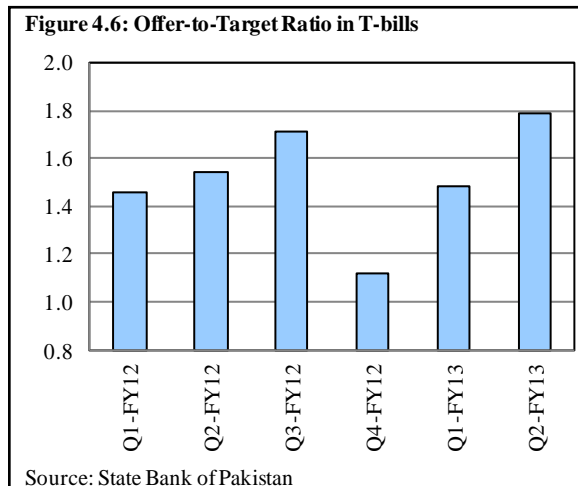
¹¹ For domestic debt sustainability, federal tax revenue to domestic debt servicing and for external debt sustainability, external debt servicing to foreign exchange earnings ratios are used.

Composition of domestic debt

Within domestic debt, the improvement in maturity profile observed in Q1-FY13, continued during the Q2-FY13 as well.¹²

Floating Debt

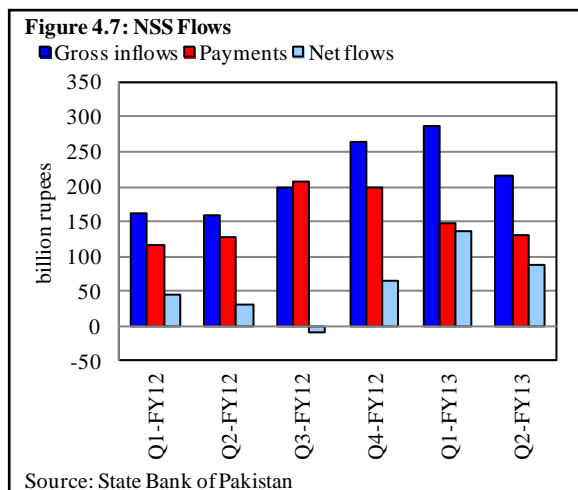
In addition to 1.5 trillion T-bill maturities in Q1-FY13, another Rs 1.1 trillion fell due during the second quarter of FY13.¹³ As reflected from rising offer-to-target ratio, although banks were keen to invest in T-bills during Q2-FY13 as well, federal government perhaps anticipating further fall in interest rates opted to finance its deficit from relatively cheaper sources such as drawing down its deposits and borrowing from SBP (**Figure 4.6**). Resultantly, the net of maturity acceptance of T-bills stood at negative 64 billion during Q2-FY13, compared to Rs 276.4 billion raised during Q1-FY13.



Unfunded debt

Net inflows via NSS remained strong during Q2-FY13 compared to the same period last year. The impact of selective resumption of institutional investment that was allowed in April 2012, appears to have peaked in Q1-FY13 (**Figure 4.7**).

Furthermore, NSS repayments have declined after peaking in Q3-FY12, a possible reflection



¹² The share of floating debt in domestic debt recorded 0.6 percentage point reduction in end-December 2012, compared to the same period last year.

¹³ Specifically, the maturity of 12-m T-bills worth Rs 195 billion, raised for the settlement of circular debt, fell due in this period.

of the ECC decision (in April 2011) to ban institutional investment in NSS schemes.

Permanent debt

During Q2-FY13, mobilization through permanent debt witnessed a sharp fall, as the government raised only Rs 62.9 billion compared to Rs 130.5 billion in the previous quarter. This was the first time in last six consecutive quarters that total amount accepted in PIB auctions fell short of target. On one hand, banks that already had exposure of Rs 1.1 trillion in PIBs as on end September 2012 were reluctant to increase their exposure, while on the other, government was also not interested in the borrowing through long term instrument at higher rates in the presence of cheaper avenues.^{14 15}

Interest payments on domestic debt

Interest payments on domestic debt recorded a significant 42.4 percent YoY increase during H1-FY13.¹⁶ A part of this increase was on account of payments on 12 m T-bills (Table 4.7).¹⁷

However, federal tax revenues (adjusted for transfers to provinces), which is a determinant of the domestic debt servicing capacity, could not keep pace with the rising interest payments during H1-FY13, indicating an erosion in the debt sustainability of the country (Table 4.7).

Table 4.7: Interest Payments on Domestic Debt -H1

billion Rupees

	FY12	FY13	Abs Δ
Permanent	48.0	78.7	30.7
Floating	176.6	286.1	109.5
Treasury Bills (Auctioned)	93.6	196.1	102.4
3-months	7.1	22.6	15.5
6-months	76.5	24.7	-51.8
12-months	10.1	148.8	138.8
MRTBs	83.0	90.1	7.1
Unfunded	114.7	121.0	6.3
Total Interest Payment*	351.4	500.2	148.8
*See footnote 16 explaining difference between SBP and MoF data.			
Memorandum items:			
Domestic debt interest payment/Federal tax revenues (after transfer to provinces)	87.6	143.0	

Source: State Bank of Pakistan

¹⁴ The offer-to-target ratio declined from 2.9 times in Q1-FY13 to 1.6 times in Q2-FY13.

¹⁵ Against a target of Rs 90 billion, government raised Rs 62.9 billion in PIB auctions during Q2-FY13.

¹⁶ These numbers do not match with the amount of interest payments reported in Section 4.1. Since, MoF takes actual interest paid on T-bills during the year, while SBP calculates interest payment on accrual basis.

¹⁷ This was expected in view of the substantial investment that went into 12 m T-bills during H1-FY12

As regards the impact of incremental borrowing during FY13, around 45 percent of the entire T-bills stock as on end-December 2012 was 12-m securities with repayments falling due in FY14; this suggests a slight relief in debt servicing during the second half of FY13.

External Debt

Encouragingly, the stock of Pakistan's *external debt & liabilities* continued to decline further, falling by US\$ 2.2 billion during H1-FY13 (**Table 4.8**). This is largely because of repayment to IMF.

Despite the decline in external debt stock, Pakistan's external vulnerability increased compared to end-June. Specifically, external debt servicing to foreign exchange earnings deteriorated from 9.0 percent in Jun- 2012, to 12.0 percent in Dec-2012 (**Table 4.8**). Furthermore, import coverage as measured in terms of weeks of imports also fell from 19.9 weeks as of end-June 2012, to 18.1 weeks as of end-December 2012.

Table 4.8: External Debt & Liabilities

million US\$

	End-Jun 2012	End-Dec 2012	Change
Total External Debt & Liabilities	65,833.5	63,662.5	-2,171.0
Government External Debt	46,123.1	45,351.2	-771.9
Debt from IMF	7,337	6,164.4	-1,172.6
External Liabilities	2,402.2	2,424.6	22.4
Private Sector External Debt	6,346.9	5,873.3	-473.7
PSEs External Debt	1,523.9	1,775.6	251.7
Intercompany debt	2,100.30	2,073.30	-27.0
Memorandum items:			
DS/FEE*	9.0	12.0	
WoM**	19.9	18.1	

*: External debt servicing/foreign exchange earnings, wom: reserves week of imports

Source: State Bank of Pakistan

5 External Sector

5.1 Overview

Pakistan's overall external account balance posted a deficit of US\$ 0.5 billion during H1-FY13 compared to a deficit of US\$ 1.8 billion in the corresponding period last year. This relative improvement in the external account was entirely due to a positive turnaround in the current account, which posted a surplus of US\$ 0.22 billion against a deficit of US\$ 2.4 billion in the corresponding period last year (**Table 5.1**). The development in current account was due to a combination of CSF inflows, steady growth in worker remittances and a contraction in the trade deficit. Of these, the impact of CSF inflows was the largest.

As against the current account, *capital* and *financial* account

deteriorated further during the period under review. Specifically, against a surplus of US\$ 0.37 billion in H1-FY12, the financial and capital accounts recorded a deficit of US\$ 0.5 billion in H1-FY13. Although net foreign investment improved somewhat compared to last year, it was the fall in foreign borrowings that led to the overall deterioration in the financial account.

Nevertheless, despite the improvement in the overall external account position, the country's liquid foreign reserves declined by US\$ 1.4 billion during H1-FY13, mainly due to the repayments made to the IMF (principal and interest). The adverse impact of this decline was reflected in Rupee Dollar exchange rate, which depreciated by 2.6 percent against the US dollar during H1-FY13.

Table 5.1: Summary of External Accounts

billion US\$

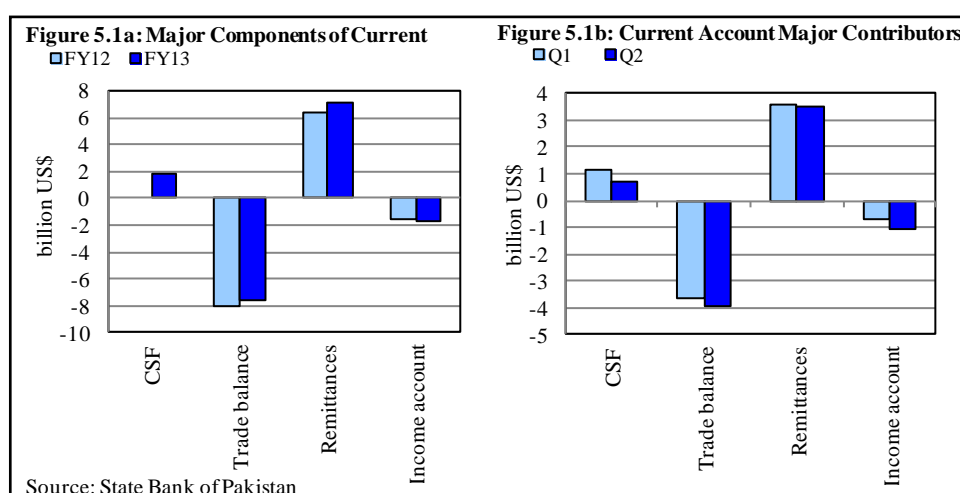
	H1-FY12	FY13P		
		H1	Q1	Q2
A-C/A balance	-2.40	0.22	0.34	-0.13
i) Trade balance	-8.02	-7.65	-3.67	-3.98
<i>Exports</i>	12.07	12.01	5.98	6.03
<i>Imports</i>	20.09	19.66	9.66	10.01
ii) Services account balance	-1.37	0.26	0.24	0.02
iii) Income account balance	-1.57	-1.77	-0.71	-1.05
iv) Current transfers	8.56	9.38	4.49	4.89
<i>Remittances</i>	6.33	7.12	3.60	3.52
B-Financial/Capital balance	0.37	-0.51	0.07	-0.59
i) FDI	0.53	0.56	0.12	0.44
ii) FPI	-0.16	0.16	0.13	0.03
iii) Others	-0.01	-1.24	-0.18	-1.06
C-Errors & omissions	0.24	-0.25	-0.45	0.20
Overall balance (A+B+C)	-1.79	-0.54	-0.03	-0.51
Foreign reserves (31 st Dec)	16.92	13.85		
Exchange rate (31 st Dec)	89.97	97.13		

P: Provisional

Source: State Bank of Pakistan

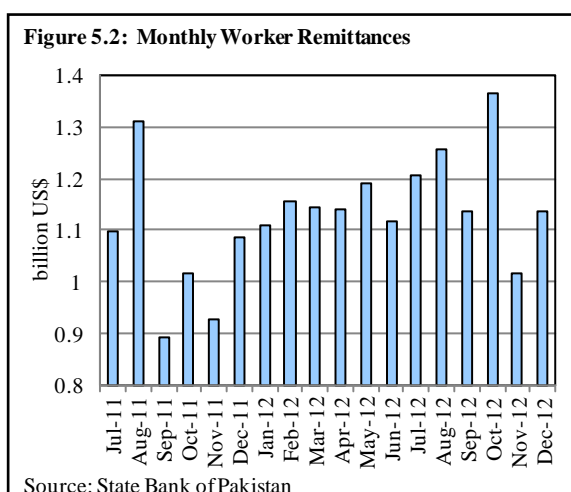
5.2 Current Account

As mentioned earlier, CSF inflows were the deciding factor that pushed the current account into a surplus in H1-FY13. However, even without the CSF inflows, the current account deficit in H1-FY13 was still 36.2 percent lower than last year, as remittances remained strong and the trade deficit contracted (**Figure 5.1a**). The bulk of the improvement in the current account was concentrated in the first quarter, as contributory factors to the improvement lost momentum in Q2-FY13 (**Figure 5.1b**).



Major components of the current account

With CSF inflows acting as the swing factor in the current account, the *services account* balance posted a surplus during H1-FY13, against a deficit recorded last year. The *trade account* deficit contracted by 3.6 percent in H1-FY13, due to a 1.6 percent decline in imports (a reduction of US\$ 0.4 billion). This decline was largely due to lower commodity prices during the period (**Section 5.6**).



Current transfers accelerated during H1-FY13, supported by a steady growth in worker remittances. Monthly data shows that after a seasonal decline in September and November 2012, remittances rebounded in subsequent months (**Figure 5.2**).¹

Country-wise data show that remittances from all traditional sources have increased. The share of Saudi Arabia was the largest followed, by the UAE and US. Other sources of remittances, like the UK and GCC countries, also contributed to the increase during the period under review.

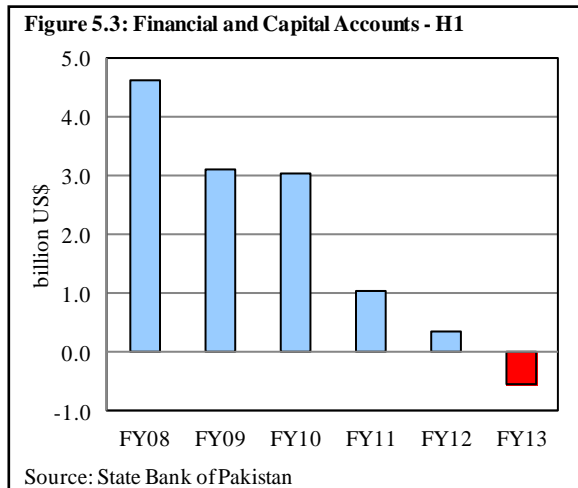
5.3 Financial and Capital Account

After recording a surplus for the last 5 years, financial and capital accounts recorded a deficit in H1-FY13 (**Figure 5.3**). This was caused by Pakistan's inability to secure program loans from the IFIs, as well as an increase in repayments.

The decline in external borrowing overshadowed the slight improvement in net foreign investment, which increased by US\$ 0.3 billion, on account of an improvement in both Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI). During Jul-Dec FY13, FDI increased by 6.0 percent in contrast to a decline of 36.7 percent during the same period last year. A major part of FDI went to the financial sector.²

In contrast, the telecommunication sector continued to record net outflows during this period

Owing to improved performance of stock market, FPI posted net inflows of US\$ 0.2 billion during H1-FY13, compared to net outflows last year.



¹ Remittances tend to fall after the Eid festival months.

² As against net inflows of US\$ 44.1 million in Jul-Dec FY12, this sector attracted net inflows of US\$ 140.0 million during Jul-Dec FY13.

5.4 Foreign Exchange Reserves

Pakistan's foreign exchange reserves fell by US\$ 1.4 billion from their end-June 2012 level, to US\$ 13.86 billion by the end of December 2012. This fall was entirely in SBP reserves, driven by the repayments to the IMF loan (**Table 5.2**).³

This depletion reduced the country's reserve adequacy as measured in weeks of imports, which fell from 19.9 weeks in June 2012, to 18.1 weeks in December 2012 (**Figure 5.4**).

5.5 Exchange Rate

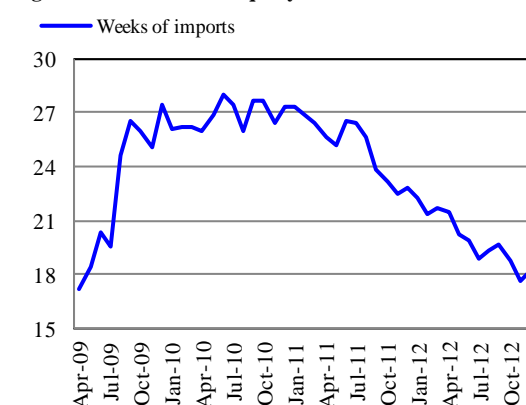
Pakistan's currency depreciated by 2.6 percent vis-à-vis the US dollar during H1-FY13, compared to 4.4 percent in the same period last year. Weakness of the Pak rupee against US Dollar, coupled with the depreciation of US dollar against the Euro and the Sterling,⁴ the Rupee lost 7.8 and 5.1 percent of its value against the Euro and GB pound respectively. Nonetheless, Pak rupee appreciated by 5.6 percent against the Japanese Yen as

Table 5.2: Causative Factors of Changes in SBP Reserves -H1
million US\$

	FY12	FY13
Inflows	4,599.5	5,041.0
Purchases	850.0	160.0
Inter-bank purchases	850.0	160.0
Swaps	2,194.0	1,668.6
Donor agencies & others	1,555.5	3,212.4
IDA	161.2	160.76
ADB	206.9	180.9
UN troops	138.9	130.9
Logistic support	0.0	1,806.5
Outflows	6,490.2	6,840.1
Sales	525.0	820.0
Inter-bank sales	525.0	820.0
Swaps	2,922.4	2,515.7
External debt servicing	2,902.2	3,377.7
IMF	229.6	1,321.8
IBRD	91.9	88.1
IDA	143.4	156.9
ADB	355.2	385.0
IDB	14.7	271.8

Source: State Bank of Pakistan

Figure 5.4: Reserves Adequacy Ratio



Source: State Bank of Pakistan

³ Inflows and repayments to IMF are treated separately and are not reflected in either the current or the financial account.

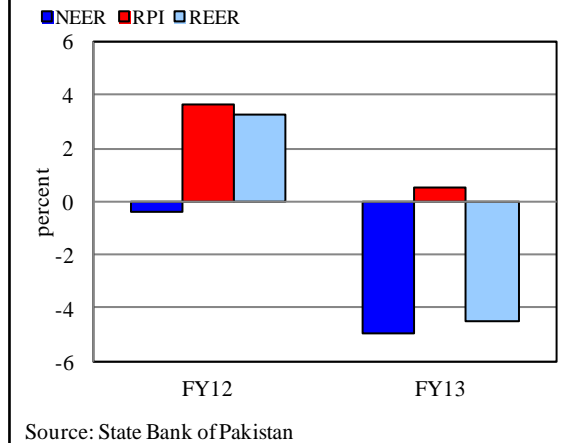
⁴ US dollar depreciated by 4.6 and 3.6 percent against the Euro and Pound during this period.

the Yen weakened against major currencies during H1-FY13.

The real effective exchange rate depreciated by 4.5 percent during H1-FY13 in contrast to an appreciation of 3.2 percent during the same period last year (**Figure 5.5**). This depreciation in real terms was the result of narrowing relative prices and the 4.9 percent depreciation of the Nominal Effective Exchange Rate (NEER) during H1-FY13 compared with a depreciation of 0.4 percent during the same period last year. On the other

hand, the relative price index recorded a rise of 0.5 percent compared with a rise of 3.7 percent during Jul-Dec FY12. The deceleration in the relative price index was attributed to a slowdown in domestic inflation during this period.

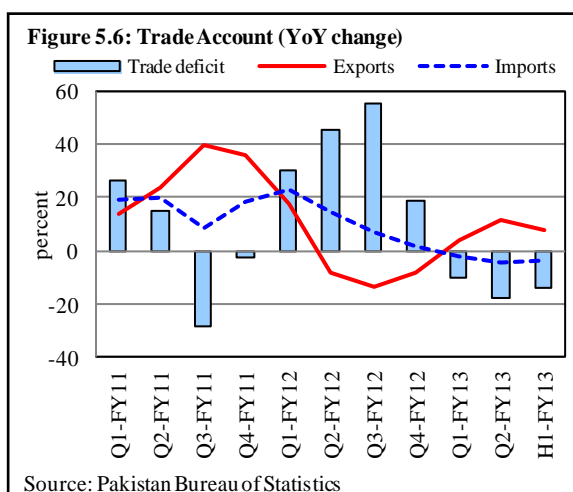
Figure 5.5: NEER, RPI, REER - H1



5.5 Trade Account⁵

Pakistan's trade deficit contracted by 13.9 percent during H1-FY13, compared to a 38.4 percent increase recorded last year (**Figure 5.6**).

While a slowdown in global commodity prices and better production of intermediate goods reduced the import bill (see **Chapter 2**), an extraordinary increase in the gold price differential and award of GSP status to Pakistan by the EU, boosted jewelry and textile exports.



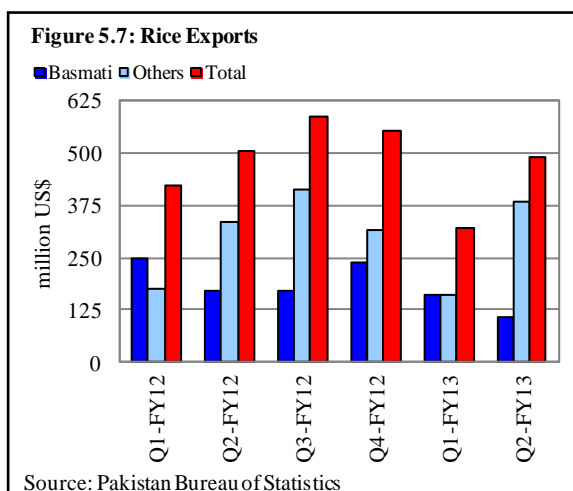
5.5.1 Exports

Exports grew by 7.5 percent YoY during H1-FY13, compared to 3.6 percent in the same period last year. The analysis of export growth shows that the impetus came from cotton; value added textile; vegetables; jewelry and engineering goods.

Rice Exports

Despite the increase in global prices, *rice exports* declined by 12.6 percent – entirely due to a decline in export quantum. Although late monsoon rains kept rice exports under pressure during the first quarter of FY13, they managed to stage a comeback in Q2-FY13 (**Figure 5.7**).

Basmati rice exports declined 35.1 percent YoY on account of lower quantum during H1-



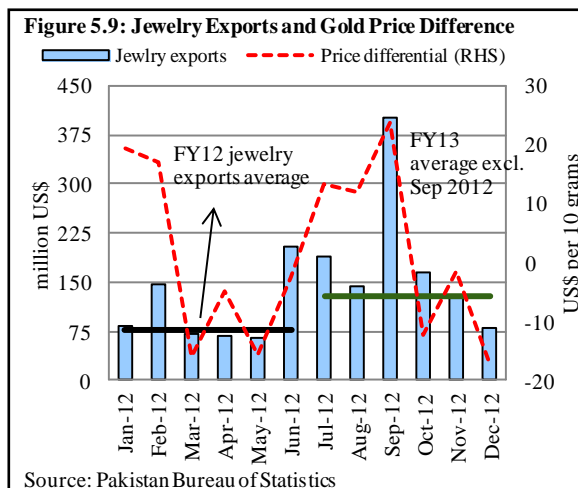
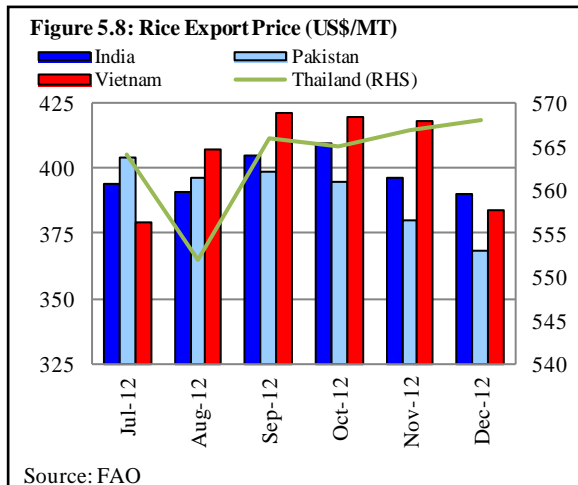
⁵ The analysis in this section is based on the data from the Pakistan Bureau of Statistics (PBS), which differs from the exchange records data prepared by the SBP.

FY13, whereas non-basmati rice exports recorded a rise of 6.6 percent YoY entirely on account of higher unit value. In case of non-basmati rice, Pakistan gained from the rise in Indian and Vietnamese export prices from September 2012 onwards (**Figure 5.8**). With regard to basmati rice, however, the situation was complicated by a new high – yield basmati rice variety launched by India. Having said this, demand from China in the coming months is expected to have positive impact on basmati exports in the remaining part of FY13.

Jewelry exports continued to grow strongly and recorded a 300 percent YoY growth during H1-FY13. This surge is attributed to a sharp rise in the price differential between the domestic and international gold prices. Jewelry exports seem to have reverted to average levels with the vanishing of the differential (**Figure 5.9**).

Chemical and pharmaceutical exports recorded YoY decline of 28.3 percent during Jul-Dec FY13, in sharp contrast to 37.2 percent rise witnessed during the same period last year. This was primarily on account of plastics and other chemicals. Exports of plastics declined by 11.0 percent entirely due to the lower quantum, despite higher unit values of exported items.

This decline in export is disappointing as there is substantial potential to enhance exports of plastics to India. Pakistan has recently enhanced its PVC production whereas India is unable to meet its own domestic demand. Among other chemicals, ethylene dichloride and phthalic anhydride are produced in surplus



quantities in Pakistan, and are in demand in India. As for inorganic chemicals, there is a significant potential for export of caustic soda, soda ash and hydrogen peroxide, while aluminum hydroxide, dithionite, sulphonylates and chlorates have significant potential⁶.

Leather manufactured exports recorded a 3.8 percent YoY fall during Jul-Dec FY13. This fall appears to be the result of slack global demand and supply issues like the rising cost of production, unskilled force and the use of obsolete machinery.

According to the Leathers Manufactures and Exporters Association, this sector is confronting high raw material prices and depressed demand from the European Union (EU) (Table 5.3). The rising price of leather apparel has forced European consumers to opt for cheaper products made from artificial leather, which has adversely affected our exports in the EU.

Table 5.3: EU Leather Imports Jul-Oct (YoY change)

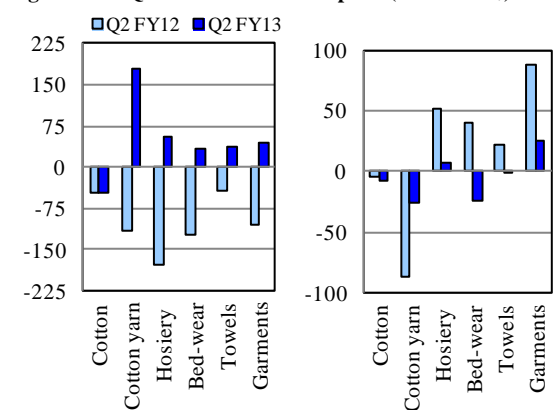
	India		China		Pakistan	
	Quantity	Value	Quantity	Value	Quantity	Value
FY11	-11.8	1.0	-31.9	-11.3	1.0	9.2
FY12	-28.5	-55.6	475.3	181.9	-90.5	-95.9
FY13	-3.0	1.0	-0.4	18.3	-27.3	-13.5

Source: Eurostat

Textiles

After recording YoY declines for eleven consecutive months, **textile** exports have registered double digit growth from September 2012 onwards. During H1- FY13 textile exports posted a 8.3 percent YoY increase. This was quite broad-based ranging from yarn and fabric, to final garments that are higher value added. Although both quantum and price impact remained positive, impact of quantum was much stronger (Figure 5.10).

Figure 5.10: Quantum and Price Impacts (million US\$)



Source: Pakistan Bureau of Statistics

⁶ International Trade Center: Normalization of Trade of Industrial Goods with India – Opportunities and Challenges for Pakistan. Trade Related Technical Assistance (TRTA II) Program funded by EU.

Quarterly data of textile exports reveal that a major part of this growth was recorded in the second quarter of FY13, during which exports grew by 15.0 percent YoY compared to 2.5 percent in the first quarter. Moreover, while the recovery in textile was largely because of low value-added items in Q1-FY13, the second quarter witnessed much stronger growth of high value-added items.

According to industry sources, growth in value-added textiles is a spillover of developments in China and Taiwan. Rising labor wages has significantly increased production costs in these countries, with some segments of global demand diverted to Pakistan.

Moreover, the announcement of duty waiver on 75 products by the EU from November 15, 2012 also provided impetus to textile exports, which could gain more ground with the award of GSP plus status in 2014. American buyers are also re-establishing links with Pakistan's textile and clothing manufacturers, following supply disruptions in Egypt. Industry sources attribute improved performance to uninterrupted provision of gas to the textile sector. Yarn and fabric exports specifically benefitted from improved energy supply.

5.6.2 Imports

Lower import prices along with declining quantum, led to a 3.3 percent YoY fall in the import bill during Jul-Dec FY13, in contrast to a rise of 18.7 percent during the same period last year. Monthly data reveals that Pakistan's imports declined in five of the first six months of FY13. The contractionary impact of these factors was more pronounced in Q2 than in Q1 (**Table 5.4**).

Group-wise data on imports show that the food, transport,

textile and agriculture imports recorded YoY declines, which partially offset by the rise in machinery, oil and metal imports during H1-FY13. Food played the dominant part in reducing the country's import bill largely due to the decline in spices, palm oil and sugar imports.

Table 5.4: Import Performance (FY13)

percent

	YoY Growth			Cont. in Growth		
	Q1	Q2	H1	Q1	Q2	H1
Food	-6.2	-27.8	-17.4	30.2	77.0	60.6
Machinery	13.3	-2.5	4.3	-59.6	8.2	-15.6
Transport	-2.5	-12.7	-7.8	19.6	13.9	15.9
Petroleum	4.6	-2.2	1.2	-65.0	17.2	-11.6
Textile	-13.6	-4.7	-9.2	31.8	5.9	15.0
Agri. & chemical	-18.9	-12.9	-15.9	148.8	50.6	85.0
Metal	0.4	21.3	11.0	-1.5	-30.2	-20.1
Total	-2.4	-4.2	-3.3	100.0	100.0	100.0

Source: Pakistan Bureau of Statistics

The decline in *palm oil* imports is attributed to both lower quantum and price. Record stockpiles in the world and a reduction in export duty by Malaysia (the largest producer and exporter of palm oil), could be the primary reason behind lower prices in the international markets (**Table 5.5**). The lower import quantum may also be linked to the increased use of soybean oil after record production of soybean in Indonesia.

Table 5.5: Quantum and Price Impact – Import Categories

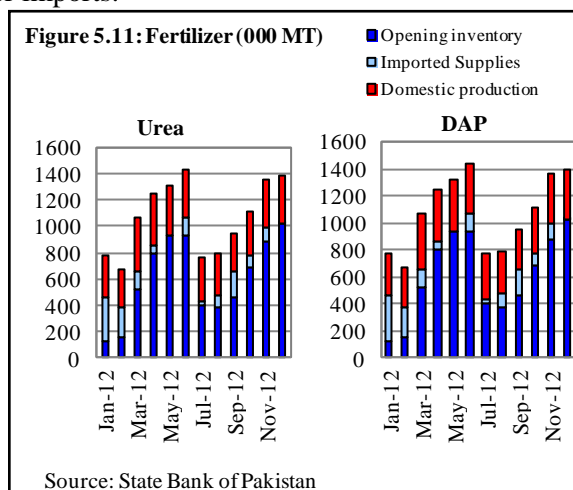
million US\$

	Quantum			Price		
	Q1	Q2	H1	Q1	Q2	H1
Petroleum Crude	-20.7	538.4	476.7	-11.8	-192.3	-163.1
Fertilizer Manufacture	-196.2	-284.6	-479.5	16.1	13.9	28.6
Raw Cotton	151.2	103.8	249.9	-122.5	-58.5	0.0
Gold	-9.0	34.8	24.8	0.6	-1.3	0.3
Tea	-6.0	24.9	19.4	-10.5	2.8	-8.2
Soybean oil	11.2	-1.1	10.2	-0.5	-0.4	-0.9
Palm Oil	3.0	-83.2	-83.1	-70.6	-88.2	-155.8
Iron	16.3	-15.4	0.9	15.1	36.0	51.2
Sugar	-4.9	-4.9	-9.8	-0.2	0.0	-0.2

Source: Pakistan Bureau of Statistics

Agriculture and chemical imports also recorded a fall during H1-FY13, which is because of the decline in fertilizer imports.

Imports of manufactured fertilizer recorded a steep decline in quantum during Jul-Dec FY13. This follows the high price of domestic fertilizer, which led to lower Urea off-take during the period under review.⁷ In addition, large domestic inventories were also available from last year's imports, which precluded the need for further imports (**Figure 5.11**).



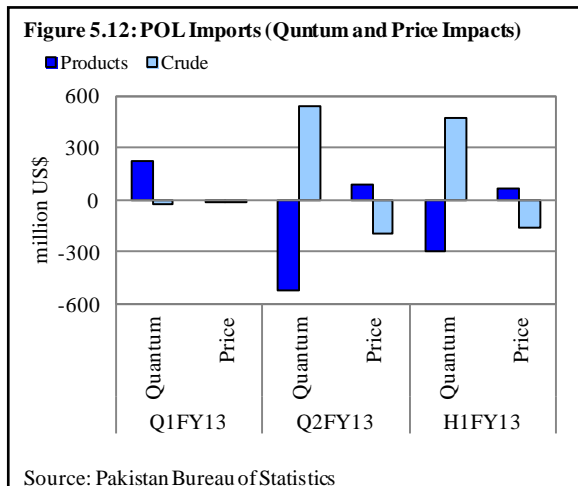
⁷ Urea off-take recorded 2489 thousand MT during H1FY13 compared to 3289 thousand MT for the same period last year.

Machinery imports posted a rise of 4.3 percent during H1-FY13. Category-wise data reveals that import of office, construction, and telecom machinery increased, which more than offset the decline in import of textile, agriculture, and power generating machineries.

Transport group imports fell 7.8 percent mainly due to the fall in aircrafts, ships & boats, auto parts and CKD kits. Imports of aircrafts, ships & boats declined by 31.2 percent during H1 FY13, mainly due to sluggish activity on one of the world's largest ship breaking sites at Gaddani.

Lower import of CKD kits follows the fall in domestic production of cars in the country⁸ as manufacturers discontinued the Suzuki Alto and Daihatsu Cuore models. Moreover, more than 20,000 cabs were produced for the Punjab government yellow cab scheme in FY12, which did not boost the domestic demand this year.

In overall terms, *petroleum* imports recorded a nominal 1.2 percent YoY increase during Jul-Dec FY13, almost all of which was due to a rise in quantum of petroleum crude. All the increase came in Q2-FY13, as petroleum crude imports increased by 30.6 percent, but this was partially offset by the decline of 16.3 percent in *petroleum products* (Figure 5.12). In terms of quantum, petroleum imports recorded an increase during Q2-FY12 after declining in Q1-FY12, which may have been due to more frequent load-shedding of CNG.



⁸ According to PAMA car production in the country recorded at 45,665 units at during H1FY13 compared to 60,628 units during the same period last year.