

THE STATE OF PAKISTAN'S ECONOMY

**Third Quarterly Report
for the year 2013-14 of the
Central Board of State Bank of Pakistan**



State Bank of Pakistan

LETTER OF TRANSMITTAL


State Bank of Pakistan
Karachi.
July 10, 2014

Dear Mr. Chairman,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the Third Quarterly Report for the year 2013-14 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With warmest regards,

Yours sincerely,



(ASHRAF M. WATHRA)
Governor

Syed Nayyer Hussain Bokhari
Chairman
Senate
ISLAMABAD

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Speaker
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Economic Policy Review Department would like to thank Monetary Policy, Research, and Statistics & Data Warehouse departments for their valuable comments.

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1 Overview

Pakistan's economy appears to have turned a corner during the third quarter of FY14. After many years of low growth, sentiments about the economy seem to have improved. Manifestations can be seen in the rebound in real GDP growth; the rise in private sector credit; a contained fiscal deficit; the subdued inflation outlook; the sharp increase in FX reserves; and the appreciation and subsequent stability in the exchange rate.

While this change in sentiments can be traced to a one-off bilateral grant, a series of events (both before and after) appears to have consolidated this positive turn. For example, the government's resolve to address the energy shortage; a growing perception of business friendly policies; and external inflows that had been anticipated for many years, have recently been realized. More specifically, auction of 3G/4G licenses; a larger than projected inflow via Eurobonds; program loans from the IFIs; and SBP's efforts to support the FX reserves, have sharply improved the outlook of the country's external sector, and to some extent, its fiscal position.

Table 1.1: Selected Economic Indicators

		FY12	FY13	FY14
<u>Growth rate (percent)</u>				
Real GDP ¹	Jul-Jun	3.8	3.7	4.1
Agriculture	Jul-Jun	3.6	2.9	2.1
Industry	Jul-Jun	2.5	1.4	5.8
o/w LSM	Jul-Jun	1.1	4.1	5.3
Services	Jul-Jun	4.4	4.9	4.3
Exports	Jul-Mar	2.5	0.0	3.0
Imports	Jul-Mar	15.8	-0.6	3.3
Tax revenue (FBR)	Jul-Mar	25.1	4.9	17.9
CPI (period average)	Jul-Mar	10.8	8.0	8.6
Private sector credit	Jul-Mar	6.4	4.1	10.0
Money supply (M2)	Jul-Mar	8.2	9.0	5.9
<u>billion US dollars</u>				
Total liquid reserves	30 th April	16.3	11.8	12.2
Home remittances	Jul-Apr	10.9	11.0	12.9
Net foreign investment	Jul-Apr	0.6	1.3	3.0
<u>percent of GDP</u>				
Fiscal deficit	Jul-Mar	4.5	4.7	3.2
Trade deficit	Jul-Apr	5.3	5.0	5.0
Current a/c deficit	Jul-Apr	1.4	0.5	0.9

Sources: Pakistan Bureau of Statistics (PBS), State Bank of Pakistan (SBP), and Federal Board of Revenue (FBR)

It must be said that these signs of improvements should not discount the challenges faced by the economy; and efforts for much needed structural reforms should continue. These positives developments provide a strong platform to move towards sustained economic growth in the medium term.

The revival of economic activity is a key development in FY14, with real GDP growth of 4.1 percent, which is the highest in the past five years. However, this growth was not broad-based, as it was driven primarily by construction and large-scale manufacturing (LSM). Even the LSM growth came largely from two items (sugar and fertilizer), which was realized in H1-FY14, and is not likely to be sustained in the second half.¹ As will be discussed later, this uneven growth can be traced to structural imbalances that need to be addressed.

Nevertheless, the second half of the year witnessed some important events that have improved business confidence:

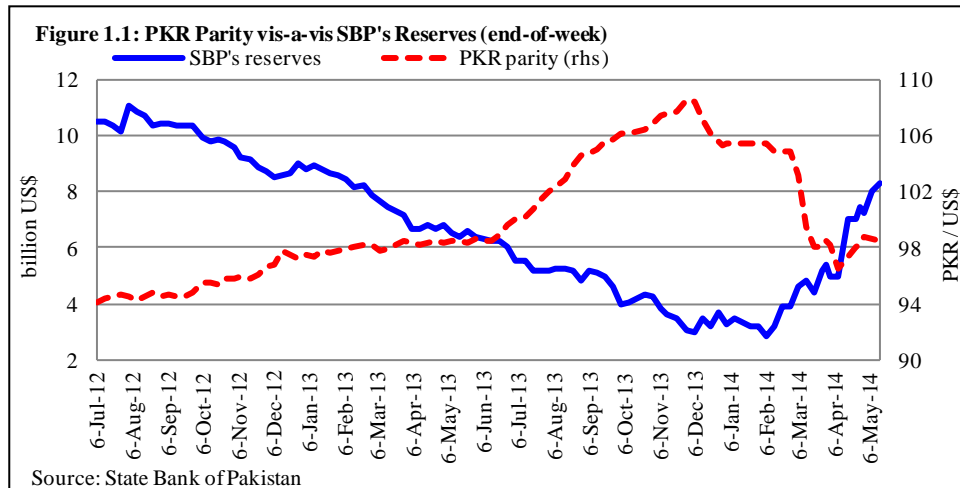
- The receipt of a US\$ 1.5 billion grant from a friendly country (in February and March, 2014), triggered a sharp appreciation of the PKR and changed sentiments in the FX market (see **Chapter 5** for details);²
- Against a target of US\$ 500 million, the government was able to mobilize US\$ 2 billion via the Eurobond issue;³
- The long-awaited auction of 3G/4G licenses was finally realized, fetching US\$ 1.1 billion;
- The country received US\$ 355 million in February 2014 and US\$ 370 million in May 2014 under CSF; and
- By staying on track with the EFF, Pakistan witnessed the resumption of program loans from the Asian Development Bank and World Bank after many years. These loans should help push reforms in the power sector, education, social services and overall economic development.

As shown in **Figure 1.1**, these inflows have not only stabilized the exchange rate, but have sharply increased SBP's FX reserves. As of 30th May 2014, SBP's reserves were US\$ 8.7 billion, compared to only US\$ 3.5 billion as of end-December 2013. While the PKR's appreciation improved business sentiments and its subsequent stability has eased inflationary expectation, the sharp increase in the country's FX reserves provides some comfort for domestic and foreign investment. As will be discussed later, the sequence of events has also changed the market's interest rate outlook.

¹ As productions of sugar and fertilizer were concentrated in the first half of the year due to their seasonal nature; their impact on LSM growth dissipated in H2-FY14. Other factors affecting LSM growth during the second half included: increase in power tariffs, imposition of Gas Infrastructure Development Cess, and a sharp fluctuation of PKR.

² This grant was recorded in Capital Account of the Balance of Payments, and its rupee counterpart (Rs 157 billion) was placed in a special account of the government with SBP, under the name Pakistan Development Fund.

³ Eurobonds were heavily oversubscribed with total bids amounting to US\$ 7 billion (See MoF Press Release, PR No. 620, May 03, 2014).



The changed realities, regarding the availability of external resources with the government, have made the commercial banks to refocus on the private sector to deploy their funds. While this change may appear difficult from their perspective, one must realize that it would force them to focus on their core responsibility – financial intermediation to the private sector.

Real economic growth

After five years of sluggish economic activity, the economy has posted real GDP growth of 4.1 percent in FY14.⁴ The momentum came from the industrial sector, which grew by 5.8 percent in FY14, compared with an average growth of only 1.3 percent since FY08. This industrial growth was also higher than the 4.8 percent target set in the Annual Plan for FY14. However, services and agriculture, which grew by 4.3 percent and 2.1 percent, respectively, could not achieve their target growth.

Agriculture was adversely impacted by the poor performance of minor crops (including fodder) and livestock. However, the five major crops (rice, cotton, sugarcane, wheat, and maize) together, posted growth of 3.7 percent, which was significantly higher than the 1.2 percent growth shown last year. Bumper crops of

⁴ Average real GDP growth during the last five years was 2.8 percent, which was the lowest 5-year average in the past 60 years.

rice, sugarcane and wheat, more than compensated for the decline in cotton production.⁵

The services sector, which largely depends on the performance of commodity producing sectors, could not gain momentum in FY14. Although *wholesale & retail trade* and *transport, storage & communication* supported growth in services, the drag from *finance & insurance* and *general government services* kept this sector's performance weak. The lower growth in value addition by finance & insurance may be linked with slower growth in M2 than previously anticipated, while the slowdown in general government services corresponds to the fiscal austerity observed by the government.

Looking at the National Income Accounts for FY14⁶, private consumption, which increased by 5.9 percent, was the driving force behind economic growth in FY14 – this was more than double what was realized in FY13. Nevertheless, real investment only grew by 1 percent during the year, with the result that the investment-to-GDP ratio continues to decline (it is 12.4 percent in FY14, compared with 13.0 percent last year). In our view, Pakistan's investment rate will only increase by addressing the law and order situation in the country; eliminating the energy shortage; and improving business sentiments. Other than sentiments, the government has partially tackled the circular debt issue in the initial phase of its tenure, and has announced ambitious plans to set up new power generation plants. However, we believe more is required to reduce losses due to theft and non-payments of bills, and to restructure Gencos and Discos.

Inflation and monetary policy

Average inflation during Jul-Mar FY14 was 8.6 percent, which was higher than the 8.0 percent realized during the same period last year. Encouragingly, YoY inflation started to decline after November (when it peaked at 10.9 percent), and is likely to end the fiscal year in the range of 8.0 to 9.0 percent. This may appear high, but one must realize that the impetus for rising prices can be linked to the reduction of subsidies in the early part of FY14, when administered prices were increased. Ignoring the seasonal and supply-driven volatility of food prices, the stability of PKR, stable international oil prices, and softer global commodity prices should contain inflationary expectations for the year ahead.

⁵ This outcome of value addition by major crops was contrary to our earlier assessment, given in Second Quarterly Report FY14, which was based on partial information available at that time.

⁶ One must realize that the annual data recently released by the National Income Accounts Committee, is based on 9-month data. The real sector data for FY14 will be revised in the latter part of FY15.

Monetary policy has been tight since September 2013 (there were two consecutive 50 bps increases in the policy rate in September and November), which has also helped cap inflation. SBP's policy rate has been kept unchanged since then, keeping in mind the stability of key macroeconomic variables, in particular the sustainability of recent improvements in the external sector.

Overall monetary expansion was only 5.9 percent during Jul-Mar, FY14, compared with 9.0 percent during the same period last year. It is encouraging to note that this slowdown came primarily from a decline in government borrowing, while private sector credit recorded a healthy growth of 10 percent during the period. This increase in credit was broad-based in the sense that it financed external trade activities; working capital; fixed investment and consumer financing.

Government borrowing from the banking system (cash basis) declined significantly to Rs 436.9 billion during Jul-Mar FY14, compared with Rs 856.7 billion during the same period last year. This decline was facilitated by the grant from a friendly country, which allowed the government to keep its borrowing from SBP within IMF limits.⁷

Table 1.2: Government Borrowing through Auctions viz-a-viz Retirement to SBP (FY14)

billion Rupees			
	T-bill Auction	PIB auctions	Retirement to SBP (-)
19-Sep	305.7		-309.6
28-Nov	395		-403.3
23-Jan	146.9		-146.9
30-Jan		199.2	-195.5
27-Feb		245.0	-248.8
27-Mar		533.3	-540.2
24-Apr		429.1	-427.6
2-May	299.5		-267.1
22-May		248.2	
23-May			-287.6

Source: State Bank of Pakistan

During the first quarter of the year, the government relied heavily on SBP borrowing, as commercial banks were not interested in buying government securities as they anticipated an increase in interest rates. After the November 2013 increase in policy rate, the government was able to borrow much more from commercial banks. In fact, during the third quarter of FY14, the government borrowed more than its pre-announced targets for PIBs, and utilized the funds to immediately retire SBP borrowing (**Table 1.2**).

This change in commercial banks behavior in terms of their bid patterns, can be traced to the December YoY inflation number, which was made public in early January 2014. At 9.2 percent (against 10.9 percent YoY inflation in November), the market sensed that further monetary tightening was not on the cards. With

⁷ While the government successfully met its end-March 2014 target, SBP's NDA target was missed with a small margin.

January's YoY inflation at 7.9 percent, this view became dominant, and by early February, banks started investing not just in longer term T-bills, but also participated enthusiastically in subsequent PIB auctions. Against a Q3 PIB target of Rs 180 billion, commercial banks offered Rs 1,030 billion during the quarter. This indicates that banks expected SBP to keep interest rates low for the short to medium term.

This aggressive bidding behavior, created a need for liquidity in the money market. Commercial banks that were earlier placing funds with SBP (before the November 2013 policy decision) were either dependent on OMOs for liquidity, or resorted to SBP's discount window. The overnight money market rate actually exceeded the policy rate on various occasions, as SBP tried to limit the liquidity it injected through OMOs. Interestingly, on many occasions, the OMO cut-off rate was also higher than the policy rate.

Despite market expectations of an interest rate cut, the central bank kept its policy rate unchanged during H2-FY14, as sudden external sector developments needed close monitoring; furthermore, the high inflation number for April required careful management.

Fiscal operations

In addition to the implications for the monetary sector, the grant from a friendly country also had a beneficial impact on the government's fiscal position. Its rupee counterpart reduced the government borrowing for budgetary support and hence lowered the fiscal deficit during Jul-Mar, FY14.⁸ According to data released by the Ministry of Finance, the fiscal deficit during the first nine months of FY14 was only 3.2 percent of GDP, which is significantly lower than the average gap of 4.6 percent posted in the last five years. Even if we exclude the grant, the budget deficit is still only 3.8 percent of GDP, which is lower than the past trend.⁹ Having said this, a positive outcome for the full year will be contingent on whether the government pays off the circular debt, as it has for the past three consecutive years.

⁸ The grant amounting to Rs 157 billion has been kept separately in an account Pakistan Development Fund; and was shown as statistical discrepancy in fiscal data for Jul-Mar FY14. Excluding this, the statistical discrepancy would have been Rs 14 billion, which would imply a deficit of Rs 969 billion, i.e. approximately 3.8 percent of GDP, which is lower than the last year's deficit of 4.6 percent of GDP.

⁹ Budget deficit during Jul-Mar FY14 was Rs 811.7 billion, compared with Rs 1,046.2 billion during the same period last year.

Although efforts towards fiscal consolidation can be seen on the expenditure side (e.g., interest payments, defence spending, pensions, etc., have all shown lower growth during Jul-Mar FY14, compared with the same period last year), tax mobilization still remains lackluster. FBR collected Rs 1,575 billion during this period, against a revised target of Rs 2,275 billion for the full year.¹⁰

FBR is still operating on a narrow tax base. To meet its target, FBR has mainly relied on raising tax rates (sales and income tax rates) rather than increasing the tax base. Beyond broadening the tax base, steps to plug leakages in collection and push towards the documentation of all financial transactions, are still to be taken. The government has, however, committed to reduce tax exemptions worth Rs 500 billion over the next three years. Although the government has contained expenditures growth (through lower subsidies and PSDP spending) and seems committed to austerity, meaningful fiscal consolidation cannot be achieved without increasing the tax-to-GDP ratio, which remains abysmally low (currently the ratio of overall federal and provincial taxes to GDP is less than 10 percent).¹¹

In this regard, provincial governments have much potential in terms of resource mobilization, as they have the constitutional right to tax services and agricultural income. Although provinces have already imposed a GST on services, they need to increase efforts for the collection of agriculture income tax. Effective implementation of this tax will disallow the widespread tax leakage that currently takes place at the national level.

On the financing side, reduced government borrowing from the banking system has already been mentioned. Supporting this trend, is the fact that resource mobilization from non-bank sources increased sharply from Rs 193.7 billion in Jul-Mar FY13 to Rs 424.8 billion in the same period this year. This increase can be traced to rise in PIB holdings by non-banks, and the increase in NSS rates in October 2013 and January 2014.

Although external financing of the budget deficit during the period Jul-Mar FY14 was negative, this increased significantly in Q4-FY14 because of the issuance of Eurobonds, fresh loans from IFIs, and bilateral assistance. The resumption of external inflows is important for a resource constrained economy, but this will add

¹⁰ FBR has revised downward its tax collection target twice from original target of Rs 2,475 billion to Rs 2,345 billion, and more recently to Rs 2,275 billion.

¹¹ Some measures have been proposed to control expenditures that include: reducing power sector subsidies by increasing electricity tariff; the National Power Policy will address line-losses, increase power generation, and restructure Gencos and Discos; the divestiture of public sector entities (e.g., UBL, PPL and OGDCL); and restructuring PIA, Pakistan Steel, and Pakistan Railways.

to Pakistan's external indebtedness. It is important to highlight here that total public debt (external plus domestic) has already crossed the limit of 60 percent of GDP, as set by the Fiscal Responsibility and Debt Limitation Act (2005) for FY13 onward. Hence, any addition to the external debt should at least be matched with an equivalent reduction in the domestic debt outstanding.

Balance of payments

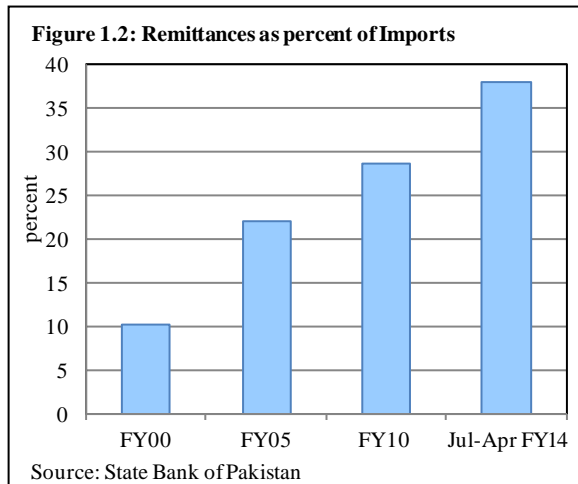
Before external funding started flowing in, Pakistan's external account was stressed by heavy repayments to the IMF, and oil payments. The country's FX reserves declined by US\$ 2.8 billion during Jul-Nov 2013, and the PKR depreciated by 8.2 percent. However, pressures started to ease in December 2013 as bulky payments to the IMF subsided, and Pakistan received the second tranche of US\$ 544 million as part of the EFF. This recovery gained momentum in Q3-FY14: the current account deficit declined with the strong growth in remittances and receipt of CSF money; the country received a US\$ 1.5 billion grant from a friendly country; and fresh disbursements from the IMF more than offset SBA repayments. As a result, the country's FX reserves increased by US\$ 1.8 billion during the quarter, and the PKR appreciated by 6.9 percent against the US Dollar.

The performance of the external sector improved further after March 2014, when Pakistan re-entered the global capital market after 7 years, and comfortably mobilized US\$ 2.0 billion via the Eurobond issue.¹² Furthermore, the ADB disbursed US\$ 400 million in April, and IDA provided two single-tranche loans worth US\$ 1 billion in May 2014. Pakistan also signed a Country Partnership Strategy (CPS) with the World Bank Group in May 2014, for US\$ 11 billion to be disbursed over a period of 5 years (FY15-19). Furthermore, the auction of 3G/4G licenses in April 2014 (for US\$ 1.1 billion, but with a portion in PKR) also improved the country's balance of payment outlook.

There are concerns about future repayments on recent external inflows, as the ratio of external debt servicing to FX earnings (exports and remittances) has been rising consistently since 9/11 (see **Chapter 4**). This makes it all the more important for Pakistan to reduce its current account deficit to ensure that future debt servicing does not drawdown the country's FX reserves. Support may come from home remittances.

¹² There are concerns that the government is paying too much for this money, but with Pakistan's sub-investment grade credit rating and its poor international image, the higher price of borrowing was expected. In fact, given the circumstances, the government's effort to raise higher external financing from the international market was significant.

Home remittances have been growing remarkably since 9/11. As a country with surplus labor, one should view manpower as a key export of Pakistan. Since a country's external sector sustainability is based on whether its exports can finance its imports, remittances should be added onto existing export revenues to gauge FX earnings. **Figure 1.2** shows that even with the country's rising import bill, remittances are financing a



growing share of total imports. This critical source of comfort for the external sector cannot be under-stated: while remittances only financed 10 percent of total imports in FY00, it is currently financing almost 38 percent. Given that informal avenues to send remittances still exist, we expect the share of remittances (to total imports) to grow as the global financial infrastructure closely scrutinizes informal networks of fund transfers across countries.

Outlook

While we acknowledge the perceptible improvement in business sentiments, there is a need to be mindful of the structural problems that continue to plague Pakistan's economy. In this regard, some positive steps have been taken in the power sector, and we hope this momentum carries forward into the fiscal arena – especially in terms of mobilizing tax revenues.

Beyond the need to stop the hemorrhaging in the power sector, and forcing economically active (vibrant) sectors to pay their share of federal and provincial taxes, the government must focus on *inclusive* growth, which is more likely to make it sustainable. In our view, policymakers need to formulate an Industrial Policy that prioritizes production efficiency and job creation. Such an initiative should focus on: efforts to promote competitiveness, instead of a culture that creates and rewards inefficiencies; restructure loss-making PSEs (especially in the power and transportation sectors) to make them more dynamic and profitable; and create a skilled labor force that meets the current (and potential) needs of the manufacturing sector.

While the government has listed a number of public sector entities (including PIA and Pakistan Steel) for strategic private sector participation, it should be fast-tracked to avoid a further fiscal drain from these loss making enterprises. Similarly, the plan to restructure Pakistan Railways, Gencos and Discos, needs to be firmed up so that these institutions can play a more positive role in the Pakistan economy.

Furthermore, there is no getting away from the fact that Pakistan has no choice but to increase its tax-to-GDP ratio. However difficult, there is an urgent need to eliminate tax exemptions; clampdown on corruption and leakages in the tax collection machinery; expand the tax base to include all productive sectors of the economy; and enhance the independence and professional capacity of provincial tax authorities.

So far it seems that the task of keeping a stressed economy moving forward, has dominated policy thinking and formulation. The recent positive developments and improvement in sentiments provide a strong base for future growth. Policymakers should, therefore, stay the course towards inclusive growth while taking the harder steps to create a larger and more equitable tax base; to fix the energy sector; to create an environment that will absorb the growing number of job-seekers; and to project Pakistan more competitively in the international markets.

2 Real Sector

2.1 Overview

Pakistan's real GDP grew by 4.1 percent in FY14 – higher than last year's growth of 3.7 percent (**Table 2.1**).¹

Although the growth remained lower than the target of 4.4 percent, what is encouraging is that it exceeded the 4.0 percent mark for the first time after FY08.²

This recovery in FY14 was led by the above-target performance of the industrial sector. Agriculture and services, on the other hand, posted lower growth compared to the previous year.

Higher growth in industry was mainly due to a sharp turnaround in *construction* and *electricity & gas distribution*, and a better showing by *large scale manufacturing (LSM)*. Within LSM, a number of factors were supportive to growth: for example, increased availability of gas for fertilizer; improved capacity utilization in steel, paper, beverages and rubber;³ investment in alternate energy; and a higher production of sugar on the back of a healthy sugarcane crop.

A further breakup of industrial data shows a much stronger growth of 6.5 percent in LSM during H1-FY14, compared to 2.2 percent in the corresponding period of FY13. As discussed later, some industry-specific developments in H2-FY14 have dampened LSM performance: the increase in power tariffs in September 2013;

Table 2.1: Overall GDP (at Constant Basic Prices of 2005-06)

Growth in percent; contribution in percentage points

	Growth			Contribution to growth	
	FY13 ^R	FY14 ^T	FY14 ^P	FY13 ^R	FY14 ^P
Agriculture (21%)	2.9	3.8	2.1	0.6	0.5
Industry (20.8%)	1.4	4.8	5.8	0.3	1.2
Services (58.1%)	4.9	4.6	4.3	2.8	2.5
GDP	3.7	4.4	4.1	3.7	4.1

R = Revised; T = Target; and P = Provisional

Note: Figures in parentheses are sectoral share in GDP for FY14.

Source: Pakistan Bureau of Statistics

¹ The annual GDP numbers are prepared by the Pakistan Bureau of Statistics and approved by the National Income Accounts Committee. These estimates are based on information available up to March, and are subject to revision later when information for full fiscal year (i.e., Jul-Jun) becomes available.

² The average annual GDP growth during FY09-13 was 2.8 percent.

³ Installation of new (coal/biomass fired) boiler allowed the Century Papers Mills to utilize capacity that was previously underutilized due to gas shortages. Similarly, Engro fertilizer received additional gas since end July 2013 from Mari gas fields, which enabled the company to operate its plants at more than 80 percent capacity. Furthermore, as the operation of Tuwairqi commenced in January 2013, it resulted in higher steel production during Jul-Dec FY14. Finally, General Tyre introduced motor cycle tyres in the last quarter of FY13, which supported LSM growth in FY14.

imposition of the Gas Infrastructure Development Cess (GIDC) from January 2014; and the two-sided volatility of the PKR against major currencies during Jul-Mar FY14, may have impacted LSM growth in the third quarter of FY14. Hence, LSM only recorded growth of 0.5 percent on a YoY basis during Q3-FY14.⁴

Notwithstanding this uneven performance of LSM, the strong recovery in both *construction* and *electricity & gas distribution*, allowed the industrial sector to surpass its target of 4.8 percent for FY14 (**Table 2.2**). In addition to a low base in FY13, the initiation of new projects in both the public and private sector helped push higher growth in *construction* during FY14.

Table 2.2: Value addition by Industry

Growth and share in percent; contribution in percentage points

	Share in FY14	Growth		Contribution to industry growth	
		FY13 ^R	FY14 ^T	FY13	FY14
Mining & quarrying	14.4	3.8	4.4	0.5	0.6
Manufacturing	64.9	4.5	5.5	2.9	3.6
Large scale	52.4	4.1	5.3	2.1	2.8
Small scale	8.0	8.3	8.4	0.6	0.7
Slaughtering	4.5	3.6	3.5	0.2	0.2
Electricity gen & dist and gas dist	9.2	-16.3	3.7	-1.8	0.3
Construction	11.5	-1.7	11.3	-0.2	1.2
Overall	100.0	1.4	5.8		

Source: Pakistan Bureau of Statistics

The value addition in *electricity and gas distribution* also witnessed stronger growth in FY14, mainly due to higher production in power generation companies following the settlement of circular debt in the earlier months of FY14. Hence, the industrial sector grew by 5.8 percent in FY14, compared to only 1.4 percent in the previous year. This recovery was sufficient to offset the slowdown in services and agriculture.

Lower growth in the services sector during FY14 can be traced to a slowdown in *general government services* and *finance and insurance*.⁵ However, *wholesale and retail trade* posted stronger growth compared to FY14, reflecting the improved performance by major crops and large scale manufacturing (see **Section 2.4**).

⁴ The recent data on LSM shows YoY growth of 4.3 percent for Jul-Mar FY14, which is considerably lower than the full-year estimate of 5.3 percent in the National Income Accounts.

⁵ The value addition by general government includes services such as education, health, social work, defence and public administration provided by federal, provincial, district governments, local bodies, and cantonment boards.

2.2 Agriculture⁶

Agriculture growth remained below target for the second year in a row. However, unlike FY13 when losses in rice and cotton held back agriculture growth, it was a significant decline in *minor* crops which suppressed value addition by the agriculture sector in FY14. This was exacerbated by the livestock subsector, which posted lower growth compared to FY13 (**Table 2.3**).

Crop sector

Better than expected growth of rice, sugarcane, wheat and maize, overshadowed the below-target cotton crop (**Table 2.4**).^{7,8} At the time of finalizing the *Second Quarterly Report* for FY14, when only provisional estimates were available, SBP was positive on rice, sugarcane and wheat; but its assessment on the overall performance of major crops was bearish mainly due to the drag from cotton. The final outcome appears to be quite different, as upward revisions in the production of all major crops, led to a growth of 3.7 percent in FY14, significantly higher than 1.2 percent in the previous year.

Unfortunately, the unanticipated decline in *minor* crops offset most of the gains from *major* crops. A further breakdown identifies lower production of pulses and

Table 2.3: Value Addition by Agriculture

Share and growth in percent; contribution in percentage points

	FY14 Share	Growth		Contribution to growth in agriculture	
		FY13 ^R	FY14 ^P	FY13 ^R	FY14 ^P
Crop	40.0	2.3	1.2	0.9	0.5
Major crops	25.6	1.2	3.7	0.3	0.9
Other crops	11.6	6.1	-3.5	0.7	-0.4
Cotton ginning	2.8	-2.9	-1.3	-0.1	0.0
Livestock	55.9	3.5	2.9	1.9	1.6
Forestry	2.0	1.0	1.5	0.0	0.0
Fishing	2.0	0.7	1.0	0.0	0.0
Overall	100.0	2.9	2.1		
Annual target		4.1	3.8		

Source: Pakistan Bureau of Statistics

Table 2.4: Major Crops

Production in million tons; for cotton million bales; Growth in percent

	FY13	FY14 ^T	Growth		
			FY14	FY13	FY14
Cotton	13.0	14.1	12.8	-4.1	-2.0
Rice	5.5	6.2	6.8	-10.1	22.8
Sugarcane	63.8	65.0	66.5	9.2	4.3
Wheat	24.2	25.0	25.3	3.1	4.4
Maize	4.2	4.6	4.5	-2.7	7.3

Source: Pakistan Bureau of Statistics

⁶ This section focuses on the major crops which account for 26 percent of the value addition by the agriculture sector. The livestock subsector, the largest contributor to agriculture with 52 percent share, is not covered in detail due to non-availability of sufficient information.

⁷ Cotton crop recorded a decline for the second consecutive year.

⁸ Rice, sugarcane and wheat together generally contribute around 65 percent of the value addition in major crops, whereas share of cotton crop is roughly 28 percent.

vegetables (especially potatoes) in FY14, mainly due to unfavorable weather conditions.

Furthermore, the growth in livestock recorded a slowdown during FY14. The value addition in this sector includes headcount and age of cattle, products (milk, wool, etc.), and poultry products (meat and eggs).

It may be noted that this sector has been experiencing a significant technological upgrade in recent years, with vertical integration in supply chain of meat and dairy products, and the focus on new processing techniques that are based on international hygiene and health standards. However, the hard data on livestock may not reflect such trends, as the share of the formal segment is still very low compared to the informal market.⁹ So while official data may not reflect the higher prosperity generated by livestock, rural and semi-urban areas may be better off compared to the past.¹⁰

2.3 Industry

Large scale manufacturing

LSM recorded growth of 4.3 percent during Jul-Mar FY14, compared to 3.5 percent during the corresponding period of last year. However, this higher growth was largely concentrated in sugar and fertilizer (**Table 2.5**). A closer look shows industries like cotton yarn & clothing, edible oil & ghee, POL, and paper & board, which had posted decent growth in Q1-FY14, could not sustain this momentum in subsequent quarters.

Quarterly data reveals a sharp decline in YoY growth of LSM during Q3-FY14. While some slowdown in LSM growth was expected due to the high base effect from September 2013,¹¹ as shown below, other factors also dampened LSM growth in Q3-FY14.

- First, sugarcane crushing was concentrated in Q2-FY14, which meant lower production was realized in the third quarter. This trend stands in sharp contrast to last year, when most of the crushing was carried out in Q3-FY13.

⁹ Gross value addition in the livestock is computed on the basis of past surveys or by applying fixed parameters.

¹⁰ Furthermore, to support livestock sector, SBP has not only issued guidelines on livestock financing, but also launched the Agricultural Lending Diversification Project (which encouraged bank lending to non-farm activities) and the Livestock Loan Insurance Scheme (which was issued in November 2013 to safeguard the interest of livestock farmers).

¹¹ Since most of these industries started to recover from September 2012, we were expecting some slowdown in their growth after September 2013.

Table 2.5: Growth in Large Scale Manufacturing (YoY)
percent

	wt.	FY13				FY14			
		Q1	Q2	Q3	Jul-Mar	Q1	Q2	Q3	Jul-Mar
Overall LSM	70.3	0.6	3.8	5.5	3.4	6.6	6.4	1.0	4.3
Textile	21.0	-0.5	0.9	2.4	0.9	2.4	1.2	0.9	1.5
Cotton yarn	13.0	-0.6	1.2	3.2	1.3	3.0	1.4	0.9	1.8
Cotton cloth	7.2	-0.3	0.1	0.9	0.2	0.9	0.6	0.5	0.7
Food & beverages	12.4	6.5	1.3	11.0	7.4	8.0	24.4	-0.3	7.8
Sugar	3.5	0.0	-29.0	11.0	3.0	0.0	87.2	-1.8	10.9
Vegetable ghee	1.1	-5.8	2.9	15.7	3.8	7.0	2.2	3.1	4.1
Cooking oil	2.2	6.4	20.6	17.1	14.6	8.7	-1.4	-5.9	0.2
Soft drinks	0.9	28.3	14.7	1.8	17.1	18.4	40.5	57.8	34.0
POL	5.5	3.4	18.0	19.4	13.3	12.7	4.2	5.9	7.5
Petroleum products	5.4	4.0	18.1	19.1	13.5	13.6	6.5	8.6	9.5
Coke	0.1	-17.8	16.8	28.0	6.9	-28.0	0.0	0.0	-78.4
Steel	5.4	16.1	22.8	2.8	13.2	9.4	-5.0	5.5	3.4
Pig iron	1.6	-35.6	-38.7	3.6	-25.3	-21.1	-66.7	-71.3	-53.4
Billets	1.5	-4.5	8.4	-0.8	0.9	32.5	21.5	33.8	29.2
H.R sheets/strips	2.3	72.9	78.8	4.8	45.5	7.3	-4.5	18.5	6.7
Cement	5.3	4.0	5.1	9.0	6.1	0.7	1.7	-2.0	0.1
Automobile	4.6	-1.2	-14.7	-18.2	-12.0	-5.5	3.1	2.5	0.0
Tractors	0.5	156.4	75.7	-33.5	34.5	-46.0	-26.3	-30.6	-33.6
Jeeps and Cars	2.8	-11.9	-36.3	-20.3	-22.9	-5.3	12.0	-0.3	1.3
Fertilizer	4.4	-27.0	11.2	6.6	-5.0	44.6	15.8	7.6	21.6
Nitrogenous fertilizers	4.0	-28.5	9.3	2.7	-7.3	47.4	18.9	10.8	24.6
Phosphatic fertilizers	0.4	-15.9	24.3	52.0	13.5	26.8	-2.7	-17.7	2.1
Paper	2.3	14.5	40.5	2.6	17.8	19.9	6.4	-2.4	8.0
Leather products	0.9	-10.0	-2.7	7.9	-1.7	14.0	8.5	15.8	13.0
Leather footwear	0.5	-10.3	1.1	10.9	0.3	12.8	9.8	22.8	15.7
<i>Memorandum item</i>									
<i>LSM excl. sugar & fertilizer</i>	<i>62.3</i>	<i>2.3</i>	<i>5.7</i>	<i>4.1</i>	<i>4.0</i>	<i>4.9</i>	<i>2.0</i>	<i>1.3</i>	<i>2.7</i>

Source: Pakistan Bureau of Statistics

- Second, the drag on Q3 growth came from the textile sector, especially cotton yarn. This moderation in growth was unexpected as it primarily came from a reversal in China's cotton policy. A more detailed discussion is covered in a subsequent section.
- Finally, the poor performance of Pakistan Steel Mill also pulled down LSM growth. Specifically, the production of coke and pig iron came to a halt in Q3-FY14, which at the margin had a significant impact on overall LSM growth during Q3-FY14.

Besides the above-mentioned factors, the rise in power tariffs for industrial users in September 2013, increased the production costs for almost all industries. Moreover, the imposition of Gas Infrastructure Development Cess (GIDC) in

January 2014 increased the cost for gas-dependent industries such as textiles, fertilizer, cement and paper.

Furthermore, industries which are heavily dependent on imported raw materials like POL, faced rising costs following the sharp depreciation of the PKR against major currencies during Q1-FY14.¹² Similarly, a steady increase in the price of palm oil in the international market adversely impacted the cooking oil and ghee production.¹³

Despite the subdued performance during Q3-FY14, overall LSM growth during Jul-Mar FY14 was still higher than the previous year. In fact, some of the industries (e.g., urea, leather products, soft drinks, and petroleum products) continued to show strong growth throughout the year. This is detailed below:

Sugar production rose again in FY14

Sugar production grew by 10.9 percent in Jul-Mar FY14, compared to 3.0 percent in the corresponding period of last year. As mentioned earlier, better sugarcane crop and timely crushing was the key reasons for this improved performance.¹⁴

The timely commencement of crushing can be traced to a better understanding between the government and sugar mills. More specifically, given that most sugar mills were facing a shortage of liquidity at the start of crushing season due to excessive carryover stocks, the government not only purchased part of this stock through TCP, it also allowed sugar exports on condition that mills in Sindh and Punjab would commence crushing on 1st and 15th of November, respectively.^{15, 16}

The crushing reached its maximum in the month of January 2014, against the normal peak in February (**Figure 2.1**). As mentioned earlier, the impact of this

¹² In fact, all listed refineries have reported huge exchange loss in their financial statements for second half of 2013. However, their margins started to recover following PKR appreciation towards the end of Q3-FY14.

¹³ After experiencing a continuous decline since Jan 2012, international price of palm oil started to recover in October 2013.

¹⁴ According to recent estimates prepared by Pakistan Bureau of Statistics, sugarcane production during FY14 was 66.5 million tons, which was significantly higher than the final estimates of 63.8 million tons for FY13.

¹⁵ In addition to offering rebate on sugar exports, the government reduced the sales tax from 8 percent to 0.5 percent on local supply of sugar to the extent of quantities actually exported (see SRO # 77 (1) of 7th February 2013).

¹⁶ Delays in crushing generally reduce the water contents in the cane. This not only improves the recovery rate (which is the ratio of sugar produced and cane crushed), the resulting fall in the weight of sugarcane implies lesser payment to cane grower for the same crop.

change in the crushing cycle was reflected in later months when the YoY growth of sugar became *negative* in both February and March 2014.

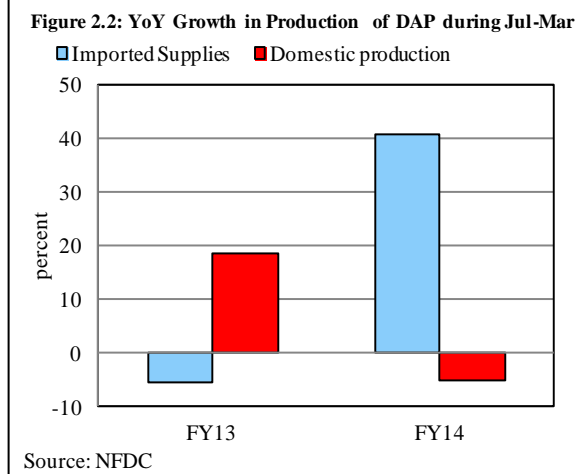
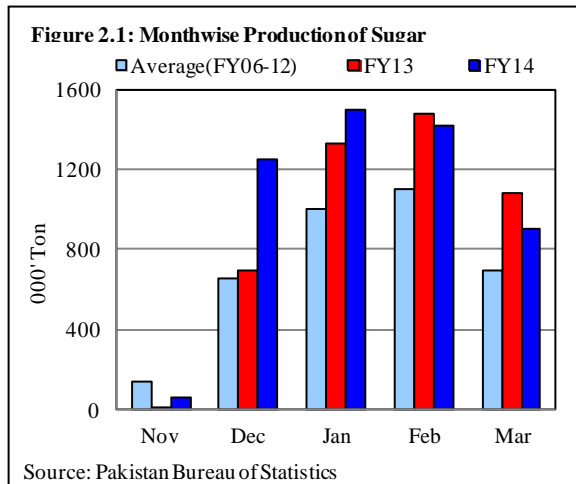
Fertilizer supported the LSM growth

With 21.6 percent YoY growth in Jul-Mar FY14 (compared to a *fall* of 5.0 percent in Jul-Mar FY13), the fertilizer sector alone contributed more than one-fifth of the overall growth in LSM. Better availability of gas to the fertilizer sector, and a higher off-take of fertilizer during Jul-Mar FY14, largely explain this improved performance.

The industry even survived the adverse impact of GIDC, which was raised in January 2014.¹⁷

Manufacturers initially passed on this increase to farmers by raising retail prices from Rs 1,720 per bag to Rs 1,900. However, when the government fixed the retail price at Rs 1,786 per bag, margins of most fertilizer companies came under pressure during Q3-FY14.

Production of DAP, which had accelerated sharply in Q1-FY14, experienced a slowdown in the following two quarters. A steep fall in international DAP prices and the resulting widening of price differential between landed and domestic prices, led to a substantial



¹⁷ Government increased the GIDC on feedstock gas from Rs 197 to Rs 300 per mmbtu, and on fuel gas from Rs 50 to 100 per mmbtu.

increase in DAP imports during Jul-Mar FY14 (**Figure 2.2**).¹⁸ This dampened domestic production of DAP.

Lackluster performance by cement

Cement production only increased by 0.1 percent during Jul-Mar FY14 compared to a growth of 6.1 percent in the last year. The recent hike in power tariff and the imposition of GIDC, increased the cost of production for the cement sector. The impact was more pronounced on smaller units that generally depend on the national grid and piped gas. In comparison, larger production units are using alternative fuels (such as tyre-derived fuel) and have incorporated waste heat recovery plants to reduce their energy cost.

Nonetheless, the industry passed on the increased production cost to end-users.¹⁹ The higher retail price and lower PSDP allocations during the nine months of FY14 reduced the domestic demand for cement.²⁰ The growth in local cement dispatches was only 2.1 percent in Jul-Mar FY14, compared to 6.1 percent in the previous year, while demand from international markets also remained subdued during the period. Most of the fall in external demand came from Afghanistan as subsidized Iranian cement captured that market.²¹

Some domestic cement manufacturers have announced their investment plans in Africa, and Iraq. These projects will not only diversify their product market but also provide an opportunity to grab market share in Gulf and African region. Although their additional production will not be reflected in Pakistan's cement sector, the profits repatriated may help the country's BoP, while the experience overseas may help improve production efficiencies in the country.

The outlook for the cement sector appears bright as new infrastructure projects like the Economic Corridor from Gawadar port to Khunjrab, and the construction of dams are expected to start in the coming year. From the private sector, cement demand is likely to come from construction companies that have launched mega

¹⁸ International DAP price reached 4-year low of US \$351.3/metric tons in November 2013. Although there was some uptick in December 2013 following a closure of a DAP plant in Morocco, prices soon started a downtrend from March 2014 onwards.

¹⁹ Retail price of cement rose on average by 11.5 percent on YoY basis during Nov-Mar FY14.

²⁰ PSDP spending during Jul-Mar FY14 was Rs 393 billion which was marginally lower than Rs 407.1 billion during the corresponding period of last year.

²¹ For their fuel requirement, Iranian cement sector is mainly reliant on the local gas, available at cheaper rates. In contrast, Pakistan's cement sector is mainly dependent on thermal energy and imported coal.

housing projects in the major cities. Finally, the real estate sector should also receive support from the relaxation in SBP prudential regulations.²²

Yarn production

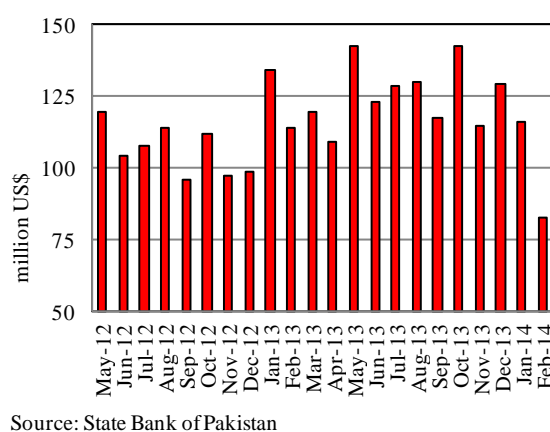
Although yarn manufacturing posted growth compared to the previous year, a gradual slowdown is visible in Q2 and Q3 of current fiscal year (**Table 2.6**). While external demand for yarn weakened after a change in cotton policy by China (**Box 2.1**), import of cheaper yarn from India (at zero tariffs) lowered the domestic demand.²³

Box 2.1: Reversal of Cotton Policy by China

China has been building cotton stocks since 2011 by offering higher than competitive price to local farmers. The consequent widening of the gap between the international and the local cotton prices encouraged Chinese manufacturers to increase their import of cotton yarn and its bi-products. Hence, Pakistan's export of textile items flourished. In fact, during FY11-H1FY14, the country earned US\$ 3.5 billion from the export of cotton yarn to China only.

In March 2014, Chinese government introduced a major shift in this policy, i.e., instead of buying cotton at higher than market prices, the government would pay the price differential to farmers if market price falls from a target level, which is significantly smaller than the price at which government was earlier buying from the market.²⁴ Interestingly, yarn demand from China had already fallen in February 2014 in anticipation of this new policy (**Figure 2.1.1**). At the same time, this policy shift eased the pressure on yarn prices in the international market.

Figure 2.1.1: Yarn Export Receipts from China



²² In order to promote housing finance, SBP has issued separate prudential regulations. The key feature of new prudential regulations is the extension in the period for classifying overdue loans under the 'loss' category from one year to two years (IH&SMEFD Circular No. 03 of 2014).

²³ The import of the Indian yarn reached to US\$ 86.3 million during Jul-Mar FY14 compared to US\$ 58.3 million during the same period of FY13. This not only lowered the demand for local yarn, but also kept market prices down. In response, the Economic Coordination Committee of the cabinet restored 5 percent duty on yarn import from India in April 2014.

²⁴ The Chinese government announced a lower target price in the new cotton reserve policy relative to support price offered in the older policy.

Cotton clothing

Cotton cloth, which is the second largest segment after yarn in textile manufacturing, posted moderate growth of 0.7 percent in Jul-Mar FY14 against 0.2 percent in the corresponding period of FY13. This trend is consistent with growing domestic demand for light cotton fabric (i.e., lawn) which has impacted the cotton cloth sales.

2.4 Services²⁵

FY14 growth in services remained lower than last year and also below the target of 4.6 percent (**Table 2.6**). This relatively weak performance is largely because of *finance & insurance* and *general government services*;²⁶ whereas *wholesale & retail trade* and *transport, storage & communication* continued to provide impetus to overall growth in services.

Strong growth in LSM, better production of major crops and the increase in trade volumes, largely explain increased activity in *wholesale & retail trade*. Furthermore, the strong credit growth to wholesale and retail trading, also bodes well for this sub-sector.

In the transportation sector, PIA struggled with operating losses; the company posted a net loss of Rs 44.5 billion during CY13, as compared to Rs 30.6 billion in CY12.²⁷ However, recent corporate results for Q1-CY14 reveal an improvement:

Table 2.6: Value Addition by Services

Share and growth in percent; contribution in percentage points

	Share in FY14	Growth		Contribution to growth in services	
		FY13 ^R	FY14 ^P	FY13 ^R	FY14 ^P
Wholesale & retail trade	31.9	3.4	5.2	1.1	1.6
Transport, storage & communication	22.3	2.9	3.0	0.7	0.7
Finance & insurance	5.4	9.0	5.2	0.5	0.3
Housing services	11.6	4.0	4.0	0.5	0.5
General govt. services	12.1	11.3	2.2	1.3	0.3
Other private services	16.6	5.2	5.8	0.9	1.0
Overall	100.0	4.9	4.3	4.9	4.3

P: Provisional; R: Revised

Source: Pakistan Bureau of Statistics

²⁵ A detailed analysis of developments in the services sector will be done in SBP's forthcoming Annual Report, when relevant information for the full year becomes available.

²⁶ Although banks' profitability increased during this period, the value addition by this sector showed lower growth. In fact, value addition in *finance & insurance* is computed by using a method called Financial Intermediation Services Indirectly Measured (FISIM) by PBS, which may not necessarily reflect the actual profitability of financial institutions.

²⁷ According to annual report of PIA, the company suffered losses mainly on account of (1) shortage of operational aircraft; (2) higher operational cost, and (3) the sharp depreciation of Rs against major currencies.

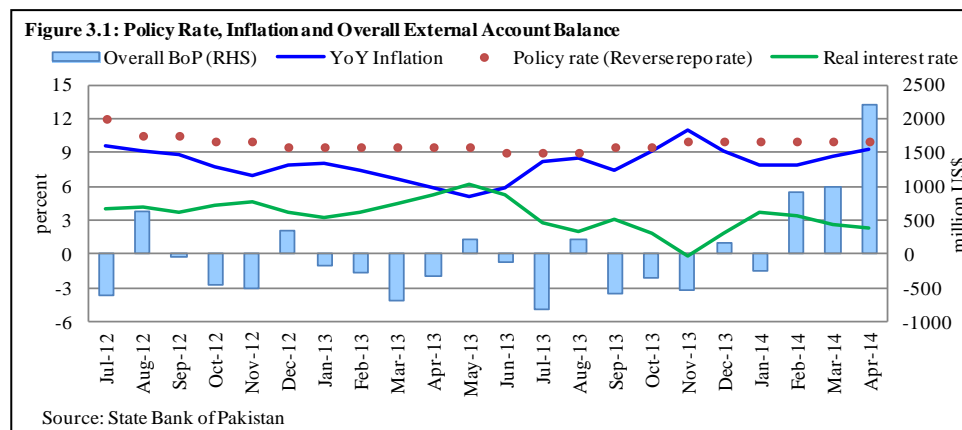
the net loss has fallen from Rs 8.62 billion in Q1-CY13 to Rs 1.98 billion in Q1-CY14. Stronger revenue growth could be traced to the acquisition of four narrow body aircrafts, as well as stability in the exchange rate.

The growth in *communication* came mainly from value addition in cellular segment. According to PTA, cellular companies operating in Pakistan earned revenue of Rs 440.2 billion in FY 2012-13, which is the highest recorded. The recent auction of licenses for 3G/4G spectrum is likely to boost revenues in this segment of the telecom sector.

3 Inflation and Monetary Policy

3.1 Overview

The gradual monetary tightening pursued during the first half of the year, was put on hold in Q3-FY14, as the risks associated with the inflationary pressures and external sector dissipated to some extent.¹ More specifically, SBP kept the policy rate unchanged at 10 percent in its monetary policy decisions of January and March 2014. Broadly speaking, following factors were key: (i) higher-than-anticipated financial inflows coupled with the appreciation of PKR; (ii) an encouraging trend towards fiscal consolidation; and (iii) a lower-than-expected increase in inflation (**Figure 3.1**). Although developments in the external and fiscal sectors signaled further improvement as the government successfully mobilized US\$ 2.0 billion from Eurobonds and generated US\$ 1.1 billion from the long awaited auction of 3G/4G spectrum licenses, the comfort on inflation slightly waned as YoY inflation for April 2014 turned out to be higher (at 9.2 percent) than expected. Keeping in view the sustainability of external sector developments and stability in key macro variables, SBP adopted a cautious approach in its monetary policy decision on May 17, 2014, by maintaining its policy rate at 10 percent.



¹ The external sector weaknesses and building up of inflationary expectations at the beginning of FY14, forced SBP to make a shift in its monetary policy stance from accommodative to gradual tightening. Specifically, SBP increased the policy rate by 50 bps each in its monetary policy decisions announced in September and November 2013.

In fact, as shown in **Figure 3.1**, the somewhat erratic pattern of YoY inflation during Jul-Apr FY14, which was largely driven by excessive volatility in perishable food items and adjustments in administered prices, complicated the task of formulating the inflation outlook for FY14. The average inflation for FY14 was initially projected at 11.0 to 12.0 percent, which was considerably higher than the average inflation of 7.4 percent for FY13.² As the year progressed, inflation did pick up and reached double-digit (10.9 percent) in November 2013. However, this was followed by a decline in YoY inflation in December 2013 and January 2014. This, along with the softening of inflationary expectations, led to a downward revision in projected inflation to 10.0 to 11.0 percent.³ In fact, SBP now expects average inflation for FY14 to fall in the range of 8.0 to 9.0 percent due to: (a) the appreciation of exchange rate; (b) relative stability in oil prices in both international and domestic markets; (c) government efforts to shift its borrowing away from SBP; (d) deceleration in money growth; and (e) the easing inflationary expectations as indicated by SBP-IBA Consumer Confidence Survey in May 2014.

Monetary expansion, which is often considered to be one of the leading indicators of inflation, decelerated to 5.9 percent during Jul-Mar FY14, compared with 9.0 percent during the same period last year. This deceleration was expected due to the quantitative limits on SBP's NDA, and limits on government borrowing from SBP.

The government was able to contain its borrowing from SBP within the limit agreed with the IMF for end-March 2014. In fact, the large inflows into the Pakistan Development Fund in Q3-FY14, received as a capital grant from a friendly country, helped reduce government borrowing from SBP (in net terms) quite significantly.⁴ Despite this, SBP's NDA target was missed by a small margin.

On a cash basis, the government borrowed Rs 436.9 billion for budgetary financing from the banking system during Jul-Mar FY14, which was almost half the amount borrowed during the same period in FY13. This sharp deceleration

² Inflation was projected to increase due to: (a) the government's decision for upwards adjustment in electricity and gas prices; (b) an increase in GST rate; (c) removal of certain exemptions to contain subsidies; and (d) inflationary expectations built on upward adjustment in prices of petroleum products, and depreciation of exchange rate. For details, see Monetary Policy Statement of September 2013.

³ Monetary Policy Statement of January 2013.

⁴ Government borrowing from SBP has been the prime source of changes in SBP's NDA in recent years.

can be attributed to government efforts to contain its overall budgetary deficit, and the availability of non-bank funding.

The reduction in government borrowing, forced commercial banks to shift their focus towards the private sector. This was made easier with the improvement in power and gas availability; higher business and consumer confidence; and relatively low real cost of borrowing, which created demand for bank credit. Both the demand and supply side factors resulted in healthy growth in credit to the private sector after a gap of five years. Specifically, private sector credit expanded by 10.0 percent during Jul-Mar FY14, which was more than double the growth realized during the same period last year. Moreover, the growth was seen in all the three segments, i.e., working capital, trade financing, and fixed investment loans.

3.2 Liquidity condition

Money market liquidity posted considerable volatility during Jul-Mar FY14, which was largely driven by: (i) a pickup in private sector credit; (ii) a sharp reduction in government borrowing; (iii) the unplanned substitution of short-term debt (T-bills) with the medium to long term instruments (PIBs); (iv) the unexpected external inflows; (v) unanticipated exchange rate developments; and (vi) the market view about interest rate. Not only did the money market rate move outside the normal interest rate corridor (IRC) at times, the OMO cut-off rate were also higher than the SBP's reverse repo rate, which is the upper limit of the IRC.

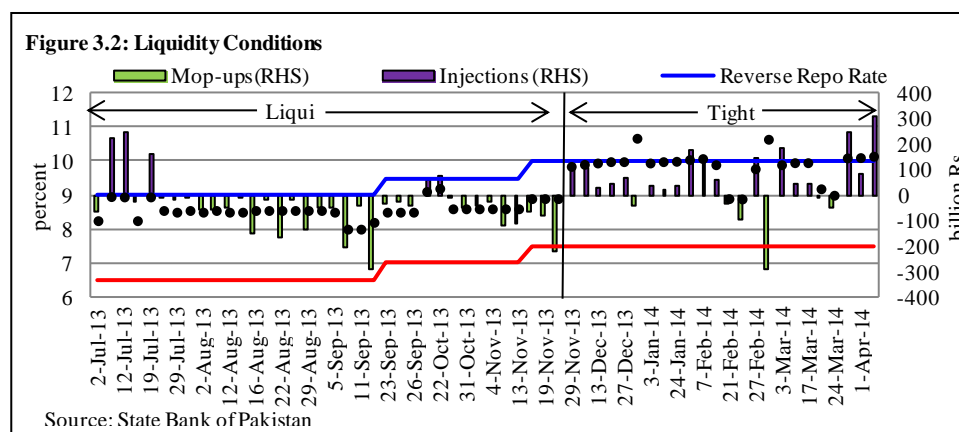
For a meaningful analysis, liquidity conditions and the behavior of money market rates during Jul-Mar FY14, should be bifurcated into two periods, i.e., the periods before and after the monetary policy decision of November 2013. **Figure 3.2** shows that excess liquidity prevailed in the market prior to the November 2013 decision as the weighted average overnight rate was hovering near the middle of the IRC; SBP was conducting open market operations (OMOs) to drain liquidity from the market;⁵ and individual banks were frequently placing their funds with SBP at the floor rate.⁶

Following the increase in the policy rate in November 2013 (which followed up the 50 bps rise in September), banks started to participate aggressively in T-bill

⁵ As mentioned in the First Quarterly Report for FY14, the banks' reluctance to reinvest their maturing T-bills holdings due to expected increase in interest rates, and SBP's net foreign exchange purchases to comply with the prior actions required for the IMF program, created excess liquidity in the market.

⁶ IRC activity indicates that banks placed their funds with SBP at 79 times during first quarter of the year.

auctions. At the same time, the government accepted huge amounts in these auctions to retire its borrowing from SBP to meet end-December targets. This pushed the cut-off rates for all tenors almost to the policy rate, creating a very flat yield curve up to one year maturity.⁷ The overnight money market rate also exceeded the policy rate (reverse repo rate) on various occasions, as SBP provided limited liquidity through OMOs in a market where commercial banks had overcommitted in the primary auctions. Even the OMO cut-off rate was higher than the policy rate on many occasions, as the SBP consciously kept the money market tight, keeping in view external sector developments.⁸

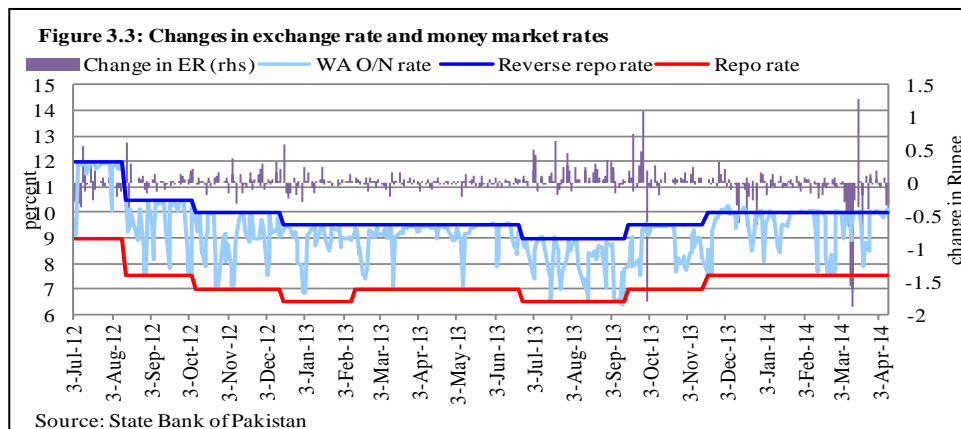


Besides getting liquidity through OMOs, the utilization of SBP's overnight repo (floor) and reverse repo (ceiling) facilities shows that banks approached SBP for liquidity 113 times during Q3-FY14 (they borrowed an average of Rs 13.8 billion per visit), but placed liquidity only 32 times (with an average of Rs 7.5 billion). Moreover, fifteen commercial banks, including three of big 5 banks, used SBP's reverse repo facility at least 4 times to secure liquidity during the quarter. This shows that money market rates remained elevated during the quarter.

⁷ Specifically, the government accepted Rs 1,413.9 billion (excluding non-competitive bids) in three T-bill auctions held after the change in policy rate in November 2013, compared with the pre-auction (cumulative) target of Rs 875.0 billion and maturity of Rs 1,125.1 billion.

⁸ Interest Rate Corridor (IRC) was introduced with effect from August 17, 2009, with a width of 300 bps between the ceiling (reverse repo) and the floor (repo). The width of IRC was subsequently reduced to 250 bps. Moreover, to make the IRC more effective, SBP explicitly discouraged frequent use of the standing facilities by introducing a spread of 50 bps (plus/minus) for all those institutions visiting either the reverse repo/repo facilities more than 7 times during a quarter. This amendment effectively widened the width of IRC from 250 to 350 bps for all those banks, which have already accessed the SBP facility for 7 times during a quarter.

Elevated money market rates helped stabilize exchange rate by increasing the cost of Rupee liquidity (**Figure 3.3**). This not only discouraged speculative activity in the FX market, but also kept the interest rate differential between the rupee and foreign currency loans high. The demand for FX loans to finance oil payments also factored in during the period when SBP's FX reserves were falling. Specifically, trade financing against FE-25 deposits increased by US\$ 940 million during Jul-Mar FY14, against a net retirement of US\$ 431 million during the same period in FY13. Appreciation of the PKR in March 2014, also contributed to this increase, as the effective cost of foreign currency borrowing depends on expected depreciation/appreciation of the PKR, and the interest rate differential between domestic and international markets (LIBOR). With a large interest rate differential and an appreciating PKR, foreign currency loans became very attractive.



In addition to the exchange rate, notable developments at the very short-end of the yield curve (up to 12 months), also impacted the term premium, and the market's participation in government securities. Specifically, elevated interest rates, and the fall in inflation from December 2013 onwards, in the presence of healthy term premiums on medium to long term government securities, sharply changed banks' interest in PIBs. The government received bids of Rs 1,030.0 billion in three PIB auctions held during Q3-FY14, against the pre-auction cumulative target of Rs 180 billion. The government accepted most of these bids (Rs 985.1 billion), which sharply increased the average maturity of bank holdings of government securities; this is good for the banking industry and also for the government's maturity profile.

The bid pattern of T-bill auctions, especially in March 2014, also indicates that banks were expecting a rate cut in the near future. Specifically, commercial banks offered money in 6 & 12 month T-bills, in sharp contrast to the pattern observed during H1-FY14. Similarly, banks offered record volume of Rs 542.9 billion in PIB auction held on 26th March 2014, against the target of Rs 60.0 billion. This aggressive bidding to lock in their funds for longer maturities (i.e., PIBs), even when there was a liquidity shortage at the time of settlement, is an indication of the interest rate outlook of the banks. SBP injected Rs 250 billion just after the settlement day through an OMO with a cut-off rate at 10.1 percent. While these developments helped increase the maturity profile of government debt, liquidity management for both SBP and banks became more challenging due to the unplanned and sudden nature of these developments.

3.3 Developments in monetary aggregates

Broad money supply (M2) increased by Rs 526.6 billion during Jul-Mar FY14, compared with an expansion of Rs 686.4 billion during Jul-Mar FY13 (**Table 3.1**). It is encouraging to note that the deceleration in monetary expansion was primarily driven by lower government borrowing, which overshadowed the healthy 10 percent growth in private sector credit during this period. Moreover, external sector developments, especially the inflow of US\$ 1.5 billion into the Pakistan Development Fund in Q3-FY14, have favorably impacted the composition of broad money supply during Jul-Mar FY14.

Table 3.1: Monetary Aggregates during Jul-Mar
billion Rupees

	Cumulative Flows		Quarterly Flows (FY14)		
	FY13	FY14	Q1	Q2	Q3
Broad money (M2)	686.4	526.6	21.5	506.4	-1.3
NFA	-161.2	-103.2	-173.2	-42.0	112.0
SBP	-163.0	-59.0	-146.1	-83.7	170.8
Scheduled banks	1.8	-44.2	-27.1	41.7	-58.9
NDA	847.6	629.8	194.6	548.4	-113.2
SBP	387.0	178.0	174.2	161.2	-157.5
Scheduled banks	460.6	451.8	20.4	387.2	44.2

Source: State Bank of Pakistan

Quarterly data of monetary aggregates shows that almost the entire improvement in the composition of M2 came in Q3-FY14. In sharp contrast to the net contraction of Rs 215.2 billion during the first half of the year, net foreign assets (NFA) of the banking system expanded by Rs 112.0 billion during Q3-FY14 (**Table 3.1**). However, the expansionary impact on money supply was completely

offset by the net contraction of Rs 113.2 billion in NDA of the banking sector, leaving broad money supply almost unchanged during the quarter.

Fall in government borrowing

Following a prolonged period of excessive government borrowing from the banking system, a visible deceleration was observed during the third quarter of the year. Both the lower fiscal deficit, and availability of non-bank funding, helped reduce government reliance on the banking system.

Besides the overall fall in government borrowing, government efforts to shift its borrowing away from SBP towards commercial banks is also clearly visible during Jul-Mar FY14 (**Table 3.2**). The government relied heavily on SBP funding during the first quarter of FY14 as commercial banks were reluctant to invest in government securities.

Table 3.2: Net Budgetary Borrowing during Jul-Mar (Cash-basis)
billion Rupees

	Cumulative Flows		Quarterly Flows (FY14)		
	FY13	FY14	Q1	Q2	Q3
From Banking System	856.7	436.9	198.1	285.2	-46.4
From SBP	-25.7	58.8	352.9	90.3	-384.3
From Scheduled Banks	882.4	378.1	-154.8	195.0	337.9

Source: State Bank of Pakistan

As mentioned earlier, commercial bank offered huge amount in primary auctions of government securities after the change in policy rate, especially of November 2013. This allowed the government to contain its borrowing from SBP. The situation further improved in Q3-FY14, as net government borrowing from SBP saw a net reduction of Rs 384.3 billion. It is important to highlight here that net reduction in borrowing from SBP was primarily attributed to an inflow of US\$ 1.5 billion into the Pakistan Development Fund (PDF). In fact, these inflows pushed government deposit with SBP from Rs 96.3 billion at the beginning of the year, to Rs 309.9 billion by end-Q3-FY14.

Commodity operations⁹

With a net retirement of Rs 133.8 billion during Jul-Mar FY14, outstanding loans for commodity operations reached Rs 336.0 billion by end March-2014. Like the previous year, this net retirement was entirely driven by the repayment of loans for

⁹ The numbers discussed in this section will not match with the data from the monetary survey as the latter does not include the financing availed from Pak Oman Inv. Co, Pak Libya Holding Co. and Saudi Pak Industrial & Agricultural Investment Co.

wheat procurement, which more than offset the increase in loans for the procurement of sugar and fertilizers during the period of analysis (**Table 3.3**).

Despite a pickup in domestic production, net borrowing for the import of fertilizer saw an expansion of Rs 9.3 billion during Jul-Mar FY14. In fact, the government decision to import fertilizer for the Rabi season (October-December) created demand for credit, while the unexpected availability of gas contributed to higher domestic production.¹⁰ However, the relatively lower increase in credit compared to Jul-Mar FY13, is also because of the realization of subsidy payments from the government.¹¹

Table 3.3: Loans for Commodity Operations - Cumulative flows (Jul-Mar)

billion Rupees

	FY13	FY14
Wheat	-145.4	-146.1
Sugar	14.5	3.0
Fertilizer	17.9	9.3
Total	-113.0	-133.8

Source: State Bank of Pakistan

Borrowing for sugar procurement increased by only Rs 3.0 billion during Jul-Mar FY14, compared with a rise of Rs 14.5 billion the year before. The nominal increase during Jul-Mar FY14 was primarily attributable to sugar procurement by TCP before the commencement of crushing season.¹²

Finally, the accumulated receivables of procurement agencies (on account of sale proceeds and subsidies) continued to impair their repayment capacity. As of end March 2014, the volume of receivables stood at Rs 282.2 billion, which was 84.2 percent of the outstanding loans for commodity operations. This implies that speedy settlement of these receivables would help procurement agencies repay their loans. Within receivables, subsidy payments due from the government declined by Rs 3.7 billion during Jul-Mar FY14, to Rs 172.4 billion (**Box 3.1**). As highlighted in previous SBP Annual and Quarterly Reports, there is an urgent need to settle these subsidies, as this will also be cost effective for the government.

¹⁰ In fact, gas supplied to Guddu thermal power plant was diverted towards the fertilizer sector, as the plant was temporarily shut down for the maintenance.

¹¹ The amount of subsidy receivable (for fertilizer) decreased from Rs 57.2 billion as of end June 2013 to Rs 53.0 billion as of end March 2014.

¹² In Jul-Mar FY13, the government intervened in sugar sector at a large scale to stabilize the domestic price.

Box 3.1: Subsidies Receivable for Commodity Operations

Procurement agencies aim at stabilizing commodity prices through the crop cycle by ensuring adequate supply in the market. Their commodity operations are financed by the government-guaranteed bank loans, and should be self-liquidating in nature. If the release price is less than procurement price (including cost of storage and waste), it implies that the government is subsidizing that commodity. To keep these commodity operations sustainable, federal and provincial governments allocate specific amount of subsidies in their respective budgets for these institutions.

Despite this self liquidating nature of commodity operations, delays in the realization of receivables (sale proceeds and subsidies) impair the repayment capacity of these institutions, which keeps outstanding borrowing from scheduled banks high. As of end March 2014, the amount of receivable subsidies stood at Rs 172.4 billion, despite decline of Rs 3.7 billion during Jul-Mar FY14.

Budget documents reveal that the federal government has been allocating subsidy for TCP and PASSCO over the years. However, the amount allocated in the budgets has been lower than the amount of subsidies receivable by these institutions (**Table 3.1.1**). Consequently, the amount of subsidies receivables stood at Rs 17.3 billion and Rs 56.1 billion for PASSCO and TCP respectively.

Table 3.1.1: Subsidy Allocation viz-a-viz Receivables in Commodity Operations[^]

billion Rupees

	FY10	FY11	FY12	FY13	FY14
Allocation in Fed budget (for TCP & PASSCO)	30.2	20.0	4.0	5.2	9.0
Receivable of TCP & PASSCO	50.6	53.3	43.7	89.2	73.4*
Allocation in Punjab Budget (overall)	26.7	21.0	30.0	34.0	36.0
Receivable of Punjab Food Department	38.0	53.2	42.9	68.8	80.8*
Allocation in Sindh Budget (overall)	n.a	1.6	1.5	3.0	3.0
Receivable of Sindh Food Department	0.0	8.7	13.9	18.1	18.1*

[^]: In case of both Khyber Pakhtunkhwa and Balochistan, the food departments do not have any outstanding receivables of subsidies towards their respective governments.

*: As of end March

Source: State Bank of Pakistan; Ministry of Finance; Annual Budget Statements of respective provinces

Although overall receivable subsidies have declined by Rs 3.7 billion during Jul-Mar FY14, there is a need to settle this pending liability. As repeatedly highlighted in SBP Annual and Quarterly Reports, this will not only help improve fiscal transparency, but also be cost effective for the government, as these are funded by commercial borrowings.

Credit to PSEs

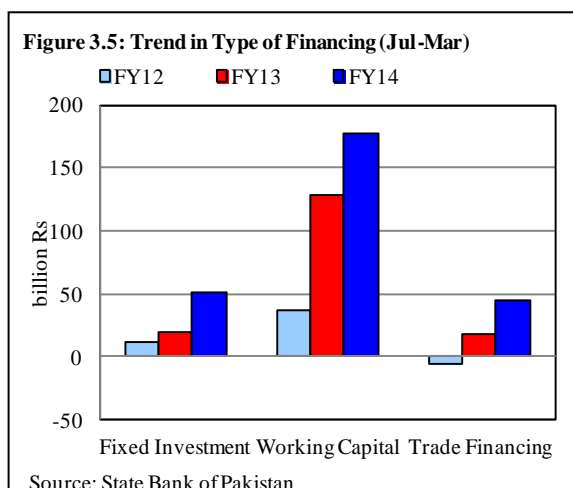
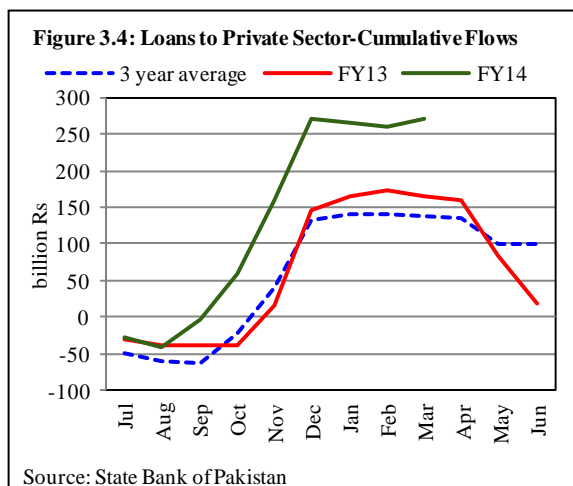
Credit to PSEs expanded by Rs 74.3 billion during Jul-Mar FY14, compared to an increase of Rs 44.9 billion during the same period last year. The entity-wise breakup shows that higher demand came primarily from energy-related PSEs,

which were facing liquidity problems due to re-accumulation of inter-agency receivables, albeit at a lower levels than the previous years.¹³

Credit to private sector

Following five years of low growth, credit to the private sector expanded by Rs 335.8 billion during Jul-Mar FY14, compared with Rs 139.8 billion during same period last year (**Figure 3.4**). Within total credit to the private sector, healthy growth was largely driven by loans to private businesses, which is an indication of the revival of industrial activities. As mentioned earlier, both demand and supply side factors contributed to the growth. The pickup in consumer financing also bodes well as it supports manufacturing activity by creating demand. However, it must be realized that overall

credit to the private sector in Jul-Mar FY13 was understated by retirement of Rs 76.3 billion in credit to NBFCs, this contractionary impact was limited during Jul-Mar FY14, as net retirement by NBFCs stood at only Rs 7.6 billion (**Table 3.4**).¹⁴



¹³ Specifically, Pakistan State Oil Company (PSO) borrowed Rs 86.8 billion in net terms for import financing and to meet its working capital requirements during Jul-Mar FY14. Similarly, credit to Pak Arab Refinery Ltd (PARCO) increased by Rs 19.4 billion, of which Rs 17.4 were for import financing. WAPDA borrowed Rs 14.3 billion in net terms, which were primarily used to meet the working capital needs.

¹⁴ Banks' investment in NBFCs increased significantly during FY12 due to tax incentive on the investments in NBFCs, especially of mutual funds. However, the government announced the partial withdrawal of tax incentive in a phased manner in June 2012. Consequently, the banks are restraining their investments in NBFCs.

Credit distribution by types of financing reveals that growth was visible in all three categories during Jul-Mar FY14 (**Figure 3.5**).

Table 3.4: Change in Credit to Private Sector
billion Rupees

	FY13				FY14			
	Q1	Q2	Q3	Jul-Mar	Q1	Q2	Q3	Jul-Mar
Overall	-84.9	189.5	35.2	139.8	-17.4	338.7	14.5	335.8
<i>of which</i>								
Loans to private business	-39.6	186.1	18.6	165.1	-3.0	274.8	0.0	271.7
Investments in private stocks	-1.1	12.3	4.4	15.6	1.4	5.2	8.3	14.8
Consumer financing	-1.8	8.4	1.9	8.5	13.4	4.7	3.4	21.5
Credit to NBFCs.	-65.7	-12.6	2.0	-76.3	-16.2	2.9	5.7	-7.6

Source: State Bank of Pakistan

Trade financing witnessed a significant increase during Jul-Mar FY14, largely driven by export financing.¹⁵ Both the bumper rice crop (which contributed to the exportable surplus),¹⁶ and a modest increase in textile exports, also contributed to the increase in trade financing. Moreover, the increased import of petroleum products, for power generation and shortage of CNG in the winter, also added to the volume of import financing.

The distribution of private sector credit indicates that sector specific developments influenced lending during the period under review.

Food products and beverages:

- Credit expansion to the *sugar* sector benefited from strong growth in production, which came about because of the healthy sugarcane crop.¹⁷ Besides working capital, fixed investment loans were availed by sugar mills investing to generate electricity from bagasse, and for capacity enhancement (**Table 3.5**). Large carry-over stocks from the previous season, also added to the credit requirements of the sugar sector.
- Capacity expansion and product diversification by suppliers of drinking water and soft drinks, continued to create credit demand from the *beverages* sector.¹⁸

¹⁵ It is important to note here that massive rise in foreign currency loans (against FE-25 deposits) for import financing should not be confused with trade financing to private businesses discussed here.

¹⁶ Rice production reached 6.8 million tons during FY14, which is not only more than the last year's production of 5.5 million tons, but also higher than the target of 6.2 million tons.

¹⁷ Sugar production grew by 7.8 percent during Jul-Mar FY14, compared with 3.0 percent in the same period last year.

¹⁸ Beverages sector has been performing well for last couple of years due to rising demand. Three Greenfield production plants have also been established. FDI inflows to beverages sector stood at

- Another notable development during Jul-Mar FY14, was the significant volume of working capital availed by manufacturing units that produce feed stuff for animals. However, credit expansion was largely concentrated in Q3-FY14, on account of liquidity pressures caused by rising prices of raw material (maize and soybean).

Table 3.5: Net Change in Loans to Private Sector Businesses during Jul-Mar

billion Rupees, share in percent

	Share-End		Overall Loans		Trade Financing		Working Capital		Fixed Investment	
	Mar FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	
Private. Business	100.0	165.1	271.7	17.3	44.4	128.6	177.0	19.1	50.3	
a) Manufacturing	60.8	145.5	215.1	17.5	35.4	112.5	143.4	15.5	36.4	
Of which										
Food & beverages	15.0	60.4	95.2	10.5	8.6	40.1	71.0	9.8	15.6	
Of which										
Animal feed	0.7	2.5	5.9	0.8	-1.4	1.2	6.8	0.5	0.5	
Sugar	6.5	39.9	49.7	2.9	0.6	30.6	38.8	6.5	10.3	
Beverages	1.1	1.8	13.1	0.7	0.5	3.7	12.5	-2.6	0.0	
Textiles	21.3	74.9	68.6	10.1	13.6	56.8	53.7	8.1	1.3	
Of which										
Spinning	9.0	34.0	32.6	-2.9	9.1	35.4	29.8	1.5	-6.3	
Weaving	3.9	10.7	16.5	3.5	1.3	6.3	11.7	0.9	3.5	
Finishing	3.6	11.8	13.1	-0.8	7.7	7.5	10.0	5.1	-4.6	
Fertilizer	3.5	-3.3	-1.8	-2.8	0.3	3.5	0.4	-4.0	-2.6	
Appliances	0.7	4.1	6.7	0.9	0.0	2.8	6.2	0.4	0.5	
b) Energy	9.3	-0.8	26.8	1.3	-0.4	11.6	8.0	-13.6	19.2	
c) Others*	29.9	20.4	29.8	-1.4	9.4	4.5	25.7	18.5	-5.3	

*Agriculture, fishing, mining, ship breaking, construction, hotel, transport, real estate, education, health, etc.

Source: State Bank of Pakistan

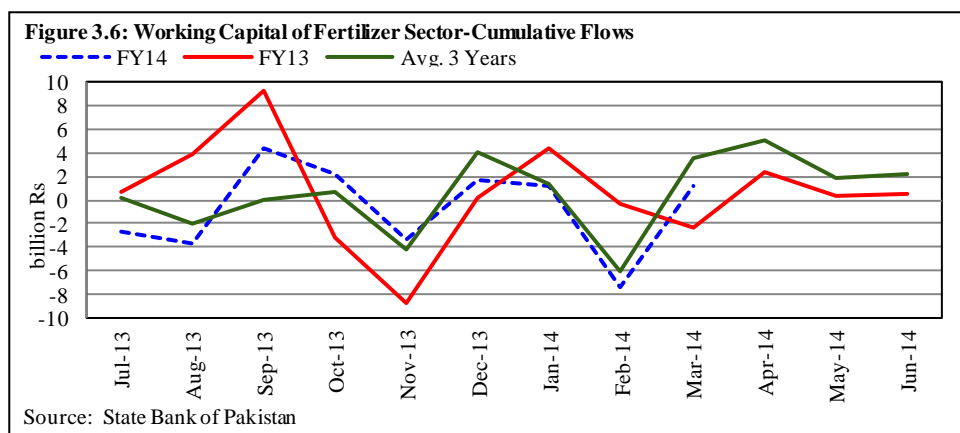
Textile sector: Following growth in credit to the textile sector during the first half of the year (especially from September to December),¹⁹ Q3-FY14 recorded a net retirement of Rs 31.4 billion. Segment-wise data indicates that loans for fixed investments fell as a number of textile firms were retiring credit that had been utilized for alternate energy sources and BMR (balancing, modernization and replacement) in the recent past.²⁰

US\$ 23.5 million during Jul-Mar FY14, compared to an outflow of US\$ 7.5 million during the same period last year.

¹⁹ Credit to textile sector expanded by Rs 100.0 billion during H1-FY14, compared with Rs 65.2 billion during H1-FY13.

²⁰ Fixed investment loans recorded a net retirement of Rs 4.3 billion during Q3-FY14, while the textile sector borrowed Rs 6.8 billion (in net terms) in previous 4 quarters (Q3-FY13 to Q2-FY14) for the BMR.

The *fertilizer* sector continued to retire its fixed investment loans utilized for capacity expansion a few years back (**Table 3.5**). However, quarterly data indicates that there was some improvement in working capital loans during Q3-FY14, especially in the month of March (**Figure 3.6**). This was largely due to the pickup in domestic production and a decline in fertilizer off-take during Q3. Furthermore, import payments for phosphoric acid (main raw material in DAP production) led to a nominal increase in trade financing during Jul-Mar FY14.



Energy Sector, which accounted for 9.3 percent of outstanding loans to the private sector as of end Mar 2014, availed fixed investment loans worth Rs 19.2 billion during Jul-Mar FY14, in sharp contrast to the net retirement seen during the same period last year. These loans were primarily used to set up small projects and rehabilitation of existing power plants.²¹ The modest increase in working capital availed by energy sector, can be traced to liquidity problems facing power companies.

Manufacture of appliances: Credit to appliance manufacturers witnessed a notable improvement during Jul-Mar FY14. A leading manufacturer of electronic products heavily borrowed to shore up its production facilities in the wake of reviving consumer demand, and for product diversification.²²

²¹ Imports of power generating machinery reached \$507.4 million during Jul-Mar FY14, compared to \$385.9 million same period last year.

²² The results of SBP-IBA Consumer Confidence Survey indicate improving consumer and business confidence. The latest survey (May 2014) also suggests that an increasing number of consumers are planning to purchase consumer durables in next six months, and they expect financial conditions to improve in coming months.

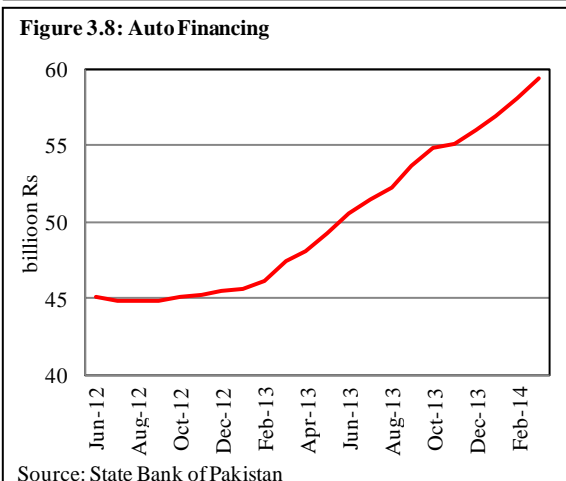
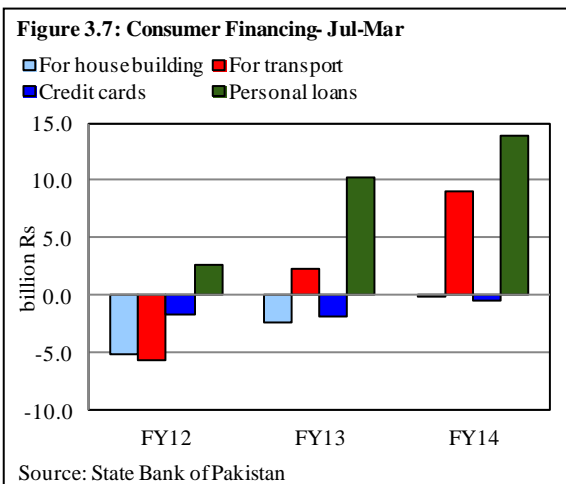
Finally, *consumer financing* that recorded a modest increase in September 2012 after a prolonged period of net retirement, continued to gain momentum during Jul-Mar FY14. The recovery is primarily driven by personal loans and auto financing, while other categories of consumer financing are yet to show much of an improvement (**Figure 3.7**). Bank-wise data indicate that the growth in

personal loans can be traced to one public sector commercial bank, which accounted for 89.1 percent of the increase during Jul-Mar FY14. In contrast to personal loans, the increase in auto financing is driven by one private sector bank, which aggressively followed its segmented marketing strategy (**Figure 3.8**).²³

3.4 Inflation

Average inflation during the period Jul-Mar FY14 was 8.6 percent, compared with 8.0 percent during the same period last year. However, quarterly data shows that inflationary pressures declined in Q3 after rising in Q2 (**Figure 3.9**). Interestingly, the same factors, which pushed Q2 inflation upward, contributed to bringing it down in Q3, i.e.:

- (a) Wheat and perishable food inflation declined significantly after December 2013 (as discussed later);



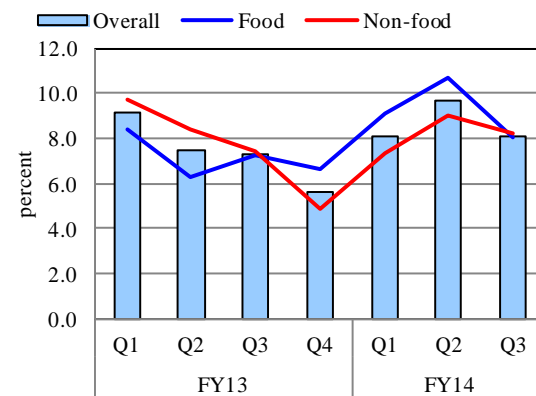
²³ Bank-wise loans for auto financing indicate that 25.6 percent of increase in auto financing during Jul-Mar FY14 came from one commercial bank.

- (b) Global petroleum prices that were rising since June 2013, stabilized after October 2013.²⁴ Some of this price benefit was transferred to consumers by reducing retail POL prices in November, 2013. There was another major reduction in March 2013.
- (c) Exchange rate, which was depreciating during the first half of FY14, appreciated sharply in Q3.²⁵ The PKR appreciation, along with stability in POL prices has dampened inflationary expectations.

In addition to wheat and POL prices, inflation in some other items that are regulated by the government also moderated during the third quarter. YoY inflation in an index of these items (Administered Price Index) declined significantly in Q3.²⁶ As shown in **Figure 3.10**, the overall CPI inflation

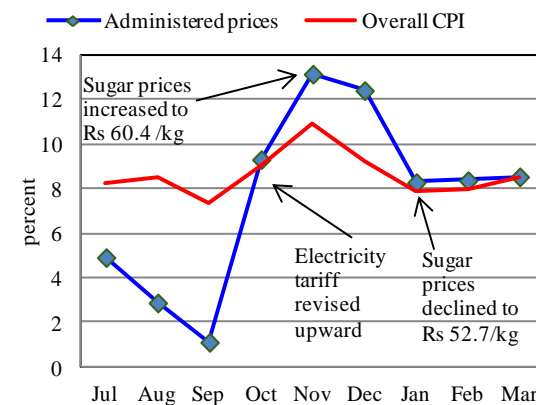
has been following the changes in Administered Price Index during the year. In fact, headline inflation was driven largely by supply side factors and administrative prices during this period.

Figure 3.9: YoY Inflation in FY14



Source: Pakistan Bureau of Statistics

Figure 3.10: YoY Change in Administred Prices



Source: Pakistan Bureau of Statistics

²⁴ IMF Crude Oil Index (average of Brent, West Texas, and Dubai Fateh) increased from 187.68 in June 2013 to 204.58 in September, 2013 and then declined to 192.56 in January 2014.

²⁵ Exchange rate depreciated from Rs 99.66 per US\$ on end June 2013 to Rs 105.32 on end December 2013, and then appreciated to Rs 98.53 on end March 2014.

²⁶ Administered price index includes wheat, sugar, electricity, gas charge, kerosene oil, petrol super, high speed diesel, CNG, Gas cylinder (LPG), car tax (800 cc – 1300 cc), train fares, platform tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.

Having said this, monetary policy that has been tight since September 2013, also contributed to reining-in inflationary pressures. Core inflation (measured both by NFNE and Trimmed mean) came down during Q3 (see **Table 3.7** at the end of this section for a snapshot of inflation).

Major contributors to inflation

It is interesting to note that price inflation in the heaviest 10 items in the CPI basket, which explain more than 60 percent of the overall CPI inflation during Q3, either remained stable or declined during the quarter (**Table 3.6**). House rent index (HRI), which typically has the highest contribution due to its large weight in the CPI basket, showed stable inflation during this period.²⁷ Similar is the case with fresh milk, which has the second highest weight, i.e., 6.68 percent in the CPI basket.

Table 3.6: Top 10 Contributors to Inflation

		% Contribution *	YoY Inflation		
			Q1	Q2	Q3
1	House Rent	17.4	8.2	7.9	8.0
2	Wheat & its products	10.9	24.5	26.0	16.8
3	Electricity	9.6	0.0	15.8	15.8
4	Milk Fresh	6.7	7.4	6.7	6.5
5	Fresh Vegetable	3.4	17.6	16.5	18.1
6	Education	3.4	8.0	8.6	7.9
7	Cigarette	3	14.7	15.1	16.2
8	Chicken	2.7	12.6	10.5	16.4
9	Cotton Cloth	2.6	15.0	13.9	13.3
10	Potatoes	2.5	13.0	70.2	51.2
Overall Inflation			8.1	9.7	8.1

*: These items are selected according to their contribution to Q3 inflation.

Source: Pakistan Bureau of Statistics

Within this group of top 10 contributors, two notable items which have shown considerably lower inflation in Q3 compared to the previous quarter, are wheat and potato.

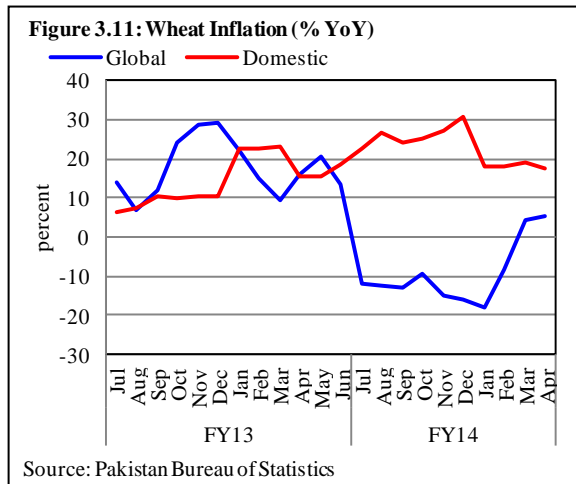
Wheat prices have been rising since June 2013, mainly due to short supply in the domestic market as a result of below target production in the last season. However, the pace of increase eased in Q3, as supply improved with higher wheat releases by the government and the private sector.²⁸ Moreover, the high base effect also kept YoY wheat price inflation lower in Q3, than the previous quarter.²⁹

²⁷ HRI weight in the CPI basket is 21.81 percent.

²⁸ Anecdotal evidence suggests that the private sector had built its stock by local purchases at the time of harvest, and imports during Aug-Dec, 2013. After December, it increased wheat supply to the market, in an anticipation of forthcoming bumper crop.

²⁹ Wheat prices increased by more than 20 percent in January 2013.

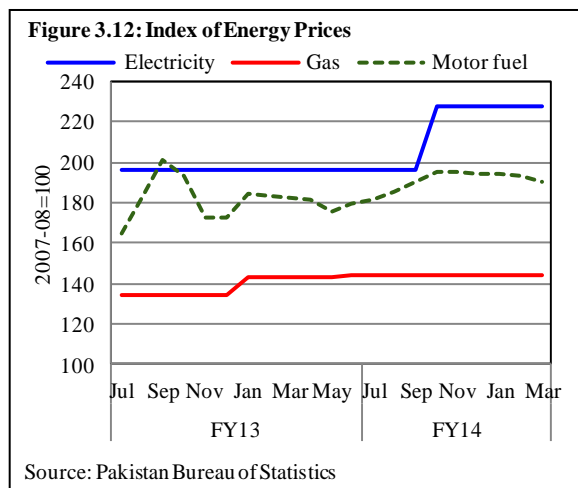
Global wheat prices, on the other hand, rebounded in February 2014 after a declining trend since July 2013 (**Figure 3.11**). Adverse weather condition in the U.S. and South America, and concerns about possible wheat supply disruption due to Ukraine-Russia stand-off, contributed to the recent increase in global prices. However, with an expected 8.5 percent growth in global wheat production in 2013-14, the recent pressure on global prices is likely to recede.³⁰ Similarly, in Pakistan, wheat prices are expected to remain stable with above target production during this year.



Within perishable items, potato prices have fluctuated throughout the period (Jul-Mar). While, the average price came down from Rs 48.4 per kg in Q2 to less than Rs 28.4 in February 2014, it again increased sharply in March 2014 with a MoM change of 39.2 percent. The fluctuations in potato prices were mainly due to issues with the crop, which was affected by inadequate weather. In addition to low production, retail potato prices also saw pressure due to the increase in exports to the Middle East, Russia and other central Asian states.³¹

Energy prices

Energy prices impact inflation directly, as well as indirectly through second round impact. During the quarter, energy prices



³⁰ Global Economic Prospects (April 2014): Commodity Markets Outlook.

³¹ Pakistan's potato export was US\$ 20.9 million during July-March FY14 compared with US\$ 14.2 million during the same period last year.

remained stable, as discussed below:

- Electricity price has remained unchanged since October 2013, when it was increased by 15 to 24 percent for different user slabs (**Figure 3.12**);
- Gas prices for households were increased in January 2013 by around 6 percent, with a slight upward adjustment in June 2013. Since then, there is no change;
- A major upward adjustment in CNG prices (by 21.2 percent) was made in January 2013. With this high base, YoY inflation in Q3 was significantly lower compared with previous quarters; and
- Motor fuel prices (which have an important role in shaping inflationary expectations) were gradually increased during the first half of the fiscal year, but as shown in **Figure 3.12**, the downward adjustment during Q3 (tracking the trend in international prices), has dampened the inflationary outlook.³²

Inflation outlook

While we foresee no broad based pressure on consumer prices in the coming months, individual items and one off factors may keep headline inflation at its current level. For example, CPI inflation increased sharply in April 2014 due to just two items: one from perishable food group (potato), which showed MoM inflation of 42.1 percent in the month; and the second is education (mainly fees for private English medium schools), which increased by 9.7 percent. On the flip side, we expect some softening in wheat prices as the new crop enters the market, and some pass through emanating from stable exchange rate. Moreover, SBP-IBA Consumer Confidence Survey (for May 2014) also indicates lower inflationary expectations for months ahead. In effect, SBP projects average inflation to remain in the range of 8 to 9 percent during FY14.

³² For example, price of petrol was increased gradually from Rs 100.63 per liter in June 2013 to Rs 113.26 in October. It was reduced to Rs 112.76 in November 2013 and then to Rs 110.03 in March 2014. Similar adjustments were also made in the prices of high speed diesel.

Table 3.7: Inflationary Trends

	CPI General	Food			Non-Food		Core Inflation		Administered price index *	
		Wheat & its products	Perishable	Food Overall	Energy	HRI	Non- food Overall	NFNE		Trimmed
YoY inflation										
Jun-FY13	5.9	19.8	15.1	7.9	-10.6	7.1	4.4	7.8	6.8	-8.7
Jul-FY14	8.3	23.2	20.9	9.2	4.3	8.2	7.6	8.2	7.8	4.9
Aug-FY14	8.5	26.9	18.0	10.3	1.2	8.2	7.3	8.5	7.9	2.9
Sep-FY14	7.4	23.5	6.6	7.9	-1.1	8.2	7.0	8.7	7.6	1.1
Oct-FY14	9.1	24.3	18.5	9.8	9.5	7.9	8.6	8.4	9.0	9.3
Nov-FY14	10.9	26.4	43.1	13.0	13.7	7.9	9.4	8.5	9.2	13.2
Dec-FY14	9.2	27.2	14.4	9.3	13.6	7.9	9.1	8.2	8.7	12.4
Jan-FY14	7.9	15.8	8.6	7.2	10.2	8.0	8.4	8.1	8.2	8.3
Feb-FY14	7.9	16.6	8.0	7.5	10.2	8.0	8.2	7.8	8.1	8.4
Mar-FY14	8.5	18.1	11.8	9.2	9.9	8.0	8.0	7.6	8.1	8.5
MoM Inflation										
Jan-2014	0.5	0.0	-4.4	0.0	0.0	2.1	0.9	1.0	0.6	-0.4
Feb-2014	-0.3	0.6	-6.6	-1.0	-0.1	0.0	0.2	0.2	0.2	-0.2
Mar-2014	1.0	1.0	10.8	2.1	-0.5	0.0	0.2	0.3	0.3	0.0
Average inflation										
FY12	11.0	2.7	6.6	11.0	13.0	6.7	11.0	10.6	11.5	8.6
FY13	7.4	13.6	1.8	7.1	-2.1	6.7	7.5	9.6	9.0	-3.6
Q1-FY14	8.1	24.5	15.0	9.1	1.4	8.2	7.3	8.5	7.8	2.9
Q2-FY14	9.7	26.0	25.4	10.7	12.2	7.9	9.0	8.4	9.0	11.6
Q3-FY14	8.1	16.8	9.5	8.0	10.1	8.0	8.2	7.8	8.2	8.4
Jul-Mar FY13	8.0	12.3	-1.0	7.3	0.9	6.6	8.5	10.1	9.5	-1.8
Jul-Mar FY14	8.6	22.2	16.8	9.3	7.9	8.0	8.2	8.2	8.4	7.6

* API is a weighted index, compiled by Research Department of SBP on the basis of prices data of PBS. It includes wheat, sugar, electricity, gas, kerosene oil, petrol, HSD, CNG, gas cylinder (LPG), car tax (800 cc – 1300 cc), train fares, platform tickets, postal envelope (domestic and Saudi Arabia), telephone charges (local and inter-city), TV license fee, government college and university fee.

4 Fiscal Policy and Public Debt

4.1 Fiscal operations

The budget deficit was 3.2 percent of GDP during Jul-Mar FY14, according to the fiscal operations data. This was significantly lower than the level observed in the same period last year (**Figure 4.1**), and the ceiling agreed with IMF.¹ This reduced gap includes US\$ 1.5 billion grant received from a friendly country in Q3-FY14; its rupee counterpart increased the overall deposits of government which decreased the government budgetary borrowing from SBP.² Had this grant not been received, the fiscal deficit for Jul-Mar FY14 would have been 3.8 percent of GDP, which is still lower than the level observed in the same period last year, and the average for the past five years.

Besides the grant, this improvement can be traced to a slowdown in current expenditures and an increase in

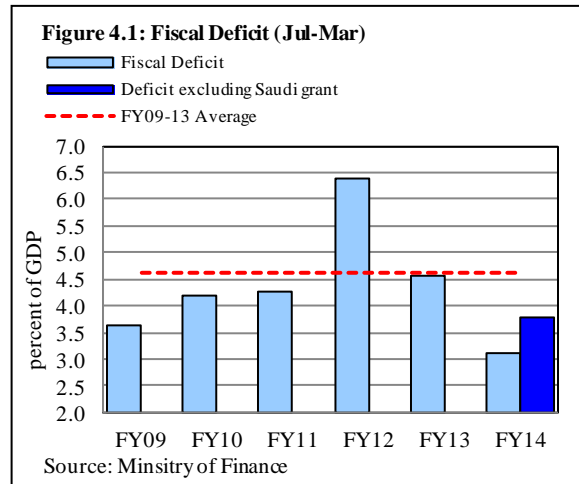


Table 4.1: Summary of Fiscal Operations during Jul-Mar
billion Rupees, growth in percent

	FY13	FY14	YoY Growth	
			FY13	FY14
A. Revenue	2,124.9	2,477.4	22.2	16.6
Tax revenue	1,527.8	1,786.2	11.4	16.9
o/w FBR revenues	1,335.2	1,574.8	4.9	17.9
Non-tax	597.0	691.2	62.3	15.8
B. Expenditure	3,171.1	3,289.0	20.4	3.7
Current	2,642.0	2,904.6	22.7	9.9
Development	444.7	469.9	5.6	5.7
Net lending	1.1	85.9	NA	NA
Statistical discrepancy	83.3	-171.3	59.4	NA
Overall deficit (A-B)	-1,046.2	-811.7	16.9	-22.4
Balance as % of GDP				
Fiscal	-4.7	-3.2	2.5	-31.6
Revenue	-2.3	-1.7	9.4	-27.2
Primary	-1.2	0.4	-11.1	NA

Source: Ministry of Finance

¹ The budget deficit, in absolute terms, was Rs 811.7 billion during Jul-Mar FY14, compared to the IMF ceiling of Rs 1,209 billion (excluding grants) for this period. Even after adjusting for the capital grant, the deficit remains lower than this ceiling.

² Rupee counterpart was deposited in "Pakistan Development Fund (PDF)" – a special account with SBP. Fiscal operations data shows this as "statistical discrepancy" with a negative sign in the expenditure side. However, the recently released Budget documents for FY15, reflects this under non-tax revenue as well as under other development expenditures.

tax revenues (**Table 4.1**). The improvement in current spending is broad based, as almost all heads of spending showed lower growth. On the other hand, growth in overall tax revenues was also higher in Jul-Mar FY14 than that in the same period last year. However, this does not provide room for complacency, as the resurfacing of energy sector payables and the government's continued support to PSEs, may lead to a surge in current spending at the end of FY14. On the revenues side, while tax collection by FBR showed an increase of 17.9 percent in Jul-Mar FY14, the annual FBR target has been revised downward by Rs 200 billion, given the difficulty in achieving the initial target announced by the tax authority.

Within the overall fiscal position, the consolidated provincial surplus posted a marked increase during this period. This largely came from cuts in development expenditure, while growth in tax receipts remained sluggish during Jul-Mar FY14, compared to the same period last year (**Section 4.4**).

To address the deep seated structural issues facing the economy, a number of reform initiatives have been announced by the government so far: the National Power Policy announced in June 2013 aims at resolving energy sector issues;³ and the restructuring plans for Pakistan Steel, PIA, Pakistan Railways (PR) and other PSEs are in the pipeline. Similarly, to improve FBR revenues, tax authorities are in the process of formulating a plan to eliminate tax exemptions over a period of three years. Importantly, FBR has identified that these tax exemptions cause Rs. 500 billion loss of tax revenues annually.⁴

In our view, while the government has set its priorities in the right direction, implementation is what matters to achieve a sustainable improvement in the fiscal accounts. This requires strong commitment and some difficult decisions.

Financing mix of the deficit

The financing of the budget deficit during Jul-Mar FY14, came almost equally from the bank and the non-bank sources (**Table 4.2**). Although, external financing remained negative during the first three quarters of the year, this has changed significantly in the fourth quarter.

³ In June, 2013, the GoP announced a National Power Policy, 2013 (NPP 2013). This policy proposed to eliminate load shedding; decrease cost of generation; reduce transmission and distribution losses from 25 percent to 16 percent; and improve collection of bills to 95 percent, by FY17.

⁴ [http://www.fbr.gov.pk/PressRelease.aspx?view=Press Release&ActionID= &ArticleID=](http://www.fbr.gov.pk/PressRelease.aspx?view=Press+Release&ActionID=&ArticleID=)

Public debt increased by Rs 277.9 billion in the third quarter, with the significant additions to the domestic debt stock. On a positive note, with the active interest of banks in long-term PIBs, the maturity profile of domestic debt is likely to improve significantly in Q4-FY14 and

FY15. Moreover, the share of external financing has increased significantly after the receipt of the US\$ 2 billion from Eurobonds and US\$ 1.4 billion from International Financial Institutions (IFIs) during Q4-FY14 (**Section 4.5**).⁵

Table 4.2: Financing of the Budget Deficit during Jul-Mar
billion Rupees

	FY13	FY14
Total financing	1,046.2	811.7
External	-4.1	-50.1
Domestic	1,050.3	861.7
Bank	856.7	436.9
Non Bank	193.7	424.8

Source: Ministry of Finance

Although, the shift towards external financing will help reduce the roll-over and interest rate risks from over reliance on short-term domestic financing, this will lead to an increase in external debt servicing. Given Pakistan's history of external deficits, its external debt repayment capacity has been a source of some concern. It is not surprising that the mobilization of US\$ 2 billion through the Eurobonds has raised concerns about the buildup of external debt. Although, Pakistan's market debt has increased from US\$ 1.6 billion to US\$ 3.6 billion in recent month, the debt vulnerability is far less than many emerging market countries and members of the OECD. However, looking at overall debt (domestic and external), the country has already surpassed the limit set in the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005), which required public debt to be less than 60 percent of GDP by end-June 2013 and falling subsequently. Since, this has not happened, only a structural improvement in the country's fiscal indicators can put the country's debt burden on a sustainable path.

4.2 Revenues

Tax collection by FBR posted a 17.9 percent increase in Jul-Mar FY14, compared to 4.9 percent growth witnessed in the same period last year. Despite this improvement, given the below target tax collection in the previous two quarters, the fiscal authorities revised downward the annual tax collection target to Rs 2,275 billion in Q3-FY14 (**Table 4.3**).⁶ FBR receipts will now have to grow by 16.5 percent in Q4-FY14 on YoY basis, to achieve the revised target.⁷ Furthermore,

⁵Pakistan has also signed US\$ 11 billion Country Partnership Strategy with the World Bank for the period FY15-19.

⁶ FBR tax receipts missed the half-yearly target by Rs 80 billion, during H1-FY14.

⁷ FBR has to collect Rs 700.2 billion in Q4-FY14, compared with the actual collection of Rs 600.9 billion in Q4-FY13.

the inflows from the auction of 3G/4G licenses in April 2014, although fell short of target, should bolster overall revenues in Q4-FY14.

Table 4.3: FBR Tax Collection during Jul-Mar (Provisional)

billion Rupees

	Actual		% Growth		FY14 Target		% achievement	
	FY13	FY14	FY13	FY14	Jul-Mar ¹	Total	Of Jul-Mar target	Of full year target
A. Indirect taxes	844.0	975.9	5.1	15.6	1,001.3	1,434.7	97.5	68.0
Sales Tax	594.7	716.8	4.3	20.5	673.1	959.2	106.5	74.7
FED	78.8	89.9	-7.0	14.0	129.9	191.2	69.2	47.0
Customs	170.5	169.3	15.0	-0.7	198.2	284.3	85.4	59.5
B. Direct taxes	491.3	598.8	4.6	21.9	600.9	910.3	99.7	65.8
Total (A+B)	1,335.2	1,574.8	4.9	17.9	1,602.2	2,345.0	98.3	67.2

¹SBP's internal estimates, based on FBR's performance in the past five years.

Source: Ministry of Finance

Around 51.0 percent of the increase in total collection was contributed by sales tax in Jul-Mar FY14, which was mainly due to the increase in tax rates. According to our estimates, 34.5 percent of the total increase in sales tax receipts was driven by one-percentage point increase in GST rate that was announced in the FY14 Budget. While collection from direct taxes also remained strong, custom duties posted a 0.7 percent fall during Jul-Mar FY14, compared to 15.0 percent increase in the same period last year. This shift in tax incidence away from imports is required as part of trade reforms, but its impact on the fiscal side cannot be ignored.

A more detailed look shows that around one-third of total custom duties are collected from imports of vehicles, petroleum products and edible oil. Growth in the import value of these items has been subdued during the year: the import of automobiles (completely built units) is declining as the age limit of re-conditioned cars was reduced from five to three years in December 2012; the import

Table 4.4: Non-tax Revenues during Jul-Mar

billion Rupees; growth in percent

	FY13	FY14	Growth	
			FY13	FY14
Non-tax Revenue	597.0	691.2	62.3	15.8
Interest	7.9	62.3	9.3	na
Dividend	40.6	46.3	22.6	14.3
SBP profits	150.0	205.0	-2.6	36.7
Defense (incl. CSF)	178.5	77.8	na	-56.4
Royalties on Gas and Oil	51.1	59.5	12.8	16.5
Development surcharge on Gas	12.7	34.6	-13.3	na
Gas Infrastructure Development cess	30.0	20.9	na	-30.2
Universal Support Fund	0	67.7	0	na
Others	126.3	117.1	18.8	-7.2
Non-tax revenues excluding defense	418.5	613.4	16.1	46.6

Source: Ministry of Finance

value of petroleum products was lower in Q3-FY14 compared to the previous two quarters (due to stable international prices); and palm oil import fell in Jul-Mar FY14, mainly due to a rise in international prices.

Non-tax revenues

Non-tax revenues posted a healthy increase in Jul-Mar FY14. While CSF inflows remained weak, non-tax receipts were shored up by other factors during Jul-Mar FY14 (Table 4.4).⁸ For instance, SBP profits witnessed a sharp increase due to the transfer of arrears from the previous year; the one-off markup from PSEs as part of circular debt adjustment along with transfer in Universal Service Fund (USF) and Research & Development Fund (RDF);⁹ and the collection of Gas Infrastructure Development Cess (GIDC) resumed in January 1, 2014.¹⁰

4.3 Expenditures

Growth in fiscal spending eased in Jul-Mar FY14, compared to the same period last year, mainly because of a reduction in current spending growth (Table 4.5). The growth in development expenditures, on the other hand, was the same as last year, despite the increase in federal development expenditures. Net lending of the federal government also increased sharply, mainly to settle the circular debt during FY14.

The current expenditures posted a growth of 9.9 percent during this period, compared with 22.7 percent last year same period. However, this improvement is not based on fundamentals, as

Table 4.5: Fiscal Spending during Jul-Mar
billion Rupees; growth in percent

	FY13	FY14	YoY Growth	
			FY13	FY14
Current expenditures	2,642.0	2,904.6	22.7	9.9
Interest payment	772.2	909.1	23.6	17.7
Domestic	724.7	855.0	25.3	18.0
Foreign	47.5	54.1	3.3	13.9
Other general public services ¹	323.0	254.2	na	-21.3
Defense	405.8	451.7	16.6	11.3
Grants (other than provinces)	140.4	188.9	10.8	34.5
Pensions	120.0	133.0	21.6	10.8
Others	178.7	198.6	21.4	11.1
Provinces	754.9	821.4	11.8	8.8
Development	444.7	469.9	5.6	5.7
PSDP	407.4	393.0	8.5	-3.5
Federal	187.5	193.3	-6.5	3.1
Provincial	219.9	199.7	25.7	-9.2
Other development	37.3	77.0	-18.0	106.4
Net lending	1.1	85.9	na	na
Total Expenditure²	3,087.8	3,460.4	19.6	12.1

Source: Ministry of Finance

¹This head mostly includes subsidies; ² Total is not adjusted for statistical discrepancy, and will not match with the expenditures in Table 4.1

⁸ Pakistan received US\$ 675 million CSF inflows during Jul-Mar FY14, compared to US\$ 1.8 billion in the same period last year.

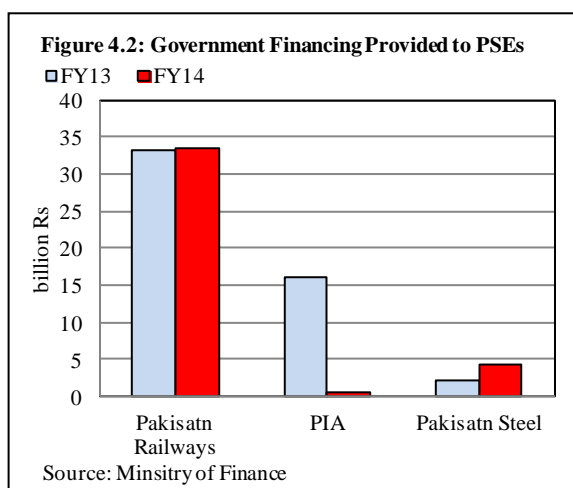
⁹ In Q1-FY14, federal government made Rs 138 billion non-cash adjustment of circular debt in the power sector. This receipt is a part of that adjustment.

¹⁰ For details see, SBP 1st Quarterly Report for FY14.

discussed below:

- i) Subsidies eased significantly in Jul-Mar FY14, compared to the same period last year. However, this decline was accompanied by a rapid accumulation of payables in the power sector, which will have to be settled going forward;¹¹
- ii) The servicing of domestic debt posted a YoY slowdown in Jul-Mar FY14, but this cannot hide the sharp increase in interest payments on domestic debt in Q3-FY14, which is likely to continue in Q4-FY14;¹²
- iii) Grants given by the federal government to different institutions (other than provinces) posted a sharp increase in Jul-Mar FY14, compared to the same period last year.

In terms of the last point, despite a slight improvement in Pakistan Railways' financials, the government had to increase its financial support to this entity compared to the same period last year (**Figure 4.2**).¹³ In the case of PIA, the government earmarked a substantial amount of money in Jun 2013, which is being released in the current fiscal year.¹⁴ In addition, expenses linked to the on-going war against



¹¹ In response to a question in the National Assembly on March 7, 2014, the Minister of Water and Power informed the National Assembly that payables of the power sector stood at Rs 246.2 billion as of end-December 2013. However, the Council of Common Interest (CCI) has agreed in May 2014, to deduct the outstanding power sector payables of the provinces at source from FY15. However, the mechanism for settlement of old dues is still to be finalized.

¹² The main thrust came from payments on government borrowing from SBP and 3m T-bills. In Q1-FY14, sensing a hike in policy rate, banks mostly shied away from investing in government paper, which caused government to meet its deficit financing requirements from SBP, the payment of which fell due in Q3-FY14. However, in Q2-FY14, with the revival in banks' interest in the government paper, the government mobilized Rs 2.3 trillion, through 3m T-bills, with payments also due in Q3-FY14. Furthermore, around one-third of the total increase in domestic debt during FY13, was seen in the fourth quarter, through 12m T-bills, with payments due in Q4-FY14.

¹³ The losses of Pakistan Railways stood at Rs 13.8 billion during H1-FY14, compared to Rs 15.0 billion in the same period last year.

¹⁴ Rs 16.0 billion were placed in a separate account to provide financial support to PIA on Jun 29th 2013. This amount was charged in the fiscal operations for FY13. Out of this amount, Rs 14.65 billion have been released to PIA for different payments in Jul-Mar FY14.

terrorism, captured a greater share in grants. Given the current security situation that is linked to the withdrawal of NATO troops from Afghanistan these expenses have also undergone a substantial increase, which is likely to continue into FY15.

Coming back to PSEs, it is important to mention that PIA and Pakistan Steel are included in the list of entities up for strategic private sector participation. The fiscal authorities are in the process of appointing financial advisers for these entities, who will be responsible for preparing comprehensive restructuring and privatization plans for these entities. Furthermore, the government is in the process of reviving the board of Pakistan Railways to oversee the restructuring activities. There is, however, a need to speed up these efforts to minimize the fiscal drain caused by these loss making enterprises. In addition, the government has also identified eleven companies for divestment through capital market transactions. Out of these entities, government's shares in United Bank Limited were divested in June 2014. Furthermore, the divestment process of Pakistan Petroleum Limited has also been approved.

Table 4.6: Provincial Fiscal Operations during Jul-Mar
billion Rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
A. Total revenue	506.1	549.6	326.2	358.1	181.3	212.3	111.8	128.0	1125.3	1248.0
Share in federal revenue	416.6	460.9	236.4	280.4	146.0	168.8	94.2	107.6	893.2	1017.8
Taxes	56.1	69.0	49.8	56.1	2.9	9.0	0.8	2.0	109.6	136.2
Non-taxes	22.0	15.5	16.9	3.9	6.4	11.5	3.7	3.8	49.0	34.7
Federal loans & transfers	11.4	4.1	23.1	17.7	26.0	23.0	13.1	14.6	73.7	59.4
B. Total expenditure	473.8	486.6	272.1	299.5	149.5	158.7	90.9	86.3	986.3	1031.1
Current	374.2	397.8	212.9	228.8	110.1	130.0	69.1	74.8	766.3	831.4
Development	99.6	88.8	59.2	70.7	39.4	28.7	21.8	11.5	219.9	199.7
Overall balance (A-B)	32.3	63.0	54.1	58.6	31.8	53.6	20.9	41.7	139.1	216.9

Source: Ministry of Finance

4.4 Provincial fiscal operations

The consolidated provincial fiscal accounts, show a marked improvement in Jul-Mar FY14, with a 56.0 percent YoY increase in the budget surplus (**Table 4.6**). This performance reflects the agreement in the Council of Common Interest (CCI) whereby the provincial governments agreed to post surpluses in FY14, to support the federal government's fiscal consolidation efforts.^{15,16} In overall terms, this

¹⁵ http://www.finance.gov.pk/mefp/MEFP_201314_201516_1stReview.pdf

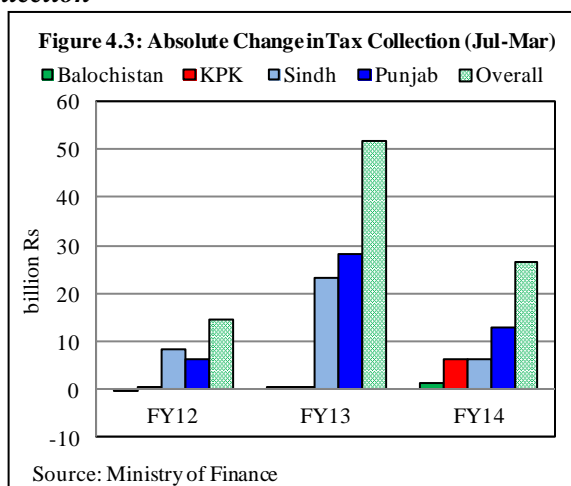
¹⁶ The Council of Common Interest consists of the Chief Ministers of the provinces and an equal number of ministers of the federal government. The 18th amendment strengthened its role as a mechanism for resolving conflicts.

improvement was mainly due to decline in development expenditures. In fact, Sindh was the only province that posted an increase in development spending, while low growth in current spending was contributed by the Punjab.

Low growth in provincial tax collection

After rising substantially in the previous year, the pace of tax collection weakened in Jul-Mar FY14. In terms of individual provinces, tax receipts by Sindh and the Punjab posted a sharp slowdown during this period. However, collections by KPK almost doubled in Jul-Mar FY14, following the establishment of KPK Revenue Authority in August 2013. In our view, the growth in provincial tax revenues is

likely to settle down, after witnessing an initial spurt following the devolution of sales tax collection (**Figure 4.3**).¹⁷ Having said this, we believe the improvement in tax administration and widening the tax base, can lead to a significant increase in provincial tax receipts. In this context, a look at the details of taxable services in Sindh and the Punjab, provides some important insights:^{18,19}



- The rate of GST on services is 16 percent, compared to 17 percent in the rest of the country;
- The base of sales tax on services is wider in Sindh (150 services) compared to the Punjab (105 services);
- The scope of telecommunication services is much broader in Sindh, with 65 services in the tax net, compared to 29 in the Punjab;
- Services provided by the financial sector, hotels, restaurants, advertising agencies, professional and consultants, and couriers, are almost fully covered in both these provinces;

¹⁷ The growth in cumulative provincial tax revenues fell from 90.1 percent in Jul-Mar FY13 to 24.3 percent in Jul-Mar FY14.

¹⁸ Tax collection by Sindh and Punjab had 91.9 percent share in overall provincial tax collection in Jul-Mar FY14. The detailed data for KPK and Balochistan is not available.

¹⁹ Source: Second Schedule of the Sindh Sales Tax on services Act, 2011; First & Second Schedule of the Punjab Sales Tax Act on services Act 2012.

- The tax net can be enhanced by expanding the coverage to untaxed (or under-taxed) services.²⁰

This analysis suggests there is a significant scope for widening the tax base on services for GST collection at the provincial level. In this regard, it should be noted that under the 7th NFC award, 57.5 percent of total tax revenue are to be transferred to the provinces. Although this has been complemented by the devolution of spending responsibilities, the substantial increase in the provincial share of federal revenues, in the absence of binding fiscal targets for provincial revenue generation, may discourage them to increase their own revenue generation efforts. This anomaly should be taken into account, while finalizing the new NFC award with the provinces.

Priorities in development spending: As anticipated, provincial development spending had to bear the brunt of the fiscal consolidation efforts, falling by 9.2 percent in Jul-Mar FY14, compared to the same period last year. Such development spending had grown substantially in the last two years, after the complete transfer of additional spending responsibilities was implemented in FY12.²¹ However, there is an urgent need to enhance provincial capacity if the provinces are to make a contribution to national economic growth by channeling fiscal resources to priority areas, like education and health.

An international comparison suggests that the spending on education and health is lower in Pakistan compared to regional countries.²² In this regard, the analysis of provincial development spending in Pakistan provides some insights (**Figure 4.4**):²³

In terms of average provincial expenditure in Pakistan, social and community spending is the biggest claimant on development funds, followed by transport and

²⁰ For example, travel services, specialized workshops (partially covered in Sindh), cable TV operators, rent a car (taxed in Punjab), designers, auctioneers, prize bond dealers, commission agents, art painters, fumigation services, property and automobile dealers, internet cafes, coaching & training centers, corporate law and tax consultants, building maintenance and service providers, etc.

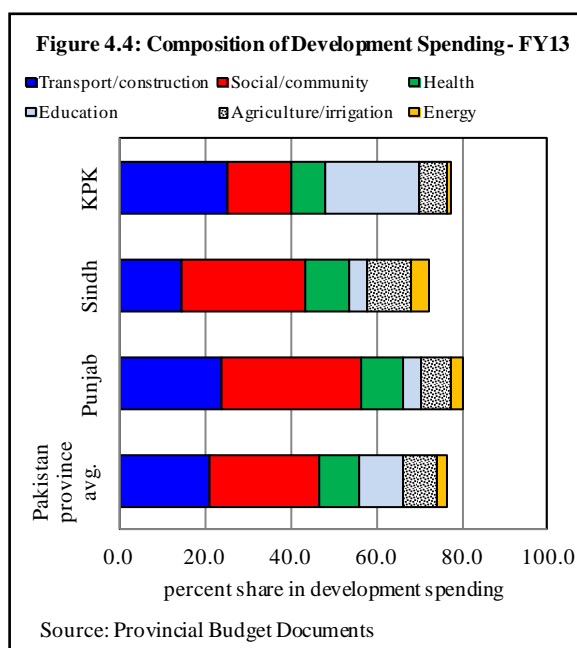
²¹ Under the 18th amendment, the functions of 17 ministries were transferred to provinces in FY11 and FY12.

²² According to the World Bank database, the spending on education and health (as a percent of GDP) stood at 5.2 percent in Pakistan in 2012, compared to 7.2 percent in India, 9.8 percent in Malaysia, and 5.8 percent in Indonesia.

²³ Source: Provincial Budget Documents for FY14. This analysis is based on the revised estimates of development spending in FY13, for Sindh, Punjab and KPK.

construction.²⁴ Furthermore, education, agriculture and health seem to get equal importance at the provincial level.

Provinces in Pakistan allocate a significant amount of resources to transport and construction. In fact, one-fourth of the entire development budget in Punjab and KPK is allocated to this head. However, there is some difference when it comes to spending on education – this critical social service captures a large share of development spending in KPK, while it accounts for a small share in Punjab and Sindh (**Figure 4.4**). Furthermore, spending on agriculture & irrigation is low in Punjab and KPK, while health captures about the same share of the development budget across all provinces.



The sharp contrast in the provincial allocations for education is surprising. This could be traced to the fact that education was recently transferred to the provinces as a result of the fiscal devolution process that started in FY11. Hence, the provincial capacity to identify development needs in this area will take some time to develop.

Similarly, the importance given to transport and construction at the provincial level is also intriguing. While the differences in sub-national development priorities can be attributed to individual provincial needs, a review of literature on the determinants of public spending provides another perspective. According to this literature, the composition of government spending is often shaped by the degree of inefficiencies and wastages of financial resources in a country. The types of government expenditure that creates opportunities for bribe taking and other types of rent seeking behavior are often prioritized when governance is poor.

²⁴ Social and community spending includes the areas of rural and urban development, housing, rural works program, etc.

As a result, investments in huge projects (buildings, highways, airports, etc.) attract more public funds compared to social sector [Reference: Mauro (1998), Delavallade (2006)].²⁵

4.5 Public debt

With an addition of Rs 1.3 trillion during Jul-Mar FY14, Pakistan's public debt reached Rs 15.9 trillion as of end-Mar 2014 (**Table 4.7**). A large part of this increase was seen in Q1-FY14. However, government debt resumed its upward trajectory in Q3-FY14, after falling slightly in the second quarter of FY14. The recent increase was entirely because of domestic debt.^{26,27}

Table 4.7: Public Debt

(billion Rupees)	Stocks		Absolute Change				
			Jul-Mar		FY14		
	13-Jun	14-Mar	FY13	FY14	Q1	Q2	Q3
Public debt	14,574.7	15,882.1	937.5	1,307.4	1,052.7	-23.1	277.9
Public domestic debt	9,520.9	10,820.0	1,162.3	1,299.0	634.0	72.7	592.3
Public external debt	5,053.7	5,062.2	-224.8	8.4	418.7	-95.8	-314.4
Government external debt	4,311.1	4,373.4	-60.3	62.3	361.1	-34.3	-264.4
Debt from the IMF	434.8	356.6	-172.4	-78.2	6.5	-61.9	-22.7
External liabilities	307.8	332.1	7.9	24.3	51.1	0.4	-27.3

Source: State Bank of Pakistan

Composition of domestic debt

With the fall in inflation in December 2013, banks changed their interest rate outlook; and sharply increased their participation in PIBs during Q3-FY14. Out of the entire amount mobilized via PIBs in the third quarter (Rs 977.5 billion), around one-half was raised through 3 year paper, with an effective maturity of slightly more than two years.²⁸ The significance of the change in sentiments can

²⁵ Mauro Paolo (1998), Corruption and the Composition of Public Expenditure; *Journal of Public Economic*; 69, 263-279. Paolo presented a significant negative relationship between corruption and spending on education. Delavallade Clara (2006), Corruption and Distribution of Public Spending in Developing Countries; *Journal of Economics and Finance*; 30:2. Clara provided empirical evidence using a dataset of 64 countries from 1996-2001 to prove that corruption plays an important role in distributing government spending between various sectors. Specifically, it favors spending on defense, fuel, public services, law and order at the cost of spending on social sector.

²⁶ In US Dollar terms, however, the public external debt & liabilities stock recorded a US\$ 0.6 billion increase during Jul-Mar FY14, over the end-Jun 2013 level. The reduction in the Rupee value of debt was caused by a sharp appreciation of the PKR.

²⁷ After taking into account Rs 309.9 billion government deposits with SBP as on end-March 2014, the net increase in domestic debt during Jul-Mar reduces to Rs 989 billion.

²⁸ This amount was raised through re-opening of 3-year PIB, which was originally issued in July 2013. The re-opening of a bond refers to the practice of offering the same maturity bond in the consecutive auctions for a year or more. This is a normal practice in a number of countries to develop benchmark issues.

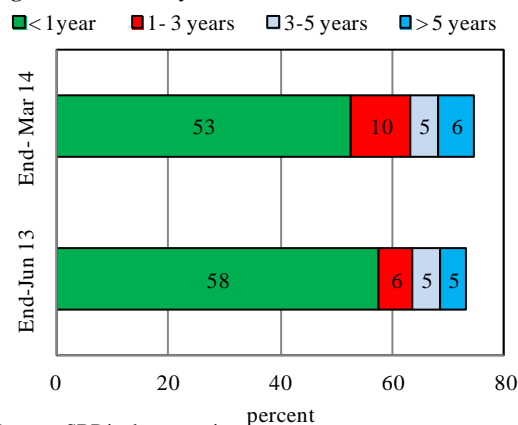
be gauged by comparing Q3 with what happened in the first two quarters of FY14 (as discussed in **Chapter 3**).

This change in banks' behavior led to an improvement in the tenor-wise composition of domestic debt (**Figure 4.5**). The share of medium term debt with maturity between 1 – 3 years, increased to 10.4 percent in end-Mar 2014 compared to 5.8 percent as of end-Jun 2013; correspondingly, short term-debt fell from 57.6 percent on end-Jun 2013, to 52.6 percent as of end-Mar 2014. These movements are significant, when one looks at the growing volume of outstanding domestic debt.

Short-term debt declines in Q3

As mentioned above, Pakistan's short-term debt declined in Q3-FY14 by Rs 437.3 billion after rising sharply in the first two quarters (**Table 4.8**).²⁹ Both the stock of debt owed to SBP (MRTBs), and commercial banks (T-bills) fell in this period.

Figure 4.5: Maturity Profile of Domestic Debt



Source: SBP in-house estimates

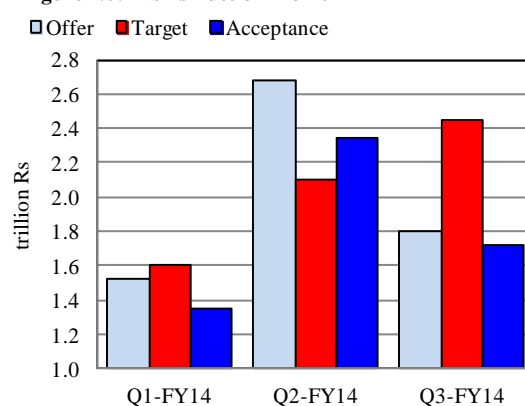
Table 4.8: Government Domestic Debt (Change in Jul-Mar)
billion Rupees

	Jul-Mar		FY14		
	FY13	FY14	Q1	Q2	Q3
Total domestic debt	1,162.3	1,299.0	634	72.7	592.3
Permanent debt	260.6	948.4	-3.0	-1.5	952.9
Floating debt	633.1	237.4	611.1	63.6	-437.3
T-bill auction*	564.6	-263.6	-138.6	264.9	-389.9
SBP	68.5	501	749.7	-201.3	-47.4
Unfunded debt	265.6	113.3	25.6	10.7	77
FC loans	3.1	-0.1	0.3	0	-0.3

*: Including outright sale of MTBs by SBP

Source: State Bank of Pakistan

Figure 4.6: T-bills Auction Profile

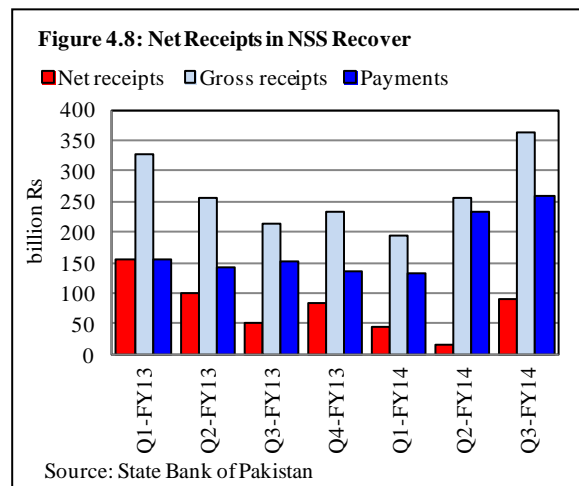
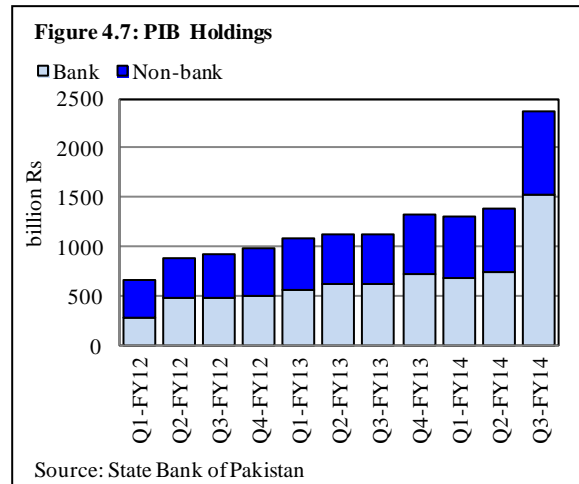


Source: State Bank of Pakistan

²⁹ The numbers reported in Table 4.8, refer to change in stock of debt. In actual terms, government retired Rs 384.3 billion to SBP in Q3-FY14, compared to Rs 443.1 billion borrowing during H1-FY14.

T-bills also lost their attractiveness following the change in market perception about interest rates in Q3-FY14: as shown in **Figure 4.6**, there was a sharp reversal in the behavior of banks in Q3 compared to Q2. Offered amounts were much lower, despite the increase in targets. During Q3, the net-of-maturity acceptance of T-bills stood at negative Rs 730.6 billion compared to Rs 98.2 billion in Q2. On the other hand, banks' PIB holdings more than doubled from Rs 744.3 billion in Q2 to Rs 1.5 trillion in Q3 (**Figure 4.7**).

Furthermore, the US\$ 1.5 billion grant in Q3-FY14 alleviated the financing pressures on the central bank. This, along with the substantial mobilization through PIBs, was instrumental in the large retirement to the central bank during Q3-FY14.



NSS revived in Q3

Net receipts in National Savings Scheme (NSS) posted a 50.9 percent decline in Jul-Mar FY14, compared to the same period last year. This does not capture the recovery in Q3-FY14, following the upward adjustment in profit rates in October 2013 and January 2014 (**Figure 4.8**). Nevertheless, the rise in return on NSS that allowed for a healthy increase in gross mobilization, was more than offset by large volumes of encashment. Higher encashment were likely the result of the income support levy, announced in the budget FY14, which discouraged individuals from

keeping their savings in NSS, and the withdrawal of the minimum threshold of withholding tax on profits in some saving schemes.^{30,31}

Public external debt

The stock of Pakistan's public external debt and liabilities posted a US\$ 0.6 billion increase in Jul-Mar FY14, compared to a US\$ 4.5 billion decline in the same period last year (**Table 4.9**). Although principal repayments increased by 25.3 percent during this period, the debt stock still increased on the back of US\$ 1.7 billion inflows from the Fund under the EFF, and increase in loan disbursement from IFIs during Jul-Mar FY14.³² Furthermore, the country also incurred US\$ 173 million revaluation losses in this period because of the depreciation of the US Dollar against major currencies. Going forward, the external debt & liabilities stock is expected to record a significant increase on account of the Eurobonds and program loan disbursements from the IFIs.

Table 4.9: Public External Debt & Liabilities
billion US\$

	Stock		Flows				
	13-	14-Mar	Jul-Mar		FY14		
			FY13	FY14	Q1	Q2	Q3
Public external debt	51	51.5	-4.5	0.6	0.6	-0.7	0.7
Govt. debt	43.5	44.5	-2.4	1	0.6	-0.2	0.6
IMF	4.4	3.6	-2	-0.8	-0.2	-0.6	0
Monetary authority liabilities	3.1	3.4	0	0.3	0.3	0	0

Source: State Bank of Pakistan

Disbursements

Inflows from external creditors posted a 12.8 percent increase during Jul-Mar FY14, compared to the same period last year (**Table 4.10**). This increase came from the financing agreements prior to the start of this fiscal year.³³ Having said this, fresh commitments by international donors also witnessed a sizeable increase

³⁰ S.R.O No. 904(I)/2013. The government has imposed 0.5 percent income support levy in the budget FY14 on movable assets. However, the recovery of this levy was stopped due to legal issues.

³¹ The exemption from withholding tax, which was available on maximum investment of Rs 150,000, on Defense Savings Certificates, Special Savings Certificates, Savings Accounts or Post Office Savings Accounts or Term Finance Certificates (TFCs), was withdrawn in the FY14 budget.

³² The principal repayments to IMF stood at US\$ 2.5 billion in Jul-Mar FY14 compared to US\$ 2.0 billion in the same period last year.

³³ Out of the entire disbursements during Jul-Mar FY14, the inflows from fresh commitments made in this fiscal year stood at US\$ 237 million during this period.

during H1-FY14, compared to the same period last year.³⁴ Already, the country has received US\$ 3.4 billion inflows from Eurobonds and other IFIs under the new arrangements during April and May 2014 (**Table 4.11**). Particularly, IDA has disbursed two loans worth US\$ 1 billion in May 2014, while ADB has disbursed US\$ 400 million in April 2014, as discussed in the following:³⁵

- The *Power Sector Development Credit* from IDA, aims at developing an efficient and consumer-oriented power system in the country. It seeks to reduce subsidies and rationalize tariffs; improve performance of the sector and ensure greater accountability and transparency;
- The economic reforms loan (*Fiscally Sustainable and Inclusive Growth*) obtained from IDA aims to support the government's reforms for improving economic growth, ensuring fiscal consolidation and increasing investment;
- *Sustainable Energy Sector Reform Credit* from ADB

Table 4.10: External Loans Inflows (Jul-Mar)

US\$ million				
	FY13		FY14	
	BE	Actual	BE	Actual
A. Bilateral	963.4	761.9	1,816.9	464.9
<i>of which</i>				
China	451.7	413.1	1,365.5	303.9
Japan	422.4	210.8	284.5	78.4
S. Arabia	20.3	31.5	12.8	52.8
B. Multilateral	1,810.7	912.5	2,779.3	1,102.1
<i>of which</i>				
ADB	450.9	277.1	991.7	325.0
IBRD	33.8	40.2	126.8	84.8
IDA	695.5	271.7	951.6	237.9
IDB	592.5	315.2	680.6	408.8
IFAD	22.0	2.1	19.2	6.3
OPEC	16.1	6.3	9.4	17.6
C. Commercial banks		--		322.5
Total ²(A+B+C)	3,274.2	1,674.5	5,096.2	1,889.5

BE = Budget estimates for the entire fiscal year.

Note: The totals budget estimates also include US\$ 500 million of Eurobonds.

Source: : EAD Status Reports

Table 4.11: New Arrangements in Apr-May FY14

US\$ million				
Source	Amount	Maturity	Terms	
A. Bonds				
Eurobond	1,000	5 years	Market	
Eurobond	1,000	10 years	Market	
B. IDA				
Power sector development policy credit	600	25 years	Soft	
Fiscally sustainable inclusive growth	400	25 years	Soft	
C. ADB				
Sustainable energy sector reform project	400	25 years	Soft	
Total (A+B+C)	3,400			

Source: Economic Affairs Division

³⁴ During H1-FY14 new commitments worth US\$ 2,081.7 million were made by the external creditors, compared to US\$ 864.9 million commitments made in the same period last year.

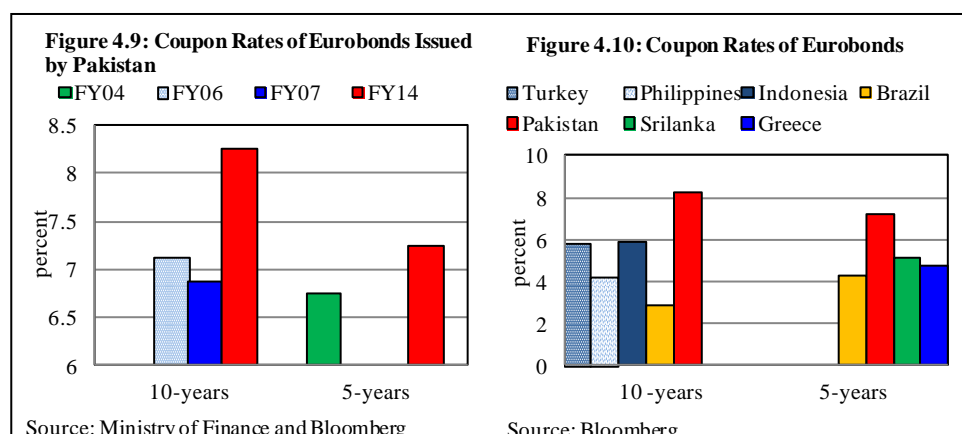
³⁵ Pakistan has also signed US\$ 11 billion Country Partnership Strategy with the World Bank for the period FY15-19. This strategy aims to achieve the twin goals of poverty reduction and shared prosperity. The four strategic reform areas are: energy, economy, extremism, and education.

aims to support the National Power Policy 2013.³⁶

Issuance of Eurobonds

After a gap of seven years, Pakistan entered the international capital market in April 2014, raising US\$ 2 billion through two issues of US\$ 1 billion each, with 5 and 10 years maturity, respectively. In fact, Pakistan received bids amounting to US\$ 7 billion from international investors, against an initial target of US\$ 0.5 billion. This strong response of the international market can be traced to the availability of funding and the high return that was offered by the government.

The higher rates compared to similar bonds issued by a number of other countries in 2014³⁷ can be attributed to the lower credit ratings assigned to Pakistan (Figures 4.9 & 4.10).



This is because of the country's external and fiscal outlook, and security risks due to the war in Afghanistan.³⁸ The interest payments on these two issues will add US\$ 155 million annually to Pakistan's external debt servicing from FY15. It may be noted that increased access to external borrowing creates more room for private sector credit expansion.

³⁶ Another US\$ 438 million loan from ADB is in the pipeline for social protection development project. This program aims to support the Benazir Income Support Program, by increasing the coverage of cash transfers. This loan is likely to be disbursed in FY15.

³⁷ Turkey, Indonesia, and Philippines issued 10 year Eurobonds in January 2014, whereas Brazil issued the same tenor bond in April 2014. Similarly, Brazil and Sri Lanka issued 5 year Eurobonds in April 2014.

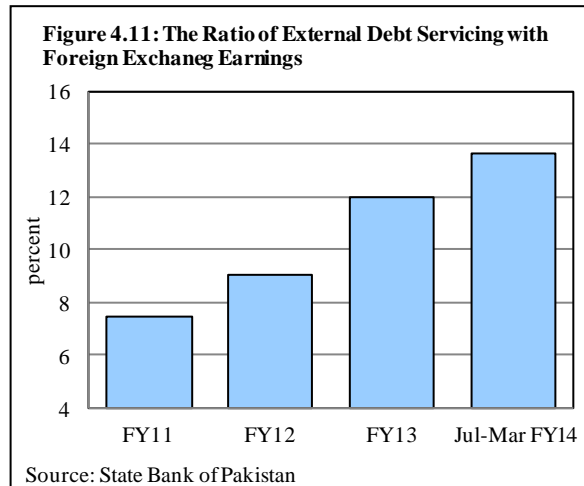
³⁸ Pakistan was assigned Caa1 rating by Moody's, compared to Vietnam's B2 and Baa3 of Philippines and Indonesia.

External debt sustainability

External debt sustainability is gauged by a country's ability to repay external liabilities without recourse to debt rescheduling.³⁹

Furthermore, the IMF has identified that most of the debt correction episodes in emerging economies with high inflation and previous history of defaults has occurred when the external debt-to-GDP ratio was higher than 35 percent.⁴⁰ Pakistan's external debt as a percentage of GDP, declined from 29.1 percent in FY12 to 25.3 percent in FY13. This

declining trend is likely to reverse in FY14, with the external inflows from the IFIs and the Eurobond issue. Furthermore, the servicing capacity of Pakistan has been deteriorating in the past few years (**Figure 4.11**). This pressure may increase as repayments of the re-scheduled Paris Club debt come online following the end of the grace period that was agreed upon in late 2001.⁴¹ With this background, unless the country's FX earnings (exports and remittances) improve significantly, the government should be conservative in raising funds from the international capital market.



³⁹ Akyüz Yilmaz (2007), Debt Sustainability in Emerging Markets: A Critical Appraisal; *DESA Working Paper*; 61, UNCTAD.

⁴⁰ IMF (2003), "Sustainability Assessments—Review of Application and Methodological Refinements", June 2003; <http://www.imf.org/external/np/pdr/sustain/2003/061003.htm>.

⁴¹ The repayments for rescheduled Paris Club debt under Official Development Assistance (US\$ 8.8 billion) will start from FY17.

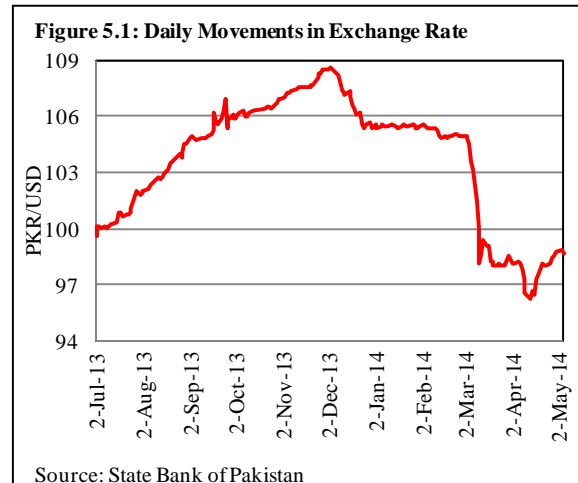
5 External Sector

5.1 Overview

Pakistan's external account witnessed a sharp improvement in Q3-FY14: the country's FX reserves increased by US\$ 1.8 billion, and the PKR appreciated by 6.9 percent to touch 98.53 per US\$ by end-March 2014 – close to the level seen during June 2013 (**Figure 5.1**). While some improvement in the external sector was expected (e.g., proceeds under 3G/4G auction; divestiture of public shares; and assistance from

IFIs), the significant improvement in the external outlook during the quarter came as a surprise. More specifically, the PKR parity appreciated sharply following the receipt of US\$ 1.5 billion grant from a friendly country; moreover, market expectation of additional bilateral inflows triggered a degree of panic selling in the FX market.¹ Although less decisive, several other factors also helped ease FX pressure during the quarter: a reduction in the current account deficit (**Table 5.1**); commercial loans mobilized by the government; ban on import of gold; and the roll-over of maturing FX loans for oil import (**Section 5.5**).

Market sentiments improved further in April 2014, when Pakistan re-entered the global capital market after 7 years. The government was able to mobilize US\$ 2 billion via the issuance of Eurobonds of 5 and 10 years maturity.² The exchange rate touched PKR 96.21 per US\$ on 14th April 2014, when this news was made public (**Figure 5.1**).³ Two weeks later, the government conducted its much



¹ It is important to note that since this was an *official* bilateral inflow, it came into SBP's FX reserves and did not impact the interbank market. The reason it impacted the exchange rate was mainly market speculation of additional inflows, and not SBP intervention. In fact, SBP made FX purchases in March 2014 from the interbank to build reserves and to stop the PKR appreciating further (**Section 5.5**).

² Against the target of US\$ 0.5 billion, the government received bids of US\$ 7 billion.

³ Between 8th April (announcement date) to 15th April (issuance date), the PKR gained 2.0 percent.

anticipated license auction for the 3G/4G spectrum, which further shored up SBP's reserves by US\$ 516 million. These sequence of events (unexpected bilateral inflows, a much larger Eurobond issue and 3G/4G auction), was followed by lumpy inflows from both the World Bank and Asian Development Bank (ADB) (Section 5.4).⁴ Since late 2001, Pakistan has not experienced such a sequence of positive developments in the external sector. It is, therefore, not surprising that sentiments about the economic outlook have improved considerably.

Notwithstanding the needed increase in the country's FX reserves, underlying fundamentals do not show much of an improvement. Foreign direct investment has still to pick up; export growth remains modest; and the trade account continues to show a sizable deficit.⁵ During Jul-Mar FY14, the current account deficit stood at US\$ 2.1 billion, compared to only US\$ 1.3 billion in the same period last year (Table 5.1). Although quarter-wise data shows a YoY decline in the deficit during Q3-FY14, this does not represent any structural improvement in the domestic economy, as it stemmed primarily from a rise in home remittances and receipt of CSF inflows during the quarter (Section 5.2).⁶ As shown in Table 5.2, deficits in

Table 5.1: Major External Sector Indicators
million US\$

	Q3		Jul-Mar	
	FY13	FY14	FY13	FY14
Country's FX reserves (change)	-1,609	1,761	-3,041	-945
SBP's FX reserves (change)	-1,861	1,885	-3,677	-644
Current account balance	-1,172	-350	-1,255	-2,107
Net capital flows*	94	1,561	192	1,726
Net FDI in Pakistan	62	250	631	670
FX loans and liabilities	-252	172	-395	-212

*This includes the capital grant from a friendly country.

Source: State Bank of Pakistan

Table 5.2: Composition of Current Account
million US\$

	Q3		Jul-Mar	
	FY13	FY14	FY13	FY14
Current account balance	-1,172	-350	-1,255	-2,107
I. Trade balance	-3,679	-3,661	-11,585	-12,027
Exports	6,192	6,372	18,346	18,904
Imports	9,871	10,033	29,931	30,931
II. Services balance	-735	-532	-782	-2,019
o/w CSF	0	353	1,806	675
III. Primary income*	-847	-848	-2,559	-2,844
o/w Payments on FDI**	679	683	1,902	2,121
IV. Secondary income***	4,089	4,691	13,671	14,783
o/w Home remittances	3,237	3,793	10,354	11,583

*Includes receipt and payments related to dividend; mark-up; reinvested earnings; profit repatriation, etc.

** Repatriation of profit and dividend income by foreign investors

***Includes all current transfers

Source: State Bank of Pakistan

⁴ Pakistan has also received US\$ 375.0 million CSF in May 2014.

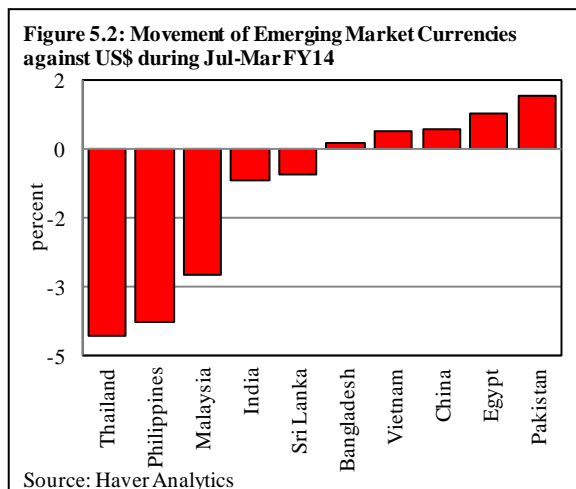
⁵ Trade deficit stood at US\$ 3.7 billion in Q3-FY14, and US\$ 12.0 billion in Jul-Mar FY14.

⁶ Pakistan received US\$ 353 million CSF inflows in February 2014. Home remittances totaled US\$ 3.8 billion during Q3-FY14, showing a growth of 17.2 percent over the same period last year.

trade and primary income account, remained almost unchanged during Q3 from last year same period.

As far as capital and financial inflows are concerned, these were sufficient to finance the current account deficit. In addition to the grant, Pakistan also attracted net FDI of US\$ 250 million and loan receipts of US\$ 172 million during Q3-FY14, which helped to comfortably finance the current account deficit of US\$ 350 million. Moreover, repayments to the IMF during the quarter were less problematic as these were surpassed by fresh disbursements under the EFF program.

Going forward, we expect the full-year current account deficit to settle between US\$ 2 – US\$ 2.5 billion (i.e., around 1 percent of GDP) for FY14. However, some downside risks remain, like a possible slowdown in the Chinese economy, and how the PKR appreciation could impact Pakistan's trade balance going forward. As shown in **Figure 5.2**, the PKR has appreciated the most compared to currencies of other emerging economies. Having said this, a part of this loss of competitiveness could be offset by the availability of cheaper imported inputs, which most Pakistani exporters are dependent upon.



As far as remittances are concerned, we expect a mixed impact of the PKR appreciation. A positive effect may come from overseas Pakistanis who would compensate for the appreciation by sending more foreign exchange into the country (for immediate consumption), whereas a negative effect may come from those who would wait for the PKR to depreciate to realize more (say, for investment).⁷

⁷ According to market analysts, the latter could explain the month-on-month decline in home remittances in April 2014. In our view, however, it is still too early to give a definitive assessment of the impact of the PKR appreciation on remittances.

In our view, while realizing one-off FX inflows (bilateral grants and 3G/4G auction) and raising fresh loans were necessary steps to avert a crisis-like situation in the external sector, the real challenge is to improve the fundamentals to sustain reserves adequacy, and ensure exchange rate stability over the medium-to-long-term. This task seems difficult without addressing structural weaknesses that keep Pakistan's trade deficit at stubbornly high levels. An added challenge is to enhance the country's external debt repayment capacity to avoid payment pressures when newly taken loans fall due.

5.2 Current account

As mentioned before, the current account posted a larger deficit in Jul-Mar FY14, compared to the same period last year (**Table 5.2**). However, the deficit in Q3-FY14 was about one-third the deficit seen in Q3-FY13, with the improvement coming from a rise in home remittances and receipt of CSF money during the quarter.

Home Remittances

With an additional US\$ 3.8 billion in Q3-FY14, the cumulative growth in home remittances nearly doubled from 6.3 percent YoY in Jul-Mar FY13, to 11.9 percent in Jul-Mar FY14. With remittance growth of 3.3 percent (on average) in other developing countries during 2013, and expected growth of 7.8 percent in 2014, Pakistan's performance is impressive.⁸ If remittance continues to grow with the same pace in the final quarter, the annual target of US\$ 15.1 billion set for the year, is likely to be achieved.

The growth in home remittances is primarily due to a rise in Pakistanis working abroad, and tighter compliance of anti-money laundering laws. During Jul-Feb FY14, 406 thousand more Pakistanis proceeded abroad for employment.^{9,10} More than half of these workers chose to go the UAE.

In addition to a rise in economic activity in the Emirate, the UAE remains a preferred destination compared to other countries in the GCC. For example, Oman has put a ban on foreign recruitments in cleaning and construction sectors in October 2013, in addition to carrying out raids on illegal workers. Similarly, Bahrain has also become a less attractive destination for Pakistani workers due to

⁸ Source: Migration and Remittances: Recent Development and Outlook; World Bank; April 2014.

⁹ This data has been taken from the Bureau of Emigration and Overseas Employment (BEOE), Government of Pakistan. The number includes only those migrants, who are registered with the BEOE.

¹⁰ There may be some Pakistanis returning to the country during this period, but their number would be insignificant.

political uncertainty and security concerns in the Kingdom. Kuwait, has been discouraging Pakistani workers by implementing a strict visa policy, while Saudi Arabia continues to implement a policy to indigenize its work force.

Pakistani workers in Saudi Arabia, which used to absorb the largest number of Pakistanis up until last year, declined sharply during Jul-Feb FY14 as per their indigenization policy (**Table 5.3**). Nevertheless, it is surprising that most of the remittance growth during Jul-Mar FY14 came from Saudi Arabia (**Table 5.4**). This can be explained by the regularization and documentation of Pakistanis as per the new labor rules – more specifically, this forced these workers to use banking channels to send money to their families.¹¹ Furthermore, higher remittances may also reflect money sent back by thousands of Pakistanis who have been deported, or are in the process of deportation.¹²

Table 5.3: Number of Pakistanis Proceeded Abroad for Employment during Jul-Feb

	Number		%Share		% growth in FY14
	FY13	FY14	FY13	FY14	
UAE	130,058	211,063	29.9	52.0	62.3
Bahrain	6,534	5,570	1.5	1.4	-14.8
Iraq	97	1,100	0.0	0.3	
Libya	2,851	2,782	0.7	0.7	-2.4
Oman	42,204	28,907	9.7	7.1	-31.5
Qatar	4,407	5,585	1.0	1.4	26.7
Saudi Arabia	243,805	143,616	56.1	35.4	-41.1
UK*	103	121	0.0	0.0	17.5
US*	100	212	0.0	0.1	112.0
Others	4,728	7,196	1.1	1.8	52.2
Total	434,887	406,152	100.0	100.0	-6.6

*Number of workers proceeding to US and UK is grossly understated, because this data only shows migration of those Pakistanis who get registered with the Bureau of Emigration and Overseas Employment (BEOE), and are predominantly recruited through licensed overseas employment promoters (OEPs). The role of OEPs is most critical in case of Middle-East, from where formal demand letters come from foreign employers, with job requirements, and terms & conditions. On the contrary, workers who are recruited directly (on their own) by foreign firms, may choose not to get registered with the BEOE, which is mostly common in case of US and Europe.

Source: Bureau of Emigration and Overseas Employment

Remittance inflow from the UAE also remained strong – especially from Dubai. As mentioned earlier, the UAE remains an attractive destination for Pakistanis lately, both blue and white collar workers. Remittances from the US and UK also increased with the economic recovery in these countries.¹³

¹¹ According to most recent estimates, around 950,000 Pakistanis regularized their status as per the new rules. Furthermore, around 2,000 illegal workers also got registered during the campaign.

¹² According to Pakistan's Embassy in Saudi Arabia, a total of 59,000 Pakistani workers have already left the Kingdom since April 2013.

¹³ Anecdotal evidence suggests a rise in the number of Pakistanis working in these countries as well, but reliable data is unavailable.

In addition to these factors, tight scrutiny of the global hundi network, and aggressive marketing of remittance products by commercial banks helped channelizing remittances via formal avenues. Small sized banks, microfinance institutions and Islamic banks are also entering the remittance business, and global money transfer organizations like Western Union have started participating in direct-to-bank transfers.¹⁴ Furthermore, the government has cleared the backlog of Rs 10.5 billion during Jul-Apr FY14 that was due as a rebate to banks.^{15,16}

Table 5.4: Country wise Home Remittances in Jul-Mar

	Amount in million US\$			YoY growth in percent		Contribution to growth (%age pt)	
	FY12	FY13	FY14	FY13	FY14	FY13	FY14
USA	1,724.4	1,636.7	1,820.9	-5.1	11.3	-0.90	1.78
U.K.	1,131.9	1,435.0	1,632.2	26.8	13.7	3.11	1.90
Saudi Arabia	2,655.4	2,979.3	3,391.3	12.2	13.8	3.33	3.98
UAE	2,140.9	2,085.9	2,288.9	-2.6	9.7	-0.56	1.96
of which Dubai	1,085.8	914.7	1,140.8	-15.8	24.7	-1.76	2.18
Other GCC	1,099.5	1,195.9	1,357.7	8.8	13.5	0.99	1.56
Bahrain	149.7	211.9	230.6	41.6	8.8	0.64	0.18
Kuwait	432.0	459.2	501.7	6.3	9.3	0.28	0.41
Qatar	235.8	238.9	246.1	1.3	3.0	0.03	0.07
Oman	282.0	285.9	379.3	1.4	32.7	0.04	0.90
EU Countries	273.5	269.0	318.9	-1.6	18.5	-0.05	0.48
Other	710.5	752.1	772.8	5.9	2.7	0.43	0.20
Total	9,736.0	10,353.9	11,582.8	6.3	11.9		

Source: State Bank of Pakistan

5.3 Capital account

The capital account showed a surplus of US\$ 1.7 billion in Jul-Mar FY14, compared to only US\$ 0.2 billion surplus in the same period last year. This abnormal development can be traced to the receipt of *capital* grant of US\$ 1.5 billion from a friendly country in two equal tranches during February and March 2014.¹⁷ According to the latest conventions in presenting a country's BoP

¹⁴ Direct-to-bank transfer is a facility as per which, the sender can directly credit money into the designated bank account in Pakistan.

¹⁵ To encourage banks and exchange companies in their remittance mobilization efforts, the government of Pakistan partially reimburses the telegraphic transfer (TT) cost that these institutions bear in transferring money to Pakistan (25 Saudi Riyal for every US\$ 100).

¹⁶ As a result of this, all outstanding claims related to reimbursement of TT charges up till June 2013, have been cleared.

¹⁷ Grants are typically treated as transfer incomes, as no good, service or asset is provided in return from the counterparty. These transfer incomes are recorded in the secondary income account, which is a sub-component of the Current Account. However, the grant that Pakistan received from a

position, infrequent inflows are captured in the capital account, with normal debt and portfolio inflows being posted in the financial account (see below).

5.4 Financial account

Financial account did not show much of an improvement during Jul-Mar FY14: foreign investments continued to remain low, and expected debt inflows did not materialize during the period.

Foreign investment

Net FDI posted a growth of 6.1 percent YoY in Jul-Mar FY14, compared to 5.3 percent in the same period last year. This improvement was more pronounced in the third quarter of FY14, in which there was a net FDI inflow of US\$ 250 million – nearly four times the inflow in Q3-FY13. However, this recovery came primarily from a decline in gross FDI *outflows* (disinvestments) in Q3-FY14, compared to Q3-FY13, as gross FDI *inflows* failed to recover (**Table 5.5**).¹⁸

Table 5.5: Composition of FDI in Pakistan

(million US\$)	Jul-Mar FY13	Jul-Mar FY14	Q3-FY13			Q3-FY14		
	Net FDI	Net FDI	Inflow	Outflow	Net FDI	Inflow	Outflow	Net FDI
Total	631.0	669.8	502.2	440.0	62.3	467.9	218.3	249.6
Food	41.8	73.0	13.0	1.2	11.8	38.9	8.4	30.6
Tobacco	7.8	55.5	10.1	17.4	- 7.4	25.2	15.0	10.2
Chemicals	- 73.4	76.0	33.9	136.1	- 102.3	16.0	5.1	10.9
Oil & Gas	426.1	346.9	134.4	0.5	133.8	140.4	5.4	135.0
Power	39.3	28.7	44.4	22.9	21.5	57.9	32.2	25.7
Communications	- 313.7	- 132.5	59.4	186.5	- 127.0	47.2	69.1	- 21.9
o/w Telecom	- 331.6	- 138.4	51.4	180.9	- 129.6	39.9	59.6	- 19.7
Financial Business	225.7	118.7	103.3	17.3	86.0	59.4	19.8	39.5
Cement	6.1	15.4	2.1	0.1	2.0	7.0	2.0	5.0
Construction	29.4	16.0	5.8	0.7	5.1	8.4	1.9	6.5
Others	241.9	72.0	95.9	57.2	38.6	67.5	59.3	8.1

Source: State Bank of Pakistan

On a cumulative basis, gross FDI inflows declined by 11.2 percent in Jul-Mar FY14, over the same period last year. In fact, the current level of FDI is even smaller than profit repatriation on previous investments in the country.¹⁹ This drying up of fresh inflows can be traced to: inadequate infrastructure; persistent

friendly country has been recorded in the Capital Account; this is because it is a long-term capital grant, which will be used to finance development projects in the country.

¹⁸ Gross FDI outflows in Q3-FY13 were exceptionally large due to heavy debt repayment by Telenor to its parent company, and de-merger and sale of ICI Pakistan with Dutch-based AkzoNobel.

¹⁹ Payments on existing direct investment in Pakistan (in the form of repatriation of profit and dividend) reached US\$ 2.1 billion in Jul-Mar FY14.

energy shortages, and a poor law and order situation. Furthermore, despite extensive policy deliberations, structural issues that impede the ease of doing business, governance and taxation are yet to be addressed.

Despite this, market sentiments regarding the outlook for foreign investment have turned positive after the improvement in the external outlook, and reports that China is planning to invest US\$ 32 billion in the country, under the China-Pakistan Economic Corridor program.²⁰

FX loans and liabilities

Pakistan's FX liabilities posted an increase of US\$ 172 million during Q3-FY14, after recording net declines in the previous four quarters. However, due to heavy debt payments in the first two quarters by the government, the cumulative FX loans and liabilities showed a net decline in Jul-Mar FY14 (**Table 5.6**).

During Q3-FY14, most of the increase in FX loans was by commercial banks' borrowing from abroad to finance part of the country's current account deficit (**Section 5.5**). As for official loans, the government continued to post net retirements during the quarter – especially long-term loans. However, the government was able to mobilize short-term commercial loans of US\$ 248 million from a syndicate of foreign commercial banks.

Table 5.6: Pakistan's FX Liabilities

million US\$	Jul-Mar		Q3	
	FY13	FY14	FY13	FY14
Net flow of FX liabilities	-395	-212	-252	172
Central bank	-5	245	-3	0
Deposit-taking corporations	-339	174	-1	332
General government	157	-395	-172	-43
i. Disbursements	1,905	1,883	499	601
IMF loans	0	0	0	0
Other long-term	1,649	1,265	499	353
Short-term	256	618	0	248
ii. Amortization	1,748	2,278	671	644
IMF loans	226	660	136	240
Other long-term	1,131	1,618	405	404
Short-term	391	0	130	0
iii. Other liabilities (net)	0	0	0	0
Other sector	-208	-236	-76	-117

Source: State Bank of Pakistan

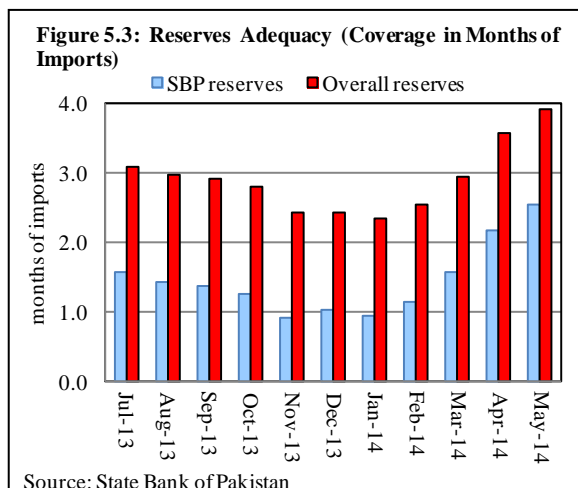
²⁰ The economic corridor is being developed as part of a strategic partnership between the governments of two countries. Announced in July 2013, this corridor will connect Gwadar Port to China's northwestern autonomous region of Xinjiang via highways, railways, and pipelines, to transport oil and gas. Special Economic Zones (SEZ) will be established in areas alongside the corridor that will target specific products and services based on availability of local raw materials and labor force. The BOI, in consultation with provincial governments and National Industrial Parks, is working to identify areas where SEZs can be established. So far 22 sites all over the country have been identified; one SEZ – based in Khairpur district, has been approved.

Going forward, Pakistan is expected to receive support from the IFIs to finance various projects in the country. In particular, the World Bank Group (WBG) has approved the Country Partnership Strategy (CPS) for Pakistan that covers the period FY15-19. This strategy envisages a financing program of about US\$ 11 billion over the CPS period. In addition to this, Pakistan has also received IDA loan of US\$ 1 billion in May 2014. Moreover, the Asian Development Bank (ADB) has also approved the Sustainable Energy Sector Reform Program of US\$ 400 million to initiate the government's long-term restructuring of the power sector to make it more sustainable (**Chapter 4**).

5.5 Reserves and exchange rate

Pressure on the country's FX reserves had started to ease in December 2013, as Pakistan had met lumpy repayments to the IMF, and repayments in remaining part of the year were to be offset by fresh disbursements.^{21,22} During Q3-FY14, the country's FX reserves increased by US\$ 1.8 billion, compared to a decline of US\$ 1.6 billion in Q3-FY13. As mentioned before, this improvement was driven mainly by the receipt of a bilateral grant of US\$ 1.5 billion.

Within the banking system, SBP's reserves increased by US\$ 1.9 billion during the quarter, as the bilateral grant came directly to its reserves. SBP further shored up its FX reserves by purchasing hard currency directly from the interbank market. Because of these efforts, and after the receipt of Eurobond proceeds, the import



²¹ Current account also recorded a surplus of US\$ 157 million in December 2013.

²² After the country met bulky repayments to the IMF in November 2013, the external sector outlook improved considerably. This was evident in a 3.0 percent appreciation of the PKR in December 2013, after a cumulative depreciation of 8.2 percent in Jul-Nov FY14. This improvement, however, was not aligned with market's view on the direction of interest rates: banks continued to bid in 3m papers in the T-bill auctions held during the month. It was only when December inflation numbers came out (early January) – that showed a steep fall of 1.7 percentage points compared to the preceding month, the market expectations turned in favor of a rate cut. These expectations were reinforced by a stable PKR, and a surplus in the December's current account. A more pronounced shift in market expectations was seen in March 2014, when the country received a bilateral grant of US\$ 1.5 billion, and the PKR posted a sharp appreciation (discussed later in detail).

coverage of SBP's reserves rose to 2.5 months at end-May 2014, from only one month at end-December 2013 (**Figure 5.3**). Import coverage, in terms of overall reserves, increased to 3.9 months, from 2.4 months at end-December 2013. Commercial banks' reserves, posted a decline of US\$ 125 million during the quarter, which was mainly due to the use of FE-25 deposits to finance lumpy oil imports.²³

In overall terms, the PKR posted an appreciation of 1.1 percent during Jul-Mar FY14, compared with a 4.0 percent depreciation in the same period last year. However, most of the gain in the PKR parity was recorded in Q3-FY14, when the PKR appreciated by 6.9 percent, which more than offset the depreciation of 5.4 percent in H1-FY14. In fact, most of this appreciation took place between 10th to 12th March 2014 (**Figure 5.4**).²⁴ Pakistan received the grant from a friendly country in two tranches of US\$ 750 million each: first during the 3rd week of February 2014, and the second in the 1st week of March 2014.

When the first tranche was received, the interbank market did not react, even after the impact on the country's FX reserves was made public on 27th February (**Figure 5.4**).²⁵ This was because the source of this inflow was not known, and the market attributed the increase in FX reserves to expected bilateral and multilateral inflows, and higher-than-expected remittances. However, when the second tranche was received (during the week ending 7th March 2014), the market responded almost with a sense of panic, even before the FX reserves data was made public.²⁶ We identify two reasons for this: First was the press statement by the Finance Minister on 10th March, disclosing the level of the country's FX reserves (inclusive of the second tranche), and the claim that FX reserves would reach US\$ 10.0 billion by end-March 2014.²⁷ Second was panic selling by exporters in the interbank – especially after some large exporters offloaded their FX holdings in bulk, in an anticipation that this would be followed up by a deferred oil payment facility from Saudi Arabia, which Pakistan was given in late 1998.

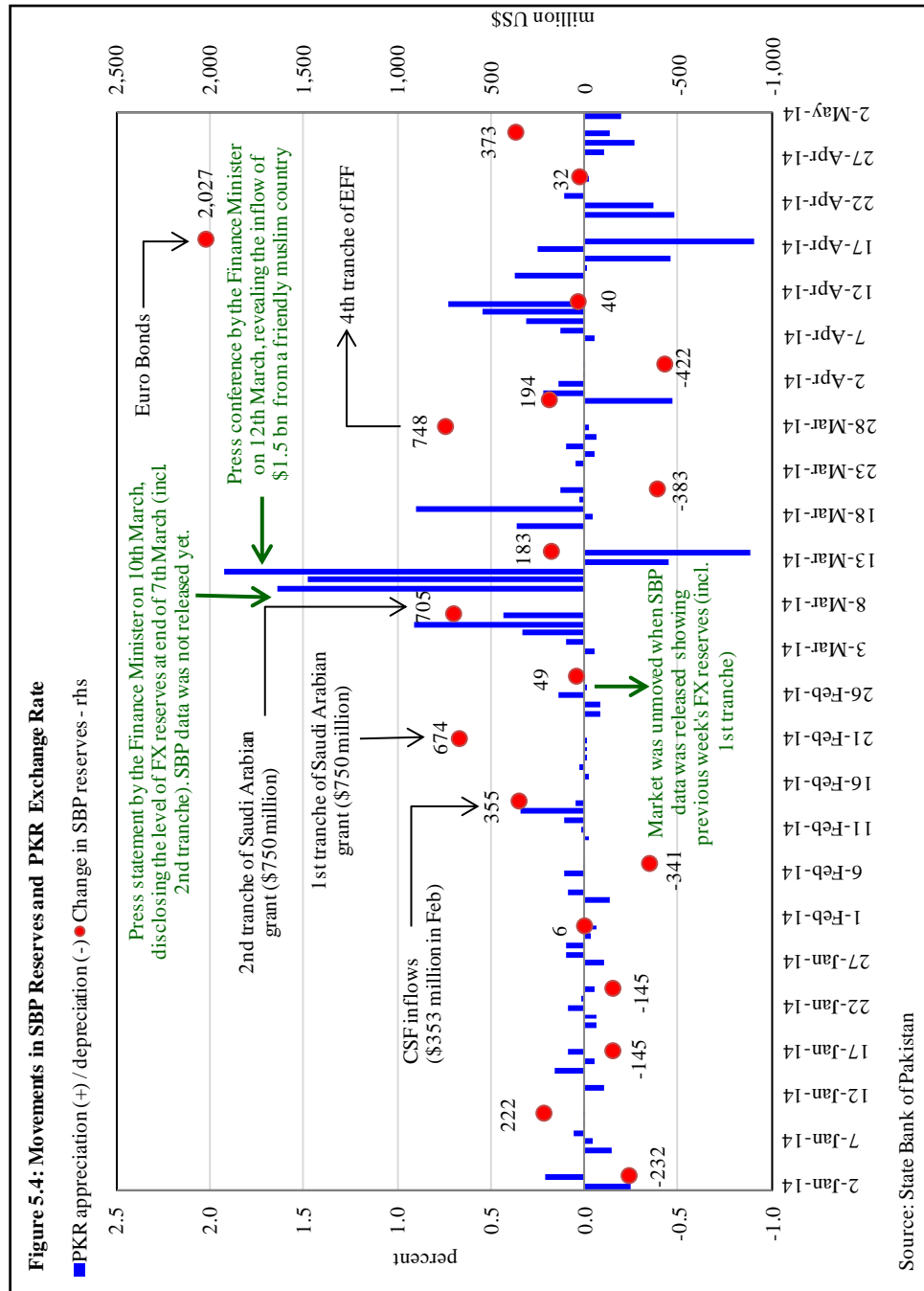
²³ Commercial banks' reserves are calculated as FE-25 deposits minus trade financing.

²⁴ The PKR gained 5.1 percent between 10th to 12th March 2014, followed by a correction of 1.0 percent during 13th to 18th March 2014.

²⁵ SBP releases end-week data on country's FX reserves on every subsequent Thursday.

²⁶ SBP released data on FX reserves (inclusive of the second tranche) on 13th March 2014.

²⁷ Two days later, on 12th March 2014, the Finance Minister specified that the country has received a total of US\$ 1.5 billion from a 'friendly Muslim country'.



In addition to the receipt of the grant and expectations of additional inflows, there were other factors that eased pressures in the interbank exchange rate during the quarter. These included:

Import financing from FE-25 deposits

As mentioned in the *Second Quarterly Report*, importers financed a part of their import bill via FX borrowings from commercial banks during H1-FY14.²⁸ This enabled importers to benefit from a wide interest rate differential between PKR and FX loans, amid an outlook of a stable exchange rate. In addition, financing of imports through FX loans deferred the pressure on the exchange rate till the maturity of these loans, which in most cases was 3 months. Some of the maturing loans were rolled over in Q3-FY14, especially those taken by oil marketing companies and oil refineries.²⁹ These companies were facing liquidity problems because of the re-emergence of circular debt.³⁰

FX borrowings by commercial banks from abroad

Commercial banks arranged short-term FX funding of US\$ 332 million from abroad in Q3-FY14, to finance the current account gap. Of this, banks borrowed US\$ 242 million in the month of March 2014. Commercial banks' FX requirements from abroad were higher as SBP had started spot purchases of hard currency from the interbank market (see footnote 26).

Ban on import of gold

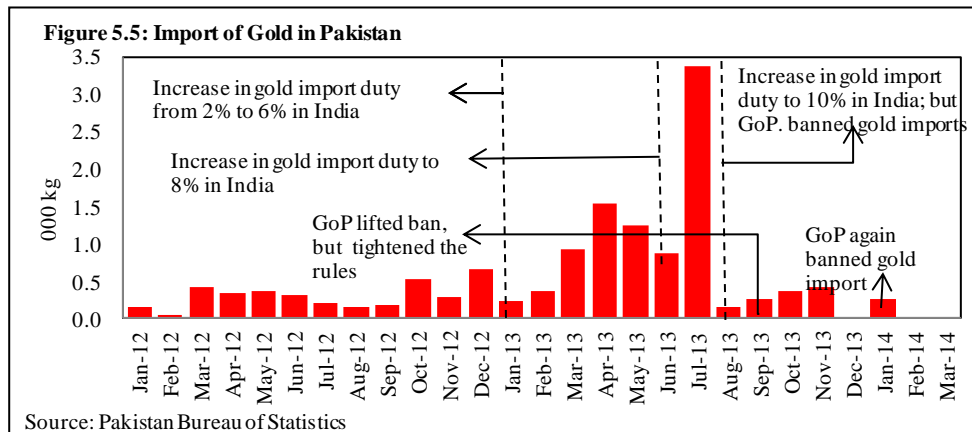
The government of Pakistan banned the import of gold under the duty-free scheme for January 2014; subsequently, it extended this ban to February 2014 as well. This was done to avoid the import of gold for onward smuggling to India, which had put curbs on gold import (**Figure 5.5**).

The above discussion clearly shows that the PKR rally during Q3-FY14 was heavily influenced by one-off inflows; the resulting improvement in market sentiments; and short-term arrangements to alleviate FX pressures. Hence, the appreciation of the PKR was abrupt, characterized by sharp inter-day and intra-day variations during the quarter. A further repercussion of this rally, was the increase in kerb market premium: from 13th March till end-April 2014, the kerb premium averaged around 1.7 PKR per US\$.

²⁸ Banks are allowed FX lending to importers and exporters, against foreign currency deposits (commonly known as FE-25 deposits) placed with them.

²⁹ There was an increase of only US\$ 155 million in the stock of import financing against the FE-25 deposits during Q3-FY14, compared to an increase of US\$ 449 million in the preceding quarter.

³⁰ Interest rate differential between PKR and FX loans rose to 8.1 percent on average in Q3-FY14, from 7.0 percent in the preceding quarter.



The increase in the kerb premium came from both demand and supply-side factors: since the bulk of PKR appreciation took place on 3 working days, there was a lack of confidence over the sustainability of exchange rate. Therefore, there was a rush to purchase cash Dollars from the kerb market, which put pressure on the exchange companies. These companies, on the other hand, started hoarding FX in anticipation of a reversal in the PKR parity; the perception of an FX shortage with exchange companies added to the sense of panic. In fact, the kerb market had become dysfunctional, as it was hard for the public to buy FX Dollars at designated rates.³¹ Both SBP and government advised exchange companies and other market players to avoid unnecessary speculation.³²

Given the fact that Pakistan has met lumpy repayments to the IMF, and also considering the expected FX inflows in Q4-FY14, we believe the current level of the exchange rate is sustainable in the short-to-medium term.³³ SBP's management of the FX market was driven by the twin goals to limit excessive volatility in the exchange rate and to gradually build FX reserves. The current level of SBP's reserves has surpassed the level seen at end-June 2013, therefore, the current PKR parity touching the level at the year start should not appear unusual.

³¹ Anecdotal evidence has it that exchange companies would not sell at designated rates, but could be more obliging if the buyer was willing to offer a higher rate.

³² As a result of these measures, as well as lumpy repayments from IFIs in late April and May 2014, the kerb market returned to calm and the premium dropped to 0.7 PKR per US\$ on average in May 2014.

³³ Pakistan has already received US\$ 400 million from the ADB and US\$ 1 billion from the World Bank in April and May 2014, respectively.

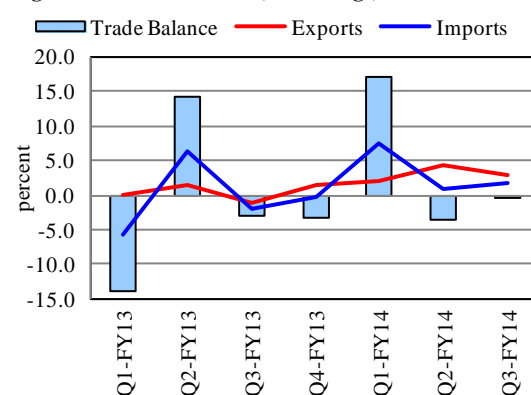
5.6 Foreign trade

Pakistan's trade deficit was US\$12.0 billion during Jul-Mar FY14, showing an increase of 3.8 percent over the corresponding period last year. In fact, much of this deficit was realized during the first quarter of the year, when imports increased sharply (**Figure 5.6**). Key items that led to higher growth in imports, were POL (after the settlement of power sector circular debt), machinery for telecom and power generation; fertilizer and metal. On the other hand, exports also showed some recovery during Jul-Mar, FY14, which can be attributed to: the GSP plus status that helped textile and leather exports; higher exports of petroleum products as oil refineries increased production; and rice exports from an above target crop.³⁴

Exports

Exports grew by 3.0 percent reaching US\$ 18.9 billion during Jul-Mar FY14, compared to US\$ 18.3 billion in the same period last year. As usual, more than half came from the textile sector, which showed a YoY growth of 6.3 percent during this period.³⁵

Figure 5.6: Trade Account (YoY change)



Source: State Bank of Pakistan

Table 5.7: Textiles Exports (Jul-Mar)

	Export value million US\$		Cont. to textiles export growth (%)	
	FY13	FY14	FY13	FY14
Cotton	161.2	191.5	-3.0	0.3
Yarn	1553.1	1612.0	3.1	0.6
Cotton cloth	1944.4	2051.1	0.0	1.1
Other textile materials	526.6	494.6	0.5	-0.3
Synthetic textile	324.4	321.3	-1.8	0.0
Knitwear	1527.7	1634.9	-2.7	1.1
Bed wear	1375.4	1530.1	-0.7	1.6
Towels	518.9	541.3	0.2	0.2
Readymade garments	1241.3	1351.5	1.9	1.1
Other textiles	409.8	462.7	0.4	0.6
Textiles total	9582.8	10191.0	-2.1	6.3

Source: State Bank of Pakistan

³⁴ Rice production recorded 6.8 million MT against a target of 6.2 million MT.

³⁵ The textile export growth was negative and overall exports showed zero growth during the same period last year.

Textile exports

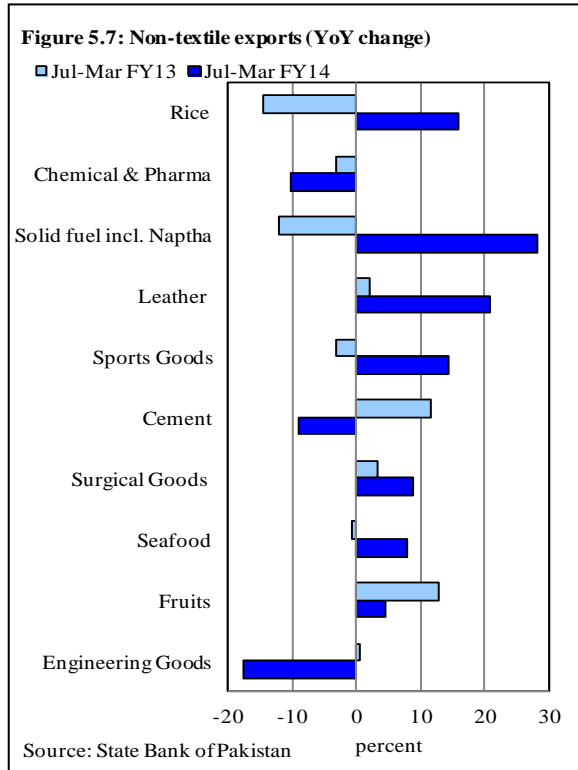
The growth in textile exports can entirely be attributed to higher export quantum, as the price impact remained negligible. During the first nine months of FY14, Pakistan exported higher volume of yarn, cotton fabrics, knitwear, bed-wear and readymade garments. Improvement in energy supply and opportunities from *GSP Plus* enabled the textile sector to increase production and its export business.

Although *GSP plus* is not restricted to textiles, Pakistani textiles are better placed to benefit from this facility, due to its established infrastructure, expertise in global trade, and specialized manpower. Nevertheless,

these benefits can only be realized fully if the sector gets adequate supply of energy and other raw materials – especially cotton. However, there is also a risk to the sector, as safeguard measures introduced by the EU, do not leave much room for our existing export base, which is highly concentrated in terms of commodities.³⁶ Thus, Pakistan needs to focus on diversification of its exports to maximize the benefits from *GSP plus* status in the medium to long-run.

Non-textile exports

In case of non-textiles, while exports of rice, leather, sports goods, seafood, and POL products increased; cement, engineering goods, chemicals and pharmaceutical exports declined during this period (**Figure 5.7**). Key sectors that figured prominently in the trade sector (other than textile) are as follows:



³⁶ EU has put limit on the import volume of a single item, that is: it should not exceed 6 percent of total EU's GSP imports of that commodity. Previously the restriction was placed on overall sector.

- a) Rice – the second largest export after textiles – showed strong growth of 15.9 percent during Jul-Mar FY14, in contrast to a 14.5 percent decline in the same period last year. Both quantum and price contributed to this increase in export proceeds.
- b) Exports of *fish and fish preparation* increased by 8.0 percent, reaching US\$ 254 million during Jul-Mar FY14. The rising trend in seafood exports can be traced to: (1) the resumption of shipments to EU countries; (2) increased exports to the Chinese market; and (3) higher foreign sales of frozen fish and crustaceans like shrimp and lobsters.³⁷
- c) Petroleum products (including naphtha) contributed 25 percent of the total export growth during Jul-Mar FY14.³⁸ While Pakistan's export of naphtha has been increasing continuously since the early 2000s, FY14 has witnessed an unprecedented volume of exports, as oil refineries increased capacity utilization using the more comfortable liquidity position after the settlement of the circular debt during the first quarter of the year.³⁹

The major markets for Pakistani naphtha are China, India, Japan, Korea and the UAE. Going forward, higher global demand for paraxylene, which uses naphtha as an input, may provide an opportunity for Pakistan to increase its share in global trade of this commodity.

- d) Leather, a traditional export for Pakistan, recorded a 17.2 percent YoY growth during Jul-Mar FY14, compared with a 4.2 percent increase in the same period last year. According to the Leather Manufactures Association of Pakistan, the country's share in the world leather exports is only 2 percent, and can be increased further through concerted efforts to resolve long standing issues like the disruption in energy supplies, unskilled labor force and obsolete machinery.
- e) *Cement* exports lost the momentum of last two years and posted a decline of 9.0 percent during Jul-Mar FY14, due to lower quantum and export price. While, cement production also came under pressure due to increased cost of production, exports to Afghanistan also slowed down due to increasing competition from Iran.

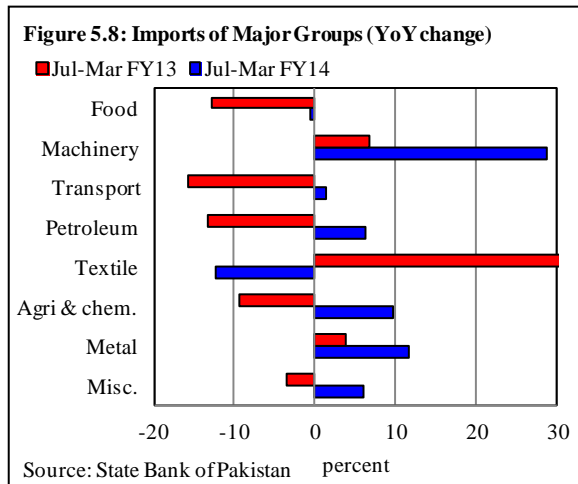
³⁷ In FY13, about one-third of total seafood export earning originated from China and Vietnam.

³⁸ Naphtha, a by-product of oil refining process, is further refined for making high-octane fuels and chemicals used in plastic and man-made fibre industries.

³⁹ LSM data released by Pakistan Bureau of Statistics shows that petroleum production is up by 8.6 percent during Jul-Feb FY14 compared with the same period last year.

Import payments

Total imports increased by 3.4 percent during Jul-Mar FY14, compared with a 0.6 percent decline during the same period last year. As mentioned earlier, this increase in imports was mainly driven by higher demand for machinery, petroleum, fertilizer, and metals (**Figure 5.8**). The rise in the import bill was largely the result of higher quantities, as the price impact was negative.



Machinery imports recorded a YoY growth of 28.7 percent during Jul-Mar FY14, which bodes well for the LSM sector in Pakistan. The highest contribution to machinery imports came from the construction sector followed by telecom, textiles and power generation.

The import of petroleum products increased by 6.3 during this period, which was entirely due to higher quantities, as the unit value declined during Jul-Mar FY14. This increase was largely driven by higher demand for furnace oil, thinner for paints, lubricating oil and motor spirit oil. We believe this can be traced to more frequent shutdown in CNG supply to the transport sector.

Despite higher domestic production of fertilizer,⁴⁰ its imports increased by 20.2 percent during Jul-Mar FY14. This rise is the result of the Government's decision to import 0.5 million tons of urea for *Rabi* 2013-14. The current pace of fertilizer imports is likely to continue with the planned import of 0.35 million tons of urea for the *kharif* season.

⁴⁰ The industry sources said that main fertilizer plants were operating at about 90 per cent capacity during this period.

Acronyms

ADB	Asian Development Bank
BMR	Balancing, Modernization and Replacement
BoP	Balance of Payment
bps	Basis Points
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
DAP	Diammonium Phosphate
DISCO	Distribution Companies
EFF	Extended Fund Facility
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FX/FE	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GSP	Generalized System of Preferences
GST	General Sales Tax
IBA	Institute of Business Administration
IMF	International Monetary Fund
IRC	Interest Rate Corridor
Kg	Kilograms
KPK	Khyber Pukhtunkhwa
LIBOR	London Interbank Offered Rate
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
M2	Broad Money Supply
Mof	Ministry of Finance
MRTBs	Market related Treasury Bills
MT	Metric Tons
NADRA	National Database and Registration Authority

NBFC	Non-Bank Finance Companies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NSS	National Savings Scheme
OECD	Organization for Economic Co-operation and Development
OGDCL	Oil & Gas Development Company Limited
OMOs	Open Market Operations
PASSCO	Pakistan Agricultural Storage & Services Corporation Ltd.
PBS	Pakistan Bureau of Statistics
PDF	Pakistan Development Fund
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
PPL	Pakistan Petroleum Limited
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSO	Pakistan State Oil
rhs	Right Hand Side
Rs	Rupees
SBA	Stand-by Arrangement
SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
UAE	United Arab Emirates
UBL	United Bank Limited
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US/USA	United States of America
WAPDA	Water and Power Development Authority
YoY	Year on Year
3G	3 RD Generation
4G	4 th Generation